MAURICE A. DEANE SCHOOL OF LAW
HOFSTRA LAW

Meltzer Lippe

2016

PRIVATE WEALTH & TAXATION INSTITUTE

Continuing Professional Education Series

DAY 1

THURSDAY

MAY 19, 2016

Program held at
121 Hofstra University –Room 308, Hempstead, NY 11549

Private Wealth & Taxation Institute

Day 1 - May 19, 2016

Timed Agenda

8:00 – 8:30am	**Breakfast and Sign In**
8:30 – 8:45am	**Introduction to Program** *Stephen M. Breitstone*
8:45 – 9:45am	**Estate Planning through an Asset Protection Lens** *Gideon Rothschild*
9:45 – 10:45am	**Current Developments in Estate Planning** *Sharon L. Klein, Mary P. O'Reilly and Sanford J. Schlesinger*
10:45 – 11:00am	**Break**
11:00 – 12:00pm	**Cross Border Tax Planning – Structuring Foreign Investment in U.S. Real Estate** *Professor Alan I. Appel, Stephen M. Breitstone and Phillip S. Pepper*
12:00 – 1:00pm	**Lunch**
1:00 – 2:00pm	**The Delaware Trust Option for New York, New Jersey and Connecticut Residents** *Richard W. Nenno*
2:00 – 3:00pm	**Estate Planning with Grantor Trusts – Storm Clouds on the Horizon** *Stephen M. Breitstone, Robert L. Goldfarb, David C. Jacobson and Barry L. Sunshine*
3:00 – 3:15pm	**Break**
3:15 – 4:15pm	**Using Partnerships to Maximize Basis in Estate Planning** *Professor Jerome M. Hesch and Paul S. Lee*
4:15 – 5:15pm	**Rethinking the Fabric of Estate Planning** *Amy F. Altman and Avi Z. Kestenbaum*

Questions and Answer period will follow each topic

8.0 CLE credits in Professional Practice
8.0 CPE credits in Taxation

Table of Contents

Day 1

Thursday, May 19, 2016

1

Amy F. Altman

"Want more? Demand Better! Hire Us."

Associate
516-747-0300 Ext. 506
aaltman@meltzerlippe.com

Amy F. Altman is an Associate in the Firm's Trusts & Estates Practice Group. Amy focuses on estate and trust administration, estate planning, and probate litigation. She prepares wills, durable powers of attorney, and health care proxies and various types of trusts, including supplemental needs trusts. Amy understands, from personal experience, that the loss of a loved one can be a tumultuous time for any family. Amy is sensitive to the needs of each individual client and provides them with the time and attention they need to ensure that they understand the probate or administration process.

Amy advises executors, trustees and beneficiaries in contested probate and contested administration proceedings. She has been appointed as a guardian ad litem, by various Surrogates in multiple counties. Amy counsels families and individuals, who are in need of estate planning with the understanding that every family dynamic is different. Amy has a personal interest in planning for families with special needs children, as Amy had the privilege of growing up with her older sister Carol, who was born with cerebral palsy. Amy is a contributor to law.com, the New York Law Journal and the New York State Bar Association Trusts and Estates newsletter.

Amy has an interest in writing about cutting edge topics in trusts and estates, including art law—such as the new ban on ivory, New York's law on posthumously conceived children and ideas for new legislation.

Some of Amy's recent publications include:

Art Law Part 2: The Legal Entanglement of Modern Art from Degenerate Art to Cornelius Gurlitt, published, September 30, 2014
Lost Trusts in New York—the Case for Statutory Intervention, NYSBA Trusts and Estates newsletter, Summer 2014
Art Law Part 1: From Eagles to Ivory, The Art of Lost Value, published May 12, 2014, and republished in the NYSBA Trusts and Estates Section newsletter, Fall 2014
Inheritance Issues Abound for Children Conceived After Death, published March 10, 2014.
Amy is admitted to practice in New York and New Jersey. Amy speaks conversational Hebrew and Polish.

Prior to joining Meltzer Lippe, Amy obtained estate administration and estate planning experience as an associate at Herzfeld & Rubin, P.C.

Amy, a Brooklyn native, now lives on Long Island with her husband Erik, a cardiologist with a specialty in electrophysiology, and their two lovely daughters, Evelyn and Naomi.

Education:
New York University, B.A.
Brooklyn Law School, J.D.

Bar Admissions:
New York State Bar
New Jersey State Bar

Publications:
- New Inheritance Rights for Children Conceived After Death
- The Public's Interest in Charitable Trusts: Unsettled Issues

NEW YORK LAW SCHOOL 125 YEARS

WE ARE NEW YORK'S LAW SCHOOL

Alan I. Appel

Professor of Law
Director, International Tax Program
New York University, L.L.M., 1980
New York Law School, J.D., 1976
Baruch College, B.B.A, 1973

Professor Alan I. Appel specializes in international and domestic tax planning involving taxation of mergers and acquisitions, partnerships, joint ventures, limited liability companies and tax controversy matters. Prior to joining New York Law School, he spent 13 years in the New York office of Bryan Cave LLP. Professor Appel began his career as a trial attorney in the Office of Chief Counsel, Internal Revenue Service in Washington, D.C., and New York City. On behalf of the American Bar Association Tax Section, Professor Appel had the primary responsibility for drafting and submitting comments to the U.S. Treasury Department and IRS concerning the scope of the guidance provided by the proposed regulations under Section 1446 of the Internal Revenue Code and was also asked by the Office of the Chief Counsel to train its attorneys on this issue. Professor Appel published four articles on the Section 1446 regulations in The Journal of International Taxation, Tax Management Memorandum, and Tax Management International Journal.

Professor Appel is on the Board of Advisors for the Journal of International Taxation and the Journal of Taxation and Regulation of Financial Institutions. He has published articles in The Journal of Taxation, Tax Management Memorandum, Tax Management International Journal, The Journal of International Taxation, the New York Law Journal and the Westchester Bar Journal. He was formerly the Chair of the U.S. Activities of Foreigners and Tax Treaties Committee of the American Bar Association Section of Taxation. He currently sits on the Section's executive committee as Counsel Director for the Foreign Activities of US Taxpayers Committee and the US Activities of Foreigners and Tax Treaties Committee. He is also a Fellow of the American College of Tax Counsel.

Professor Appel has appeared on both radio and television discussing various income tax issues. He was also recently featured in "Taxpayers Strained by New FATCA Requirements" in AccountingToday.com, a leading provider of online business news for the tax and accounting community, concerning the Foreign Account Tax Compliance Act's new requirements.

Professor Appel holds a J.D. from New York Law School and an L.L.M. from New York University. Professor Appel began his career in academia as an adjunct professor at New York Law School in 2009 and joined the faculty full-time in 2013. At New York Law School he is also the Director of the International Tax Program. He teaches courses in International Tax, Corporate Tax, Federal Income Tax and a Tax Planning Clinic.

Meltzer, Lippe, Goldstein & Breitstone, LLP

Stephen M. Breitstone

"Want more? Demand Better! Hire Us."

Vice Chairman
516-747-0300 Ext. 241
sbreitstone@meltzerlippe.com

Stephen M. Breitstone, in addition to being the Vice Chairman of the firm, also leads the Private Wealth & Taxation Group at Meltzer Lippe.
He is counsel to many of the firm's wealthiest and most prominent clients, providing sophisticated tax and estate planning advice for several large New York real estate families, private equity funds, Wall Street investment bankers, fund managers, corporate executives, large estates and others. He has pioneered many novel tax planning techniques – some combining his broad knowledge of partnership taxation and estate planning. Steve began his practice in large New York City law firms, after graduating from law school in 1982. While beginning to practice as a tax lawyer, Steve studied for his LL.M in Taxation at New York University School of Law and taught courses as an adjunct professor in taxation at Cardozo Law School. During that period, his clientele comprised mainly of large domestic and international institutions and public corporations. After practicing for some years in the large public corporate arena, Steve decided to reestablish his practice and began representing a more entrepreneurial clientele. He started to represent high net worth individuals with real estate holdings and closely-held businesses. During the early 1990's Steve's practice evolved with the changing economic climate. He became increasingly involved in structuring and negotiating real estate workouts and joint ventures. As economic conditions improved, with the rise of the bull market and rapidly accelerating merger and acquisition activity, Steve played a key role as tax advisor in connection with Meltzer Lippe's prominent corporate practice in structuring transactions. He also played a key role in structuring the tax aspects of Meltzer Lippe's technology oriented client activities.

Steve is a frequent lecturer and author of numerous published articles on taxation of real estate transactions and estate planning for real estate owners. Steve currently teaches the course in Tax and Business Planning for Real Estate Transactions as an adjunct professor at Cardozo Law School. Steve has lectured at the NYU Institute on Federal Taxation, Practicing Law Institute, Notre Dame Tax and Estate Planning Conference, Bloomberg BNA Tax Management Real Estate Board, Bloomberg BNA Tax Management Estate Planning Board, National Multi-Housing Conference; and the Federation of (1031) Exchange Accommodators and for many more institutions. Steve has also lectured at the American Bar Association Tax Section on topics such as Foreign Investment in U.S. Real Estate and Income Tax and Estate Planning for leveraged real estate and many other topics.. He is a leader in development of the partnership freeze, an estate planning technique that avoids many income tax pitfalls for leveraged real estate and maximizes the bases step up at death. Steve is a nationally recognized authority on section 1031 exchanges.

On behalf of the firm's clients, Steve has interfaced with top policy makers Washington, DC including the Chairman of the Senate Finance Committee, to discuss legislative proposals and reforms such as estate tax reform or repeal and carried interest proposals. As the Fiscal Cliff was approaching, Steve moderated a program on Tax Policy at the NYU Institute on Federal Taxation. Steve has also testified before the U.S. House of Representatives Small Business subcommittee at hearings regarding the repeal of the estate tax. Steve has been in high demand from national news media for expert commentary on issues pertaining Carried Interest, Tax Treatment of Ponzi Scheme Victims, Estate tax matters impacting celebrities, Presidential Candidate Mitt Romney's Intentional Defective Grantor Trust (IDGT) and more. As a result, Steve has been interviewed by

Education:
New York University, B.S.

Cardozo Law School, J.D.

New York University, LL.M.

Honors:
- AV-Preeminent
  - Martindale-Hubbell
- NYU Institute on Federal Taxation
  - Advisory Board Member
- Cardozo Law School
  - Dean's Advisory Board Member
- Adelphi University
  - Dean's Advisory Board Member

Bar Admissions:
New York State Bar

Publications:
- What Happens to My Debts When I Die?
- Dividing a Real Estate Empire: The Mixing Bowl Alternative
- Madoff Victims Who Paid Taxes on Scheme Seek Refunds
- Carried Interest Bill – Impact on Real Estate Partnerships
- Carried Interest Bill – A 'Death Trap' for Real Estate Partnerships
- Faulty IRA Beneficiary Designations Explode Estate Plans
- Section 1031 "like-kind" exchanges – Use of Tenants in Common to "Pool" Capital and to Create Liquidity
- Popular Estate Planning Techniques Can Cause Income Tax Horrors For Real Estate Owners
- IRS Expands Tax-Free Exchanges of Real Estate

CBS Evening News, ABC News, Fox News, Fox Business News, News 12, Long Island, Accounting Today, Bloomberg News, Dow Jones, The Wall Street Journal, Newsday, etc.

Steve's style of practice is personal, not institutional; and his client's goals and objectives are his priority. Steve resides in Melville, Long Island with his wife Jill, who is also a lawyer. He has two children in college. He enjoys sailing, skiing, woodworking, politics and charitable work including a number of pro-Israel organizations.

- Lapsing 2012 Estate Planning Opportunities & large Estates Holding Businesses and Real Estate
- Estate Planning for Negative Capital
- Reckoning With New York's Marital Right of Election
- Income and Transfer Tax Planning for Negative Capital – The Entity Freeze Solution

190 Willis Avenue, Mineola, NY 11501
Phone: 516-747-0300 Fax: 516-747-0653 E-mail: theadvantage@meltzerlippe.com

Robert L. Goldfarb, CPA, PFS, CGMA, CFP®, CFE, DBAFA, DBAFE
Principal

Phone 516.542.6300, ext. 6824
e-Mail: robert.goldfarb@janoverllc.com

Services Provided

Tax Planning and Consulting
Estate Tax Planning
Divorce and Financial Planning
Forensic Accounting

Industries Served

Real Estate
Family Businesses
High Net Worth Individuals
Professional Practices

Bob was the managing Partner of Schoenfeld Mendelsohn Goldfarb LLP when the 52 year old firm merged with Janover LLC on August 1, 2013 at which time Bob became a Principal of Janover LLC. He received his Masters of Arts degree from Adelphi University and his Masters of Business Administration from Hofstra University. Bob started his professional career in accounting over thirty-five years ago when he joined the staff of Price Waterhouse. He was a tax manager when he left Price Waterhouse.

Bob has appeared on television news and has written several books on taxation updates for the profession. He was also the technical editor of Clinton Administration Tax Legislation published by Harcourt, Brace & Janovich. He has also spoken extensively for the American Institute of CPAs, many State Societies of CPAs and the National Conference of CPA Practitioners. Additionally, Bob was recently appointed to serve a 5-year term as a member of the New York State Board of Public Accountancy.

Bob is a Past President of the National Conference of CPA Practitioners and served as Chair of their National Tax Policy Committee and their National Issues Committee for several years. He recently completed a three-year term on the governing council of the American Institute of CPAs and is an active member of the New York State Society of CPAs where is served as a member of several of their committees including the Executive Board of the Nassau County Chapter. Bob was also named as one of the 100 most influential people in Accounting for two consecutive years by the highly regarded publication Accounting Today. Additionally Bob was recognized as "Businessperson of the Year" for his service while President of the Great Neck Chamber of Commerce and President of the Great Neck Lions Club. He also was a Senior Adjunct Professor of Accounting at Adelphi University where he taught accounting for more than twenty years and was an adjunct professor for Hofstra University teaching in their CPA Review Course which was given to accounting students seeking their CPA certification.

Bob raised more than $30,000 for the Leukemia and Lymphoma Society by participating in several triathlons and more than $15,000 on bicycle rides from Boston to New York for Aids Research. He recently completed an Iron Distance Triathlon in Sandusky, Ohio.

PROFESSOR JEROME M. HESCH

Jerome M. Hesch, Miami, Florida serves as a tax and estate planning consultant for lawyers and estate planning professionals throughout the country and is Special Tax Counsel to Oshins & Associates in Las Vegas Nevada. He is the Director of the Notre Dame Tax and Estate Planning Institute, on the Tax Management Advisory Board, a Fellow of American College of Trusts and Estates Council and the American College of Tax Council, has published numerous articles, Tax Management Portfolios, and co-authored a law school casebook on Federal Income Taxation, now in its fourth edition. He has presented papers for the University of Miami Heckerling Institute on Estate Planning, the University of Southern California Tax Institute, the Southern Federal Tax Conference, and the New York University Institute on Federal Taxation, among others. He participated in several bar association projects, including the Drafting Committee for the Revised Uniform Partnership Act and preparing the ABA's comments on the IRS's proposed private annuity regulations. He received his BA and MBA degrees from the University of Michigan and a JD degree from the University of Buffalo Law School. He was with the Office of Chief Counsel, Internal Revenue Service, Washington, D.C. from 1970 to 1975, and was a full-time law professor from 1975 to 1994, teaching at the University of Miami School of Law and the Albany Law School, Union University. He is currently an adjunct professor of law, teaching courses at the Florida International University Law School, the Graduate Program in Estate Planning at the University of Miami, the On-Line LL.M. Program at the Boston University Law School and the Vanderbilt Law School. Having grown up in Buffalo, NY, he remains a Buffalo Bills fan.

Meltzer, Lippe, Goldstein & Breitstone, LLP

David C. Jacobson

"Want more? Demand Better! Hire Us."

Counsel
516-747-0300 Ext.250
djacobson@meltzerlippe.com

David C. Jacobson is Counsel in the Trusts & Estates, Tax Law and Tax-Exempt Organizations Departments of Meltzer Lippe.

David has worked with entrepreneurs and business owners for his entire career. His common sense approach, and his comprehensive knowledge of tax, estate planning, family governance and philanthropy, allow him to counsel families effectively.

David has held senior positions at Deutsche Bank and UBS, where he provided trust and estate planning advice to wealthy families throughout the United States. Most recently, David led the national wealth planning effort for Capital One. He was previously an attorney with the law firm Carter, Ledyard & Milburn, in Manhattan.

David's practice encompasses all aspects of estate planning, with an emphasis on the efficient transfer of assets among several generations of a family. He has considerable expertise in minimizing the impact of transfer taxes upon the death of senior family members. He specializes in the structuring and implementation of sophisticated estate plans for both U.S. residents and non-residents.

David counsels individuals on sophisticated charitable giving techniques. His tax-exempt organizations practice includes the representation of public charities and private foundations, from formation through dissolution, monitoring compliance with state and federal regulations, and advising on administrative matters with particular emphasis on grant-making activities.

In addition to wealth transfer planning, David also advises on all aspects of complex estate and trust administration. He supervises the administration of estates from probate through final distribution, including all dealings with the federal and state tax authorities.

David has published numerous articles in leading national publications, including Journal of Wealth Management, Estate Planning Journal, Trusts and Estates, Institutional Investor's Private Asset Management, and the New York Law Journal.

He has spoken at prominent national conferences sponsored by prestigious professional organizations including American Bankers Association Graduate Trust School, Institute for Private Investors, Practicing Law Institute, Institute for International Research, Institutional Investor's Integrated Wealth Management Forum, Financial Research Associates, American Bankers Association, New York City Bar Association, and Florida Bar Association.

David is a member of the Asset Protection Planning and the Income and Transfer Tax Planning Committees of the American Bar Association. He is also a member of the Planned Giving Advisory Committee of the New York Museum of Modern Art.

David received his LL.M. in Taxation from Georgetown University Law Center in 1992, his J.D. from the University of Miami School of Law in 1991, and his B.A. from the University of Oklahoma in 1988. He is admitted to practice law in Florida and New York.

Education:
University of Oklahoma, B.A.

University of Miami, J.D.

Georgetown University, LL.M. (Tax)

Bar Admissions:
New York State Bar

Florida State Bar

David has resided in Melville, with his wife and two daughters, for many years.

Publications

- Private Equity Carried Interests: Income Tax Uncertainty is an Estate Planning Opportunity
  New York Law Journal
- Hedge Fund Interests in Estate Planning
  New York Law Journal
- Turning Lemons Into Lemonade: Wealth Transfer Planning in Today's Turbulent Environment
  Institutional Investor's Private Asset Management
- Clients Want Asset Protection First
  Registered Representative
- What Clients Want to Talk About Now
  Trusts and Estates
- Aesthetically Planning With Art
  The Journal of Wealth Management
- Estate Planning for Unmarried and Same-Sex Couples
  Family Office Exchange (FOX) Members News Letter
- Trustees May Prudently Invest in Financial Derivatives
  Estate Planning Journal
- Fund Managers' Transfer Tax Risks
  Trusts and Estates
- Hedge Fund Discounts: Quick, think about using deflated interests in hedge funds for tax-efficient transfers of wealth to heirs
  Trusts and Estates

190 Willis Avenue, Mineola, NY 11501

Phone: 516-747-0300 Fax: 516-747-0653 E-mail: theadvantage@meltzerlippe.com

Meltzer, Lippe, Goldstein & Breitstone, LLP

Avi Z. Kestenbaum

"Want more? Demand Better! Hire Us."

Partner
516-747-0300 Ext. 237
akestenbaum@meltzerlippe.com

Equity Partner of the Firm, ACTEC Fellow and listed in Super Lawyers and Best Lawyers in America.

Co-Chair Trusts & Estates Department and co-founder of STEP Long Island.

Listed in "Top L.I. Partners", Long Island Business News, and often quoted in Forbes, The Wall Street Journal, The Washington Post, USA Today and more.

Adjunct Tax Professor at Hofstra University School of Law.

Former Trust Administrator for Smith Barney/Citigroup Private Trust Company and attorney with prestigious law firms in New York City, New Jersey and Florida.

Member of Trusts & Estates Magazine editorial advisory board, and Chair of The Modern Practice Committee.

Founder and former Chair of the Tax-Exempt Organizations Committee of the Taxation Section of the New Jersey Bar Association.

Avi is Co-Chair of the Trusts and Estates Department, for which the firm is nationally ranked Tier 1 by *U.S. News and World Report,* and is a Partner in the Tax and Tax Exempt Organizations Departments. Avi provides creative and sophisticated domestic and international tax, estate planning, and asset preservation counsel to CEOs of major corporations, ultra high net worth individuals, multinational businesses, and large charitable organizations. He is often quoted in *Forbes, The Wall Street Journal, The Washington Post, USA Today, Investor's Business Daily,* and other major publications, and is a prominent national lecturer and author in leading tax journals. He is also an Adjunct Tax Professor at Hofstra University School of Law teaching several different tax and trusts and estates courses (and formerly with the Baruch MBA Program), ACTEC Fellow, and is listed in *Super Lawyers and Best Lawyers in America.* Avi is also a member of *Trusts & Estates Magazine* editorial and advisory board, where he is Chair of *The Modern Practice Committee.* His practice places special emphasis on domestic and international tax and trust planning, "big picture" philosophy, family business succession planning and effectively dealing with estate disputes. His diverse client base is located in New York City, Long Island and in many other states and countries.

Over the years, Avi's practice has continued to rapidly expand into several additional complex and sophisticated areas in which he advises many clients, including, but not limited to: international tax and wealth preservation planning; family business succession planning; tax and estate controversies; corporate and partnership business structuring; and income tax planning for closely held businesses and real estate clients. Additionally, Avi serves as legal advisor to many prominent charitable organizations and has developed a niche practice in the complicated area of charitable planning and the structuring and operations of nonprofit organizations under federal and state laws dealing with complex issues including, lobbying, advocacy, unrelated business income tax, joint ventures, avoiding excise taxes and foreign charities. Avi is also co-founder of *STEP Long Island* and has a substantial international tax and estate planning practice.

Education:
Touro College, B.S.

Brooklyn Law School, J.D.

University of Miami, LL.M.

Honors:
- AV-Preeminent
  - Martindale-Hubbell
- New York *Super Lawyers*
  - Estate Planning
- *Best Lawyers*
  - Estate Planning
- ACTEC Fellow

Bar Admissions:
New York State Bar

New Jersey State Bar

Publications:
- Why the Buffet-Gates Giving Pledge Requires Limitation of the Estate Tax Charitable Deduction
- Memento Mori: Death and Wills
- Practicing in the Age of Instant Gratification
- Navigating the Discussion of Business Succession Planning
- Avi Z. Kestenbaum & the Family Business Succession Planning Crisis: A Call to Action
- Know the Differences – Why All Charitable Contribution Deductions Are Not Equal
- Numerous Pension Act Changes Affect Charitable and Estate Planning
- Proposed Revisions to the Uniform Management of Institutional Funds Act
- Duties and Liabilities of Nonprofit Directors and Officers
- The New Age of Corporate Governance for Non-Profit Organizations
- Planning Beyond the Galaxy of Exemptions

Avi has also published numerous articles in leading national tax, estate planning and tax-exempt organization publications, including, among others, *Estate Planning Journal, Trusts and Estates, Leimberg's Newsletter, Practical Tax Strategies, Journal of Taxation of Exempts,* and *The New York Law Journal, Special Trusts and Estates Sections* (see firm website for some of these articles). He is a prominent national lecturer for and to prestigious professional organizations including, but not limited to, the "Notre Dame Tax and Estate Planning Institute," "New York Bar Association," "Ed Slott's Master Elite Program," the "American Bar Association," "Estate Planning Council of New York" and "New York State CPA Society, Annual Estate Planning Conference" and several national insurance companies and nonprofit institutions.

Over the last few years with estate litigations on the rise, Avi has lectured and written articles in leading journals on this subject and is pursuing a national platform advocating all estate planning attorneys better understand their client's unique situations to create individually tailored plans to mitigate the potential for and effects of estate litigations, in addition to avoiding costly income and estate taxes. Additionally, Avi helps many families with business succession planning, which is another complex area requiring individually tailored philosophy and documents to ensure family businesses can achieve success and longevity.

Prior to joining Meltzer Lippe, Avi obtained complex tax and estate planning experience with prestigious law firms in New York City, New Jersey and Florida and as a Trust Administrator for Smith Barney/Citigroup Private Trust Company. Avi received his Bachelors of Science from Touro College, *summa cum laude*, Juris Doctor from Brooklyn Law School and Masters of Law in Taxation from the University of Miami School of Law. Avi received academic scholarships for his high achievement at each of these institutions and is admitted to practice in New York and New Jersey.

Avi enjoys spending time with his wife, Miriam, who is a kindergarten teacher with the New York City Board of Education and their four young and lively sons, Eli Jonah, Joseph Tyler, Nathan Jude and Liam Mason. He continues his pursuit and interest in academics and very active schedule while serving as an Adjunct Tax Professor at Hofstra University School of Law (and formerly with the Baruch College MBA Program) teaching courses in *Federal Income Tax, Gift and Estate Tax, State and Local Tax, Wills and Trusts, and Estate Planning.*

- Integrating Self-Management With Estate Planning
- The Virtual Clone Trustee
- The Quarterback Dilemma
- The State of Estate Planning
- Reckoning With New York's Marital Right of Election
- The Beneficiary's Defective Inheritor's Trust: Is It Really Defective?
- A Practitioner's Risk Assessment Checklist
- Risk Assessment: Do It At The Outset of All Estate Planning
- Know the Differences
- It's Personal
- True Counselor
- Use Disclaimers to Add Flexibility and Hindsight to Estate Plans
- The Importance of International Tax and Estate Planning

190 Willis Avenue, Mineola, NY 11501
Phone: 516-747-0300 Fax: 516-747-0653 E-mail: theadvantage@meltzerlippe.com

WILMINGTON
TRUST

Sharon L. Klein

Managing Director of Family Office Services & Wealth Strategies
Wilmington Trust, NA

350 Park Avenue, 9th Floor
New York, NY 10022
Phone: (212)415-0531
sklein@wilmingtontrust.com

Sharon L. Klein is Administrative Vice President and Managing Director of Family Office Services & Wealth Strategies at Wilmington Trust, N.A., where she assists high net worth clients in developing and implementing sophisticated planning strategies.

Sharon has over 20 years' experience in the area of trusts and estates and is a nationally recognized speaker and author on trust & estate issues. She has spoken for many professional organizations, including the Heckerling Institute on Estate Planning, the New York University Institute on Federal Taxation, the Notre Dame Estate Planning Institute, the Duke University Estate Planning Conference, and the Bloomberg BNA Tax Management Advisory Board. Sharon has been featured or quoted in publications such as The Wall Street Journal, The New York Times, The New York Law Journal and Trusts & Estates Magazine.

Sharon serves as Chair of the Trusts and Estates Law Section Taxation Committee of the New York State Bar Association and Vice-Chair of the Estate & Gift Tax Committee of the American Bar Association. She is a member of New York Bankers Association Trust & Investment Division Executive Committee, The Rockefeller University Committee on Trust and Estate Gift Plans, the Estates, Gifts and Trusts Advisory Board for The Bureau of National Affairs and the Professional Advisory Council of the Anti-Defamation League. She is the immediate past Chair of the Trusts, Estates and Surrogate's Court Committee for the New York City Bar Association and a current member of its Estate and Gift Taxation Committee.

Prior to joining Wilmington Trust, Sharon was Managing Director and Head of Wealth Advisory at Lazard Wealth Management where she led the delivery of all wealth advisory services, including trusts & estates, tax and philanthropic planning. Prior to Lazard, Sharon headed the Estate Advisement department at Fiduciary Trust Company International. Prior to joining Fiduciary Trust, Sharon was Special Counsel in the Trusts & Estates Department at Rosenman & Colin (now Katten Muchin Rosenman LLP), where she began her career in 1990.

Sharon earned a BA and LLB from the University of New South Wales, Australia, and an LLM from the Boalt Hall School of Law at the University of California, Berkeley.

PAUL S. LEE

Paul S. Lee is a Managing Director and Senior Regional Wealth Advisor with The Northern Trust Company. Prior to joining Northern Trust, he was at Bernstein Global Wealth Management as National Managing Director, and a partner in the Atlanta-based law firm of Smith, Gambrell & Russell, LLP.

Mr. Lee received a BA, cum laude, in English and a BA in chemistry from Cornell University, and a J.D., with honors, from Emory University School of Law, where he was notes and comments editor of the *Emory Law Journal*; he also received an LL.M. in taxation from Emory University. Mr. Lee was the recipient of the Georgia Federal Tax Conference Award for Outstanding Tax Student and the Ernst & Young Award for Tax and Accounting. In 2014, Mr. Lee was inducted into the NAEPC Estate Planning Hall of Fame®, and designated an Accredited Estate Planner® (Distinguished).

A frequent lecturer and panelist on investment planning, tax and estate planning, Mr. Lee has spoken at the Heckerling Institute on Estate Planning, ACTEC National Meeting, Southern Federal Tax Institute, USC Institute on Federal Taxation, Southern California Tax & Estate Planning Forum, Notre Dame Tax and Estate Planning Institute, AICPA National Tax Conference, and the AICPA Advanced Estate Planning Conference. His articles have been published by *The ACTEC Law Journal*, *BNA Tax Management Estates, Gifts & Trusts Journal*, *BNA Tax Management Memorandum*, *Estate Planning Journal*, *Trusts & Estates*, *Estate Planning & Community Property Law Journal*, *The Practical Tax Lawyer*, *Major Tax Planning*, and the *Emory Law Journal*. Mr. Lee co-authored the law review article, "*Retaining, Sustaining and Obtaining Basis*," which was awarded Outstanding Law Review Article in 2015 by the Texas Bar Foundation.

He is a member of the Advisory Committee of the Heckerling Institute and the Wilson Society Advisory Council for the Hospital for Special Surgery in New York City.

WILMINGTON TRUST

Richard W. Nenno

Senior Managing Director and Trust Counsel

Richard W. Nenno, Esquire, is a Senior Managing Director and Trust Counsel in Wealth Advisory Services at Wilmington Trust Company, Wilmington, Delaware. Dick has nearly 40 years of estate planning experience and is admitted to the practice of law in Delaware and Pennsylvania. He is a Fellow of the American Bar Foundation, an observer on the Uniform Law Commission committee that is drafting a Uniform Divided Trusteeship Act, a member of the Bloomberg BNA Estates, Gifts, and Trusts Advisory Board, a Distinguished Accredited Estate Planner, and a Registered Trust and Estate Practitioner. Prior to joining Wilmington Trust Company in 1982, he was an associate in the Estates Department of the Philadelphia law firm of Ballard, Spahr, Andrews & Ingersoll.

Dick is a cum laude graduate of Princeton University with an A.B. degree from the Woodrow Wilson School of Public and International Affairs. He earned his J.D. degree from Harvard Law School.

Dick is recognized as a national speaker and published authority on estate planning issues. He has presented at the Heckerling Institute on Estate Planning, the ALI-ABA Planning Techniques for Large Estates Conference, the IBA/ABA International Wealth Transfer Practice Conference, the Notre Dame Tax and Estate Planning Institute, the AICPA Advanced Estate Planning Conference, the NYU Institute on Federal Taxation, the Southern California Tax and Estate Planning Forum, and the Practising Law Institute Estate Planning Institute. He is a member of the American Bar Association, Section of Real Property, Trust & Estate Law (Member of Council) and Section of Taxation; Delaware State Bar Association (Past Chair: Estates and Trusts Section); Estate Planning Council of Delaware, Inc. (Past President); Philadelphia Bar Association.

Dick is the author or co-author of numerous publications, including A Practitioner-Friendly Guide to the Delaware Asset-Protection Trust, 30 Prob. & Prop. 53 (Jan./Feb. 2016); A Comparison of Selected New York, New Jersey, Connecticut, and Delaware Trust Laws, 48 NYSBA Tr. & Est. L. Sec. Newsltr. 8 (Winter 2015); Good Directions Needed When Using Directed Trusts, 42 Est. Plan. 12 (Dec. 2015); Planning for New York Trusts to Escape State Income Tax, 42 Est. Plan. 12 (Oct. 2015); Getting a Stepped-Up Income-Tax Basis and More by Springing—or Not Springing—The Delaware Tax Trap the Old-Fashioned Way, 40 Tax Mgmt. Est., Gifts & Tr. J. 215 (Sept. 10, 2015); Delaware Trusts 2013-2014, Asset Protection: Domestic & Int'l Law & Tactics Chap. 14A (2014); There's No Place Like Home, But Where's Home? The Role of "Residence" and "Domicile" in State Income and Transfer Tax Planning, 48 Heckerling Inst. on Est. Plan. ¶ 400 (2014); 869 T.M., State Income Taxation of Trusts (2013); Directed Trusts: Making Them Work, 38 Tax Mgmt. Est., Gifts & Tr. J. 159 (Mar. 14, 2013); A Comparison of the Leading Trust Jurisdictions, 37 Tax Mgmt. Est., Gifts & Tr. J. 233 (July 12, 2012); Let My Trustees Go!: Planning to Minimize or Avoid State Income Taxes on Trusts, 46 Heckerling Inst. on Est. Plan. ¶ 1500 (2012); 867 T.M., Choosing a Domestic Jurisdiction for a Long-Term Trust (2010); 868 T.M., Domestic Asset Protection Trusts (2010); Terrors of the Deep: Tax Dangers When Exercising Powers Over Trusts—The GST Regulations and the Delaware Tax Trap, 34 Tax Mgmt. Est., Gifts & Tr. J. 76 (Jan. 8, 2009); Planning to Minimize or Avoid State Income Tax on Trusts, 34 ACTEC J. 131 (Winter 2008).

CONTACT INFORMATION

Rodney Square North
1100 North Market Street
Wilmington, DE 19890
Phone | 302.651.8113
Email | menno@wilmingtontrust.com

EXPERTISE IN

- Estate planning
- Delaware law
- Asset-protection trusts, dynasty trusts, and directed trusts
- State income taxation of individuals and trusts
- Comparing trust jurisdictions

Meltzer, Lippe, Goldstein & Breitstone, LLP

Mary P. O'Reilly

"Want more? Demand Better! Hire Us."

Partner
516-747-0300 Ext. 286
moreilly@meltzerlippe.com

Mary Pokojny O'Reilly is a Partner in the Trusts and Estates Group and the Tax Exempt Organization Group of Meltzer Lippe.

Mary assists individuals and families in the preservation and transfer of wealth. Her clients include family business owners, real estate developers, investment bankers, private equity fund managers, physicians, inventors, entertainers, business professionals, retirees, non-resident aliens, domestic partners and those of inherited wealth.

Understanding that all family situations are different, Mary establishes an estate plan tailored to each client's needs and tax objectives. Her estate planning expertise includes drafting wills and revocable trusts to ensure the client's succession plan and tax goals are maintained beyond the client's life; establishing trusts during the client's life for residences, minor children, disabled children, life insurance and wealth preservation; developing a business succession plan for family businesses; creating family companies to preserve control over family assets; counseling individuals on charitable giving, including establishing and administering family foundations, donor advised funds, charitable trusts and conservation easements.

Mary's practice includes estate and trust administration. She represents executors in probating wills and administering estates and understands the delicate nature of losing a loved one and its impact on the estate administration process. She handles will contests, prepares and files estate tax returns, and represents fiduciaries in estate tax audits. Mary also advises trustees in their administration of trusts, including amending and decanting existing irrevocable trusts; migrating trusts to more favorable tax jurisdictions; advising trustees on the investment and distribution of assets; and settling accounts of individual and corporate fiduciaries.

Mary has expertise with non-profit organizations. She assists tax-exempt organizations in formation and counsels them in their administration and day-to-day operations, including fundraising, grant making and compliance with corporate and tax requirements.

A frequent lecturer to other estate planning professionals, Mary has spoken at prominent national legal conferences such as the American Bar Association's Real Property, Trusts and Estates Section's Spring Symposia and Practicing Law Institute's Annual Estate Planning Institute. Mary was recently named a Rising Star in Super Lawyers—a recognition which only 2.5% of attorneys receive—and has been recognized for several years as a Who's Who In Women in Professional Services.

Prior to joining Meltzer Lippe in January 2011, Mary practiced for over seven years in the Trusts and Estates Group of the international law firm of Fulbright & Jaworkski, in New York City, where she represented ultra high net worth individuals and families.

Mary received her LL.M. (Masters of Law) in Taxation from New York University School of Law in 2007. She received her J.D., cum laude, from St. John's University School of Law in 2003, where she attended law school on a full academic scholarship and served as Managing Editor of the St. John's Law Review. She received her BA, cum laude, from SUNY Binghamton in 1998.

Prior to attending law school, Mary lived abroad in Madrid, Spain for two years where she taught English to adults and became fluent in Spanish. Mary is a dual citizen of both the United States and Ireland and spent many summers of her childhood with her extended family in County Donegal, Ireland.

During her free time, Mary enjoys being with her family. She and her husband Brian, who is also

Education:
Binghamton University, B.A.

St. John's University, J.D. (Cum Laude)

New York University, LL.M.

Honors:
- American Bar Association Wealth and Non-Tax Estate Planning Considerations Group of the Real Property, Trusts & Estates Law Section
  - Chair
- American Bar Association Wealth and Non-Tax Estate Planning Considerations Group of the RPTE Law Section
  - Group Vice-Chair
- American Bar Association Non-Tax Issues Affecting the Planning and Administration of Estates & Trusts Committee of the RPTE Law Section
  - Past Chair

Bar Admissions:
New York State Bar

Publications:
- Planning Beyond the Galaxy of Exemptions
- The Virtual Clone Trustee

an attorney, have two wonderful children—Brian Jr., who is 7 years old, and Brigid, who is 5 year old. They live on Long Island surrounded by their extended family whom they all see and spend time with each week.

190 Willis Avenue, Mineola, NY 11501
Phone: 516-747-0300 Fax: 516-747-0653 E-mail: theadvantage@meltzerlippe.com

Meltzer, Lippe, Goldstein & Breitstone, LLP

Phillip Pepper

"Want more? Demand Better! Hire Us."

Partner
516-747-0300 Ext. 230
ppepper@meltzerlippe.com

Phillip Pepper is a Partner in the Tax Law Group of Meltzer Lippe. Phillip advises on the tax aspects of business and investment transactions. In addition, Phillip represents clients in tax controversies with the IRS and New York State.

Phillip's practice focuses on the tax aspects of forming, operating, and exiting different forms of business entities, including partnerships, limited liability companies, joint ventures, corporations, private equity and other investment funds, and real estate investment trusts. Phillip advises on the tax consequences of business and investment transactions, including: mergers, acquisitions, and dispositions; tax-free reorganizations; spin-offs and divisions; dissolutions and liquidations; contributions, distributions, redemptions, and other transactions between entities and their owners. Phillip has received private letter rulings from the IRS.

Phillip advises on sophisticated partnership and real estate matters, including complex real estate and investment partnerships, like-kind exchanges under Section 1031 of the Internal Revenue Code, freeze partnerships, leveraged partnerships, partnership mergers and divisions, transactions raising disguised sale and mixing bowl issues, guaranteed payments, partnership debt and equity, and compensatory and carried interests.

Phillip has published in the area of tax law. In addition, Phillip has taught a graduate-level course in taxation as an adjunct professor at Baruch College. Prior to joining Meltzer Lippe, Phillip practiced tax law in the New York City office of Kronish, Lieb, Weiner & Hellman, LLP, which became Cooley Godward Kronish, LLP.

Phillip received his J.D., with honors, from the George Washington University Law School and his LL.M. (Taxation) from New York University School of Law. Phillip graduated from the University of California, Berkeley with a B.A., with honors. He is admitted to the State Bars of New York, New Jersey, and California.

Education:
University of California, Berkeley, B.A., with Honors

The George Washington University Law School, J.D., with Honors

New York University School of Law, LL.M. (Taxation)

Bar Admissions:
New York State Bar

New Jersey State Bar

California State Bar

U.S. Tax Court

Gideon Rothschild

Partner
grothschild@mosessinger.com

T (212) 554-7806
F (917) 206-4306

PRACTICES & INDUSTRIES
- Trusts and Estates
- Asset Protection
- Income Tax
- Family Offices
- Accounting Law Practice

EDUCATION
- New York Law School (J.D., *with honors*)
- Bernard M. Baruch College of the City University of New York (B.B.A.)

BAR/COURT ADMISSIONS
- U.S. District Court, Southern District of New York
- New York
- U.S. Tax Court

As Chair of Moses & Singer's Trusts & Estates and Asset Protection practices, Gideon Rothschild focuses on domestic and international estate planning and asset protection. He is a nationally-recognized authority on the use of offshore trusts and estate planning strategies for wealth preservation and succession planning. His practice also includes estate administration and the representation of clients in taxpayer disputes at the federal, state and local levels.

Gideon serves high-net-worth individuals with assets ranging from $5 million to more than $1 billion. His clients include professionals, entrepreneurs, real estate developers and owners, closely-held business owners and directors of publicly-held companies.

Gideon distinguishes himself from many of his peers in that his estate planning recommendations are integrated with asset protection objectives. By educating his clients on the non-tax benefits available with trusts and other vehicles and how they can be drafted in a flexible manner, his clients can echieve both tax savings and wealth preservation. Such benefits include protection from divorce, creditors or litigation exposure.

Gideon is the Immediate Past Chair of the ABA's Real Property Trust & Estate Law Section, a Fellow of the American College of Trust & Estate Counsel, an Academician of the International Academy of Estate & Trust Lawyers and a Vice-Chair of the Society of Trust & Estate Practitioners (STEP) - US Region.

Clients describe Gideon as "*one of the top asset protection attorneys in the country*" and is regarded by peers as "*a leading authority on asset protection.*" Since 2006, Gideon has been listed in *New York Super Lawyers®*, appearing as one of the "Top 100 New York Super Lawyers" - the only Trusts and Estates lawyer who received the highest point totals in the New York Metro area. *Chambers USA* acknowledges Gideon as *"a very accomplished attorney"* who is *"preeminent in the trusts and estates field."* He has been peer-recognized by *Best Lawyers in America* for over 10 years. He further has the distinction of being an AV® Preeminent™ Rated lawyer and one of New York's Top Rated Lawyers in his field by Martindale-Hubbell.

Gideon's other notable honors and awards include:

"World's Leading Practitioners," *Who's Who Legal: Private Client 2015*

Best Lawyers in America® for 10 years, *The Best Lawyer 2016 Edition*

"Best for Asset Protection - New York," *2015 Legal Awards*

Citywealth Leaders List 2015

Winner, STEP Founders Award of the Society of Trusts & Estate Practitioners

"World's Leading Trust & Estate Practitioners," *Euromoney's Expert Guides*

"Top 40 Tax Advisors," *CPA Magazine*

"Top 100 Attorneys" serving private clients, *Worth/Robb Report*

"Distinguished Accredited Estate Planner" award, National Association of Estate Planners & Councils

Best Lawyers in America®, *American Lawyer*

Best Lawyers in New York®, *American Lawyer*

2008 Honoree, UJA-Federation of New York, Trusts & Estates Group of The Lawyers Division

Who's Who in American Law

AV® Preeminent™, Martindale-Hubbell

AVVO rated "Superb" (with a score of 10 out of 10)

AVVO Clients' Choice Award 2012

Gideon is the co-author of BNA Tax Management Portfolio on "Asset Protection Planning" and is a member of the Advisory Boards of BNA Tax Management and Trusts & Estates magazine. He has served as an Adjunct Professor at the University of Miami School of Law and New York Law School Graduate Programs. He lectures frequently on asset protction and advanced estate planning strategies to professional groups.

Gideon is active in numerous charitable organizations including the Anti-Defamation League where he serves as National Planned Giving Chair and is a member of the National Executive Committee. He also serves on the professional advisory committees of the Metropolitan Museum of Art and the Israel Museum.

Gideon is also licensed as a Certified Public Accountant.

SANFORD J. SCHLESINGER, FOUNDING PARTNER
SCHLESINGER GANNON & LAZETERA LLP

Sanford ("Sandy") J. Schlesinger is a founding partner of the law firm of Schlesinger Gannon & Lazetera LLP. Mr. Schlesinger is a nationally recognized expert in the areas of estate and tax planning, estate administration, family-owned business planning, charitable planning and all related areas. He also handles all aspects of contested and litigated estate, trust and related tax matters.

Mr. Schlesinger is a fellow of the American College of Trust and Estate Counsel and is a past Downstate New York Chair and a former member of its Charitable Planning and Exempt Organizations Committee. He was Co-Chair of the NYU-SCPS 73rd Institute on Federal Taxation (2014). His other memberships include the Trusts, Estates, and Surrogate's Courts Committee of the New York City Bar, the Editorial Board of the New York State Bar Journal (Emeritus since 2006), Board of Directors of the New York State Bar Foundation (through July

2013), National Academy of Elder Law Attorneys, International Academy of Estate and Trust

Law (Academician), Estate Planning Advisory Committee of the Practicing Law Institute, and Financial and Estate Planning Advisory Board of the Commerce Clearing House (CCH). He has chaired The Annual Estate Planning Institute of the Practicing Law Institute for over 20 years.

He is a former Chair of the New York State Bar Association's Trusts and Estates Law Section

and the Advisory Board of the New York University Institute on Federal Taxation, (currently a member of The Advisory Board and Chair of its 2013 through 2016 programs). He is also a former Adjunct Professor of Law at New York Law School, where he taught estate and gift taxation, former Adjunct Professor of Law at the University of Miami Law School and a former Adjunct faculty member at Columbia University School of Law. He has also been elected to the National Association of Estate Planners and Councils Estate Planning Hall of Fame.

Mr. Schlesinger received a B.S. (with honors) in 1963 from Columbia University and a J.D. in1966 from Fordham University School of Law. In addition to being a frequent lecturer, Mr. Schlesinger has authored three books and numerous publications on trusts, estates, taxation, closely held business and family succession planning, charitable giving and related matters. He is listed in the Who's Who in America and Who's Who in the World, as well as having been named to the lists of "The New York Area's Best Lawyers," New York Magazine and New York Times (through 2016), "New York Super Lawyers," New York Times and, for over 30 years as one of "The Best Lawyers in America".

Barry L. Sunshine CPA, CGMA
Partner

Phone: 212.542.6300, ext. 5602
e-Mail: barry.sunshine@janoverllc.com

Services Provided

Tax Planning
Consulting
Estate Tax Planning

Industries Served

Financial Services
Real Estate
Manufacturing and Distribution
High Net Worth Individuals
Closely Held Businesses
Architect and Engineering
Oil and Gas

Barry is a tax partner and specializes in providing sophisticated tax planning to closely held businesses and their owners. His experience covers income and estate tax planning including succession planning for businesses and structuring business purchases and sales. Also, he has extensive experience handling tax controversies with the Internal Revenue Service and various State and local governmental agencies. His tax planning experience includes implementing and maximizing research and development credits, cost segregations studies, use of qualified and non-qualified pension plans, as well as federal and state tax credit utilization.

Barry has extensive industry experience covering real estate, financial services, professional services including architects and engineers, manufacturing and distribution, construction and high net worth individuals. His prior experience includes being a CFO of a NYSE company which provides him with the ability to advise clients with an "inside look".

Barry is a discussion leader on many tax topics to various state societies including advanced partnership taxation and flow- through entities. Also, he writes tax articles on tax planning techniques for closely held businesses.

Barry received his Bachelor of Science degree in Accounting from Fairleigh Dickinson University and earned his Master of Science from Pace University in Taxation.

He is licensed in New York State and Connecticut. He is a member of the American Institute of Certified Public Accountants as well as the New York State and Connecticut Societies of Certified Public Accountants.

2

ESTATE PLANNING THROUGH AN ASSET PROTECTION LENS

PRIVATE WEALTH & TAXATION INSTITUTE
Continuing Professional Education Series

Asset Protection Strategies

Gideon Rothschild, J.D., C.P.A.
Moses & Singer LLP
405 Lexington Avenue
New York, NY 10174
Telephone: 212.554.7806
grothschild@mosessinger.com
www.mosessinger.com

ASSET PROTECTION PLANNING IS THE PROCESS OF ORGANIZING ONE'S AFFAIRS TO INSULATE ONESELF FROM FUTURE CREDITOR RISKS

ASSET PROTECTION PLANNING IS NOT A MEANS TO ENGAGE IN FRAUD OF CREDITORS OR TO CONCEAL ASSETS FROM CREDITORS

3

ASSET PROTECTION STRATEGIES

The Need For Asset Protection

- Legal System No Longer Links Liability to Causation
- Increasing Theories of Liability
- Unpredictable Judges and Juries
- Emotional Distress of a Defendant
- Reducing Appeal as a Defendant
- Government Expropriation
- Divorce

4

ASSET PROTECTION STRATEGIES

Candidates for Asset Protection Planning

- Professionals
- Officers and directors
- Fiduciaries
- Real estate owners with exposure to environmental claims
- Individuals exposed to lawsuits arising from claims alleging negligent acts, intentional torts (discrimination, harassment, libel), or contractual claims
- As a pre-nuptial alternative

5

ASSET PROTECTION STRATEGIES

FRAUDULENT CONVEYANCE ISSUES

- The Law prohibits transfers made with the intent to "...hinder, delay or defraud" creditors.
- Differentiate between:
  - **Present creditors** - the transferor has notice of these creditors when making the transfer
  - **Subsequent creditors** - the transferor had actual fraudulent intent against these creditors, even if the actual claim arose after the transfer
  - **Potential future creditors** - those nameless, faceless persons of whom no awareness existed when the transfer was made

6

ASSET PROTECTION STRATEGIES

Traditional Methods

- Transfers to Spouse
- Corporate Formation, Limited Partnerships and Limited
- Liability Company
- Joint Ownership of Property
- State and Federal Exemptions (other than ERISA)
- ERISA Based Exemptions

Transfers to Spouse

- Such transfers involve surrendering:
  - all rights to control the transferred assets, and
  - any certainty that the transferor can continue to enjoy the benefits of the transferred assets.
- Potential for undesirable consequences in event of divorce or death of spouse.
- Possible imposition of "constructive trust doctrine" can lead to attachment by creditors.
- Courts will "unwind" a fraudulent conveyance.

Can/should "portability" be relied upon for estate tax efficiency?

- REASONS WHY ONE SHOULD NOT RELY ON PORTABILITY…
- Portability is temporary
- Portability does not apply to state estate taxes
- Portability does not apply to the GST exemption
- The amount subject to portability is not adjusted for Inflation
- Portability requires an affirmative election and likely disclosure
- Portability requires "privity" between the spouses
- "Credit shelter" trusts provide the trust type benefits that portability cannot

- SITUATIONS WHERE ONE MIGHT RELY ON PORTABILITY…
- Where the decedent's estate has a large IRA or qualified plan and few other asset
- To save state estate taxes on the decedent's estate
- To generate a "stepped up" basis on the decedent's assets

9

ASSET PROTECTION STRATEGIES

Joint Ownership

- Tenancy by the Entirety:
  - Form of joint ownership between a husband and wife recognized in 20+ states.
  - Generally limited to ownership of real estate, but in some states can also be used with respect to intangibles.
  - Creditor of one spouse only cannot foreclose against the property unless tenancy by the entirety is severed (whether by death, divorce or some other transfer).
  - Non-debtor spouse receives property 100% free and clear, but if debtor spouse is survivor, and period has not expired, creditor can exercise rights against the property.

10

ASSET PROTECTION STRATEGIES

State and Federal Exemptions

- Pension and ERISA qualified retirement plans are protected from creditors.
- Life insurance and annuities are generally protected.
- Homestead exemption under some state laws.
- Asset protection planning can never be used to evade taxes - IRS can also invade retirement plans, insurance and annuities.

11

ASSET PROTECTION STRATEGIES

IRAs and Asset Protection Planning

- An IRA is generally protected from the claims of creditors or the IRA owner.
- However, it is unclear whether an inherited IRA is protected from the claims of the beneficiary's creditor.
- The vast majority of cases have denied creditor protection to inherited IRAs, but recent cases have bucked this trend.

12

AS SET PROTECTION STIRATEGIES

Creditor Protection of IRAs

- Bankruptcy law specifically exempts from a debtor's bankruptcy estate "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, or 501(a) of the [Code]."
  - *11 U.S.C. § § 522(b) (2), 522(b) (3) (C), and 522(d)(12).*
- Limited to $1,000,000 (adjusted for inflation and currently $1,245,475), excluding amounts attributed to rollover contributions.
  - *11 U.S.C. § 522(n)*

13

ASSET PROTECTION STRATEGIES

Creditor Protection of Inherited IRAs

- Question as to whether an inherited IRA constitutes "retirement funds" under the Federal bankruptcy exemption – Supreme Court held not retirement funds=not exempt
- State law exemptions v. Federal exemptions
- State law controls outside of bankruptcy context

14

ASSET PROTECTION STRATEGIES

Planning to Protect Inherited IRAs – Designate a trust as the beneficiary

- "Conduit Trust"
  - Advantage: beneficiary's life expectancy used to determine amount and timing of the mandatory distributions
  - Disadvantage: distributions from the inherited IRA will no longer be protected from creditors following their payment to the trust beneficiary
- Accumulation Trust
  - Advantage: greater asset protection
  - Disadvantage: all beneficiaries must be taken into consideration in calculating mandatory required distributions (even if merely contingent, or permissible appointees under a special power of appointment) and non-individual beneficiaries (such as charities) may not be permissible beneficiaries (See Treas. Reg. § 1.401(a)(9)-5 (Q-7 & A-7))

15

ASSET PROTECTION STRATEGIES

Formation of Limited Partnership or LLC

- Owner of property contributes to an LLC or LP and retains interest as a member or limited partner.
- Need a valid "business purpose" for LLC/LP.
- Assets are generally secure from claims of creditors because assets are owned by entity rather than individual member/partner.
- Creditor can generally only get a charging order remedy and cannot step into the shoes of LLC/LP Manager or GP to sell off the assets or liquidate the LLC/LP.

16

ASSET PROTECTION STRATEGIES

Charging Order Protection

- A "charging order" is a court order that dictates that the LP or LLC must make distributions that would normally be paid to the debtor to the creditor.
- BUT, court cannot mandate timing or amount of distributions.
- LLCs or LPs should be formed in states that provide for the charging order as exclusive remedy.
  - See Prof. Carter G. Bishop's Fifty State charts at: http://ssrn.com/abstract=1565595 and http://ssrn.com/abstract=1542244
  - Currently, Wyoming and Nevada are the only states that provide for exclusive charging order remedy for single-member LLCs.

17

ASSET PROTECTION STRATEGIES

Trusts, in General

- What is a trust?
  - A trust is a contractual relationship between a grantor, a trustee and a beneficiary for the trustee to hold legal title to property, formerly owned by the grantor, for the benefit of the beneficiary.
- Why does a trust protect against creditors?
  - Most succinctly stated in Latin, *"cujus est dare, ejus est disponere"*

18

ASSET PROTECTION STRATEGIES

What is the major limitation on a trust's protection?

- Public policy - an argument that it is unfair to let a man enjoy the fruits of a trust that he himself has established for his own benefit, while at the same time denying his legitimate creditors payment on their claims.

19

ASSET PROTECTION STRATEGIES

Third-Party Irrevocable Trusts

- Third-party trusts are irrevocable trusts in which the Grantor is not a beneficiary
- The $5 million gift tax exemption opens up huge opportunities
- Trust for Spouse - QTIP election
- Trust for Spouse and Descendants
- Trust for Descendants

20

ASSET PROTECTION STRATEGIES

Trust for Spouse and Descendants

- Settlor retains the power to fire and hire trustees
- Use a "floating spouse" provision

Discretionary Trust

- Discretionary Trusts are the most protective
  - "Sole and absolute discretion"
  - "Unreviewable by a court of law"
  - Doesn't have to rely on a spendthrift provision

Domestic Trusts

- Advantages
  - Probate Avoidance
  - Confidentiality
  - Spendthrift Protection for Beneficiaries
- Disadvantages
  - Self-Settled Trust Rule Applies in Most States
  - Subject to Domestic Legal System
  - Subject to Fraudulent Conveyance and Sham Trust Challenges
- DAPT Legislation

Alaska	Nevada	South Dakota
Delaware	New Hampshire	Tennessee
Hawaii	Ohio	Utah
Mississippi	Oklahoma	Virginia
Missouri	Rhode Island	Wyoming

23

ASSET PROTECTION STRATEGIES

Domestic APTs

- Advantages
  - Settlor can be Beneficiary and Protector
  - Statutory Protection from Creditors
  - Will Substitute
  - Protection for attorneys, advisors
  - Settlor may retain income or principal under ascertainable standard.
- Disadvantages
  - Subject to full faith and credit
  - Statute of limitations open-ended for existing creditors
  - Ten year statute of limitations in bankruptcy

24

ASSET PROTECTION STRATEGIES

Incomplete Gifts – What retained powers required?

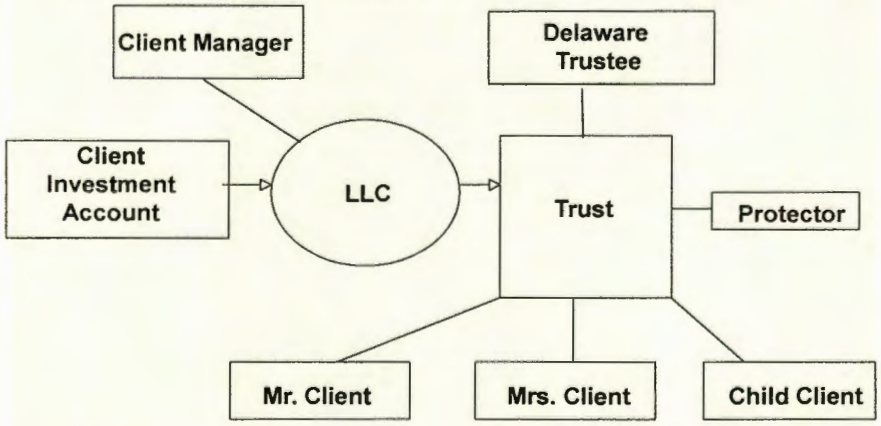
- CCA 201208026 - Chief Counsel memo concludes transfer was a completed gift notwithstanding Settlor's retained testamentary power of appointment. To ensure incomplete gift treatment settlor should retain either a lifetime limited power or a veto power over distributions. Prior issued rulings and Treas. Reg. § 25.2511-2(b) suggest testamentary power is adequate.

25

ASSET PROTECTION STRATEGIES

Domestic Trust Planning Structure

Example: Trust in Delaware, Settlor in New York



26

ASSET PROTECTION STRATEGIES

Foreign Trusts

- Advantages
  - Settlor can be Beneficiary and Protector
  - Statutory Protection from Creditors
  - Short Statute of Limitations Period
  - Standard of Proof to Succeed in Fraudulent Conveyance Action
  - U.S. Judgments not Recognized
  - Confidentiality
  - Grantor Trust - Tax Neutral during Grantor's lifetime
  - Will Substitute

27

ASSET PROTECTION STRATEGIES

Foreign Trusts (cont'd)

- Disadvantages
  - Reporting Requirements
  - U.S. Court Perception/Contempt
  - Foreign Trustee Concerns
  - Section 684

28

ASSET PROTECTION STRATEGIES

EXAMPLE

	Dynasty Trust	W/O Trust
Initial Amount (Grantor 50 Years Old)	$5,000,000	$5,000,000
Value at Grantor's Death(7% Growth – 25 Years)	$27,137,160	$27,137,160
Estate Tax @ 40%	$0	10,854,864
	27,137,160	$16,282,296
Value at child's Death – 50 Years (7%)	147,285,135	88,371,065
Estate Tax @ 40%	$0	35,348,259
	$147,285,135	53,022,806
Value at Grandchild's Death – 75 Years	$799,380,150	287,777,708
Estate Tax @ 40%	$0	115,111,083
	$799,380,150	172,666,625

29

ASSET PROTECTION STRATEGIES

Service's Ruling in PLR 200944002:

- Grantor proposed to create a trust for the benefit of himself, his wife, and his descendants. Under the terms of the trust, the trustee could, but was not required to, accumulate all income or pay income and/or corpus to one or more of the beneficiaries, including the grantor.
- The IRS citing Rev. Rul. 2004-64: "...the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036."
- However, the IRS refused to rule whether the trustee's discretion to distribute income and principal to the settlor, when combined with other facts (such as, but not limited to, an understanding or preexisting arrangement between Grantor and trustee regarding the exercise of this discretion), would cause inclusion under § 2036.

30

ASSET PROTECTION STRATEGIES

Questions?

- Gideon Rothschild J.D., CPA
- Moses & Singer LLP
- 405 Lexington Avenue
- New York, NY 10174
- Telephone: 212.554.7806
- grothschild@mosessinger.com
- www.mosessinger.com

Estate Planning

Through an

Asset Protection Lens

Gideon Rothschild, J.D., CPA
Moses & Singer LLP
405 Lexington Avenue
New York, New York 10174
(212) 554-7806
grothschild@mosessinger.com
http://www.mosessinger.com

Gideon Rothschild, J.D., C.P.A.
Moses & Singer LLP
405 Lexington Avenue
New York, New York 10174-1299
212-554-7806
grothschild@mosessinger.com
http://www.mosessinger.com

GIDEON ROTHSCHILD is a partner with the New York City law firm of MOSES & SINGER LLP, where he co-chairs the Trusts & Estates and Wealth Preservation Group. He focuses his practice in the areas of domestic and international estate planning techniques for high net worth clients and is a nationally recognized authority on wealth preservation and offshore trusts.

Mr. Rothschild is the Immediate Past Chair of the Real Property Trust & Estate Law Section of the American Bar Association, a Fellow of the American College of Trust and Estate Counsel and Academician of The International Academy of Trust and Estate Lawyers. He is a Past Chair of the New York Chapter of the Society of Trust and Estate Practitioners (STEP), and a member of the New York State Bar Association.

Mr. Rothschild is the co-author of the BNA *Tax Management* portfolio on *Asset Protection Planning* and a member of the Advisory Boards of BNA's *Tax Management* and *Trusts and Estates*. . He has also authored numerous articles for publications including the *New York Law Journal*, *Trusts and Estates* and *Estate Planning.*

Mr. Rothschild has lectured frequently to professional groups including the University of Miami's Philip Heckerling Institute, the New York University Federal Tax Institute, the New York State Bar Association, the American Bar Association, the Southern Federal Tax Institute and the American Institute of Certified Public Accountants. Mr. Rothschild has been designated as a Distinguished Estate Planner by the National Association of Estate Planners and Councils and has earned the distinction of being listed in *Chambers USA ("...*in addition to his extensive experience in domestic and international estate planning, is regarded by peers as '*a leading authority on asset protection'."), Best Lawyers in America, New York Superlawyers* (Top 100 in New York City) and Worth's *Top 100 Lawyers.* Mr. Rothschild is also licensed as a Certified PublicAccountant.

ESTATE PLANNING

THROUGH AN ASSET PROTECTION LENS

By

Gideon Rothschild, J.D., CPA
Moses & Singer LLP
405 Lexington Avenue
New York, New York 10174
(212) 554-7806
grothschild@mosessinger.com
http://www.mosessinger.com

I. INTRODUCTION

A. The Current Litigation Environment Creates Greater Exposure to Risk of Loss Than Ever Before:

1. Expanded theories of liability

2. Higher and higher jury awards

3. Unpredictable judges and juries

B. Traditional Forms of Protection Have Become Inadequate

1. Insurance

a. Exclusions

b. Policy limits

c. Solvency of insurer

d. Policy lapses

2. Incorporation

a. Piercing the corporate veil

b. New theories of shareholder/officer liability

C. Candidates for Asset Protection Planning

1. Professionals

2. Corporate officers and directors

3. Fiduciaries

4. Real estate owners

5. Individuals exposed to lawsuits arising from claims alleging negligent acts, intentional torts (i.e., discrimination, harassment, libel, etc.), or contractual liability

6. Individuals seeking a prenuptial alternative

D. Asset Protection Is Not New

1. Incorporation of business activities

2. Formation of LLC's, LLP's, LP's

3. Offshore trusts have been long used to avoid forced heirship and expropriation

4. Exemption and pre-bankruptcy planning

E. Asset protection is part of an overall wealth preservation process including:

1. Financial planning

2. Insurance planning

3. Income tax planning

4. Estate tax planning

II. FRAUDULENT TRANSFER ISSUES

A. Every asset protection plan must account, in the very first instance, for the law of fraudulent transfers. In general, the law of fraudulent transfers, which dates back to the enactment of the Statute of Elizabeth in England in 1571, provides that the transfer of assets in anticipation of a creditor problem will be disregarded by the courts and the creditor will be allowed to enforce its judgment against the transferee of the property.

B. Although minor variations exist, fraudulent transfer statutes can be found under the law of every state and almost all foreign jurisdictions, as well.

C. A fraudulent transfer is often deemed to be a transfer of property that was made with the intent to "hinder, delay or defraud" either existing or reasonably anticipated future creditors. Common law usually divides creditors into three categories:

1. Present creditors - those persons of whom the transferor has notice when making transfers.

2. Subsequent creditors - those persons against whom the transferor harbored an actual fraudulent intent when transferring assets, including creditors whose rights arose after the transfer if the transferor intended to proceed with his or her affairs in a fraudulent manner or with reckless disregard for the rights of others.

3. Potential future creditors - those nameless, faceless persons of whom the transferor had no awareness when the transfer was made.

D. In addition, a transfer which has the effect of rendering the transferor insolvent will automatically be held a fraudulent transfer.

E. Moreover, in certain jurisdictions, the mere fact that one has been named as a defendant in a lawsuit can render all transfers made without sufficient return consideration as *per se* fraudulent transfers irrespective of the transferor's actual intent in making the transfer.

F. Under all other circumstances, however, the issue remains the transferor's intent in effecting the transfer, which generally boils down to how close in time the transfer of property was to the subsequent creditor claim.

1. It is notable that, except as specified hereinabove, it is unimportant whether or not a creditor's claim has yet coalesced into a lawsuit (which, of course, might be months or years later).

G. It is, therefore, absolutely imperative that asset protection planning be undertaken as far in advance of a potential creditor claim as possible in order to ensure that any transfer of property incident to such plan is not later undone as a fraudulent transfer.

III. TRADITIONAL FORMS OF ASSET PROTECTION

A. Transfers to spouse - "Poor man's" asset protection

1. Potentially effective (assuming it is not later deemed a fraudulent transfer).

2. Numerous problems exist, however, in connection with outright transfers to a spouse, including:

   a. Possibility of divorce

   b. Spouse's potential exposure to creditors

   c. Loss of control over assets

   d. Potential gift tax consequences where spouse is not a U.S. citizen

   e. Estate tax issues where states have an estate tax and don't recognize portability (i.e., transferor spouse should retain in his/her own name assets at least equal to exemption amount).

B. Corporate ownership

1. In the usual case (absent a personal guarantee of corporate obligations), a shareholder will not be personally liable for the debts of the corporation and thus, the shareholder's personal assets are protected from the creditors of the corporation.

   a. This type of protection is referred to as "inside out" protection because the shareholder's personal assets (which are outside of the corporation) are protected from the corporation's creditors (whose claims arose inside of the corporation's business dealings).

   b. The inside out protection is not absolute.

      - In the case of a closely held corporation, a plaintiff's attorney is likely to join the shareholder (in the shareholder's capacity as a corporate officer or director) in the action.

      - The protection may also be breached via statutory and/or common-law arguments including an argument to "pierce" the "corporate veil" due to a failure to consistently observe the formalities of the corporate form.

2. The reverse, however, is not also true, and if the shareholder is sued personally, the shareholder's interest in the corporation (in the form of his or her shares) will be reachable by the judgment creditor and, in the case of a sole or even a majority shareholder, a personal creditor would be able to reach the assets of the corporation in satisfaction of a judgment through the liquidation of the corporation following execution on the shares of the shareholder.

C. Limited Partnerships and Limited Liability Companies

1. The asset protection afforded by the limited partnership or limited liability company structure is based upon what is commonly known as a "charging order" protection.

   a. Under the law of every state it is arguably the case that if the limited partner or limited liability company member is successfully sued his or her creditor would only be entitled to a lien on the limited partnership interest or limited liability company membership interest, and would not be entitled to enforce its claim directly against the underlying assets of the limited partnership or limited liability company.

   b. In addition, the creditor's charging order may not necessarily entitle the creditor to become a limited partner in the limited partnership, or a member in the limited liability company, entitle the creditor to vote on limited partnership or limited liability company matters, entitle the creditor to inspect or copy limited partnership or limited liability company records, or entitle the creditor to obtain the business and tax information of the limited partnership or limited liability company (which is usually available to limited partners and limited liability company members as a matter of law).

   c. The sole entitlement of a creditor with a charging order is, arguably, the right to receive the distributions that are allocable to the debtor limited partner from the limited partnership, or the debtor member from the limited liability company, if and when distributions might be made.

      - The creditor's "remedy" of being able to receive distributions from the limited partnership or limited liability company if and when distributions might be made may ultimately prove hollow in a "family" limited partnership, or "family" limited liability company situation, since it is unlikely that the general partner or manager will distributions while a charging order is outstanding.

      - A limited partnership agreement or limited liability company agreement drafted for asset protection purposes will provide the general partner, manager or managing member with broad discretion to make, or to refrain from making,

distributions from the limited partnership or limited liability company.

2. Under the tax law there is some authority to the effect that the taxable income of the limited partnership or limited liability company will be chargeable to the creditor who has obtained a charging order notwithstanding the fact that no distributions may ever actually be made to the creditor.

   a. Therefore, the effect of a charging order might be that the creditor will be forced to realize "phantom" income on which the creditor would have to pay income tax on a current basis.

   b. There is substantial doubt, however, as to whether the creditor will, in fact, actually be charged under the tax law with phantom income by reason of the charging order. In fact, it is at least as likely that, notwithstanding the charging order, the limited partner or limited liability company member will be liable to report the income of the limited partnership or limited liability company on his or her own return, perhaps with the tax paid on such phantom income deemed to reduce the judgment debt to the charging order creditor.

   c. Even if phantom income were realized by the judgment creditor, all of the remaining non-debtor partners would at the same time also be realizing phantom income with respect to their own limited partnership or limited liability company interests and, therefore, they might force a distribution to be made, thereby negating any leverage that the debtor might otherwise have *viz a viz* his or her creditor.

3. There is substantial uncertainty in most states as to whether or not the courts will consider a charging order as the sole and exclusive remedy available to a creditor.

4. Even where the charging order might be held to be an exclusive remedy to the creditor, a sale of the limited partnership interest or limited liability company membership interest may still be allowed where the creditor can demonstrate to the court that monies that might be collected pursuant to the charging order (if in fact, any are ever collected), will likely be insufficient to satisfy the creditor's judgment in a reasonably timely manner.

5. Alternatively, it might be argued by the creditor that the limited partnership or limited liability company should be deemed to be an "alter ego" of the debtor. Such an argument might be made, for example, where:

   a. The limited partnership or limited liability company lacks any real business purpose.

   b. The limited partnership or limited liability company is funded with an excess of personal use assets.

   c. There has been a pattern of non-adherence to the legal formalities attendant to the limited partnership form or limited liability company form.

   d. The interests of the other limited partners or limited liability company members in the limited partnership or limited liability company are inconsequential relative to the debtor's limited partnership or limited liability company interest.

D. Joint ownership of property - Tenancy by the Entireties

1. A tenancy by the entireties is a special form of joint ownership of property that can only exist between a husband and wife. In some states, only real estate can be held in a tenancy by the entireties form. In other states, including Pennsylvania, Virginia and Florida, intangible property may also be held as tenants by the entirety.

2. A tenancy by the entireties is characterized by five coincident unities: unity of possession (joint ownership and control); unity of interest (the interests must be the same); unity of title (the interests must originate in the same instrument); unity of time (the interests must commence simultaneously); and the unity of marriage.

   a. The unity of possession has the effect of requiring a husband and wife to act together to convey title to tenancy by the entireties property, thereby generally precluding a unilateral severance.

   b. As a result, in those states that follow the common law rule, the creditor of only one spouse cannot execute upon property held as a tenancy by the entireties.

   c. Property which is exempt from creditors by reason of a tenancy by the entireties under state law will also be exempted from an estate in bankruptcy.

3. No asset protection is afforded by a tenancy by the entirety, however, where:

   a. There is a divorce.

   b. In the event of death of the non-debtor spouse.

   c. The creditor is a joint creditor of the two spouses.

   d. The real property is sold and the governing state law provides that only real estate can be held as a tenancy by the entireties.

4. In addition, the asset protection afforded by husband and wife holding title to property as tenants by the entirety is frequently at odds with the couple's estate tax planning, since proper estate tax planning often requires that the joint estate be divided between the spouses for purposes of estate equalization or so as to ensure that each spouse's estate can make maximum use of the applicable exclusion amount.

   a. Seven states allow property transferred into a joint revocable trust to retain its status as tenancy by the entirety property, and thus remain protected from creditors. Those states are: Delaware, Hawaii, Illinois, Indiana, Maryland, Missouri and Virginia.

E. Exemption planning

1. Homestead

   a. One asset that is frequently granted an exemption from creditors' claims is an individual's principal residence. This exemption is most often referred to as a "homestead exemption."

   b. The fairly obvious legislative purpose behind the enactment of a statutory homestead exemption is the preservation of that asset most necessary for the subsistence of an individual and his or her dependents – their home.

      - In fact, so significant is the family homestead deemed to be to one's subsistence that forty-eight of the fifty states provide at least some level of exemption for an individual's principal residence. Only New Jersey and Pennsylvania provide no exemption.

      - Only Florida, Iowa, Kansas, Oklahoma, South Dakota and Texas, plus the District of Columbia, provide for a so-called "unlimited" homestead exemption.

- Even where the homestead exemption is unlimited, this does not necessarily also mean that the exemption is unqualified – for example, certain specially protected classes of creditors (i.e., the Internal Revenue Service or an ex-spouse), might be permitted to avoid this exemption and enforce a judgment against the home.

c. In order to maximize use of the homestead exemption, one might consider moving, subject to the time requirement of the Bankruptcy Code for establishing residency in that jurisdiction, to a jurisdiction that allows a more generous or even an unlimited homestead exemption.

- The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act imposed restrictions upon the homestead exemption in a Bankruptcy case. Most significantly, §522 of the Bankruptcy Code now imposes an aggregate monetary limitation of $125,000 (subject to adjustment for inflation and currently $146,450), on the value of property that the debtor may claim as exempt under state or local law under certain circumstances - most significantly, where the debtor acquired such property within the 1,215-day period preceding the filing of the petition.

d. Alternatively, where one is already domiciled in such a jurisdiction, or even where one wants to make the best use of the limited homestead exemption available in one's current jurisdiction, one might pay down one's mortgage, improve one's home, or purchase a larger, more expensive home, in furtherance of one's asset protection plan.

2. Retirement Plans and IRAs

a. A retirement plan that is "qualified" under the Employee Retirement Income Security Act of 1974 (ERISA) is protected from the plan participant's creditors pursuant to the 1992 decision of the U.S. Supreme Court in *Patterson v. Shumate*.

- In that case, the Supreme Court ruled on the issue of whether the legally required anti-alienation provision contained in every ERISA qualified pension plan caused the participant's interest therein to fall within the exclusion from the

bankruptcy estate provided under § 541(c)(2) of the Bankruptcy Code.

- Section 541(c)(2) of the Bankruptcy Code excludes from the bankruptcy estate all property subject to a restriction on transfer which is enforceable under "applicable nonbankruptcy law." Although the trustee contended that the term "applicable nonbankruptcy law" was limited to state law, the Supreme Court, resolving a conflict among the circuits, held that the term "applicable nonbankruptcy law" as used in that section of the Bankruptcy Code, in fact, encompassed any relevant nonbankruptcy law including federal nonbankruptcy law such as ERISA.

b. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, amended the Bankruptcy Code to provide protection for IRAs.

- Prior to the effective date of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, IRAs established under § 408 of the Internal Revenue Code were not necessarily deemed the equivalent of an ERISA-qualified plan and, as a consequence, were not automatically afforded any creditor protection under the Supreme Court's holding in *Patterson v. Shumate*.

c. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, amended § 522 of the Bankruptcy Code to permit a debtor to exempt certain retirement funds to the extent those monies are in a fund or account that is exempt from taxation under §408 or §408A. The exemption is subject to a $1 million cap (subject to adjustment for inflation and currently $1,171,650), however, on the value of the debtor's interest in an IRA established under either §408 or §408A.

- This limit applies without regard to amounts attributable to rollover contributions and earnings thereon.

- The cap may be increased if required in the interests of justice.

d. Inherited IRAs, however, may well be treated differently.

- With one exception, the authority that exists on this point has generally held that an inherited IRA is not protected from creditor claims under *state* exemption law. The courts so holding have cited to the following factors in favoring a rule whereby an inherited IRA is available to the beneficiary's creditors:

  - The IRA exemption is based upon a public policy intending that retired persons should be assured their support.

  - The beneficiary of an inherited IRA has an unrestricted right to withdraw the assets of the account without penalty, which is not the case with an original IRA.

  - The inherited IRA is substantially different from an original IRA under the tax law.

- Arizona, Alaska, Florida, Idaho, Missouri, North Carolina, Ohio and Texas have enacted legislation to provide that inherited IRAs are protected from creditors.

- In the Bankruptcy context, however, the authority was mixed until the US Supreme Court in a 9-0 decision held that an inherited IRA is not exempt from the beneficiary's creditors as it does not constitute "retirement funds". within the meaning of § 522(b)(2), (3)(C) and (d)(12) of the Bankruptcy Code which exempt from a debtor's bankruptcy estate "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, or 501(a) of the [Code]." See, *Clark vs. Rameker, 573 U.S.____, 2014.*

ii. Consider designating either a conduit or accumulation trust as a beneficiary of an IRA to protect the inherited IRA from a beneficiary's creditors. (see infra at V.E.)

3. Life Insurance

a. The federal bankruptcy exemptions for life insurance policies owned by the debtor are found at 11 U.S.C. §§ 522(d)(7) and (8) and provide that unmatured policies owned by the debtor and up to $8,625 of the debtor's aggregate interest in any accrued dividend or interest under, or loan value of, an unmatured life insurance contract, is exempt provided that the insured is either the debtor or an individual of whom the debtor is a dependent.

- Federal bankruptcy law, 11 U.S.C. § 522(d)(7), broadly defines a dependent as including a spouse, regardless of whether the debtor's spouse is actually dependent on the debtor.

b. Since the federal exemption scheme for life insurance that is owned by the debtor is so parsimonious, if an exemption under an alternative state scheme is provided, its use in lieu of the federal exemption scheme should be carefully considered.

- New York's scheme for the exemption of life insurance, Insurance Law § 3212; Civil Practice Law and Rules § 5205(i), distinguishes between the several permutations which can result depending on whether the debtor is the owner of the policy (referred to under the New York statute as the person "effecting the policy," and need not be the person who actually purchased the policy), the insured, the beneficiary, or some combination thereof. More specifically, the New York State exemption scheme for life insurance provides that:

  - If the owner of a life insurance policy insures his or her own life for the benefit of another (*i.e.*, a beneficiary other than the owner's estate), that other person shall be entitled to the proceeds and avails of the policy as against the creditors of the owner. (In other words, the beneficiary's interest in a life insurance policy owned by another is protected from claims of the

policy owner's creditors, notwithstanding the fact that a power to change the beneficiaries of the life insurance policy has been reserved by the owner).

- If the owner of a life insurance policy insures the life of another for the owner's own benefit, the owner is entitled to the proceeds and avails of the policy as against the creditors of the insured. (In other words, the interest of an owner of life insurance in the policy is protected from the creditors of the insured).

- If the owner of a life insurance policy insures the life of his or her spouse for the owner's own benefit, the owner is also entitled to the proceeds and avails of the policy as against his or her own creditors. (In other words, the interest of an owner/beneficiary of life insurance in the policy is protected from the owner/beneficiary's own creditors if the insured is the owner's spouse).

- If the owner of a life insurance policy insures the life of another person for the benefit of a third party, the third party is entitled to the proceeds and avails of the policy as against the creditors of both the owner and the insured. (In other words, the beneficiary's interest in a life insurance policy is protected from claims of the creditors of both the owner of the policy and the insured).

- The owner of a life insurance policy, regardless of the identity of the insured, is entitled to accelerated payment of the death benefit or accelerated payment of a special surrender value permitted under such policy as against the creditors of the owner. (In other words, the owner's interest in the cash surrender value of a life insurance policy is protected from claims of the owner's own creditors).

- In the New York statute, Insurance Law § 3212(a)(2), the phrase "proceeds and avails" is defined to include "...death benefits, cash surrender and loan values, premiums waived, and dividends, whether used in reduction of premiums or in whatever manner used or applied, except where the debtor has, after issuance of the policy, elected to receive the dividends in cash."

4. Annuities

a. The federal bankruptcy exemption for annuity payments is located at 11 U.S.C. § 522(d)(10)(E) and, like many federal exemptions, the exemption for the right to receive an annuity is neither overly generous nor does it lend itself to asset protection or pre-bankruptcy planning.

b. Specifically, the federal exemption for the right to receive an annuity provides that payments may be exempted only if payable by reason of "...illness, disability, death, age, or length of service..." and even then, only to the extent that such payments are "reasonably necessary" for the support of the debtor and any dependent of the debtor.

- While the "reasonably necessary" standard should arguably be sensitive to the debtor's particular situation, the courts have not necessarily applied the exemption in this manner. Moreover, the courts have generally proven extremely spare in applying such standard in any event.

c. State law exemptions for the right to receive an annuity vary broadly from one state to another.

- New York's exemption for annuities, Insurance Law § 3212(d)(1), initially provides that "[t]he benefits, rights, privileges and options which, under any annuity contract are due or prospectively due the annuitant, who paid the consideration for the annuity contract, shall not be subject to execution." Unfortunately, the New York exemption statute goes on to provide that: "...the court may order the annuitant to pay to a judgment creditor or apply on the judgment in installments, a portion of such benefits that appears just and proper to the court, with due regard for the reasonable requirements of the

judgment debtor and his family, if dependent upon him..."

- The New York exemption for the right to receive an annuity is further qualified by New York Debtor and Creditor Law § 283(1), which generally provides that the exemption for annuity contracts initially purchased by the debtor within six months of the debtor's bankruptcy filing are capped at five thousand dollars irrespective of the reasonable income requirements of the debtor and his or her dependents.

  - The intent of this section of the statute, according to the Bankruptcy Court, is to "...limit the debtor's ability to deliberately 'load up' on exempt property." *See, In re Moore*, 177 B.R. 437 (Bkrtcy. N.D.N.Y. 1994).

IV. A BRIEF (AND SELECTIVE) HISTORY OF SPENDTHRIFT (AND DISCRETIONARY) TRUST PROTECTIONS

A. Trusts serve a multitude of client purposes, including, not insignificantly, asset protection. The use of a self-settled spendthrift trust (commonly called an "asset protection trust"), is certainly one way to garner asset protection benefits through the use of a trust; but it is by no means the only way, or even necessarily, the best way.

B. Spendthrift Trusts

1. "Trusts in which a beneficiary cannot assign the interest, or that provide that creditors cannot reach it, are known as 'spendthrift trusts.'" SCOTT AND ASCHER ON TRUSTS § 15.2, Vol. 3 at 898 (5th ed. 2007).

2. "The term 'spendthrift trust' refers to a trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests." RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

C. Discretionary Trusts

1. A "discretionary" trust is a trust in which distributions to the beneficiary are left wholly within the discretion of the trustee, generally without regard to any ascertainable standard. RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

D. Combined Discretionary and Spendthrift Trusts

1. "A spendthrift trust is to be distinguished from a discretionary trust but may or may not also contain discretionary interests..." RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

2. A discretionary spendthrift trust has the potential to afford a beneficiary a significant amount of creditor protection. A trio of cases is instructive in this regard; they are (i) *Nichols v. Eaton*, 91 U.S. 716 (1875), (ii) *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997), and (iii) *Scheffel v. Krueger,* 782 A.2d 410 (N.H. 2001).

E. *Nichols v. Eaton*, 91 U.S. 716 (1875)

1. It was actually not until 1875, with the Supreme Court decision in *Nichols v. Eaton*, that a break with the English common law on spendthrift trusts was affected, and their validity became generally accepted throughout the United States.

2. The theoretical basis underlying the general acceptance of the validity of spendthrift trusts in the United States, as demonstrated by the Supreme Court in *Nichols*, is the idea that an individual should be able to transfer property subject to certain limiting conditions upon which the property will be available to the beneficiary. In this regard, the maxim "*cujus est dare, ejus est disponere*," or "[w]hose it is to give, his it is to dispose" is frequently cited in connection with references to the validity of spendthrift trust restrictions.

3. In *Nichols*, the trust in question was a testamentary trust established by a mother for her son, who had failed in business and who had assigned all of his property for the benefit of his creditors and then later filed for bankruptcy. The mother's will included a provision that stated that if any of her sons should "alienate or dispose of the income to which they were entitled under the trusts of the will, or if, by reason of bankruptcy or insolvency, or any other means whatsoever, said income could no longer be personally enjoyed by them respectively, but the same would become vested in or payable to some other person, then the trust expressed in said will concerning so much thereof as would so vest should immediately cease and determine. In that case, during the residue of the life of such son, that part of the income of the trust fund was to be paid to the wife and children, or wife or child, as the case might be, of such son, and in default of any objects of the last-mentioned trust, the income was to accumulate in augmentation of the principal fund." *Nichols* at 718.

4. In establishing the modern rule with regard to spendthrift trusts, the Supreme Court in *Nichols* stated that:

"[w]e concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate...We also admit that there is a just and sound policy...to protect creditors against frauds upon their rights...But the doctrine, that the owner of property...cannot so dispose of it, but that the object of his bounty...must hold it subject to the debts due his creditors...is one which we are not prepared to announce as the doctrine of this court." *Nichols* at 725.

F. *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997)

1. The defendant in *Sligh v. First National Bank of Holmes County* was a beneficiary of two spendthrift trusts which had been established by his mother. The defendant was operating a vehicle while intoxicated and was involved in a motor vehicle accident which left the plaintiff paralyzed with the loss of the use of both legs, loss of all sexual functions and loss of the ability to control bowel and urinary functions. The plaintiff won a $5 Million civil judgment against the defendant for compensatory and punitive damages and tried to collect against the trusts alleging that the defendant's mother had actual knowledge that the defendant was an alcoholic and had created the trusts to shield his interest from the likely claims of involuntary tort creditors. The defendant had no other assets aside from his beneficial interests in the trusts.

2. The plaintiff 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 urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors. The Mississippi Supreme Court ultimately allowed the plaintiff to collect against the trusts by concluding that spendthrift protection should not extend to judgments for "gross negligence and intentional torts."

3. Most significant, however, is the fact that the Mississippi legislature promptly negated the import of *Sligh* in future cases through enactment of the "Family Trust Preservation Act of 1998." Miss. Code Ann. §§ 91-9-501, *et seq.* (1998). That act provides that except in the case of a self-settled trust, a beneficiary's interest in a spendthrift trust may not be transferred nor subjected to a money judgment until paid to the beneficiary.

G. *Scheffel v. Krueger,* 782 A.2d 410 (N.H. 2001)

1. In *Scheffel v. Krueger*, the defendant was a convicted child molester who was the beneficiary of a discretionary spendthrift trust established by his grandmother in 1985. The plaintiff filed suit in 1998 asserting tort claims

against the defendant in connection with the molestation charges and seeking an attachment of the defendant's beneficial interest in the discretionary spendthrift trust. Under the terms of the trust, all income was to be distributed to the defendant annually and distributions of principal were to be made in the Trustee's discretion. The defendant had the power to invade the principal of the trust only following his fiftieth birthday on April 6, 2016.

2. The court found no basis for relief for the plaintiff and held that nothing in the language of the relevant statute suggested that the legislature intended to exempt a tort creditor from a spendthrift provision.

3. The court also found that the defendant's ability to direct trust income and principal after attaining age fifty did not in and of itself disqualify the trust as a spendthrift trust.

H. Uniform Trust Code

1. Article 5 of the Uniform Trust Code addresses the validity of spendthrift provisions and the rights of creditors against a beneficiary's interest in a spendthrift trust. Some form of the Uniform Trust Code has been adopted by the following twenty two states (as well as the District of Columbia): Alabama, Arizona, Arkansas, Florida, Kansas, Maine, Missouri, Michigan, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia and Wyoming. A number of other states have either introduced bills or are reviewing bills to adopt the Uniform Trust Code.

2. Uniform Trust Code § 502(a) provides that a spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest. Accordingly, the settlor may not permit a beneficiary to assign trust assets while prohibiting a beneficiary's creditors from collecting on an involuntary basis. Pursuant to Uniform Trust Code § 502(b), a statement that the beneficiary's interest is held subject to a "spendthrift trust" is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.

3. Uniform Trust Code § 504(b), provides that whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion even if the discretion has been expressed in the form of a standard of distribution or the trustee has abused the discretion; however, in certain cases a court may compel a distribution. For example, under Uniform Trust Code § 504(c)(1), in specified circumstances the court may order discretionary distributions that the beneficiary's child, spouse, or former spouse can reach.

4. Uniform Trust Code § 503 sets forth exceptions to the spendthrift provision, which are discussed in detail below.

I. Exception Creditors

1. Exception creditors are creditors whose claims are "excepted" from spendthrift trust protections under certain circumstances.

2. Exception creditors sometimes include:

   a. creditors with claims for necessaries provided to the beneficiary

   b. creditors with claims for services to protect the beneficiary's interest in the trust

   c. claims by a governmental entity

   d. spouses with support claims

   e. children with child support claims

   f. (very rarely) involuntary tort creditors

3. Exception creditors vary based on the applicable law

   a. Uniform Trust Code § 503 provides for the following exception creditors:

      i. The beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance.

      ii. A judgment creditor who has provided services for the protection of a beneficiary's interest in the trust.

      iii. The state or the United States to the extent a statute of the state or federal law so provides.

4. The exception for spousal support claims and the claims of dependent children is recognized in both the Restatement of the Law of Trusts and, to a significantly lesser extent, the Uniform Trust Code

   a. Section 59, Paragraph (a) of the Restatement (Third) of Trusts (2003), provides that "[t]he interest of a beneficiary in a valid spendthrift trust can be reached in satisfaction of an enforceable claim against the beneficiary for support of a child, spouse, or former spouse." This Section is carried forward from § 157 of the Restatement (Second) of Trusts (1959), which provided that "[a]lthough a trust is a spendthrift trust or a trust for support, the

interest of the beneficiary can be reached in satisfaction of an enforceable claim against the beneficiary by the wife or child of the beneficiary for support, or by the wife for alimony."

b. Uniform Trust Code § 503(b) provides that "[e]ven if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment or court order against the beneficiary for support or maintenance...may obtain from a court an order attaching present or future distributions to or for the benefit of the beneficiary."

i. The comment to this section of the Uniform Trust Code notes, however, that the quoted subsection "does not authorize the spousal or child claimant to force a sale of the beneficiary's interest." Instead, Uniform Trust Code § 504(c) (which deals with discretionary trusts as opposed to spendthrift trusts), provides that "[t]o the extent a trustee has not complied with a standard of distribution or has abused a discretion: (1) a distribution may be ordered by the court to satisfy a judgment or court order against the beneficiary for support or maintenance of the beneficiary's child, spouse, or former spouse; and (2) the court shall direct the trustee to pay to the child, spouse, or former spouse such amount as is equitable under the circumstances but not more than the amount the trustee would have been required to distribute to or for the benefit of the beneficiary had the trustee complied with the standard or not abused the discretion."

V. Planning With Spendthrift (and Discretionary) Trusts

A. *Inter vivos* QTIP Trusts

1. A basic tenet of estate planning (particularly prior to portability) is that each spouse should own sufficient assets in his or her own name to utilize his or her own estate tax exemption. However, due to the possibility that the transferee spouse may have existing or potential future creditor issues, an outright transfer from the "monied" spouse might be ill advised from an asset protection perspective. An alternative is to effect the transfer into an *inter vivos* QTIP trust.

2. If the settlor-spouse survives the donee spouse the trust may continue for the settlor's benefit. Technically, this might be thought to result in a self-settled trust which, in most states, would then be available to the settlor's creditors.

a. While Treas. Reg. § 25.2523(f)-1(f), Ex. 11 provides that assets held in trust for the settlor's benefit after the donee spouse's death will not be includable in the settlor's estate under Sections 2036 and 2038, the question of the availability of those assets to the settlor's creditors may not necessarily follow from the estate tax result

i. A number of states have, however, enacted legislation to provide that such trusts will not be treated as self-settled trusts in the hands of the donor spouse. Those states include: Arizona, Delaware, Florida, Michigan, North Carolina, Ohio, Texas, Virginia and Wyoming.

3. The enactment of "portability" under The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, which was made a permanent feature of the tax law under The American Taxpayer Relief Act of 2012, does not negate the need for an *inter vivos* QTIP trust to be used for estate tax planning and asset protection planning purposes. Specifically, there are a number of shortcomings inherent in the use of portability as a planning device, as follows:

a. Portability governs only the federal estate tax exemption, and not the state estate tax exemption on estate taxes imposed in a substantial minority of states, as well as the District of Columbia.

b. The deceased spousal unused exclusion amount is not indexed for inflation, and even if it were indexed for inflation, it would likely not keep pace with actual appreciation.

c. Portability requires an affirmative election, without any opportunity for redress in the event of a failure to make a timely election; in addition, the election is made on an estate tax return, which might not otherwise be required, and which might expose matters to scrutiny by the Internal Revenue Service which would not otherwise have been exposed.

d. The GST exemption is not portable, and those estates that are large enough to benefit from portability are also likely large enough to require generation-skipping transfer tax planning.

e. Portability is only available for the estate tax exemption of the last predeceased spouse – thus, reliance upon portability will waste the predeceased spouse's unused exemption if the surviving spouse remarries and then survives his or her new spouse.

B. Qualified Personal Residence Trusts ("QPRTs") (and GRATs, GRUTs GRITs and Charitable Split-Interest Trusts)

1. An example of a "traditional" type of estate planning trust which provides a potentially significant asset protection benefit by converting the settlor's outright ownership of property into a less attractive retained interest is the "qualified personal residence trust" as described under Internal Revenue Code § 2702(a)(3)(A)(ii) and as defined by Treas. Regs. § 25.2702-5(c).

   a. In brief, a qualified personal residence trust leverages the gift tax cost of a donative transfer of the settlor's personal residence to a trust by valuing the gift after reduction for the settlor's retained right to reside in the residence for a set period of years.

2. From an asset protection perspective, by creating the trust the settlor has arguably transmuted his interest in real property from an absolute interest, subject to foreclosure and sale, into a mere right to reside in the residence for a term of years.

   a. Moreover, the settlor's right to reside in the property may be coincident to a concurrent right of the settlor's spouse (who may not be subject to the same creditor claims) to reside in the property if the settlor's spouse also has an interest in the residence.

      i. Where the settlor does not have a spouse with a concurrent right to the use of the residence (or where the settlor's spouse is subject to the same creditor claims), a creditor may be able to cause a sale of the property within the trust, which (under a properly drafted qualified personal residence trust) would have the effect of converting the trust from a qualified personal residence trust into a grantor retained annuity trust (or "GRAT") under Internal Revenue Code §2702(b)(2) for the remainder of its initial term of years.

      ii. Even then, however, the annuity interest which the creditor can reach is substantially less valuable than an immediate right to possess the entire corpus of the trust, and may even be fully protected from creditors under a possible state law exemption for annuities. *See*, *infra*.

         - Of course, a grantor retained annuity trust can also be used for asset protection in its own right and without being a converted qualified personal residence trust. Similarly, a grantor retained unitrust, or a grantor retained income trust or

charitable split-interest trust can also be used for such purpose.

iii. Note that the creditor protection inherent in a QPRT (or a GRAT, or a charitable remainder trust (a "CRT")), should increase with the passage of time as the initial term, and hence the retained interest diminishes.

3. It may also be advisable to create the trust in a jurisdiction that permits self-settled spendthrift trusts in order to protect even the settlor's retained interest.

a. Moreover, in certain self-settled spendthrift trust jurisdictions, the legislation specifically provides that the retained interest shall not be subject to the settlor's creditors.

i. For example, in New Hampshire, which (as is typical) requires a self-settled spendthrift trust to be irrevocable, New Hampshire Statutes § 564-D:2 specifically provides that the trust instrument shall not be deemed revocable on account of the inclusion in the trust instrument of any one of the following rights (amongst others):

- The transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument.

- The transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust

- The transferor's potential or actual receipt or use of real property held under a personal residence trust.

- The transferor's potential or actual receipt or use of a qualified annuity interest.

b. Of course, since a personal residence is almost certainly immovable property, governing conflict of laws principles will provide for the law of the situs of the real estate to govern, rather than the law designated by the settler as governing the trust. Therefore, if the personal residence is located in a jurisdiction that does not itself provide for self-settled spendthrift trusts, one might consider creating a single member limited liability company to own the personal residence prior to any transfer to the QPRT.

i. The single member limited liability company will be disregarded for all federal tax purposes, but should be given effect for state law property purposes.

4. It should be noted, however, that a transfer of the settlor's principal residence to a qualified personal residence trust may, in certain circumstances, be inappropriate. For example, the settlor may be domiciled in a state with an unlimited homestead exemption which may or may not extend to a residence held in a qualified personal residence trust. *See*, *infra*. Similarly, the settlor may own the real estate together with the settlor's spouse as tenants by the entirety which may afford greater protection than would the qualified personal residence trust. *See*, *supra*.

C. Trusts Under Wills

1. Marital Trusts

a. Typical last wills and testaments for married couples of a certain net worth will provide for a so-called "credit shelter trust" to be funded at the death of the first spouse to die. The balance of the deceased spouse's estate will then pass to the surviving spouse either outright or in a trust that is intended to qualify for the unlimited marital deduction. This structure ensures that no federal estate tax is payable until the death of the surviving spouse.

i. Note that an outright transfer of assets to the surviving spouse (who is a United States citizen) automatically qualifies for the marital deduction whereas a transfer in trust must satisfy certain requirements in order to qualify (Internal Revenue Code § 2056).

b. Of course, any outright transfer to the surviving spouse will be subject to the surviving spouse's creditors. Thus, a marital trust is in almost all situations preferable to an outright disposition of the marital share because it can provide a significant level of asset protection.

c. The inherent difficulty with using a trust to hold the marital share lies in the client's possible perception that a trust will be overly restrictive for the surviving spouse. Although the same issue exists with a credit shelter trust, the tax benefits of a credit shelter trust are well recognized and will usually serve to overcome any negative perception.

d. The client's resistance to a marital trust can be overcome fairly easily, however, by structuring the marital trust so that it is

extremely flexible. This flexibility will give the married couple comfort that the surviving spouse will still have access to the marital share even though it is held in trust.

e. Some examples of the flexibility that can be incorporated into a marital trust include:

i. Naming the surviving spouse as a co-trustee of the marital trust;

ii. Providing for a broad distribution standard (*i.e.*, distributions may be made for "any purpose"), rather than a more restrictive distribution standard (*i.e.*, distributions may be made only for the surviving spouse's health, education, welfare and maintenance");

iii. Providing the surviving spouse with the ability to remove and replace his or her co-trustee by naming the surviving spouse as the "Protector" of the trust. This will provide the surviving spouse with the necessary leverage over the trustee in order to ensure significant access to trust assets; and

iv. Giving the surviving spouse a testamentary power of appointment, which power can be broad or limited to the decedent's descendants.

f. As with any trust, of course, care must be taken not to unintentionally undermine the spendthrift protection otherwise provided by the trust.

i. The beneficiary should not be named as the sole trustee of the trust, because the beneficiary's ability, as trustee, to exercise discretion in making distributions to himself or herself, would likely cause a creditor to be able to reach the trust property subject to such discretion.

ii. Section 60 of the Restatement (Third) of Trusts provides that "...if the terms of a trust provide for a beneficiary to receive distributions in the trustee's discretion, a transferee or creditor of the beneficiary is entitled to receive or attach any distributions the trustee makes or is required to make in the exercise of that discretion after the trustee has knowledge of the transfer or attachment. The amounts a creditor can reach may be increased where the beneficiary...holds the discretionary power to determine his or her own distributions." The Restatement provides the following examples:

iii. "S's will leaves his residuary estate to his daughter D, as trustee, "to pay income or principal to or for the benefit of anyone or more of D, her children, and their issue in such amounts, if any, as the trustee deems appropriate and desirable for the particular beneficiary's support, education, and care, taking account of the beneficiary's other resources if and to whatever extent the trustee deems appropriate. D's creditors may reach the maximum amount of trust funds that she may, without abuse of her discretion, distribute to herself for the authorized purposes...without reduction for other resources available to her for those purposes, but subject to a possible reservation the court may make for D's actual support needs." Restatement (Third) of Trusts § 60, cmt. g, illustration 9 (2003).

iv. If, however, "...T serves as co-trustee with D, and they together hold the discretionary power to determine trust distributions ....[t]he special rule of this Comment does not apply." Restatement (Third) of Trusts § 60, cmt. g, illustration 10 (2003).

v. The question as to whether the beneficiary can also be the protector without negatively impacting the trust's asset protection, however, is a question addressed in only a few cases.

vi. In the Bankruptcy context, § 541(b)(2) of the Bankruptcy Code provides that "[p]roperty of the estate does not include any power that the debtor may exercise solely for the benefit of any entity other than the debtor." By implication, therefore, a power that the debtor may exercise in whole or in part in favor of the debtor might render the property subject to the power includible in the bankruptcy estate. In at least one case, *In re Cattafi*, 237 B.R. 853 (Bankr. M.D. Fla., 1999), it was held that a broad power to remove the trustee was sufficient control to compel inclusion of the trust's assets in the bankruptcy estate. However, in a second case, *In re Parrish*, 11 B.R. 65 (Bankr. N.D. Tx, 1981), it was held that the power to remove the trustee was not a power that "conferred a benefit upon the beneficiary".

vii. Again in the Bankruptcy context, § 541(c)(2) of the Bankruptcy Code provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is

enforceable in a case under this title." In the matter of *In re Herzig*, 167 B.R. 707 (Bankr. Mass. 1994), the debtor was the beneficiary of an ostensibly spendthrift trust established for his benefit under New York law pursuant to the terms of his mother's will. The will named the debtor's brother as trustee, but gave the debtor the power to require his brother's resignation as trustee, in which case the debtor's wife would become the successor trustee provided that she was living with debtor at such time. Although the *Herzig* court noted that neither the debtor's brother nor his wife could "...be considered an alter ego of the Debtor nor under his control," on the basis that the "...Debtor could...take up residence elsewhere, require [his brother] to resign, refuse to agree to the appointment of a successor to [his brother], and [thereby] obtain the Trust assets..." the spendthrift aspect of the Trust was destroyed and the trust was available to the debtor's creditors.

viii. Outside of the Bankruptcy context, in *F.T.C. v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999), the U.S. District Court for the District of Nevada held the settlors in contempt of court for failing, pursuant to a preliminary injunction, to repatriate trust assets that had been invested offshore in the name of the foreign co-trustee of the asset protection trust. In large part, this determination was based upon the fact that the settlors were the protectors of the trust. Specifically, the court found that the settlors, in their purported attempt to comply with the district court's order to repatriate trust assets either intentionally invoked (or at least intentionally failed to preclude the invocation of), an "anti-duress" clause in the trust agreement which then ensured that the assets would not be repatriated pursuant to the district court's order. In an appeal of the District Court's determination to hold the settlors in contempt, the Ninth Circuit Court of Appeals stated that "[t]he provisions of the trust also make clear that the [settlors'] position as protectors gives them control over the trust since whether or not an event of duress has occurred depends upon the opinion of the protector. It is clear that the [settlors] could have ordered the trust assets repatriated simply by certifying to the trustee that in their opinion, as protectors, no event of duress had occurred."

ix. Conversely, in *United States v. Raymond Grant and Arline Grant*, 2008 U.S. Dist. LEXIS 51332, U.S. District Ct., S.D. Florida May 27, 2008, the District Court held

that the protector-beneficiary of a foreign trust could not be held in civil contempt for failing to repatriate the trust's assets pursuant to a court order because she had established that, notwithstanding her authority as protector, she was unable to effect the repatriation of the trust's assets.

x. Finally, in *In re Baldwin*, 142 B.R. 210 (Bankr. S.D. Ohio 1992), which involved a purely domestic trust that was not self-settled, the debtor-beneficiary's right to remove and replace the trustee of a trust otherwise purporting to be a spendthrift trust was held to constitute a level of dominion and control over the trust assets such that the spendthrift clause was held invalid because the right to remove and replace the trustee with a "corporate trustee" was not limited to bank and trust companies.

xi. Similarly, in *Simpson v. Department of Social Rehabilitation Services*, 21 Kan. App.2d 680 (1996), the beneficiary of a non-self settled discretionary trust held a power to remove the trustee without cause, and such power was determined to be sufficient control over the trust's assets to deny the beneficiary financial assistance for medical costs under a Kansas needs based benefit program.

g. Once the requisite comfort level is reached, the couple can be made to understand that the use of a marital trust, instead of an outright bequest, actually enhances the availability of the inheritance to the surviving spouse because the marital trust renders the property unavailable to involuntary creditor claims.

2. Lifetime Trusts for Descendants

a. Frequently last wills and testaments (or revocable "living" trusts intended as a will substitute) provide for distributions to children and more remote descendants to be made either outright, if the children or more remote descendants that are expected to inherit are of a certain age and financial maturity, or in trusts that terminate at a specified age at which the children or more remote descendants that are expected to inherit are presumed to be of an appropriate financial maturity.

b. Providing for the outright distribution of assets to descendants at any age, no matter how financially mature the descendants might be at that age, has several adverse aspects:

i. A descendant may be in a bad marriage, or in the middle of a divorce (or already divorced with a support obligation to an ex-spouse), and property distributed out of trust will potentially lose any protection that it might otherwise have from the claim of an ex-spouse.

ii. A descendant may have other third-party creditor issues, and property distributed out of trust will lose the significant creditor protections that it would have had if left in trust.

iii. A certain amount of property, equal to the transferor's generation-skipping transfer tax exemption, can be retained in trust for the lifetime of the transferor's children, and can then pass to the transferor's grandchildren free of any further transfer tax at the death of the children. To the extent that such property was instead made distributable to the transferor's children outright, the opportunity afforded by the transferor's generation-skipping transfer tax exemption would have been wasted.

c. Again, as noted above, the difficulty with using trusts, and in particular these types of "lifetime trusts" for descendants, is the possible perception that a trust structure would be overly restrictive.

d. Again, as noted above, any resistance to lifetime trusts for descendants can generally be overcome by structuring these trusts so that they are extremely flexible, and by providing descendants with "leverage" over the trustee through the use of the Protector concept upon the descendant attaining a certain age.

e. In order to permit the uninhibited use of trust funds in a situation where the descendant may have an existing creditor issue, consider naming the beneficiary's spouse (and, in such capacity; *i.e.*, as the "descendant's spouse"), as an additional discretionary beneficiary of the descendant's trust. In this manner, the descendant's spouse might be used as a conduit for the use of the trust funds for the benefit of the descendant where a direct distribution to the beneficiary, or for the beneficiary's use or benefit, cannot be made.

f. Inasmuch as the post-2011 estate tax exemption may be more than sufficient to shelter the beneficiary's entire estate from federal estate tax, even if the beneficiary's trust were includible in the beneficiary's estate, consider providing the trustee with the

power to grant the beneficiary a testamentary general power of appointment over the trust property for the purpose of causing estate tax inclusion and, thus, a "stepped-up" basis in the trust's assets.

i. It is most appropriate to provide the trustee the authority to grant a general power of appointment, rather than to provide a general power of appointment by formula, because property subject to a general power of appointment *may* be subject to the claims of the donee's creditors. Specifically, since the donee of a general power of appointment can grant himself or herself a beneficial interest in the property subject to the power, under certain circumstances the property will be subject to the claims of the donee's creditors.

- In Alabama, for example, "[e]very special and beneficial power is liable to the claims of creditors, and the execution of the same may be ordered for their benefit." Code of Ala. §35-4-305 (2009).

- Similarly, in New York, "[p]roperty covered by a general power of appointment which is presently exercisable, or of a postponed power which has become exercisable, is subject to the payment of the claims of creditors of the donee, his estate and the expenses of administering his estate. It is immaterial whether the power was created in the donee by himself or some other person, or whether the donee has or has not purported to exercise the power." N.Y. Est., Powers & Trusts §10-7.2 (2005).

- In Tennessee, "[w]hen the unlimited power of disposition, qualified or unqualified, not accompanied by any trust, is given expressly, in any written instrument, to the owner of any particular estate for life or years, legal or equitable, such estate is changed into a fee absolute as to right of disposition, and rights of creditors and purchasers." Tenn. Code. Ann. §66-1-106 (2009).

- A similar rule governs in the bankruptcy context; since the bankruptcy estate consists of "all legal or equitable interests of the debtor in property as of

the commencement of the case," a donee's general power of appointment is available to the donee's creditors in bankruptcy. *See*, 11 USC §541(a)(1); In re Shurley, 171 B.R. 769 (Bankr. W.D. Tex. 1994) (because a general power of appointment can be exercised for the benefit of the donee herself, it is included in the donee's bankruptcy estate), rev'd on other grounds, 115 F.3d 333 (5th Cir. 1997).

ii. The general rule is, however, to the contrary and to the effect that, absent a statute to the contrary, not even property subject to a general power of appointment can be reached by the donee's creditors (provided that the donee was not also the creator of the general power) until the power is actually exercised by the donee.

- "Traditionally, it has been thought that if the donee of a general power created by someone else failed to exercise the power, the donee's creditors could neither acquire the power, compel its exercise, nor reach the property subject to the power." 3 Scott and Ascher on Trusts § 14.11.3 at 888-89 (5th ed. 2008).

- See, e.g., *Gilman v. Bell*, 99 Ill. 144 (Ill. 1881), wherein the court stated that "[n]o title or interest in the thing vests in the donee of the power until he exercises the power. It is virtually an offer to him of the estate or fund, that he may receive or reject at will, and like any other offer to donate property to a person, no title can vest until he accepts the offer, nor can a court of equity compel him to accept the property or fund against his will, even for the benefit of creditors...Until accepted, the person to whom the offer is made has not, nor can he have, the slightest interest or title to the property. So the donee of the power only receives the naked power to make the property or fund his own. And when he exercises the power, he thereby consents to receive it, and the title thereby vests in him, although it may pass out of him *eo instante*, to the appointee. *Id.* at 149-150.

D. Contingent Marital Trusts Under GRATs and QPRTs

1. Both grantor retained annuity trusts ("GRATs") and qualified personal residence trusts ("QPRTs") have an "estate tax inclusion period" (generally referred to as an "ETIP") during which the trust fund would be included in the settlor's gross estate if the settlor should die.

2. Inasmuch as the trust fund of a GRAT or QPRT (referred to here in the collective as an "ETIP Trust"), will be subject to taxation as part of the settlor's estate in the event that the settlor should die during the estate tax inclusion period, these trusts commonly provide that the balance of the trust fund will be payable to the settlor's estate in such event. A significant benefit of paying over the trust fund to the settlor's estate in the event of the settlor's death during the estate tax inclusion period is the ease with which it coordinates allocation of appropriate portions of the settlor's estate under the settlor's last will and testament between: (i) the credit shelter trust, the marital share and, in many cases, a reverse QTIP trust, in the event that the settlor's spouse shall have survived the settlor, or (ii) between generation-skipping transfer tax exempt and generation-skipping transfer tax non-exempt trusts for the settlor's descendants in the event that the settlor's spouse shall not have survived the settlor.

3. When factoring in asset protection concerns, however, it becomes clear that the trust should not be payable to the settlor's estate even if the settlor should die during the estate tax inclusion period. Instead, the ETIP Trust should provide, as follows:

   a. For a separate QTIP trust, within the ETIP Trust, should the settlor die survived by the settlor's spouse during the estate tax inclusion period.

      i. By drafting QTIP trust provisions directly into the ETIP Trust, the unlimited marital deduction can be obtained without unnecessarily exposing the ETIP Trust property to the creditors of the settlor's estate if the settlor has developed creditor problems since the original funding of the ETIP Trust. To the extent that there is insufficient other property remaining in the settlor's estate to fully fund the credit shelter trust under the settlor's last will and testament, the advisor has two options, as follows:

         - Carefully draft for a formula allocation of the property held in the ETIP Trust so as to allocate between a separate QTIP trust under the ETIP Trust and a separate credit shelter trust under the ETIP Trust, after accounting for all other property included in the settlor's estate

- To provide the settlor's executor with authority to split the QTIP trust under the ETIP Trust into separate shares and to make a QTIP election only with respect to one of those separate shares.

b. For a separate trust (or separate trusts) for descendants, within the ETIP Trust, should the settlor die survived by descendants, but not by the settlor's spouse, during the estate tax inclusion period.

i. By drafting a separate trust (or separate trusts) for descendants directly into the ETIP Trust, creditor protection can be obtained if the settlor has developed creditor problems since the original funding of the ETIP Trust.

E. Trusts and Retirement Benefits

1. As noted above, many courts which have considered, under state law, the issue of whether an inherited IRA should receive the same protection from creditors of the beneficiary as an IRA would receive from the creditors of the original owner have determined that inherited IRAs do not receive such creditor protection.

2. As it remains at least unclear (depending upon (i) the jurisdiction, (ii) whether the dispute is determined under federal or state law, and (iii) what further appellate courts may ultimately decide), whether an inherited IRA will be exempt from creditors, clients concerned about providing creditor protection to their children or other designated beneficiaries should be advised as to the advantages of designating a trust as the beneficiary of their IRAs. A trust which is designated as the beneficiary of an IRA, and which provides spendthrift protection to the beneficiaries of the trust, whether pursuant to the terms of the trust instrument or pursuant to state law, can provide significant protection to the funds held in the inherited IRA until distribution irrespective of whether an inherited IRA itself is treated as being exempt from creditors. Such a trust may be created inter vivos, or under the account owner's last will and testament or revocable living trust agreement.

a. The following types of trusts should be considered as being named as the beneficiary of an IRA:

i. Irrevocable Discretionary Spendthrift Trusts/ Accumulation Trusts

- A completely discretionary irrevocable trust with a spendthrift clause will provide the most

substantial protection from the claims of a beneficiary's creditors.

- The beneficiary will not have the power to compel distributions from the trust, making the beneficiary's interest in the trust sufficiently tenuous so that it does not qualify as a property right which is subject to attachment by creditors.

- Additionally, a purely discretionary trust may also be the best option for a client whose primary estate planning objective is to pass wealth to future generations inasmuch as no distributions need actually be made. Although the trustee will be required to take mandatory distributions from the inherited IRA, the trustee will have the ability to accumulate such distributions within the trust and invest them for future generations where a distribution to the trust beneficiary is not appropriate or desirable.

ii. Conduit Trusts

- A conduit trust is a trust which, as its name suggests, acts as a conduit for the distributions from the inherited IRA by receiving the required distributions from the inherited IRA and then paying them out to the beneficiary of the trust on a current basis.

- A conduit trust will not provide as much protection from the claims of the beneficiary's creditors as a trust in which the trustee's ability to make distributions is completely discretionary since the trustee will be required to make current distributions of the minimum required distribution from the conduit trust to the beneficiary and, once the minimum required distribution is made from the conduit trust to the beneficiary, the distributed amount is subject to the claims of the beneficiary's creditors.

- However, conduit trusts do provide certain advantages over purely discretionary trusts:

  - The main advantage of a conduit trust is that, if properly drafted, it is clear that the

beneficiary receiving the mandatory distributions from the trust will be the individual whose life expectancy is used to determine the amount and timing of the mandatory distributions from the inherited IRA.

- In contrast, where a purely discretionary trust is the designated beneficiary of an inherited IRA, the age of the oldest beneficiary will need to be used in calculating the mandatory distributions, even if such beneficiary is merely a contingent beneficiary, or is merely a permissible appointee under a special power of appointment given to the primary beneficiary, and non-individual beneficiaries (such as charities), may not be beneficiaries of such trust.

iii. Additionally, a purely discretionary trust may subject the assets in the inherited IRA to greater income tax than a conduit trust, as the trust will be liable for the income tax (unlike a conduit trust, in which the beneficiary is liable for the income tax by reason of the current distribution out of the conduit trust to the beneficiary), thus subjecting such distributions to tax at significantly more compressed brackets.

- In order to provide increased asset protection, a conduit trust could include a class of beneficiaries as opposed to a single beneficiary and provide that the trustee may "sprinkle" trust assets among the class of beneficiaries. If one beneficiary has asset protection concerns, then the trustee could simply avoid making distributions to that beneficiary and instead spread the mandatory distributions among the other beneficiaries.

VI. Utilization of One's Lifetime Gift Tax Exemption – To Save Taxes *and* for Asset Protection Purposes

A. Tax Planning vs. Asset Protection

1. Many of the structures that are used to maximize planning with the lifetime gift tax exemption also provide potentially significant asset

protection benefits by (i) divesting the settlor of an asset, or (ii) converting the settlor's outright ownership of an asset into either (a) a less attractive retained interest, or (b) an entirely different type of property which is less attractive to creditors.

2. Moreover, the asset protection benefit of such structures is enhanced by the fact that since these structures are ubiquitous as estate planning vehicles, they are much less controversial and prone to scrutiny than so-called "asset protection trusts."

3. Finally, since these structures provide undisputedly significant estate and gift tax savings, they can help to counter potential creditor claims to the effect that transfers in connection with the structures were made with the intent (or at least the sole intent) to hinder, delay or defraud creditors (*i.e.*, a fraudulent transfer).

B. Dynasty Trusts

1. A "dynasty trust" might be defined as a trust which is intended to be generation-skipping transfer ("GST") tax exempt and which will continue, at a minimum, for a period beyond the lifetime of the settlor's children.

2. The term of a dynasty trust can be the maximum term allowed under the applicable Rule Against Perpetuities; in a jurisdiction which has abolished the Rule Against Perpetuities, a dynasty trust can last forever.

   a. The Rule Against Perpetuities period is most states provides, generally, that a trust cannot continue beyond twenty-one years after the death of an individual living at the time of the trust's creation.

   b. In order to attract trust business, more than one half of the states have either repealed or substantially modified the Rule Against Perpetuities, thereby encouraging dynasty trusts. Of those states, a number of states, such as Alaska, Delaware, Florida, New Hampshire, Nevada, Ohio, South Dakota and Wyoming, also do not impose a state income tax on trust income.

3. A dynasty trust can be created by *inter vivos* or testamentary transfer. The advantage of an *inter vivos* dynasty trust is that it allows any appreciation between the date of the transfer and the date of the settlor's death to avoid estate taxation, thereby leveraging the settlor's gift and estate tax exemption and the settlor's GST tax exemption. Also, it is obviously only with an *inter vivos* dynasty trust that the assets used to fund the dynasty trust will avoid creditor claims against the settlor (assuming, of course, that the funding of the dynasty trust is not later found to have been a fraudulent transfer).

4. The trustees of a dynasty trust are usually given discretion to distribute income and/or principal to a class of beneficiaries which includes the descendants of the settlor and can also include the settlor's spouse. One of the purposes of naming the settlor's spouse as a discretionary beneficiary of the dynasty trust (a so-called spousal lifetime access trust or "SLAT") is to enable the settlor to indirectly benefit from the trust fund, within the trustees' discretion, if the settlor should so require (*i.e.*, a distribution can be made to the settlor's spouse within the trustees' discretion, and the settlor's spouse might then use the distribution for the settlor's benefit, or even transfer the distributed property to the settlor's spouse, if the settlor's spouse is so inclined).

   a. In order to facilitate cooperation by the trustees, the settlor may act as the "Protector" of the dynasty trust and hold the power to remove and replace the trustees.

   b. Obviously, in the event of a divorce, or in the event that the settlor's spouse should predecease the settlor, this avenue of accessing the trust fund would become unavailable to the settlor. This problem can be ameliorated, however, by naming "the Settlor's Wife" or "the Settlor's Husband" as the beneficiary, rather than including the actual name of the settlor's spouse as a beneficiary of the dynasty trust. This is sometimes called a "floating spouse" clause and it obviously defines the beneficiary, in effect, as the person to whom the settlor is married at the time reference might be made. Therefore, in the event that the settlor is no longer married to the person he or she was married to at the time of the creation of the dynasty trust, whether by reason of the spouse's untimely death or by reason of a divorce, the settlor can regain access to the dynasty trust by remarrying.

   c. In addition, the dynasty trust can also include a "revisions of interests" provision that would provide the trustees with discretion, during the settlor's lifetime, to add or remove individuals as beneficiaries of the dynasty trust. Therefore, in the event of the settlor's spouse's untimely death or a divorce, and if the settlor should require access to the dynasty trust, the trustees would have the discretion to add the settlor as an additional beneficiary of the dynasty trust. This should not cause estate tax inclusion if the dynasty trust is created in a state, such as Alaska, Delaware, Nevada, South Dakota, or in one of the other states that permits so-called "self-settled spendthrift trusts". The existence of such a power might, however, cause the trust to be taxed as a grantor trust.

5. Advantages of Dynasty Trusts:

a. Trust assets are not available to the settlor's potential future creditors.

b. Trust assets are not generally available to the beneficiaries' creditors under state spendthrift trust law.

c. Property is made available for successive generations of descendants without the imposition of estate or gift taxation; and

d. The lifetime use of the settlor's GST tax exemption amount will avoid the imposition of generation-skipping transfer taxation for so long as the property remains in trust.

C. Leveraging the Lifetime Gift Tax Exemption to Enhance Trust Benefits

1. Discounting

a. After years of challenging discounts in the family transfer context, in 1993 the Internal Revenue Service issued Rev. Rul. 93-12, IRB 1993-7 recognizing (at least in theory), the applicability of such discounts.

b. Upon the transfer of a limited partnership interest or limited liability company membership interest, the transferor may be entitled to certain discounts off of a proportionate share of the value of the company's underlying assets. The two most important of such discounts are (i) a discount for a lack of marketability, and (ii) a minority interest discount.

i. A lack of marketability discount is based on the inability to convert an interest into cash quickly with minimum transactional costs. For example, a closely-held business will generally have a smaller pool or buyers than an interest in a publicly traded company because the publicly traded stock is readily available to buy and sell on an established stock exchange.

ii. A minority interest discount is based on the lack of control that accompanies the ownership of a minority interest (*i.e.*, fifty percent or less of the voting interest in the business). Typically only a majority interest owner in a business will have the authority to make decisions relating to distributions, liquidation, management, etc. Accordingly, the owner of a minority interest has no control over the flow of distributions out of the business (amongst other things), and consequently has a less

valuable interest in the company than the majority interest holder who can typically make these decisions without the consent of the minority interest holders.

c. In addition, as noted above, a limited partnership or limited liability company structure may also provide an asset protection benefit based upon what is commonly known as a "charging order" protection.

2. Installment Sales

a. Another commonly utilized estate planning technique that offers asset protection benefits is the sale of property on credit to a "defective" or "grantor" type trust (including a dynasty trust).

b. Such sale provides a potentially significant asset protection benefit by converting the settlor's outright ownership of one type of property (*i.e.*, marketable securities), into an entirely different type of property which is likely less attractive to creditors (*i.e.*, an unsecured note receivable from the purchasing trust).

i. The trust's promissory note is likely to be less attractive to a creditor than the property sold for various reasons:

- In order to leverage the estate planning benefits of the sale, the promissory note likely provides only for the payment of interest for a term of years with a balloon payment of capital due at the end of the term.

- In addition, the differential between the applicable federal rate and the actual return on the transferred assets can be captured free of tax and protected from creditors in the trust. With the current federal "hurdle" rates at near historically low rates, the additional amount "transferred" in a loan transaction can be quite significant.

c. Alternatively, consider a sale in exchange for a private annuity if the transaction is governed by the law of a state that provides a substantial creditor exemption for annuities. In such a case, an asset protection benefit is conferred not only through the conversion of the settlor's outright ownership of one type of property (*i.e.*, marketable securities), into an entirely different type of property which is likely less attractive to creditors, but rather into a type of property that is actually exempt from creditors (*i.e.*, an annuity).

i. Florida, as but one example, fully exempts the annuity contracts from creditors. *See* Fla. Stat. §222.14.

- An effective use of a private annuity for asset protection planning under Florida's unlimited and broadly defined annuity exemption took place in *In re Mart*, 88 B.R. 436 (Bankr. S.D. Fla. 1988). In *Mart* the debtor's daughter-in-law established an irrevocable trust for the benefit of seven children, nieces and nephews of the debtor and minimally funded same with the sum of $2,000. The debtor's daughter was also appointed as trustee of the trust. The day after the trust was created, the debtor and his spouse entered into an annuity agreement with their daughter as trustee. In furtherance of the annuity agreement, the debtor and his spouse transferred the sum of $350,000 to the trust in exchange for a return stream of annuity payments in the amount of $3,000 per month. Thirteen months later, the debtor filed bankruptcy and claimed that the annuity was exempt under Florida Statute §222.14. The objecting creditors argued that: "if [the debtor's] income stream from the transfer of this property is an Annuity, any debtor can go to his cousin and give him all of his property in return for a promised stream of income. That debtor need only pull out his big rubber stamp with the word Annuity on it and label the agreement from his cousin to pay the money." *Id.* at 438. Notwithstanding the piquancy of this argument, the bankruptcy court in *Mart* dismissed this argument to find in favor of the debtor, explaining that: "I agree that this statutory exemption, perhaps like all exemptions, invites abuse. I also agree that the debtor's relationship with the...trustee, her evident willingness to accept her father's proposals, and the fact that this is a completely private arrangement are grounds for careful scrutiny...I reject the argument and the objections, however, because, (1) ...the statutory exemption is not restricted to annuities provided by completely unrelated, public entities, and (2) I find no intent to defraud creditors in this debtor's conversion of his non-exempt assets to exempt

assets through the establishment of this annuity contract." *Id.*

VII. Modifying Existing "Irrevocable" Trusts for Asset Protection Purposes

A. A trust modification may be desirable for asset protection purposes where the trust, as currently drafted, provides for the mandatory payment of income or principal to the beneficiary, or provides the beneficiary the right to withdraw income or principal (which is effectively either (i) a presently exercisable general power of appointment, or (ii) a self-settled trust, and, thus, subject to creditors in most jurisdictions), and the beneficiary either has existing creditor issues or anticipates the possibility of future creditor issues.

B. It may be possible to obtain the necessary modification through a court proceeding.

1. For example, in *In re Joseph Heller Inter Vivos Trust*, 613 N.Y.S.2d 809 (Surr. Ct., NY Co. 1994), the trustee of an *inter vivos* trust applied to the Surrogate's Court for a severance of the trust for the "novel purpose of insulating the trust's substantial cash and securities from potential creditor's claims that could arise from the trust's real property." *Id.* at 810. Of note is the trustee's express representation to the Surrogate's Court that there were no current claims and none threatened or reasonably anticipated. In ordering the trust to be severed in the manner requested, the *Heller* court stated that: "New York law recognizes the right of individuals to arrange their affairs so as to limit their liability to creditors, including the holding of assets in corporate form...making irrevocable transfers of their assets, outright or in trust, as long as such transfers are not in fraud of existing creditors...The most significant of the foregoing examples is the availability of renunciation for the sole purpose of defeating existing creditors' claims...Clearly, if New York law allows a beneficiary to defeat existing creditors by a renunciation, a trust can be severed for the purpose of limiting liability to nonexistent, but possible, future creditors." *Id.* at 810-811.

C. Alternatively, a trust "decanting" might be possible. Twenty-one states have enacted so-called "decanting" statutes to permit a trustee to exercise discretion in favor of another trust for some or all of the beneficiaries without consent of the beneficiaries and without a court proceeding.

1. Alaska

2. Arizona

3. Delaware

4. Florida

5. Illinois

6. Indiana

7. Kentucky

8. Michigan

9. Missouri

10. Nevada

11. New Hampshire

12. New York

13. North Carolina

14. Ohio

15. Rhode Island

16. South Carolina

17. South Dakota

18. Texas

19. Tennessee

20. Virginia

21. Wyoming

D. For trusts located in a state other than one of the twenty-one states that currently provides for "decanting", consider whether it is possible to change the situs to a state that permits decanting in order to take advantage of the other state's decanting statute.

E. Alternatively, consider whether there is:

1. A provision in the existing trust permitting a pour-over into a new trust.

2. A power to amend the old trust to achieve the desired result.

3. An *inter vivos* limited power of appointment in any beneficiary allowing him or her to appoint the trust property to a new trust.

a. A limited power of appointment is necessary in this regard to avoid potential gift tax consequences in connection with the

appointment if it adversely affects the power-holder's beneficial interest.

F. Where none of the foregoing flexibility exists, consider selling the trust assets to a new trust with more desirable terms in exchange for a promissory note.

1. While this technique still leaves value of original assets exposed to terms of existing trust, together with a return in the form of the interest charge, it does permit appreciation, in excess of the interest rate, to be retained in new trust with more advantageous terms.

VIII. SELF-SETTLED SPENDTHRIFT TRUSTS

A. Using "Asset Protection" Trusts for Estate Planning Purposes

1. Introduction

a. The basic objective of "estate planning" is to minimize estate, gift and generation-skipping transfer taxes to the greatest extent possible while remaining true to the client's dispositive wishes.

b. An estate planner's ability to minimize transfer taxes may be frustrated by the client's desire to retain access to his or her assets during lifetime.

c. A properly structured, self-settled spendthrift trust (also often called an "asset protection trust") provides a viable solution to a client's desire to be able to minimize transfer taxes without putting his assets forever out of reach.

d. In fact, since assets held in trust will enjoy a greater degree of creditor protection than assets retained in the settlor's individual name, a transfer to a self-settled spendthrift trust will actually enhance the likelihood that the assets will be available to the settlor in case of some future emergency need

i. As an added benefit, property held in trust will avoid the delay, expense and publicity involved in transferring property at death pursuant to a probate proceeding

2. Tax Background

a. Internal Revenue Code § 2036(a)(1) provides that "[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any

period not ascertainable without reference to his death or for any period which does not in fact end before his death...the possession or enjoyment of, or the right to the income from, the property...".

b. Thus, if the settlor's creditors can reach the settlor's interest in the trust, the settlor will be deemed, at least indirectly, to have retained the "use and enjoyment" of the transferred assets and Internal Revenue Code § 2036(a)(1) will cause the transferred property to be brought back into the settlor's estate due to the "retained right to possession or enjoyment, or to income".

i. See, e.g., *Paxton v. Commissioner*, 86 T.C. 785 (1986); *German Est. v. U.S.*, 7 Cl. Ct. 641 (1985); *Outwin Est. v. Commissioner*, 76 T.C. 153 (1981), acq., 1981-2 C.B. 2; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), acq., 1962-1 CB 4 ("petitioner's creditors could at any time look to the trust of which she was settlor-beneficiary for settlement of their claims to the full extent of the income thereof. This being true, it follows that petitioner...could at any time obtain the enjoyment and economic benefit of the full amount of the trust income").

- In contrast, in PLR 200944002 (which involved a self-settled spendthrift trust under Alaska law, where such a trust is permissible), the Internal Revenue Service ruled that "...the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036."

  - For a detailed analysis of this issue see Rothschild, Blattmachr, Gans & Blattmachr, "*IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate*," 37 Estate Planning 3 (Jan. 2010).

- *See also*, Rev. Rul. 76-103, 1976-1 CB 293 ("if and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in § 25.2511-2 of the regulations.").

- The consequence of a completed gift is generally that the gifted asset is excluded from the grantor's estate for estate tax purposes.

c. Thus, an "asset protection" trust can serve as an estate planning vehicle if the gift to the trust is structured as a "completed gift".

i. This is particularly useful in the situation where the settlor is unmarried and does not have any children because, under such circumstances, it is unlikely that a prospective settlor would otherwise be inclined to utilize his or her gift tax exemption amount in connection with the funding of a trust, even if he or she anticipated having a spouse and children at some future date.

IX. DOMESTIC ASSET PROTECTION (SELF-SETTLED TRUSTS)

A. Although every state recognizes the validity of spendthrift clauses to protect a third party beneficiary's interest from creditor claims, as a matter of public policy such clauses have historically not been enforceable with respect to a settlor who is also a beneficiary to the extent of such settlor's interest. In this regard, many states have statutes or common law prohibiting such so-called "self-settled trusts" and provide that a settlor cannot create such a trust to protect him or herself from creditors.

1. *See e.g.,* New York's EPTL 7-3.1, which provides that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator."

B. However, since 1997 fourteen states have enacted legislation extending spendthrift protections to a settlor-beneficiary of a discretionary trust (provided that the funding of the trust is not a fraudulent transfer). Those states are:

1. Alaska
2. Delaware
3. Hawaii
4. Mississippi
5. Missouri
6. Nevada
7. New Hampshire

8. Ohio

9. Rhode Island

10. South Dakota

11. Tennessee

12. Utah

13. Virginia

14. Wyoming

C. In addition, Oklahoma, pursuant to the Family Wealth Preservation Trust Act of June 9, 2004 (O.S. § 10,Title 31), permits an individual to create a trust with a bank or trust company located in Oklahoma (but not an individual resident of Oklahoma), for the benefit of his or her spouse, descendants and any one or more Internal Revenue Code § 501(c)(3) charities, and to retain the right to revoke the trust, without causing the trust to thereby be available to creditors. In addition, the law provides that no court shall have the authority to compel the settlor to exercise his or her power to revoke the trust. The law does, however, limit the protection to $1 million of transferred assets plus any subsequent appreciation thereon. In addition, the corpus of the trust must consist of assets in Oklahoma based banks, real estate located in Oklahoma, and securities issued by Oklahoma based companies (including corporations, limited liability companies and limited partnerships formed or domesticated in Oklahoma and having a principal place of business in Oklahoma). However, the Oklahoma law does not technically provide for "self-settled" spendthrift trusts because the settlor himself cannot be a beneficiary of such a trust.

D. Alaska

1. The Alaska Trust Act (effective April 2, 1997), modified Alaska's previously undistinguished common law body of trust law in an effort generally touted as making Alaska a domestic alternative to foreign situs asset protection trusts.

2. Alaska Statutes § 34.40.110 permits a settlor to create a trust for his or her own benefit which will be protected from the settlor's future creditors so long as:

   a. The settlor does not retain the right to revoke or terminate the trust.

   b. The settlor was not in default by thirty (30) days or more in making a child support payment.

c. The settlor's ability to receive distributions from the trust is within the discretion of the trustees rather than mandatory. However, the trustee may permit a beneficiary the use of trust property and the settlor may retain an annuity or unitrust interest in a charitable remainder trust. The settlor may also retain the right to receive a percentage of the trust each year not to exceed the unitrust amount provided under Internal Revenue Code § 643(b).

d. The transfer of property to the trust was not intended to defraud creditors (*i.e.*, a "fraudulent transfer" generally subject to a four year statute of limitations under Alaska law).

i. Under Alaska Statutes § 34.40.110, a creditor existing at the time the trust is created must bring suit within the later of:

- Four years after the transfer is made; or
- One year after the transfer is or reasonably could have been discovered by the creditor if the creditor can demonstrate, by a preponderance of the evidence, that the creditor asserted a specific claim against the settlor before the transfer to the trust or the creditor files an action against the settlor within four years after the transfer asserting a claim based on the settlor's pre-transfer act or omission.

ii. For a creditor that comes into being as such subsequent to the creation of a self-settled spendthrift trust, a cause of action claiming a fraudulent conveyance must be brought within four years after the transfer is made.

3. Alaska Statutes § 13.36.310 prohibits a challenge to a trust on the grounds "...that the trust or transfer avoids or defeats a right, claim, or interest conferred by law on any person by reason of a personal or business relationship with the settlor or by way of a marital or similar right."

4. A mere choice of law clause, however, will not be sufficient to establish a trust as an "Alaska" trust. Alaska Statutes § 13.36.035 sets forth definitive statutory requirements for establishing a trust as a trust subject to Alaska's trust law, as follows:

a. At least one trustee must be a "qualified person" under Alaska Statutes § 13.36.390(1), meaning that at least one trustee must be

either a trust company or a bank with trust powers with its principal place of business in Alaska, or an individual resident of Alaska;

b. Some of the trust assets must be deposited in Alaska, either in a checking or brokerage account or other similar account located in Alaska;

c. The Alaska trustee's duties must include both the obligation to maintain the trust's records and to prepare or arrange for the preparation of the trust's income tax returns, although neither of these requirements must be exclusive to the Alaska trustee; and

d. Part or all of the trust's administration must occur in Alaska, including the physical maintenance of the trust's records in Alaska.

5. Consistent with the foregoing requirements, an Alaska trust may be settled by any person, regardless of whether or not he or she is domiciled in Alaska.

6. Alaska Statutes §§ 13.35.70 and 13.36.375 provide for the appointment of third party trust protectors and trustee advisors without imposing fiduciary liability.

7. The settlor must provide an affidavit of solvency in connection with his or her funding of the trust.

8. Alaska Statutes § 34.40.110(e) precludes a claim against a "...trustee of the trust or against others involved in the preparation or funding of the trust for conspiracy to commit fraudulent conveyance, aiding or abetting a fraudulent conveyance, or participation in the trust transaction." It further provides that "[p]reparation or funding of the trust includes the preparation and funding of a limited partnership or a limited liability company if interests in the limited partnership or limited liability company are subsequently transferred to the trust. The creditor and other person prevented from asserting a cause of action or claim for relief are limited to recourse against the trust assets and the settlor to the extent allowed under [Alaska's fraudulent conveyance statute]."

E. Delaware

1. The synopsis of the Delaware Qualified Dispositions in Trust Act notes that the purpose of the legislation is to allow settlors to reduce estate tax by excluding creditors' claims against self-settled trusts. The Act noted recent legislation in Alaska and provided that the Act "...is intended to maintain Delaware's role as the most favored jurisdiction for the establishment of trusts."

2. Delaware law (12 Del. C. § 3570, *et seq.*) applies to "qualified dispositions" made on or after July 1, 1997. A "qualified disposition" is a disposition by or from a transferor to a trustee who is (i) a Delaware resident, bank or institution authorized by Delaware law to act as a trustee, and (ii) who maintains or arranges for custody in Delaware of some or all of the trust corpus, maintains records (on an exclusive or nonexclusive basis), prepares or arranges for the preparation of fiduciary tax returns or otherwise materially participates in the trust's administration.

3. A trust must be irrevocable but can include one or more of the following provisions:

   a. The settlor may retain power to veto distributions;

   b. The settlor may retain a special power of appointment;

   c. The settlor may retain the right to receive:

      - Current income distributions;
      - Payments from a charitable remainder trust;
      - Annual payments of up to five percent of the initial value of the trust, or of its value as determined from time to time; or
      - Principal distributions under an ascertainable standard (*i.e.*, health, maintenance, education, or support);

   d. The settlor may receive income, principal or both in the sole discretion of a trustee;

   e. The settlor may remove a trustee or adviser and appoint a new trustee or adviser (other than a person who is a related or subordinate party with respect to the transferor within the meaning of Internal Revenue Code § 672(c) and any successor provision thereto); and

   f. The settlor may retain use of a residence held in a qualified personal residence trust.

4. Provided that the transfer of property to the trust was not intended to hinder, delay or defraud creditors, no action to enforce a judgment can be brought for attachment against such qualified disposition.

a. Under 12 Del. C. §3572(b) a creditor existing at the time a transfer to a trust is made must commence an action to enforce a judgment within the later of four years or, if later, within one year after the transfer was or could reasonably have been discovered by the creditor.

b. If the creditor's claim arose after the transfer the action must be brought within four years of the transfer.

- Furthermore, subsection (a) of 12 Del. C. § 3572 provides that a creditor whose claim arose after a qualified disposition can set the transfer aside only if that creditor proves that the transfer was made with actual intent to defraud (not merely to hinder or delay).

5. The Delaware Qualified Dispositions in Trust Act provides that no action of any kind shall be brought against the trustee or against "...any person involved in the counseling, drafting, preparation, execution or funding" of a trust that is the subject of a "qualified disposition."

6. Certain creditors may, however, avoid qualified dispositions:

a. "...any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt." Del. Code Ann. tit. 12, § 3573(1).

- For purposes of this rule, however, a "spouse" or "former spouse" includes "...only persons to whom the transferor was married at, or before, the time the qualified disposition is made." Del. Code Ann. tit. 12, § 3570(9).

- Therefore, if the transferor creates a Delaware asset protection trust prior to the marriage, he or she will be protected.

b. Any person who suffers death, personal injury or property damage on or before the qualified disposition, which, death, personal injury or property damage was caused by the transferor or another person for whom transferor is liable.

7. In 2003, 12 Del. C. § 3572 was amended by the addition of a new subsection which has the effect of immediately terminating a trustee's authority upon the occurrence of another state court's attempt to exercise

jurisdiction over a trustee if the court declines to apply Delaware's law with respect to the validity, construction or administration of the trust. If the trust instrument does not provide for a successor trustee, the Delaware Court of Chancery would appoint a successor trustee (and presumably one that would be subject only to the Delaware court's jurisdiction).

8. On June 30, 2005 the Delaware Qualified Dispositions in Trust Act was amended to (i) permit the settlor to retain the right to receive annual payments of a fixed dollar amount not to exceed five percent of the initial value of the trust corpus; (ii) clarify that a qualified personal residence trust may include provisions requiring conversion to an annuity trust in the event the residence is sold; (iii) permit the settlor to receive reimbursement for income taxes paid on trust income provided such payments are in the discretion of the trustee or trust advisor; (iv) permit a trust being redomiciled to Delaware to tack on the time during which it was located elsewhere for purposes of the statute of limitations regarding creditor claims (provided, however, that any general power of appointment that the settlor retained in the original trust is curtailed to a limited testamentary power); and (v) clarify that a creditor seeking to recover distributions made to a beneficiary, or to prevent a trustee from paying its fees and costs out of the trust, must prove by clear and convincing evidence that the beneficiary or trustee, as the case may be, acted in bad faith (except that, in the case of a beneficiary who is also the settlor, the creditor need only prove bad faith by a preponderance of the evidence).

F. Hawaii

1. Hawaii enacted the "Permitted Transfers in Trust Act" on June 30, 2010 to "...increase the assets under management by Hawaii's private financial sector, increase state tax revenues, and position the State as a world-class financial management jurisdiction." Section 1, Hawaii Act 182 (10).

2. The Permitted Transfers in Trust Act provides for enforceability of a spendthrift provision in a trust, including with respect to a beneficiary who is also the transferor of the trust, if the transfer to the trust was a "permitted transfer."

3. A "permitted transfer" is a transfer to a "permitted trustee" of property pursuant to a trust instrument.

   a. A permitted trustee is a person, other than the transferor, who is a resident of Hawaii, or a bank or trust company authorized to do business in Hawaii that possesses and exercises trust powers and has its principal place of business in Hawaii, and:

- Maintains or arranges for custody of some or all of the property that is the subject of the permitted transfer;
- Maintains records for the trust on an exclusive or nonexclusive basis;
- Prepares or arranges for the preparation of fiduciary income tax returns; or
- Otherwise materially participates in the administration of the trust."

b. A transfer is effective upon completion of:

- The delivery and acceptance of the property.
- The delivery to a permitted trustee of the transferor's signed and notarized certificate of solvency.

4. To be a permitted transfer, the trust instrument must be:

a. Irrevocable.

b. Expressly incorporate the laws of the State of Hawaii as governing the validity, construction, and administration of the trust.

5. A trust will not be deemed to be revocable, however, on account of the inclusion of:

a. The transferor's power to veto distributions from the trust.

b. The transferor's testamentary power of appointment, provided that the transferor cannot appoint the trust property to himself, his creditors, his estate, or the creditors of his estate.

c. The transferor's potential or actual receipt of income, including rights to income retained in the trust instrument.

d. The transferor's annual receipt of a percentage not to exceed five per cent of the initial value of the trust assets or its value determined from time to time pursuant to the trust instrument or of a fixed amount that on an annual basis does not exceed five per cent of the initial value of the trust assets.

e. The transferor's potential or actual receipt or use of the trust's principal due to the trustee acting in the trustee's discretion, or pursuant to a provision in the trust instrument that governs the distribution of principal that does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal, or at the direction of an advisor who is acting in the advisor's discretion, or pursuant to a provision in the trust instrument that governs the distribution of principal that does not confer upon the transferor a substantially unfettered right to the receipt or use of the principal.

f. The transferor's right to remove a trustee or advisor and to appoint a new trustee or advisor.

g. The transferor's potential or actual receipt of income or principal to pay income taxes due on income of the trust if the trust instrument includes a provision allowing or directing the use of trust funds to pay income taxes due, or if the trustee acts in the trustee's discretion to allow payment of income taxes due on the trust income.

h. A trustee's authority pursuant to discretion, direction, or the transferor's exercise of a testamentary power of appointment to pay all or any part of the transferor's debts outstanding at the time of the transferor's death, the expenses of administering the transferor's estate, or any estate or inheritance tax imposed on or with respect to the transferor's estate.

i. The transferor's potential or actual receipt of income or principal from a charitable remainder trust, and the transferor's right to release the transferor's retained interest in the trust in favor of one or more charitable organizations with a succeeding beneficial interest in the trust.

j. The transferor's potential or actual receipt of income or principal from a grantor-retained annuity trust or a grantor-retained unitrust, or the transferor's receipt each year of a percentage specified in the governing instrument of the initial value of the trust assets or their value determined from time to time; provided that the percentage received does not exceed five per cent.

k. The transferor's potential or actual use of real property held under a qualified personal residence trust, or the transferor's possession and enjoyment of a qualified annuity interest.

6. No claim, including an action to enforce a judgment or avoid a permitted transfer, is allowed unless:

a. The creditor proves that the transfer was made with actual intent to defraud, hinder, or delay; and

b. The claim arose before the permitted transfer and the action is brought before the permitted transfer; or

c. The claim arose concurrent with or subsequent to the permitted transfer and the action is brought within two years thereafter.

7. Exception creditors include:

a. "...any person to whom the transferor is indebted on account of a family court-supervised agreement or family court order for the payment of support or alimony to the transferor's spouse, former spouse, or children, or for a division or distribution of property to the transferor's spouse or former spouse, but not for any claim for forced heirship, legitime, or elective share".

- However, under Hawaii law, for this purpose, "...'[s]pouse' means a person to whom the transferor is married at the time of the permitted transfer..." and '...[f]ormer spouse' means a person to whom the transferor was married where the marriage was dissolved before the time of the permitted transfer.

b. Tort creditors with claims arising on or before the date of the permitted transfer.

c. Lenders secured by the transferred property.

d. Hawaii, in connection with tax liabilities.

G. Mississippi

1. Effective July 1, 2014, Mississippi's Qualified Disposition in Trust Act will allow spendthrift protection for self-settled trusts and applies to qualified dispositions to a qualified trustee

2. A qualified disposition is a transfer, conveyance or assignment of property to a qualified trustee by means of a qualified disposition trust.

3. A qualified trustee is a natural person who is a resident of Mississippi or an entity authorized by Mississippi law to act as a trustee.

a. Only one qualified trustee is required – other non-qualified trustees are permitted.

4. A qualified disposition trust is a trust instrument that appoints a qualified trustee and is:

   a. Irrevocable;

   b. Expressly incorporates the laws of the State of Mississippi as governing the validity, construction, and administration of the trust; and

   c. Contains a spendthrift clause.

5. The legislation specifically provides that a qualified disposition trust shall not be deemed revocable on account of its inclusion of one or more of the following:

   a. A transferor's power to veto a distribution from the trust;

   b. A power of appointment, other than a power to appoint to the transferor, the transferor's creditors, the transferor's estate or the creditors of the transferor's estate, exercisable by will or other written instrument of the transferor effective only upon the transferor's death;

   c. The transferor's potential or actual receipt of income, including rights to the income retained in the trust;

   d. The transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust;

   e. The transferor's receipt each year of an amount specified in the trust instrument, the amount not to exceed five percent of the initial value of the trust or its value determined, from time to time, pursuant to the trust;

   f. The transferor's potential or actual receipt or use of principal if the potential or actual receipt or use of principal would be the result of the qualified trustee or qualified trustees acting with discretion;

   g. The transferor's right to remove a trustee or advisor and to appoint a new trustee or advisor, provided, however, that the right shall not include the appointment of a person who is a related or subordinate party with respect to the transferor within the meaning of Internal Revenue Code Section 672(c);

h. The transferor's potential or actual use of real property held under a qualified personal residence trust;

i. The transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust if such potential or actual receipt of income or principal is pursuant to a provision in the trust that expressly permits a distribution to the transferor as reimbursement for such taxes and if such distribution would be the result of the qualified trustee acting with discretion or at the direction of an advisor who is acting in the advisor's discretion;

j. The ability, whether pursuant to direction in the qualified distribution trust or discretion of a qualified trustee to pay, after the death of the transferor, all or any part of the debts of the transferor outstanding at the time of the transferor's death, the expenses of administering the transferor's estate, or any estate or inheritance tax imposed on or with respect to the transferor's estate; and

k. A qualified trustee's authority to make distributions to pay taxes in lieu of or in addition to the power to make a distribution for taxes.

6. The transferor may retain:

a. Power to veto distributions;

b. Non-general testamentary power of appointment;

c. Power to replace trustee or advisor with a non-related, non-subordinate party; and

d. Right to serve as an investment advisor.

7. No action, including an action to enforce a judgment, may be brought at law or in equity for an attachment or other remedy against the trust property unless:

a. It is brought pursuant to the Uniform Fraudulent Transfer Act.

- If the creditor's claim arose after the transfer, the creditor must bring the claim within two years of the transfer and must prove that the transfer was made with actual intent to defraud such creditor.

- If the creditor's claim arose before the transfer, the creditor must bring the claim within the later of (i) two

years of the transfer or (ii) six months after the creditor discovered or reasonably should have discovered the transfer.

8. However, the qualified dispositions in trusts law does not apply:

   a. To any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony in favor of the transferor's spouse, former spouse or children, or for a division or distribution of property in favor of the transferor's spouse or former spouse, but only to the extent of such debt;

   b. To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused, in whole or in part, by the tortious act or omission of the transferor or another person for whom the transferor is vicariously liable.

   c. If the creditor is the State of Mississippi or any political subdivision thereof; or

   d. For any creditor in an amount not to exceed $1,500,000 if the transferor failed to maintain a $1,000,000 general liability policy.

9. The transferor may appoint one or more trust advisors (whether or nor such trust advisors would meet the definition of a "qualified trustee") with authority under the trust instrument to:

   a. Remove and appoint qualified trustees or trust advisors.

   b. Direct, consent to or disapprove of distributions from the trust.

H. Missouri

1. Missouri law provides that where the settlor is not the sole beneficiary of a trust, and does not retain the power to revoke or amend the trust, or the right to a portion of the income or principal of the trust, the trust will be protected from the settlor's creditors.

2. Section 456.5-505.3 provides that with respect to an irrevocable trust with a spendthrift provision, a spendthrift provision will prevent the settlor's creditors from satisfying their claims from the trust assets except:

   a. Where the conveyance of assets to the trust was fraudulent as to creditors; or

b. To the extent of the settlor's beneficial interest in the trust assets, if at the time the trust became irrevocable:

- The settlor was the sole beneficiary of either the income or principal of the trust or retained the power to amend the trust; or

- The settlor was one of a class of beneficiaries and retained a right to receive a specific portion of the income or principal of the trust that was determinable solely from the provisions of the trust instrument.

3. In addition, Section 456.5-504.1 provides as follows:

"Except as otherwise provided in section 456.5-503, whether or not a trust contains a spendthrift provision, a creditor of a beneficiary may not compel a distribution that is subject to the trustee's discretion, even if:

(1) the discretion is expressed in the form of a standard of distribution; or

(2) the trustee has abused the discretion.

4. The referenced exception under section 456.5-503 provides that, "[e]ven if a trust contains a spendthrift provision, a beneficiary's child, spouse, or former spouse who has a judgment against the beneficiary for support or maintenance, or a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust, may obtain from a court an order attaching present or future trust income."

I. Nevada

1. Effective October 1, 1999, Nevada began allowing spendthrift protection for self-settled trusts, provided that they meet the following requirements as set forth in Nevada Revised Statutes § 166:

a. The trust must be irrevocable;

b. The settlor is only a discretionary beneficiary;

c. The transfer was not intended to hinder, delay or defraud known creditors;

d. The settlor may retain a veto power over distributions or hold a testamentary special power of appointment;

e. All or part of the property is located in Nevada;

f. All or part of the administration of the trust is performed in Nevada; and

g. At least one Nevada resident is a trustee and has powers that include maintaining records and preparing tax returns for the trust.

2. Nevada is one of the few DAPT states that does not provide for any exception creditors (i.e. spousal claims, tort creditors).

3. A creditor may not bring an action with respect to property transferred to a spendthrift trust unless the action is brought within two years after the transfer or six months after the creditor discovers or reasonably should have discovered the transfer, whichever is later. If a person becomes a creditor after the transfer is made, he or she must bring the action with two years after the transfer.

J. New Hampshire

1. New Hampshire's "asset protection trust" legislation, entitled the Qualified Dispositions in Trusts Act, applies to qualified dispositions and dispositions by transferors who are trustees made after January 1, 2009.

2. A qualified disposition is defined as a disposition by or from a transferor to a qualified trustee or qualified trustees, with or without consideration, by means of a trust instrument.

3. A qualified trustee is defined as any person, other than the transferor, who in the case of a natural person, is a resident of the state of New Hampshire or who, in all other cases, is a state or federally chartered bank or trust company having a place of business in New Hampshire, is authorized to engage in a trust business in the state of New Hampshire, and who maintains or arranges for custody in New Hampshire of some or all of the property that is the subject of the qualified disposition, maintains records in New Hampshire for the trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation in New Hampshire of fiduciary income tax returns for the trust, or who otherwise materially participates in New Hampshire in the administration of the trust.

a. Not all trustees must be qualified trustees.

4. A trust instrument must meet the following requirements in order for the disposition to be qualified:

a. The trust instrument must be irrevocable;

b. The trust instrument must provide that the interest of the transferor or other beneficiary in the trust property or the income thereof may not be transferred, assigned, pledged, or mortgaged, whether voluntarily or involuntarily, before the qualified trustee or qualified trustees actually distribute the property or income therefrom to the beneficiary.

5. The legislation specifically provides that the trust instrument shall not be deemed revocable on account of the inclusion in the trust instrument of any one or more of the following rights, powers, and interests:

a. The transferor's power to veto a distribution from the trust;

b. A power of appointment, other than a power to appoint to the transferor, the transferor's creditors, the transferor's estate, or the creditors of the transferor's estate, exercisable by will or other written instrument of the transferor effective only upon the transferor's death;

c. The transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument;

d. The transferor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust;

e. The transferor's receipt each year of a percentage, not to exceed 5 percent, specified in the trust instrument of the initial value of the trust assets or their value determined from time to time pursuant to the trust instrument;

f. The transferor's potential or actual receipt or use of principal if such potential or actual receipt or use of principal would be the result of a qualified trustee or qualified trustees, including a qualified trustee or qualified trustees acting at the direction of a trust advisor, acting either in such qualified trustee's or qualified trustees' sole discretion or pursuant to an ascertainable standard in the trust instrument;

g. The transferor's right to remove a trustee or trust advisor and to appoint a new trustee or trust advisor, other than a related or subordinate party with respect to the transferor within the meaning of section 672(c) of the Internal Revenue Code;

h. The transferor's potential or actual receipt or use of real property held under a personal residence trust;

i. The transferor's potential or actual receipt or use of a qualified annuity interest;

j. The ability, whether pursuant to discretion or direction, of a qualified trustee to pay, after the transferor's death, all or any part of the transferor's debts outstanding at the time of the transferor's death, the expenses of administering the transferor's estate, or any estate inheritance tax imposed on or with respect to the transferor's estate.

6. Neither shall the trust instrument be deemed revocable on account of the transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on trust income if such receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of such taxes and such receipt of income or principal results from (i) the qualified trustee's acting in such qualified trustee's discretion or (ii) the qualified trustee acting at the direction of a trust advisor who is acting in such trust advisor's discretion.

7. The transferor may appoint one or more trust advisors (whether or not such trust advisors would meet the definition of a "qualified trustee"), with authority under the trust instrument to:

a. Remove and appoint qualified trustees or trust advisors;

b. Direct, consent to, or disapprove distribution from the trust.

8. The transferor may serve as a trust advisor; provided, however, that in such case his or her rights and powers as a trust advisor must be limited to the right to disapprove distribution from the trust and the right to consent to a trustee's action or inaction in relation to the investment of trust assets.

9. A creditor's claim against property which was the subject of a qualified disposition in trust is extinguished unless the creditor's claim arose before the qualified disposition was made and the action is brought within the limitations period under the New Hampshire version of the Uniform Fraudulent Transfer Act, or if the creditor's claim arose on or after the date of the qualified disposition, the action is brought within four years after such date.

10. However, the qualified dispositions in trusts law does not apply:

a. To any person to whom the transferor is indebted on account of an antenuptial agreement or an agreement or order of court for the payment of support or alimony in favor of such transferor's spouse, former spouse or children, or for a division or distribution

of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt.

- However, this exception "...shall not apply to any claim for forced heirship or legitime or the elective share of the transferor's surviving spouse, unless the transferor made the qualified disposition for the purpose of defeating the surviving spouse's elective share rights." New Hampshire Statutes § 564-D:15(II).

- In addition, "...'spouse' and 'former spouse' means only persons to whom the transferor was married at, or before, the time the qualified disposition is made." New Hampshire Statutes § 564-D:1(VIII).

b. To any person who suffers death, personal injury, or property damage on or before the date of qualified disposition by a transferor.

11. No creditor has any claim or cause of action against the trustee, or an advisor, of a trust that is the subject of a qualified disposition, or against any person involved in the counseling, drafting, preparation, execution, or funding of a trust that is the subject of a qualified disposition.

K. Ohio

1. Ohio enacted the Ohio Legacy Trust Act on December 20, 2012 which will become effective March 20, 2013. Ohio Revised Code Section 5816 provides:

a. The governing law must be Ohio;

b. The trust must be irrevocable;

c. The trust must prohibit voluntary or involuntary assignment;

d. The settlor may retain the following:

- A power to veto trust distributions;

- A limited power of appointment;

- The right to current income distributions;

- Payments from a charitable remainder trust;

- Annual payments of up to five percent of the initial value of the trust or of its value as determined from time to time;

- Principal distributions under an ascertainable standard (*i.e.*, health, maintenance, education, or support);

- The settlor may receive income, principal or both in the sole discretion of a trustee who is neither the settlor nor a related or subordinated party of the settlor;

- A power to remove and appoint advisors and trustees; and

- Right to reimburse settlor for income taxes on trust's income.

- The retained use of a residence in a Qualified Personal Residence Trust.

2. The trustee must be a resident of the state of Ohio, or a trust company, or a bank or savings association that exercises trust powers, that has its principal place of business in Ohio, which maintains or arranges for custody in the state of Ohio of some or all of the property, maintains records on an exclusive or nonexclusive basis, prepares or arranges for the preparation of the tax returns, or otherwise materially participates in the administration of the trust.

3. A creditor's claim against property which was the subject of a qualified disposition in trust is extinguished unless the creditor's claim arose before the qualified disposition was made and the action is brought within the later of 18 months after the qualified disposition or 6 months after the transfer is or reasonably could have been discovered if the creditor files suit or makes a written demand that asserts a claim based on an act or omission that occurred before the qualified disposition and that suit is filed within 3 years after the transfer.

4. Transfers are subject to provisions of the Uniform Fraudulent Transfer Act.

   a. Certain creditors may, however, avoid qualified dispositions:

      - Any person to whom the settlor is indebted on account of an agreement or court order for

support, alimony or property distribution in favor of a spouse, former spouse or children;

L. Rhode Island

1. Rhode Island Statutes § 18-9.2 applies to "qualified dispositions" made after June 30, 1999. A qualified disposition is a transfer to a trust which is:

   a. Irrevocable;

   b. Incorporates the laws of Rhode Island to govern the validity, construction and administration of the trust;

   c. Contains a restriction on assignment of income or property; and

   d. Wherein the transferor retains only:

      - The power to veto distributions;
      - A testamentary special power of appointment; and
      - The right to receive distributions in the sole discretion of a trustee who is neither related or subordinate to the transferor.

2. The trustee must be a resident of Rhode Island (in the case of an individual), or authorized by Rhode Island law to act as a trustee (in the case of a non-individual).

3. A creditor may not bring an action to avoid a qualified disposition if:

   a. The creditor's claim arose before the transfer was made unless the action is brought within four years after the transfer or, if later, within one year after the transfer was or could reasonably have been discovered by the creditor; or

   b. The creditor's claim arose after the transfer, unless the action is brought within four years after the transfer is made.

4. In Rhode Island, a transfer can be avoided by "[a]ny person to whom the transferor is indebted on or before the date of a qualified disposition on account of an agreement or order of court for the payment of support or alimony in favor of the transferor's spouse, former spouse or children, or for a division or distribution of property in favor of the transferor's spouse or former spouse, but only to the extent of the debt…". R.I. Gen. Laws § 18-9.2-5(a).

a. "…'spouse' and 'former spouse' means only persons to whom the transferor was married at, or before the time the qualified disposition is made." R.I. Gen. Laws § 18-9.2-2(7).

M. South Dakota

1. The "Act to Authorize Qualified Dispositions" is effective for trusts settled on or after July 1, 2005.

2. The trust must meet the following requirements:

   a. The governing law must be South Dakota;

   b. The trust must be irrevocable;

   c. The trust must prohibit voluntary or involuntary assignment;

   d. The settlor may retain the following:

      - A power to veto trust distributions;
      - A limited testamentary power of appointment;
      - The right to current income distributions;
      - Payments from a charitable remainder trust;
      - Annual payments of up to five percent of the initial value of the trust or of its value as determined from time to time;
      - Principal distributions under an ascertainable standard (*i.e.*, health, maintenance, education, or support);
      - The settlor may receive income, principal or both in the sole discretion of a trustee who is neither the settlor nor a related or subordinated party of the settlor;
      - A power to remove and appoint trustees; and
      - The retained use of a residence in a Qualified Personal Residence Trust.

3. The trustee must be a resident of the state of South Dakota, or a trust company, or a bank or savings association that exercises trust powers, that has its principal place of business in South Dakota, which maintains

or arranges for custody in the state of South Dakota of some or all of the property, maintains records on an exclusive or nonexclusive basis, prepares or arranges for the preparation of the tax returns, or otherwise materially participates in the administration of the trust.

4. The Act permits the appointment of a nonresident trust advisor, including a trust protector, who may hold one or more trust powers. The settlor may be designated as a trust advisor.

5. The Act provides protection to trustees and any person involved in "counseling, drafting, preparation, execution or funding of a trust" from claims of creditors.

6. Transfers are subject to provisions of the Uniform Fraudulent Transfer Act.

   a. A creditor may not bring an action with respect to property transferred to a spendthrift trust unless the action is brought within two years after the transfer or six months after the creditor discovers or reasonably should have discovered the transfer, whichever is later. If a person becomes a creditor after the transfer is made, he or she must bring the action with two years after the transfer.

   b. Certain creditors may, however, avoid qualified dispositions:

      - Any person to whom at the time of transfer the settlor is indebted on account of an agreement or court order for support, alimony or property distribution in favor of a spouse, former spouse or children;

        - "…'spouse' and 'former spouse,' mean only persons to whom the transferor was married at, or before, the time the qualified disposition is made." S.D. Code § 55-16-1(7).

      - Any person who suffers death, personal injury or property damage on or before the qualified disposition, which death, personal injury or property damage was caused by the transferor or another person for whom the transferor is liable.

N. Tennessee

1. Effective July 1, 2007, the "Tennessee Investment Services Act of 2007," began permitting the creation of self-settled spendthrift trusts under Tennessee law (called an "Investment Services Trust" in Tennessee).

2. An Investment Services Trust means an instrument appointing a qualified trustee or qualified trustees for the property that is the subject of a disposition, which instrument:

   a. Expressly incorporates the law of Tennessee as governing its validity, construction and administration;

   b. Is irrevocable; and

   c. Provides that the interest of the transferor in trust property or the income from trust property may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily.

3. A "qualified trustee" is a natural person who is a resident of Tennessee (other than the settlor), or a person authorized by the law of Tennessee to act as a trustee, and who maintains or arranges for custody in Tennessee for the property of the trust, maintains records for the trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation of required income tax returns for the trust, or otherwise materially participates in the administration of the trust.

4. The settlor is permitted to retain one or more of the following rights in an Investment Services Trust:

   a. To direct the investment of the Investment Services Trust's assets;

   b. To receive trust income;

   c. To request up to five percent of the trust principal annually;

   d. To receive additional distributions of principal based upon the discretion of the trustee or another appointed advisor;

   e. To live in a home owned by the trust;

   f. To veto distributions to any other permissible beneficiary;

   g. To direct the distribution of the trust assets upon the settlor's death to any one or more persons other than the settlor's creditors, the settlor's estate or the creditors of the settlor's estate; and

h. To remove the trustee and other trust advisors and to appoint their successors provided they are not related or subordinate to the settlor.

5. At the creation of the Investment Services Trust, the settlor is required to provide an affidavit under oath which must include, among other things, a statement that by creating the trust the settlor does not intend to defraud a creditor and that the settler does not have any pending or threatened court action against him or her other than those identified in the affidavit.

6. An Investment Services Trust will not provide asset protection for assets transferred to it until four years after the transfer. At that time, the settlor's creditors are prevented from seizing the assets of the Investment Services Trust to satisfy claims against the settlor

7. A transfer can be avoided by a creditor to whom "...the transferor is indebted on account of an agreement, judgment or order of a court for the payment of...(A) Past due child support; (B) Past due alimony in solido of a spouse or former spouse; (C) Past due alimony or support of a spouse or former spouse; or (D) A written agreement, judgment or order of a court for division of marital property of a spouse or former spouse, but only to the extent of such debt, legally mandated interest and the reasonable cost of collection. Tenn. Code Ann. § 35-16-104(i).

   a. "...'spouse' or 'former spouse' means only persons to whom the transferor was legally married at, or before, the time the qualified disposition is made..." Tenn. Code Ann. § 35-16-102(13).

O. Utah

1. The Utah legislation, which is effective for trusts created after May 5, 2003, is set forth in UCA § 25-6-14, *et seq*. It applies only to transfers of personal property or interests therein.

2. The trust must meet the following requirements:

   a. At least one trustee must be a trust company resident in Utah;

   b. The settlor does not retain the right to revoke the trust;

   c. The settlor may only receive income or principal at the discretion of the trustee; and

   d. The settlor was not in default by thirty (30) days or more under a child support order.

3. A creditor existing at the time the trust is settled must bring suit within the later of three years after the transfer is made or one year after the

transfer is or reasonably could have been discovered. A creditor arising after a transfer has two years from the transfer date to bring a suit.

4. A transfer can be avoided if "...the claim is by a spouse or former spouse of the settlor on account of an agreement or order for the payment of support or alimony or for a division or distribution of property..." Utah Code Ann. § 25-6-14(2)(c)(ix).

5. The Act provides protection from a claim against a trustee or advisor for conspiracy to commit a fraudulent conveyance or aiding and abetting a fraudulent conveyance.

6. A trust will be subject to Utah's governing law if:

   a. Some or all of the assets are deposited in the state in a bank, brokerage or trust company;

   b. The trust has at least one resident trustee; and

   c. Some administration (*i.e.*, maintaining of trust records or arranging for tax return preparation) occurs in the state.

7. The Act also modifies the state's Rule Against Perpetuities to provide for a 1,000 year period.

P. Virginia

1. Virginia enacted legislation to be effective for trusts settled after July 1, 2012.

2. An exception has been grafted into § 55-545.05 of the Virginia Code that permits the creation of self-settled spendthrift trusts, which protect the assets of a qualified irrevocable trust against the claims of the creditors of a settlor who is also a beneficiary.

3. To be a qualified self-settled spendthrift trust, it must satisfy the following criteria:

   a. irrevocable (further confirmed by subsection A.1. of § 55-545.05);

   b. created during the settlor's lifetime;

   c. has at least one beneficiary other than the settlor, (i) to whom income may be paid, if settlor is eligible to receive income, (ii) to whom principal may be paid, if settlor is eligible to receive principal, or (iii) to whom income and principal may be paid, if settlor is eligible to receive both;

   d. has at least one "qualified trustee;"

e. expressly incorporates the law of the Commonwealth of Virginia to govern the validity, construction and administration of the trust;

f. contains a spendthrift provision that restrains both voluntary and involuntary transfer of the settlor's "qualified interest;" and

g. the settlor does not retain the right to disapprove distributions (i.e., a veto power).

Q. Wyoming

1. Wyoming Statues § 4-10-510 provides for the creation of a "qualified spendthrift trust" (*i.e.*, a self-settled spendthrift trust) with a "qualified trustee" for "qualified trust property."

2. A "qualified spendthrift trust" requires:

a. The trust instrument to state that the trust is a qualified spendthrift trust under Wyoming Statutes § 4-10-510;

b. The trust instrument to expressly incorporate the law of Wyoming to govern the validity, construction and administration of the trust;

c. The trust instrument to provide that the interest of the settlor in the trust income or principal, or both, is held subject to a spendthrift provision;

d. The trust to be irrevocable, but a trust instrument will not be deemed to be revocable because of the inclusion of one or more of the following:

- The settlor's power to veto trust distributions;
- An inter vivos or testamentary limited or general power of appointment held by the settlor;
- The settlor's potential or actual receipt of income;
- The settlor's potential or actual receipt of income or principal from a charitable remainder trust;
- The settlor's receipt each year of up to five percent of the initial value of the trust or of its value as determined from time to time;

- The settlor's potential or actual receipt or use of principal under an ascertainable standard (e.g., health, maintenance, education, or support);

- The settlor's right to add or remove a trustee, trust protector or trust advisor, and to appoint a new trustee, trust protector or trust advisor, other than the settlor;

- The settlor's potential or actual use of real property held under a Qualified Personal Residence Trust;

- A trust protector has the power to add beneficiaries to the trust who are not the trust protector, the estate of the trust protector, the creditors of the trust protector or the heirs of the trust protector; or

- The settlor's service as an investment advisor to the trust.

3. "Qualified trust property" is real property, personal property and interests in real or personal property and all gains, appreciation and income thereon which are the subject of a "qualified transfer" or are acquired with the proceeds of property of a qualified transfer.

4. Qualified trust property is not protected under the following circumstances:

   a. Against any claim by any person to whom the settlor is indebted on account of an agreement or order of court for the payment of child support;

   b. If the qualified trust property is listed upon an application or financial statement used to obtain or maintain credit other than for the benefit of the qualified spendthrift trust; or

   c. Property of a qualified spendthrift trust that was transferred by a settlor who received the property by a fraudulent transfer.

5. Transfers are also subject to provisions of the Uniform Fraudulent Transfer Act.

6. A "qualified trustee" is a natural person (other than the settlor) who is a resident of Wyoming, or a person authorized by the law of Wyoming to act as a trustee, who maintains or arranges for custody in Wyoming of some or all of the qualified trust property, maintains records for the

qualified spendthrift trust on an exclusive or nonexclusive basis, prepares or arranges for the preparation of fiduciary income tax returns for the qualified spendthrift trust, or otherwise materially participates in the administration of the qualified spendthrift trust.

7. A creditor can not make any claim or bring any cause of action against the trustee, trust protector, trust advisor or other fiduciary of the trust, or against any person involved in the counseling, drafting, administration, preparation, execution or funding of the trust.

8. The settlor must provide an affidavit of solvency containing the statements set forth in Wyoming Statutes § 4-10-523.

R. Constitutional Issues

1. Notwithstanding the enactment of self-settled spendthrift trust protections under the laws of a significant minority of the states over the course of the past eighteen years, foreign trusts will likely offer a more substantial barrier to creditors (and may thus provide more certain estate tax exclusion) because of certain issues under the United States Constitution.

a. Full Faith and Credit Clause

- Under the Full Faith and Credit Clause of the United States Constitution, "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State." U.S. Const., Art. IV, § 1.

- Full faith and credit principles are so broadly construed that they generally require the judgment of another state to be recognized and enforced even though the original claim is illegal in, or contrary to the strong public policy of, the second state. *See, e.g.*, *United Nat'l Bank v. Lamb*, 337 U.S. 38, 41-42 (1949); *M & R Investments Co. v. Hacker*, 511 So.2d 1099 (Ct. App. Fl. 1987). *But see*, *Franchise Tax Board of California v. Hyatt*, 538 U.S. 488 (2003) (full faith and credit clause does not compel a state to substitute the statutes of other states for its own statutes dealing with a subject matter concerning which it is competent to legislate).

- In addition, the Full Faith and Credit Clause is also usually thought to require the enforcement of another state's judgments, even where the second

state disallows by statute jurisdiction over the action. *Hughes v. Ferter*, 341 U.S. at 611 fn. 4 (1951); *Brodderick v. Rosner*, 294 U.S. 629, 639-642 (1935); *Kenny v. Supreme Lodge of the World*, 252 U.S. 411, 415 (1920).

- In fact, assuming that in personam jurisdiction is obtained over the trustee, there are only two apparent limitations upon the application of the Full Faith and Credit Clause.

  - The first limitation upon application of the Full Faith and Credit Clause is that "for a State's substantive law to be selected in a constitutionally permissible manner, that State must have a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary nor fundamentally unfair." *Allstate Ins. Co. v. Hague*, 449 U.S. 302, 312-13 (1981).

  - The second limitation upon application of the Full Faith and Credit Clause is that the issue has been fully and fairly litigated and finally decided in the court rendering the original judgment. *Durfee v. Duke*, 375 U.S. 106, 111 (1963).

- Arguments are sometimes raised that the Full Faith and Credit Clause does not affect the protection afforded by domestic asset protection trusts. Such arguments rely upon the fact that the trustee is not the same person as the settlor, and that, therefore, a judgment obtained against the settlor in one state would not be enforceable against the trustee in another state. However, such arguments obviously ignore the possibility that the trust might be held to be a "sham" trust in the courts of the forum state (most likely being a state that does not itself provide for the validity of self-settled spendthrift trusts), or should otherwise be disregarded. Moreover, even absent such a finding, the claimant would almost certainly bring a post-judgment fraudulent transfer action and join the trustee as a transferee of the assets (assuming that jurisdiction could be obtained over

the trustee). Once joinder is accomplished, an order against the trustee might issue determining that the transfer of assets into the trust was a fraudulent transfer, which would, under the Full Faith and Credit Clause, most likely be enforceable in each other state.

- By contrast, a creditor holding a judgment from a United States court cannot hope to have the courts of a properly selected offshore jurisdiction enforce the United States judgment. Instead, the creditor must commence a new action in the offshore jurisdiction.

b. Supremacy Clause

- Under the Supremacy Clause of the United States Constitution, the "...Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const., Art. VI, §2.

- Thus, federal law overrides state laws to the extent that federal and state law conflict.

- In the asset protection trust context there is concern that the Supremacy Clause might apply, for example, where a federal bankruptcy court issues an order directing the trustee of a domestic self-settled spendthrift trust to distribute assets to a creditor.

- This concern has been mitigated somewhat, however, since the enactment of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which amended § 548(e) of the Bankruptcy Code so as to limit the power of the trustee of the bankruptcy estate to avoid transfers to a "self-settled trust or similar device" to situations where the transfer is a fraudulent transfer, and then only if made within ten years

before the date of the filing of the bankruptcy petition.

c. Contract Clause

- Under the Contract Clause of the United States Constitution, "[n]o State shall...pass any...Law impairing the Obligation of Contracts..." U.S. Const. Art. I, § 10.

- In the asset protection context, the concern over the Contract Clause, albeit somewhat ill defined, is that domestic asset protection trust legislation potentially infringes upon the ability of persons to contract with each other by allowing a contracting party to avoid the effect of certain contracts by protecting his or her assets from claims made under the contract through the use of an asset protection trust.

X. FOREIGN ASSET PROTECTION TRUSTS

A. Overview

1. Historically such trusts were used to avoid forced heirship and government expropriation in non-United States jurisdictions, but in the asset protection context such trusts are now used to place assets out of the reach of the United States courts since many foreign jurisdictions do not honor United States judgments in the asset protection trust context.

2. Such trusts, if properly funded, will require a creditor to litigate its claim in a foreign jurisdiction under that jurisdiction's laws and system (which are likely to be much more debtor friendly than would be the case in a domestic jurisdiction). Such trusts provide procedural, substantive and psychological barriers to creditors. Such trusts do not rely on secrecy or concealment to be effective.

B. Selecting a Jurisdiction

1. The following jurisdictions have enacted favorable asset protection trust legislation, some offering greater protection than others:

a. Anguilla
b. Antigua
c. Bahamas
d. Barbados
e. Belize
f. Bermuda
g Cayman Islands
h Cook Islands
i. Cyprus
j. Gibraltar
k. Labuan
l. Marshall Islands
m. Mauritius
n. Nevis
o. Niue
p. St. Vincent
q. St. Lucia
r. Seychelles
s. Turks and Caicos

2. Perhaps the most critical aspect in selecting a jurisdiction is the fraudulent transfer law of that jurisdiction. Until recently, most common law jurisdictions followed the Statute of Elizabeth, passed in 1571, which provided no limitations period within which a creditor must bring a fraudulent transfer claim or be thereafter barred from asserting its claim.

3. Other factors to consider in selecting a jurisdiction:

   a. Need for a professional and responsible institutional trustee in a stable country;

   b. Effect of tax laws;

   c. Existing language barriers;

   d. Solidity of reputation in the global financial community;

   e. Statutory trust law framework, including a short statute of limitations period for challenging a trust pursuant to a fraudulent transfer claim;

   f. Whether and to what extent a settlor can be a beneficiary and protector;

   g. Whether foreign judgments are recognized;

   h. The standard of proof required to succeed in a fraudulent conveyance action; and

   i. Issues relating to access to the legal system (*i.e.*, court costs, legal fees and the like).

C. Overview of Cook Islands

1. General Characteristics

a. The Cook Islands are located in the south Pacific Ocean east of Australia and south of Hawaii.

b. The capital is Rarotonga, with a modern international airport and regular air service to Los Angeles, Hawaii, Tahiti, Fiji and Auckland, New Zealand.

c. The islands are remote from the world's major financial centers but have modern communications systems and are in a time zone only three hours behind Pacific Standard Time.

d. The Cook Islands are self-governing. Their closest link is with New Zealand, and they use New Zealand currency. They have been independent since 1965.

e. English is the official language, and there is a common law legal system. Appeals of court decisions are brought before the Privy Council in England.

2. Confidentiality -The Cook Islands banking laws mandate secrecy of client information, with a year's imprisonment being the punishment for a violation.

3. Taxes - The Cook Islands are a "no-tax" jurisdiction.

4. Fraudulent Disposition Law

a. The Cook Islands enacted comprehensive asset protection trust legislation with the enactment of the International Trusts Act 1984, and its amendment pursuant to the International Trusts Amendment Act 1989. There have been several smaller amendments since 1989.

b. The legislation addresses "International Trusts" and the effect thereon of fraudulent dispositions and bankruptcy.

c. With respect to fraudulent dispositions, a creditor seeking to set aside a disposition to an International Trust must prove beyond a reasonable doubt that:

- The disposition was made with an intent to defraud that particular creditor; and

- The transferor was rendered insolvent by the transfer; if the fair market value of the settlor's assets after the transfer to the International Trust exceeds the value of the creditor's claim at the

time of the transfer, there can be found no intent to defraud.

d. If the creditor meets this burden of proving a fraudulent disposition, the transfer to the International Trust is not void or voidable. Instead, the creditor's claim must be paid from property that would have been subject to its claim but for the transfer. Furthermore, any punitive damage award which is part of the creditor's claim is disregarded.

e. An International Trust will not be deemed void simply by reason of the settlor's bankruptcy.

f. Statute of limitations periods for creditors requires commencement of proceedings as follows:

- If a creditor's cause of action accrues more than two years before a transfer to an International Trust, the transfer will be deemed not to be fraudulent unless proceedings in respect of that cause of action had been commenced at the date of the transfer.

- Also, if a creditor fails to bring an action within one year from the date the transfer to an International Trust occurs, the action is barred.

- Furthermore, if the transfer (whether initial or subsequent) to an International Trust occurs before a creditor's cause of action accrues, such a disposition will not be fraudulent as to that creditor. A "cause of action" is defined as the first cause of action capable of assertion against a settlor.

- For redomiciled trusts, the limitations period is deemed to have commenced at the time of original transfer, even when the transfer was to a trust located in a jurisdiction other than the Cook Islands.

g. The Cook Island International Trusts Act also defines certain circumstances that will not be deemed badges of fraud. Specifically, fraudulent intent cannot be imputed from the fact that:

- A transfer to an International Trust was made within two years of the accrual of a creditor's cause of action;

- The retention of powers or benefits by the settlor; or

- The designation of the settlor as a beneficiary, trustee or protector.

5. Trusts

a. Retained powers and benefits are explicitly addressed by statute. An International Trust cannot be "declared void or be affected in any way" because the settlor:

- Has the power to revoke or amend the trust, to dispose of trust property, or to remove or appoint a trustee or protector;

- Retains, possesses or acquires any benefit, interest, or property from the International Trust; or

- Is a beneficiary, trustee or protector of the International Trust.

b. The Rule Against Perpetuities has been repealed in the Cook Islands.

c. Selection of the law of the Cook Islands is binding and conclusive.

d. An International Trust is not subject to the forced heirship laws of other countries.

e. Foreign judgments against an International Trust, its settlor, trustee and protector, cannot be recognized in the Cook Islands.

f. The Act also provides that community property transferred to an International Trust retains its character as community property.

D. Choice of Law Clause

1. The general rule is that the settlor's designation of controlling law will govern the administration of a trust, including the efficacy of a trust's spendthrift provision.

a. If the settlor creates a trust to be administered in a state other than that of his domicile, the law of the state of the place of administration, rather than that of his domicile, ordinarily is applicable. Thus a settlor domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary's interest. This permits a person who is domiciled in a state in which restraints on alienation are not permitted, to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state. 5A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* § 626, at 419 (4th ed. 1989).

2. In addition, Restatement (Second) of Conflicts of Laws § 273 provides that:

> "[w]hether the interest of a beneficiary of [an inter vivos] trust of movables is assignable by him and can be reached by his creditor is determined...by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered and otherwise by the local law of the state to which the administration of the trust is most substantially related."

3. In some jurisdictions a settlor's ability to designate the law of a particular jurisdiction as the governing law of the trust is expressly provided for by statute.

   a. For example, Section 7-1.10 of the New York Estates, Powers and Trusts Law provides that:

   > "[w]henever a person, not domiciled in this state, creates a trust which provides that it shall be governed by the laws of this state, such provision shall be given effect in determining the validity, effect and interpretation of the disposition in such trust..."

4. There are also a number of cases that have applied conflicts of law principles to spendthrift trusts.

   a. In *Togut v. Hecht,* 54 B.R. 379, Bankr. L. Rep. (CCH) ¶ 70821 (Bankr. S.D.N.Y. 1985), decision aff'd, 69 B.R. 290 (S.D.N.Y. 1987), a case involving a non-self settled spendthrift trust, the issue was "...whether the laws of the State of Maryland or New York are applicable in determining the validity of the spendthrift trust provisions... " The debtor argued for the application of

Maryland law, because it would preclude the bankruptcy trustee from claiming any portion of the spendthrift trust's undistributed income and principal as a part of the bankruptcy estate. The bankruptcy trustee argued that the law of the forum state of New York should apply, because under the law of New York, the bankruptcy trustee would be entitled to ten percent of the trust's undistributed income as well as any portion of the remaining ninety percent of such income that might be in excess of the debtor's reasonable living requirements. The bankruptcy court's determination that the law of Maryland was the "applicable non-bankruptcy law" for purposes of determining the Bankruptcy Code section 541(c)(2) exemption was based solely upon the trust settlor's designation of Maryland law as the law governing "all questions pertaining to [the trust's] validity, construction and administration."

b. In *The National Shawmut Bank of Boston v. Cumming*, 325 Mass. 457, 91 N.E.2d 337 (1950), the settlor, a domiciliary of Vermont, created a trust of "the greater part of his property," which trust the settlor designated to be "construed and the provisions thereof interpreted under and in accordance with the laws of the Commonwealth of Massachusetts." As recognized by the lower court's opinion, the *Shawmut* settlor's clearly implied intent in designating Massachusetts law as controlling, was to defeat his surviving spouse's significantly greater inheritance rights under Vermont law. According to the *Shawmut* court:

> [i]f the settlor had been domiciled in this Commonwealth and had transferred here personal property here to a trustee here for administration here, the transfer would have been valid even if his sole purpose had been to deprive his wife of any portion of it. The Vermont law we understand to be otherwise and to invalidate a transfer made there by one domiciled there of personal property there, if made with an actual, as distinguished from an implied, fraudulent intent to disinherit his spouse.

In holding that Massachusetts law should apply, thereby depriving the surviving spouse of the greater part of her inheritance rights, the *Shawmut* court stated that "[t]he general tendency of authorities elsewhere is away from the adoption of the law of the settlor's domicile where the property, the domicile and place of business of the trustee, and the place of administration intended by the settlor are in another State."

5. For a detailed analysis of the conflict of law rules as they relate to self-settled trusts see Rothschild, Rubin and Blattmachr, "*Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch*", Vanderbilt Journal of Transnational Law, Vol. 32, No. 3, May 1999.

E. Tax and Reporting Issues

1. Income Taxation and Related Reporting Requirements

a. Residence of Trust

- Internal Revenue Code §§ 7701(a)(30) and (31)(B), and the Treasury Regulations thereunder, provide that a trust is a foreign trust unless two criteria are met:

  - A court within the United States must be able to exercise primary supervision over the administration of the trust; and

  - One or more United States persons have the authority to control all substantial decisions of the trust.

- Note that, under these rules, a trust can be structured to meet the requirements of a domestic trust for United States tax reporting purposes, but can nevertheless be governed by foreign law. Such a trust, commonly referred to as a "hybrid trust," will provide that a United States person shall control all substantial decisions of the trust (even though there will also be a foreign co-trustee), and that a United States court will have primary supervision over the administration of the trust even though it may be directed to apply foreign law in so doing.

b. A properly structured foreign trust should not be taxed any differently than a domestic trust. The only distinction, in the end, will be that additional information reporting requirements will be triggered if the trust is a foreign trust. This is because the trust would be treated as a grantor trust for federal income tax purposes (even if not otherwise structured as a grantor trust), by dint of:

- Being self-settled since Internal Revenue Code § 677 provides that "[t]he grantor shall be treated as the owner of any portion of a trust...whose

income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be – (1) distributed to the grantor...; [or] (2) held or accumulated for future distribution to the grantor..."

- Being a foreign trust since Internal Revenue Code § 679 provides that "[a] United States person who directly or indirectly transfer property to a foreign trust...shall be treated as the owner...of the portion of such trust attributable to such property if...there is a United States beneficiary of any portion of the trust."

c. Since the trust is a grantor trust, a Form 1041, *United States Income Tax Return for Estates and Trusts* (or, alternatively, a Form 1040NR, *U.S. Nonresident Alien Income Tax Return*), must be filed annually.

d. If the trust is a foreign trust, line 8 on Form 1040,*United States Individual Income Tax Return*, Schedule B, *Interest and Ordinary Dividends*, Part III, *Foreign Accounts and Trusts*, which asks "...were you the grantor of, or transferor to, a foreign trust?" must be answered in the affirmative.

e. If the trust is a foreign trust, a Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, will need to be filed by the settlor on an annual basis for the purpose of reporting any transfers to the foreign trust that occurred during the preceding taxable year. After having made the initial transfer, the settlor must continue to file Form 3520 for every succeeding year - even those years when no additional transfer is made.

f. For taxable years beginning January 1, 2011, taxpayers with foreign financial assets are required to file Form 8938, *Statement of Foreign Financial Assets* pursuant to FATCA legislation.

g. In addition, a Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*, must be filed on an annual basis by the trustee of the foreign trust to provide sufficient information to the United States owners of the foreign trust, as well as the trust beneficiaries, so that they can satisfy their obligation to report transactions with the foreign trust on Form 3520.

h. Internal Revenue Code § 684, *Recognition of gain on certain transfers to certain foreign trusts and estates*, provides "...in the case of any transfer of property by a United States person to a foreign estate or trust...such transfer shall be treated as a sale or exchange for an amount equal to the fair market value of the property transferred, and the transferor shall recognize as gain the excess of...the fair market value of the property so transferred, over...the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor." However, Internal Revenue Code § 684 also provides that this rule shall not apply "...to a transfer to a trust by a United States person to the extent that any person is treated as the owner of such trust under section 671."

- Normally, gain would be recognized upon the death of the grantor, when the foreign trust is necessarily no longer a grantor trust. However, Treas. Reg. § 1.684-3(c), provides that "...[gain] recognition...shall not apply to any transfer of property by reason of death of the U.S. transferor if the basis of the property in the hands of the foreign trust is determined under section 1014(a)."

2. Gift and Estate Taxation

i. Generally, the settlor will retain a testamentary limited power of appointment over the trust fund and either an inter-vivos limited power of appointment or a veto power over distributions in order to render the transfers to the trust as incomplete gifts. *See ILM 201208026.*

F. Foreign trustee

1. Trust can have one or more trustees with at least one trustee resident in the foreign jurisdiction.

2. Duties of offshore trustee may be nominal initially, but trust would usually provide that foreign trustee has power to remove domestic trustee(s) in event threat to assets or against trust were to develop.

3. Trust generally allows trustees to invest trust assets anywhere in the world, so trustee can direct that the assets be transferred to a financial institution (as custodian) in another jurisdiction such as Zurich or London.

4. Foreign trustee should have no presence in the United States to avoid jurisdiction by U.S. court.

G. "Protectors" who act as watchdogs over the trustees

1. A protector has veto powers over a trustee and can discharge a trustee

2. In some jurisdictions the settler may be a protector and may have certain veto powers over the trustees, including power to remove and replace trustees and veto investment and distribution decisions without such powers affecting creditor protection status. But vesting the settler with such powers may expose the settlor to contempt. See *FTC v. Affordable Media, et al.*, infra.

3. Since protector's power to veto certain trustee decisions is a negative power (as opposed to an affirmative power to initiate action), protector cannot be compelled by a court to submit the assets to its control.

H. Non-asset Protection Reasons for Offshore Trusts

1. A client may wish to create a long term dynasty trust not limited by Rule Against Perpetuities. Some jurisdictions permit trusts to last 100 years or more.

2. Although the trust is tax neutral during the settlor's lifetime under the grantor trust rules, it becomes a non-grantor foreign trust at the settlor's death. This can present tax opportunities not available to domestic trusts.

3. Avoidance of forced heirship rules (i.e., right of election provisions).

4. Properly structured foreign situs trust can invest in companies that for one reason or another do not wish to comply with SEC filing requirements (and therefore are otherwise off limits to U.S. investors).

   a. Offshore hedge funds

   b. Foreign variable life insurance

5. Foreign trusts are also used to diversify risk, avoid exchange controls, avoid government expropriation and maintain privacy.

I. Trust Structure

1. Irrevocable to avoid possibility a creditor could have the settlor compelled to revoke it. May provide for reversion to the settlor after a period of time provided no creditor claims exist provide for reversion

2. Settlor's interest as beneficiary should be discretionary

3. Settlor should retain a limited power of appointment if a completed gift is to be avoided.

4. Provision should be made for a protector and the powers of protector.

5. Give power to remove trustees located in jurisdictions where certain events occur (i.e. any threat to trust or trustees).

J. Combining Foreign Trust with Limited Liability Company

1. Maximizes both flexibility and protection.

2. When first established, transferor conveys assets to LLC in exchange for LLC interest, which is then transferred to the trust, allowing the manager/settlor to maintain control over LLC's assets.

3. Once threat appears, foreign trustee has power to remove manager (to protect manager from any potential court order) and, as sole member of the LLC, move LLC assets offshore

4. A member of the LLC can make election to be a disregarded entity by filing Form 8832. Single member LLC's electing to be disregarded entities must file annually on Form 8858.

K. Asset Transfer Considerations

1. Generally, liquid assets are best and least complicated to transfer offshore

2. If client wishes to protect illiquid assets (i.e., real estate, business interests, etc.) it may be possible to borrow out most of the equity using the property as collateral and moving the loan proceeds offshore.

3. Pension assets, including IRAs, would generally not be transferred since doing so would result in immediate income taxation and possible penalties for premature withdrawals. But ERISA qualified plans and IRA's are protected, and in many states, non-ERISA plans (i.e. Keoghs with only one participant) are protected under state exemption statutes.

4. Statutory provisions restrict transfers of professional corporation stock. However, to strip the equity out of the corporation, the grantor can borrow against corporate assets and transfer the proceeds to the partnership or trust.

5. "Nest egg" transfer for business person who must retain adequate assets to obtain bank loans versus other clients who might transfer all their property

6. Creation of several partnerships or LLC's so that inherent liabilities of certain assets do not taint other assets, e.g. real estate.

7. Subchapter S corporate stock should not be transferred to a foreign trust as it will terminate S status.

L. Export the Assets v. Import the Law

1. Exporting assets to foreign jurisdiction under control of foreign trustee.

2. Importing the law

a. Assets transferred to settlor-controlled LLC or FLP remain in United States until threat arises

b. May subject settlor to civil contempt. See Section V, *infra.*

c. U.S. court may have jurisdiction over foreign trust due to situs of assets remaining in United States. See *Nastro v. D'Onofrio*, 263 F. Supp 2d. 448 (2003).

M. Foreign vs. Domestic

1. Foreign trusts offer more substantive barriers to creditors since a U.S. judgment may not be enforceable offshore, whereas U.S. Constitution generally requires state courts to enforce other state's judgments. See e.g. *In re Mortenson,* infra..

2. Will settlor's designation of what state or foreign country's laws govern the trust be respected? Or will a creditor's rights be determined by the state's governmental interest or "significant relationship" with the settlor? See e.g., *In re Huber, In re Portnoy*, 201 B.R. 685 (S.D.N.Y. 1996) *infra.* and *B.V. Brooks* 1998 Bankr. Lexis 60 (D.CT., 1998)

3. Consider appointment of a domestic trustee resident in a state which recognizes self-settled trusts to act with a foreign trustee.

N. How Much Protection Is Necessary?

1. Some client situations warrant greater sophistication and complexity resulting in higher costs.

2. Continuum beginning with transferring assets to a spouse (at minimum cost) and proceeding through a series of alternatives offering more certainty and flexibility until you reach offshore trust/foreign LLC contribution (at the greatest cost).

O. Costs

1. In addition to legal fees, client will incur annual fees to offshore trustee of $3,500 to $5,000 depending on jurisdiction. Once trust is created only other ongoing costs are those for preparing the trust income tax returns

2. Fees paid to establish asset protection trust and administrative fees paid to operate it should, if reasonable, be deductible under IRC Code § 212 as "ordinary and necessary expenses paid or incurred... (1) for the production or collection of income or (2) for the management, conservation, or maintenance of property held for the production of income"

3. Client should assess level of protection desired and consider annual cost to be similar to that of a single premium liability policy

   a. A cost/benefit analysis

   b. Typical client has at least $1,000,000 in assets to protect

   c. Clients who place great value on peace of mind will be better able to justify more sophisticated techniques.

   d. Offshore trust on a stand alone basis, where settlor is neither a protector nor a beneficiary; but client must give up control which, as a practical matter, most clients would prefer not to do.

   e. Nature and location of assets owned by LLC or trust. If client utilizes the LLC/trust technique generally there is no need, initially, to transfer assets offshore.

   f. In authors' experience, less than 5% of clients creating such vehicles have been targeted by creditors and therefore these structures merely serve a similar purpose to that of insurance policies

   g. When a creditor attack is imminent, however, a decision will have to be made to remove assets from danger of being seized. At this time assets can be liquidated and moved to another jurisdiction.

P. Other Practical Concerns

1. Possibility that a creditor may bring legal action against planner under various theories; possibility exists that a client may have misrepresented his or her liabilities or that an aggressive creditor may name planner as a co-conspirator to gain some leverage in litigation. See, e.g., *Morganroth & Morganroth v. Norris McLauglin*, 2003 U.S. App. Lexis 10808 (3rd Cir, May 30, 2003). Planner must protect himself or herself by properly advising clients that there are limits to protecting assets, demanding full disclosure, obtaining affidavits of solvency, and most importantly knowing the client.

2. Since asset protection planning must be implemented when there are no legal claims on the horizon, the planner has the difficult task of motivating a client to take action before a fear becomes a nightmare.

3. How will the filing of bankruptcy affect the creditor protection of self-settled trusts?

   a. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added a provision that will deem a transfer to a self-settled trust to be a fraudulent transfer if made within 10 years of filing a bankruptcy petition, if the transfer is made with fraudulent intent to hinder, delay or defraud existing or future creditors.

   b. Should the settlor's interest as a beneficiary "spring" up only after 10 years? Alternatively, should the trust be settled offshore for the first 10 years and then be redomiciled onshore?

   c. Does the Act legitimize self-settled trusts that have been existent for more than 10 years? Or will the forum state still apply its own laws?

XI. EFFECTIVENESS OF AND CHALLENGES TO ASSET PROTECTION TRUSTS.

A. The effectiveness of any asset protection plan is determined by the results ultimately achieved. That is, in the final analysis, to what extent has the client protected the assets from loss.

B. In the real world plaintiffs must weigh the heavy costs of litigation against the likelihood of successful recovery. If, as a result of availing oneself of certain techniques, the client is in a better position to settle the dispute at considerably less cost, then the benefits of asset protection are realized.

C. Several reported decisions involving offshore trusts offer insight into how the courts, both in the United States and abroad, view these structures.

   1. *Re: 515 South Orange Grove Owners v. Orange Grove Partners*, brought in the Cook Islands in 1994, involved a California real estate developer against whom suit was brought in California in 1992 and a judgment of $5 million was awarded in California in 1994. During 1993 and 1994 the defendant settled a trust in the Cook Islands and transferred assets thereto. The creditors obtained a *Mareva* injunction (similar to a TRO) *ex parte*. The author has been advised that this case settled. It may not have been difficult, however, for the creditor to have satisfied its burden to prove a fraudulent conveyance beyond a reasonable doubt under the timing stated.

   2. In *Brown v. Higashi*, U.S. Bankruptcy Court 95-3072 (D. Alaska 1996), the District Court determined that the Belize trust created by the debtor

was a sham and therefore the assets of the trust were includable in the debtor's bankruptcy estate. The Court's decision was based on several factors including, importantly, the debtor's absolute failure to execute any trust documents and complete retention of control over the trust assets.

3. In *Marine Midland v. Portnoy*, 201 Bankr. 685 (SDNY 1996), the debtor transferred over $1 million to a Jersey, Channel Islands, trust at a time "when he knew his personal guarantee was about to be called." In addition, the District Court noted that the debtor misrepresented, during settlement discussions (prior to the bankruptcy filing), that the debtor had incurred large expenses for cancer treatments because of which the debtor had no assets remaining to satisfy his debt. Finally, the District Court also noted that debtor's salary was being deposited into the debtor's wife's account. The District Court denied the debtor a discharge holding that the debtor's actions demonstrated intent to defraud creditors. There are reports that this matter settled.

4. In the case of *In re B.V. Brooks*, 217 B.R. 98 (D. Conn., 1998), the issue before the court was whether to apply domestic (in this case, Connecticut) law, or foreign law to the spendthrift trust exemption under the Bankruptcy Code. Citing *Portnoy* as precedent, the court found the assets of the debtor's two trusts includable in the debtor's bankruptcy estate notwithstanding the fact that the trusts were valid spendthrift trusts under the laws of Bermuda and Jersey, Channel Islands. Although very little of the case's factual background was actually reported, the Bankruptcy Court did note that the debtor/settlor was the primary beneficiary of each of the trusts and had the right to receive all of the income. In addition, the unreported facts apparently caused the court to perceive the funding of the trusts as fraudulent since the Court twice characterized the debtor's acts in creating the trusts as a "scheme". This perception was likely buttressed by the timing of the case since the trusts were funded in 1990 and an involuntary bankruptcy petition was filed against the debtor the following year.

5. In the matter of *In re Stephan Jay Lawrence*, 227 B.R. 907 (S.D. FL 1998), following a forty-two month arbitration and just sixty-six days before an award in excess of US $20 million was entered against him, the debtor funded an off-shore trust citing first the law of Jersey, Channel Islands, and about a month later, the law of Mauritius, as governing. Citing both *Portnoy* and *B.V. Brooks* the Bankruptcy Court found that the sole purpose of the trust was to shield the debtor's assets from a creditor which "was about to obtain a staggering $20 Million arbitration award against him" and that "[t]he timing of the trust's creation is further evidence of this intent." The court also found the debtor's testimony before the court to have not been credible (and on several occasions perjurious), and that the debtor was "shockingly less than candid" with

the court. The court, therefore, entered judgment against the debtor, thereby denying him a discharge in bankruptcy.

- Subsequently, the bankruptcy trustee moved to hold the debtor in contempt if he did not repatriate the funds. In September, 1999, having failed to repatriate the funds, the debtor was held in contempt. *In re Lawrence*, 238 B.R. 498, 500 (S.D.Fla. Bankr., 1999), which finding was affirmed by the U.S. District Court in a *de novo* review. *In re Lawrence*, 251 B.R. 630 (S.D.Fla. 2000).

    - Generally, impossibility of performance is a complete defense to a charge of coercive civil contempt. *United States v. Rylander*, 460 U.S. 752 (1983). However, certain lower courts have suggested that an exception exists where the impossibility is self-created within a nexus of time of the anticipated judgment.

6. *FTC v. Affordable Media LLC, et al.*, 179 F.3d. 1228 (9th Cir. 1999). Although the facts in this case (colloquially known as the "Anderson" case after its individual defendants), were as bad as, if not worse than, those in any of the foregoing cases, the court never reached any issues of trust validity or conflict of laws. Instead, the Court tangled with the settlors' alleged contempt of court in failing, pursuant to a preliminary injunction, to repatriate trust assets which had been invested in trust name offshore. Specifically, the settlors, who were also co-trustees of their own trust, as well as the trust protectors, were ordered to instruct their foreign co-trustee to repatriate more than $6 million in profits collected under an alleged Ponzi-type investment scheme. The "anti-duress" clause in the trust agreement resulted in their removal as trustees and ensured that the assets would not be repatriated pursuant to the Court's order. When the assets were not timely repatriated, the settlors were held in civil contempt for failing to comply with the court order and jailed pending repatriation of the assets. After the FTC lost several rounds in the Cook Islands, the case was ultimately settled for $1.2 million.

    - In finding the Andersons in civil contempt, the district court rejected the Andersons' impossibility defense, specifically finding that the Andersons, in the judgment of the Court, were in control of the trust since the trust instrument provided them, as the protectors, with the exclusive power to determine what constituted an event of duress (which would negate their power to instruct to the trustee to repatriate the trust fund).

7. *United States v. Grant*, No. 00-8986, 2005 U.S. Dist. LEXIS 22440 (S.D. Fl. Sept. 2, 2005). In 1983 and 1984, Raymond Grant created a Bermuda trust and a Jersey, Channel Islands, trust. Raymond was the beneficiary

of the Bermuda trust, and his wife, Arline Grant, was the beneficiary of the Jersey, Channel Islands, trust. In 1991 and 1993, the IRS assessed millions of dollars in back taxes against the Grants for the years 1977 through 1982, and 1984 through 1987. In 2003, judgment was entered against the Grants for more than $36 million, and a motion was made to order Arline to repatriate the trust funds because Arline had the power to remove and replace any acting Trustee. The court set forth its query in simple terms: "[I]s this a trust over which the beneficiary lacks any control, such that the beneficiary is simply that and nothing more, and regardless of what she does or says, she lacks the power to repatriate these assets to the United States? – or, does the beneficiary retain such control that she has the power vested in her in some way by the terms of the trust to repatriate the corpus? If she has such power, then this asset is no different from any other asset."

- Arline took steps to have the trustees remit the funds or resign in favor of a US trustee, which was unsuccessful. Therefore, the Court denied the government's motion to hold Arline in contempt as her demonstrated impossibility to comply was a complete defense to contempt. See, *U.S. vs. Raymond Grant and Arline Grant,* 2008 U.S. Dist. LEXIS 51332, U.S. District Ct., S.D. Florida, May 27, 2008.

- But see the follow up decision wherein the Court, after further discovery revealed trust distributions indirectly benefiting Arlene, compelled her to turn over all future distributions and prohibited her from informing the trustees that she was under a Court Order. *U.S. v. Grant*, 2013 WL 1729380 (S.D. Fla., April 22, 2013).

8. *Federal Trade Commission v. Ameridebt, Inc.*, 373 F. Supp. 2d 558 (D. Md. 2005). In this case, the defendants allegedly operated a "non-profit" credit counseling service, but defrauded consumers with debt problems by offering to fashion debt payment plans for them and then deducting fees from payments the consumers made under the plans without disclosing those deductions to the consumers. The Federal Trade Commission sought a preliminary injunction appointing a receiver, freezing the defendants' assets, requiring an accounting and directing the defendants to repatriate to the receiver assets that had been transferred offshore. The FTC alleged that since the time when the defendants became aware of the investigation that led to the lawsuit the defendants had been actively dissipating their assets by making transfers to close friends and relatives, to trusts (both domestic and offshore), and by living a lavish lifestyle. In particular, less than two months after the FTC served two of the defendant companies with Civil Investigative Demands, one of the individual defendants set up domestic and offshore asset protection trusts. Presented with this set of egregious circumstances, the District Court granted the motion for preliminary injunction appointing a receiver,

freezing the defendants' assets, requiring an accounting of assets and directing the defendants to repatriate to the receiver assets that were transferred offshore. With regard to the latter aspect of the injunction, the District Court noted that if the defendant violates the order and "fails to repatriate assets in the trusts, the FTC may move for contempt, at which point Defendants will be free to argue the impossibility of performance, an argument the Court may or may not find persuasive."

9. *Nastro v. D'Onofrio*, et. al., 263 F. Supp. 2d 446 (D. Ct. 2003). The plaintiff obtained a $2.1 million judgment against the defendant for misappropriation of their formerly co-owned company's funds. Two weeks later, the defendant transferred $650,000 worth of stock and membership interests in Connecticut companies of which he was either the 100% owner or 50% owner to an irrevocable spendthrift trust in Jersey, Channel Islands, for the benefit of his wife and children. The plaintiff asserted, *inter alia*, that the transfer was fraudulent under Connecticut's Uniform Fraudulent Transfer Act. The Court dismissed the claims against the Jersey, Channel Islands, trustee, holding that there was no basis to exercise personal jurisdiction over it because the Jersey, Channel Islands, trustee had insufficient contacts with Connecticut. Further, the Court ruled that there was no basis to exercise jurisdiction over the trust assets since they consisted of "certificated" securities and, under Connecticut's version of the Uniform Commercial Code, the situs of a certificated security is the place where the certificate is located (*i.e.*, Jersey, Channel Islands). This is the case "[e]ven though the companies and, presumably, the companies' assets are located in Connecticut." However, the Court granted plaintiff's preliminary injunction enjoining the Connecticut companies from registering any further transfers of stock held by the trust and from transferring any assets to the defendant, his family or the trust during the pendency of the litigation. The Court found that the plaintiff satisfied his twin burdens of showing that he will suffer irreparable harm and that there are sufficiently serious questions on the merits. The first prong was satisfied since there was the possibility that the defendant could take further action to place the assets beyond the reach of the Court. The second prong was satisfied since there was evidence that the defendant transferred his interests in the Connecticut companies without consideration and was thereby rendered insolvent (which, under Connecticut's Uniform Fraudulent Conveyance Act, would render the transfers fraudulent).

10. *SEC vs. Jamie Solow*, 682 F. Supp. 2d 1312 (S.D. Fla., 2010). In this case, the defendant's spouse had settled a Cook Islands Trust shortly after the defendant was found liable for securities fraud and a judgment of $6 million was entered against him, including $3 million for disgorgement. The defendant had made several asset transfers to his wife during the investigation of the fraud and after numerous arbitration proceedings were commenced. Among other assets transferred to the foreign trust, the

defendant's wife had stripped the equity in their homes by obtaining a mortgage and transferring the proceeds to the foreign trust. After the judgment was entered the defendant claimed he did not have the ability to pay the judgment and the Court held him in contempt, citing the *Lawrence* case and the fact that he had created his own impossibility by, *inter alia,* co-signing the mortgage deed. The Court ordered him to be incarcerated until the judgment is satisfied.

11. *Rush University Medical Center vs. Sessions*. 2012 WL 4127261. The plaintiff, Rush University Medical Center, sued the defendant's estate to enforce a charitable pledge. Upon obtaining a successful judgment plaintiff learned that the deceased settlor transferred his assets to a Cook Islands trust one year prior to making the pledge. Defendant argued that Cook Islands law governed the trust and any transfers thereto while the plaintiff argued that the transfers were fraudulent under Illinois law and that Illinois law does not recognize self-settled trusts as against the settlor's creditors. The Supreme Court, in reversing the lower court, held in favor of plaintiff. Unfortunately, the trust held limited partnership interests in Illinois real property and therefore will likely be subject to attachment.

D. More recently a few decisions involving domestic asset protection trusts have similarly applied public policy considerations to invalidate the trusts.

1. In re Mortensen (*Battley v. Mortensen*, Adv. D. Alaska, No. A09-90036-DMD, May 26, 2011), was the first reported case to deal with a domestic asset protection trust. In that case, Mortensen, a resident of Alaska, without the aid of counsel, drafted a trust document in 2005 called the "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)" intending for the Trust to qualify as an asset protection trust under Alaska law. Following his creation and funding of the Trust, Mortensen's financial condition deteriorated, his income became "sporadic," and he ultimately filed for bankruptcy. Although the Bankruptcy Court concluded that Mortensen was not insolvent when he established and funded the Trust, due to the specific circumstances of the case it held that his funding of the trust nevertheless fell under Section 548(e) of the Bankruptcy Code as a fraudulent transfer to a self-settled trust made within ten years prior his bankruptcy filing.

2. *In Re Huber,* 201 B.R. 685 (Bankr. W.D. WA May 17, 2013) involved the creation of an Alaska asset protection trust by a Washington developer at a time when he "...was or had to be aware of the 'gathering storm clouds'," including "...the threat of a collapsing housing market," and when his prospects for repayment of several substantial loans was "fragile at best". *Huber* held the trust invalid under a conflict of laws analysis which, if correct, would invalidate every self-settled spendthrift trust created by a Washington resident, irrespective of circumstances.

Whether *Huber's* analysis was correct, however, is subject to dispute. It is unfortunate that the first case to address the conflicts of law issue with regard to a domestic asset protection trust involved fraudulent transfers that seemingly impacted the Court's decision on the conflicts of law issue.

The Court in *Huber* cited to § 270 of the Restatement (Second) of Conflict of Laws (1971), which speaks to the validity of an inter vivos trust in movables After finding that the trust had its most significant relationship with Washington, partially based on the debtor's residence, *Huber* held without real analysis that Washington had a strong public policy against "asset protection trusts". Indeed, it is not clear why the Court even felt compelled to address the conflicts of law issue, since the same result was obtainable by reference to the fact that the trust's funding was a fraudulent transfer. Thus, the question left after *Huber* is whether another court would rule similarly on the conflicts of law question absent the fact of the fraudulent transfer.

E. As many of these cases illustrate "bad facts make bad law." Based on the facts presented, the trusts were created after the debt was incurred and accordingly the Court, in each instance, reached the right decision. Notwithstanding the results obtained (and without condoning such transfers), in many cases the debtors apparently even benefited by their wrongful transfers.

1. In the end, the best results will be obtained where trusts are settled sufficiently in advance and properly structured and administered.

- A decision recognizing the validity of a foreign trust arose in the context of a divorce proceeding. In *Reichers v. Reichers* (NY Supreme Court, Westchester County), (New York Law Journal July 1, 1998), the defendant husband settled an irrevocable trust in the Cook Islands in 1992 following the successful conclusion of three medical malpractice lawsuits that had been filed against him. Ironically, his wife then sued for divorce in 1994. The Court in its decision, wrote:

> "Assuming arguendo, that this Court had jurisdiction over the corpus of the Reichers Family Trust, which it does not, a cause of action would not lie to set aside the trust since the trust was established for the legitimate purpose of protecting family assets for the benefit of the Reichers family members."

2. At the end of the day, however, the offshore trust's effectiveness as a tool to thwart future creditors will most likely not depend on whether a United States court gives credence to the application of foreign trust law when adjudicating a claim against the settlor. Provided that the trust's assets are

located offshore (whether that be in the jurisdiction of the trust's governing law or an established financial center such as Switzerland or Luxembourg), a creditor with a United States judgment will still be faced with significant hurdles before actually being able to levy on any of the trust's assets. In fact, since some jurisdictions will not recognize foreign judgments, the creditor may be forced to re-litigate its entire case against the trust. Moreover, in some jurisdictions the statute of limitations on fraudulent transfer claims may have already expired by the time suit is brought in that jurisdiction). Finally, aside from the United States, most common law jurisdictions (*i.e.*, those jurisdictions which recognize the trust concept), (i) do not allow attorneys to take matters based on a contingency fee, and (ii) provide that the losing party to a lawsuit must pay all of the victor's expenses, including attorneys' fees. Combined with an evidentiary standard in some jurisdictions requiring proof beyond a reasonable doubt on fraudulent conveyance claims, assets held in a foreign trust may, in the end, be unreachable notwithstanding the fact of a United States judgment. At the very least, the process may prove prohibitively expensive for a creditor when the potential reward is so uncertain.

XII. NEW TRENDS IN ASSET PROTECTION WITH AN EMPHASIS ON ESTATE PLANNING.

A. Tax Planning vs. Asset Protection

1. Many of the structures that are used to maximize planning with the lifetime gift tax exemption also provide potentially significant asset protection benefits by (i) divesting the settlor of an asset, or (ii) converting the settlor's outright ownership of an asset into either (a) a less attractive retained interest, or (b) an entirely different type of property which is less attractive to creditors.

2. Moreover, the asset protection benefit of such structures is enhanced by the fact that since these structures are ubiquitous as estate planning vehicles, they are much less controversial and prone to scrutiny than so-called "asset protection trusts."

3. Finally, since these structures provide undisputedly significant estate and gift tax savings, they can help to counter potential creditor claims to the effect that transfers in connection with the structures were made with the intent to hinder, delay or defraud creditors (*i.e.*, a fraudulent transfer).

B. Analysis of IRS Rulings and Court Decisions

1. Estate Tax Inclusion

a. IRC § 2036 provides that a transferor's gross estate includes the value of any transferred property over which the transferor retained the right to possession, enjoyment or income for a period not ascertainable without reference to his life.

b. A gift is incomplete in every instance in which "the donor reserves any power over its disposition." Treas. Reg. §25.2511-2.

c. Since, under Restatement (Second) of Trusts §156(2), a settlor's creditors can reach trust property to the maximum extent that the trustees may distribute the property to the settlor, the settlor is deemed to have retained rights to the property within the meaning of IRC §2036 and §2511. (See, e.g., *Paxton v. Comm'r*, 86 T.C. 785 (1986), *Outwin v. Comm'r*, 76 T.C. 153 (1981), and *Paolozzi v. Comm'r*, 22 T.C. 182 (1954)).

2. Completed Gifts

a. "If and when the [settlor's] dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a state where the [settlor's] creditors cannot reach the trust's assets, then the gift is complete for federal gift tax purposes under the rules set forth in §25.2511-2 of the Regulations." Rev. Rul. 76-103, 1976-1 C.B. 293.

b. Where "...the [settlor] cannot require that the trust's assets be distributed to the [settlor] nor can the creditors of the [settlor] reach any of the trust's assets..." the settlor has parted with dominion and control so as to have made a completed gift of the assets transferred to the trust. Rev. Rul. 77-378, 1977-2 C.B. 347.

c. Private Letter Ruling 9332006 (which is not precedential) applies the foregoing rules to a foreign situs asset protection trust of which the settlor and the settlor's family were discretionary beneficiaries. The settlor's transfer to the foreign situs trust was deemed by the IRS to be a completed gift and, therefore, outside of the settlor's taxable estate because under the laws governing the trust the settlor's creditors could not attach the trust assets.

d. Private Letter Ruling 9837007 (not precedential) applies to an Alaska trust in which the settlor was among the class of beneficiaries. The Service held the transfer to be a completed gift but refused to rule on whether the assets in the trust would be includable in the Settlor's estate at death because of the possibility

of an implied agreement with the trustee to make distribution upon the settlor's demand.

e. Private Letter Ruling 200944002 (not precedential) also applies to an Alaska Trust settled by an Alaska resident and concluded that the transfer was a completed gift and, barring other facts existing at death, should not be includable in the settlor's estate citing Rev,. Ruling 2004-64.

C. Using Self-Settled Trusts for Estate Planning Benefits.

1. Introduction

a. Basic objective of estate planning is to minimize estate, gift and generation-skipping transfer taxes to the greatest extent possible while remaining true to the client's dispositive wishes.

b. An estate planner's ability to minimize transfer taxes may be frustrated by the client's desire to retain control over and/or access to his assets during lifetime.

c. A properly structured, self-settled, spendthrift trust ("APT") provides a viable solution to a client's desire to be able to minimize transfer taxes without putting his assets forever out of reach in the event of an emergency need.

d. As an added benefit, property held in trust will avoid the delay, expense and publicity involved in transferring property at death pursuant to a probate proceeding

e. Since assets held in the trust will enjoy a greater degree of creditor protection than assets retained in the settlor's individual name, a transfer to an APT will actually enhance the likelihood that the assets will be available to the settlor in case of some future emergency need

2. Minimizing Estate and Generation-Skipping Transfer Taxes

a. A settlor can make an inter-vivos transfer of the gift tax annual exclusion amount to an APT in order to gradually reduce the size of his taxable estate without incurring any transfer tax or reducing his unified credit.

- In order to have a transfer to an APT come under the IRC §2503 gift tax exclusion the transfer must be of a "present interest" under IRC §2503(b). This can be accomplished by the inclusion of "Crummey" powers in the trust agreement.

b. A settlor could make an inter-vivos gift of his remaining IRC §2010 applicable exemption amount

i. No current transfer tax liability

ii. Removal of subsequent appreciation from settlor's estate

iii. The loss of the IRC §1015 "stepped-up" basis is more than compensated for by the overall tax savings inherent in the differential between the maximum 45% estate (and generation-skipping transfer) tax rate and the maximum 15% capital gains tax rate

c. Gifts in excess of the applicable exemption amount (in particular, gifts aggregating the IRC § 2631 generation-skipping transfer tax exemption amount of $5 million) are advisable if the settlor can afford to pay the current gift tax since inter-vivos gifts are, in effect, one-third more tax advantageous than testamentary bequests

d. Any gift tax paid will further reduce the settlor's taxable estate (provided the settlor lives 3 years)

e. An allocation of the settlor's generation-skipping transfer tax exemption to a transfer to trust will exempt the entire transfer of property and all future appreciation thereon from generation-skipping transfer tax.

3. Drafting Considerations

a. Trustee selection - trust must have at least a resident trustee but settlor could appoint others (e.g. advisory committee) to make investment or distribution decisions. Trustee should not be related or subservient to settlor

b. Trust protector - Protector can have power to discharge trustees, make certain trust amendments if necessary, etc.

c. Change of situs provision allows for subsequent changes if laws or circumstances change

d. Other asset protection provisions such as anti-duress clauses and flee clauses can be incorporated into trust

e. Distribution Guidelines - Consider incentive provisions conditioned on earned income and distributions to beneficiary's spouse while married

f. Termination powers given to trustee if continuation not in beneficiary's best interests

g. Spendthrift provision to protect from beneficiary's creditors/former spouses.

4. Advanced Considerations.

a. An APT can be combined with a limited partnership or limited liability company in order to permit investment management and control of the trust assets to continue in settlor without jeopardizing the nature of the transfer as a completed gift.

i. Structure may provide lack of marketability and lack of control discounts on the transfer of limited partnership/membership interests to the trust, thereby permitting the transfer of real value in excess of the amount subject to taxation.

ii. Structure will provide an additional layer of protection between third party creditors and the trust.

iii. In the unlikely event of trust creditors, enforcement of a judgment will be limited to a charging order against the trust's limited partnership or limited liability company interest

iv. Use of a limited partnership or limited liability company formed in the DAPT state will increase the settlor's contacts with that state, further justifying the application of that state's law to the claims of any creditor of the settlor

b. An APT can be combined with any split-interest gift in trust (*i.e.*, a QPRT, GRAT, or CLT), in order that the settlor may continue to have discretionary access to the transferred property after the initial term of the trust has expired.

c. An APT can be used to own the settlor's life insurance policies in the same manner as an irrevocable life insurance trust. So long as the settlor does not retain incidents of ownership in the transferred policies he can be a discretionary beneficiary, thereby permitting distributions of cash value to the settlor. (*See*, PLR 9434028).

5. Domestic vs. Offshore?

a. Introduction

i. Although highly touted as an asset protection vehicle, domestic trusts are generally inferior to foreign-situs asset protection trusts because of legal distinctions between domestic and foreign trust law as well as the practical difficulties encountered in proceeding against a trust (and its underlying assets) situated abroad.

ii. Selected foreign asset protection jurisdictions will not honor judgments rendered by courts in the United States, thereby requiring a creditor to re-litigate its claims offshore. In contrast, a U.S. court is required by the Full Faith and Credit Clause of the United States Constitution to honor the validly rendered judgments of its sister states (United States Constitution, Article IV, Section 1).

iii. The Statute of Limitations for fraudulent conveyances in selected foreign asset protection jurisdictions may be as short as one year from transfer.

iv. The standard of proof for a creditor on a fraudulent conveyance claim in selected foreign asset protection jurisdictions can be as high as "beyond a reasonable doubt" (a standard normally used exclusively for criminal matters in the United States).

b. The issue of which is better, domestic or offshore, should, therefore, focus on a settlor's primary use of the structure as an estate planning, rather than as an asset protection, vehicle.

c. Considerations in Favor of Offshore

i. Statutory framework and case law in foreign jurisdiction may provide greater certainty to the result of a settlor's transfer (*i.e.* whether the transfer is a completed gift despite the trustees' discretionary power to return the trust assets to the settlor).

ii. Cook Islands first enacted comprehensive asset protection trust legislation in 1984.

iii. Ten year fraudulent transfer statute under U.S. Bankruptcy Code not likely enforceable.

d. Considerations in Favor of Domestic Trusts

i. Although a properly structured foreign situs asset protection trust should not be taxed any differently than a domestic trust substantial reporting requirements are imposed on foreign trusts with U.S. beneficiaries.

ii. Many offshore asset protection trusts are designed with either automatic or discretionary "flee" clauses to cause the trust to "migrate" abroad when creditor problems arise. At that point the trust will be deemed "foreign" under the IRC and may become subject to additional tax reporting requirements.

iii. Prospective settlors of offshore asset protection trusts must concern themselves with the economic stability and political security of the jurisdiction whose laws they are entrusting their assets to compared with the economic stability and political security in the United States.

- Even offshore jurisdictions with extensive histories of political and economic stability may probably not provide the same level of comfort as a domestic trust.

iv. United States federal and state courts and the IRS may regard domestic trusts as a more legitimate creditor protection and estate planning device than offshore trusts

- A domestic court may resent transfers outside of the jurisdiction of United States courts and reason that there is no "legitimate" reason for using an offshore trust (rather than a domestic trust) other than thwarting the domestic legal system. See e.g. *In Re: Portnoy*, 201 Bkrtcy 685 (S.D. N.Y.1996) and *B.V. Brooks*, 1998 Bankr. Lexis 60 (D.Conn.1998)

v. Domestic trusts should, both in its creation and in its maintenance, be less expensive than an offshore asset protection trust with comparable assets.

e. Considerations in Favor of Alaska/Nevada/South Dakota

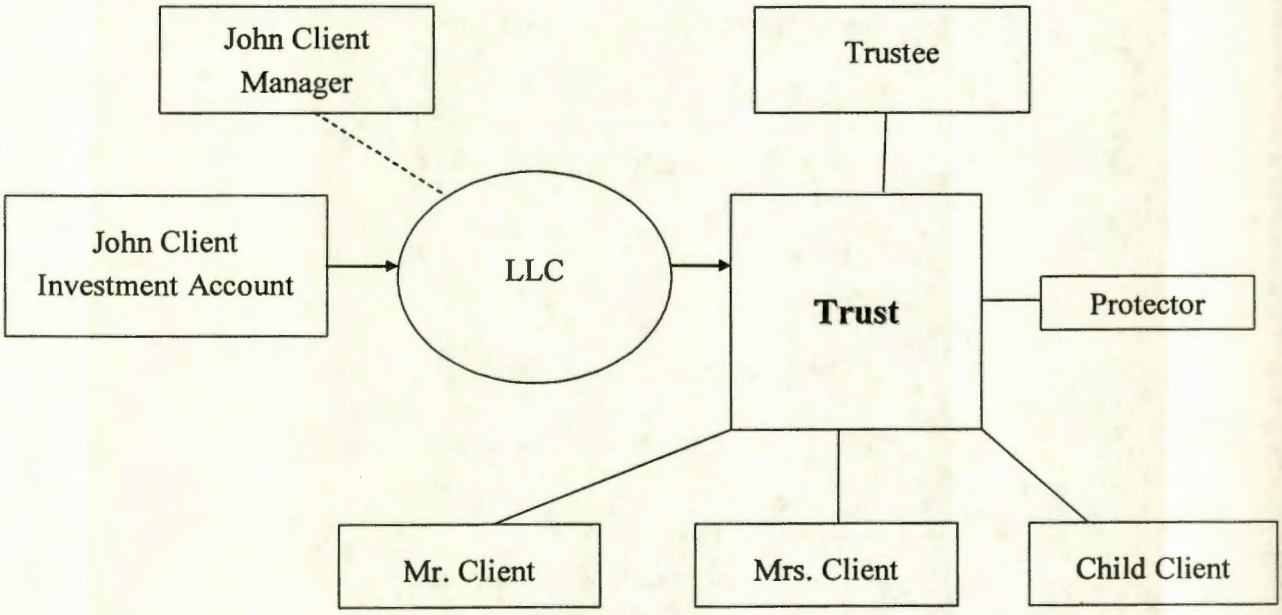
i. Due to the carve-outs available to certain creditors under the asset protection legislation of certain states (*i.e.*, Delaware's statute (*see* I.5., *supra*)) there is a risk the

IRS may take the position that the trust property, being subject to claims of creditors, even though restricted, nonetheless renders the transfer incomplete for gift and estate tax purposes.

EXAMPLE

	Dynasty Trust	Outright Gift
Initial Amount (Grantor 50 Years Old)	$5,000,000	$5,000,000
Value at Grantor's Death(25 Years)	$27,137,160	$27,137,160
Estate Tax @ 40%	$0	-10,854,864
	27,137,160	$16,282,296
Value at child's Death – 50 Years	147,285,135	88,371,065
Estate Tax @ 40%	0	-35,348,259
	$147,285,135	53,022,806
Value at Grandchild's Death – 75 Years	$799,380,150	287,777,708
Estate Tax @ 40%	$0	-115,111,083
	$799,380,150	172,666,625

*assumes 7% growth per year



ASSET PROTECTION AUDIT CHECKLIST

I. Determine Possible Sources of Liability

- A. Professional Malpractice
- B. General Torts (Auto accident, etc.)
- C. Contract Claims
- D. Creditor Exposure
- E. Officer and Director Liability
- F. Environmental Liability
- G. Divorce
- H. Forced Heirship (*i.e.*, Right of Election)
- I. Political Threats
- J. Economic Risks
- K. Existing Lawsuits

II. Insurance Adequacy Analysis

- A. Homeowners
- B. Auto
- C. Umbrella
- D. Business Risks
- E. Directors and Officers
- F. Disability
- G. Life

III. Maximization of Exemption Allowances

- A. Does Client Participate In/Have Retirement Plans?

1. Determine Exempt Status

B. Is Homestead Exemption Available?

1. Ascertain How Title is Held

2. Consider Effects (Tax and Non-tax) of Changing Title

C. Determine Extent of Joint Ownership/Community Property

IV. Review Estate Plan and Nature of Asset Holdings With View Towards Creditor Protection

A. Does Client Expect Large Inheritance?

1. Ascertain Whether Outright or in Trust

B. Do Wills and Trusts Provide for Outright Distributions to Beneficiaries?

1. Consider Amending to Retain Assets in Trust

C. Business Activities

1. What Form of Entity is Utilized?

☐ LLC ☐ Corp. ☐ Sole Proprietor

☐ LLC ☐ L.P.

2. Is Client a General Partner?

3. Has Client Provided Guarantees?

4. Consider Reorganizing Holdings and Segregating Assets with Liability Potential

V. Prepare Solvency Analysis.

VI. Consider/Discuss Following Techniques to Protect Wealth

A. Domestic Trusts

1. Non-Self-Settled

a. QPRT

b. CRT/CLT

c. QTIP

d. Discretionary

e. Power of Appointment

f. Sale to Grantor Trust

2. Self-Settled

B. Foreign Trusts

C. Swiss Annuities

D. Foreign Life Insurance

E. Limited Liability Entities

3

CURRENT DEVELOPMENTS IN ESTATE PLANNING

New York's Top 10 Trusts & Estates Lessons, Developments and Reminders of 2015

Private Wealth and Taxation Institute
Meltzer, Lippe, Goldstein & Breitstone, LLP
Hofstra Law School

May 19 & 20, 2016

Sharon L. Klein
President
Wilmington Trust, N.A.
New York Metropolitan Region
350 Park Avenue
New York, New York 10022
Phone Number: 212-415-0531
E-Mail: sklein@wilmingtontrust.com
www.wilmingtontrust.com

WILMINGTON
TRUST

The Wilmington Trust Advantage

A Powerful Combination of Strength and Expertise

With roots dating back to the founding of Wilmington Trust Company by T. Coleman duPont in 1903, Wilmington Trust has been serving successful individual and institutional clients for generations. We bring a unique blend of knowledge, experience, and resources to every client relationship that we serve, offering the highest caliber of service from a team of nationally recognized experts.

Wealth Advisory

- Clients in all 50 states and 35 other countries
- One of the largest personal trust providers in the United States
- Expert tax planning and wealth transfer strategies
- Investment management, private banking, family governance, and family office services

Institutional Client Services

- International client base with clients in more than 90 countries
- Specialized trust services for capital markets financing structures
- Trust and custody services for retirement plans
- Customized institutional investment capabilities

Corporate Facts and Figures for our parent company, M&T Bank Corporation
(as of 12/31/2015)

We are proud to be part of the M&T corporate family, one of the most financially sound and successful companies in the U.S. financial services industry.

- One of the 20 largest independent commercial bank holding companies in the U.S.
- $122.8 billion in assets
- $73.0 billion in assets under management
- $133 billion in assets under administration
- $16.2 billion in shareholders' equity
- $86.5 billion in loans and leases
- $92.0 billion in deposits
- Tier One Capital Ratio: 12.68%
- Consistent profitability for the past 158 consecutive quarters
- Through Berkshire Hathaway Inc., acclaimed investor Warren Buffett is a major M&T shareholder
- From January 1, 1980 through December 31, 2015, M&T's stock has been one of the top performers in the U.S, with an annualized total return to shareholders of 18.9%.

M&T is a financial holding company headquartered in Buffalo, New York. M&T's principal banking subsidiary, M&T Bank, operates banking offices in New York, Pennsylvania, Maryland, Virginia, West Virginia, Delaware and the District of Columbia. Trust-related services are provided by M&T's Wilmington Trust-affiliated companies and by M&T Bank.

Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Investment management and fiduciary services are provided by Wilmington Trust Company, a Delaware trust company, and Wilmington Trust, N.A., a national bank and member FDIC. Loans, retail and business deposits, private banking services, and other personal and business banking services and products are offered by M&T Bank, member FDIC.

New York Law Journal
Trusts&Estates
WWW.NYLJ.COM
An ALM Publication
TUESDAY, JANUARY 19, 2016

2015's Top **Lessons, Developments,** And **Reminders**

BY SHARON L. KLEIN

From new legislation, to important regulatory guidance to instructive case law, 2015 saw some significant New York developments, lessons and reminders.

10. Clarifications Made to Act Regarding Adult Guardianship.

The Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act[1] addresses the issue of jurisdiction over adult guardianships and other protective proceedings, providing a mechanism for resolving multi-state jurisdictional disputes. The Act also specifies procedures for transferring guardianships to New York from other state courts and vice versa, provides a framework for judges in different states to communicate with each other and outlines procedures for cooperation between state courts. It is modeled after an act promulgated by the Uniform Law Commission, which has now been adopted in 43 jurisdictions. It went into effect in New York on April 21, 2014.

In addition to technical clarifying amendments, revisions enacted on Nov. 20, 2015[2] make clear that an adult guardian appointed in another state, if authorized to do so by the appointing court, can appear in New York courts and is authorized to sell real estate. The guardian can use the same process as New York appointed guardians, without having to go through a duplicative New York guardianship process.

9. New York City Revises Reporting Requirements for Partnerships and LLCs Acquiring Real Estate.

When real property is transferred in New York City, the City requires Form NYC-RPT—Real Property Transfer Tax Return to be filed using its Automated City Register Information System (ACRIS). The form requires information about the "Grantor" and "Grantee." Effective May 18, 2015, Form NYC-RPT was revised to include two additional Grantor and Grantee types—"Single Member LLC" and "Multiple Member LLC." For any Grantor and Grantee that is a partnership or multiple-member LLC, the revised form requires the name and social security number or employer identification number for each general partner or member. If social security numbers or employer identification numbers are not provided, an affidavit must be filed attesting to the reasons the information is missing. According to the Department of Finance, the information will be "used for tax administration purposes and is confidential."

> In addition to technical clarifying amendments, revisions make clear that **an adult guardian appointed in another state,** if authorized to do so by the appointing court, can appear in New York courts and is authorized to sell real estate.

8. Court Explores Impact of Spousal Right of Election.

In *Matter of Priedits*,[3] the court tackled questions relating to the estate tax payment and beneficiaries' ratable contributions when a surviving spouse elects against a will.

In *Priedits*, the decedent did not provide for his wife under his will, but she was named beneficiary of two IRAs. The decedent made several bequests to friends, with the residue of his estate passing to charity. The tax clause provided that all taxes be borne by the residue, including taxes apportioned against non-probate assets and preresiduary bequests. The wife was a non-U.S. citizen, and when she elected against the will, her interest was taxable. She relied on the tax clause to claim that she was not responsible for the taxes attributable to her elective share. The question before the court was whether the wife forfeited the benefit of the tax clause when she elected against the will.


SHARON L. KLEIN

Based on statutory construction, Surrogate John M. Czygier Jr. determined that the wife was entitled to the benefit of the estate tax provision, despite her election. He observed that the right of election does not provide that spouses forfeit every benefit they are afforded when they elect. In affirming, the Second Department noted that Estates, Powers and Trusts Law (EPTL) §2-1.8[c] provides that estate taxes must be equitably apportioned, unless otherwise provided. The court held that the tax clause in the decedent's will clearly and unambiguously reflected the decedent's intent that his preresiduary and

SHARON L. KLEIN *is managing director of family office services and wealth strategies at Wilmington Trust, N.A. in New York.* *The author thanks colleague* REBECCA LOMAZOW *for her valuable contribution to this article.*

nontestamentary beneficiaries, including his surviving spouse, were to take their property without liability for the payment of estate taxes. Whether the same result would have followed had the tax clause not been as broad is unclear.

The second question addressed by the court involved how the ratable contribution to the elective share is determined. While EPTL §5-1.1-A(c)(2) provides that the elective share must be paid ratably by the decedent's other beneficiaries, it is unclear from the statute whether the ratable contribution is computed based on the value of the estate gross or net of estate taxes. If the charitable residuary beneficiary, against which all the estate taxes were apportioned, was required to contribute before estate taxes were deducted, a much larger contribution would have been required. The Surrogate determined that it was proper to calculate the beneficiary's pro rata contribution to the elective share before estate taxes were deducted from the net elective share estate. The appellate court upheld. Query what result would ensue if a pre-tax contribution analysis resulted in a beneficiary being liable to contribute more than it received?

7. Estate Planning Documents Should be Revisited in Event of Divorce or Separation: Lesson & Reminder.

EPTL §5-1.4 provides that divorce revokes dispositions to, and fiduciary nominations of, former spouses. In *Matter of Leyton*,[4] affirmed by the First Department on Jan. 5, 2016,[5] the decedent's mother and sister sought to disqualify the decedent's former same-sex partner as executor and a beneficiary under the decedent's will. They argued that he was the equivalent of a former spouse, disqualified from inheriting pursuant to EPTL §5-1.4. The decedent and his former partner had entered into a commitment ceremony in New York in 2002, but were separated before the decedent died.

Surrogate Nora Anderson determined that it is for the Legislature to decide matters regarding same-sex marriage, which New York did not recognize until 2011. Accordingly, the court could not retroactively apply the Marriage Equality Act to deem the commitment ceremony to have sanctified the marriage, so the parties could not be deemed divorced. The result was that the former partner, who had actually married another man before the decedent's death, was permitted to act as executor and inherit under the decedent's will. In affirming the decision, the appellate court also noted that, in order for EPTL §5-1.4's "former spouse" provision to apply, there must be a formal decree or judgment ending the marital relationship. No such decree was issued.

Matter of Lewis,[6] affirmed by the Court of Appeals on June 4, 2015,[7] provides a similar lesson. At issue in that case was the fact that EPTL §5-1.4 by its terms revokes dispositions to, and fiduciary nominations of, former spouses, but the revocatory effect of the section does not extend to the *relatives* of an ex-spouse.

In *Lewis*, the decedent executed a will many years prior to her divorce, leaving her entire estate to her then husband, who she also appointed as executor. Although EPTL §5-1.4 worked to revoke the disposition to, and fiduciary nomination of, the decedent's ex-husband, she had named her ex-husband's father as the alternate executor and alternate beneficiary of all her property. Even if the court assumed the ex-husband might someday inherit or obtain the property from his father, it determined that the statute is clear and unambiguous in omitting the relatives of an ex-spouse. The court held that the fiduciary appointment and beneficiary designation of the ex-father-in-law was valid.[8]

Note that, in those jurisdictions that have adopted the Uniform Probate Code, testamentary bequests to the former spouse's relatives, as well as bequests to the former spouse, are revoked.[9]

A proposal introduced in both houses[10] in New York embodies a middle ground: Dispositions to divorced spouses would continue to be expressly revoked, and there would be a rebuttable presumption that dispositions to relatives of an ex-spouse are revoked. Importantly, however, spouses who are in the *process* of getting divorced, but are not yet divorced, will not be able to rely on a statutory presumption under current law or under the new proposal.

And therein lies perhaps the most poignant lesson to draw from *Leyton* and *Lewis*: Do not rely on state default law at all. Divorced spouses, spouses in the process of getting a divorce and unmarried couples who are separated should give immediate attention to their planning documents, to ensure they reflect their intent.

6. Statutory Residency: Administrative Law Judge Issues Favorable Taxpayer Determination.

New York generally taxes residents on their worldwide income. There are two separate and independent bases on which an individual can be taxed as a resident: (1) the individual is domiciled in New York or (2) the individual is a nondomiciliary who satisfies the statutory residency test. That test has two prongs: The nondomiciliary must (a) maintain a permanent place of abode in New York *and* (b) spend more than 183 days in the state during the taxable year.[11]

The situation in *Matter of the Petition of David and Karen Sobotka*[12] involved a taxpayer who became domiciled in New York on Aug. 18, 2008 and was thus taxable as a resident for the period from Aug. 18 to Dec. 31, 2008. The Division of Taxation also determined that the taxpayer was

BIGSTOCK

a statutory resident, taxable for the whole year, based on the number of days that he spent in New York during 2008 in its entirety. The taxpayer argued that, because a statutory resident is defined as a nondomiciliary, the Division was precluded from counting the days in New York during which the taxpayer was a domiciliary.

The Administrative Law Judge determined that the taxpayer had to satisfy both the day count and the abode tests during the nondomiciliary period. Regarding the latter: "For purposes of determining statutory resident status during a portion of a given year, one may not count days that fall within the domicile-based resident portion of the same year." Accordingly, in the situation at hand, the taxpayer could be a statutory resident only if he spent over 183 days in New York before Aug. 18, which will be determined at a hearing.

Although the Administrative Law Judge's decision cannot be used as precedent, this ruling is very favorable to taxpayers, who might consider whether this analysis is helpful to their situation.

5. Disregarded Entities Owned by Nonresidents Will Not Shield Real Property from New York Estate Tax.

Under New York Tax Law §960, a nondomiciliary's real and personal New York situs property is subject to New York estate tax, but intangible personal property owned by a non-New York domiciliary is not subject to New York estate tax. In a recent Advisory Opinion,[13] a New York resident inquired about forming a single-member LLC under Delaware law for the "sole purpose" of contributing his New York condominium to the LLC and then moving to another state until his death. The question was whether the condominium would then be considered "intangible property" for New York estate tax purposes. The New York State Department of Taxation and Finance confirmed that it would treat the interest in the single-member LLC as real property for estate tax purposes. The basis for the Department's ruling was that a single-member LLC is a disregarded entity for federal income tax purposes, deemed not separate from its owner. This would cause the condominium owned by the LLC to be treated as real property held by the taxpayer and subject

it to New York estate tax. This ruling is consistent with a prior Advisory Opinion[14] in which the Department distinguished between an interest in a single-member LLC holding New York real estate (includable in the gross estate) and New York real estate interests held in an S Corporation or a single-member LLC electing to be treated as a corporation under the check-the-box rules (treated as intangible property, provided there is also a business purpose).

However, a compelling memorandum submitted by the New York City Bar Association,[15] asserts that, in looking to federal income tax law to determine state estate tax liability, the Department reversed the proper order of analysis. Instead, state law should first determine the character of property rights, and tax law should then be applied based on the state law characterization. Under New York Limited Liability Company (LLC) Law §601, "A membership interest in the limited liability company is personal property. A member has no interest in specific property of the limited liability company." The New York City Bar Association has requested that the Department publish a revised Advisory Opinion confirming that an interest in a single-member LLC recognized under applicable state law would constitute intangible personal property pursuant to New York LLC Law §601 and therefore would not be subject to New York estate tax.

Whether the Department will issue a revised Advisory Opinion is yet to be seen. In the interim, however, it is clear that the Department's position is that real property held in a nonresident's single-member LLC/disregarded entity will be subject to New York estate tax at the nonresident owner's death. Advisors should consider whether a more complex entity structure would be appropriate given income, estate and other non-tax considerations, or whether the issue might be bypassed altogether if the nonresident opts instead to own shares in a cooperative apartment.

4. New York Issues Estate Tax Guidance for Residents and Nonresidents Owning New York Property.

The New York State Department of Taxation and Finance issued a Technical Services Bulletin (TSB) regarding the treatment of certain deductions for New York estate tax purposes.[16] The guidance applies to estates of individuals dying on or after April 1, 2014.

In computing the New York taxable estate, both resident and nonresident estates must exclude any deductions that relate to property which is not included in the New York gross estate. The TSB provides guidance regarding three categories of deductions: (1) Deductions directly related to real and tangible property, such as charitable deductions for the donation of land included in the gross estate and real or tangible property included as part of the marital deduction, (2) deductions directly related to intangible property, such as broker fees and stocks, bonds or cash included as part of the marital deduction, and (3) deductions indirectly related to real and tangible property or intangible property ("Indirect Expenses"), such as executor's commissions, accounting fees, attorney fees, funeral expenses and debts of the decedent. The TSB explains which deductions are disallowed, including how to apportion deductions in the third category—the Indirect Expenses.

The New York taxable estate of a resident includes intangible property and excludes real or tangible personal property located outside of New York. Accordingly, in computing the New York taxable estate of a resident, federal deductions that relate directly to real and tangible property located outside New York are disallowed, federal deductions that relate to intangible property are allowed and federal deductions that are indirectly related to property outside New York are disallowed by allocating Indirect Expenses. The allocation is computed by multiplying the Indirect Expenses by a fraction equal to (1) the value of real and tangible property located outside New York over (2) the value of the federal gross estate. For example, if half of the gross estate was real and tangible property located outside of New York, half of the executor's commissions would be disallowed as a deduction.

> In computing the **New York taxable estate**, both resident and nonresident estates must exclude **any deductions that relate to property** which is not included in the New York gross estate.

The New York taxable estate of a nonresident is computed in the same way as for a resident, but does not include intangible property. Accordingly, in computing the New York taxable estate of a nonresident, federal deductions that relate directly to real and tangible property located outside New York are disallowed, federal deductions that relate to intangible property are disallowed and federal deductions that are indirectly related to property outside New York are disallowed by allocating Indirect Expenses. The allocation is computed by multiplying the Indirect Expenses by a fraction equal to (1) the value of real and tangible property located outside New York plus intangible property over (2) the value of the federal gross estate. The good news for nonresidents is that they seem to be permitted to deduct the balance of the Indirect Expenses—a fractional proportion of those expenses that are indirectly related to estate property, including executor's commissions and attorney fees. In fact, in an example given in the TSB, which posits a $45 million federal gross estate of a nonresident, with $25 million in New York real property, the deduction analysis actually results in a negative New York estate. The $25 million New York estate is reduced by a $25 million marital deduction for the real property; deductions directly related to the New York real property; and a portion of the Indirect Expenses—total allowable deductions for New York purposes being $25,646,712.

3. Legislature Enacts Gift Add-Back Clarifications, but Anomalies Remain.

As a result of 2014-15 Executive Budget changes, the New York gross estate of a deceased resident will be increased by the amount of any taxable gift made within three years of death, if the decedent was a New York resident at the time the gift was made and at the time of death.[17] The three-year look-back applied to gifts made before Jan. 1, 2019. As a result of an amendment this year, the gift add-back does not apply to estates of individuals dying on or after Jan. 1, 2019. This means that, even if a gift is made before Jan. 1, 2019, it will not be brought back into the estate if the donor dies after Jan. 1, 2019. It is unclear why the relevant date changed from the date of gift to the date of death.

The way last year's budgetary language was drafted, there appeared to be a lack of parity with the estate tax regime: Gifts by a New York resident of out-of-state real property or tangible personal property were not specifically excluded from the gift add-back, but out-of-state real and tangible property are specifically excluded from the New York gross estate for New York estate tax purposes. 2015-16 Executive Budget changes clarify that gifts are not added back to the gross estate if they consist of real or tangible property having a location outside New York.

However, a disparity in tax rates remains: Although New York estate taxes are generally deductible against the federal estate tax liability, the estate tax attributable to the gift add-back does not seem to be deductible under Internal Revenue Code §2058. The result is that gifts added back will potentially be subject to the full maximum 16 percent estate tax rate, without any offsetting federal deduction. An offsetting deduction against a 40 percent federal estate tax would reduce the effective tax rate from 16 percent to 9.6 percent. This disparity could lead to anomalous results: For example, if a New York resident gifted a New York residence within three years of death, the value of the residence would be added back to that individual's estate, and potentially subject to a 16 percent New York estate tax. But if that

same individual had died with that same New York residence, the New York estate tax would be deductible, reducing the effective tax rate to 9.6 percent.

2. 2014-2015 Budget Effects Dramatic Fiduciary Income Tax Changes: 2015 is First Year to Report Accumulated Income Distributions.

Dramatic changes to New York fiduciary income tax laws were effected with the Executive Budget for 2014-15.

Under existing New York Tax Law, an income tax is imposed on the income of a "resident trust," which is a trust created by a New York resident. However, prior law provided that a resident trust would be exempt from tax if three conditions were met: (1) there were no New York trustees, (2) there was no trust property located in New York, and (3) there was no New York source income.

The 2014-15 Executive Budget included changes to the taxation of resident trusts. While it does not impose a tax at the trust level, the new law does tax distributions of accumulated trust income to New York beneficiaries of these exempt resident trusts.[18] This new throwback tax applies to distributions of income accumulated in tax years beginning after Jan. 1, 2014. By definition, therefore, the first accumulated income distribution could only have been made in 2015, with income accumulated in 2014. Accordingly, trustees of exempt resident trusts will have reporting requirements in 2016 with respect to 2015 accumulation distributions to New York beneficiaries.

On Jan. 6, 2016 the New York Department of Taxation and Finance released 2015 Form IT-205-J—New York State Accumulation Distribution for Exempt Resident Trusts, and Instructions. Every exempt resident trust must file Form IT-205-J for any tax year in which it makes an accumulation distribution to a beneficiary who is a New York resident. Unless excepted, resident beneficiaries who received accumulation distributions from exempt resident trusts in 2015 will have to include the accumulation distribution in their 2015 New York adjusted gross income. The exempt resident trust must compute the allocation of accumulated income distributions for each resident beneficiary on Part 4 of the new form, and provide that information to each beneficiary for the beneficiary's filing purposes.

Notably, however, the form calculates the accumulated income distribution with reference to federal distributable net income (DNI). Capital gains generally are not included in federal DNI (except, for example, if the trust is a foreign trust for federal income tax purposes). Accordingly, with capital gains apparently not subject to the accumulation tax and a number of potential strategies to reduce or eliminate the tax on accumulated income, establishing an exempt resident trust in a jurisdiction like Delaware can still be a very effective strategy for New York residents.

Consider also that the foundation for trust taxation in New York is the creation of a trust by a *New York testator or grantor*.[19] Except for source income, New York will generally not tax trusts created by *nonresidents*.[20] Accordingly, for residents of other states, New York may be an attractive jurisdiction in which to consider creating trusts.

1. As New York Estate Tax Exclusion Amount Rises, Planning Becomes More Critical.

The New York estate tax exclusion amount rises over the next several years.[21] The exclusion amount was increased from $1 million to $2,062,500 for individuals dying after April 1, 2014. The amount increased to $3,125,000 for individuals dying after April 1, 2015, will increase to $4,187,500 for individuals dying after April 1, 2016, and to $5,250,000 for individuals dying after April 1, 2017 and before Jan. 1, 2019. After Jan. 1, 2019, the New York exclusion amount will be linked to the federal exclusion amount (projected in 2019 to be $5.9 million), including inflation indexing. However, the New York estate tax computation contains an estate tax "cliff": Estates that are less than or equal to the New York estate tax exclusion amount will pay no tax, but the credit for New York taxable estates that are between 100 percent and 105 percent of the basic exclusion amount is rapidly phased out and eliminated entirely if the New York taxable estate exceeds 105 percent of the basic exclusion amount.[22]

Since the cliff effect can be very dramatic, planning takes on increased importance. If an individual dies before April 1, 2016 with an estate valued at $3,125,000 (the amount of the exclusion), the estate will owe no New York tax. If instead that individual's estate is just $175,000 more at $3.3 million, the estate would pay New York estate tax of $210,000 because a $3.3 million estate exceeds 105 percent of the $3,125,000 exclusion amount and therefore loses the benefit of the exclusion entirely. Reducing the taxable estate with a $175,000 charitable bequest (or even throwing that amount in the garbage ...) would result in a tax saving of $210,000 by pushing the estate value down to the exemption level. Some practitioners are drafting formulaically with charitable gifts to prevent the cliff effect.

For estates with a surviving spouse, portability—the ability of one spouse to pass the federal unused exemption amount to the survivor—is not currently available at the New York level. That means that New York's exclusion amount is a use-it-or-lose-it proposition, making it critical to take advantage of the exemption amounts of both spouses. If one spouse simply leaves all to the other, the exemption of the first to die is wasted and that may also push the survivor's estate over a cliff. For example: Assume spouses in New York each own assets worth $3 million and the first spouse to die leaves everything to the survivor. The survivor dies when the New York exemption amount is $5,250,000. The survivor's $6 million estate will have "fallen off the cliff," and New York estate taxes of $510,800 will be payable. Structuring the estate plan to take advantage of the exemption amount at the first death with trust planning, for example, so that each estate is under the cliff threshold, could potentially result in estate tax savings to heirs of over half a million dollars.

1. N.Y. Mental Hyg. Law Ch. 27, T. E, Art. 83
2. New York A.7596/S.5482 (2015).
3. 132 A.D.3d 769, 18 N.Y.S.3d 387, 2015 N.Y. Slip Op. 07508 (2d Dept. 2015).
4. *Matter of Mauricio Leyton, Deceased*, No. 2013-4842/A/B (Surrogate's Court, N.Y. Co , June 16, 2015), NYLJ 1202730202742 (June 23, 2015).
5. *In re Estate of Leyton*, — N.Y.S.3d — (2016), 2016 N.Y. Slip Op. 00020 (1st Dept. 2016).
6. *Matter of Lewis*, 114 A.D.3d 203, 978 N.Y.S.2d 527 (4th Dept. 2014).
7. *In re Estate of Lewis*, 25 N.Y.3d 456 (2015).
8. The case has been remanded to the Surrogate to determine if the decedent had revoked her will.
9. Uniform Probate Code §2-804 (1969, last amended 2010).
10. New York A.7638/S.5684 (2015).
11. N.Y. Tax Law §605(b)(1).
12. 2015 WL 5096196 (N.Y. Div. Tax. App. 2015).
13. Advisory Opinion TSB-A-15(1)M (May 29, 2015).
14. Advisory Opinion TSB-A-08(1)M (Oct. 24, 2008).
15. http://www2.nycbar.org/pdf/report/uploads/20073013-SMLLCTaxAdvisoryEstateGiftReportFINAL121015.pdf.
16. Technical Memorandum TSB-M-15(4)M (Oct. 27, 2015).
17. N.Y. Tax Law §954(a)(3).
18. N.Y. Tax Law §612(b)(40).
19. N.Y. Tax Law §618. See 20 NYCRR §§118.1, 105.23.
20. N.Y. Tax Law §§631, 633; instructions to 2015 N.Y. Form IT-205 at 2. See N.Y. Tax Bull. TB-IT-615 (Dec. 15, 2011), available at www.tax.ny.gov/pdf/tg_bulletins/pit/b11_615i.pdf.
21. N.Y. Tax Law §952(c)(2).
22. N.Y. Tax Law §952(c)(1).

This article is for general information only and is not intended as an offer or solicitation for the sale of any financial product, service or other professional advice. Professional advice always requires consideration of individual circumstances.

Wilmington Trust is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation (M&T).

WILMINGTON TRUST

Sharon L. Klein
Managing Director of Family Office Services & Wealth Strategies
Wilmington Trust, N.A.
350 Park Avenue, 9th Floor
New York, NY 10022
(P) 212 415 0531 | (F) 212 415 0514
sklein@wilmingtontrust.com
www.wilmingtontrust.com

March 2016

ESTATE PLANNING UPDATE

By: Sanford J. Schlesinger, Esq.
and Martin R. Goodman, Esq.
Schlesinger Gannon & Lazetera LLP

TABLE OF CONTENTS

March 2016

ESTATE PLANNING UPDATE

By: Sanford J. Schlesinger, Esq.
and Martin R. Goodman, Esq.
Schlesinger Gannon & Lazetera LLP

Preface

The American Taxpayer Relief Act of 2012 (the "2012 Tax Act") was enacted on January 2, 2013.

The 2012 Tax Act retained the existing $5,000,000 exemption (adjusted for inflation from 2010) for estate tax, gift tax and generation-skipping transfer ("GST") tax purposes, and increased the maximum tax rate for all such purposes from 35% to 40%. In addition, the 2012 Tax Act made "permanent" (absent any further legislation) the federal transfer tax changes made to the Internal Revenue Code[1] by the Tax Relief, Unemployment Insurance Reauthorization, and the Job Creation Act of 2010 (the "2010 Tax Act") and many of the changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). Further, the 2012 Tax Act increased the maximum income tax rate from 35% to 39.6% for high income persons, and increased the maximum income tax rate on dividends and long-term capital gains from 15% to 20%. Part I of this outline describes the current state of the federal transfer tax and income tax laws as a result of these Acts.

The remaining parts of this outline discuss other important federal and state tax developments, and important non-tax developments, regarding estates and trusts.

---

[1] All references to the Code are to the Internal Revenue Code of 1986, as amended.

I. FEDERAL TRANSFER TAXES AND INCOME TAXES

A. Federal Estate Taxes, Gift Taxes and Generation-Skipping Transfer ("GST") Taxes

The federal estate tax and gift tax exemptions, now known as the "basic exclusion amount", is $5,000,000, indexed for inflation since 2010. It is noted that as of this writing only Connecticut imposes a state gift tax.

The federal estate tax deduction (not the credit) for state death taxes paid by the estate, which was restored by the 2010 Tax Act, was made permanent by the 2012 Tax Act.

The GST tax exemption also is $5,000,000, indexed for inflation since 2010.

The inflation adjusted amount of all of these exemptions is $5,450,000 for 2016.

As a result of the 2010 Tax Act and the 2012 Tax Act, many of the other provisions of prior law continue to be effective, including, as to GST taxes, the provisions regarding the identification of the "transferor" of a transfer, modifications of exempt trusts, the automatic allocation of the GST tax exemption, the retroactive allocation of the GST tax exemption, qualified severances, and 9100 relief for GST tax purposes, and including the relaxation of the requirements for the deferral of estate tax payments under Code Section 6166.

It also is noted that Wills and other documents that serve as testamentary substitutes may utilize a formula clause for dividing a decedent's estate between the portion of the estate that qualifies for the federal estate tax marital deduction and the balance of the estate, which may be bequeathed to or in trust for persons other than the decedent's surviving spouse. The changes in the basic exclusion amount could cause an unintentional shift in beneficial interests under estate planning documents.

For example, with the advent of a $5,000,000 basic exclusion amount for estate tax purposes, a formula clause that gives the decedent's children the maximum amount of the estate which is exempt from the federal estate tax and leaves the remainder of the estate to the surviving spouse may result in a bequest of the first $5,450,000 for decedents dying in 2016 of the decedent's assets to or for the benefit of persons other than the decedent's surviving spouse, such as the decedent's children and more remote descendants, or to a trust of which the decedent's spouse is not the sole beneficiary. This dispositive result may be different from the disposition that the testator had intended by using such a formula clause in an instrument executed when the basic exclusion amount for estate tax purposes was substantially less than $5,000,000.

Therefore, it is advisable to review estate planning documents to determine whether the dispositive plan in those documents, taking into account the provisions of the 2010 Tax Act, the 2012 Tax Act and applicable state laws, continue to reflect the testator's estate planning goals.

B. Portability

1. General

The portability provisions of the 2010 Tax Act were made permanent by the 2012 Tax Act.

Portability permits the unused applicable exclusion amount of the last deceased spouse of a person to be used by such a person for gift tax and/or estate tax purposes. However, these portability provisions do not apply to a person's GST tax exemption. It is important to note that these provisions apply only if the death of the first spouse to die occurs after 2010.

For example, if a husband dies in 2016 and he and his estate have used only $3,000,000 of his $5,450,000 estate tax applicable exclusion amount, then his surviving wife will have an aggregate applicable exclusion amount of $7,900,000 (i.e., her own $5,450,000 basic exclusion amount, plus the unused $2,450,000 of her deceased husband's applicable exclusion amount), assuming the widow does not remarry.

Importantly, these provisions of the law generally permit a person to use the unused portion of the applicable exclusion amount of only such person's last deceased spouse. Thus, a person ordinarily cannot accumulate the unused portion of the applicable exclusion amount of more than one deceased spouse.

In addition, the unused portion of the applicable exclusion amount of the deceased spouse that can be used by the surviving spouse is not itself indexed for inflation; only the basic exclusion amount of the surviving spouse is indexed for inflation, as described above.

To apply such portability provisions, the estate of the first spouse to die must elect to do so on a timely filed federal estate tax return. Thus, the estate of the first spouse to die must file such return, even if that person's gross estate is less than that person's applicable exclusion amount, if the person's estate wants to apply these portability provisions.

On September 29, 2011 the Service issued News Release IR-2011-97 and Notice 2011-82 providing guidance on portability for estates of decedents dying after December 31, 2010.

The Notice stated that:

- To elect portability, the executor must file a complete estate tax return (Form 706) on a timely basis, including extensions, whether or not the value of the gross estate exceeds the exclusion amount, and whether or not the executor is otherwise obligated to file an estate tax return.

- An estate will be deemed to make the portability election by timely filing a complete estate tax return without the need to make an affirmative statement, check a box, or otherwise affirmatively elect to make the election.

- Until the Service revises Form 706 to expressly contain the computation of the deceased spousal unused exclusion amount, a complete and properly prepared Form 706 will be deemed to contain the computation of the deceased spousal unused exclusion amount.

Note that the estate tax return and instructions for decedents who died in 2012 includes provisions for such computation.

- To not make the portability election:

•• The executor must follow the instructions for Form 706 describing the steps to do so. The instructions for the 2011 Form 706 state that to opt out of the portability election, a statement should be attached to Form 706 indicating that the estate is not making the election under Code Section 2010(c)(5), or "No Election under Section 2010(c)(5)" should be entered across the top of the first page of Form 706.

•• Not timely filing a Form 706 effectively prevents making the election.

- As the portability election is not available to the estate of a decedent dying on or before December 31, 2010, any attempt to make a portability election on a Form 706 for such estate will be ineffective.

- The Service intends to issue regulations regarding portability and invites comments on the following issues:

•• The determination in various circumstances of the deceased spousal unused exclusion amount and the applicable exclusion amount.

•• The order in which exclusions are deemed to be used.

•• The effect of the last predeceasing spouse limitation.

•• The scope of the Service's right to examine a return of the first spouse to die without regard to the period of the statute of limitations.

•• Any additional issues that should be considered for inclusion in the proposed regulations.

On May 11, 2013 a representative of the Service advised that it is considering granting so-called Code Section 9100 relief to estates that failed to elect portability by the required deadline. In this regard, practitioners have asked the Service to eliminate the current requirement of a private letter ruling for Code Section 9100 relief for late elections of estate tax portability.

In PLR 201338003 (2013), the Service ruled that a QTIP election made with respect to a credit shelter trust should be disregarded for federal transfer tax purposes because the election was not necessary to reduce the decedent's estate tax liability to zero.

Members of the American College of Trust and Estate Counsel are attempting to persuade the Service to clarify that under Rev. Proc. 2001-38, which treats certain QTIP elections as a nullity if the election is not required to reduce the estate tax, estates of less than the amount of the estate tax exemption are allowed to qualify for the federal estate tax marital deduction using a QTIP trust and electing portability. On May 10, 2014 a representative of the Service's Chief Counsel Office stated that the Service is considering addressing this issue by limiting the application of Rev. Proc. 2001-38 to instances where there is no portability election.

The Service's Priority Guidance Plan for 2015-2016 includes the preparation of a Revenue Procedure regarding this issue.[2]

In Rev. Proc. 2014-18, IRB 2014-7, the Service issued guidance providing a simplified procedure for estates to obtain an automatic extension of time to make a portability election. Pursuant to the Rev. Proc. if a decedent died after 2010 and before 2014 leaving a surviving spouse, the decedent was a citizen or a resident of the United States on his or her death, the decedent's estate is not required to file an estate tax return based on the value of the estate and the amount of the decedent's taxable gifts, and the decedent's estate did not timely file an estate tax return to elect portability, the decedent's estate may file an estate tax return on or before December 31, 2014, in order to elect portability, and such tax return will be deemed to be timely filed. This blanket relief permits a qualifying estate to file an estate tax return in order to elect portability without having to obtain Code Section 9100 relief to do so. In the preamble to the final regulations regarding portability, noted below, the Service stated that it is considering making this safe harbor permanent.

On June 12, 2015 the Service released final regulations (T.D. 9725) regarding the portability provisions in the 2010 Tax Act. A full discussion of these regulations is contained in an article written by the authors of this outline and published by Commerce Clearing House in Estate Planning Review – The Journal. A copy of that article is attached hereto as Exhibit "A".

2. Portability and the Future of Bypass Trusts[3]

Estate planning documents for spouses having combined assets of more than the basic exclusion amount of one person traditionally would commonly contain provisions under which the estate of the first spouse to die would create a so called "bypass" trust for the benefit of the surviving spouse, in order to effectively utilize the basic exclusion amount of both spouses, rather than provisions under which the first spouse to die would leave his or her entire estate to the surviving spouse, outright and free of trust. Some proponents of portability have contended that where the combined assets of a married couple are less than $10,500,000, then the necessity of the first spouse to die to create a bypass trust for the benefit of the surviving spouse is eliminated, thereby simplifying the estate planning documents for such persons. However, significant reasons continue to exist for the use of bypass trusts, even in cases where the value of the combined assets of a married couple is less than $10,500,000.

First, as noted above, the portability provisions of the 2010 Tax Act were made "permanent" by the 2012 Tax Act. However, it is always possible that portability could be repealed by future legislation.

Second, the first spouse to die, by creating a bypass trust for the surviving spouse, can ensure that the balance in such trust remaining at the death of the surviving spouse will pass

---

[2] See Part IV, Section X for a discussion of the Service's Priority Guidance Plan.

[3] This subsection of the Outline is adapted from a portion of an article that the authors of this Outline wrote and that was published in Estate Planning Review – The Journal, a Wolters Kluwer Business.

to the person or persons whom the first spouse to die wants to inherit such remaining balance, rather than giving the surviving spouse the opportunity to bequeath such assets to other persons.

Third, a bypass trust affords a degree of creditor protection for the assets in the bypass trust that the surviving spouse would not have with respect such assets if they were bequeathed to the surviving spouse, outright and free to trust.

Fourth, the appreciation in value of the assets bequeathed to a bypass trust will not be subject to estate tax in the estate of the second spouse to die, whereas the appreciation in value of assets bequeathed to a surviving spouse, outright and free of trust, will be subject to estate tax on the death of the surviving spouse.

Therefore, many sound reasons exist for the continued use of bypass trusts, even where the combined wealth of a married couple is less than $10,500,000.

However, there are other tax considerations that must be taken into account in deciding whether or not to use a bypass trust.

First, the assets in a bypass trust will not receive a so called "stepped-up" basis at the death of the surviving spouse, whereas the assets that the surviving owns at his or her death will receive a "stepped-up" basis at that time.

Second, if the state in which the decedent resided at his or her death has "decoupled" its estate tax from the federal estate tax regime, and if the state estate tax exemption is less than the federal estate tax exemption, then the use of a bypass trust could result in the payment of state estate taxes, even though no federal estate taxes would be due, whereas such state estate taxes could be avoided if the estate instead elects portability and does not use a bypass trust.[4]

These tax considerations should be taken into account in deciding whether or not to use a bypass trust.

3. Portability and Prenuptial Agreements[5]

When negotiating and drafting a prenuptial agreement, consideration should be given to the desirability of including a section in such agreement regarding portability.

Assume, for example, that one party to the intended marriage owns assets that have a value substantially in excess of the applicable exclusion amount and that the other party owns assets having a value significantly less than such amount. In such case, the wealthier party may want a provision in the agreement that requires the executor of the estate of the less wealthy party, if the wealthier party survives the less wealthy party, to timely file a federal estate tax

---

[4] See Part I, Section C, of this Outline for a fuller discussion of "decoupling".

[5] This subsection of the Outline is adapted from a portion of an article that the authors of this Outline wrote and that was published in Estate Planning Review – The Journal, a Wolters Kluwer Business.

return for the estate of the less wealthy party and to elect on that return to permit the wealthier party, as the surviving spouse, to use the unused portion of the exclusion amount of the less wealthy party. Such a provision could provide a substantial tax benefit to the wealthier party, if he or she survives the less wealthy party.

Note, however, that in such case the executor of the estate of the less wealthy party will be required to prepare and file a federal estate tax return for such estate, even though the amount of the gross estate of the less wealthy party is less than the minimum filing requirement for such tax return, in order to make the required election.

C. Omitted Transfer Tax Provisions

Neither the 2010 Tax Act nor the 2012 Tax Act contained any provisions requiring a minimum term for grantor retained annuity trusts ("GRATs"), as had been included in the President's Budget Proposal for the prior two years and in prior legislative proposals. Thus, short term GRATs continued to be a viable estate planning tool.

In addition, neither of these Acts contained any provisions restricting valuation discounts for transfer tax purposes. As a result, valuation discounts for family limited partnerships continued to apply for transfer tax purposes, as in the past.

D. Federal Income Tax Provisions

The 2012 Tax Act increased the maximum income tax rate from 35% to 39.6% for taxable income in excess $450,000 for married persons filing jointly, and $400,000 for an unmarried individual; reinstated the previously existing "phase-out" of personal exemptions (the "PEP" provision) for individuals with adjusted gross income in excess of $300,000 for married persons filing jointly, and $250,000 for an unmarried individual; reinstated the previously existing limitation on itemized deductions (the "Pease provision") for individuals with adjusted gross income in excess of $300,000 for married persons filing jointly, and $250,000 for an unmarried individual; increased the maximum income tax rate for qualified dividends and long-term capital gains from 15% to 20% for married persons filing jointly having taxable income over $450,000, and for single taxpayers having taxable income over $400,000; made alternative minimum tax relief permanent; and extended the income tax deduction for state and local sales taxes only for 2012 and 2013 (which was further extended for 2014 by the Tax Increase Prevention Act of 2014, as noted below).

In addition, the 2012 Tax Act extended for 2013 the ability of a person who is older than 70-1/2 to make a direct contribution to charity of up to $100,000 from the person's Individual Retirement Account, without the contribution being included in the person's income. This provision of the law was further extended for 2014 by the Tax Increase Prevention Act of 2014, as noted below, and was again extended for 2015 and was made permanent by the Protecting Americans From Tax Hikes Act of 2015, also as noted below.

E. State Transfer Tax Considerations

EGTRRA repealed the federal estate tax credit for state death taxes paid, for estates of decedents dying after 2004, and replaced such credit with a federal estate tax deduction

for state death taxes paid. However, most states and the District of Columbia previously had the "sop" or pick-up tax as their estate tax, although numerous states also have an inheritance tax. The estate tax in a majority of these states automatically conformed to changes in the federal estate tax, and therefore the economic effect of the elimination of the state death credit had an impact on revenue from the credit. As a result, many states enacted estate, inheritance and/or succession taxes to make up for the revenue loss due to the elimination of the credit; thus, they "decoupled" from the changes in the federal tax code. However, different states decoupled based upon different pre-EGTRRA applicable exclusion amounts, and different states have different exemption amounts. The elimination of the federal estate tax credit for state death taxes paid, the existing federal estate tax deduction for state death taxes paid, and the "decoupling" by many states of their estate tax from the federal estate tax regime, requires the consideration of the state estate tax planning implications of these changes. A discussion of actions taken by certain of these states is contained below in this Section.

1. New York

In the instance where a state statute does not automatically follow changes made to the federal estate tax, such as the New York State Tax Law, its residents may find themselves with a larger estate tax burden.

As of April 1, 2014, New York increased in stages the amount of a decedent's taxable estate that can be exempt from New York estate tax from $1,000,000 to an amount that from and after January 1, 2019 will be equal to the federal basic exclusion amount. For a New York decedent who dies in 2016 with a full federal credit shelter bequest of $5,450,000, the decedent's estate will be required to pay New York estate taxes of $444,800, even though the estate would not have to pay any federal estate taxes. Since the New York estate tax is deductible for federal estate tax purposes, the effective combined federal and New York estate tax rate for such decedents is the sum of the federal estates tax rate of 40%, plus the effective New York estate tax rate of 9.6% (i.e., 60% of the New York estate tax rate of 16%), or 49.6%. After this change is fully phased in, a credit shelter disposition upon the death of the first spouse to die of the New York estate tax basic exclusion amount (which will be the same as the federal estate tax basic exclusion amount) will not result in any New York (or federal) estate tax, as the New York taxable estate would not be more than the New York estate tax basic exclusion amount.

Possible Planning Technique: If the New York estate tax is paid from the credit shelter disposition, the amount of the New York estate tax imposed on the estate as described in the preceding paragraph will apply. However, paying the New York estate tax from the credit shelter disposition will reduce the net after-tax amount of that disposition, and correspondingly increase the amount of the marital deduction disposition, causing an increase in the amount of the federal estate tax payable on the death of the second spouse to die. Instead, practitioners should consider having the New York estate tax payable from the marital deduction disposition (which will not cause a federal estate tax to be payable, since the New York estate tax is deductible for federal estate tax purposes), in order to maximize the amount of the credit shelter disposition and avoid such increase in the amount of the federal estate tax payable on the death of the second spouse to die. Note, however, that paying the New York estate tax from the

marital deduction disposition will cause the amount of the New York estate tax to increase from $444,800 to $505,454 for decedents dying in 2016.

2. Connecticut

On May 4, 2011, as part of the budget legislation (CGA Bill No. 1239), Connecticut lowered the Connecticut estate tax and gift tax thresholds from $3,500,000 to $2,000,000 applicable retroactively to estates of decedents dying on or after January 1, 2011 and gifts made on or after January 1, 2011. The tax for estates and gifts of more than $2,000,000 will be based on graduated rates, starting at a rate of 7.2%, and the maximum tax rate will be 12% (on the excess over $10,100,000).

As a result, the estate of a person who dies in 2016 a resident of Connecticut with a taxable estate of $5,450,000 would be required to pay Connecticut estate taxes of $269,700, even though such estate would not be required to pay any federal estate taxes.

On June 30, 2015, Connecticut enacted an estate tax cap of $20,000,000 for resident and nonresident decedents of the state who died on or after January 1, 2016. This $20,000,000 cap is reduced by taxable gifts made by the decedent or the decedent's estate, or taxable gifts made by the decedent's spouse that are includible in the decedent's gross estate, made on or after January 1, 2016. In addition, Connecticut removed the $12,500 cap on probate fees for the estates of decedents who die on or after January 1, 2015. At the top bracket, for estates $2,000,000 and over, the probate fee will be $5,615 plus .5% of the excess over $500,000.

3. New Jersey

The amount of the New Jersey estate tax is the maximum state death tax credit that would have been allowable under the Code as in effect on December 31, 2001. For example, if the unified credit bequest equaled $1,000,000, there would be a New Jersey estate tax due of $33,200. There is an alternative to this method which is the amount determined using a "simplified tax system" based on the $675,000 unified estate and gift tax applicable exclusion amount provided in the Internal Revenue Code, but the simplified method cannot be used if the taxpayer files or is required to file a Federal return. A New Jersey estate tax return must be filed whenever the gross estate as determined in accordance with the provisions of the Code in effect on December 31, 2001 exceeds $675,000.

As a result, the estate of a person who dies in 2016 a resident of New Jersey with a taxable estate of $5,450,000 would be required to pay New Jersey estate taxes of $444,800, even though such estate would not be required to pay any federal estate taxes.

In Estate of Stevenson v. Director, 008300-07 (N.J. Tax Court, 2008), the New Jersey Tax Court held that when calculating the New Jersey estate tax where a marital disposition was burdened with estate taxes, creating an interrelated computation, the marital deduction must be reduced not only by the actual New Jersey estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died in 2001.

4. Pennsylvania

Pennsylvania does not have an estate tax for decedents who die after December 31, 2004, due to the elimination of the credit against federal estate taxes for state death taxes paid. However, Pennsylvania still has an inheritance tax, which is independent of the federal state death tax credit and the phase-out of that credit.

5. Florida

In certain states, there are additional barriers to decoupling. For example, in Florida, a constitutional provision restricting the amount of estate tax levied would likely need to be altered. Therefore, since the complete phase-out of the state death tax credit in 2005, Florida has not been able to collect any estate tax from its residents.

Attached hereto as Exhibit "B" is a chart showing a comparison of the state estate taxes after the 2012 Tax Act of New York, New Jersey, Florida and Connecticut.

6. Delaware

Delaware reinstated its estate tax for decedents dying after June 30, 2009. The amount of the estate tax is equal to the credit against federal estate taxes for state death taxes paid by the estate, as such credit was in effect as of January 1, 2001.

7. Other States

Attached hereto as Exhibit "C" is a chart showing the effect as of February 28, 2016 of EGTRRA on the "pick-up" tax of each state and the status as of that date of any death tax legislation in each state.

8. State QTIP Elections

In states which have decoupled and which have a separate qualified terminable interest property ("QTIP") election for state estate tax purposes, practitioners should consider drafting testamentary documents with a separate QTIP trust for that election. As of this writing, Connecticut (only if no federal QTIP election is made), Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Maine, New Jersey (only if a federal estate tax return is not required to be filed), Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee and Washington have such an election. On July 29, 2011 the New York State Department of Taxation and Finance issued TSB-M-11(9)M stating that if a federal estate tax return is filed solely to elect portability, any QTIP election that is made on such federal tax return must also be made for New York estate tax purposes. If a QTIP election is not made on such federal return, it may not be made for New York estate tax purposes. However, a New York state only QTIP election is permitted if no federal estate tax return is filed. With regard to Connecticut, the Department of Revenue Services, by special notice, has taken the position that if the federal QTIP election is made, a state election must also be made for the same amount, although this is not in accord with the underlying statute. If no federal election is made, a state-only QTIP election may be made. With regard to New Jersey, NJAC 26:18-3A.8(d) provides that the New Jersey estate tax return must be consistent with the federal return. Accordingly, if a federal QTIP election is made, it must

also be made for New Jersey in the same amount. However, if a federal QTIP election would not reduce the federal estate tax liability, such an election will not be given effect for New Jersey estate tax purposes.

Since both New York and New Jersey take the position that, even if a federal estate tax return is filed solely for the purpose of electing portability, the same QTIP election that is made on such federal return must also be made for state estate tax purposes. If a QTIP election is not made on the federal estate tax return, then it may not be made for state estate tax purposes. Thus, the executors in such states may have to choose between a state QTIP election and portability.

II. OBAMA ADMINISTRATION FISCAL YEAR 2017 PROPOSALS

President Obama's February 2015 budget request for the fiscal year ending September 30, 2017 (the "Greenbook") includes:

- A proposal to make permanent the estate tax, gift tax and GST tax exemptions and rates as they applied during 2009 (i.e., an estate tax and GST tax exemption of $3,500,000, a gift tax exemption of $1,000,000, and a maximum tax rate of 45%), effective for the estates of decedents dying, and for transfers made, after December 31, 2016.

- A proposal that would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion, and that would define a new category of transfers (without regard to the existence of any withdrawal or put rights), and would impose an annual limit of $50,000 (indexed for inflation after 2017) per donor on the donor's transfers of property within this new category that will qualify for the gift tax annual exclusion. This new $50,000 per donor limit would not provide an exclusion in addition to the annual per donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per donee exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $14,000. The new category would include transfers in trust (other than to a trust described in Code Section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

- A proposal under which the lifetime transfer, or the transfer on death, of appreciated property generally would be treated as a sale of the property, with certain limited exclusions.

- A proposal to expand the basis consistency requirements in The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, to include property qualifying for the estate tax marital deduction, provided that an estate tax return is required to be filed under Code Section 6018, even if such property does not increase the estate's federal estate tax liability, and to include property transferred by gift, if the gift is required to be reported on a federal gift tax return.

- A requirement that a GRAT have a minimum term of 10 years and a maximum term of the life expectancy of the annuitant plus 10 years.

- A requirement that the remainder interest in a GRAT at the time the interest is created must have a minimum value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000, but not more than the value of the assets contributed.

- A prohibition on any decrease in a GRAT annuity during the GRAT term.

- A prohibition on the grantor of a GRAT from engaging in a tax-free exchange of any assets held in the GRAT.

- A limitation of 90 years of the time during which a trust could be exempt for GST tax purposes.

- As to grantor trusts, if the deemed owner of a trust engages in a transaction with that trust that constitutes a sale, exchange or comparable transaction that is disregarded for income tax purposes by reason of the grantor trust rules, a proposal that the portion of the trust attributable to the property received by the trust in that transaction generally will be subject to estate tax as a part of the deemed owner's gross estate, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as the deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person during the deemed owner's life. This proposal would not apply to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor's spouse.

- If an estate elects to pay estate taxes in installments under Code Section 6166, a proposal to extend the 10 year estate tax lien under Code Section 6324(a)(1) for the entire Code Section 6166 deferral period;

- A proposal to clarify that the exclusion from the definition of a generation-skipping transfer under Code Section 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for those same purposes.

- A proposal to empower the executor of a decedent's estate to act on behalf of the decedent in all matters relating to the decedent's taxes, and to grant regulatory authority to adopt rules to resolve conflicts among multiple executors.

- A proposal to increase the highest long-term capital gains and qualified dividend tax rate from 20% to 24.2% which, together with the 3.8% net investment income tax, would result in a maximum total capital gains and dividend tax rate (including the net investment income tax) of 28%.

- A proposal to limit the income tax value of specified deductions or exclusions from adjusted gross income and all itemized deduction to 28% of the specified exclusions and deductions that would otherwise reduce taxable income in the 33%, 35% or 39.6% income tax brackets.

- A proposal to simplify the rules limiting income tax deductions for charitable contributions by providing that the contribution base limit would remain at 50% for contributions of cash to public charities, that a single deduction limit of 30% of the taxpayer's

contribution base would apply for all other contributions, and that the carry-forward period for excess contributions would be extended from 5 years to 15 years.

- A new minimum tax, called the Fair Share Tax, on high income taxpayers to be phased in linearly starting at $1,000,000 of adjusted gross income, or $500,000 in the case of a married person filing a separate return, that would be fully phased in at $2,000,000 of adjusted gross income, or $1,000,000 in the case of a married person filing a separate return, and that in general would require the taxpayer to pay a minimum income tax of 30% of adjusted gross income less a credit for charitable contributions.

- A proposal to tax so-called "carried interests" as ordinary income.

- A proposal requiring non-spouse beneficiaries of retirement plans and IRAs in general to take distributions over no more than five years.

- A proposal prohibiting a participant in a tax-favored retirement system from making additional contributions or receiving additional accruals under those arrangements, if the participant has accumulated amounts in such system in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (which currently is an annual benefit of $210,000 payable in the form of a joint and 100% survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if longer, the life of the participant's spouse). Currently, the maximum permitted accumulation for an individual age 62 is approximately $3,400,000.

- A proposal to exempt an individual from the minimum distribution requirements if the aggregate value of the individual's IRA and tax-favored retirement plan accumulations does not exceed $100,000 (indexed for inflation).

- A proposal to permit a qualified retirement plan to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or another retirement plan if the annuity investment is no longer authorized to be held under the plan, without the distribution being subject to the 10% additional tax.

- A proposal to require employers with 10 or more employees who do not already have a retirement plan to automatically enroll those employees in an IRA.

- A proposal to allow a non-spouse beneficiary of a tax-favored retirement plan or an IRA to move inherited plan or IRA assets to a non-spousal inherited IRA by a 60-day rollover of such assets.

- A proposal to index all civil tax penalties for inflation.

III. OTHER IMPORTANT FEDERAL LEGISLATION

A. Medicare Tax on Estates, Trusts and Individuals

The Health Care and Education Reconciliation Act of 2010 enacted new Code Section 1411, which imposes a 3.8% unearned income Medicare contribution tax, starting in 2013. As to estates and trusts, the tax is imposed on the lesser of (1) undistributed net investment income for the tax year, or (2) any excess of adjusted gross income over the dollar amount at which the highest tax bracket for estates and trusts begins for the applicable tax year, which for 2014 is $12,150, subject to inflation adjustments each year. Trusts all of the unexpired

interests in which are devoted to charitable purposes are exempt from this tax. As to individuals, the tax is imposed on the lesser of (1) the taxpayer's net investment income for the tax year, or (2) any excess of the taxpayer's modified adjusted gross income for the tax year, over $250,000, in the case of a taxpayer filing a joint return, or over $200,000, in the case of an unmarried taxpayer.

On November 30, 2012 the Service issued proposed regulations regarding such tax (REG-130507-11). The proposed regulations provide that any net investment income recognized by a charitable remainder trust before the end of 2012 is not included in such trust's accumulated net investment income when a subsequent distribution is made after 2012. Pursuant to Proposed Reg. Section 1.1411-3, the 3.8% tax on the net investment income of an individual, estate or trust pursuant to Code Section 1411 is imposed on the lesser of (1) the taxpayer's undistributed net income, or (2) the excess, if any, of its adjusted gross income over the threshold for the highest tax bracket under Code Section 1(e), which is $12,150 in 2014 for trusts.

On November 29, 2013 the Service issued final regulations on the net investment income tax (T.D. 9645), which generally contain many of the provisions of the proposed regulations. Under the final regulations, pooled income funds are not exempt from such tax, whereas wholly charitable trusts and wholly charitable estates are exempt from such tax. However, the regulations also state that the issue of what constitutes material participation for trusts and estates should be determined in guidance under Code Section 469, thereby leaving this issue unsettled.

On November 27, 2013 the Service updated its Questions and Answers regarding the 3.8% net investment income tax, that came into effect on January 1, 2013 and is imposed under Code Section 1411. Estates and trusts are subject to such tax if (1) they have undistributed net investment income, and (2) their adjusted gross income is greater than the dollar amount at which the highest income tax bracket for trusts and estates begins (which is $12,150 in 2014). Such tax is equal to 3.8% of the lesser of (1) the undistributed net investment income for the tax year, or (2) the excess of the gross income over the dollar amount at which the highest income tax bracket for trusts and estates begins. Such tax applies only to trusts that are subject to the fiduciary income tax under Part I of Subchapter J of Chapter 1 of Subtitle A of the Code. Trusts that are generally exempt from income tax, such as charitable trusts and qualified retirement plan trusts, are exempt from this tax. In addition, there are special rules for the calculation of the net investment income with respect to charitable remainder trusts and electing small business trusts that own interests in S corporations. Net investment income includes the various types of income and gain that are generated by investment activities, such as interest, dividends, capital gains, rental and royalty income. Individuals, estates and trusts will use Form 8960 to compute their net investment income tax and attach such form to their federal income tax returns.

At an American Law Institute Continuing Legal Education Program on February 18, 2014, an attorney with the Service's Office of Chief Counsel stated that if a trust distributes its net investment income to a beneficiary, the income will retain its character as investment income in the beneficiary's hands. In addition, such person stated that if there is an active business at the trust level, the business remains active for purposes of the beneficiary under the final regulations, even though there may not be a clear rule as to whether trust income retains its character in the beneficiary's hands for purposes of Code Section 469. Further, such person

stated that grantor trusts are disregarded for purposes of the net investment income tax, and the trust's activity therefore is treated as though the grantor owned the activity directly.

In Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014), the Court held that the services performed by the trustees of a trust with respect to the trust's real estate interests can be considered personal services performed by the trust, so the trust could be treated as materially participating in its real estate operations. On June 17, 2014 the Service asked the Tax Court to extend the deadline for filing computations of tax liability from June 16, 2014 to July 30, 2014.

On September 18, 2015 Catherine V. Hughes, a Treasury Department estate and gift tax attorney-advisor, stated that the Service is preparing guidance on what would constitute material participation for estates and trusts in which a fiduciary engages in a trade or business on behalf of an estate or trust, for purposes of determining whether or not such participation would be active, rather than passive, under Code Section 469.

As the tax applies with respect to tax years beginning after December 31, 2012, the estate of a decedent who died in 2012 and that selected a fiscal year ending on or before November 30, 2012 would avoid such tax on the estate's net investment income for such fiscal year and also for the next following fiscal year.

B. Death Master File

On December 26, 2013 the Continuing Appropriations Resolution, 2014, was enacted. The resolution includes a provision that limits public access to death records held by the Social Security Administration, known as the Death Master File, to certified entities such as life insurers and pension funds that use the data to combat fraud and administer benefits. The limits apply for three years after an individual's death.

C. Patient Protection and Affordable Care Act

On August 27, 2013 final regulations were issued on the "individual mandate" requirements of the Patient Protection and Affordable Care Act, which takes effect on January 1, 2014. Every non-exempt individual must have minimum essential coverage under a government sponsored program, an employee sponsored plan, a plan in the individual market, or any other health plan recognized by the United States Department of Health and Human Services. Exempt individuals include individuals who cannot afford coverage, individuals who obtain a hardship exempt certificate, non-United States citizens, and a United States citizen or resident with a tax home outside of the United States who is a bona fide resident of a foreign country during an uninterrupted period that includes an entire taxable year. Individuals who opt not to carry health coverage and who are not exempt must make a shared-responsibility payment, which for 2014 is the lesser of 1% of the individual's modified adjusted gross income, or $95. The penalty is scheduled to increase in 2015 to $325 and 2%, and in 2016 to $695 and 2-1/2%. After 2016, the dollar limit will be indexed for inflation. The payment is made by individuals on their income tax returns.

D. Tax Increase Prevention Act of 2014

The Tax Increase Prevention Act of 2014 was enacted on December 19, 2014. The Act, among other things, extended through the end of 2014 the election to claim an itemized deduction for state and local general sales taxes in lieu of state and local income taxes, excludes from income a cancellation of mortgage debt on a principal residence of up to $2,000,000 through the end of 2014, and extended through the end of 2014 the ability of individuals who are 70-1/2 years old and older to make tax-free distributions of up to $1,000,000 from an IRA to a qualified charitable organization.

E. Surface Transportation and Veterans Health Care Choice Improvement Act of 2015

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (also known as the Highway Funding Bill) was enacted on July 31, 2015. This statute includes the following provisions:

- The income tax cost basis of any property acquired from a decedent within the meaning of Code Section 1014 shall not exceed the estate tax value of such property. However, this requirement only applies to property whose inclusion in the decedent's estate increased the estate tax liability of such estate.

- The executor of an estate who is required to file a federal estate tax return, within the earlier of 30 days after the due date of such return or 30 days after such return is filed, must send a statement to the Service and to each person acquiring any interest in property that is included in the decedent's gross estate for federal estate tax purposes identifying the value of such interest as reported on such estate tax return.

- If there is an adjustment to the value of such interest as reported on the estate tax return, the executor, within 30 days after such adjustment is made, must send a supplemental statement to the Service and to such person advising as to such adjustment.

- The penalty under Code Section 6721 for the failure to comply with a specified information reporting requirement applies to the failure to provide such statements.

- Generally, the accuracy-related penalty for an underpayment of tax pursuant to Code Section 6662 applies if the income tax cost basis of property claimed on a return exceeds the estate tax value of such property.

- The above provisions apply to property with respect to which a federal estate tax return is filed after July 31, 2015.

- The six-year statute of limitations in the case of a substantial omission under Code Section 6501 applies to an understatement of gross income by reason of an overstatement of the income tax cost basis of property. This provision is effective with respect to tax returns filed after July 31, 2015, and also with respect to tax returns filed on or before such date if the period for the assessment of taxes under Code Section 6501 has not expired as of such date.

Effective for tax returns for tax years beginning after December 31, 2015, such Act directs the Service to amend its regulations to provide that the maximum extension for the income tax returns of trusts filing Form 1041 will be a 5-1/2 month period ending on September 30th for calendar year taxpayers (currently a 5-month period) and that returns of split-interest trusts required to file Form 5227 will be an automatic 6-month period beginning on the due date for filing the return, without regard to any extensions (currently a 3-month period).

On August 21, 2015 the Service released Notice 2015-57, which provides that the due date for such statements that are required to be filed with the Service and furnished to a beneficiary before February 29, 2016 is delayed to February 29, 2016, to allow the Service to issue guidance implementing such reporting requirements. In addition, the Notice states that executors and other persons required to file or furnish such statements should not do so until the issuance of forms or further guidance by the Service addressing such requirements. This Notice is effective on August 21, 2015, and applies to executors and other persons who are required to file a federal estate tax return if such return is filed after July 31, 2015.

On August 28, 2015 the Service released a draft of the 2015 U.S. Income Tax Return for Estates and Trusts (Form 1041). The draft instructions for Schedule D of such return, which is used to report capital gains and losses, includes a reference to these new basis consistency and reporting requirements, and states that if property reported on the Schedule increases the estate tax liability, the beneficiary must use a basis that is consistent with the estate tax value of the property to determine gain or loss when the property is sold.

On September 11, 2015 Catherine V. Hughes, a Treasury Department estate and gift tax attorney-advisor, stated that the Service is preparing regulations regarding the basis consistency requirements and the reporting and penalty provisions in such Act.

On December 19, 2015 the Service released a draft of Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent.

On February 11, 2016, the Service issued Notice 2016-19 stating that those required to file a statement with the Service or furnish a statement to a beneficiary need not do so until March 31, 2016.

On March 2, 2016, the Service issued Proposed Regulations (Reg-127923-15) and temporary rules (T.D. 9757) to clarify that the property that must be reported to beneficiaries excludes cash, income in respect of a decedent, tangible personal property for which an appraisal is not required (personal property under $3,000), and property sold or disposed of by the estate in a transaction in which capital gain or loss is not recognized. In addition, the Proposed Regulations stated that estate tax returns filed solely to elect portability are excluded from the basis consistency requirements.

F. Achieving a Better Life Experience ("ABLE") Act

On December 19, 2014 the Achieving a Better Life Experience ("ABLE") Act was enacted. The ABLE Act added new Code Section 529A that provides rules under which states may establish and maintain a new type of tax-favored savings program through which contributions may be made to the accounts of eligible disabled individuals to meet qualified

disability expenses. These accounts also receive favorable treatment for purposes of certain means-tested federal programs.

On June 22, 2015 the Service issued proposed regulations for ABLE accounts under Code Section 529A. In summary, these regulations provide that:

- An ABLE account can be established only for a designated beneficiary.
- A designated beneficiary can have only one ABLE account.
- A person is an eligible individual if he or she is entitled to benefits based on blindness or disability under Title II or XVI of the Social Security Act and the blindness or disability occurred before the date on which the individual attained age 26, or a disability certification meeting specified requirements is filed with the Service. For this purpose, a disability certification must certify that the designated beneficiary (1) has a medically determinable physical or mental impairment, which results in marked or severe functional limitations, and which (a) can be expected to result in death or (b) has lasted or can be expected to last for a continuous period of not less than 12 months; or (2) is blind and that such blindness or disability occurred before the date on which the individual attained age 26.
- Generally, all contributions to an ABLE account must be made in cash, and total contributions to an ABLE account for a designated beneficiary in a taxable year must not exceed the amount of the annual per-donee gift tax exclusion under Code Section 2503(b) in effect for that calendar year (currently $14,000).
- Contributions to an ABLE account may be made by any individual, trust, estate, partnership, association, company or corporation.
- Contributions to an ABLE account made by a person other than the designated beneficiary are treated as non-taxable gifts to the designated beneficiary.
- A qualified ABLE program generally is exempt from income taxation. However, such program is subject to the taxes imposed by Code Section 511 relating to the imposition of tax on unrelated business taxable income.
- Distributions from an ABLE account that do not exceed the designated beneficiary's "qualified disability expenses" are not includable in such person's gross income. Otherwise, the earnings portion of the distributions is includable in such person's gross income. In addition, an additional tax of 10% on the amount so includable is imposed.
- Qualified disability expenses are expenses that relate to the designated beneficiary's blindness or disability and are for the benefit for such person in maintaining or improving his or her health, independence or quality of life.
- Generally, a designated beneficiary's ABLE account is disregarded for purposes of determining such person's eligibility for an amount of any assistance or benefit provided under certain means-tested federal programs.
- The designated beneficiary is limited to no more than two opportunities in any calendar year to provide investment direction for his or her ABLE account.

On September 18, 2015 Catherine V. Hughes, a Treasury Department estate and gift tax attorney-advisor, stated that the Service is preparing guidance under the ABLE Act and that the Service expects to issue such guidance by early 2016.

On November 20, 2015 the Service issued Notice 2015-81, announcing three changes to its proposed regulations under the ABLE Act. The Notice states that ABLE programs will not need to include safeguards to determine which distributions are for qualified disability expenses, will not be required to identify distributions that will be used for housing expenses, and will not need to request the taxpayer identification number of contributors to an ABLE account, and that designated beneficiaries can open an ABLE account by certifying, under penalties of perjury, that they meet the qualification standards, including their receipt of a signed physician's diagnosis, if necessary, and that they will retain that diagnosis and provide it to the program or the Service on request.

G. Bipartisan Budget Act of 2015

The Bipartisan Budget Act of 2015, which was enacted on November 2, 2015, includes provisions regarding the tax audits of, and the payment of tax deficiencies by, partnerships (including limited liability companies that are taxable as partnerships), which generally are not effective until 2018 (unless a partnership elects to apply such rules sooner), under which audits of a partnership are generally conducted at the partnership level, and the partnership, rather than its partners, is liable for any deficiency based on an assumed tax rate. As a result, the partners in the year in which the adjustment is made will bear the cost, rather than the persons who are partners in the year that was audited, except that a partnership that has 100 or fewer partners generally may elect out of such new rules.

H. Protecting Americans From Tax Hikes Act of 2015

The Protecting Americans from Tax Hikes Act of 2015, which was enacted December 18, 2015, includes provisions extending for 2015 and making permanent itemized income tax deductions for state and local sales taxes, and tax-free distributions from IRAs for charitable purposes. The Act also amends Code Section 2501(a) to provide that transfers to Code Sections 501(c)(4), (5), or (6) organizations that are exempt from tax under Code Section 501(a) for the use of the organization are not subject to gift tax, and amends Code Section 664(e) to clarify the valuation rule for early terminations of certain charitable remainder unitrusts.

I. Bipartisan Budget Act of 2015

In addition, as part of the Bipartisan Budget Act of 2015 ("BBA"), Social Security benefit recipients will no longer be able to take advantage of the "file and suspend" strategy (which allowed married couples to claim benefits prior to age 70 without a reduction in future benefits), if they have not filed for Social Security benefits by April 30, 2016. The BBA also eliminated the option to file a restricted application for anyone who has not reached aged 62 by December 31, 2015. Prior to the enactment of BBA, filing for a restricted application allowed someone who applied for Social Security benefits before his or her full retirement age to claim his or her own retirement benefit or a spousal benefit, whichever is higher.

J. Consolidated Appropriations Act of 2016

The Consolidated Appropriations Act ("CAA"), which was enacted December 18, 2015, made several tax provisions permanent including: (i) the IRA charitable rollover (the IRA charitable rollover allows taxpayers to transfer up to $100,000 per year from an IRA directly to a charity); (ii) the election to deduct state and local sale taxes in lieu of state and local income taxes; (iii) the basis adjustment provision for an S corporation making a charitable contribution of property that allows shareholders to reduce the tax basis of their shares by the amount of the S corporation's tax basis of the donated asset rather than by its fair market value; (iv) the exclusion of 100% of gain recognized from the sale of certain small business stock; and (v) the reduced five year period that an S corporation that was previously a C corporation is required to pay tax for certain dispositions of assets that appreciated in the C corporation by the time the S corporation status was effective.

IV. 2016 INFLATION ADJUSTMENTS

In Rev. Proc. 2015-53, the Service released inflation-adjusted numbers as of January 1, 2016 as follows:

> The inflation-adjusted annual gift tax exclusion is $14,000, as it was in 2015; the annual gift tax exclusion for non-citizen spouses is $148,000, increased from $147,000 in 2015; the basic exclusion amount is $5,450,000, increased from $5,430,000 in 2015, for determining the amount of the unified credit against the estate tax and gift tax; the amount used to calculate the 2% portion for purposes of Code Section 6166 is $1,480,000, increased from $1,470,000 in 2015; for executors electing to use the special use valuation method under Code Section 2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use Code Section 2032A that is taken into account for purposes of the estate tax may not exceed $1,110,000, increased from $1,100,000 in 2015.

Beginning in 2004, the GST tax exemption became tied to the applicable exclusion amount under Code Section 2010(c). Pursuant to the 2010 Tax Act, this exemption was increased to $5,000,000, starting in 2010. Starting in 2012, this exemption is indexed for inflation from 2010, and the inflation-adjusted amount of this exemption is $5,450,000 in 2016.

In addition, Rev. Proc. 2015-53 announced the following 2016 inflation-adjusted amounts for income tax purposes: the maximum income tax bracket starts at $466,950 for married individuals filing jointly and surviving spouses, $441,000 for heads of households, $415,050 for other unmarried individuals, $233,475 for married individuals filing separately, and $12,400 for estates and non-grantor trusts; the income tax standard deduction is $12,600 for married individuals filing jointly and surviving spouses, $9,300 for heads of households, $6,300 for other unmarried individuals, and $6,300 for married individuals filing separately; the income tax personal and dependency exemptions are $4,050; the alternative minimum tax exemption is $83,800 for married individuals filing jointly and surviving spouses, $53,900 for other unmarried

individuals, $41,900 for married individuals filing separately, and $23,900 for estates and trusts; and the personal exemption phase-out (PEP) begins at adjusted gross income of $311,300 for married individuals filing jointly, at $285,350 for heads of households, at $259,400 for other unmarried individuals, and at $155,650 for married individuals filing separately.

On October 21, 2015 the Service issued IR-2015-118, which announced cost-of-living adjustments affecting dollar limitations for pension plans and other retirement-related items for tax year 2016. The adjustments include the following:

- The elective deferral (contribution) limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan remains at $18,000.

- The catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan remains at $6,000.

- The limit on annual contributions to an Individual Retirement Arrangement (IRA) remains unchanged at $5,500. The additional catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000.

- The deduction for taxpayers making contributions to a traditional IRA is phased out for singles and heads of household who are covered by a workplace retirement plan and have modified adjusted gross incomes (AGI) between $61,000 and $71,000, unchanged from 2015. For married couples filing jointly, in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, the income phase-out range remains unchanged at $98,000 to $118,000. For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between $184,000 and $194,000, increased from $183,000 and $193,000 in 2015. For a married individual filing a separate return who is covered by a workplace retirement plan, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

- The AGI phase-out range for taxpayers making contributions to a Roth IRA is $184,000 to $194,000 for married couples filing jointly, increased from $183,000 to $193,000 in 2015. For singles and heads of household, the income phase-out range is $117,000 to $132,000, increased from $116,000 to $131,000 in 2015. For a married individual filing a separate return, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

In addition, the Social Security Administration announced that the Social Security wage base for 2016 remains at $118,500.

V. DIGITAL ASSETS

As a result of the advent of the technology age, estate planning documents should expressly provide for the marshaling, access, administration and disposition of a person's technological assets, which are commonly referred to as "digital assets".

Digital assets include tangible digital devices, such as a computer, an Ipod, an Ipad and a blackberry; digital information, such as email, which may be stored in a tangible digital device, on a service provider's platform, or generally on the internet; on-line accounts, including social media accounts, such as Facebook and Twitter; and "clouds", which generally refer to the storage of digital information on the internet. Estate planning documents, such as a Will and a Power of Attorney, should provide specific authority regarding the digital assets of the decedent or principal. In addition, consideration should be given to the appointment by Will of a "Digital Executor", who would have the authority to deal with digital assets.

Accessing a person's digital assets after the person becomes incompetent, or after the person dies, may require applicable passwords. Thus, clients should be encouraged to prepare and maintain a current inventory of digital assets, including applicable passwords, so that such assets can be readily identified and accessed as needed. In addition, digital service providers may have policies and contractual provisions regarding the accessibility of the digital information that they provide. Accordingly, a person's designated agent pursuant to a Power of Attorney, or the Executor of an estate of a deceased person, may be required to review and comply with such policies and contractual provisions in order to access digital information.

Delaware has adopted the model Uniform Fiduciary Access to Digital Assets Act, effective January 1, 2015, which gives fiduciaries the right to obtain user name and password information required to access digital assets of the decedent, unless the decedent has expressly barred fiduciary access.

A few other states, including Connecticut, Idaho, Indiana, Oklahoma and Rhode Island, also have enacted legislation specifically authorizing the personal representative of a decedent's estate to obtain the decedent's digital information.

Attached hereto as Exhibit "D" are sample Will provisions regarding the appointment of a Digital Executor, the definition of digital assets, and the administration and disposition of such assets in a decedent's estate, and sample provisions for a Power of Attorney authorizing the principal's agent to act with respect to the principal's digital assets.

VI. NEW YORK ESTATE TAX AND GST TAX CHANGES

On March 31, 2014 New York enacted a major revision of its transfer tax system. Under the new law, the New York estate tax exclusion amount, which formerly was $1,000,000, is increased incrementally until the New York basic exclusion amount is equal to the federal estate tax exemption, as follows:

For decedents dying on or after:	And before:	The basic exclusion amount will be:
April 1, 2014	April 1, 2015	$2,062,500
April 1, 2015	April 1, 2016	$3,125,000
April 1, 2016	April 1, 2017	$4,187,500

April 1, 2017	Jan. 1, 2019	$5,250,000

For decedents dying on or after:	And before:	The basic exclusion amount will be:
Jan. 1, 2019		Scheduled to equal the federal estate tax exemption as indexed for inflation (and expected to be approximately $5,900,000 to $6,000,000 in 2019)

The tax benefit of this new New York basic exclusion amount is phased out for taxable estates between 100% and 105% of the New York basic exclusion amount. Thus, taxable estates that exceed 105% of the New York exclusion amount, as shown in the following chart, will lose the benefit of the exclusion completely, so the entire taxable estate will be subject to the New York estate tax.

Period	Basic Exclusion Amount	Full Phase-Out Amount
4/1/14 – 3/31/15	$2,062,500	$2,165,625
4/1/15 – 3/31/16	$3,125,000	$3,281,250
4/1/16 – 3/31/17	$4,187,500	$4,396,875
4/1/17 – 12/31/18	$5,250,000	$5,512,500
After 12/31/18	Equal to the federal exemption amount (currently $5,340,000 and indexed for inflation)	105% of the federal exemption amount

The New York estate tax is imposed at graduated rates, with a minimum tax rate of 3.06% and a maximum tax rate of 16%, which is applicable to taxable estates of more than $10,100,000.

Attached hereto as Exhibit "E" is a chart showing the amount of New York State estate tax that is payable on various amounts of a taxable estate during the phase-in period of the new tax law.

New York does not have a gift tax, but under the new New York estate tax law, the New York taxable estate includes gifts made within three years of death. However, gifts made when the decedent was not a New York resident, gifts made by a New York resident before April 1, 2014, gifts made by a New York resident on or after January 1, 2019, and gifts

that are otherwise includable in the decedent's gross estate under another provision of the Federal estate tax law, are excluded from the operation of this rule.

The new law also repeals the New York GST tax, which prior to its repeal applied to taxable distributions and taxable terminations but not to direct skips. Prior to the enactment of the new law, the New York GST tax was equal to the maximum federal credit against the federal GST tax for state GST taxes paid. The federal GST tax rate is equal to the maximum federal estate tax rate, and for this purpose New York assumed that the maximum federal estate tax rate was the maximum rate which was in effect in 2001. Thus, since that maximum credit was 5%, and the assumed maximum federal estate tax rate was 55%, the effective New York GST tax rate was 2.75%. Furthermore, for New York purposes, the maximum GST tax exemption was $1,000,000, adjusted for inflation. For 2013, the inflation adjusted New York GST tax exemption was $1,430,000. As a result, a trust's inclusion ratio could have been different for New York GST tax purposes than for federal GST tax purposes.

The New York State final Executive Budget for 2015-2016 included the following technical amendments to the new New York estate tax that was enacted in 2014:

- A drafting error in the 2014 legislation that would have caused the New York estate tax to disappear after March 31, 2015 was eliminated.

- The add-back of taxable gifts made within three years of death was clarified to provide that the gift add-back does not apply to estates of individuals dying on or after January 1, 2019.

- Since intangible personal property of a non-resident is not included in computing the non-resident's New York taxable estate, deductions associated with such properties are expressly disallowed.

- Out-of-state real property and tangible personal property is expressly excluded from the three year gift add-back.

- As to the apportionment of a non-resident's estate tax liability by reference to the percentage of New York situs property in the gross estate, there will be no New York estate tax if the value of the New York situs property does not exceed the applicable New York estate tax exclusion amount.

In addition, the 2015-2016 Executive Budget legislation did not change the New York estate tax cliff, did not include a state-only portability provision, did not include a provision for a separate New York State QTIP election when a federal estate tax return is filed, did not change the New York estate tax rates, and did not change the look-back period for gifts made within three years of death.

On August 25, 2014 the New York State Department of Taxation and Finance issued TSB-M-14(6)M regarding the new New York State estate tax law. The Technical Memorandum clarifies that a resident decedent's New York gross estate does not include gifts

made by the decedent within three years of death to the extent that the gifts consisted of real property or tangible property having a location outside of the State of New York, or if the gift was made (a) when the individual was a non-resident of New York State, or (b) before April 1, 2014, or (c) on or after January 1, 2019. The Technical Memorandum also states that the New York taxable estate for the estate of an individual who was a non-resident of the State of New York at the date of the decedent's death does not include the value of any intangible personal property otherwise includable in the decedent's New York gross estate, or the amount of any gift that is otherwise includable in the New York gross estate of a resident decedent, unless the gift was made while the non-resident decedent was a resident of the State of New York and the gift consisted of real property or tangible personal property having a location in New York State or intangible personal property employed in a business, trade or profession carried on in New York State. Importantly, the Technical Memorandum further states that elections made or waived on a federal estate tax return will be binding on the estate's New York estate tax return, and that a federal estate tax return is considered "required to be filed" not only when the decedent's gross estate exceeds the federal estate tax filing threshold, but also when the federal estate tax return is filed solely to make the federal portability election.

On October 27, 2015 the New York State Department of Taxation and Finance issued Technical Memorandum TSB-M-15(4)M regarding the treatment of deductions relating to real or tangible personal property located outside of New York State, and to intangible personal property, for New York estate tax purposes.

As to a resident estate, the Technical Memorandum states that the amount of allowable federal deductions for New York State purposes equals the total federal deductions reported on federal Form 706, less the federal deductions directly or indirectly related to real and tangible personal property that is located outside of New York State. The amount of deductions that are indirectly related to property located outside of New York State is the total amount of federal deductions not directly related to property inside or outside of New York State or to intangible personal property, multiplied by a fraction, the numerator of which is the total value of real and tangible personal property located outside of New York State, and the denominator of which is the total value of the federal gross estate. The Technical Memorandum further states that since intangible personal property is includable in the New York gross estate of a resident individual, any deductions related to intangible personal property are allowable for New York estate tax purposes.

As to a nonresident estate, the Technical Memorandum states that the amount of allowable federal deductions for New York State purposes equals the total federal deductions reported on federal Form 706 or federal Form 706-NA, minus the federal deductions directly or indirectly related to real or tangible personal property located outside of New York or to intangible personal property. The amount of deductions indirectly related to property located outside of New York State is the total federal deductions not directly related to property inside or outside of New York State, or to intangible personal property, multiplied by a fraction, the numerator of which is the total value of real and tangible personal property located outside of New York State, plus intangible personal property, and the denominator of which is the total value of the federal gross estate. Since intangible personal property is not includable in the New York gross estate of a nonresident decedent, any deductions related to intangible personal property are not allowable for New York estate tax purposes.

The Technical Memorandum further states that deductions that are directly related to real or tangible personal property include charitable deductions for the donation of land that is includable in the gross estate, mortgages secured by real property, and the amount of any real or tangible personal property that is included as part of the marital deduction; that deductions that are directly related to intangible personal property include broker fees, and the amount of any stocks, bonds or cash includable as part of the marital deduction. For this purpose, an ownership interest in a cooperative apartment corporation is considered intangible personal property for New York estate tax purposes. In addition, the Technical Memorandum states that deductions that are not directly related to real, tangible or intangible personal property include executor's commissions, accounting fees, attorney fees, funeral expenses and unsecured debts of the decedent.

The Technical Memorandum further states that the treatment of deductions as described in the Technical Memorandum applies to the estates of persons who die on or after April 1, 2014; that as to an estate of a person who died on or after April 1, 2014 that already has filed its New York State estate tax return, where the calculation of the allowable federal deductions for New York State estate tax purposes is affected by the Technical Memorandum, such estate will have to file an amended New York estate tax return to comply with the Technical Memorandum; and that if an estate already has filed its New York State estate tax return and has overpaid its New York State estate taxes, such estate must file a claim for refund by the later of three years from the date the original return was filed (or if the original return was filed before its due date, three years from such due date), or two years from the date the tax was paid.

New York amended Section 951 of the Tax Law by eliminating the requirement to create a qualified domestic trust ("QDOT") if no federal estate tax return is required to be filed. The amendment applies to the estates of decedents dying on or after January 1, 2010, and the amendment expires on July 1, 2016.

On September 26, 2012 the New York State Department of Taxation and Finance issued a Technical Memorandum (TSB-M-12(4)M) advising that where a federal estate tax return is filed solely to elect portability, the decedent's estate must file with the New York estate tax return both a copy of the federal estate tax return, as filed with the Service, and a completed pro forma Part 5-Recapitulation (form 706) and all applicable schedules that report the actual date of death value of all property the value of which was only estimated for federal estate tax purposes.

On July 29, 2011 the New York State Department of Taxation and Finance issued TSB-M-11(9)M stating that if a federal estate tax return is filed solely to elect portability, any QTIP election that is made on such tax return must also be made for New York estate tax purposes. If a QTIP election is not made on such federal return, it may not be made for New York estate tax purposes.

On October 12, 2011 the Department of Taxation and Finance issued Advisory Opinion TSB-A-11(1)M, stating that a non-resident's revocable trust that owns an interest in a multiple member limited liability company or a partnership that owns an interest in New York real property, is an interest in an intangible asset that is not subject to New York estate tax.

On April 8, 2010 the New York State Department of Taxation and Finance, in Advisory Opinion (TSB-A-10(1)(M)), considered whether a non-resident decedent's interest in a revocable trust, which owned interests in several multi-member New York limited liability companies that had elected to be treated as partnerships for federal income tax purposes, which in turn owned New York residential and commercial rental real property, is subject to New York estate tax. The Department concluded that the decedent's interest in the trust was an intangible asset that was not subject to New York State estate tax.

On January 14, 2009 the Office of Counsel of the New York State Department of Taxation and Finance issued an informational statement (NYT-G-09(1)M) stating that an executor may elect to use alternate valuation for purposes of calculating the New York gross estate when no federal estate tax return is required to be filed, provided that the requirements for electing alternate valuation under Code Section 2032 (i.e., reduction of the gross estate and reduction of the estate tax and the GST tax liability) are met applying the provisions of the Code as it existed on July 22, 1998 and applying the limitations on the unified credit in Section 951(a) of the New York Tax Law. Presumably, this election will continue to apply after March 31, 2014 with respect to the new New York basic exclusion amount.

On October 24, 2008 the New York State Department of Taxation and Finance published an advisory opinion (TSB-A-08(1))M), which considered whether an interest owned by a non-New York resident in an S corporation or in a single member limited liability company that owns real property located in New York constitutes intangible personal property, rather than real property, and therefore will not be included in the non-resident decedent's New York gross estate. The advisory opinion concluded that an interest in an S corporation owning New York real property is considered an intangible and is not included in a non-resident decedent's New York gross estate, unless the S corporation is not entitled to recognition under the Moline Properties test (Moline Props. v. Commissioner of Internal Revenue, 319 U.S. 436 (1943)). Under the Moline Properties test, a corporation's separate existence would be recognized for tax purposes if its purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation. The advisory opinion also concluded that an interest in a single member limited liability company owning New York real property is considered an intangible and is not included in the non-resident decedent's New York gross estate if the limited liability company elects to be treated as a corporation under the Service's "check-the-box" regulations (Treas. Reg. Sections 301.7701-1 through 301.7701-3). Although the advisory opinion only referenced the Moline Properties test in its discussion regarding an S corporation, it is likely that New York would also apply such test with respect to a single member limited liability company for purposes of the advisory opinion.

In Advisory Opinion TSB-A-15(1)(M) (May 29, 2015), the New York State Department of Taxation and Finance confirmed that if a single-member limited liability company owning a condominium in New York is a disregarded entity for income tax purposes, the membership interest in the entity will not be treated as intangible property for New York estate tax purposes.

VII. CONNECTICUT GIFT TAX AND ESTATE TAX LEGISLATION

On June 30, 2015, Connecticut enacted an estate tax cap of $20,000,000 for resident and nonresident decedents of the state who died on or after January 1, 2016. This $20,000,000 cap is reduced by taxable gifts made by the decedent or the decedent's estate, or taxable gifts made by the decedent's spouse that are includible in the decedent's gross estate, made on or after January 1, 2016. In addition, Connecticut removed the $12,500 cap on probate fees for the estates of decedents who die on or after January 1, 2015. At the top bracket, for estates $2,000,000 and over, the probate fee will be $5,615 plus .5% of the excess over $500,000.

Effective for the estates of decedents dying on or after January 1, 2015, the Connecticut estate tax laws have been amended to modify the definition of "Connecticut taxable estate" to exclude Connecticut taxable gifts that are otherwise included in the gross estate for federal estate tax purposes, and to provide a Connecticut estate tax credit for the Connecticut gift tax paid by the taxpayer or the taxpayer's spouse for Connecticut taxable gifts when such gift tax is otherwise included in the decedent's gross estate.

On May 4, 2011, as part of the budget legislation (CGA Bill No. 1239), Connecticut lowered the Connecticut estate tax and gift tax thresholds from $3,500,000 to $2,000,000 applicable retroactively to estates of decedents dying on or after January 1, 2011 and gifts made on or after January 1, 2011. The tax for estates and gifts of more than $2,000,000 will be based on graduated rates, starting at a rate of 7.2%, and the maximum tax rate will be 12% (on the excess over $10,100,000). The Connecticut budget legislation also increased the marginal income tax rates for taxpayers by increasing the number of tax brackets from three to six and by increasing the maximum income tax rate from 6.5 % to 6.7%.

The Connecticut estate tax and gift tax statute was amended to treat parties to a same sex marriage in the same manner as parties to a heterosexual marriage for estate tax and gift tax purposes, effective April 23, 2009.

EXHIBIT "A"

FINAL REGULATIONS REGARDING PORTABILITY

By Sanford J. Schlesinger, Esq. and Martin R. Goodman, Esq.

Mr. Schlesinger is a Founding Partner and **Mr. Goodman** is a Partner at Schlesinger Gannon & Lazetera LLP, New York, New York. Mr. Schlesinger is a member of the CCH Financial and Estate Planning Advisory Board.

On June 12, 2015, the Internal Revenue Service (the IRS) released final regulations (T.D. 9725) (the final regulations) regarding the portability provisions in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312)(the 2010 Act), which provisions were amended and made permanent by the American Taxpayer Relief Act of 2012 (P.L. 112-240)(the 2012 Act). The final regulations also removed the proposed temporary regulations (the proposed regulations) regarding portability that were issued on June 15, 2012 (after the enactment of the 2010 Act, but before the enactment of the 2012 Act), and that would have expired on June 15, 2015. This analysis will review and discuss the final regulations and the IRS's supplementary information (the supplementary information) provided in the preamble that accompanied the final regulations, and, where applicable, will compare the final regulations to the proposed regulations.

Preliminarily, it is important to note that portability applies for estate and gift tax purposes, but it does not apply for generation-skipping transfer tax purposes.

The final regulations consist of estate tax regulations and gift tax regulations, which are largely the same as the proposed regulations, with certain important differences that are discussed below. The estate tax regulations are contained in Reg. §20.2001-2, which states that the final regulations provide additional rules regarding the IRS's authority to examine tax returns, even if the time in which the tax may be assessed has expired, for the purpose of determining the deceased spousal unused exclusion (DSUE, described below) amount, Reg. §20.2010-1, which sets forth definitions and general rules regarding the unified credit against the estate tax, Reg. §20.2010-2, which contains portability provisions that are applicable to the estate of a decedent who is survived by a spouse, and Reg. §20.2010-3, which contains portability provisions that are applicable to the estate of the surviving spouse. The gift tax regulations consist of Reg. §25.2505-1, which sets forth general rules regarding the unified credit against the gift tax, and Reg. §25.2505-2, which contains provisions regarding lifetime gifts made by a surviving spouse who has a DSUE amount available.

In general, the final regulations are effective on June 12, 2015.

Estate Tax Regulations

Reg. §20.2001-2 states that Reg. §§20.2001-1(b), 20.2010-2(d) and 20.2010-3(d), all of which are discussed below, provide additional rules regarding the IRS's authority to examine any gift tax return or other tax returns, even if the statute of limitations for assessments has expired, for the purpose of determining the DSUE amount that is available to the surviving spouse.

Reg. §20.2010-1 defines certain relevant terms and sets forth general rules regarding the unified credit against the estate tax.

This regulation begins by stating that the estate of every decedent is allowed a credit under Code Sec. 2010(a) of the Internal Revenue Code of 1986, as amended (the Code), of the "applicable credit amount" (which sometimes is referred to as the "unified credit"). The applicable credit amount is the amount of the tentative tax that would be determined under Code Sec. 2001(c) if the amount on which the tentative tax is computed were equal to the "applicable exclusion amount" (which credit is determined by applying the tax rate schedule to the applicable exclusion amount). The regulation then defines the term applicable exclusion amount to be equal to the sum of the "basic exclusion amount" (defined below) and, with respect to the estate of a surviving spouse, the DSUE amount (also defined below). The basic exclusion amount (which is commonly referred to as the estate tax exemption) is defined as $5,000,000 for the estate of a decedent dying in 2011, and $5,000,000, adjusted for inflation from 2010, for the estate of a decedent dying after 2011. The inflation adjusted basic exclusion amount is $5,430,000 for the estate of a person who dies in 2015. Thus, the amount of this credit for the estate of a decedent who dies in 2015 without any DSUE amount is $2,117,800, as determined from a basic exclusion amount of $5,430,000. The amount of this credit for the estate of a decedent who dies after 2015 is determined based on the applicable exclusion amount, consisting of the sum of the decedent's basic exclusion amount of $5,000,000, as adjusted for inflation from 2010, and the decedent's DSUE amount, if any. This credit is reduced by 20 percent of the portion of the gift tax exemption of $30,000 that was allowable prior to 1977 and that the decedent used with respect to gifts made after September 8, 1976, and before January 1, 1977, but in any case the amount of this credit is not more than the amount of the tentative estate tax determined under Code Sec. 2001(c).

The regulation states that the DSUE amount generally is the unused portion of a decedent's applicable exclusion amount to the extent that such amount does not exceed the basic exclusion amount in effect in the year of the decedent's death.

Finally, the regulation defines the term "last deceased spouse" as the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse.

Portability Election Requirements

Reg. §20.2010-2(a) sets forth the requirements for a valid portability election.

The regulation states that the executor of a decedent's estate must elect portability of the DSUE amount on a timely filed federal estate tax return (Form 706) to allow the decedent's surviving spouse to take into account the decedent's DSUE amount. The regulation provides that an estate that elects portability will be treated as an estate that is required to file an estate tax return under Code Sec. 6018(a), even if the estate otherwise would not be required to do so. Therefore, the due date of an estate tax return that is filed to elect portability is nine months after the date of the decedent's (not the surviving spouse's) death, subject to any allowed extension of time to file such tax return, even if an estate tax return is not otherwise required to be filed for the estate.

Importantly, this regulation (unlike the temporary regulations) clarifies circumstances under which an extension of time to elect portability will or will not be granted under Reg. §301.9100-3. The regulation states that such an extension to elect portability is not available to estates that are required to file an estate tax return based on the applicable exclusion amount, since in such case the due date for the portability election is prescribed by statute and Reg. §301.9100-3 applies only to an election whose due date is prescribed by regulation. However, an extension of time under Reg. §301.9100-3 to elect portability may be available to an estate that is under the value threshold for being required to file an estate tax return, as in such case the due date for the portability election is prescribed by regulation, rather than by statute.

In this regard, note that Rev. Proc. 2014-18, IRB 2014-7, 513, provided that if a United States citizen or resident died after December 31, 2010, and on or before December 31, 2013, and had a surviving spouse, and if the decedent's estate was below the threshold for filing an estate tax return, and if such estate did not timely file an estate tax return, then such estate will be deemed to meet the requirements for relief under Reg. §301.9100-3, and is granted relief under such regulation to extend the time to elect portability, if such estate files a complete and properly prepared estate tax return on or before December 31, 2014. It is important to note that the IRS's supplementary information stated that the IRS is continuing to consider permanently extending the type of relief granted in such revenue procedure, although such relief is not included in the final regulations.

The regulation further states that if an estate tax return is complete and properly prepared (as discussed below) and is timely filed, the executor of the estate of a decedent who is survived by a spouse will be treated as having elected portability of the decedent's DSUE amount, unless the executor affirmatively chooses *not* to elect portability. An executor will not be considered to have elected portability if the executor states on a timely filed estate tax return, or in an attachment to that return, that the executor is not electing portability under Code Sec. 2010(c)(5), or if the executor does not timely file an estate tax return. The regulation states that the manner in which the executor may make the above-described affirmative statement on the estate tax return is as set forth in the instructions issued for that tax return.

The regulation then states that the portability election, once made, becomes irrevocable after the due date of the estate tax return, including extensions actually granted. However, before a portability election, or an election to not have portability apply, becomes irrevocable, an executor may make a portability election or may supersede a portability election previously made by timely filing another estate tax return making a portability election or reporting the decision not to make a previously made portability election. The regulation provides that an

executor of the estate of a decedent who is survived by a spouse may elect portability on behalf of the estate if the decedent dies on or after January 1, 2011. However, the regulation also provides that the executor of the estate of a nonresident decedent who was not a citizen of the United States at the time of his or her death may not elect portability on behalf of that decedent, and that the timely filing of an estate tax return for such decedent will not be deemed to make the portability election.

The regulation states that a duly appointed executor or administrator of the estate of a decedent, who is appointed, qualified and acting within the United States, can file the estate tax return for the decedent's estate and elect portability, or elect not to have portability apply. Such regulation also provides that if no executor or administrator has been appointed for a decedent's estate, then any person in actual or constructive possession of any property of the decedent (a non-appointed executor) can file the estate tax return for the decedent's estate and elect portability, or can elect not to have portability apply. Such regulation further provides that an election to allow portability made by a non-appointed executor cannot be superseded by a contrary election to have portability not apply made by another non-appointed executor of that estate, unless such other non-appointed executor is the successor of the non-appointed executor who made the portability election. However, the regulation also states that a portability election made by a non-appointed executor when there is no appointed executor for that decedent's estate can be superseded by a subsequent contrary election made by an appointed executor of such estate on an estate tax return that is timely filed.

In this regard, it is noted that circumstances may exist which cause the executor to be unwilling to elect portability. For example, the executor may be a child of the decedent from a former marriage who, due to animus, may not want to confer a tax benefit on the decedent's surviving spouse by electing portability. However, the state in which the decedent's Will is probated may authorize the appointment of an executor for a limited purpose. For example, the State of New York provides such pursuant to the Section 702 of the New York Surrogate's Court Procedure Act. In such a case, it may be possible for the surviving spouse to be appointed as the executor of the estate for the limited purpose of filing the estate tax return and making the portability election.

The IRS, in the supplementary information, stated that several persons who submitted comments with regard to the proposed regulations requested that the final regulations allow a surviving spouse who is not an executor of the deceased spouse's estate to file an estate tax return and make the portability election in various circumstances, including where the surviving spouse is given the right to file the estate tax return in a premarital agreement, or the surviving spouse has petitioned the appropriate local court for his or her appointment as an executor solely for the limited purpose of filing the estate tax return in order to make the portability election. However, the IRS concluded that any consideration of what, if any, state law action might bring the surviving spouse within the definition of executor under Code Sec. 2203 is outside of the scope of these regulations, and the final regulations do not include any of such changes requested by those commentators.

The regulation then sets forth the requirements for a complete and properly prepared estate tax return pursuant to which the executor may elect portability. The regulation provides that, in general, an estate tax return will be considered complete and properly prepared if it is

prepared in accordance with the instructions issued by the IRS for the preparation of an estate tax return and if the requirements of Reg. §20.6018-2 (which, in general, contains additional provisions as to the person or persons required to file an estate tax return), Reg. §20.6018-3 (which sets forth the requirements for the contents of an estate tax return) and Reg. §20.6018-4 (which sets forth certain requirements as to documents that must be filed with an estate tax return) are satisfied.

The IRS in its supplementary information stated that a person who submitted comments after the publication of the proposed regulations suggested that the final regulations elaborate on the circumstances under which a timely filed estate tax return may be considered insufficient as to render the estate tax return incomplete for purposes of electing portability. However, the IRS considered the issue of whether or not an estate tax return is complete and properly prepared to be an issue that must be determined on a case-by-case basis by applying standards as prescribed in current law. Therefore, the final regulations did not adopt this suggestion.

The regulation also sets forth a special rule regarding the reporting of the value of certain property of estates as to which the executor is not required to file an estate tax return other than for the purpose of making the portability election (i.e., an estate of a decedent whose gross estate and adjusted taxable gifts do not exceed the filing requirement threshold for the year of the decedent's death). Pursuant to this special rule, an executor is not required to report a value for property that is includible in the decedent's gross estate and that qualifies for either the estate tax marital deduction or the estate tax charitable deduction. Instead, the executor will only be required to report the description, ownership and/or beneficiary of such property, and all other information necessary to establish the right of the estate to the estate tax marital deduction or the estate tax charitable deduction for such property.

However, this special rule does not apply if:

(a) the value of such property relates to, affects or is needed to determine the value passing from the decedent to another recipient;

(b) the value of such property is needed to determine the estate's eligibility for the provisions of Code Sec. 2032 (regarding the alternate valuation date election), Code Sec. 2032A (regarding the valuation of qualified real property), or another estate tax or generation-skipping transfer tax provision of the Code for which the value of such property or the value of the gross estate or the adjusted gross estate must be known (not including Code Sec. 1014, which sets forth the rules for determining the income tax cost basis of property acquired from a decedent), such as Code Sec. 6166 (regarding the election to pay the portion of the estate tax that is attributable to an interest in a closely held business in installments);

(c) less than the entire value of an interest in property that is includible in the decedent's gross estate qualifies for the estate tax marital deduction or the estate tax charitable deduction; or

(d) a partial disclaimer or a partial qualified terminable interest property (QTIP) election is made with respect to property that is includible in the decedent's gross estate, part of which qualifies for the estate tax marital deduction or the estate tax charitable deduction. Thus, in any of these instances, an estate tax return that is filed solely to make the portability election, and that would

not otherwise be required to be filed, will require all of the information and related documentation that would be required for an estate tax return for the estate of a decedent whose gross estate and adjusted taxable gifts exceeds the filing threshold, in order to be considered a complete and properly prepared estate tax return.

This special rule reducing the requirements for reporting the value of certain property that is includible in the decedent's gross estate will apply only if the executor exercises due diligence to estimate the fair market value of the decedent's gross estate, including the property that is includible in the decedent's gross estate and that qualifies for the estate tax marital deduction or the estate tax charitable deduction. The regulation states that the executor, using his, her or its best estimate of the value of the properties that qualify for the estate tax marital deduction or the estate tax charitable deduction must report on the estate tax return, under penalties of perjury, the amount corresponding to the particular range within which the executor's best estimate of the total gross estate falls, in accordance with the instructions for Form 706. In this regard, it is noted that such instructions contain a Table of Estimated Values for such assets, in increments of $250,000, and state that the amount reported on Form 706 for such assets should correspond to the applicable range of dollar values for such assets.

This regulation contains examples illustrating the operation of this special rule.

In Example 1, the gross estate of the first spouse to die consisted solely of assets owned jointly with the decedent's surviving spouse, with right of survivorship, a life insurance policy payable to the surviving spouse, and a survivor annuity payable to the surviving spouse for her life. The decedent made no taxable gifts during his lifetime. The example states that an estate tax return that identifies these assets on the proper schedules, but provides no information with regard to the date of death value of such assets, that includes evidence verifying the title of each jointly held asset, confirming that the surviving spouse is the sole beneficiary of both the life insurance policy and the survivor annuity, and verifying that the annuity is exclusively for the surviving spouse's life, and that reports the executor's best estimate, determined by exercising due diligence, of the fair market value of the decedent's gross estate, is considered a complete and properly prepared estate tax return in which the executor has elected portability.

In Example 2, the decedent died testate, leaving a will in which he bequeaths his entire estate to his surviving wife, outright and free of trust. The decedent also had non-probate assets that are includible in his gross estate, consisting of a life insurance policy payable to his children and an individual retirement account (IRA) payable to his wife. The decedent made no taxable gifts during his lifetime. The executor of the decedent's estate filed an estate tax return in which all of the assets that are includible in the decedent's gross estate are identified on the proper schedule. As to the decedent's probate assets and the IRA, no information is provided regarding the date of death value of such assets. The executor attaches a copy of the decedent's will, and describes each such asset and its ownership to establish the estate's entitlement to the estate tax marital deduction for such assets. With respect to the life insurance policy payable to the decedent's children, all of the regular estate tax return requirements apply, including reporting and establishing the fair market value of such asset. The executor also reports the executor's best estimate, determined by exercising due diligence, of the fair market value of the decedent's gross estate. This example states that the estate tax return is considered to be complete and properly prepared, and that the executor has elected portability.

In Example 3, the decedent died testate, and his will bequeathed 50 percent of his probate assets to a marital trust for the benefit of the decedent's wife and the other 50 percent thereof to a trust for the benefit of the decedent's wife and their descendants. This example states that, as the amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the decedent's will, the value of the property of the marital trust relates to or affects the value of the property passing to the non-marital trust, so that the general return requirements apply to all of the property includible in the decedent's gross estate. Thus, in this example, the special rule described above waiving such requirements does *not* apply.

The IRS in its supplementary information stated that a person who submitted comments after the proposed regulations were issued suggested that the IRS prepare a shorter version of the estate tax return to be used by estates that are not otherwise required to file an estate tax return, but do so only to elect portability. The IRS concluded that a timely filed, complete and properly prepared estate tax return affords the most efficient and administrable method of obtaining the information necessary to compute and verify the DSUE amount, and that the alleged benefits to taxpayers from an abbreviated form is far outweighed by the anticipated administrative difficulties in administering the estate tax that would occur from the use of a short version of such tax return. Thus, the IRS did not adopt this suggestion.

In this regard, it should be noted that Rev. Proc. 2001-38, IRB 2001-24, 1335, states that the IRS will disregard for federal estate tax, gift tax, and generation-skipping transfer tax purposes, a QTIP election that is made under Code Sec. 2056(b)(7) where the election was not necessary to reduce the estate tax liability to zero. The IRS, in the supplementary information, stated that multiple commentators have requested guidance on the application of such revenue procedure when an estate that is below the filing threshold files an estate tax return and makes the portability election and a QTIP election on such tax return. The commentators have noted that, with the introduction of portability, an executor may purposefully file an estate tax return in such a case in order to elect both portability and QTIP treatment, and that the rationale for the rule voiding the QTIP election (that such election was of no benefit to the taxpayer) is no longer applicable. However, the IRS declined to provide such guidance in the final regulations, and stated that it intends to provide such guidance by publication in the Internal Revenue Bulletin to clarify whether a QTIP election that is made for estate tax purposes may be disregarded when the executor has elected portability.

It also is noted that the IRS recently announced on its website that it will not automatically issue closing letters for estate tax returns filed on or after June 1, 2015, and that a taxpayer who wants a closing letter should request it in a separate letter submitted to the IRS at least four months after the estate tax return is filed. This departure from the IRS's long-standing practice of issuing estate tax closing letters may be due to the IRS's belief that if it issues an estate tax closing letter for an estate that elects portability, then the IRS could be "prejudiced" in any effort that it may make to subsequently review such estate tax return in order to determine the amount of the decedent's DSUE amount, even though Code Sec. 2010(c)(5)(B) grants the IRS such examination authority whether or not the statute of limitation for assessments has expired with respect to such tax return. In addition, it is possible that with the advent of portability, the number of estate tax returns that are being filed and will be filed may far exceed the number of estate tax returns that were filed before portability was enacted, and the IRS may believe that it would be overly burdensome to issue estate tax closing letters as a matter of course

for each such tax return. However, if the IRS's new policy regarding the issuance of estate tax closing letters is based on this administrative concern, the IRS could simply limit the application of this new policy to the estates of decedents that are below the filing threshold. Regardless of the rationale for this change in policy, it may be desirable for executors to routinely request estate tax closing letters approximately four months after filing estate tax returns, especially with respect to estates that have a low risk or no risk of adjustments on audit.

DSUE Computation

Reg. §20.2010-2(b) provides that the executor of a decedent's estate must include a computation of the DSUE amount on the decedent's estate tax return to elect portability, and that this requirement is satisfied by the timely filing of a complete and properly prepared estate tax return, as long as the executor has not elected out of portability.

Reg. §20.2010-2(c) contains provisions regarding the computation of the DSUE amount. This regulation provides that such amount generally is the lesser of the basic exclusion amount in effect for the year of the decedent's death (i.e., $5,000,000, adjusted for inflation, as noted above), or the excess of the decedent's applicable exclusion amount over the sum of the decedent's taxable estate and the amount of the decedent's adjusted taxable gifts as to which gift taxes were not paid.

In this regard, it is noted that the 2010 Act defined the DSUE amount as the lesser of (a) the basic exclusion amount, or (b) the excess of the basic exclusion amount (rather than the applicable exclusion amount) of the last deceased spouse of the surviving spouse over the amount with respect to which the tentative tax is determined under Code Sec. 2001(b)(1) on the estate of such deceased spouse. However, the proposed regulations, which as noted above, were issued after the enactment of the 2010 Act but before the enactment of the 2012 Act, defined the DSUE amount as the lesser of (a) the basic exclusion amount, or (b) the excess of the applicable exclusion amount (rather than the basic exclusion amount) of the last deceased spouse of the surviving spouse over the amount with respect to which the tentative tax on the estate of such deceased spouse is so determined.

The effect of such statutory formulation in the 2010 Act, and the effect of the regulatory interpretation of it in the proposed regulations, can be illustrated by the following example:

Assume that H-1 dies in 2011, having made taxable gifts during his life of $3,000,000 and having no taxable estate, that the executor of H-1's estate files an estate tax return electing portability, that H-1's surviving spouse, W, makes no taxable gifts during her life, and that W remarries H-2 and W predeceases H-2. Pursuant to the statutory formulation in the 2010 Act, after H-1's death, W's applicable exclusion amount is $7,000,000 (i.e., her $5,000,000 basic exclusion amount, plus the DSUE amount of $2,000,000 from H-1). W has a taxable estate of $3,000,000 at her death, and the executor of W's estate files an estate tax return electing portability. Pursuant to the statutory formulation, W's DSUE amount is the lesser of (a) W's basic exclusion amount of $5,000,000, or (b) the excess of W's basic exclusion amount of $5,000,000, over her taxable estate of $3,000,000, or $2,000,000. Thus, W's DSUE amount is $2,000,000. Therefore, H- 2's applicable exclusion amount would be the sum of his own basic exclusion amount of $5,000,000, plus W's DSUE amount of $2,000,000, or $7,000,000.

However, pursuant to the proposed regulation, W's DSUE amount is the lesser of (a) W's basic exclusion amount (i.e., $5,000,000), or the (b) excess of W's applicable exclusion amount, which is $7,000,000 (i.e., W's $5,000,000 basic exclusion amount, plus the $2,000,000 DSUE amount from H-1), over the amount of W's taxable estate of $3,000,000, for an excess amount of $4,000,000. Thus, pursuant to the proposed regulations, W's DSUE amount is $4,000,000, and the applicable exclusion amount of H-2 is $9,000,000 (i.e., H-2's basic exclusion amount of $5,000,000, plus W's DSUE amount of $4,000,000).

Consequently, such regulatory interpretation of the statute increased the applicable exclusion amount of H-2 by $2,000,000.

Interestingly, the technical explanation of the 2010 Act prepared by the Joint Congressional Committee on Taxation (JCX-55-10, December 10, 2010, Footnote 57), in its discussion regarding the portability provisions of the 2010 Act, included an example (Example 3), which in effect adopted the view regarding the computation of the DSUE amount that is set forth in the proposed regulations. In addition, on March 23, 2011, the same Committee issued an errata to its general explanation of the 2010 Act (JCX-20-11) stating that the intent of the 2010 Act was to compute the DSUE amount of the wife in the above example in the same manner as it is computed pursuant to the proposed regulations, and further stating that a technical correction of the 2010 Act may be necessary to replace the statutory reference to the "basic exclusion amount of the last such deceased spouse of such surviving spouse" with a statutory reference to the "applicable exclusion amount of the last such deceased spouse of such surviving spouse" to reflect this intent. In fact, the 2012 Act included such technical correction of the 2010 Act. As a result, there was no need for a reference to this issue in the final regulations, and there was none.

The regulation also states that the amount of the adjusted taxable gifts of a decedent is reduced by the amount on which gift taxes were paid, in order to compute the decedent's DSUE amount.

It should be noted that the temporary regulations did not provide guidance, and reserved a section thereof for future provision, on the impact of the estate tax credits under Code Secs. 2012 through 2015 (the credit for gift taxes, the credit for tax on prior transfers, the credit for foreign death taxes, and the credit for death taxes on remainders, respectively). The IRS, in the supplementary information, stated that it concluded that the amount of such allowable credits can be determined only after subtracting the applicable credit amount determined under Code Sec. 2010 from the tax imposed by Code Sec. 2001. Thus, to the extent that the applicable credit amount is applied to reduce the tax imposed by Code Sec. 2001 to zero, the credits allowable in Code Secs. 2012 through 2015 are not available. In addition, the IRS stated that the computation of the DSUE amount does not take into account any unused credits arising under Code Secs. 2012 through 2015. For these reasons, the IRS concluded that no adjustment to the computation of the DSUE amount to account for any such unused credits is warranted, and the final regulations so state.

The regulation also sets forth a special rule regarding portability in the case of property passing to a qualified domestic trust (QDOT). Pursuant to Code Sec. 2056(d), the estate of a decedent is not allowed an estate tax marital deduction for property passing from the decedent to a surviving spouse who is not a United States citizen, unless the property passes to a QDOT.

Pursuant to Code Sec. 2056A, in general, a QDOT is a trust that requires that at least one trustee shall be an individual who is a United States citizen or a domestic corporation, who or which will pay the estate tax with respect to such trust from any principal distribution of the trust before the death of the surviving spouse, and from the value of the trust that is remaining on the death of the surviving spouse. The regulation provides that in such case the DSUE amount of the decedent is computed on the decedent's estate tax return for the purpose of electing portability in the same manner as such amount would otherwise be computed, but the decedent's DSUE amount is subject to subsequent adjustments. The regulation states that the DSUE amount of the decedent must be redetermined upon the occurrence of the final distribution or other event (generally, the death of the surviving spouse or the earlier termination of all QDOTs for that surviving spouse) on which the estate tax is imposed. Thus, a surviving spouse generally cannot use any of the DSUE amount received from the deceased spouse while a QDOT for the benefit of the surviving spouse remains in effect. As a result of this rule, a non-citizen surviving spouse will generally not be able to use the deceased spouse's DSUE amount to make lifetime gifts.

In this regard, it is noted that the proposed regulations provided that in the case of a decedent's estate claiming a marital deduction for property received through a QDOT, the earliest date on which a decedent's DSUE amount could be included in determining the applicable exclusion amount available to the surviving spouse or the surviving spouse's estate is the date of the event that triggers the final estate tax liability of the first spouse to die under Code Sec. 2056A. However, the IRS stated in the supplementary information that a person who submitted comments regarding such regulations challenged this delay in the surviving spouse's ability to use the decedent's DSUE amount if the surviving spouse becomes a United States citizen after the decedent's estate tax return is filed and after the property passes to a QDOT for the benefit of such surviving spouse. The IRS stated that it concluded that in such a case the tax imposed by Code Sec. 2056A(b)(1) would no longer apply, and the decedent's DSUE amount would no longer be subject to adjustment and would become available for transfers by the surviving spouse as of the day the surviving spouse becomes a United States citizen. Accordingly, the final regulations included this change, by providing that if the surviving spouse becomes a United States citizen after the death of the first spouse to die, in general no estate tax will be imposed under Code Sec. 2056(a) either on subsequent QDOT distributions or on the property remaining in the QDOT on the surviving spouse's death, and the decedent's DSUE amount is no longer subject to adjustment.

The regulation contains four examples illustrating its application:

In Example 1, H and W are United States citizens. H makes a taxable gift of $1,000,000 in 2002, pays no gift tax due to the applicable exclusion amount available to H of $1,000,000 in 2002, and dies in 2015 survived by W. H's taxable estate is $1,000,000, and the executor of H's estate timely files an estate tax return electing portability. The example states that H's DSUE amount is $3,430,000 (the lesser of (a) the $5,430,000 basic exclusion amount in 2015, or (b) the excess of H's $5,430,000 applicable exclusion amount over the sum of H's $1,000,000 taxable estate and the $1,000,000 amount of adjusted taxable gifts that H made).

In Example 2, the facts are the same as in Example 1, except that the value of H's taxable gift in 2002 is $2,000,000, as to which H paid a gift tax on $1,000,000. This example states that H's DSUE amount is $3,430,000 (the lesser of (a) the $5,430,000 basic exclusion amount in

2015, or (b) the excess of H's $5,430,000 applicable exclusion amount over the sum of the $1,000,000 taxable estate of H and the $1,000,000 of adjusted taxable gift made by H as to which gift taxes were not paid).

In Example 3, H, a United States citizen, made a taxable gift of $1,000,000 in 2002 as to which no gift taxes were due. H dies in 2015 with a gross estate of $2,000,000 survived by W, who is a United States resident but not a United States citizen. H bequeathed the sum of $1,500,000 to a QDOT for the benefit of W. H's executor timely filed an estate tax return making the QDOT election and electing portability. H's taxable estate, after the marital deduction of $1,500,000, is $500,000. The preliminary DSUE amount of H is $3,930,000 (the lesser of (a) the $5,430,000 basic exclusion amount in 2015, or (b) the excess of H's $5,430,000 applicable exclusion amount over the sum of H's $500,000 taxable estate and the $1,000,000 adjusted taxable gift made by H). At W's death in 2017, the value of the assets of the QDOT is $1,800,000. The example states that the DSUE amount is redetermined to be $2,130,000 (the lesser of (a) the $5,430,000 basic exclusion amount in 2015, or (b) the excess of H's $5,430,000 applicable exclusion amount over $3,300,000 (the sum of the $500,000 taxable estate of H augmented by the $1,800,000 of QDOT assets and the $1,000,000 of adjusted taxable gifts)).

In Example 4, the facts are the same as in Example 3, except that W becomes a United States citizen in 2016 and dies in 2018. The example states that pursuant to Code Sec. 2056A(b)(12), the estate tax under Code Sec. 2056A no longer applies to the QDOT property. The example further states that because H's DSUE amount is no longer subject to adjustment once W becomes a United States citizen, H's DSUE amount is $3,930,000, as it was preliminarily determined as of H's death, and that on W's death in 2018, the value of the QDOT property is includible in W's gross estate.

The regulation also states that the IRS may examine the tax returns of a decedent to determine the decedent's DSUE amount, regardless of whether or not the period of limitations on the assessment of additional taxes has expired for such tax return. However, as noted below regarding the gift tax regulations, the IRS cannot assess any additional taxes with respect to any such tax return after the expiration of the statute of limitations for such assessment.

In this regard, the IRS in the supplementary information stated that a person who submitted comments concerning the proposed regulations requested that such examination authority of the IRS be limited to issues of the reporting and valuation of assets, and not extend to other legal issues that may impact on the availability of the DSUE amount to the surviving spouse. The IRS stated that such limited authority would be inconsistent with the statute, which grants broad authority to the IRS to examine the correctness of any return, without regard to the statute of limitations on assessments, to make determinations with respect to the allowable DSUE amount. In addition, another commentator requested confirmation that, in the examination of a tax return for the purpose of determining the allowable DSUE amount that takes place after the expiration of the statute of limitations, the valuation of assets may be increased or decreased, with a possible result that the allowable DSUE amount may decrease or increase. The IRS stated that no clarification or change in the regulations was required for this purpose. Further, another commentator suggested that the final regulations consider whether, in the case of such an examination, an adjustment to the value of an asset reported on the estate tax return affects the income tax cost basis of such asset under Code Sec. 1014. The IRS stated that

the basis of property acquired from a decedent is determined in accordance with the existing principles of Code Sec. 1014, and that the scope of such examination authority is sufficiently clear and therefore no change need be made in this regard in the final regulations. Moreover, another commentator suggested that the final regulations clarify the deductibility of administration expenses associated with such an examination. The IRS stated that any such expenses should be treated as any other expense associated with preparation of the surviving spouse's tax returns, that the standards for deducting such expenses for estate tax and gift tax purposes are sufficiently clear, and that no change to the temporary regulation in this regard is necessary. Finally, another commentator suggested clarifying who may participate in such an examination. The IRS stated that each taxpayer has the authority to participate in the resolution of issues raised in the audit of his or her tax return, and that addressing this issue is outside the scope of the final regulations.

Portability Provisions Applicable to the Surviving Spouse's Estate

Reg. §20.2010-3 provides that the DSUE amount of a decedent is included in determining the applicable exclusion amount of the decedent's surviving spouse for estate tax purposes only if such decedent is the last deceased spouse of such surviving spouse on the date of the death of such surviving spouse, and only if the executor of the estate of such last deceased spouse elected portability. This regulation further states that the surviving spouse's estate has no DSUE amount available if the last deceased spouse of such surviving spouse had no DSUE amount, or if the executor of the last deceased spouse's estate did not make a portability election, even if the surviving spouse previously had a DSUE amount available from another decedent who, prior to the death of the last deceased spouse, was the last deceased spouse of such surviving spouse. For example, if H-1 and W are married, and if H-1 dies having a DSUE amount and the executor of his estate makes the portability election, but thereafter W marries H-2 who then dies having no DSUE amount, then on W's death the DSUE amount from H-1 would not be available to the estate of W.

In addition, this regulation states that a decedent is the last deceased spouse of a surviving spouse even if, on the date of the death of such surviving spouse, the surviving spouse is married to another then living individual. Further, the regulation states that if a surviving spouse remarries and that marriage ends in a divorce or an annulment, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. Since the divorced spouse, at his or her death, is not married to the surviving spouse, such divorced spouse is not the last deceased spouse of the surviving spouse.

The regulation provides a special rule to compute the DSUE amount of a surviving spouse for estate tax purposes where the surviving spouse previously applied the DSUE amount of one or more deceased spouses to lifetime taxable gifts. This rule states that if a surviving spouse has applied the DSUE amount of one or more last deceased spouses to the surviving spouse's lifetime gifts, and if any of those last deceased spouses is not the surviving spouse's last deceased spouse at the death of the surviving spouse, then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse at the time of the surviving spouse's death is the sum of the DSUE amount of the surviving spouse's last deceased spouse, and the DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such DSUE amount was applied to one or more taxable gifts of the surviving spouse.

This regulation contains the following example to illustrate the operation of this provision:

H-1 dies in 2011, survived by W, and neither of them has made any taxable gifts during H-1's life. H-1's executor elects portability of H-1's DSUE amount, which is $5,000,000. In 2012 W makes taxable gifts of $2,000,000, and W is considered to have applied $2,000,000 of H-1's DSUE amount to the taxable gifts. Thereafter, W has a remaining applicable exclusion amount of $8,120,000, consisting of H-1's $3,000,000 remaining DSUE amount, plus W's own $5,120,000 basic exclusion amount. After H-1's death, W marries H-2 in 2013. H-2 dies in 2014. H-2's executor elects portability of H-2's DSUE amount, which is $2,000,000. W dies in 2015. The example states that the DSUE amount to be included in determining the applicable exclusion amount available to W's estate is $4,000,000, which is determined by adding the $2,000,000 DSUE amount of H-2 and the $2,000,000 DSUE amount of H-1 that was applied by W to W's 2012 taxable gifts. Thus, W's applicable exclusion amount is the sum of her own basic exclusion amount of $5,430,000, plus such DSUE amount of $4,000,000, for a total of $9,430,000.

Therefore, this special rule effectively permits a wealthy person to make a very large aggregate amount of lifetime gifts on a tax-free basis, as long as portability remains in effect, by having serial marriages to individuals, each of whom predeceases such person and has a DSUE amount, and whose executors elect portability, and by such person making a lifetime gift equal to such DSUE amount of each such deceased individual before such person remarries.

The regulation provides rules regarding the date as of which a decedent's DSUE amount is to be taken into consideration by the surviving spouse. This regulation states that in general a portability election applies as of the date of the death of the person with respect to whom such election is made. Therefore, a decedent's DSUE amount is included in the applicable exclusion amount of the decedent's surviving spouse and will be applicable to transfers made by the surviving spouse after the death of the decedent. However, this regulation also states that even if the surviving spouse made a transfer in reliance on the availability or computation of the decedent's DSUE amount, such DSUE amount will <u>not</u> be included in the applicable exclusion amount of the surviving spouse (a) if the executor of the decedent's estate supersedes the portability election by timely filing a subsequent estate tax return in which no such election is made, or (b) to the extent that the DSUE amount is subsequently reduced by a valuation adjustment or a correction of an error in the computation of such amount, or (c) to the extent that the surviving spouse cannot substantiate the DSUE amount that is claimed on the surviving spouse's tax return.

This regulation also provides a special rule when property passes from a decedent for the benefit of a surviving spouse in one or more QDOTs and the decedent's executor elects portability. The regulation states that in such case the DSUE amount that is available to be included in the applicable exclusion amount of the surviving spouse is the DSUE amount of the decedent as redetermined (see earlier description). Thus, the earliest date on which the decedent's DSUE amount can be included in the applicable exclusion amount of the surviving spouse is the date of the occurrence of the final QDOT distribution or other final event (generally, the death of the surviving spouse or the earlier termination of all QDOTs for that

surviving spouse) on which the estate tax is imposed. Thereafter, however, the decedent's DSUE amount as so redetermined may be applied to taxable gifts of the surviving spouse.

The regulation provides that for the purpose of determining the DSUE amount that is included in the applicable exclusion amount of the surviving spouse, the IRS may examine the tax returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, whether or not the statute of limitations for the assessment of additional taxes has expired for any such tax return. In this regard, the regulation also states that IRS's authority to examine returns of a deceased spouse applies with respect to each transfer by the surviving spouse to which a DSUE amount is or has been applied. This regulation further states that the IRS, upon such examination, may adjust or even eliminate the DSUE amount reported on such a return, but that the IRS can assess additional taxes on that return only if that tax is assessed within the applicable period of limitations regarding assessments.

The regulation provides that the estate of a nonresident surviving spouse who is not a United States citizen at the time of his or her death cannot take into account the DSUE amount of any deceased spouse of such surviving spouse, except to the extent allowed under any applicable treaty obligation of the United States.

Gift Tax Regulations

Reg. §25.2505-1 provides general rules regarding the application of the unified credit against the gift tax. First, these provisions refer to the general rules and definitions in the estate tax regulations described above regarding such rules and definitions concerning the application of the unified credit against the estate tax. Second, as in the estate tax regulations, this regulation also provides that the applicable credit must be reduced by 20 percent of the amount allowed as a specific exemption for gifts made by the decedent after September 8, 1976 and before January 1, 1977. Third, similar to the estate tax regulations, this regulation provides that the applicable credit shall not exceed the amount of the gift tax that is otherwise imposed.

Reg. §25.2505-2 sets forth rules regarding lifetime gifts made by a surviving spouse who has a DSUE amount available.

This regulation provides that a DSUE amount of a decedent is included in determining the surviving spouse's applicable exclusion amount if (a) such decedent is the last deceased spouse of the surviving spouse at the time of the surviving spouse's taxable gift, and (b) the executor of the decedent's estate elected portability. In addition, this regulation provides that if, on the date that the surviving spouse makes a taxable gift, the last deceased spouse of the surviving spouse had no DSUE amount, or if the executor of the estate of such last deceased spouse did not elect portability, then the surviving spouse has no DSUE amount available to determine his or her applicable exclusion amount, even if the surviving spouse previously had a DSUE amount available from another decedent who, prior to the death of the last deceased spouse, was the last deceased spouse of such surviving spouse (except as provided below).

Further, this regulation provides that a decedent is the last deceased spouse of a surviving spouse even if, on the date of the surviving spouse's taxable gift, the surviving spouse is married

to another individual who is then living. Moreover, if a surviving spouse remarries and that marriage ends in divorce or an annulment, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse, as the divorced spouse, at his or her death, was not married to the surviving spouse.

As in the proposed regulations, this regulation contains a much needed ordering rule that provides that if a surviving spouse makes a taxable gift and has a DSUE amount that is included in determining the surviving spouse's applicable exclusion amount, then the surviving spouse will be treated as applying such DSUE amount to the taxable gift before applying the surviving spouse's own basic exclusion amount to such gift.

Very importantly, also as provided in the proposed regulations, this regulation contains a special rule regarding multiple deceased spouses and a previously used DSUE amount that is available to a surviving spouse. This rule states, in general, that if a surviving spouse applied the DSUE amount of one or more last deceased spouses to the surviving spouse's prior lifetime gifts, and, if any of those last deceased spouses is different from the surviving spouse's last deceased spouse at the time of the surviving spouse's current taxable gift, then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse that will apply at the time of the current taxable gift is the sum of (a) the DSUE amount of the surviving spouse's last deceased spouse, and (b) the DSUE amount of each of the other deceased spouses of the surviving spouse to the extent that such amount was applied to one or more previous taxable gifts of the surviving spouse.

This regulation contains the following example to illustrate the operation of this special rule: H-1 dies in 2011, survived by W, and neither of them made any taxable gifts during H-1's life. H-1's executor elects portability, and the DSUE amount of H-1 is $5,000,000. In 2012 W makes taxable gifts of $2,000,000. W is treated as having applied $2,000,000 of H-1's DSUE amount to such gifts. Thereafter, W is considered to have a remaining applicable exclusion amount of $8,120,000, consisting of H-1's $3,000,000 remaining DSUE amount, plus W's own $5,120,000 basic exclusion amount. In 2013 W marries H-2, and H-2 dies on June 30, 2015. H-2's executor elects portability, and H-2's DSUE amount is $2,000,000. The DSUE amount to be included in determining the applicable exclusion amount available to W for gifts that she makes from July 1, 2015 through December 31, 2015 is $4,000,000, determined by adding the $2,000,000 DSUE amount of H-2 and the $2,000,000 DSUE amount of H-1 that was applied by W to W's 2012 taxable gifts. Thus, W's applicable exclusion amount for the second half of 2015 is $9,430,000, consisting of the sum of the two $2,000,000 DSUE amounts described above, plus W's own basic exclusion amount of $5,430,000 for 2015. Since the gift tax on any gifts that W makes during the second half of 2015 will be computed on both the amount of such gifts and the $2,000,000 of taxable gifts that W made in 2015, W in effect can make additional gifts of $7,430,000 during the second half of 2015 without having to pay any gift tax on account of such gifts.

As in the estate tax regulations, this regulation also provides that a portability election that is made by an executor of a decedent's estate generally applies as of the date of such decedent's death. Thus, a decedent's DSUE amount will be included in the applicable exclusion amount of the decedent's surviving spouse and will be applicable to transfers made by the surviving spouse after the decedent's death. However, this regulation also provides that such

decedent's DSUE amount will not be included in the applicable exclusion amount of the surviving spouse, even if the surviving spouse has made a taxable gift in reliance on the availability or computation of the decedent's DSUE amount, (a) if the executor of the decedent's estate supersedes the portability election by timely filing a subsequent estate tax return negating such election, (b) to the extent that the DSUE amount is subsequently reduced by a valuation adjustment or the correction of an error in calculation, or (c) to the extent that the DSUE amount claimed on the decedent's return cannot be determined.

As in the estate tax regulations, this regulation also states that if a surviving spouse for whom property has passed from a decedent to a QDOT becomes a United States citizen, then the date on which such decedent's DSUE amount will be included in the surviving spouse's applicable exclusion amount is the date on which the surviving spouse becomes a United States citizen.

This regulation contains a special rule regarding the computation and redetermination of the DSUE amount for property passing to a QDOT for the benefit of a surviving spouse where the decedent's executor elects portability that is similar to the comparable rule in the estate tax regulations discussed above. However, this regulation further states that the decedent's DSUE amount as so redetermined may be applied to the surviving spouse's taxable gifts that are made in the year of the surviving spouse's death, or if the terminating event occurs prior to the surviving spouse's death, then in the year of that terminating event and/or in any subsequent year of the surviving spouse's life.

This regulation also contains provisions regarding the authority of the IRS to examine the tax returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, that are similar to the comparable rules in the estate tax regulations discussed above.

Finally, this regulation also contains rules that are similar to the comparable rules in the estate tax regulations discussed above regarding the inability of a non-resident surviving spouse who was not a citizen of the United States at the time he or she makes a gift that is subject to gift taxes to take into account the DSUE amount of any deceased spouse.

Conclusion

These final regulations provide comprehensive guidance regarding the complex portability provisions set forth in the 2010 Act and that were made permanent by the 2012 Act. As noted above, in certain important respects these regulations are very favorable to the taxpayer and clarify areas of uncertainty that were in the proposed regulations, but there still remain areas that need clarification.

EXHIBIT "B"
STATE ESTATE TAX AFTER EGTRRA, THE 2010 TAX ACT AND THE 2012 TAX ACT ON
A TAXABLE ESTATE EQUAL TO THE FEDERAL BASIC EXCLUSION AMOUNT

Year of Death	Florida Estate Tax	Taxable Connecticut** Estate Estate Tax	Federal/State Death Tax Credit	New York Estate Tax	New Jersey* Estate Tax
2002-2003	0	$1,000,000 0	0	0	$ 33,200
2004	0	$1,500,000 0	0	$ 64,400	$ 64,400
2005	0	$1,500,000 0	0	$ 64,400	$ 64,400
2006-2008	0	$2,000,000 0	0	$ 99,600	$ 99,600
2009	0	$3,500,000 $229,200	0	$229,200	$229,200
2010	0	$5,000,000 $121,800	0	$391,600	$391,600
2011	0	$5,000,000 $229,800	0	$391,600	$391,600
2012	0	$5,120,000 $240,000	0	$405,200	$405,200
2013	0	$5,250,000 $251,700	0	$420,800	$420,800
2014	0	$5,340,000 $259,800	0	$431,600	$431,600
2015	0	$5,430,000 $267,900	0	$442,400	$442,400
2016	0	$5,450,000 $269,700	0	$444,800	$444,800

* New Jersey also imposes an inheritance tax. Transfers to surviving spouses, fathers, mothers, grandparents, children (both natural and adopted) and issue of children are exempt from such tax.

** Prior to January 1, 2005, Connecticut also imposed an inheritance tax on property passing to beneficiaries other than spouse or descendants.

EXHIBIT "C"
STATE DEATH TAX LEGISLATION

AS OF FEBRUARY 28, 2016

Reprinted with the permission of
The American College of Trust and Estate Counsel

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
Alabama	None	Tax is tied to federal state death tax credit. AL ST § 40-15-2.		
Alaska	None	Tax is tied to federal state death tax credit. AK ST § 43.31.011.		
Arizona	None	Tax was tied to federal state death tax credit. AZ ST §§ 42-4051; 42-4001(2), (12). On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repealed Arizona's state estate tax.		
Arkansas	None	Tax is tied to federal state death tax credit. AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003.		
California	None	Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411.		
Colorado	None	Tax is tied to federal state death tax credit. CO ST §§ 39-23.5-103; 39-23.5-102.		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
Connecticut	Separate Estate Tax	As part of the two year budget which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for decedents dying on or after January 1, 2010, the Connecticut tax is due six months after the date of death. CT ST § 12-391. In May 2011, the threshold was lowered to $2 million retroactive to January 1, 2011	On July 10, 2015, the Connecticut Governor signed Senate Bill 1502 which implemented the biannual budget. The budget bill included a $20 million dollar cap on the amount of Connecticut estate and gift tax for both residents and nonresidents. This cap will be effective for decedents dying on or after January 1, 2016. It is estimated that the tax cap will affect taxable estates greater than $170.5 million. The Connecticut exemption remains at $2 million.	$2,000,000
Delaware	Pick-up Only	For decedents dying after June 30, 2009. The federal deduction for state death taxes is not taken into account in calculating the state tax. DE ST TI 30 §§ 1502(c)(2)	On March 28, 2013, the Governor signed HB 51 to eliminate the four year sunset provision that originally applied to the tax as enacted in June 2009.	$5,450,000 (indexed for inflation)
District of Columbia	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001. In 2003, tax imposed only on estates exceeding	On June 24, 2015, the D.C. Council approved changes to the D.C. Estate Tax. The changes include possible	$1,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		EGTRRA applicable exclusion amount. Thereafter, tax imposed on estates exceeding $1 million. DC CODE §§ 47-3702; 47-3701; approved by Mayor on June 20, 2003; effective retroactively to death occurring on and after January 1, 2003. No separate state QTIP election.	increases in the D.C. estate tax threshold to $2 million in 2016 and to the federal threshold of $5 million indexed for inflation in 2018 or later. Both increases are subject to the District meeting or exceeding certain revenue targets which may or may not happen.	
Florida	None	Tax is tied to federal state death tax credit. FL ST § 198.02; FL CONST. Art. VII, Sec. 5		
Georgia	None	Tax is tied to federal state death tax credit. GA ST § 48-12-2.		
Hawaii	Modified Pick-up Tax	Tax was tied to federal state death tax credit. HI ST §§ 236D-3; 236D-2; 236D-B. The Hawaii Legislature on April 30, 2010 overrode the Governor's veto of HB 2866 to impose a Hawaii estate tax on residents and also on the Hawaii assets of a non-resident or a non US citizen.	On May 2, 2012, the Hawaii legislature passed HB 2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after January 25, 2012.	$5,450,000 (indexed for inflation for deaths occurring after January 25, 2012)
Idaho	None	Tax is tied to federal state death tax credit. ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002).		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
Illinois	Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).		$4,000,000
Indiana	None	Pick-up tax is tied to federal state death tax credit. IN ST §§ 6-4.1-11-2; 6-4.1-1-4.	On May 11, 2013, Governor Pence signed HB 1001 which repealed Indiana's inheritance tax retroactively to January 1, 2013. This replaced Indiana's prior law enacted in 2012 which phased out Indiana's inheritance tax over nine years beginning in 2013	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
			and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012.	
Iowa	Inheritance Tax	Pick-up tax tied to federal state death tax credit. IA ST § 451.2; 451.13. Effective July 1, 2010, Iowa specifically reenacted it pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST §451.2. Iowa has separate inheritance tax on transfers to remote relatives and third parties.		
Kansas	None.	For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand alone estate tax. KS ST § 79-15, 203		
Kentucky	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KT ST § 140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.		
Louisiana	None	Pick-up tax is tied to federal state death tax credit.		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		LA R.S. §§ 47:2431; 47:2432; 47:2434.		
Maine	Pick-up Only	For decedents dying after December 31, 2002, pick-up tax is frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which will increase the Maine estate tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10% between $5 million and $8 million and 12% for the excess over $8 million. On June 30, 2015, the Maine legislature overrode the Governor's veto of LD 1019, the budget bill for fiscal years 2016 and 2017. As part of the new law, the Maine Exemption is tagged to the federal exemption for decedents dying on or after January 1, 2016.		$5,450,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		The tax rates will be: 8% on the first $3 million above the Maine Exemption; 10% on the next $3 million above the Maine Exemption; and 12% on all amounts above $6 million above the Maine Exemption. The new legislation did not include portability as part of the Maine Estate Tax. For estates of decedents dying after December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non resident's estate. M.R.S. Title 36, Sec. 4064.		
Maryland	Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the following: 1. Increase the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in		$2,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount. 2. Continues to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state tax credit is then in effect. 3. Continues to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus eliminating a circular computation. 4. Permits a state QTIP election.		
Massachusetts	Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002. Tax imposed on estates exceeding applicable		$1,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev. Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.		
Michigan	None	Tax was tied to federal state death tax credit. MI ST §§ 205.232; 205.256		
Minnesota	Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that	On March 21, 2014, the Minnesota Governor signed HF 1777, which retroactively repealed Minnesota's gift tax (which was enacted in 2013). With respect to the estate tax, the new	$1,600,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		amount is below EGTRRA applicable exclusion amount. MN ST §§ 291.005; 291.03; instructions for MN Estate Tax Return; MN Revenue Notice 02-16. Separate state QTIP election permitted.	law increases the exemption to $1,200,000 for 2014 and thereafter in annual $200,000 increments until it reaches $2,000,000 in 2018. It also modifies the computation of the estate tax so that the first dollars are taxed at a 9% rate which increases to 16%. The new law permits a separate state QTIP election. The provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota has been amended to exclude certain publicly traded entities. It still applies to entities taxed as partnerships or S Corporations that own closely held businesses, farms, and cabins.	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
Mississippi	None	Tax is tied to federal state death tax credit. MS ST § 27-9-5.		
Missouri	None	Tax is tied to federal state death tax credit. MO ST §§ 145.011; 145.091.		
Montana	None	Tax is tied to federal state death tax credit. MT St § 72-16-904; 72-16-905.		
Nebraska	County Inheritance Tax	Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax. NEB REV ST. § 77-2101.01(1).		
Nevada	None	Tax is tied to federal state death tax credit. NV ST Title 32 §§ 375A.025; 375A.100.		
New Hampshire	None	Tax is tied to federal state death tax credit. NH ST §§ 87:1; 87:7.		
New Jersey	Pick-up Tax Inheritance Tax	For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001. NJ ST §§ 54:38-1 Pick-up tax imposed on estates exceeding federal applicable exclusion amount in effect December 31, 2001 ($675,000), not including		$675,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. The executor has the option of paying the above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ St §§ 54:38-1; approved on July 1, 2002. In Oberhand v. Director, Div. of Tax, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula provisions. In Estate of Stevenson v. Director, 008300-07 (N.J.Tax 2-19-2008) the NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died in 2001.		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		New Jersey allows a separate state QTIP election when a federal estate tax return is not filed and is not required to be filed. The New Jersey Administration Code also requires that if the federal and state QTIP election is made, they must be consistent. NJAC 18:26-3A.8(d)		
New Mexico	None	Tax is tied to federal state death tax credit. NM ST §§ 7-7-2; 7-7-3.		
New York	Pick-up Only	Tax frozen at federal state death tax credit in effect on July 22, 1998. NY TAX § 951. Governor signed S. 6060 in 2004 which applies New York Estate Tax on a *pro rata* basis to non-resident decedents with property subject to New York Estate Tax. On March 16, 2010, the New York Office of Tax Policy Analysis, Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a	The Executive Budget of 2014-2015 which was signed by Governor Cuomo on March 31, 2014 made substantial changes to New York's estate tax. The New York estate tax exemption which was $1,000,000 through March 31, 2014 has been increased as follows: April 1, 2014 to March 31, 2015 -- $2,062,500 April 1, 2015 to March 31, 2016 --	$3,125,500 (as of April 1, 2015 and through March 31, 2016). $4,187,500 (April 1, 2016 through March 31, 2017)

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		federal return. See TSB-M-10(1)M. Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it appears that New York would look through the S Corporation and subject the condominium to New York estate tax in the estate of the non-resident. There would likely be no business purpose if the sole reason for forming the S Corporation was to own assets.	$3,125,000 April 1, 2016 to March 31, 2017 -- $4,187,500 April 1, 2017 to December 31, 2018 -- $5,250,000 As of January 1, 2019 the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death between April 1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax will be a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available.	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
			On April 1, 2015, as part of 2015-2016 Executive Budget, New York enacted changes to the New York Estate Tax. New York first clarified that the new rate schedule enacted in 2014 applies to all decedents dying after April 1, 2014. Previously, the rate schedule only applied through March 31, 2015. New York then modified the there year gift add-back provision to make it clear that the gift add-back does not apply to any individuals dying on or after January 1, 2019. Previously, the gift add-back provision did not apply to gifts made on or after January 1, 2019. New York continues to not permit portability for New York estates and no QTIP election is allowed.	

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
North Carolina	None		On July 23, 2013, the Governor signed HB 998 which repealed the North Caroline estate tax retroactively to January 1, 2013	
North Dakota	None	Tax is tied to federal state death tax credit. ND ST § 57-37.1-04		
Ohio	None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contains a repeal of the Ohio state estate tax effective January 1, 2013.		
Oklahoma	None	Tax is tied to federal state death tax credit. OK ST Title 68 § 804 The separate estate tax was phased out as of January 1, 2010.		
Oregon	Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541 which replaces Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates		$1,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		increasing from ten percent to sixteen percent between $1 million and $9.5 million. Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.		
Pennsylvania	Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. § 9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit. Pennsylvania recognizes a state QTIP election.		
Rhode Island	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST § 44-22-1. Rhode Island recognized a separate state QTIP election in the State's Tax Division Ruling Request No. 2003-03.	On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax.	$1,500,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		Rhode Island's Governor signed in to law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U).... rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1.		
South Carolina	None	Tax is tied to federal state death tax credit. SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002.		
South Dakota	None	Tax is tied to federal state death tax credit. SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002).		
Tennessee	None	Pick-up tax is tied to federal state death tax credit. TN ST §§ 67-8-202; 67-8-203. Tennessee has not decoupled, but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.	On May 2, 2012, the Tennessee legislature passed HB 3760/SB 3762 which phases out the Tennessee inheritance Tax as of January 1, 2016. The Tennessee inheritance Tax Exemption is	$5,000,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
			increased to $1.25 million in 2013, $2 million in 2014, and $5 million in 2015. On May 2, 2012, the Tennessee legislature also passed HB 2840/SB 2777 which repeals the Tennessee state gift tax retroactive to January 1, 2012.	
Texas	None	Tax is tied to federal state death tax credit. TX TAX §§ 211.001; 211.003; 211.051		
Utah	None	Tax is tied to federal state death tax credit. UT ST § 59-11-102; 59-11-103.		
Vermont	Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a. Previously the estate tax was frozen at federal state death tax credit in effect on January 1, 2001. VT ST T. 32 §§ 7402(8),		$2,750,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted		
Virginia	None	Tax is tied to federal state death tax credit. VA ST §§ 58.1-901; 58.1-902. The Virginia tax was temporarily repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902.		
Washington	Separate Estate Tax	On February 3, 2005, Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005). In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow	On June 14, 2013, Governor Inslee signed HB 2075 which closed an exemption for marital trusts retroactive immediately prior to when the Department of Revenue was about to start issuing refund checks, created a deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million	$2,079,000

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§ 83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. Washington permits a separate state QTIP election. WA ST §83.100.047.	Washington state death tax threshold for inflation.	
West Virginia	None	Tax is tied to federal state death tax credit. WV § 11-11-3.		
Wisconsin	None	Tax is tied to federal state death tax credit. WI ST § 72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under		

State	Type of Tax	Effect of EGTRRA on Pick-up Tax and Size of Gross Estate	Legislation Affecting State Death Tax	2016 State Death Tax Threshold
		pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.		
Wyoming	None	Tax is tied to federal state death tax credit. WY ST §§ 39-19-103; 39-19-104.		

EXHIBIT "D"

DIGITAL PROPERTY

A. WILL CLAUSES

1) Tangible Personal Property and Definition of Digital Property

I give and bequeath all of my jewelry, clothing, books, silverware, glassware, works of art, antiques, all other personal and household effects, furniture, furnishings, automobiles, digital devices of every nature and kind, including, but not limited to, computers, laptops, notebooks, and smartphones and similar devices that now exist or may exist in the future, and "digital assets", hereinafter defined, of every nature and kind (except for any digital financial accounts or digital business accounts such as on-line banking or brokerage accounts, which digital financial accounts and digital business accounts shall be disposed of as a part of my "Residuary Estate", as hereinafter defined, to the extent that such accounts are testamentary assets) to my wife, _____, if she shall survive me. For all purposes of this my Last Will and Testament, the term "digital assets" shall include, but not be limited to, all of my files stored on my digital devices and backup systems, including but not limited to, files stored on desktops, laptops, tablets, peripherals, storage devices, mobile telephones, smartphones, and any similar digital device which currently exists or may exist as technology develops, and all emails received by me, my email accounts such as any and all Gmail, Yahoo, America on Line (AOL) accounts, my digital music, digital photographs, digital videos, and digital games, my software licenses, my social network accounts such as any Facebook, Twitter, LinkedIn, Flickr, Shutterfly and YouTube accounts, my file sharing accounts, my domain registrations and domain name system (DNS) service accounts, my web hosting accounts, my tax preparation service accounts, and my online stores, affiliate programs, other online accounts and similar digital items which currently exist or may exist as technology develops or such comparable items as technology develops regardless of the ownership of the physical device upon which the digital item is stored.

2) Digital Executor - (A) I hereby nominate, constitute and appoint _____as the Digital Executor of this my Last Will and Testament in connection with the administration of all of my "digital assets", as hereinbefore defined. If _____shall die or shall be or become unwilling or unable to qualify and/or act or continue to act as Digital Executor, I hereby nominate, constitute and appoint _____to be Digital Executor in his/her place and stead.

(B) I hereby nominate, constitute and appoint _____as the Executor of this my Last Will and Testament in connection with the administration of all of my assets, except for my "digital assets". If _____shall die or shall be or become unwilling or unable to qualify and/or act or continue to act as Executor, I hereby nominate, constitute and appoint _____to be Executor in his/her place and stead.

3) Powers Clause re Digital Assets - My Executors (or my Digital Executors) shall have full authority granted to them under applicable law to administer all of my "digital assets", as

hereinbefore defined, including, but not limited to: (i) the power to access, use, control, transfer and dispose of my digital devices, including but not limited to, desktops, laptops, tablets, peripherals, storage devices, mobile telephones, smartphones, and any similar digital device which currently exists or may exist as technology develops or such comparable items as technology develops for the purpose of accessing, using, modifying, deleting, controlling, transferring or disposing of my "digital assets", as hereinbefore defined, and (ii) the power to access, use, modify, delete, control, transfer and dispose of all of my "digital assets", as hereinbefore defined.

B. POWER OF ATTORNEY

My agent, to the extent permissible under applicable law, shall have the same powers and rights that I possess over all of my "digital assets", as hereinafter defined, including, but not limited to: (i) the power to access, use, control, transfer and dispose of my digital devices, including but not limited to, desktops, laptops, tablets, peripherals, storage devices, mobile telephones, smartphones, and any similar digital device which currently exists or may exist as technology develops or such comparable items as technology develops for the purpose of accessing, using, modifying, deleting, controlling, transferring or disposing of my digital assets, as hereafter defined, and (ii) the power to access, use, modify, delete, control, transfer and dispose of my "digital assets" as hereafter defined. For all purposes of this Power of Attorney, the term "digital assets" shall include, but not be limited to, all of my files stored on my digital devices and backup systems, including but not limited to, desktops, laptops, tablets, peripherals, storage devices, mobile telephones, smartphones, and any similar digital device which currently exists or may exist as technology develops, and all emails received by me, my email accounts such as any and all Gmail, Yahoo, America on Line (AOL) accounts, my digital music, digital photographs, digital videos, and digital games, my software licenses, my social network accounts such as any Facebook, Twitter, LinkedIn, Flickr, Shutterfly and YouTube accounts, my file sharing accounts, my domain registrations and domain name system (DNS) service accounts, my web hosting accounts, my tax preparation service accounts, and my online stores, affiliate programs, other online accounts and similar digital items which currently exist or may exist as technology develops or such comparable items as technology develops regardless of the ownership of the physical device upon which the digital item is stored.

EXHIBIT "E"

Computation of New York State Estate Tax
(on various amounts of Taxable Estate)

Taxable Estate of:	4/1 to 12/31/14	1/1 to 3/31/15	4/1 to 12/31/15	1/1 to 3/31/16	4/1 to 12/31/16	1/1 to 3/31/17	4/1 to 12/31/17	2018
NYS Basic Exclusion Amount	2,062,500.00	2,062,500.00	3,125,000.00	3,125,000.00	4,187,500.00	4,187,500.00	5,250,000.00	5,250,000.00
Resulting NYS Estate Tax	-	-	-	-	-	-	-	-
102.5% of Basic Exclusion Amount	2,114,062.50	2,114,062.50	3,203,125.00	3,203,125.00	4,292,187.50	4,292,187.50	5,381,250.00	5,381,250.00
Resulting NYS Estate Tax*	65,906.25	65,906.25	128,837.50	128,837.50	205,931.25	205,931.25	287,550.00	287,550.00
105% of Basic Exclusion Amount	2,165,625.00	2,165,625.00	3,281,250.00	3,281,250.00	4,396,875.00	4,396,875.00	5,512,500.00	5,512,500.00
Resulting NYS Estate Tax*	112,050.00	112,050.00	208,200.00	208,200.00	324,050.00	324,050.00	452,300.00	452,300.00
Resulting NYS Estate Tax**	121,793.00	121,793.00	230,310.00	230,310.00	364,921.00	364,921.00	513,977.00	513,977.00
Federal Basic Exclusion Amount	5,340,000.00	5,430,000.00	5,430,000.00	Unknown	Unknown	Unknown	Unknown	Unknown
Resulting NYS Estate Tax*	431,600.00	442,400.00	442,400.00					
Resulting NYS Estate Tax **	490,454.00	502,727.00	502,727.00					

* These calculations apply either (a) in the case of an unmarried decedent, or (b) in the case of a married decedent (whose will divides such decedent's residuary estate into a credit shelter trust and a QTIP trust) assuming that the NYS Estate Tax is paid out of the credit shelter trust.

** These calculations assume that the NYS Estate Tax is paid out of the QTIP trust (in order to maximize the amount of the credit shelter trust). Payment of the NYS Estate Tax out of the QTIP trust will cause an interrelated calculation for NYS Estate Tax purposes because it reduces the marital deduction.

{00070844.DOC/}

4

CROSS BORDER TAX PLANNING – STRUCTURING FOREIGN INVESTMENT IN U.S. REAL ESTATE

PRIVATE WEALTH & TAXATION INSTITUTE
Continuing Professional Education Series

Cross Border Tax Planning- Structuring Foreign Investment in U.S. Real Estate
May 19, 2016

Principal Topics

Background: Taxation of Foreign Persons
- Income Taxation
- Gift and Estate Taxation

FIRPTA
- Basics
- Simple Structures
- More Interesting Structures
- PATH Act Changes

Income Taxation of Nonresident Aliens and Foreign Corporations

- Income Effectively Connected with a U.S. Business ("ECI")
  - Net basis at regular rates
  - FC subject to BPT at 30% or lower treaty rate
- Fixed, Determinable, Annual or Periodical Income ("FDAP") from U.S. sources
  - Gross basis at 30% or lower treaty rate
  - Includes interest, dividends, rents, royalties
    - Exception for portfolio interest, described below
    - Exception for sovereign investors
    - Net income election
  - Capital Gains generally not FDAP
    - Limited exception if NRA in U.S. for 183 Days and other requirements satisfied
- Gain from disposition of U.S. real property interests ("FIRPTA") treated as ECI
  - FIRPTA discussed in detail below
- Section 1411 NII tax not applicable

Estate and Gift Taxation of NRAs

- Only U.S. Situs Assets Subject to Tax
- Intangibles Exempt from Gift Tax
  - Stock of US corporation
  - Probably a partnership interest
    - IRS does not concede; may argue for aggregate approach
    - Cf. Rev. Rul. 91-32
- U.S. Situs Assets Include:
  - Real property located in the U.S.
  - Shares of stock in a U.S. corporation
  - Tangible personal property located in the U.S.
  - Certain debt obligations of U.S. issuers
  - Intangible property used in the U.S.
- As in domestic context, value reduced by NR debt

FIRPTA - Overview

- Foreign persons taxed on gain from disposition of United States real property interest ("USRPI") as ECI
  - Generally, same tax rates as applicable to US persons
  - BPT may also apply
  - Look-through rules for partnerships
  - Must file!

- Buyer required to withhold percentage of amount realized from foreign seller
  - Arbitrary and may exceed tax due
  - Includes assumption of debt
    - Complicated if purchase partnership interest
  - May request withholding certificate from IRS
  - Previously 10%, but increased by the PATH Act to 15% (discussed later)

US Real Property Interest Generally Includes

- Land, buildings, improvements, etc.

- Any other interest, other than solely as a creditor, in real property
  - Does not necessarily include debt secured by real property
  - Is there a kicker?

- Any interest, other than solely as a creditor, in any US corporation that is (or, during 5-year or shorter look-back period, was) a US real property holding corporation ("USRPHC")

- Corporation is a USRPHC if USRPIs represent 50% or more of total of USRPIs, plus foreign real property, plus assets used in a trade or business
  - "Rookies" are cautioned that not all assets enter the denominator

- Cleansing exception: stock of former USRPHC not a USRPI if
  - Corporation sold all USRPIs
  - Recognized all gain

Exceptions

- Like-kind exchanges (section 1031)
  - Careful that US and non-US cannot be like kind
- Certain publicly traded stock
  - If do not own (and have not owned during applicable look-back period) interest of greater than 5%
    - Subject to REIT-related revision under the PATH Act
- Interest in domestically controlled REIT (discussed below)
- Stock owned by foreign government
- New Exceptions (discussed below)

Exceptions

- Sale of interest in partnership owning USRPI triggers ECI under Sec. 897
  - Sec. 897(g), Notice 88-72
- But no 1445 withholding unless 50/90 test met
- Temp. Reg. Sec. 1.897-7T(a)- "50/90 partnerships":
  - if >=50% of partnership assets are USRPI and >=90% of partnership assets are USRPI, cash, and cash equivalents, entire partnership interest classified as USRPI for Section 1445 purposes (but not Section 897 purposes).
  - withhold on entire amount realized.
  - or apply for withholding certificate.

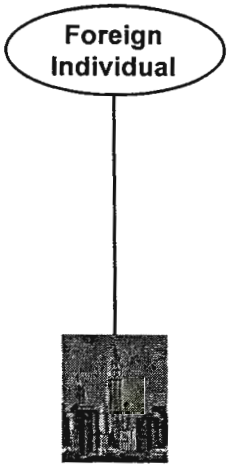
Using Debt to Reduce Inefficiency of Corporate Structure

- Interest deduction reduces corporate tax base
  - Earnings-stripping and other limitations apply
- Repayment of principal allows repatriation to shareholder on tax-free basis
- Desirable to avoid or reduce WHT if possible
  - Treaty
  - Portfolio interest exemption
- Need to ensure debt respected for tax purposes, e.g.,
  - Documentation
  - Interest rate cannot be excessive
  - Cannot be thinly capitalized
  - Reasonable term

Portfolio Interest Exemption (for non-ECI)

- Interest must be fixed
  - No kicker allowed
- Lender may not be "10% shareholder" of borrower
  - For corporate borrower, based on voting power
  - For partnership borrower, based on capital or profits interests
  - Limitation N/A to trusts
- Lender may not be a bank making loan in ordinary course or a CFC related to borrower
- Must certify foreign status

Structure 1: Direct Investment by a Foreign Individual



Must File Personal Return: Possible deal breaker!

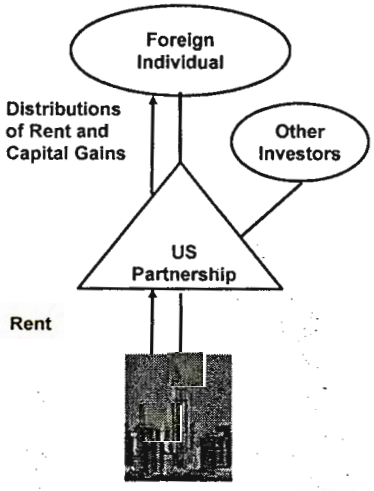
Rental Income:
- **Gross rental income taxable at 30%; or**
- **Net rental income taxable at graduated rates up to 39.6%***

Long Term Capital Gains:
- **LTCG taxable at 20%***
- **FIRPTA withholding at 15% of amount realized unless reduced by withholding certificate**

Gift/Estate Tax:
- **Applies at 40%***
- **May purchase term insurance to ameliorate risk**
- **May use NR debt to reduce value**

***plus state and local tax, where applicable**

Structure 2: Investment by Foreign Individual Through Domestic Partnership

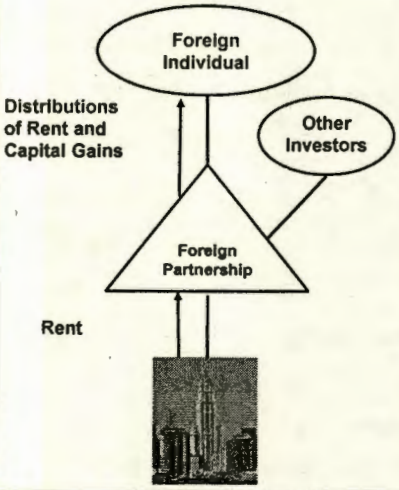


Rental Income:
- **Same as direct investment in Structure 1, except no withholding on rent by lessee, and partnership withholding on ECI rent required under section 1446.**

Long Term Capital Gains:
- **Same as direct investment in Structure 1, except no FIRPTA withholding imposed on property sale by partnership, and partnership must withhold on gain under section 1446.**

Gift/Estate Tax:
- **Tax-free gifts should be possible, pursuant to intangible exception.**
- **No clear authority as to whether estate tax would apply**

Structure 3: Investment by Foreign Individual Through Foreign Partnership



Rental Income:
- Same as with domestic partnership, except lessee should withhold on non-ECI rent.

Long Term Capital Gains:
- Same as with domestic partnership, except purchaser must withhold on sale of property by the partnership, absent a withholding certificate.

Gift/Estate Tax:
- Same as with domestic partnership, but somewhat better argument for avoiding estate tax.

Structure 4: Trust Alternative

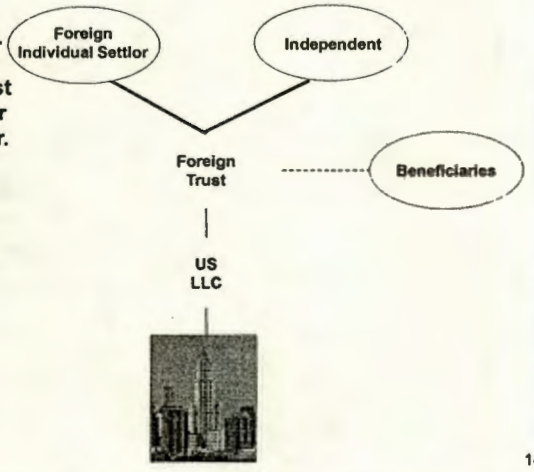
Settlor transfers cash to FT; then trustee buys the property (if desired).

Settlor must have no right to use trust property, no dominion or control over the trust. This is often a deal-breaker.

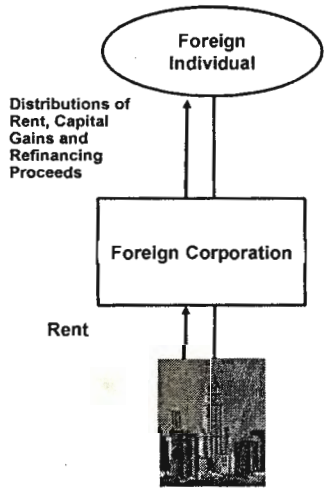
If properly structured, no gift tax when trust funded and no estate tax when settlor dies.

Income tax consequences same as for individual investor, e.g., LTCG rates apply.

Can also use domestic trust, but 3.8% NII tax applies.



Structure 5: Investment by Foreign Individual Through Foreign Corporation



To Corporation

Rental Income:
- Gross rental income taxable at 30% via withholding by Lessee; or
- Net rental income taxable at graduated rates up to 35%*
  - Branch Profits Tax applies at 30% or lower treaty rate

Gain from Sale:
- Gain taxable at graduated rates up to 35%,* plus potentially BPT at 30% or lower treaty rate
- FIRPTA withholding on sale of property by FC

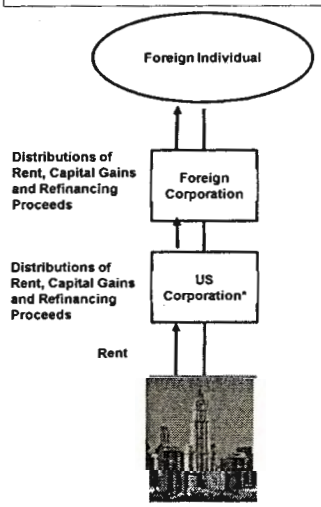
To Shareholder

Income Tax:
- No tax on distributions of dividends or § 301(c)(3) amounts

Estate Tax:
- No U.S. estate tax

*plus state and local tax, where applicable

Structure 6: Investment by Foreign Individual Through Foreign and Domestic Corporation



To US Corporation

- Rental income and gain taxable at graduated rates up to 35%*

To Foreign Corporation

- Dividends taxable at 30% or lower treaty rate.
- Need withholding certificate for § 301(c)(2) distributions, and § 301(c)(3) distributions taxable.
- Liquidating distributions from US Corporation may be tax-free, per cleansing exception.
- Sale of stock of US Corporation generally subject to regular corporate tax, at 35% maximum rate.

To Foreign Individual

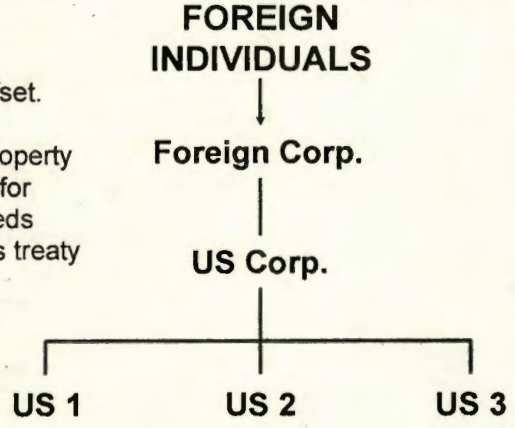
No consequences.

*plus state and local tax, where applicable

Structure 7: Multiple Properties – Consolidation Priority

Profits and losses may be offset.

However, when US 1 sells property at a substantial gain, difficult for US Corp. to repatriate proceeds without dividend WHT, unless treaty allows for ZWD.

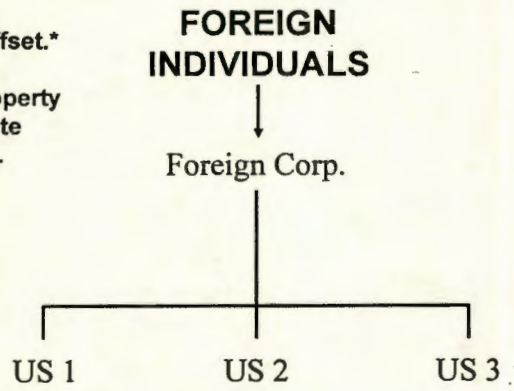


Structure 8: Multiple Properties – Distribution of Sale Proceeds Priority

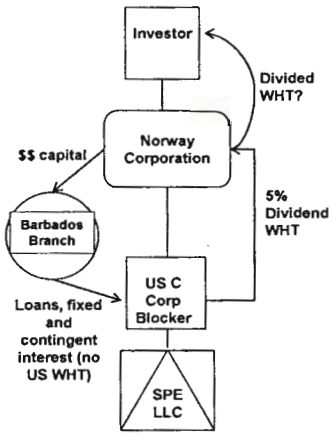
Profits and losses may not be offset.*

However, when US 1 sells all property at a substantial gain, can liquidate tax-free per cleansing exception.

*** However, consider merger!**



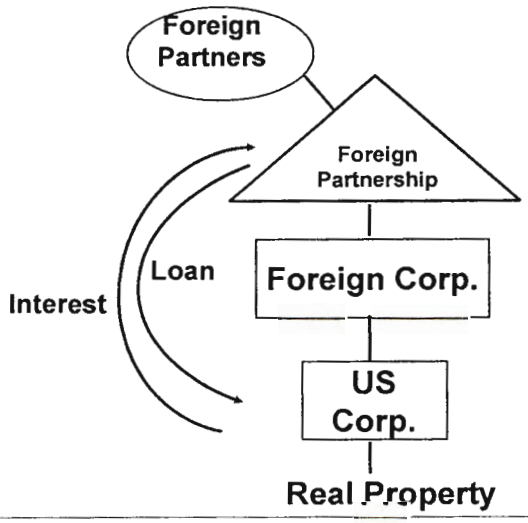
Structure 9: Treaty Debt Structure



Benefits

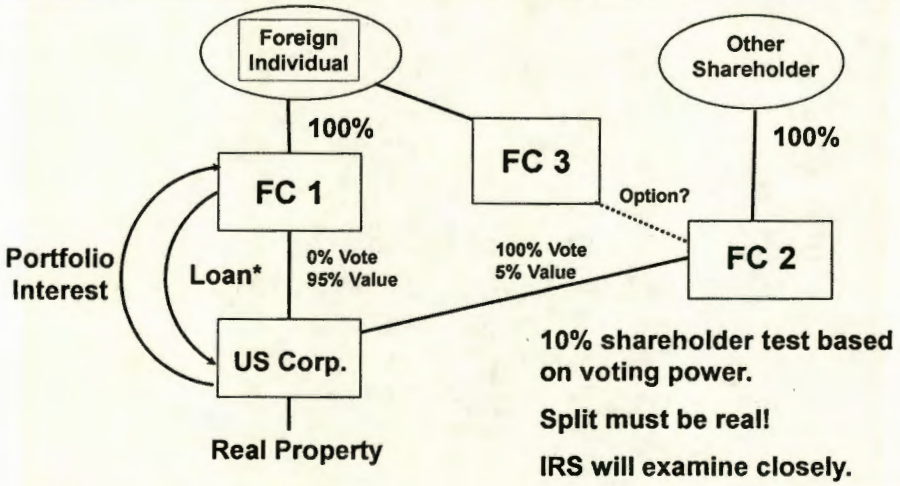
- Share of Income allocated to US C Corp Blocker by SPE
- US C Corp Blocker pays deductible interest (fixed x% plus contingent interest on certain gains and income), thereby reducing US tax base
- No US withholding tax on the interest payments
- Norway also should not tax receipt of interest payments, nor should Barbados
- Any dividends paid by US Blocker to Norway Co subject to 5% US tax, and <1% effective tax in Norway
- Norway dividends to EU Co not taxed (may need further structuring)

Structure 10: Portfolio Interest Partnership Lender Structure For Investor Group



All foreign partners have less than 10% of FP.

Structure 11: Portfolio Interest Split Vote/Value Structure



10% shareholder test based on voting power.

Split must be real!

IRS will examine closely.

REIT Structures – Taxation of the REIT

- Will not cover REIT requirements
- Very simple: REITS effectively pay no tax
  - Deduction for dividends paid

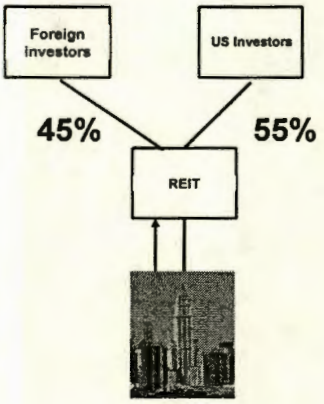
Taxation of Foreign Shareholder: Sales

- Sale of REIT stock generally subject to tax
- Public trading exception described above
- Exception for stock of DC REIT
  - <50% of the REIT stock is owned, directly or indirectly, by foreign persons
  - Practical difficulties: purchaser must be willing to acquire REIT stock

Taxation of Foreign Shareholder: Distributions

- Ordinary REIT Dividend
  - Generally same as from non-REIT : WHT at 30% or lower treaty rate
  - Treaty benefits less likely
- "FIRPTA" Dividends
  - When a REIT sells USRPI at a gain and makes distributions attributable to such gain, those "FIRPTA" dividends generally are treated as USRPI gains under section 897(h)(1).
    - Treaty benefits do not apply.
    - Also subject to BPT, in the case of foreign corporations.
    - Public trading exception
      - **Where exception applies, ordinary REIT dividend rules apply.**

Structure 12: DC REIT (Private)



- **Ordinary dividends at 30% (unless treaty)**
- **No tax for foreign investors if sell REIT stock**
  - **May not be possible**
- **If REIT sells a property and distributes proceeds, foreign investors recognize FIRPTA gain under sec. 897(h)(1) equal to their share of REIT's FIRPTA gain**
- **Some question about whether same rule applies to liquidating distributions. Per IRS, the answer is yes. Notice 2007-55.**

PATH Act: Increased Withholding

- Arbitrary 10% of amount realized increased to 15%
- Theoretically, not a substantive tax increase
- However, many foreign investors decline to file required U.S. returns
- Foreign sellers who disregard U.S. tax filing obligation will find it more expensive to do so

New or Expanded PATH Act Exceptions: All About REITs

- Expanded Publicly Traded Stock Exception
  - PATH Act increases threshold to 10% in case of REITs. See new sec. 897(k)(1).
- New Exception for qualified foreign pension fund
- New Exception to USRPI status for certain REIT stock held by qualified shareholder

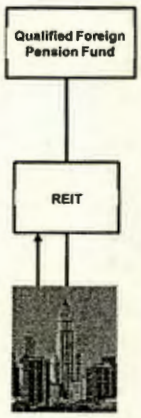
Qualified Foreign Pension Fund Exception: New Section 897(l)

- Qualified foreign pension fund exempt from FIRPTA entirely
  - Not limited to REIT investments
- Qualified foreign pension means a trust, corporation, or other organization or arrangement that
  - Is organized under the laws of a foreign country,
  - Is established to provide retirement/pension benefits to current or former employees (or their designees) in consideration of services rendered,
  - Does not have a single participant or beneficiary with a right to 5% or more of its assets or income,
  - Is subject to certain government regulation and provides certain information about its beneficiaries to the local tax authorities, and
  - Is entitled to certain tax-favored treatment in its local country.

Qualified Foreign Pension Fund Exception: Curious Implications

- Exemption from FIRPTA doesn't mean no tax
- Gain on sale may be ECI
- Can avoid ECI by avoiding ETBUS, but what of rent income?
  - 30% WHT (not good)
- Can avoid 30% WHT by making net income election, but now gain deemed to be ECI!
  - Can't limit election to rent. All or nothing!
- So, what's the point?
  - May be able to use certain treaties to revoke net income election for year of sale
  - Or perhaps you'd like a nice REIT ...?

Structure 13: Qualified Pension / REIT



- **Ordinary dividends at 30% (unless treaty)**
  - **No need for any election to be taxed on net basis**
- **Sale of REIT stock not taxed**
  - **No reason to be ECI**
- **No tax if REIT sells property and distributes proceeds.**
- **In some cases where sec. 897(h)(1) N/A, distribution re-characterized as ordinary dividend, but does not appear to be the case here.**
- **New pension exemption encourages investment through REITs**

Qualified Shareholder Exception: New Section 897(k)(2)

- Exception to USRPI status for stock of REIT owned by qualified shareholder
- Qualified Shareholder means a foreign person that
  - Is a publicly traded corporation eligible for treaty benefits or a publicly traded partnership and, in either case, subject to certain information exchange requirements (under the treaty, in the former case, or an exchange of information agreement, in the latter case)
  - Is a "qualified collective investment vehicle,"
  - Maintains records of persons who own 5%-or-greater interests
- Exception N/A to extent of REIT stock allocable to any "applicable investor" in the qualified shareholder
  - Generally, a person owning 10% of the REIT
  - A few quirks in the statute

Qualified Collective Investment Vehicle (QCIV)

- Is eligible for reduced withholding on REIT dividends under a treaty even if it holds more than 10% of the REIT; or
- Is publicly traded, but classified as a partnership notwithstanding the PTP rules, is a withholding foreign partnership (*i.e.*, agrees with IRS to undertake withholding obligations otherwise imposed on payors), and would be treated as a USRPHC if it were a domestic corporation (disregarding § 897(k)(1)); or
- Is designated as such by the IRS and is either (a) fiscally transparent within the meaning of § 894, or (b) required to include dividends in its gross income, but entitled to a deduction for distributions to its investors (semi-transparent).

Issues with Qualified Shareholder Exception

- How often will U.S. tax treaties permit a reduced WHT for REIT dividends?
- What rationale for the USRPHC requirement under the second potential means of meeting QCIV definition?
- What types of records must be maintained with respect to 5% shareholders?

5

THE DELAWARE TRUST OPTION FOR NEW YORK, NEW JERSEY AND CONNECTICUT RESIDENTS

2016 PRIVATE WEALTH AND TAXATION INSTITUTE

A COMPARISON OF NEW YORK, NEW JERSEY, CONNECTICUT, AND DELAWARE TRUST LAWS

Richard W. Nenno, Esquire
Senior Managing Director and Trust Counsel
Wilmington Trust Company
Rodney Square North
1100 North Market Street
Wilmington, Delaware 19890-0001
Tel: (302) 651-8113
Fax: (302) 427-4920
rnenno@wilmingtontrust.com

May 19, 2016

Table of Contents

A COMPARISON OF NEW YORK, NEW JERSEY, CONNECTICUT, AND DELAWARE TRUST LAWS

By

Richard W. Nenno, Esquire
Wilmington Trust Company

I. A GENERAL COMPARISON OF TRUST LAWS

A. Delaware vs. New York State—see separate chart.

B. Delaware vs. New York City—see separate chart.

C. Delaware vs. New Jersey (New Jersey Uniform Trust Code effective July 17, 2016)—see separate chart.

D. Delaware vs. Connecticut—see separate chart.

II. DIRECTED TRUSTS

A. New York

New York does not have a directed trust statute so that the effectiveness of directed trust language in trusts governed by New York law is unpredictable. For instance, one case held that a directed trust worked, but a later case held that it did not.

Thus, in In re Estate of Rubin (1989),[1] the decedent's Will named his son and daughter as coexecutors but specified that, in the event of disagreement, they were to act as directed by two named individuals. On the son's request, those individuals directed that he be given sole check-writing authority and management responsibility over five commercial properties. Rejecting the daughter's claim that the arrangement violated her rights as coexecutor, the court held that:[2]

> [T]he designation of advisors . . . to make directives controlling the actions of the coexecutors in any disputes is a valid limitation upon the powers of such executors

[1] In re Estate of Rubin, 143 Misc. 2d 303 (N.Y. Sur. Ct. Nassau Co. 1989), aff'd, 570 N.Y.S.2d 996 (2d Dep't 1991).

[2] 143 Misc. 2d at 308.

But, in Matter of Rivas (2011),[3] the corporate trustee objected to a direction by the Investment Advisory Committee formed under the governing instrument of a charitable trust to invest in the charitable donee's long-term investment pool. The court held:[4]

> [T]his Court cannot allow the proposed investment of the Helen Rivas Trust corpus, as such investment in the LTIP is contrary to the Agreement and the intent of the settlor, may give rise to an impermissible division of fiduciary loyalties among the majority of the Advisory Committee, and would also violate the Prudent Investor Act.

Efforts began in New York several years ago to draft directed trust legislation, but that legislation has not yet become law.

B. New Jersey

At this writing, the status of direction advisers for irrevocable trusts in New Jersey is uncertain, at least as to investment matters. This is because two different statutes cover the subject and apply different standards.

The first statute, which imposes significant monitoring responsibilities on a directed trustee, provides:[5]

> If the terms of a trust confer upon a person other than the settlor of a revocable trust the power to direct certain actions of the trustee, the trustee shall act in accordance with a written exercise of the power unless the attempted exercise is contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.

The second statute, which is based on the Delaware statute discussed below and imposes lesser monitoring duties on a directed trustee, says:[6]

> If a governing instrument provides that a fiduciary is to follow the direction of an investment adviser, and the fiduciary acts in accordance with such a

[3] Matter of Rivas, 30 Misc. 3d 1207(A) (N.Y. Sur. Ct. Monroe Co. 2011), aff'd, 939 N.Y.S.2d 918 (4th Dep't 2012).

[4] 30 Misc. 3d 1207(A) at 7.

[5] NJSA § 3B:31-61(b) (emphasis added).

[6] NJSA § 3B:31-62(b) (emphasis added).

> direction, then except in cases of willful misconduct or gross negligence on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act.

Neither statute defers to the other. Thus, until the issue is clarified, directed trustees probably should assume that the first statute governs.

C. Connecticut

Connecticut does not have a directed trust statute.

D. Delaware

Delaware has honored directed trusts since early in the 20th century, and the practice was codified in 1986.[7] The directed trust statute currently provides in pertinent part:[8]

> (a) Where 1 or more persons are given authority by the terms of a governing instrument to direct, consent to or disapprove a fiduciary's actual or proposed investment decisions, distribution decisions or other decision of the fiduciary, such persons shall be considered to be advisers and fiduciaries when exercising such authority provided, however, that the governing instrument may provide that any such adviser (including a protector) shall act in a nonfiduciary capacity.
>
> (b) If a governing instrument provides that a fiduciary is to follow the direction of an adviser or is not to take specified actions except at the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of wilful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act. . . .
>
> (d) For purposes of this section, unless the terms of the governing instrument provide otherwise, "investment decision" means with respect to all of the trust's investments (or, if applicable, to

[7] 12 Del. C. § 3313.

[8] 12 Del. C. § 3313(a), (b), (d), (e), (f).

investments specified in the governing instrument), the retention, purchase, sale, exchange, tender or other transaction or decision affecting the ownership thereof or rights therein (including the powers to borrow and lend for investment purposes), all management, control and voting powers related directly or indirectly to such investments (including, without limitation, nonpublicly traded investments), the selection of custodians or sub-custodians other than the trustee, the selection and compensation of, and delegation to, investment advisers, managers or other investment providers, and with respect to nonpublicly traded investments, the valuation thereof, and an adviser with authority with respect to such decisions is an investment adviser.

(e) Whenever a governing instrument provides that a fiduciary is to follow the direction of an adviser with respect to investment decisions, distribution decisions, or other decisions of the fiduciary or shall not take specified actions except at the direction of an adviser, then, except to the extent that the governing instrument provides otherwise, the fiduciary shall have no duty to:

(1) Monitor the conduct of the adviser;

(2) Provide advice to the adviser or consult with the adviser; or

(3) Communicate with or warn or apprise any beneficiary or third party concerning instances in which the fiduciary would or might have exercised the fiduciary's own discretion in a manner different from the manner directed by the adviser.

Absent clear and convincing evidence to the contrary, the actions of the fiduciary pertaining to matters within the scope of the adviser's authority (such as confirming that the adviser's directions have been carried out and recording and reporting actions taken at the adviser's direction), shall be presumed to be administrative actions taken by the fiduciary solely to allow the fiduciary to perform those duties assigned to the fiduciary under the

> governing instrument and such administrative actions shall not be deemed to constitute an undertaking by the fiduciary to monitor the adviser or otherwise participate in actions within the scope of the adviser's authority.
>
> (f) For purposes of this section, the term "adviser" shall include a "protector" who shall have all of the power and authority granted to the protector by the terms of the governing instrument, which may include but shall not be limited to:
>
> (1) The power to remove and appoint trustees, advisers, trust committee members, and other protectors;
>
> (2) The power to modify or amend the governing instrument to achieve favorable tax status or to facilitate the efficient administration of the trust; and
>
> (3) The power to modify, expand, or restrict the terms of a power of appointment granted to a beneficiary by the governing instrument.

In a 2004 case,[9] a Delaware Vice Chancellor ruled that a corporate trustee was not liable for the failure of a sophisticated (i.e., securities lawyer) investment adviser to direct it on an investment decision where the trustee forwarded relevant information to the adviser. The Vice Chancellor held:[10]

> The Court . . . finds that section 3313(b) of title 12 of the Delaware Code insulates fiduciaries of a Delaware trust from liability associated with any loss to the trust where a governing instrument provides that the fiduciary is to follow the direction of an advisor, the fiduciary acts in accordance with such direction and the fiduciary did not engage in willful misconduct. The trust agreement involved in this case appointed Plaintiff as the investment advisor to the Trust and, at all times, Plaintiff made all of the investment decisions for the Trust, including not to tender the securities in the Exchange Offer. In connection with Plaintiffs

[9] Duemler v. Wilmington Trust Co., 2004 Del. Ch. Lexis 206, 2004 WL 5383927 (Del. Ch. 2004).

[10] 2004 Del. Ch. Lexis 206 at 1–3.

> decision not to tender the securities in the Exchange Offer, Wilmington Trust acted in accordance with Plaintiff's instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information concerning the Exchange Offer. Accordingly, 12 Del. C. § 3313(b) insulates Wilmington Trust from all liability for any loss to the Trust resulting from plaintiff's decision not to tender the securities in the Exchange Offer.

III. SELF-SETTLED AND OTHER TRUSTS

A. New York

1. Self-Settled Trusts

New York does not allow an individual to protect assets from creditor claims by creating an irrevocable self-settled spendthrift trust. Hence, a New York statute provides:[11]

> A disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator.

Another statute says:[12]

> [A]ll property while held in trust for a judgment debtor, where the trust has been created by, or the fund so held in trust has proceeded from, a person other than the judgment debtor, is exempt from application to the satisfaction of a money judgment.

2. Lifetime QTIP and Other Trusts

New York does not have a statute that protects a donor's contingent interest in a lifetime qualified-terminable-interest-property ("QTIP") or other trust from claims of creditors.

B. New Jersey

1. Self-Settled Trusts

[11] N.Y. Est. Powers & Trusts Law § 7-3.1(a).

[12] N.Y. C.P.L.R. § 5205(c)(1).

New Jersey also does not permit an individual to protect assets through a self-settled trust. Thus, a New Jersey statute provides in relevant part:[13]

> With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit.

To reinforce the point, another statute says:[14]

> Except as provided in subsection b. of this section, every deed of gift and every conveyance, transfer and assignment of goods, chattels or things in action, made in trust for the use of the person making the same, shall be void as against creditors.

2. Lifetime QTIP and Other Trusts

New Jersey has not enacted legislation that protects a donor's contingent interest in a lifetime QTIP or other trust from creditor claims.

C. Connecticut

Connecticut does not have a statute that addresses the effectiveness of self-settled trusts or that shields a donor's contingent interest in a lifetime QTIP or other trust from claims of creditors.

D. Delaware

1. Introduction

On July 9, 1997, Governor Carper signed the Delaware Qualified Dispositions in Trust Act ("Delaware Act").[15] The Delaware Act has been amended several times since its enactment.[16] Because it probably will be amended in the future, an attorney should confirm that he or she is working with the current statute in a particular case.

---

[13] NJSA § 3B:31-39(a)(2), NJSA § 3B:11-1 is to similar effect.

[14] NJSA § 25:2-1(a).

[15] 12 Del. C. §§ 3570–3576, 71 Del. Laws 159 (1997).

[16] 71 Del. Laws 159 (1997); 71 Del. Laws 254 (1998); 71 Del. Laws 343 (1998); 72 Del. Laws 59 (1999); 72 Del. Laws 195 (1999); 72 Del. Laws 341 (2000); 73 Del. Laws 378 (2002); 74 Del. Laws 100 (2003); 75 Del. Laws 97 (2005); 75 Del. Laws 301 (2006); 76 Del. Laws 90 (2007); 76 Del. Laws 254 (2008); 77 Del. Laws 98 (2009); 77 Del. Laws 330 (2010); 78 Del. Laws 117 (2011); 79 Del. Laws 198 (2014); 80 Del. Laws 153 (2015). The current Delaware Act is available at www.delcode.delaware.gov/title12/c035/sc06/index.shtml (last visited Mar. 22, 2016).

2. How to Create a Delaware APT

To create an asset-protection trust ("APT") under the Delaware Act ("Delaware APT"), a person must create an irrevocable trust that contains a spendthrift clause; provides that Delaware law governs the trust's validity, construction, and administration; and appoints at least one "qualified trustee."[17] A "qualified trustee" is either an individual who resides in Delaware or a corporation that is authorized to conduct trust business in Delaware and is regulated by the Delaware Bank Commissioner or a federal agency.[18] The qualified trustee or trustees must maintain or arrange for custody in Delaware of some trust property, maintain records for the trust, prepare or arrange for the preparation of fiduciary income-tax returns, or otherwise materially participate in the administration of the trust.[19] If only one qualified trustee is acting, it will be deemed to have resigned if it ceases to meet these requirements.[20] Similarly, a trustee of a Delaware APT automatically ceases to serve if a court declines to apply Delaware law in determining the validity, construction, or administration of such trust, or the effect of its spendthrift clause, in a proceeding involving such trustee.[21] If a trustee ceases to act for one of these reasons, any successor trustee designated in the trust will take its place and the Delaware Court of Chancery may fill any vacancy. The trust may have non-Delaware cotrustees[22] and Delaware or non-Delaware advisers with authority to replace advisers and qualified trustees, participate in investment decisions, and/or perform other duties.[23]

The Delaware Act specifically permits the trustor of a Delaware APT to have the power to:

1. Consent to or direct investment changes;

2. Veto distributions;

3. Replace trustees or advisers; and/or

4. Reacquire trust assets in a nonfiduciary capacity under Internal Revenue Code ("IRC") § 675(4)(C).[24]

---

[17] 12 Del. C. § 3570(11)(a)–(c).

[18] 12 Del. C. § 3570(8)(a).

[19] 12 Del. C. § 3570(8)(b).

[20] 12 Del. C. § 3570(8)(e).

[21] 12 Del. C. § 3572(g).

[22] 12 Del. C. § 3570(8)(f).

[23] 12 Del. C. § 3570(8)(c).

[24] 12 Del. C. §§ 3570(8)(d), 3570(11)(b).

The Delaware Act also expressly authorizes the trustor to have:

1. The ability to receive income or principal pursuant to broad discretion or a standard as determined by Delaware trustees, non-Delaware trustees, and/or advisers;

2. The right to receive current income distributions;

3. An interest in a charitable-remainder trust ("CRT"), an interest in a qualified personal residence trust ("QPRT"), or a qualified annuity interest created if a residence in a QPRT ceases to be used as a personal residence;

4. An interest in a grantor-retained annuity trust ("GRAT"), an interest in a grantor-retained unitrust ("GRUT"), or up to a 5% interest in a total-return unitrust;

5. A nongeneral lifetime or testamentary power of appointment; and/or

6. The ability to provide for the payment of debts, expenses, and taxes following death.[25]

The Delaware Act addresses Rev. Rul. 2004-64,[26] which held, inter alia, that the grant of discretion to a trustee to reimburse the trustor for income taxes that he or she must pay on a grantor trust will not cause estate-tax inclusion under IRC§ 2036 if applicable local law does not subject the trust assets to the claims of the trustor's creditors.[27] The trustor might be reimbursed for such taxes pursuant to discretion given to the trustee, adviser, or protector under a Delaware APT.[28] For trustors who do not want to grant such broad discretion, the Delaware Act permits a Delaware APT simply to grant discretion to reimburse the trustor for income taxes attributable to the trust.[29]

Most Delaware APTs are structured as incomplete gifts. In such a trust, it is not disadvantageous from an estate-planning standpoint to have the trust pay its share of income taxes. So, a Delaware APT may direct the trustee to pay income taxes attributable to the trust.[30]

---

[25] 12 Del. C. § 3570(11)(b).

[26] Rev. Rul. 2004-64, 2004-2 C.B. 7 (July 6, 2004).

[27] 2004-2 C.B. 7 at 9.

[28] 12 Del. C. § 3570(11)(b)(3), (6).

[29] 12 Del. C. § 3570(11)(b)(9).

[30] 12 Del. C. § 3570(11)(b)(9).

Under the Delaware Act, the trustor may not be a trustee[31] and may only have the interests and powers described above.[32] Furthermore, the trustor has only the powers and authorities conferred by the trust instrument, and any agreement or understanding purporting to grant or permit the retention of any greater rights or authority is void.[33] To be conservative, Delaware attorneys counsel clients not to retain powers and interests that are not specifically authorized by the Delaware Act. Consequently, the trustor probably should not have the express right to get the assets back. Although the Delaware Act permits a variety of interests and powers, certain provisions might be inappropriate in a particular case. For example, the use of cotrustees in the trustor's state of residence or business might increase a trust's susceptibility to process in that jurisdiction and the possibility that Delaware law might be found not to govern the trust or, more importantly, the rights of beneficiaries and their creditors. Under the Delaware Act,[34] a spendthrift clause will be deemed to be a restriction on the transfer of the trustor's beneficial interest in the trust that is enforceable under applicable nonbankruptcy law within the meaning of the United States Bankruptcy Code.[35]

3. Who May Defeat a Delaware APT

a. Introduction

Any action to set aside a Delaware APT (including an action to enforce a judgment from another jurisdiction) must be based on § 1304 or § 1305 of the Delaware Uniform Fraudulent Transfer Act ("UFTA") and any related changes to the Delaware UFTA by the Delaware Act.[36] The Delaware Act vests the Delaware Court of Chancery with exclusive jurisdiction over any action involving a Delaware APT.[37]

b. Creditors Who May Defeat a Delaware APT

Certain federal "super-creditors" (including the Internal Revenue Service ("IRS"), the Securities and Exchange Commission ("SEC"), the Federal Trade Commission ("FTC"), and minor children seeking support) may reach the assets of a domestic APT,

[31] 12 Del. C. § 3570(8)(d).

[32] 12 Del. C. § 3571.

[33] 12 Del. C. § 3571.

[34] 12 Del. C. § 3570(11)(c).

[35] 11 USC § 541(c)(2).

[36] 12 Del. C. § 3572(a); 6 Del. C. §§ 1301–1311.

[37] 12 Del. C. § 3572(a).

Delaware or otherwise. Under the Delaware Act, the following four categories of creditors may defeat Delaware APTs.

(1) Pre-Transfer Claims

If a creditor's claim arose before the trust was created, the creditor must bring suit within four years after the trust's creation or, if later, within one year after the creditor discovered (or should have discovered) the trust[38] and must prove, by clear and convincing evidence, that creation of the trust was a fraudulent transfer. To minimize the effect of the one-year limitation, the trustor might notify known pre-transfer creditors of the trust's existence within three years of its creation. If multiple transfers are made to the same trust, a subsequent transfer is disregarded in determining whether a creditor's claim with respect to a prior transfer is extinguished as provided above;[39] distributions to beneficiaries are deemed to come from the latest transfer.[40]

(2) Post-Transfer Claims

If a creditor's claim arose after the trust was created, the creditor must bring suit within four years after the trust's creation and must prove, by clear and convincing evidence, that creation of the trust was made with actual intent to defraud—not to hinder or delay—that creditor.[41] Hence, as a practical matter, this exception is not available for a creditor who does not exist or is not foreseeable when a Delaware APT is created because it will be extremely hard to prove that a trustor intended to defraud a nonexistent, unforeseen creditor. If multiple transfers are made to the same trust, a subsequent transfer is disregarded in determining whether a creditor's claim with respect to a prior transfer is extinguished as provided above;[42] distributions to beneficiaries are deemed to come from the latest transfer.[43]

(3) Family Claims

[38] 12 Del. C. § 3572(b)(1).

[39] 12 Del. C. § 3572(f)(1).

[40] 12 Del. C. § 3572(f)(2).

[41] 12 Del. C. § 3572(a), (b)(2).

[42] 12 Del. C. § 3572(f)(1).

[43] 12 Del. C. § 3572(f)(2).

A person whose claim results from an agreement or court order providing for alimony, child support, or property division "incident to a judicial proceeding with respect to a separation or divorce" may reach the assets of a Delaware APT,[44] but only a spouse who was married to the trustor of the trust before it was created may invoke this exception.[45]

Shortly after the IRS issued Rev. Proc. 2005-24,[46], the Delaware Act was amended to address that pronouncement, which required spouses of trustors of certain post-June 27, 2005, inter vivos CRTs to waive rights to reach such trusts by electing against the Will. Under § 2-205 of the Uniform Probate Code ("UPC"), a surviving spouse may reach the assets of an inter vivos CRT created during his or her marriage to the deceased spouse (but not while the deceased spouse was unmarried or was married to a prior spouse) by electing against the Will.[47] Section 2-205 (or the comparable provision of the earlier version of the UPC) is in effect in at least 14 states—Alaska, Colorado, Hawaii, Kansas, Maine, Minnesota, Montana, Nebraska, New Jersey, North Dakota, South Dakota, Utah, Virginia, and West Virginia.[48]

The surviving spouse of a Delaware decedent never has been able to reach trust assets by electing against the Will,[49] and Delaware law does not defer to the law of a decedent's domicile to determine a surviving spouse's elective-share rights.[50] Since the passage of the Delaware Act, Delaware attorneys have been of the view that a spouse may reach the assets of a Delaware APT only for the specified purposes (i.e., alimony, child support, or property division incident to a separation or divorce proceeding) and that, because they do not include elective-share rights, the surviving spouse of the trustor of a

[44] 12 Del. C. § 3573(1).

[45] 12 Del. C. § 3570(9).

[46] 2005-1 C.B. 909 (Apr. 18, 2005).

[47] UPC § 2-205(2)(A) (2010).

[48] See Alaska Stat. § 13.12.205(2)(A); Colo. Rev. Stat. § 15-11-205(2)(a); Haw. Rev. Stat. § 560:2-205(2)(A); Kan. Stat. Ann. § 59-6a205(b)(1); Me. Rev. Stat. Ann. tit. 18-A, § 2-202(1)(i); Minn. Stat. § 524.2-205(2)(i); Mont. Code Ann. § 72-2-222(2)(b)(ii)(A); Neb. Rev. Stat. § 30-2314(a)(1)(i); NJSA § 3B:8-3(a); N.D. Cent. Code § 30.1-05-02(2)(b)(2)(a); S.D. Codified Laws § 29A-2-205(2)(i); Utah Code § 75-2-205(2)(a)(i); Va. Code Ann. § 64.2-305(A)(3)(a); W. Va. Code § 42-3-2(b)(2)(iii)(A).

[49] 12 Del. C. §§ 901(a), 908(b).

[50] 12 Del. C. § 901(b).

Delaware APT may not reach the assets of the trust by electing against the Will, whether or not the trustor lived in Delaware at death. To respond to Rev. Proc. 2005-24, the Delaware Act made this explicit. Thus, the final sentence of the pertinent section of the Delaware Act provides that a Delaware APT may not be reached to satisfy a claim for elective share.[51] Although the IRS deferred the effective date of the revenue procedure in 2006,[52] it alerted taxpayers in 2008[53] and again in 2014[54] that it has not forgotten the issue by requesting comments on procedures to ensure that elective rights do not affect assets for which a charitable deduction was taken on the creation of a CRT. A client therefore should consider structuring a CRT as a Delaware APT so that the trust's assets will be protected in case the IRS issues similar restrictions in the future or in case a surviving spouse actually elects against the Will.

The trustor of a CRT that is structured as a Delaware APT may release a retained interest in favor of charity.[55]

In appropriate circumstances (e.g., if a trustor wants to make a completed gift and to exclude assets from the gross estate), it is worth exploring whether a current or former spouse is willing to waive this provision.

(4) Tort Claims

A person who suffers death, personal injury, or property damage before a Delaware APT is established for which the trustor is liable may reach trust assets.[56]

4. Consequences if a Delaware APT Is Defeated

If one of the above exceptions applies (and after payment of the trustee's costs as described below), the Delaware APT is defeated only to the extent necessary to pay that creditor's claim together with related costs, including attorneys' fees allowed by the court.[57] Thus, if a trustor is confronted by

[51] 12 Del. C. § 3573.

[52] Notice 2006-15, 2006-1 C.B. 501 (Feb. 21, 2006).

[53] 2008 Tax Notes Today 93-33 (May 13, 2008).

[54] 2014 Tax Notes Today 67-32 (Apr. 8, 2014).

[55] 12 Del. C. §§ 3536(e), 3570(11)(b)(4). See Rev. Rul. 86-60, 1986-1 C.B. 302 (Jan. 1986); PLRs 200834013 (Apr. 15, 2008), 200808018 (Nov. 7, 2007), 200802024 (Sept. 14, 2007).

[56] 12 Del. C. § 3573(2).

[57] 12 Del. C. § 3574(a).

multiple creditors with the type of claim that is permitted to be pursued, each creditor must bring a separate action for avoidance.

Unless a creditor proves by clear and convincing evidence that a trustee acted in bad faith in accepting and administering the trust, that trustee may use trust assets to pay its costs of litigating the claim before satisfying the claim and related costs, if any.[58] A trustee's mere acceptance of the trust is presumed not to be in bad faith. Similarly, a beneficiary who received a distribution before a creditor brings a successful suit to defeat a Delaware APT may keep the distribution unless the creditor proves by clear and convincing evidence (by a preponderance of the evidence if the beneficiary is the trustor) that he or she acted in bad faith.[59]

In Delaware, "the Delaware Fraudulent Transfer Act does not create a cause of action for aiding and abetting, or conspiring to commit, a fraudulent transfer."[60] Nevertheless, the Delaware Act provides that the creation of a Delaware APT will not be treated as fraudulent or otherwise contrary to law for purposes of any action against any trustee, adviser, or protector acting under a trust instrument or against any attorney or other professional adviser involved in establishing the trust.[61]

5. Moving Trusts to Delaware

A trustee may create a Delaware APT either by establishing a Delaware APT or by effectuating the transfer of a trust that meets the requirements of the Delaware Act to Delaware[62] except that the trust does not have to provide that Delaware law governs.[63] If a trustee of an irrevocable spendthrift trust creates a Delaware APT, the time that the trust existed before it is moved to Delaware counts toward the four-year period for pursuing post-transfer claims against the trust.[64] Thus, it might be possible for the trustee of an existing onshore or offshore trust to create a Delaware APT that cannot be defeated under the Delaware Act.

Under the Delaware Act, a trustor may have a lifetime or testamentary power to appoint to anyone except the trustor, the trustor's estate, the trustor's creditors, or creditors of the trustor's estate.[65] An existing trust

[58] 12 Del. C. § 3574(b)(1), (c).

[59] 12 Del. C. § 3574(b)(2), (c).

[60] Edgewater Growth Capital Partners, L.P. v. H.I.G. Capital, Inc., 2010 WL 720150 at 2 (Del. Ch. 2010) (citing earlier cases).

[61] 12 Del. C. § 3572(d)–(e).

[62] 12 Del. C. § 3570(10).

[63] 12 Del. C. § 3570(11), penultimate sentence.

[64] 12 Del. C. §§ 3572(c), 3575.

[65] 12 Del. C. § 3570(11)(b)(2).

will not qualify under the Delaware Act if it gives the trustor an inter vivos or testamentary general power of appointment. The existing trustee may, with the written consent of the trustor, bring such a trust into conformity with the Delaware Act by deleting the excessive power.[66]

6. Infrastructure

An important factor in evaluating the effectiveness of Delaware APTs is that Delaware has a long-standing tradition of leadership in the financial services industry. The original version of the Delaware Act was written and enacted over a three-month period in 1997, and amendments have been drafted and enacted in short order.

Delaware has been a trust-friendly jurisdiction for generations. As evidence of this, a 2006 empirical study, which analyzed pertinent data beginning in 1969, found that, "Delaware was clearly attracting trust funds from out of state in the early 1970s,"[67] and that, "[i]n 1986 Delaware had a disproportionate share of the nation's trust funds."[68]

The Chancellor and Vice Chancellors of the Delaware Court of Chancery (which the Wall Street Journal described in 2014 as "the nation's most influencial business court"[69]) and the Justices of the Delaware Supreme Court (the courts that handle corporate matters and that would handle challenges to APTs in Delaware) are not elected. Instead, the Delaware Constitution requires that they be appointed by the Governor with the consent of a majority of the members of the Senate and that all Delaware judges come as equally as possible from the two major political parties.[70] For this and other reasons, Delaware's liability system was ranked as the best in the country in a 2015 U.S. Chamber of Commerce study.[71]

In 2015,[72] Vice Chancellor Parsons of the Delaware Court of Chancery held that creditors' claims that transfers to Delaware APTs constituted

---

[66] 12 Del. C. § 3572(c).

[67] Schanzenbach & Sitkoff, Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust, 27 Cardozo L. Rev. 2465, 2495–96 (Apr. 2006).

[68] 27 Cardozo L. Rev. at 2479 (footnote omitted). See Sitkoff & Schanzenbach, Perpetuities, Taxes, and Asset Protection: An Empirical Assessment of the Jurisdictional Competition for Trust Funds, 42 U. Miami Inst. on Est. Plan. ¶ 1400 (2008); Sitkoff & Schanzenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J. 356, 375 n.62, 393–94 (Nov. 2005).

[69] Hoffman, Tough Judge Polices Merger Scene, Wall St. J., July 15, 2014, at C1.

[70] Del. Const. art. IV, § 3.

[71] U.S. Chamber of Commerce Institute for Legal Reform 2015 Lawsuit Climate Survey: Ranking the States (Sept. 2015), available at www.instituteforlegalreform.com/states (last visited Mar. 22, 2016).

[72] TrustCo Bank v. Mathews, 2015 WL 295373 (Del. Ch. 2015).

fraudulent transfers were time-barred.[73] In other contexts, Delaware judges have demonstrated a willingness to enforce Delaware statutes in difficult cases, similar to those that might arise if creditors were to challenge Delaware APTs.

The following excerpt from the opinion of Vice Chancellor Berger in a 1984 case[74] is representative:

> In the absence of a statute, I would not hesitate to . . . allow Aetna's claim. I am not at all comfortable with the fact that Virginia Barwick, by use of a spendthrift trust, assisted her son in avoiding his obligation to pay for his crimes. [He was indicted on eight counts of arson, burglary, and criminal mischief and pled guilty to the lesser included offenses of criminal trespass in the first degree, arson in the third degree, and criminal mischief.] However, it is not the Court's function to write the law but only to interpret it. The statute enacted by the General Assembly contains no exceptions. . . . The proposed statute, which contained an exception for tort claimants . . . was available to the General Assembly in 1959 when § 3536 was amended. The fact that such a modification was not enacted leaves me no choice but to conclude that the General Assembly intended § 3536 to [be] an 'unrestrained' form of spendthrift provision. As a result, I reluctantly conclude that Aetna is a creditor within the meaning of § 3536 and its proof of claim must be denied.

In another difficult case two years later, Chancellor Allen of the Delaware Court of Chancery said that:[75]

> The policy of the legislature with respect to the seizure or garnishment of funds held by Delaware banks is clear. I cannot conclude that that policy may be ignored by the simple expedient of denominating the writ sought as one of injunction rather than one of garnishment. Therefore, I conclude that irrespective of the strong probability of merit shown by the complaint, it would be

[73] 2015 WL 295373 at 14.

[74] Gibson v. Speegle, 1984 Del. Ch. Lexis 475 at 6–7 (Del. Ch.) (citations and internal quotation marks omitted).

[75] Delaware Trust Co. v. Partial, 517 A.2d 259, 262 (Del. Ch. 1986).

> inappropriate for this Court to grant the remedy now sought insofar as it seeks to restrain pendente lite the disposition by the Wilmington Trust Company of funds held by it.

7. Tenancy-by-the-Entireties Property Contributed to Trust

Several states recognize tenancies by the entireties in real and personal property.[76] In 2007, Vice Chancellor Parsons of the Delaware Court of Chancery described the rules for tenancy by the entireties in Delaware real property as follows:[77]

> In Delaware, a husband and wife generally hold title to real property in a tenancy by the entirety. Consequently, neither interest can be sold, attached, or liened except by the joint act of both spouses. Specifically, a judgment against the husband cannot be executed against a property interest he holds in a tenancy by the entirety.

A tenancy by the entireties also may be created in Delaware personal property.[78]

From an estate-planning standpoint, working with tenancy-by-the-entireties property is problematic because:[79]

> When assets held as TBE are transferred to a trust in which only one party maintains control, the terms of the trust eliminate any TBE protection.

Once the property's character is destroyed, it cannot later be restored:[80]

> [E]ven if the trust were revoked, the Debtor provides no legal support for the assertion that the property will return to the Debtor and his wife as tenants by the entirety, and the Court can find nothing that would support such an assertion. To the contrary, the initial transfer of the property to the

---

[76] See Franke, Asset Protection and Tenancy by the Entirety, 34 ACTEC J. 210 (Spring 2009).

[77] Wilmington Sav. Fund Soc'y, FSB v. Kaczmarczyk, 2007 WL 704937 at 3 (Del. Ch. 2007) (footnotes omitted). See 25 Del. C. § 309.

[78] 2007 WL 704937 at 10.

[79] Quaid v. Baybrook Home of Polk County, 2011 WL 5572605 at 2 (M.D. Fla. 2011).

[80] In re Cowles, 143 B.R. 5, 10–11 (Bankr. D. Mass. 1992) (citation omitted). Accord In re Goldman, 111 B.R. 230, 232–33 (Bankr. E.D. Mo. 1990).

> trust thirteen years ago terminated the tenancy by the entirety. While it is true that one spouse acting alone cannot terminate a tenancy by the entirety without the consent of the other, nothing prevents such termination by the two acting together. In the present case, when the Debtor and his wife together transferred the property to the trust, to be controlled by the Debtor alone, they terminated the joint ownership and control that is a requirement of a tenancy by the entirety. Such a tenancy does not renew itself automatically in the future. For these reasons, the Debtor's argument that creditors will only be able to reach his fifty percent interest in the property is irrelevant.

In 2010, Delaware enacted a statute that allows tenancy-by-the-entireties property contributed to a revocable trust to retain its character and thereby its ability to protect the property from a spouse's separate creditors.[81] The statute, as amended in 2011 and 2013,[82] provides as follows:[83]

> Where spouses make a contribution of property to 1 or more trusts, each of which is revocable by either or both of them, and, immediately before such contribution, such property or any part thereof or any accumulation thereto was, pursuant to applicable law, owned by them as tenants by the entireties, in any action concerning whether a creditor of either or both spouses may recover the debt from the trust, the sole remedy available to the creditor with respect to such trust property shall be an order directing the trustee to transfer the property to both spouses as tenants by the entireties.

Hawaii, Illinois, Maryland, Missouri, North Carolina, Tennessee, Virginia, and Wyoming offer similar protection.[84]

The Delaware Act provides one more level of protection for tenancy-by-

---

[81] 12 Del. C. § 3334. I would like to thank Jonathan Gopman of Akerman Senterfitt, Naples, Florida, for suggesting this legislative change. See Gopman, STET: Delaware Introduces New Asset Protection Trust for Tenancy by the Entireties Property, LISI Asset Protection Plng. Newsltr. #161 (Sept. 8, 2010), www.leimbergservices.com.

[82] 78 Del. Laws 117, § 4 (2011); 79 Del. Laws 172, § 2 (2013).

[83] 12 Del. C. § 3334.

[84] Haw. Rev. Stat. § 554G-10(f); 765 ILCS 1005/1c; Md. Code Ann., Est. & Trusts § 14.5-511, Md. Code Ann., Cts. & Jud. Proc. § 11-504(b)(8)–(9); RSMo § 456.950; N.C. Gen. Stat. §§ 39-13.5–39-13.7; Tenn. Code Ann. § 35-15-510; Va. Code Ann. § 55-20.2(B); Wyo. Stat. § 4-10-402(c), (d).

the-entireties property added to a Delaware APT. Hence, under the Delaware Act, tenancy-by-the-entireties property transferred to a Delaware APT retains its character until the death of the first spouse,[85] and, if the trust is set aside (e.g., as a fraudulent transfer or a sham), the property retains its traditional protection from creditors.[86] The current provision says:[87]

> Where spouses make a qualified disposition of property to 1 or more trusts and, immediately before such qualified disposition, such property or any part thereof or any accumulation thereto was, pursuant to applicable law, owned by them as tenants by the entireties, in any action concerning whether a creditor of either or both spouses may recover the debt from the trust, upon avoidance of the qualified disposition, the sole remedy available to the creditor with respect to such trust property shall be an order directing the trustee to transfer the property to both spouses as tenants by the entireties.

In addition, the Delaware Act allows multiple transferors to contribute undivided interests to a Delaware APT as follows:[88]

> "Qualified disposition" means a disposition by or from a transferor (or multiple transferors in the case of property in which each such transferor owns an undivided interest) to 1 or more trustees, at least 1 of which is a qualified trustee, with or without consideration, by means of a trust instrument.

The conflict-of-laws issues relating to the funding of a Delaware APT with tenancy-by-the-entireties property are comparable to those for Delaware APTs. In short, Delaware and non-Delaware residents should be able to take advantage of this technique for tenancies in personal property, but its effectiveness for tenancies in non-Delaware real property is questionable.[89]

8. Lifetime QTIP and Other Trusts

---

[85] 12 Del. C. § 3574(f).

[86] 12 Del. C. § 3574(f).

[87] 12 Del. C. § 3574(f).

[88] 12 Del. C. § 3570(7).

[89] See Ruben & Gopman, Delaware Statutory Tenancy By The Entireties Trusts: Potentially Powerful Asset Protection for Couples Across the Country, 39 Tax Mgmt. Est., Gifts & Tr. J. 123, 126 (May 8, 2014).

a. The Delaware Statute

Thanks to recent federal tax legislation, the exemptions from the federal estate tax, gift tax, and generation-skipping transfer ("GST") tax have jumped to $5,450,000 per individual for 2016.[90] This might cause wealthier spouses to create inter vivos QTIP trusts for less wealthy spouses to enable the latter to use their estate and GST exemptions in whole or in part. One concern with this strategy is that the trust might be treated as self-settled if the donor spouse will benefit from trust assets if he or she survives the donee spouse, thereby producing adverse tax and asset-protection results. Long ago, the Treasury Department issued regulations specifying that trust assets would not be included in a donor spouse's gross estate under IRC § 2036 or § 2038 if this eventuated.[91] However, whether creditors could reach trust assets under state law remained unresolved for many years.

In 2009, Delaware amended its spendthrift trust statute to provide that an inter vivos marital-deduction trust generally will not be treated as self-settled because the donor spouse might benefit from trust assets by surviving the donee spouse.[92] In 2014, the statute was expanded to cover lifetime credit-shelter trusts and other lifetime trusts.[93] The protection now extends to:[94]

> [A] beneficial interest that is contingent upon surviving the trustor's spouse such as, but not limited to, an interest in an inter vivos marital deduction trust in which the interest of the trustor's spouse is treated as qualified terminable interest property under § 2523(f) of the Internal Revenue Code of 1986 [26 U.S.C. § 2523(f)], as amended, an interest in an inter vivos marital deduction

[90] Rev. Proc. 2015-53 § 3.33, 2015-44 I.R.B. 615, 623 (Oct. 21, 2015).

[91] Reg. § 25.2523(f)-1(f), Ex. 11.

[92] 12 Del. C. § 3536(c)(2), as amended by 77 Del. Laws 98, § 16 (2009).

[93] 12 Del. C. § 3536(c)(1), as amended by 79 Del. Laws 352, § 4 (2014).

[94] 12 Del. C. § 3536(c)(1). States with similar statutes include Arizona (Ariz. Rev. Stat. § 14-10505(E)); Florida (Fla. Stat § 736.0505(3)); Kentucky (Ky. Rev. Stat. Ann. § 386B.5-020(8)); Maryland (Md. Code Ann., Est. & Trusts § 14.5-1003(a)(2)); Michigan (Mich. Comp. Laws § 700.7506(4)); New Hampshire (N.H. Rev. Stat. Ann. § 564-B:5-505(a)(2)(C)–(D)); North Carolina (N.C. Gen. Stat. § 36C-5-505(c)); Oregon (Or. Rev. Stat. § 130.315(4)); South Carolina (S.C. Code Ann. § 62-7-505(b)); Tennessee (Tenn. Code Ann. § 35-15-505(d)); Texas (Tex. Prop. Code § 112.035(g)); Virginia (Va. Code Ann. § 64.2-747(B)(2)); Washington (RCW § 6.32.250); Wyoming (Wyo. Stat. Ann. § 4-10-506(e)–(f)).

> trust that is treated as a general power of appointment trust for which a marital deduction would be allowed under § 2523(a) and (e) of the Internal Revenue Code of 1986 [26 U.S.C. § 2523(a) and (e)], as amended, and an interest in an inter vivos trust commonly known as a "credit shelter trust" that used all or a portion of the trustor's unified credit under § 2505 of the Internal Revenue Code [26 U.S.C. § 2505], as amended, ...

b. The Supercharged Credit Shelter Trust[SM]

In 2007, Mitchell Gans, Jonathan Blattmachr, and Diana Zeydel introduced the concept of the Supercharged Credit Shelter Trust[SM],[95] under which a donor spouse creates an inter vivos QTIP trust for a donee spouse who subsequently dies and creates a credit-shelter trust for the donor spouse. The credit-shelter trust is "supercharged" because it is treated as a grantor trust with respect to the donor spouse for federal income-tax purposes.[96] The Treasury Regulation mentioned above allays any IRC §§ 2036 and 2038 concerns, but it is silent regarding IRC § 2041. Accordingly, the designers of the Supercharged Credit Shelter Trust[SM] recommend subjecting distributions to an ascertainable standard and creating the trust in a state that recognizes self-settled trusts.[97] Attorneys creating such trusts for clients also should consider the Delaware statute which was passed subsequent to introduction of the Supercharged Credit Shelter Trust[SM] concept, as an alternative to a self-settled trust because it is a straightforward solution and presents far fewer unresolved issues than the domestic APT.

IV. SELF-SETTLED TRUST TAX ISSUES

A. Structuring a Self-Settled Trust to Be an Incomplete Gift

To date, most domestic APTs have been designed to offer protection from creditor claims but not to be completed gifts or excluded from the gross estate. For federal gift-tax purposes, an individual makes a taxable transfer when he or

---

[95] Gans, Blattmachr, & Zeydel, Supercharged Credit Shelter Trust[SM], 21 Prob. & Prop. 52 (July/Aug. 2007). See Blattmachr, Gans & Zeydel, Supercharged Credit Shelter Trust[SM] Versus Portability, 28 Prob. & Prop. 11 (Mar./Apr. 2014).

[96] 21 Prob. & Prop. at 54–55.

[97] 21 Prob. & Prop. at 56–57.

she parts with dominion and control over property.[98] The traditional rule against self-settled trusts prevented taxpayers from making taxable gifts because they could incur debt and relegate creditors to trust assets. The domestic APT statutes are intended to change this result.

Early private letter rulings involving APTs concluded that the trustor's retention of a limited testamentary power of appointment was sufficient, by itself, to prevent a completed gift.[99] But, more recently, the IRS announced a change of position.[100] It now requires that the trustor be able to prevent the making of gifts from the trust during his or her lifetime. Thus, in five 2013 rulings,[101] many 2014 rulings,[102] and several 2015 rulings,[103] it said that a trustor will not make a completed gift to a self-settled trust if he or she keeps a limited lifetime power of appointment and/or a power to prevent trustees, advisers, or protectors from making distributions to other beneficiaries as well as a nongeneral testamentary power of appointment.

B. Structuring a Self-Settled Trust To Be a Completed Gift and Excludable From the Gross Estate

In 2009, the IRS ruled that the transfer of assets by an Alaska resident to an Alaska APT was a completed gift and that the trustee's discretion to pay income and principal to the trustor, the trustor's spouse, and the trustor's descendants was not sufficient, by itself, to cause inclusion of the trust's assets in the trustor's gross estate.[104] But, the IRS warned that:[105]

> We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding

[98] Reg. § 25.2511-2(b).

[99] See PLRs 200731019 (May 1, 2007), 200729025 (Apr. 10, 2007), 200715005 (Jan. 3, 2007), 200647001 (Aug. 7, 2006), 200637025 (June 5, 2006), 200612002 (Nov. 23, 2005), 200502014 (Sept. 17, 2004), 200247013 (Aug. 14, 2002), 200148028 (Aug. 27, 2001).

[100] See IRS CCA 201208026 (Sept. 28, 2011). See also Zeydel, When is a Gift to a Trust Complete—Did CCA 201208026 Get It Right?, 117 J. Tax'n 142 (Sept. 2012); Covey & Hastings, Powers of Withdrawal; Gift Tax Annual Exclusion; Taxable Gifts; IRC Sec. 2702, Prac. Drafting 10770, 10773–76 (Apr. 2012).

[101] See PLRs 201310002–006 (Nov. 7, 2012).

[102] PLRs 201440008–012 (Dec. 31, 2013), 201436028–032 (Dec. 30, 2013), 201436023–027 (Dec. 19, 2013), 201436018–022 (Dec. 24, 2013), 201436013–017 (Jan. 3, 2014), 201436008–012 (Dec. 27, 2013), 201430003–007 (Feb. 7, 2014), 201426014 (Feb. 24, 2014), 201410001–010 (Oct. 21, 2013).

[103] PLRs 201550005-013 (Aug. 7, 2015); 201510001–008 (Oct. 10, 2014).

[104] PLR 200944002 (July 15, 2009).

[105] PLR 200944002 (July 15, 2009).

> the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036.

Although Alaska, Delaware, New Hampshire, and South Dakota allow the assets of APTs to be reached to pay certain claims of current and former spouses and minor children, the author of a recent Chief Counsel Advice Memorandum observed that:[106]

> [T]he Supreme Court considered various situations in which a trust instrument purported to divest the respective grantor of all dominion and control over property to the extent that the property could not be returned to the grantor except by reason of contingencies beyond his control. In these cases, the Court noted that the respective grantor lost all economic control upon making the transfer, which he would not regain unless certain contingencies occurred. The Court concluded that the respective gifts were complete . . . .

To support the above proposition, the writer cited two U.S. Supreme Court cases and one Tax Court case.[107] The foregoing authorities and cases involving the acts-of-independent-significance doctrine indicate that completed gift treatment should be available in these four states.[108]

Apparently without studying the Nevada Act closely, some commentators have opined that Nevada is comparable to Alaska for these purposes.[109] Nevada permits the assets of APTs to be accessed not only to pay fraudulent-transfer claims but also if "the transfer violates a legal obligation owed to the creditor under a contract or a valid court order that is legally enforceable by that creditor."[110] I am not aware of any authority that supports the proposition that a

---

[106] IRS CCA 201208026 (Nov. 7, 2012).

[107] See Smith v. Shaughnessy, 318 U.S. 176, 181 (1943) ("grantor has neither the form nor substance of control and never will have unless he outlives his wife"); Robinette v. Helvering, 318 U.S. 184, 187 (1943) (property "could not be returned to them except because of contingencies beyond their control"—whether daughter had children); Kolb Est. v. Comr., 5 T.C. 588, 596 (1945) ("the donor decedent had no power to modify the trust in any way and never could have except upon the happening of an event beyond his control"—birth of more grandchildren).

[108] See U.S. v. Byrum, 408 U.S. 125, 150 (1972); Ellis v. Comr., 51 T.C. 182, 187–88 (1968), aff'd, 437 F.2d 442 (9th Cir. 1971); Tully Est. v. U.S., 528 F.2d 1401, 1406 (Ct. Cl. 1976); TAM 8819001 (Jan. 6, 1988); PLR 9141027 (July 11, 1991).

[109] See Gassman, Crotty & Pless, Safe Trust Guide—Why Your Family Needs a Safe Trust and What to Do to Implement One by the End of 2012 (the Spouse and Family Exempt ("Safe") Trust, 37 Tax Mgmt. Est., Gifts & Tr. J. 193 (May/June 2012); Rothschild, et al., IRS Rules Self-Settled Alaska Trust Will Not Be In Grantor's Estate, 37 Est. Plan. 3, 12 (Jan. 2010).

[110] Nev. Rev. Stat. § 166.170(3).

transfer to an APT will be a completed gift and excludible from the gross estate where such an open-ended exception exists.

In any event, in 2011, Wilmington Trust Company engaged counsel to attempt to obtain a Delaware private letter ruling comparable to the Alaska ruling. Late in the year, representatives of the IRS told counsel that the IRS was not willing to issue the ruling. According to counsel, the IRS's unwillingness to rule was not attributable to Delaware's family exceptions, etc. Rather, the IRS appears to be troubled by commentary about the 2011 In re Mortensen[111] bankruptcy case in Alaska. The IRS representative said that the Alaska ruling probably would not be issued if they were looking at it now and that the IRS since has declined other Alaska ruling requests.

C. Structuring a Self-Settled Trust to Be an Incomplete Gift and a Nongrantor Trust: The DING Trust

Most domestic APTs are grantor trusts for federal income-tax purposes under IRC § 677(a) because the trustee may distribute income to—or accumulate it for—the trustor without the approval of an adverse party. But, a client might use a type of domestic APT known as the Delaware Incomplete Gift Nongrantor Trust ("DING Trust") to avoid income tax on undistributed ordinary income and capital gains imposed by a state (i.e., Pennsylvania) that has not adopted the federal grantor-trust rules or, if the client is willing to subject distributions to himself or herself to the approval of an adverse party, to avoid income tax on such income imposed by one of the 43 states (e.g., Connecticut or New Jersey) that have adopted the federal grantor-trust rules.

In five 2013 private letter rulings,[112] numerous 2014 rulings,[113] and several 2015 rulings,[114] the IRS ruled that domestic APTs that followed the DING-Trust approach qualified as nongrantor trusts. Most—if not all—of the trusts in question were created under Nevada law in large part because, at the time, Nevada was the only domestic APT state that allowed a trustor to keep a lifetime nongeneral power of appointment. Delaware now offers that option as well.[115]

The trustor of a DING Trust might be able to receive tax-free distributions of the untaxed income in later years.[116]

---

[111] In re Mortensen, 2011 WL 5025252 (Bankr. D. Alaska 2011); In re Mortensen, 2011 WL 5025249 (Bankr. D. Alaska 2011); In re Mortensen, 2011 WL 5025288 (Bankr. D. Alaska 2011).

[112] PLRs 201310002–006 (Nov. 7, 2012).

[113] PLRs 201440008–012 (Dec. 31, 2013), 201436028–032 (Dec. 30, 2013), 201436023–027 (Dec. 19, 2013), 201436018–022 (Dec. 24, 2013), 201436013–017 (Jan. 3, 2014), 201436008–012 (Dec. 27, 2013), 201430003–007 (Feb. 7, 2014), 201426014 (Feb. 24, 2014), 201410001–010 (Oct. 21, 2013).

[114] PLRs 201550005-013 (Aug. 7, 2015); 201510001–008 (Oct. 10, 2014).

[115] 12 Del. C. § 3570(11)(b)(2).

[116] See Akhavan, DINGing State Income Taxes in Artwork Transactions, 153 Tr. & Est. 31 (June 2014); Schaller,

Effective June 1, 2014, DING Trusts no longer work in New York,[117] but the technique still is viable for residents of Connecticut, New Jersey, and other states.

V. OTHER ISSUES

A. FLP/LLC Laws

A good trust jurisdiction should have favorable family-limited partnership ("FLP") and limited-liability company ("LLC") statutes. Specifically, those statutes should provide that a charging order is a creditor's sole remedy and that other remedies, particularly foreclosure, are not available. Delaware meets these requirements (including for single-member LLCs).[118] But Connecticut[119] and New York[120] allow foreclosure and other remedies. New Jersey satisfies the requirements for LLCs[121] but still does not prohibit foreclosure of FLP interests.[122]

Because there has been some confusion over the status of FLPs and LLCs in Delaware, I summarize those rules briefly here. Not only do Delaware's FLP and LLC statutes stipulate that a charging order is a creditor's sole remedy and that other remedies, including foreclosure, are unavailable, but Delaware and non-Delaware caselaw also confirms these results.

Specifically, the pertinent provision of Delaware's LLC statute provides that:[123]

> The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's limited liability

---

Reduce State Tax With DINGs, NINGs, WINGs, and Other ThINGs, 41 Est. Plan 23, 24–26 (Apr. 2014); Brown & Lambourne, California ING Trusts: A Cautionary Tale of Your Future State Law?, LISI Inc. Tax Planning Newsltr. #63 (Mar. 11, 2014), www.leimbergservices.com; Flubacher & Goodwin, DINGed but not Dented, 152 Tr. & Est. 14 (July 2013).

[117] See N.Y. Tax Law § 612(b)(41), added by 2014 N.Y. Laws 59, Part I, § 2 (2014).

[118] 6 Del. C. § 17-703(d) (FLPs); 6 Del. C. § 18-703(d) (LLCs).

[119] Conn. Gen. Stat. § 34-30, Madison Hills Limited Partnership II v. Madison Hills, Inc., 644 A.2d 363, 370 (Conn. App. Ct. 1994) (FLPs); Conn. Gen. Stat. § 34-171, PB Real Estate v. DEM II Properties, 1997 WL 625465 at 3 (Conn. Super. Ct. 1997) (LLCs).

[120] N.Y. Partnership Law §§ 111(3), 121-703 (FLPs); N.Y. Ltd. Liab. Co. Law § 607 (LLCs). See Merric, Comer & Monasky, Updated Limited Partnership Asset Protection Planning Table, LISI Asset Protection Planning Newsltr. #189 (Jan. 10, 2012),www.leimbergservices.com; Merric, Comer & Monasky, Updated LLC Asset Protection Planning Table, LISI Asset Protection Planning Newsltr. #190 (Jan. 23, 2012), www.leimbergservices.com.

[121] NJSA § 42:2C-43.

[122] NJSA § 42:2A-48.

[123] 6 Del. C. § 18-703(d).

> company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.

The synopsis to the 2005 legislation that enacted the above provision describes the law in Delaware as follows:[124]

> Sections 9, 10, 11, 12, 13, 14 and 15. These sections amend Section 18-703 to clarify the nature of a charging order and provide that a charging order is the sole method by which a judgment creditor may satisfy a judgment out of the limited liability company interest of a member or a member's assignee. Attachment, garnishment, foreclosure or like remedies are not available to the judgment creditor and a judgment creditor does not have any right to become or to exercise any rights or powers of a member (other than the right to receive the distribution or distributions to which the member would otherwise have been entitled, to the extent charged).

Delaware's FLP statute[125] and the synopsis to the 2005 legislation that updated it[126] contain comparable language.

In 2010, Judge Sleet of the United States District Court for the District of Delaware wrote:[127]

> Because Delaware law does not permit foreclosure on charging orders, Bay Guardian would be unable to foreclose against New Times and the entities.

In the same year, Judge Ericksen of the United States District Court for the District of Minnesota wrote:[128]

> [A] charging order is the exclusive remedy under Delaware law by which a judgment creditor may

---

[124] 75 Del. Laws 51, synopsis to §§ 9–15 (2005). A bill's synopsis constitutes legislative history in Delaware.

[125] 6 Del. C. § 17-703.

[126] 75 Del. Laws 31, synopsis to §§ 10–16 (2005).

[127] New Times Media, LLC v. Bay Guardian Co., Inc., 2010 WL 2573957 at 2 (D. Del. 2010).

[128] General Elec. Capital Corp. v. JLT Aircraft Holding Co., 2010 WL 3023316 at 3 (D. Minn. 2010).

> satisfy a judgment out of a member's interest in a limited liability company.

If a resident of State 1 creates an LLC or FLP of personal property in State 2, does State 1 or State 2 law determine whether a creditor may reach a partner's or member's interest? A 2011 article suggests that State 2 law should be used:[129]

> [I]f an individual resides in one state but has a personal property interest in a limited partnership or LLC located in another state, he or she may be held to the law of the state where the entity is located. The courts have consistently leaned toward finding that the controlling law with respect to the entity is the state law where the entity was formed . . . .

Nevertheless, a federal district court in Florida held in 2015 that Florida law would determine whether a creditor could reach a Florida resident's interest in a single-member Nevis LLC.[130]

B. Delaware Estate Tax

The Delaware estate tax,[131] was reinstated on July 1, 2009,[132] made permanent early in 2013,[133] and amended later that year.[134] It applies to resident estates[135] and to nonresident estates.[136] In 2016, the exemption amount is $5,450,000.[137] Rates range from 0% on the first $40,000 of the Delaware taxable estate to 16.0% on the excess of the Delaware taxable estate over $10,040,000.[138] Portability of a deceased spouses unused applicable credit amount[139] and a QTIP election

---

[129] Gassman & Denicolo, Pass-Through Entities Have Protections in Charging Order Law, 38 Est. Plan. 31, 36 (Nov. 2011).

[130] Wells Fargo Bank, N.A. v. Barber, 85 F. Supp.3d 1308, 1316 (M.D. Fla. 2015). See Gassman & Arango, Wells Fargo v. Barber: The Barber of Seville Replaces No Time For Sargeants, LISI Asset Protection Plng. Newsltr. #287 (March 24, 2015), www.leimbergservices.com.

[131] 30 Del. C. §§ 1501–1507. The statute may be viewed at www.delcode.delaware.gov/title30/c015/index.shtml (last visited Mar. 22, 2016).

[132] 77 Del. Laws 85, § 1 (2009).

[133] 79 Del. Laws 11, § 1 (2013).

[134] 79 Del. Laws 162, § 1 (2013).

[135] 30 Del. C. § 1502(c). The resident return may be viewed at www.revenue.delaware.gov/services/current_pit/TY14_900re.pdf (last visited Mar. 22, 2016).

[136] 30 Del. C. § 1504. The nonresident return also may be viewed at www.revenue.delaware.gov/services/current_pit/TY14_900nre.pdf (last visited Mar. 22, 2016).

[137] 30 Del. C. § 1501(3)(c); Rev. Proc. 2015-53 § 3.33, 2015-44 I.R.B. 615, 623 (Oct. 21, 2015).

[138] 30 Del. C. § 1502(c).

[139] 30 Del. C. § 1501(3)(c); IRC § 2010(c).

independent of any federal election are available.[140] The return and the tax are due nine months after the date of death.[141]

The existence of the estate tax does not represent a significant diminution of Delaware's attractiveness as a trust jurisdiction. If a Delaware resident or nonresident creates an irrevocable Delaware trust that is a completed gift and excludable from the gross estate, the trust will not be subject to Delaware estate tax whether or not the trust holds real property or tangible personal property situated in Delaware. In addition, if a Delaware nonresident creates a revocable Delaware trust or an irrevocable Delaware trust that is includable in the gross estate, the trust will not be subject to Delaware estate tax if it does not hold Delaware real or tangible personal property. Furthermore, even if a Delaware nonresident has a revocable Delaware trust or a federally taxable irrevocable Delaware trust (e.g., a Delaware APT in many cases) that holds Delaware real or tangible personal property, the trust might not be taxable in Delaware because the trustor does not "own" the property as required by the statute.[142] Even if tax would be payable, the trustee might avoid tax by selling the property or placing it in an LLC or FLP prior to the trustor's death because an interest in such an entity is intangible personal property under Delaware law.[143]

Connecticut,[144] New Jersey,[145] and New York[146] impose estate taxes. Currently, Connecticut is the only state that assesses a gift tax;[147] New Jersey has an inheritance tax as well as an estate tax.[148]

---

[140] 30 Del. C. § 1501(4)(d).

[141] 30 Del. C. § 105(b), (c).

[142] 30 Del. C. § 1504(a) bases taxation on real or tangible personal property "owned" by a nonresident. Similarly, 30 Del. C. § 1505(a) imposes a duty to file a return on estates of nonresidents "having" Delaware property. If such property is in a trust, the trustee—not the trustor—"owns" or "has" it.

[143] 6 Del. C. §§ 17-701, 18-701. See 25 Del. C. § 503(e).

[144] Conn. Gen. Stat. §§ 12-391–12-398.

[145] NJSA §§ 54:38-1–54:38-16.

[146] N.Y. Tax Law §§ 951–999a. See State Death Tax Chart (Feb. 28, 2016), media.mcguirewoods.com/publications/State-Death-Tax-Chart.pdf (last visited Mar. 22, 2016).

[147] Conn. Gen. Stat. §§ 12-640–12-649.

[148] NJSA §§ 54:33-1–54:37-8.

WILMINGTON TRUST

DELAWARE vs. NEW YORK STATE TRUST LAW COMPARISON

March 17, 2016

KEY DELAWARE ADVANTAGES

- **Directed trust—under long-standing Delaware practice/statute—upheld by court—trust instrument can bifurcate trustee's duties**
- **Self-settled asset protection trust (APT)—Delaware allows, including for lifetime marital-deduction, credit-shelter, and other trusts**
- **Silent trust—Delaware trust instrument may restrict disclosure of information to beneficiary for period of time**
- **Perpetual trust—Delaware permits; Delaware also allows donee to exercise nongeneral power of appointment to spring Delaware tax trap and get stepped-up income-tax basis**
- **Decanting power—Delaware and New York allow; Delaware statute more flexible**
- **Nonjudicial settlement agreement—Delaware allows**
- **Lifetime validation of trust—under Delaware statute—upheld by Delaware Supreme Court—notified person must act within 120 days**
- **Income tax—New York State income tax may be deferred or avoided by appointing Delaware not New York trustee, even after 2014–2015 budget bill**
- **Trust provisions—Delaware more flexible**
- **Court system—Delaware courts address trust matters promptly and efficiently**
- **Unitrust—Delaware statutes more flexible**
- **Power to adjust—Delaware statute more flexible**
- **Third-party trust—Delaware statutes more protective**
- **Noncharitable purpose trust—Delaware permits perpetual trust for any noncharitable purpose**
- **Insurance trust—Delaware gives trustee of ILIT insurable interest**
- **Trust laws—Delaware updates more frequently**

Prepared by Richard W. Nenno, Esquire, Senior Managing Director and Trust Counsel

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK STATE TRUST LAWS

POINT OF LAW	DELAWARE	NEW YORK STATE
Directed Trust **Division of Trustee Duties**	Since 1986 (codifying practice dating from early 20th century)—trust may designate person to direct trustee on investment, distribution, and other decisions. Directed trustee not liable for following direction or not taking specified action without direction of adviser except for wilful misconduct and has no duty to monitor adviser's activities. Adviser is fiduciary unless instrument provides otherwise and must furnish directed trustee with specified information (12 Del. C. §§ 3301(g), 3313, 3317). Del. Court of Chancery enforced statute in unreported case (Duemler, 2004 WL 5383927 (2004)).	No statute.
Asset Protection Trust (APT) **Self-Settled Spendthrift Trust**	Del. law recognizes domestic APT. Since 1997—creditor may reach settlor's interest only in limited circumstances under Qualified Dispositions in Trust Act (12 Del. C. §§ 3570–3576). Del. Court of Chancery held creditors' attempt to reach assets of Del. APTs time-barred (TrustCo, 2015 WL 295373 (2015)). Since 2009—creditor may not reach settlor's contingent interest in lifetime marital-deduction trust, credit-shelter trust, or other trust (12 Del. C. § 3536(c)(1)).	NYS does not recognize domestic APT. Trust created for settlor void against claims by settlor's existing and subsequent creditors (NY EPTL § 7-3.1(a); NY CPLR § 5205(c)(1)).
Disclosure to Beneficiary **Silent Trust**	Since 2003—trust instrument may restrict disclosure of information to beneficiary for period to time, such as until beneficiary reaches specified age, death of settlor or spouse, end of term of years or arrival of specified date, or occurrence of specified event. Designated representation may represent and bind beneficiary in judicial or nonjudicial proceeding (12 Del. C. §§ 3303, 3339). Absent such language, trustee must provide current beneficiary with relevant information about trust (McNeil, 798 A.2d 503 (2002)).	No statute.
Rule Against Perpetuities **Permissible Duration of Trust**	Since 1933 statute—perpetual trust possible through exercise of Del. nongeneral power of appointment. Since 1995 statute—trust interest in personal property may be perpetual; trust interest in real property must vest within 110 years after creation of interest (limitation may be avoided by putting interest in FLP, LLC, or other entity). Nongeneral power of appointment may be exercised to spring Del. tax trap and get stepped-up income-tax basis (25 Del. C. §§ 501–505).	Common-law rule followed—trust interest must vest 21 years after death of individual living when interest was created (NY EPTL § 9-1.1). Nongeneral power of appointment may not be exercised to spring Del. tax trap and get stepped-up income-tax basis (NY EPTL § 10-8.1).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK STATE TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW YORK STATE
Modification of Trust		
❖ **Merger/ Combination**	Since 2005—trustee may merge old and new trusts unless merger would result in material change in beneficial interests of trust beneficiaries (12 Del. C. § 3325(29)).	Trustee may hold property of two or more trusts created by same instrument as undivided whole without separation as between trusts, provided separate trusts have undivided interests in such property and no such holding shall defer vesting of any estate (NY EPTL § 11-1.1(b)(18)).
❖ **Decanting**	Since 2003—trustee of testamentary or irrevocable inter vivos trust (including revocable trust in which settlor is incapacited) with power to invade principal/income may distribute principal/income into another trust with same or more limited distribution standards and for benefit of all or fewer of beneficiaries of first trust (12 Del. C. § 3528).	Since 1992. Under 2011 revision—different rules set for trustees having unlimited and limited discretion to invade principal (NY EPTL § 10-6.6).
❖ **Nonjudicial Settlement Agreement**	Since 2013—modification may not violate material purpose of trust and must be of type otherwise approvable by court. Trustee, specified beneficiaries, and other interested persons must consent (12 Del. C. § 3338).	Creator may revoke or amend trust with written consent of all persons beneficially interested (NY EPTL § 7-1.9(a)).
❖ **Court Petition**	Formalized in 2012 via Del. Ct. Ch. Rs. 100–104, Del. Court of Chancery may modify trust under consent-petition procedure. Del. Court of Chancery denied petition to modify trust that departed from testator's intent in unreported case (Flint, 118 A.3d 182 (2015)).	No statute.
No-Contest (In Terrorem) Clause	Enforcement during lifetime of settlor. Since 2003—person barred from bringing judicial proceeding to contest validity of revocable trust, amendment to revocable trust, or irrevocable trust 120 days after notice by trustee (12 Del. C. § 3546). Del. Supreme Court enforced statute in unreported case (Ravet, 2015 WL 631588 (2015)). No-contest clause generally enforceable in Will or trust (12 Del. C. § 3329).	No-contest clause generally enforceable in Will or trust but strictly construed (NY EPTL § 3-3.5(b); Stralem, 181 Misc. 2d 715 (1999)).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK STATE TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW YORK STATE
Taxation of Trust Income	For nongrantor trust, tax is not payable and return is not due if trust has no Del. resident beneficiary. Combination of Del.'s small population and its favorable rule for determining residence of future beneficiary means that few trusts created by nonresidents pay Del. income tax. For trust subject to tax, highest rate in 2016 is 6.60% (30 Del. C. §§ 1102(a)(14), 1601(8), 1605(b), 1636).	Settlor taxed on all income of trust treated as grantor trust for federal purposes. In 2016, tax of up to 8.82% payable by trustee on accumulated ordinary income and capital gains of nongrantor trust created by Will of NYS decedent or inter vivos trust created by NYS settlor (NY Tax Law §§ 601(c)(1)(A), 605(b)(3); 20 NYCRR § 105.23). Even after 2014–2015 budget bill, tax may be deferred or avoided if trust has no NYS trustee, asset, or source income.
Flexibility in Drafting Trust Provisions	Since 2003—regardless of common law or other statute, governing instrument may expand, restrict, eliminate, or otherwise vary rights and interests of beneficiary. Specifically, trust may negate duty to diversify investments or defer age at which trustee must notify beneficiary of trust interest (12 Del. C. § 3303(a)).	No statute.
2015 State Lawsuit Climate Ranking[1]	# 1. Judges are appointed by Governor with consent of Senate and must come as equally as possible from two major political parties (Del. Const. Art. IV, § 3). Judges decide all trust issues.	# 21.
Unitrust		
❖ **Recognition of Trust Created as Unitrust**	Since 2004—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-107).	Since 2002—limited to 4% (NY EPTL § 11-2.4(e)(1)(A)).
❖ **Procedure for Converting Income Trust into Total-Return Unitrust**	Since 2001—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-106).	Since 2002— limited to 4% (NY EPTL § 11-2.4).

[1] Based on data in U.S. Chamber of Commerce survey available at www.instituteforlegalreform.com/states (last visited Mar. 17, 2016).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK STATE TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW YORK STATE
Power to Adjust Between Income and Principal Under § 104 of 1997 Uniform Principal and Income Act	Since 2005—includes tax-ordering rule (12 Del. C. §§ 61-104–61-105).	Since 2002 (NY EPTL § 11-2.3(b)(5)).
Rule Against Accumulations	Since 1986—no provision directing or authorizing accumulation of trust income is invalid (25 Del. C. § 506).	Provision directing or authorizing accumulation of trust income beyond rule against perpetuities is invalid (NY EPTL § 9-2.1).
Third-Party Trust		
❖ **Enforcement of Spendthrift Clause**	By statute, trust income and principal not subject to voluntary or involuntary transfer. Amount that may be protected is not limited (12 Del. C. § 3536). By caselaw, trust income may be reached for separate maintenance of current—but not divorced—spouse (Garretson, 306 A.2d 737 (1973)).	Beneficiary of spendthrift trust may transfer income to person beneficiary must support and may transfer income above $10,000 to specified persons (NY EPTL § 7-1.5).
❖ **Discretionary Interest**	Since 2007—creditor may not compel distribution of discretionary interest. Court may change trustee's exercise of discretion only for abuse of discretion within meaning of Second Restatement of Trusts (12 Del. C. §§ 3315, 3536).	No statute.
Noncharitable Purpose Trust	Since 2007—perpetual trust for any noncharitable purpose is valid (12 Del. C. § 3556, 25 Del. C. § 503(a)).	Since 1996—trust for domestic or pet animal is valid until earlier of death of last living pet or 21 years (NY EPTL § 7-8.1).
Trustee of ILIT Has Insurable Interest	Since 1998 (18 Del. C. § 2704(c)(5)).	No statute.
Investment Rules	In 1986—prudent-investor rule was adopted. Trustee may consider other resources and trust interests in determining investment policy for trust (12 Del. C. § 3302). Since 2003—special rules set for acquisition and administration of life insurance by trustee (12 Del. C. § 3302(d)).	In 1995— prudent-investor rule was adopted (NY EPTL § 11-2.3).

WILMINGTON
TRUST

DELAWARE vs. NEW YORK CITY TRUST LAW COMPARISON

March 17, 2016

KEY DELAWARE ADVANTAGES

- **Directed trust—under long-standing Delaware practice/statute—upheld by court—trust instrument can bifurcate trustee's duties**
- **Self-settled asset protection trust (APT)—Delaware allows, including for lifetime marital-deduction, credit-shelter, and other trusts**
- **Silent trust—Delaware trust instrument may restrict disclosure of information to beneficiary for period of time**
- **Perpetual trust—Delaware permits; Delaware also allows donee to exercise nongeneral power of appointment to spring Delaware tax trap and get stepped-up income-tax basis**
- **Decanting power—Delaware and New York allow; Delaware statute more flexible**
- **Nonjudicial settlement agreement—Delaware allows**
- **Lifetime validation of trust—under Delaware statute—upheld by Delaware Supreme Court—notified person must act within 120 days**
- **Income tax—New York City/State income tax may be deferred or avoided by appointing Delaware not New York City/State trustee, even after 2014–2015 budget bill**
- **Trust provisions—Delaware more flexible**
- **Court system—Delaware courts address trust matters promptly and efficiently**
- **Unitrust—Delaware statutes more flexible**
- **Power to adjust—Delaware statute more flexble**
- **Third-party trust—Delaware statutes more protective**
- **Noncharitable purpose trust—Delaware permits perpetual trust for any noncharitable purpose**
- **Insurance trust—Delaware gives trustee of ILIT insurable interest**
- **Trust laws—Delaware updates more frequently**

Prepared by Richard W. Nenno, Esquire, Senior Managing Director and Trust Counsel

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK CITY TRUST LAWS

POINT OF LAW	DELAWARE	NEW YORK CITY
Directed Trust **Division of Trustee Duties**	Since 1986 (codifying practice dating from early 20th century)—trust may designate person to direct trustee on investment, distribution, and other decisions. Directed trustee not liable for following direction or not taking specified action without direction of adviser except for wilful misconduct and has no duty to monitor adviser's activities. Adviser is fiduciary unless instrument provides otherwise and must furnish directed trustee with specified information (12 Del. C. §§ 3301(g), 3313, 3317). Del. Court of Chancery enforced statute in unreported case (Duemler, 2004 WL 5383927 (2004)).	No statute.
Asset Protection Trust (APT) **Self-Settled Spendthrift Trust**	Del. law recognizes domestic APT. Since 1997—creditor may reach settlor's interest only in limited circumstances under Qualified Dispositions in Trust Act (12 Del. C. §§ 3570–3576). Del. Court of Chancery held creditors' attempt to reach assets of Del. APTs time-barred (TrustCo, 2015 WL 295373 (2015)). Since 2009—creditor may not reach settlor's contingent interest in lifetime marital-deduction trust, credit-shelter trust, or other trust (12 Del. C. § 3536(c)(1)).	NYS does not recognize domestic APT. Trust created for settlor void against claims by settlor's existing and subsequent creditors (NY EPTL § 7-3.1(a); NY CPLR. § 5205(c)(1)).
Disclosure to Beneficiary **Silent Trust**	Since 2003—trust instrument may restrict disclosure of information to beneficiary for period of time, such as until beneficiary reaches specified age, death of settlor or spouse, end of term of years or arrival of specified date, or occurrence of specified event. Designated representation may represent and bind beneficiary in judicial or nonjudicial proceeding (12 Del. C. §§ 3303, 3339). Absent such language, trustee must provide current beneficiary with relevant information about trust (McNeil, 798 A.2d 503 (2002)).	No statute.
Rule Against Perpetuities **Permissible Duration of Trust**	Since 1933 statute—perpetual trust possible through exercise of Del. nongeneral power of appointment. Since 1995 statute—trust interest in personal property may be perpetual; trust interest in real property must vest within 110 years after creation of interest (limitation may be avoided by putting interest in FLP, LLC, or other entity). Nongeneral power of appointment may be exercised to spring Del. tax trap and get stepped-up income-tax basis (25 Del. C. §§ 501–505).	Common-law rule followed—trust interest must vest 21 years after death of individual living when interest was created (NY EPTL § 9-1.1). Nongeneral power of appointment may not be exercised to spring Del. tax trap and get stepped-up income-tax basis (NY EPTL § 10-8.1).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK CITY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW YORK CITY
Modification of Trust		
❖ **Merger/ Combination**	Since 2005—trustee may merge old and new trusts unless merger would result in material change in beneficial interests of trust beneficiaries (12 Del. C. § 3325(29)).	Trustee may hold property of two or more trusts created by same instrument as undivided whole without separation as between trusts, provided separate trusts have undivided interests in such property and no such holding shall defer vesting of any estate (NY EPTL § 11-1.1(b)(18)).
❖ **Decanting**	Since 2003—trustee of testamentary or irrevocable inter vivos trust (including revocable trust in which settlor is incapacitated) with power to invade principal/income may distribute principal/income into another trust with same or more limited distribution standards and for benefit of all or fewer of beneficiaries of first trust (12 Del. C. § 3528).	Since 1992. Under 2011 revision—different rules set for trustees having unlimited and limited discretion to invade principal (NY EPTL § 10-6.6).
❖ **Nonjudicial Settlement Agreement**	Since 2013—modification may not violate material purpose of trust and must be of type otherwise approvable by court. Trustee, specified beneficiaries, and other interested persons must consent (12 Del. C. § 3338).	Creator may revoke or amend trust with written consent of all persons beneficially interested (NY EPTL § 7-1.9(a)).
❖ **Court Petition**	Formalized in 2012 via Del. Ct. Ch. Rs. 100–104, Del. Court of Chancery may modify trust under consent-petition procedure. Del. Court of Chancery denied petition to modify trust that departed from testator's intent in unreported case (Flint, 118 A.3d 182 (2015)).	No statute.
No-Contest (In Terrorem) Clause	Enforcement during lifetime of settlor. Since 2003—person barred from bringing judicial proceeding to contest validity of revocable trust, amendment to revocable trust, or irrevocable trust 120 days after notice by trustee (12 Del. C. § 3546). Del. Supreme Court enforced statute in unreported case (Ravet, 2015 WL 631588 (2015)). No-contest clause generally enforceable in Will or trust (12 Del. C. § 3329).	No-contest clause generally enforceable in Will or trust but strictly construed (NY EPTL § 3-3.5(b); Stralem, 181 Misc. 2d 715 (1999)).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK CITY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW YORK CITY
Taxation of Trust Income	For nongrantor trust, tax is not payable and return is not due if trust has no Del. resident beneficiary. Combination of Del.'s small population and its favorable rule for determining residence of future beneficiary means that few trusts created by nonresidents pay Del. income tax. For trust subject to tax, highest rate in 2016 is 6.60% (30 Del. C. §§ 1102(a)(14), 1601(8), 1605(b), 1636).	Settlor taxed on all income of trust treated as grantor trust for federal purposes. In 2016, tax of up to 12.696% payable by trustee on accumulated ordinary income and capital gains of nongrantor trust created by Will of NYC decedent or inter vivos trust created by NYC settlor (NY Tax Law §§ 601(c)(1)(A), 605(b)(3), 1304(a)(3)(A), 1304-B(a)(1)(ii), 1305(c); 20 NYCRR § 105.23; NYC Admin. Code §§ 11-1704.1, 11-1705(b)(3)). Even after 2014–2015 budget bill, tax may be deferred or avoided if trust has no NYS/NYC trustee, asset, or source income.
Flexibility in Drafting Trust Provisions	Since 2003—regardless of common law or other statute, governing instrument may expand, restrict, eliminate, or otherwise vary rights and interests of beneficiary. Specifically, trust may negate duty to diversify investments or defer age at which trustee must notify beneficiary of trust interest (12 Del. C. § 3303(a)).	No statute.
2015 State Lawsuit Climate Ranking[1]	# 1. Judges are appointed by Governor with consent of Senate and must come as equally as possible from two major political parties (Del. Const. Art. IV, § 3). Judges decide all trust issues.	# 21.

[1] Based on data in U.S. Chamber of Commerce survey available at www.instituteforlegalreform.com/states (last visited Mar. 17, 2016).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK CITY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW YORK CITY
Unitrust		
❖ **Recognition of Trust Created as Unitrust**	Since 2004—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-107).	Since 2002—limited to 4% (NY EPTL § 11-2.4(e)(1)(A)).
❖ **Procedure for Converting Income Trust into Total-Return Unitrust**	Since 2001—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-106).	Since 2002— limited to 4% (NY EPTL § 11-2.4).
Power to Adjust **Between Income and Principal Under § 104 of 1997 Uniform Principal and Income Act**	Since 2005—includes tax-ordering rule (12 Del. C. §§ 61-104–61-105).	Since 2002 (NY EPTL § 11-2.3(b)(5)).
Rule Against Accumulations	Since 1986—no provision directing or authorizing accumulation of trust income is invalid (25 Del. C. § 506).	Provision directing or authorizing accumulation of trust income beyond rule against perpetuities is invalid (NY EPTL § 9-2.1).
Third-Party Trust		
❖ **Enforcement of Spendthrift Clause**	By statute, trust income and principal not subject to voluntary or involuntary transfer. Amount that may be protected is not limited (12 Del. C. § 3536). By caselaw, trust income may be reached for separate maintenance of current—but not divorced—spouse (Garretson, 306 A.2d 737 (1973)).	Beneficiary of spendthrift trust may transfer income to person beneficiary must support and may transfer income above $10,000 to specified persons (NY EPTL § 7-1.5).
❖ **Discretionary Interest**	Since 2007—creditor may not compel distribution of discretionary interest. Court may change trustee's exercise of discretion only for abuse of discretion within meaning of Second Restatement of Trusts (12 Del. C. §§ 3315, 3536).	No statute.

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW YORK CITY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW YORK CITY
Noncharitable Purpose Trust	Since 2007—perpetual trust for any noncharitable purpose is valid (12 Del. C. § 3556, 25 Del. C. § 503(a)).	Since 1996—trust for domestic or pet animal is valid until earlier of death of last living pet or 21 years (NY EPTL § 7-8.1).
Trustee of ILIT Has Insurable Interest	Since 1998 (18 Del. C. § 2704(c)(5)).	No statute.
Investment Rules	In 1986— prudent-investor rule was adopted. Trustee may consider other resources and trust interests in determining investment policy for trust (12 Del. C. § 3302). Since 2003—special rules set for acquisition and administration of life insurance by trustee (12 Del. C. § 3302(d)).	In 1995—prudent-investor rule was adopted (NY EPTL § 11-2.3).

WILMINGTON TRUST

DELAWARE vs. NEW JERSEY TRUST LAW COMPARISON

March 9, 2016

KEY DELAWARE ADVANTAGES

- **Directed trust—under long-standing Delaware practice/statute—upheld by court—trust instrument can bifurcate trustee's duties**
- **Self-settled asset protection trust (APT)—Delaware allows, including for lifetime marital-deduction, credit-shelter, and other trusts**
- **Silent trust—Delaware trust instrument may restrict disclosure of information to beneficiary for period of time**
- **Perpetual trust—Delaware permits; Delaware also allows donee to exercise nongeneral power of appointment to spring Delaware tax trap and get stepped-up income-tax basis; New Jersey permits perpetual trust but has not abolished common-law rule against accumulations**
- **Decanting power—Delaware statute allows**
- **Trust modification—Delaware more respectful of testator's/settlor's intent**
- **Lifetime validation of trust—under Delaware statute—upheld by Delaware Supreme Court—notified person must act within 120 days**
- **No-contest clause—Delaware statute enforces in trust as well as in Will**
- **Income tax—New Jersey income tax may be avoided if nongrantor trust has Delaware not New Jersey trustee**
- **Trust provisions—Delaware more flexible**
- **Court system—Delaware courts address trust matters promptly and efficiently**
- **Unitrust—Delaware statutes allow creation of new trust as unitrust and conversion of income trust into unitrust**
- **Power to adjust—Delaware statute more flexible**
- **Noncharitable purpose trust—Delaware permits perpetual trust for any noncharitable purpose**
- **Trust laws—Delaware updates more frequently**

Prepared by Richard W. Nenno, Esquire, Senior Managing Director and Trust Counsel

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW JERSEY TRUST LAWS

POINT OF LAW	DELAWARE	NEW JERSEY
Directed Trust **Division of Trustee Duties**	Since 1986 (codifying practice dating from early 20th century)—trust may designate person to direct trustee on investment, distribution, and other decisions. Directed trustee not liable for following direction or not taking specified action without direction of adviser except for wilful misconduct and has no duty to monitor adviser's activities. Adviser is fiduciary unless instrument provides otherwise and must furnish directed trustee with specified information (12 Del. C. §§ 3301(g), 3313, 3317). Del. Court of Chancery enforced statute in unreported case (Duemler, 2004 WL 5383927 (2004)).	Since 2016—trust may designate person to direct trustee on certain trustee actions. Directed trustee liable if direction is contrary to terms of trust or trustee knows direction is breach of fiduciary duty of directing person (NJSA § 3B:31-61). Since 2016—trust may designate person to direct trustee on investment decisions. Directed trustee not liable for following direction except for willfull misconduct or gross negligence and has no duty to monitor adviser's activities. Adviser is fiduciary unless instrument provides otherwise (NJSA § 3B:31-62).
Asset Protection Trust (APT) **Self-Settled Spendthrift Trust**	Del. law recognizes domestic APT. Since 1997—creditor may reach settlor's interest only in limited circumstances under Qualified Dispositions in Trust Act (12 Del. C. §§ 3570–3576). Del. Court of Chancery held creditors' attempt to reach assets of Del. APTs time-barred (TrustCo, 2015 WL 295373 (2015)). Since 2009—creditor may not reach settlor's contingent interest in lifetime marital-deduction trust, credit-shelter trust, or other trust (12 Del. C. § 3536(c)(1)).	NJ law does not recognize domestic APT. Since 2016—creditor may reach maximum amount that can be distributed to settlor (NJSA §§ 3B:31-39, 3B:11-1(a), 25:2-1(a)).
Disclosure to Beneficiary **Silent Trust**	Since 2003—trust instrument may restrict disclosure of information to beneficiary for period of time, such as until beneficiary reaches specified age, death of settlor or spouse, end of term of years or arrival of specified date, or occurrance of specified event. Designated representative may represent and bind beneficiary in judicial or nonjudicial proceeding (12 Del. C. §§ 3303, 3339). Absent such language, trustee must provide current beneficiary with relevant information about trust (McNeil, 798 A.2d 503 (2002)).	Since 2016—unless trust provides otherwise, trustee must keep qualified beneficiary reasonably informed about trust's administration and comply with such beneficiary's request for copy of trust instrument and relevant information. But, regardless of trust, trustee must comply with such request from qualified beneficiary over 35 (NJSA §§ 3B:31-5(b)(7), 3B:31-67).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW JERSEY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW JERSEY
Rule Against Perpetuities **Permissible Duration of Trust**	Since 1933 statute—perpetual trust possible through exercise of Del. nongeneral power of appointment. Since 1995 statute—trust interest in personal property may be perpetual; trust interest in real property must vest within 110 years after creation of interest (limitation may be avoided by putting interest in FLP, LLC, or other entity). Nongeneral power of appointment may be exercised to spring Del. tax trap and get stepped-up income-tax basis (25 Del. C. §§ 501–505).	Since 1999—perpetual trust permitted (NJSA §§ 46:2F-9–46:2F-11). Nongeneral power of appointment may not be exercised to spring Del. tax trap to get stepped-up income-tax basis (NJSA § 46:2F-10(a)(3)).
Modification of Trust		
❖ **Merger/ Combination**	Since 2005—trustee may merge old and new trusts unless merger would result in material change in beneficial interests of trust beneficiaries (12 Del. C. § 3325(29)).	Since 2016—trustee may combine trusts if does not impair beneficiaries' rights or adversely affect achievement of trusts' purposes (NJSA § 3B:31-34).
❖ **Decanting**	Since 2003—trustee of testamentary or irrevocable inter vivos trust (including revocable trust in which settlor is incapacited) with power to invade principal/income may distribute principal/income into another trust with same or more limited distribution standards and for benefit of all or fewer of beneficiaries of first trust (12 Del. C. § 3528).	No statute. By caselaw, might be available in certain circumstances (Wiedenmayer, 254 A.2d 534 (1969)).
❖ **Nonjudicial Settlement Agreement**	Since 2013—modification may not violate material purpose of trust and must be of type otherwise approvable by court. Trustee, specified beneficiaries, and other interested persons must consent (12 Del. C. § 3338).	Since 2016—modification may not violate material purpose of trust and must be of type otherwise approvable by court. All interested persons must consent (NJSA § 3B:31-11).
❖ **Court Petition**	Formalized in 2012 via Del. Ct. Ch. Rs. 100–104, Del. Court of Chancery may modify trust under consent-petition procedure. Del. Court of Chancery denied petition to modify trust that departed from testator's intent in unreported case (Flint, 118 A.3d 182 (2015)).	Since 2016—trustee and beneficiaries may modify or terminate noncharitable irrevocable trust if not inconsistent with material purpose of trust. Beneficiaries may modify or terminate noncharitable irrevocable trust if court concludes that material purpose is not defeated. Spendthrift provision is not presumed to be material purpose (NJSA § 3B:31-27).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW JERSEY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW JERSEY
No-Contest (In Terrorem) Clause	Enforcement during lifetime of settlor. Since 2003—person barred from bringing judicial proceeding to contest validity of revocable trust, amendment to revocable trust, or irrevocable trust 120 days after notice by trustee (12 Del. C. § 3546). Del. Supreme Court enforced statute in unreported case (Ravet, 2015 WL 631588 (2015)). No-contest clause generally enforceable in Will or trust (12 Del. C. § 3329).	No-contest clause generally enforceable in Will (NJSA § 3B:3-47).
Taxation of Trust Income	For nongrantor trust, tax is not payable and return is not due if trust has no Del. resident beneficiary. Combination of Del.'s small population and its favorable rule for determining residence of future beneficiary means that few trusts created by nonresidents pay Del. income tax. For trust subject to tax, highest rate in 2016 is 6.60% (30 Del. C. §§ 1102(a)(14), 1601(8), 1605(b), 1636).	Settlor taxed on all income of trust treated as grantor trust for federal purposes. In 2016, tax of up to 8.97% payable by trustee on accumulated ordinary income and capital gains of nongrantor trust created by Will of NJ decedent or inter vivos trust created by NJ settlor (NJSA §§ 54A:1-2(o)(2)–(3), (p), 54A:2-1(b)(5)). Tax not payable if trust has no NJ trustee, asset, or source income (Kassner, 28 N.J. Tax 541 (2015)).
Flexibility in Drafting Trust Provisions	Since 2003—regardless of common law or other statute, governing instrument may expand, restrict, eliminate, or otherwise vary rights and interests of beneficiary. Specifically, trust may negate duty to diversify investments or defer age at which trustee must notify beneficiary of trust interest (12 Del. C. § 3303(a)).	Since 2016—although testator's/settlor's intent is relevant, trust must be for benefit of beneficiaries (NJSA §§ 3B:31-3, 3B:31-5(b)(3), 3B:31-21, 3B:31-54, 3B:31-55(a)).
2015 State Lawsuit Climate Ranking[1]	# 1. Judges are appointed by Governor with consent of Senate and must come as equally as possible from two major political parties (Del. Const. Art. IV, § 3). Judges decide all trust issues.	# 38.

[1] Based on data in U.S. Chamber of Commerce survey available at www.instituteforlegalreform.com/states (last visited Mar. 9, 2016).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW JERSEY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW JERSEY
Unitrust		
❖ **Recognition of Trust Created as Unitrust**	Since 2004—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-107).	No statute.
❖ **Procedure for Converting Income Trust into Total-Return Unitrust**	Since 2001—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-106).	No statute.
Power to Adjust **Between Income and Principal Under § 104 of 1997 Uniform Principal and Income Act**	Since 2005—includes tax-ordering rule (12 Del. C. §§ 61-104–61-105).	Since 2002—includes 3%–5% safe harbor (NJSA § 3B:19B-4).
Rule Against Accumulations	Since 1986—no provision directing or authorizing accumulation of trust income is invalid (25 Del. C. § 506).	No statute.
Third-Party Trust		
❖ **Enforcement of Spendthrift Clause**	By statute, trust income and principal not subject to voluntary or involuntary transfer. Amount that may be protected is not limited (12 Del. C. § 3536). By caselaw, trust income may be reached for separate maintenance of current—but not divorced—spouse (Garretson, 306 A.2d 737 (1973)).	Since 2016—spendthrift provision must restrain voluntary and involuntary transfer of beneficiary's interest (NJSA § 3B:31-36).
❖ **Discretionary Interest**	Since 2007—creditor may not compel distribution of discretionary interest. Court may change trustee's exercise of discretion only for abuse of discretion within meaning of Second Restatement of Trusts (12 Del. C. §§ 3315, 3536).	Since 2016—beneficiary's creditor may not compel distribution subject to trustee's discretion. Trustee must exercise discretionary power in good faith and in accordance with trust terms and purposes and interests of beneficiaries (NJSA §§ 3B:31-38, 3B:31-68).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND NEW JERSEY TRUST LAWS continued

POINT OF LAW	DELAWARE	NEW JERSEY
Noncharitable Purpose Trust	Since 2007—perpetual trust for any noncharitable purpose is valid (12 Del. C. § 3556, 25 Del. C. § 503(a)).	Since 2016—duration of noncharitable purpose trust not limited (NJSA § 3B:31-25). Perpetual trust might not be possible because separate common-law rule limiting duration of noncharitable purpose trust has not been repealed.
Trustee of ILIT Has Insurable Interest	Since 1998 (18 Del. C. § 2704(c)(5)).	No statute.
Investment Rules	In 1986—prudent-investor rule was adopted. Trustee may consider other resources and trust interests in determining investment policy for trust (12 Del. C. § 3302). Since 2003—special rules set for acquisition and administration of life insurance by trustee (12 Del. C. § 3302(d)).	In 1997—Uniform Prudent Investor Act was adopted (NJSA §§ 3B:20-11.1–3B:20-11.12).

WILMINGTON TRUST

DELAWARE vs. CONNECTICUT TRUST LAW COMPARISON

March 18, 2016

KEY DELAWARE ADVANTAGES

- **Directed trust—under long-standing Delaware practice/statute—upheld by court—trust instrument can bifurcate trustee's duties**
- **Self-settled asset protection trust (APT)—Delaware allows, including for lifetime marital-deduction, credit-shelter, and other trusts**
- **Silent trust—Delaware trust instrument may restrict disclosure of information to beneficiary for period of time**
- **Perpetual trust—Delaware permits; Delaware also allows donee to exercise nongeneral power of appointment to spring Delaware tax trap and get stepped-up income-tax basis**
- **Trust modification— Delaware allows by merger, nonjudicial settlement agreement, and court petition as well as by decanting**
- **Lifetime validation of trust—under Delaware statute—upheld by Delaware Supreme Court—notified person must act within 120 days**
- **No-contest clause—Delaware enforces in trust as well as in Will**
- **Income tax—tax might be avoided if nongrantor inter vivos trust has Delaware not Connecticut trustee**
- **Trust provisions—Delaware more flexible**
- **Court system—Delaware courts address trust matters promptly and efficiently**
- **Unitrust—Delaware statutes allow creation of new trust as unitrust and conversion of income trust into unitrust**
- **Power to adjust—Delaware statute more flexible**
- **Third-party trust—Delaware statutes protect beneficiary's interest in spendthrift and discretionary trusts**
- **Noncharitable purpose trust—Delaware permits perpetual trust for any noncharitable purpose**
- **Insurance trust—Delaware gives trustee of ILIT insurable interest**
- **Trust laws—Delaware updates more frequently**

Prepared by Richard W. Nenno, Esquire, Senior Managing Director and Trust Counsel

WILMINGTON TRUST

COMPARISON OF DELAWARE AND CONNECTICUT TRUST LAWS

POINT OF LAW	DELAWARE	CONNECTICUT
Directed Trust **Division of Trustee Duties**	Since 1986 (codifying practice dating from early 20th century)—trust may designate person to direct trustee on investment, distribution, and other decisions. Directed trustee not liable for following direction or not taking specified action without direction of adviser except for wilful misconduct and has no duty to monitor adviser's activities. Adviser is fiduciary unless instrument provides otherwise and must furnish directed trustee with specified information (12 Del. C. §§ 3301(g), 3313, 3317). Del. Court of Chancery enforced statute in unreported case (Duemler, 2004 WL 5383927 (2004)).	No statute.
Asset Protection Trust (APT) **Self-Settled Spendthrift Trust**	Del. law recognizes domestic APT. Since 1997—creditor may reach settlor's interest only in limited circumstances under Qualified Dispositions in Trust Act (12 Del. C. §§ 3570–3576). Del. Court of Chancery held creditors' attempt to reach assets of Del. APTs time-barred (TrustCo, 2015 WL 295373 (2015)). Since 2009—creditor may not reach settlor's contingent interest in lifetime marital-deduction trust, credit-shelter trust, or other trust (12 Del. C. § 3536(c)(1)).	No statute.
Disclosure to Beneficiary **Silent Trust**	Since 2003—trust instrument may restrict disclosure of information to beneficiary for period to time, such as until beneficiary reaches specified age, death of settlor or spouse, end of term of years or arrival of specified date, or occurrence of specified event. Designated representative may represent and bind beneficiary in judicial or nonjudicial proceeding. (12 Del. C. §§ 3303, 3339). Absent such language, trustee must provide current beneficiary with relevant information about trust (McNeil, 798 A.2d 503 (2002)).	No statute.
Rule Against Perpetuities **Permissible Duration of Trust**	Since 1933 statute—perpetual trust possible through exercise of Del. nongeneral power of appointment. Since 1995 statute—trust interest in personal property may be perpetual; trust interest in real property must vest within 110 years after creation of interest (limitation may be avoided by putting interest in FLP, LLC, or other entity). Nongeneral power of appointment may be exercised to spring Del. tax trap and get stepped-up income-tax basis (25 Del. C. §§ 501–505).	Since 1989—Uniform Statutory Rule Against Perpetuities—trust interest must vest 21 years after death of individual living when interest was created (Conn. Gen. Stat. § 45a-491). Nongeneral power of appointment may not be exercised to spring Del. tax trap and get stepped-up income-tax basis (Conn. Gen. Stat. § 45a-491(c)).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND CONNECTICUT TRUST LAWS continued

POINT OF LAW	DELAWARE	CONNECTICUT
Modification of Trust		
❖ **Merger/ Combination**	Since 2005—trustee may merge old and new trusts unless merger would result in material change in beneficial interests of trust beneficiaries (12 Del. C. § 3325(29)).	No statute.
❖ **Decanting**	Since 2003—trustee of testamentary or irrevocable inter vivos trust (including revocable trust in which settlor is incapacitated) with power to invade principal/income may distribute principal/income into another trust with same or more limited distribution standards and for benefit of all or fewer of beneficiaries of first trust (12 Del. C. § 3528).	Since 1976—donee of power of appointment may appoint property in further trust and may create further special powers of appointment (Conn. Gen. Stat. § 45a-572).
❖ **Nonjudicial Settlement Agreement**	Since 2013—modification may not violate material purpose of trust and must be of type otherwise approvable by court. Trustee, specified beneficiaries, and other interested persons must consent (12 Del. C. § 3338).	No statute.
❖ **Court Petition**	Formalized in 2012 via Del. Ct. Ch. Rs. 100–104, Del. Court of Chancery may modify trust under consent-petition procedure. Del. Court of Chancery denied petition to modify trust that departed from testator's intent in unreported case (Flint, 118 A.3d 182 (2015)).	No statute.
No-Contest (In Terrorem) Clause	Enforcement during lifetime of settlor. Since 2003—person barred from bringing judicial proceeding to contest validity of revocable trust, amendment to revocable trust, or irrevocable trust 120 days after notice by trustee (12 Del. C. § 3546). Del. Supreme Court enforced statute in unreported case (Ravet, 2015 WL 631588 (2015)). No-contest clause generally enforceable in Will or trust (12 Del. C. § 3329).	No-contest clause generally enforceable in Will (Thompson, 1999 WL 311241 (1999)).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND CONNECTICUT TRUST LAWS continued

POINT OF LAW	DELAWARE	CONNECTICUT
Taxation of Trust Income	For nongrantor trust, tax is not payable and return is not due if trust has no Del. resident beneficiary. Combination of Del.'s small population and its favorable rule for determining residence of future beneficiary means that few trusts created by nonresidents pay Del. income tax. For trust subject to tax, highest rate in 2016 is 6.60% (30 Del. C. §§ 1102(a)(14), 1601(8), 1605(b), 1636).	Settlor taxed on all income of trust treated as grantor trust for federal purposes. In 2016, tax of 6.99% payable by trustee on accumulated ordinary income and capital gains of nongrantor trust created by Will of Conn. decedent or inter vivos trust created by Conn. settlor except to extent inter vivos trust has nonresident noncontigent beneficiaries (Conn. Gen. Stat. §§ 12-700(a)(9)(E), (a)(10), 12-701(a)(4)(C)–(D); Conn. Agencies Regs. § 12-701(a)(4)-1; Gavin, 249 Conn. 172 (1999)). Tax might not be payable if inter vivos trust with noncontingent Conn. beneficiary has no Conn. trustee, asset, or source income (see Kaestner, 2015 WL 1880607 (N.C. 2015); Linn, 2 N.E.3d 1203 (Ill. 2013); McNeil, 67 A.3d 185 (Pa. 2013)).
Flexibility in Drafting Trust Provisions	Since 2003—regardless of common law or other statute, governing instrument may expand, restrict, eliminate, or otherwise vary rights and interests of beneficiary. Specifically, trust may negate duty to diversify investments or defer age at which trustee must notify beneficiary of trust interest (12 Del. C. § 3303(a)).	No statute.
2015 State Lawsuit Climate Ranking[1]	# 1. Judges are appointed by Governor with consent of Senate and must come as equally as possible from two major political parties (Del. Const. Art. IV, § 3). Judges decide all trust issues.	# 22.

[1] Based on data in U.S. Chamber of Commerce survey available at www.instituteforlegalreform.com/states (last visited March 18, 2016).

WILMINGTON TRUST

COMPARISON OF DELAWARE AND CONNECTICUT TRUST LAWS continued

POINT OF LAW	DELAWARE	CONNECTICUT
Unitrust		
❖ **Recognition of Trust Created as Unitrust**	Since 2004—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-107).	No statute.
❖ **Procedure for Converting Income Trust into Total-Return Unitrust**	Since 2001—3%–5% range permitted—includes tax-ordering rule (12 Del. C. § 61-106).	No statute.
Power to Adjust **Between Income and Principal Under § 104 of 1997 Uniform Principal and Income Act**	Since 2005—includes tax-ordering rule (12 Del. C. §§ 61-104–61-105).	Since 2001 (Conn. Gen. Stat. § 45a-542c).
Rule Against Accumulations	Since 1986—no provision directing or authorizing accumulation of trust income is invalid (25 Del. C. § 506).	No statute.
Third-Party Trust		
❖ **Enforcement of Spendthrift Clause**	By statute, trust income and principal not subject to voluntary or involuntary transfer. Amount that may be protected is not limited (12 Del. C. § 3536). By caselaw, trust income may be reached for separate maintenance of current—but not divorced—spouse (Garretson, 306 A.2d 737 (1973)).	No statute.
❖ **Discretionary Interest**	Since 2007—creditor may not compel distribution of discretionary interest. Court may change trustee's exercise of discretion only for abuse of discretion within meaning of Second Restatement of Trusts (12 Del. C. §§ 3315, 3536).	No statute.

WILMINGTON TRUST

COMPARISON OF DELAWARE AND CONNECTICUT TRUST LAWS continued

POINT OF LAW	DELAWARE	CONNECTICUT
Noncharitable Purpose Trust	Since 2007—perpetual trust for any noncharitable purpose is valid (12 Del. C. § 3556, 25 Del. C. § 503(a)).	Since 2009—trust for care of animal is valid until death of animal (Conn. Gen. Stat. § 45a-489a).
Trustee of ILIT Has Insurable Interest	Since 1998 (18 Del. C. § 2704(c)(5)).	No statute.
Investment Rules	In 1986—prudent-investor rule was adopted. Trustee may consider other resources and trust interests in determining investment policy for trust (12 Del. C. § 3302). Since 2003—special rules set for acquisition and administration of life insurance by trustee (12 Del. C. § 3302(d)).	In 1997— Uniform Prudent Investor Act was adopted (Conn. Gen. Stat. §§ 45a-541–45a-541l).

2016 PRIVATE WEALTH AND TAXATION INSTITUTE

A COMPARISON OF DELAWARE, NEVADA, AND SOUTH DAKOTA TRUST LAWS

Richard W. Nenno, Esquire
Senior Managing Director and Trust Counsel
Wilmington Trust Company
Rodney Square North
1100 North Market Street
Wilmington, Delaware 19890-0001
Tel: (302) 651-8113
Fax: (302) 427-4920
rnenno@wilmingtontrust.com

May 19, 2016

A Comparison of Delaware, Nevada, and South Dakota Trust Laws

By
Richard W. Nenno, Esquire
Wilmington Trust Company
Wilmington, DE

I. INTRODUCTION

Choosing an appropriate jurisdiction for a client's trusts is a critical part of the estate-planning process. Delaware, Nevada, and South Dakota generally are recognized as leading U.S. personal trust jurisdictions. This paper will compare their trust infrastructures and trust laws.

II. TRUST INFRASTRUCTURE

A. Trust Tradition

Delaware has been trust-friendly for longer than Nevada or South Dakota. The following table shows the year in which each state first developed attractive trust laws:

	Delaware	Nevada	South Dakota
Year Became Trust Friendly	1903[1]	1999[2]	1983[3]

Delaware's longstanding leadership in the trust field has been verified empirically. Hence, Professor Robert Sitkoff of Harvard Law School and Professor Max Schanzenbach of Northwestern University School of Law reported in a 2006 empirical study, which analyzed pertinent data beginning in 1969, that, "Delaware was clearly attracting trust funds from out of state in the early 1970s,"[4] and that, "[i]n 1986 Delaware had a disproportionate share of the nation's trust funds."[5]

---

[1] Wilmington Trust Company founded.

[2] Nevada Spendthrift Trust Act amended to permit self-settled trusts (1999 Nev. Laws 299).

[3] South Dakota rule against perpetuities amended to permit perpetual trusts (1983 S.D. Sess. Laws 304).

[4] Schanzenbach & Sitkoff, Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust, 27 Cardozo L. Rev. 2465, 2495–96 (Apr. 2006).

[5] Schanzenbach & Sitkoff, Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust, 27 Cardozo L. Rev. 2465, 2479 (Apr. 2006). See Sitkoff & Schanzenbach, Perpetuities, Taxes, and Asset Protection: An Empirical Assessment of the Jurisdictional Competition for Trust Funds, 42 U. Miami Inst. on Est. Plan. ¶ 1400 (2008); Sitkoff

In 2010, a coalition of Delaware law firms and financial institutions commissioned Professor Schanzenbach to assess the impact of personal trusts created by non-Delaware residents on the state's economy. Professor Schanzenbach's report,[6] dated May 25, 2011, quantified Delaware's past and present success in the personal trust field. Highlights of the report include:

- Personal trusts created by nonresidents contribute as much as $1.1 billion (2% of economic output) to Delaware's economy annually.
- Such trusts generate at least $300 million of trustee fees in Delaware each year.
- As much as $33 million in annual Delaware income tax revenue is attributable to the state's excess trust business.
- Delaware's personal trust business has grown substantially over the past decade, taking an increasingly larger share of a growing national market, and the state is well-positioned to continue to grow this business.

Given that South Dakota's and Nevada's efforts to attract trust business did not begin until 1983 and 1999, respectively, time will tell whether these efforts will continue.

B. Financial Condition

The following table shows the rating agencies' assessment of Delaware's, Nevada's, and South Dakota's financial condition:

Agency	Delaware	Nevada	South Dakota
Moody's[7]	Aaa (states 1–15)	Aa2 (states 34–44)	Aa1[8] (states 16–33)
Standard & Poor's[9]	AAA (states 1–16)	AA (states 30–44)	AAA (states 1–16)

C. Nearby Population

& Schanzenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J.356, 375 n.62, 393–94 (Nov. 2005).

[6] Professor Schanzenbach's report may be viewed at www.leimbergservices.com/docs/report-5-25-11b.pdf (last visited Mar. 23, 2016).

[7] www.moodys.com (last visited Mar. 23, 2016).

[8] Moody's does not give a general obligation rating for South Dakota, but a Aa2 lease debt rating generally equates to a Aa1 overall rating.

[9] www.standardandpoors.com (last visited Mar. 23, 2016).

As shown by the 2010 census,[10] Delaware can draw on a much larger talent pool for its trust industry than Nevada or South Dakota:

Population	Wilmington, Delaware	Reno, Nevada	Sioux Falls, South Dakota
Within 50 miles	7,151,472	588,804	335,369
Within 100 miles	20,464,043	1,690,519	908,084
Within 150 miles	40,244,858	4,942,483	1,656,250

Staff members commute to Wilmington from Maryland, New Jersey, and Pennsylvania (including Philadelphia) as well as from Delaware. Many had relevant prior experience in Baltimore, New York City, Philadelphia, and Washington, DC, and elsewhere.

D. Court System

I'm not aware of a national ranking of probate court systems. But, since 2002, the United States Chamber of Commerce has issued 10 rankings of state liability systems. The ratings for Delaware, Nevada, and South Dakota in each of those studies are shown below:[11]

Year	Delaware	Nevada	South Dakota
2015	1	35	9
2012	1	37	11
2010	1	28	10
2008	1	40	12
2007	1	28	11
2006	1	37	7
2005	1	29	8
2004	1	34	17
2003	1	34	4
2002	1	30	9

E. Number of ACTEC Fellows

The American College of Trust and Estate Counsel ("ACTEC") is known as the leading organization of trusts and estates attorneys. The following table shows the number of ACTEC fellows from Delaware, Nevada, and South Dakota:

	Delaware	Nevada	South Dakota
Population in 2014[12]	935,614	2,839,000	853,175

[10] 2010 U.S. Census. The population figures for Las Vegas, NV, are 1,992,016 within 50 miles, 2,177,630 within 100 miles, and 2,505,505 within 150 miles.

[11] www.instituteforlegalreform.com/states (last visited Mar. 23, 2016).

[12] U.S. Census Bureau.

Number of ACTEC Fellows[13]	16	5	15

F. Trust Conference

The Delaware Bankers Association held its tenth annual Delaware Trust Conference in Wilmington on October 26 and October 27, 2015.[14] This one-of-a-kind program drew almost 400 attendees from throughout the country. In addition to round-table discussions, the sessions included:

- Recent Developments in Federal Case Law, Regulations, and Delaware Trust Law
- Roadblocks to Utilizing Delaware Trusts
- Trust Ethics
- Trust Design: Drafting Delaware Trusts
- Multinational Planning with Delaware Trusts
- Completing the Picture of Wealth: Managing Tangible Assets
- Silent Trusts and Beneficiary Notice Considerations
- Domestic Asset Protection Trusts Under Attack
- Trust Litigation in Delaware: An Inside Look at Gore, Mennen and Kloiber
- Working with Dysfunctional Families When Exercising Discretion: Handling the Difficult Discussions
- Fiduciary Risk Management
- Dispelling the Myths: Why Directed Trusts are Not as Simple as They Seem
- Running the Basis (Catching Maximum Tax Savings)
- The Value Proposition: The Key Benefits a Corporate Trustee Can Make in Trust Administration
- Addressing Diminished Capacity of Donors, Individual Trustees and Advisers: Plan Now or Confront It Later
- Trust Portability: Using NJSA's, Mergers and Decantings to Move Trusts
- Trusts for Multinational Families: Navigating the Tangled Tax and Regulatory Compliance Web
- Recent Developments: Questions and Answers
- Case Studies in Ethical Behavior.

Only 26 of the 58 presenters were from outside Delaware. Fourteen speakers were practicing Delaware attorneys; 15 others were Delaware representatives of 13 different trust institutions. I'm not aware of a similar program in Nevada or South Dakota (let alone one that has been held for the past 10 years) and doubt that either state can match the depth of Delaware's local talent.

The 11th Annual Delaware Trust Conference is scheduled for October 25th and

[13] www.actec.org.

[14] www.debankers.com/2015_DE_Trust_Conf.html (last visited Mar. 23, 2016).

26th in Wilmington.

G. Academic Program

At this writing, the University of Delaware is introducing a minor in trust services in its business school. Soon, students from throughout the country will be able to come to Delaware for training in the trust field. I'm not aware of a comparable academic program elsewhere.

H. Summary

Based on what's shown above, one can agree that Delaware's trust infrastructure has a significant advantage over the other states. For these reasons and because Delaware continually strives to modernize its trust laws, a client and his or her advisers should at least consider Delaware in almost every case.

III. A COMPARISON OF DELAWARE AND NEVADA TRUST LAWS

A. Trust Legislation Generally

1. Nevada Advantages

In my view, Nevada offers the following advantages.

a. Proximity

Nevada is adjacent to California. Many Californians own property in Nevada and visit the state with some frequency.

b. Electronic Trusts

Nevada allows settlors (but not testators) to create electronic trusts;[15] Delaware does not have a comparable provision.

c. Spousal Claims

By caselaw, Delaware allows a current—but not a divorced—spouse to reach the assets of a third-party trust for support,[16] but Nevada practitioners often misrepresent this advantage. Typical is the following statement in a January 2016 article:[17]

---

[15] NRS § 163.0095.

[16] Garretson v. Garretson, 306 A.2d 737 (Del. 1973).

[17] Oshins & Siegel, The Anatomy of the Perfect Modern Trust—Part 1, 43 Est. Plan. 3, 12 (Jan. 2016) (footnote omitted).

> Delaware provides that spouses who are beneficiaries of discretionary trusts do not receive protection of their trust assets from alimony claims of a divorced spouse.

In the case in question, the Supreme Court of Delaware noted that, "we . . . . consider that, ... the record discloses solely that the individual parties are still husband and wife."[18] The court concluded:[19]

> It of course remains to be seen, if the husband appears generally in this litigation and subjects himself to the jurisdiction of the Court of Chancery, whether, on final hearing, his contentions with regard to his Mexican divorce will be ultimately upheld, in which event we assume that the wife would lose her status as wife, and there may be an entirely different situation then facing the Chancellor. This question, however, is not before us, and we make no ruling upon the future outcome of the course of the litigation.

2. Delaware Advantages

To my knowledge, Delaware offers the following advantages.

a. Perpetual Trusts

Since 1933, perpetual trusts have been available in Delaware through the exercise of nongeneral powers of appointment.[20] Since 1995, trust interests in personal property may be perpetual.[21] Although trust interests in real property must vest within 110 years after creation of the interest,[22] this limitation may be avoided by putting the interest in a family limited partnership ("FLP"), limited-liability company ("LLC"), or other entity.[23]

---

[18] Garretson, 306 A.2d at 739.

[19] 306 A.2d at 742.

[20] 38 Del. Laws 198 (1933).

[21] 25 Del. C. § 503(a).

[22] 25 Del. C. § 503(b).

[23] 25 Del. C. § 503(e).

A Nevada statute has permitted the creation of 365-year trusts since 2005,[24] but the statute might be invalid. This is because Nevada's constitution contains the following prohibition:[25]

> No perpetuities shall be allowed except for eleemosynary purposes.

Moreover, Nevada voters disapproved a ballot initiative to repeal the constitutional prohibition in 2002. Regarding this issue, Professor Sitkoff and a co-author wrote in 2014 that:[26]

> [L]egislation authorizing perpetual or long-enduring dynasty trusts is constitutionally suspect in a state with a constitutional prohibition of perpetuities.

A Nevada practitioner contends that a 1941 decision of the Supreme Court of Nevada[27] and a 2015 decision of the same court[28] mean that the constitutional limitation no longer is relevant.

The earlier case was decided long before Nevada adopted a 365-year period for trust interests. Its entire description of the law of perpetuities in Nevada is as follows:[29]

> Section 4 of article XV of the constitution of Nevada reads: "No perpetuities shall be allowed except for eleemosynary purposes." There is no Nevada statute defining the rule against perpetuities. The common-law rule is usually stated thus: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest." **Other than the**

---

[24] NRS § 111.1031.

[25] Nev. Const. Art. 15, § 4.

[26] Horowitz & Sitkoff, Unconstitutional Perpetual Trusts, 67 Vand. L. Rev. 1769, 1803 (Nov. 2014). Accord Blattmachr, Gans & Lipkin, What if Perpetual Trusts are Unconstitutional?, LISI Est. Plng. Newsltr. #2263 (Dec. 18, 2014), www.leimbergservices.com.

[27] Sarrazin v. First Nat'l Bank, 111 P.2d 49 (Nev. 1941). See Oshins, The Rebuttal to Unconstitutional Perpetual Trusts, LISI Est. Plng. Newsltr. #2265 (Dec. 22, 2014), www.leimbergservices.com.

[28] Bullion Monarch Mining, Inc. v. Barrick Gold Strike Mines, Inc., 345 P.3d 1040 (Nev. 2015). See Oshins, Unconstitutional Perpetual Trusts—Not So Fast Says the Nevada Supreme Court, LISI Est. Plng. Newsltr #2297 (Apr. 6, 2015), www.leimbergservices.com.

[29] Sarrazin, 111 P.2d at 51 (citation omitted; emphasis added).

> **constitutional provision above quoted, there have not been called to our attention any other provisions, either constitutional or statutory, invalidating interests which vest too remotely, or forbidding restraints on alienation.**

The above emphasized sentence is dictum at best because the court concluded that all interests in the trust in question would vest within the common-law rule against perpetuities period.[30]

The later case involved the applicability of Nevada's rule against perpetuities to "commercial mining agreements for the payment of area-of-interest royalties."[31] Not surprisingly, the court held that it did not.[32] In the course of the opinion, the court discussed a 1974 case as endorsing statutes that depart from the common law.[33] Nevertheless, the 1974 case, which dealt with the "old common-law rule of interspousal immunity,"[34] did not involve a common-law rule that had been codified in Nevada's constitution.

A decision of the Supreme Court of Nevada validating 365-year trusts might be helpful. It has been suggested that the court would uphold the statute in the interest of supporting Nevada's business-development efforts. That would be a regrettable basis for such a decision if the law is to the contrary.

The best way to resolve the issue would be for the voters to repeal the constitutional prohibition.

b. Delaware Tax Trap

In Nevada, a donee of a nongeneral power of appointment cannot exercise the power to trigger the so-called "Delaware tax trap."[35] In Delaware, the donee of such a power may exercise it either to spring the trap or not to spring it.[36] Having the option to trigger

---

[30] 111 P.2d at 53.

[31] Bullion Monarch Mining, 345 P.3d at 1041.

[32] 345 P.3d at 1044.

[33] Rupert v. Stienne, 528 P.2d 1013 (Nev. 1974).

[34] Bullion Monarch Mining, 345 P.3d at 1042.

[35] NRS § 111.1031(3).

[36] 25 Del. C. §§ 501–505. See Nenno, Getting a Stepped-Up Income-Tax Basis and More by Springing—or Not Springing—The Delaware Tax Trap the Old-Fashioned Way, 40 Tax Mgmt. Est., Gifts & Tr. J. 215 (Sept. 10, 2015).

the trap and thereby to cause estate-tax inclusion and to get a stepped-up income-tax basis is important given the recent increase in federal transfer-tax exemptions and income-tax rates.

c. Directed Trusts

Under long-standing Delaware practice/statute,[37] which has been upheld by a court,[38] a trust instrument can bifurcate the trustee's duties. The Nevada statute[39] is relatively new and untested.

d. Silent Trusts

Delaware and Nevada statutes allow a trust instrument to postpone the sharing of information with trust beneficiaries for a period of time.[40] The Delaware statute is more comprehensive, though, because it lists examples of such periods (such as until a beneficiary reaches a specified age or the settlor dies) and allows a designated representative to receive information.

e. Lifetime Validation of Trusts

Under a Delaware statute, which was upheld by the Delaware Supreme Court,[41] a trust beneficiary must object to the creation of a revocable trust, an amendment to a revocable trust, or an irrevocable trust within 120 days after receiving notice from the trustee. The Nevada statute[42] is relatively new and untested.

f. Court Systems

The highly regarded Delaware courts address trust matters promptly and efficiently. They decided important trust cases decades ago[43]and in more recent years.[44] To date, Nevada courts

---

[37] 12 Del. C. § 3313. See Nenno, Good Directions Needed When Using Directed Trusts, 42 Est. Plan. 12 (Dec. 2015).

[38] Duemler v. Wilmington Trust Co., 2004 WL 5383927 (Del. Ch. 2004).

[39] NRS § 163.5549.

[40] 12 Del. C. §§ 3303, 3339; NRS §§ 163.004(1)(a), 165.160(1)(a).

[41] 12 Del. C. § 3546; Ravet v. Northern Trust Co., 2015 WL 631588 (Del. 2015).

[42] NRS § 164.021(4).

[43] See, e.g., Wilmington Trust Co. v. Wilmington Trust Co., 24 A.2d 309 (Del. 1942) (applicability of Delaware law); Lewis v. Hanson, 128 A.2d 819 (Del. 1957), aff'd, 357 U.S. 235 (1958) (same); Gibson v. Speegle, 184 Del. Ch. Lexis 475 (Del. Ch. 1984) (spendthrift trust).

[44] See, e.g., Ravet v. Northern Trust Co., 2015 WL 631588 (Del. 2015) (lifetime validation of trust); In re Peierls Family Testamentary Trusts, 77 A.3d 223 (Del. 2013) (applicability of Delaware law); In re Peierls Charitable Lead Unitrust, 77 A.3d 232 (Del. 2013) (same); In re Peierls Family Inter Vivos Trusts, 77 A.3d 249 (Del. 2013) (same);

have not rendered comparable decisions.

g. New Unitrusts

A Delaware statute allows the creation of a new trust as a unitrust.[45] Nevada doesn't have a comparable statute.

h. Noncharitable Purpose Trusts

Delaware permits a perpetual trust for any noncharitable purpose.[46] Nevada legislation covers trusts for animals only.[47]

i. Trust Legislation

Delaware has state-of-the-art trust laws, which it refines almost every year. Because the Nevada legislature ordinarily meets only in odd years, Nevada cannot enact badly needed legislation in 2016 and other even years. In addition, Nevada has not passed certain key provisions until long after its competitors. For example, it did not enact a directed trustee or decanting statute until 2009.[48]

B. Asset-Protection Trust Legislation

1. Nevada Advantages

The Nevada asset-protection trust ("APT") legislation ("Nevada Act") supposedly has the following advantages.

a. Limitations Periods

The limitations periods for bringing actions to contest APTs are half as long under the Nevada Act as under the Delaware Act. Specifically, Nevada requires present creditors to sue within two years of a transfer or six months after the date on which a transfer was discovered or reasonably should have been discovered, whichever is later, while future creditors must sue within two years of a transfer.[49] Delaware's time spans are double that (four

---

Duemler v. Wilmington Trust Co., 2004 WL 5383927 (Del. Ch. 2004) (directed trusts).

[45] 12 Del. C. § 61-107.

[46] 12 Del. C. § 3556, 25 Del. C. § 503(a).

[47] NRS §§ 163.006(4), 163.0075.

[48] 2009 Nev. Stat. 215, §§ 20–35 (directed trustee) (2009); 2009 Nev. Stat. 215, § 37 (decanting) (2009).

[49] NRS § 166.170(1).

years/one year for present creditors, four years for future creditors).[50] Thus, the difference is the "added time" available to plaintiffs under Delaware law. This "advantage" is more apparent than real for the following reasons.

(1) Given that the determination as to whether the creation of an APT is a fraudulent transfer is made as of the time the trust was created not when a creditor brings a challenge, the statute of limitations really doesn't matter. If an APT is properly constructed at the outset, then a creditor will lose no matter when he or she brings suit.

(2) If a settlor really is concerned about statutes of limitations, he or she will not go to Nevada. Instead, he or she will go to an offshore jurisdiction where limitations periods are even shorter and claims are even harder to prove.

(3) Nevada's limitations periods will not apply if the debtor ends up in bankruptcy.[51]

(4) Conflict-of-laws rules will allow courts of other states to apply their longer limitations periods in many instances.

b. Family Claims

Unlike the Delaware APT legislation ("Delaware Act"),[52] the Nevada Act contains no specific exception for claims by spouses, former spouses, and minor children related to separation or divorce proceedings. It should be noted, however, that Delaware's exception for spousal claims is far narrower than might appear because it does not extend to future spouses and because it limits the rights of current and former spouses.[53] Moreover, this Nevada "advantage" might not exist at all for the following reasons.

(1) A Nevada statute,[54] as amended in 2011,[55] provides:

> A creditor may not bring an action with respect to transfer of property to

[50] 12 Del. C. § 3572(b), 6 Del. C § 1309.

[51] 11 U.S.C. § 548(e).

[52] 12 Del. C. § 3573(1).

[53] 12 Del. C. § 3570(9), 12 Del. C. § 3573, flush language at end.

[54] NRS § 166.170(3) (emphasis added).

[55] 2011 Nev. Stat. 270, § 206 (2011).

> a spendthrift trust unless a creditor can prove by clear and convincing evidence that the transfer of property was a fraudulent transfer pursuant to chapter 112 of NRS or that **the transfer violates a legal obligation owed to the creditor under a contract or a valid court order that is legally enforceable by that creditor.**

It certainly appears that the emphasized language will give spouses with alimony and child-support claims an opportunity to reach the assets of Nevada APTs.

(2) Federal law might enable persons with child support claims to reach the assets of Nevada APTs.[56]

(3) Even if these exceptions are not already in the Nevada Act, Nevada courts might add them. In cases decided before and after the passage of the Nevada Act,[57] the Supreme Court of Nevada has demonstrated a propensity to establish nonstatutory exceptions to the state's homestead exception,[58] another state-created protection from creditor claims. Therefore, in sympathetic cases, Nevada courts might extend this judicial activism to Nevada APTs as well.

(4) This "advantage" is not important to clients. In a January 2014 article, two commentators, neither of whom practices in Nevada or Delaware, observe:[59]

> In an article we wrote in January 2013 for this journal, we also discussed that the existence of exception creditors, such as child support or maintenance, did little to weaken the asset protection of a DAPT. From a practical standpoint, we've never come across a situation

---

[56] 28 U.S.C. § 1738B.

[57] Breedlove v. Breedlove, 691 P.2d 426, 428 (1984); Phillips v. Morrow, 760 P.2d 115, 116–17 (1988); Maki v. Chong, 75 P.3d 376, 379 (2003).

[58] NRS §§ 115.005–115.090.

[59] Worthington & Merric, Which Trust Situs is Best in 2014?, 153 Tr. & Est. 53, 61–62 (Jan. 2014) (footnote omitted).

in which a client was proposing to create a DAPT with the objective of shirking a child support obligation.

c. Tort Claims

Nevada does not have Delaware's exception for tort claims that predate a transfer into an APT,[60] but the holder of such a claim might fall within the highlighted exception in the Nevada statute, quoted above.

2. Delaware Advantages

In my view, the Delaware Act[61] offers the following advantages.

a. Spendthrift Protection

Unlike the Delaware Act,[62] the Nevada Act does not require an APT to have any particular spendthrift clause and does not provide that a spendthrift trust is to fall within the trust exclusion under the federal bankruptcy code, which might expose trust assets to creditor claims in poorly drafted instruments, particularly if, as is permitted by the Nevada Act,[63] the trustee has minimal ties to the state.

b. Automatic Resignation

Unlike the Nevada Act, the Delaware Act[64] provides that the trustee of an APT will cease to act if a court determines that Delaware law does not govern the trust or the effect of its spendthrift clause.

c. Consequences of Successful Attack

Unlike the Nevada Act, the Delaware Act[65] describes the implications for the trust, the trustee, and the beneficiaries if a creditor brings a claim that may be paid from the trust. The

---

[60] 12 Del. C. § 3573(2).

[61] 12 Del. C. §§ 3570–3576. See Nenno, A Practitioner-Friendly Guide to the Delaware Asset-Protection Trust, 30 Prob. & Prop. 53 (Jan./Feb. 2016).

[62] 12 Del. C. § 3570(11)(c).

[63] NRS § 166.015(2).

[64] 12 Del. C. § 3572(g).

[65] 12 Del. C. § 3574.

inclusion of these provisions in the Delaware Act greatly increases its asset-protection effectiveness.[66]

d. Additional Distribution Options

A Delaware APT gives the settlor additional distribution options. Thus, a settlor may obtain creditor protection if he or she creates a self-settled trust that is a grantor-retained income trust ("GRIT") that meets the requirements of the Delaware Act.[67] A Delaware APT also may provide for the payment of debts, expenses, and taxes following the settlor's death.[68] This latter option might be particularly helpful when the settlor structures the APT as an incomplete gift and the APT's value appreciates relative to the size of the settlor's gross estate.

e. Tenancy-by-the-Entireties Property

Delaware law offers protection to tenancy-by-the-entireties personal property contributed to a Delaware APT.[69]

f. Public Policy

The Delaware Act is less "aggressive" than the Nevada Act. A court in a state that does not have domestic APT legislation that is adjudicating the ability of a creditor to reach the assets of a domestic APT therefore might be less likely to disregard Delaware law than Nevada law.

g. Lifetime Marital-Deduction Trusts

Unlike Nevada, Delaware does not permit creditors to reach a settlor's contingent interest in a lifetime marital-deduction trust, credit-shelter trust, or other trust.[70]

h. Court System

In 2015, the Delaware Court of Chancery held creditors' claims that transfers to Delaware APTs were fraudulent transfers to be

---

[66] Sullivan, III, Gutting the Rule Against Self-Settled Trusts, 23 Del. J. Corp. L. 423, 464, 475 (1998).

[67] 12 Del. C. § 3570(11)(b).

[68] 12 Del. C. § 3570(11)(b)(10).

[69] 12 Del. C. § 3574(f).

[70] 12 Del. C. § 3536(c)(1).

time-barred.[71] Nevada courts have not yet rendered decisions involving Nevada APTs.

i. Trust Legislation

Delaware revises its APT legislation frequently. As noted above, the Nevada legislature generally convenes only in odd years. Moreover, Nevada did not add crucial provisions to its APT legislation until 2009 or even 2011,[72] long after other states.

IV. A COMPARISON OF SOUTH DAKOTA AND DELAWARE TRUST LAWS

A. Trust Legislation Generally

1. South Dakota Advantages

In my opinion, South Dakota currently offers no advantages.

2. Delaware Advantages

a. Directed Trusts

Under long-standing Delaware practice/statute,[73] which was upheld by a court,[74] a trust instrument can bifurcate a trustee's duties. South Dakota's statute[75] is relatively new and untested.

b. Delaware Tax Trap

In South Dakota, the donee of a nongeneral power of appointment cannot exercise the power to trigger the Delaware tax trap.[76] In Delaware, the donee of such a power may exercise it either to spring the trap or not to spring it.[77] As noted above, recent federal tax changes make it important to have the option to spring the trap in certain circumstances to get a stepped-up income-tax basis.

---

[71] TrustCo v. Mathews, 2015 WL 295373 (Del. Ch. 2015).

[72] 2009 Nev. Stat. 215, §§ 58–60 (2009); 2011 Nev. Stat. 270, §§ 201–206 (2011).

[73] 12 Del. C. §§ 3301(g), 3313, 3317.

[74] Duemler v. Wilmington Trust Co., 2004 WL 5383927 (Del. Ch. 2004).

[75] S.D. Codified Laws §§ 55-1B-1–55-1B-11, 55-2-13.

[76] S.D. Codified Laws § 43-5-5.

[77] 25 Del. C. §§ 501–505

c. Silent Trusts

Delaware and South Dakota allow a trust instrument to postpone the sharing of information with beneficiaries for a period of time.[78] Delaware's legislation is more comprehensive because it lists specific periods (such as until a beneficiary reaches a certain age or until the settlor's death) and allows a designated representative to receive information.[79]

d. Trust Modification

The trustee and other interested persons as well as beneficiaries must consent to the modification of a trust in Delaware.[80] Beneficiaries alone may modify or terminate a trust in South Dakota so that a testator's/settlor's wishes might be defeated.[81] For example, in a 2014 case, a federal district judge in South Carolina dismissed a protector's petition to block the termination of a 2009 South Dakota dynasty trust because the protector lacked standing under South Dakota law.[82]

e. Trust Provisions

Since 2003, regardless of the common law or other statute, a Delaware governing instrument may expand, restrict, eliminate, or otherwise vary the rights and interests of the beneficiary. Specifically, the trust may negate the duty to diversify investments or defer the age at which a trustee must notify a beneficiary of a trust interest.[83] South Dakota's statute is less comprehensive.[84]

f. Court System

Over many decades, Delaware courts have rendered leading trust decisions, [85] whereas South Dakota courts have yet to display such

---

[78] 12 Del. C. §§ 3303, 3339; S.D. Codified Laws § 55-2-13.

[79] 12 Del. C. §§ 3303, 3339.

[80] 12 Del. C. § 3338.

[81] S.D. Codified Laws § 55-3-24.

[82] McDevitt v. Wellin, 2014 WL 7146967 (D.S.C. 2014).

[83] 12 Del. C. § 3303(a).

[84] S.D. Codified Laws § 55-1-53.

[85] See, e.g., Ravet v. Northern Trust Co., 2015 WL 631588 (Del. 2015) (lifetime validation of trust); In re Peierls Family Testamentary Trusts, 77 A.3d 223 (Del. 2013) (applicability of Delaware law); In re Peierls Charitable Lead Unitrust, 77 A.3d 232 (Del. 2013) (same); In re Peierls Family Inter Vivos Trusts, 77 A.3d 249 (Del. 2013) (same); Lewis v. Hanson, 128 A.2d 819 (1957), aff'd, 357 U.S. 235 (1958) (applicability of Delaware law); Wilmington

leadership.

g. Trust Laws

Delaware updates its trust laws more promptly than South Dakota. South Dakota often copies Delaware's legislation.

B. Asset-Protection Trust Legislation

Both South Dakota's APT statute ("South Dakota Act") and the Delaware Act are attractive laws. It is not surprising that South Dakota's laws are favorable because it essentially copied Delaware's provisions.

1. South Dakota Advantages

In my view, South Dakota offers the following advantages.

a. Future Claims

Whereas the general limitations rule in Delaware is four years,[86] South Dakota's general limitations rule is two years.[87] For reasons discussed above for the Nevada Act, this "advantage" might be more apparent than real.

b. Existing Claims

Delaware's "date-of-discovery" rule, which extends the limitations period for certain existing creditors, requires that plaintiffs file suit within one year of the time they discovered or should have discovered a claim against the APT.[88] South Dakota's six-month date of discovery rule also imposes on plaintiffs a duty to file suit on the underlying claims within certain time periods.[89] Further, Delaware requires that future creditors prove an intent to defraud, and does not allow future creditors to prevail based on showings of intent to hinder or delay. However, existing creditors can still prevail by proving an intent to hinder or delay.[90] South Dakota,

---

Trust Co. v. Wilmington Trust Co., 24 A.2d 309 (same); Duemler v. Wilmington Trust Company, 2004 WL 5383927 (Del. Ch. 2004) (directed trusts); Gibson v. Speegle, 184 Del. Ch. Lexis 475 (Del. Ch. 1984) (spendthrift trust).

[86] 12 Del. C. § 3572, 6 Del. C. § 1309.

[87] S.D. Codified Laws § 55-16-10.

[88] 12 Del. C. § 3572(b)(1).

[89] S.D. Codified Laws § 55-16-10.

[90] 12 Del. C. § 3572(a), 6 Del. C. §§ 1304–1305.

however, has eliminated the "hinder or delay" theory for all creditors.[91]

c. Tort Claims

Unlike South Dakota, Delaware permits a person who has a tort claim against the settlor when the settlor creates a Delaware APT to reach the assets of the trust at any time.[92] Nevertheless, creditors availing themselves of this exception in Delaware's law almost always will pursue their claims within the time limits imposed by the South Dakota Act for pre-existing claims, i.e., within two years after the trust was created or, if later, within six months after the creditor discovered (or should have discovered) the trust.

2. Delaware Advantages

In my view, Delaware offers the following advantages.

a. GRAT/GRUT

In Delaware,[93] a settlor may keep an interest in a grantor-retained annuity trust ("GRAT") or grantor-retained unitrust ("GRUT") but, in South Dakota, a settlor may retain only up to a 5% interest in such a trust.[94]

b. Spousal Claims

In Delaware,[95] but not in South Dakota,[96] a spouse or former spouse may reach the assets of an APT for property division, etc., only if it is "incident to a judicial proceeding with respect to a separation or divorce."

c. Right of Election

In South Dakota,[97] but not in Delaware,[98] a surviving spouse may

[91] S.D. Codified Laws § 55-16-9.

[92] 12 Del. C. § 3573(2).

[93] 12 Del. C. § 3570(11)(b)(5).

[94] S.D. Codified Laws § 55-16-2(2)(f).

[95] 12 Del. C. § 3573(1).

[96] S.D. Codified Laws § 55-16-15(1).

[97] S.D. Codified Laws §§ 29A-2-202(d), 29A-2-205(2)(i).

[98] 12 Del. C. § 3573, flush language at end.

reach the assets of a South Dakota APT by electing against the Will of a South Dakota resident or nonresident decedent.

d. Tenancy-by-the-Entireties

Unlike South Dakota, Delaware provides protection for tenancy-by-the-entireties personal property contributed to an APT.[99]

e. Lifetime Trusts

Delaware allows creditor protection for a donor's contingent interest in a lifetime qualified-terminable-interest-property ("QTIP") trust, credit-shelter trust, or other trust.[100] To date, South Dakota does not have such legislation.

f. Court System

In 2015, the Delaware Court of Chancery held creditors' claims that transfers to Delaware APTs were fraudulent transfers to be time-barred.[101] South Dakota courts have not yet ruled on the viability of South Dakota APTs.

g. Trust Legislation

Delaware updates its APT legislation more promptly than South Dakota.

---

[99] 12 Del. C. § 3574(f).

[100] 12 Del. C. § 3536(c)(1).

[101] TrustCo v. Mathews, 2015 WL 295373 (Del. Ch. 2015).

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2331

Date: 11-Aug-15
From: Steve Leimberg's Estate Planning Newsletter
Subject: Richard Nenno on the Taxpayer Victory in New Jersey Kassner Case: More Than One Way to Skin a Cat and Save State Income Taxes on Trusts

"Following the United States Supreme Court's Quill decision in 1992, the tide appeared to be flowing in the direction of sustaining states' power to tax trust income. Thus, the Court of Appeals of the District of Columbia and the Supreme Court of Connecticut upheld their states' ability to tax in questionable circumstances.

Since 2013, though, the tide appears to have turned as five state courts have denied their states' power to tax. In addition to the New Jersey Tax Court and the Appellate Division of the Superior Court of New Jersey, they are the Commonwealth Court of Pennsylvania, the Appellate Court of Illinois, and the North Carolina Business Court. The Kassner case shows that a trustee may emerge victorious without even having to duke it out with state taxing authorities over constitutional issues."

Dick Nenno provides members with his analysis of a recent decision by the Appellate Division of the New Jersey Superior Court holding the taxpayer, the Residuary Trust A U/W/O Fred E. Kassner, did not owe $192,379 in taxes plus interest and penalties, on the trust's undistributed, out-of-state income.

Richard W. Nenno is a Senior Managing Director and Trust Counsel at **Wilmington Trust Company,**[1] Wilmington, Delaware. He received his A.B. degree from Princeton University and his J.D. degree from Harvard Law School. Dick is a member of the Council of the Real Property, Trust and Estate Law Section of the American Bar Association and has presented at many national conferences, including the Heckerling Institute, the Notre Dame Tax and Estate Planning Institute, the NYU Institute on Federal Taxation, and the AICPA Advanced Estate Planning Conference. He has written numerous articles and has authored or coauthored Tax Management Portfolios on Choosing a Domestic Jurisdiction for a Long-Term Trust (TMP 867), Domestic Asset Protection Trusts (TMP 868), and State Income Taxation of Trusts (TMP 869).

Before we get to Dick's commentary, members should note that two new **Podcasts** were recently posted to the **LISI** homepage:

- In the first Podcast, **Bob Keebler** and **Jonathan Blattmachr** discuss sophisticated GST planning techniques. Click this link to listen to Bob and Jonathan's Podcast: Keebler & Blattmachr

- In his **60 Second Planner, Bob Keebler** discusses Section 2004 of The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41, which requires consistent basis

reporting between an estate and a person acquiring property from the decedent. **LISI** will provide members with additional commentary on the consistent basis reporting issue in two separate newsletters, the first by **DeeAnn Thompson** and **Mike Jones**, and the second by **Andrew Katzenstein** and **Michael Rosenblum**. Click this link to listen to **Bob Keebler**'s podcast: Bob Keebler

Now, here is Dick Nenno's commentary:

EXECUTIVE SUMMARY:

At present, 27 states[2] tax a trustee on income (including accumulated ordinary income and capital gains) of a nongrantor trust created by a Will in whole or in part because the testator lived there at death.[3] They are Alabama, Arkansas, Connecticut, Delaware, the District of Columbia, Idaho, Illinois, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota (trusts created or first administered in state after 1995), Missouri, Nebraska, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, Utah, Vermont, Virginia, West Virginia, and Wisconsin.

Similarly, 25 states currently tax an inter vivos nongrantor trust in whole or in part because the trustor resided in the state. Those states are Alabama, Arkansas, Connecticut, Delaware, the District of Columbia, Idaho, Illinois, Iowa, Maine, Maryland, Massachusetts, Michigan, Minnesota (trusts created or first administered in state after 1995), Missouri, Nebraska, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Rhode Island, Vermont, Virginia, West Virginia, and Wisconsin (trusts created or first administered in state after October 28, 1999). Recognizing constitutional limitations on their ability to tax, many of the states in question provide that a nongrantor trust created by a resident trustor or testator will not be taxed if certain conditions are satisfied. In addition, practitioners recognize that imposition of tax is invalid in other situations.

A recent decision of an intermediate appellate court in one of the above states—New Jersey—shows that a trustee may succeed using nonconstitutional arguments.[4]

FACTS:

The Tax Court Decision

New Jersey classifies a trust created by a resident testator or trustor as a Resident Trust as follows:[5]

> o. Resident . . . trust. A resident . . . trust means:
>
> . . .
>
> (2) A trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this State, or
>
> (3) A trust, or portion of a trust, consisting of the property of:
>
> (a) A person domiciled in this State at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (b) A person domiciled in this State at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.
>
> For the purposes of the foregoing a trust or portion of a trust is revocable if it is subject to a power, exercisable immediately or at any future time, to revest title in the person whose property constitutes such trust or portion of a trust, and a trust or portion of a trust becomes

> irrevocable when the possibility that such power may be exercised has been terminated.

In Residuary Trust A v. Director (2013),[6] the New Jersey Tax Court held that a trust was not taxable on interest income and income attributable to business activity conducted outside New Jersey. About $200,000 of taxes, interest, and penalties was involved.

Because the trust was created by the Will of a New Jersey resident who died in 1998, it met the definition of "Resident Trust" for New Jersey tax purposes. But, for all of 2006—the tax year in question, the sole trustee resided in New York and administered the trust outside New Jersey. The trustee filed a return and paid New Jersey tax on S corporation income attributable to activity in New Jersey but not on interest income or on S corporation income allocated outside New Jersey. After an audit, the Director of the Division of Taxation contended that the trustee was taxable on all undistributed income because the trust held assets in New Jersey.

Reaffirming its earlier decisions in Pennoyer v. Taxation Division Director (1983)[7] and Potter v. Taxation Division Director (1983),[8] the court granted the taxpayer's motion for summary judgment and made several points in support of its holding. First, the court gave short shrift to the fact that the return showed the tax preparer's New Jersey address rather than the trustee's New York address:[9]

> This court finds that simply using a New Jersey address on the NJ-1041 return does not create the required contacts between Trust A and New Jersey for the Director to overcome the due process threshold that would otherwise permit this court to distinguish the facts of this case from those of Pennoyer.

Second, regarding the decision of the United States Supreme Court in Quill Corporation v. North Dakota (1992),[10] the court said:[11]

> The court rejects the Director's assertion that the lack of a presence in New Jersey can be overcome by the Supreme Court's ruling in Quill Corp. v. North Dakota, because (1) Quill involved a plaintiff actively conducting a mail order business that targeted residents of the state, whereas Trust A carries out no business directly as a passive owner of stock; and (2) Quill involved the imposition of use tax, whereas the present issue before the court is the imposition of income tax.

Next, the court found that the decisions of the Court of Appeals of the District of Columbia in District of Columbia v. Chase Manhattan Bank (1997)[12] and the Supreme Court of Connecticut in Chase Manhattan Bank v. Gavin (1999) [13] had no relevance in New Jersey:[14]

> Despite the Director's insistence that the law has evolved following Pennoyer, the District of Columbia and Gavin cases have no precedent value in New Jersey and directly conflict with New Jersey Court's rulings in Pennoyer and Potter. Moreover, the Director has not set forth compelling reasons why this court should disregard New Jersey's own case law in favor of contrary out of state authority. To do so would be a drastic step this court finds inappropriate under the circumstances.

The court then summarized the first part of its analysis as follows:[15]

> Trust A was not administered in New Jersey and the Trustee was a resident of New York. Therefore, Trust A could only be taxed on the undistributed income if it owned assets in New Jersey, thus running afoul of the precedent set by the Tax Court in Pennoyer and Potter and the guidance adopted by the Director.

The heading to the last portion of the opinion reads:[16]

> Trust A cannot be Deemed to Own Assets in New Jersey merely because it was a Shareholder in S Corporations that Owned New Jersey Assets.

The Appellate Division Decision

The Appellate Division of the New Jersey Superior Court affirmed in Residuary Trust A U/W/O Kassner v. Director, Division of Taxation (2015). [17] Unlike the tax court, though, the appellate court did not find it necessary to apply constitutional principles. Instead, it based its decision on New Jersey's "square corners doctrine," which it described as follows:[18]

> The square corners doctrine requires the government to deal fairly with its citizens, eschewing inequitable practices.
>
> We have in a variety of contexts insisted that governmental officials act solely in the public interest. In dealing with the public, government must "turn square corners." This applies, for example, in government contracts. Also, in the condemnation field, government has an overriding obligation to deal forthrightly and fairly with property owners. It may not conduct itself so as to achieve or preserve any kind of bargaining or litigational advantage over the property owner. Its primary obligation is to comport itself with compunction and integrity, and in doing so government may have to forego the freedom of action that private citizens may employ in dealing with one another.
>
> Similarly, the statutory provisions governing substantive standards and procedures for taxation, including the administrative review process, are premised on the concept that government will act scrupulously, correctly, efficiently, and honestly.
>
> We have applied the doctrine in the context of tax appeals, as has the Tax Court.

The court then observed:[19]

> In this case, since 1999, the Division's official guidance publication gave taxpayers unequivocal advice that undistributed trust income would not be taxable if the trustee was not a New Jersey resident and the trust had no New Jersey assets. In 2009, the Division assessed taxes on the Trust's 2006 income based on an assertion that the Trust owned assets in New Jersey, a position the Tax Court rejected and the Division then abandoned. Perhaps perceiving the weakness of its position, the Division asserted before the Tax Court a series of arguments that were at variance with the clear guidance it had provided trust taxpayers for at least two decades. Among those arguments, it asserted for the first time that, as set forth in a 2011 issue of Tax Topic, a trust was subject to taxation of its retained income if it had any New Jersey income.
>
> We agree with the Tax Court that the doctrine was appropriately applied to preclude the Division from applying to the Trust's 2006 income a standard the Division did not announce until 2011.

It continued:[20]

> We need not determine here whether the new criterion is constitutionally permissible, or whether the Division was required to adopt the criterion in a regulation rather than simply announcing it in a newsletter. However, in this context, application of the square corners doctrine bears a close relationship to our decisional law concerning the adoption of regulations. That is, an agency may not spring upon the regulated community a new policy, never before announced, and apply it retroactively. That conduct is especially inappropriate when, as here, it occurs in the middle of a taxpayer's appeal.

The court concluded:[21]

> The square corners doctrine is particularly important in the field of taxation, because trusts, businesses, individuals and others must be able to reliably engage in tax planning and, to do so, they must know what the rules are. It is fundamentally unfair for the Division to announce in its

official publication that, under a certain set of facts a trust's income will not be taxed, and then retroactively apply a different standard years later.

At this writing, I don't know whether the state of New Jersey will appeal.

COMMENT:

Following the United States Supreme Court's Quill decision in 1992, the tide appeared to be flowing in the direction of sustaining states' power to tax trust income. Thus, the Court of Appeals of the District of Columbia and the Supreme Court of Connecticut upheld their states' ability to tax in questionable circumstances.

Since 2013, though, the tide appears to have turned as five state courts have denied their states' power to tax. In addition to the New Jersey Tax Court and the Appellate Division of the Superior Court of New Jersey, they are the Commonwealth Court of Pennsylvania,[22] the Appellate Court of Illinois,[23] and the North Carolina Business Court.[24] The Kassner case shows that a trustee may emerge victorious without even having to duke it out with state taxing authorities over constitutional issues.

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

Dick Nenno

CITE AS:

LISI Estate Planning Newsletter #2331 (August 11, 2015) at http://www.leimbergservices.com

CITATIONS:

[1] This document is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought. Wilmington Trust is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Investment management and fiduciary services are provided by Wilmington Trust Company, operating in Delaware only, and Wilmington Trust, N.A., a national bank. Loans, retail and business deposits, and other personal and business banking services and products are offered by M&T Bank, member FDIC. Wilmington Trust Company operates offices in Delaware only. Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts. Investment Products: | Are NOT Deposits | Are NOT FDIC-Insured | Are NOT Insured By Any Federal Government Agency

[2] The term "state" includes the District of Columbia.

[3] For comprehensive treatment of this subject, see Nenno, 869 T.M., State Income Taxation of Trusts. For thorough coverage of New York, see Nenno,

Minimizing New York Income Taxes on Trusts After the 2014–2015 Budget Bill, 47 NYSBA Tr. & Est. L. Sec. Newsltr. 4 (Winter 2014).

[4] Residuary Trust A U/W/O Kassner v. Director, Div. of Taxation, 2015 N.J. Tax Lexis 11 (N.J. Super. Ct. App. Div. 2015), aff'g, 27 N.J. Tax 68 (N.J. Tax Ct. 2013).

[5] NJSA § 54A:1-2(o)(2)–(3).

[6] Residuary Trust A v. Director, 27 N.J. Tax 68 (N.J. Tax Ct. 2013).

[7] Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (N.J. Tax Ct. 1983).

[8] Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (N.J. Tax Ct. 1983).

[9] Residuary Trust A, 27 N.J. Tax at 74 (footnotes omitted).

[10] Quill Corp. v. North Dakota, 504 U.S. 298 (1992).

[11] Residuary Trust A, 27 N.J. Tax at 75 n.11 (citations omitted).

[12] District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. 1997).

[13] Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999).

[14] Residuary Trust A, 27 N.J. Tax at 76.

[15] 27 N.J. Tax at 76.

[16] 27 N.J. Tax at 76.

[17] Residuary Trust A U/W/O Kassner v. Director, Div. of Taxation, 2015 N.J. Tax Lexis 11 (N.J. Super. Ct. App. Div. 2015), aff'g., 27 N.J. Tax 68 (N.J. Tax Ct. 2013).

[18] 2015 N.J. Tax Lexis 11 at 7–8 (citation omitted).

[19] 2015 N.J. Tax Lexis 11 at 8–9.

[20] 2015 N.J. Tax Lexis 11 at 9–10 (citations omitted).

[21] 2015 N.J. Tax Lexis 11 at 10 (citations omitted).

[22] McNeil v. Commonwealth, 67 A.3d 185 (Pa. Commw. Ct. 2013).

[23] Linn v. Dep't of Revenue, 2 N.E.3d 1203 (Ill. App. Ct. 2013).

[24] Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dep't of Revenue, 2015 NCBC Lexis 39 (N.C.B.C. 2015).

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2339

Date: 31-Aug-15
From: Steve Leimberg's Estate Planning Newsletter
Subject: Richard Nenno on the Taxpayer Victory in North Carolina Kaestner Case: Presence of Resident Discretionary Beneficiaries Does Not Justify Income Taxation of Nonresident Trustee

"In Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue (2015), the Business Court Division of the Superior Court of Wake County, North Carolina, held that North Carolina could not tax a nonresident trustee on the accumulated ordinary income and capital gains of a nongrantor trust based on the existence of resident discretionary beneficiaries. Unless the decision is reversed on appeal, the trust will have saved over $1.3 million. The court's analysis of the Due Process Clause and the Commerce Clause of the United States Constitution should be of interest to attorneys, accountants, and other planners seeking to reduce income taxes on trusts in at least seven other states—Alabama, California, Georgia, Michigan, Missouri, North Dakota, and Ohio—that attempt to tax trustees in whole or in part on the same basis."

As **Dick Nenno** notes in him commentary, some states recognize the principle from the *Kaestner* case that a state's imposition of income tax on the accumulated ordinary income and capital gains of a nonresident trustee because the trust has one or more resident discretionary beneficiaries is unconstitutional. Although several states besides North Carolina purport to tax nonresident trustees on accumulated income where the trust has resident beneficiaries, as Dick points out in his commentary, planners in those states need to keep *Kaestner* and its predecessors in mind.

Richard W. Nenno is a Senior Managing Director and Trust Counsel at **Wilmington Trust Company**,[1] Wilmington, Delaware. He received his A.B. degree from Princeton University and his J.D. degree from Harvard Law School. Dick is a member of the Council of the Real Property, Trust and Estate Law Section of the American Bar Association and has presented at many national conferences, including the Heckerling Institute, the Notre Dame Tax and Estate Planning Institute, the NYU Institute on Federal Taxation, and the AICPA Advanced Estate Planning Conference. He has written numerous articles and has authored or coauthored Tax Management Portfolios on Choosing a Domestic Jurisdiction for a Long-Term Trust (TMP 867), Domestic Asset Protection Trusts (TMP 868), and State Income Taxation of Trusts (TMP 869).

Here is his commentary:

EXECUTIVE SUMMARY:

In Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue (2015),[2] the Business Court Division of the Superior Court of

Wake County, North Carolina, held that North Carolina could not tax a nonresident trustee on the accumulated ordinary income and capital gains of a nongrantor trust based on the existence of resident discretionary beneficiaries. Unless the decision is reversed on appeal, the trust will have saved over $1.3 million.[3] The court's analysis of the Due Process Clause and the Commerce Clause of the United States Constitution should be of interest to attorneys, accountants, and other planners seeking to reduce income taxes on trusts in at least seven other states—Alabama, California, Georgia, Michigan, Missouri, North Dakota, and Ohio—that attempt to tax trustees in whole or in part on the same basis.

FACTS:

Background

North Carolina taxes the accumulated ordinary income and capital gains of nongrantor trusts pursuant to the following statute:[4]

> The tax imposed by this part applies to the taxable income of . . . trusts as determined under the provisions of the Code . . . . The tax is computed on the amount of the taxable income of the . . . trust that is for the benefit of a resident of this State.

The court applied the above statute in the Kaestner case, the essential facts of which were:

- 1992—New York settlor created irrevocable inter vivos trust for his children naming New York individual trustee and designating New York law to govern
- 1997—One of settlor's children moved to North Carolina
- December 30, 2002—Trust divided into equal shares for settlor's three children, including a share for the North Carolina resident and her three children
- 2005–2008—Trust investments consisted of financial assets; custodian was in Boston; tax returns, accountings, and other records were prepared and kept in New York; no distributions were made to North Carolina residents
- February 11, 2011—North Carolina Department of Revenue denied trust's requests for refunds of North Carolina income taxes paid for 2005 –2008

Due Process Clause Analysis

The court began by quoting from the United States Supreme Court's decisions in Quill Corporation v. North Dakota (1992)[5] and Wisconsin v. J.C. Penney Company (1940),[6] which had established the following governing principles: [7]

> When a state seeks to impose a tax, the Due Process Clause requires: (1) some definite link, some minimum connection, between a state and a person, property or transaction it seeks to tax; and (2) that the income attributed to the State for tax purposes be rationally related to values connected with the taxing state. Under the first requirement, courts consider whether a taxed entity's connections with a State are substantial enough to legitimate the State's exercise of power over it. Where the taxed entity has no physical presence in a state, the entity must purposefully avail itself of the benefits of an economic market in the forum state. This requirement ensures that the taxed entity is given fair warning that its activity may subject it to the jurisdiction of a foreign sovereign. Under the second requirement, courts analyze whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state.

Regarding the first requirement, the court stressed that the focus of its inquiry must be on the trust's contacts with North Carolina.[8] Finding that the trust had no physical presence in the state,[9] the court had to determine whether the trust had purposefully availed itself of the benefits of North Carolina through the beneficiaries' residence there.[10] The court held that the trust had not because the defendant had conflated the trustee's and the beneficiaries' North Carolina contacts and because the beneficiaries had no control over the trust.[11] The court concluded:[12]

> [T]he Court does not believe that the residency of the beneficiaries in North Carolina, standing alone, can be viewed as the Trust's purposeful activity in this State.

Turning to the second requirement, the court noted[13] that the United States Supreme Court had stipulated in J.C. Penney that, "[t]he simple but controlling question is whether the state has given anything for which it can ask return."[14] In the present case, the court held that North Carolina had not:[15]

> While the presence of Kaestner and her children in North Carolina may provide some contact with the State, absent any other contact by Plaintiff, it does not provide the minimum contacts necessary to satisfy the due process requirement of the United States and North Carolina Constitutions.

The court then distinguished the decisions of the Supreme Court of California in McCulloch v. Franchise Tax Board (1964)[16] and the Supreme Court of Connecticut in Chase Manhattan Bank v. Gavin (1999).[17]

Regarding McCulloch, the court conceded that the Supreme Court of California had stated that,[18] "the beneficiaries residence in California confers the essential minimum connection necessary for due process of law,"[19] but noted that the beneficiary in McCulloch also was a trustee and that California was seeking to tax the beneficiary (not the trust) upon termination.[20] In the end, the court held:[21]

> Ultimately, however, this Court simply does not find McCulloch persuasive and reaches a different result. The Court concludes that the beneficiary's residence in North Carolina, standing alone, is not a sufficient contact by the Trust with this State to support the imposition of the tax at issue, and that the benefits enjoyed by Ms. Kaestner and her children as residents of North Carolina are not protection, opportunities, and benefits conferred upon the Trust.

Regarding Gavin, the court noted[22] that the Supreme Court of Connecticut had held that:[23]

> [J]ust as the state may tax the undistributed income of a trust based on the presence of the trustee in the state because it gives the trustee the protection and benefits of its laws . . . it may tax the same income based on the domicile of the sole non-contingent beneficiary because it gives her the same protections and benefits.

The court distinguished Gavin in two respects. First, unlike in the present case, the settlor in Gavin resided in Connecticut so that the trust was a "Resident Trust"[24] for tax purposes. Second, in the court's view, the court in Gavin had concluded erroneously that the decision of the United States Supreme Court in Safe Deposit and Trust Company v. Virginia (1929),[25] which held that Virginia could not tax a nonresident trustee based on the presence of resident beneficiaries,[26] no longer was good law.[27]

The court wrapped up its Due Process Clause analysis by stating:[28]

> [T]he Court concludes that the portion of G.S. § 105-160.2 providing that a trust may be taxed on income that is for the benefit of a resident of this State violates the Due Process Clause of the United States Constitution and Article I, Section 19 of the North Carolina Constitution as applied to

> Plaintiff in this case where the only basis for imposition of the taxes is the beneficiaries' residence in the State of North Carolina.

Commerce Clause Analysis

The court first summarized the principles established by the United States Supreme Court in Complete Auto Transit, Inc. v. Brady (1977),[29] as follows:[30]

> In Complete Auto Transit, Inc. v. Brady, the Supreme Court articulated the now well-established four prong analysis for determining the constitutionality of a tax under the Commerce Clause. A state tax withstands scrutiny under the Commerce Clause if: (1) it is applied to an activity with a substantial nexus to the taxing state; (2) it is fairly apportioned so as to tax only the activities connected to the taxing state; (3) it does not discriminate against interstate commerce; and (4) it is fairly related to services provided by the state. To pass constitutional muster, all four prongs must be satisfied and the failure to meet any one of these requirements renders the tax unconstitutional. Because the Court, largely for reasons already discussed above, finds that the application of G.S. § 105-160.2 to Plaintiff fails to satisfy the first and fourth prongs of Complete Auto, the Court need not address prongs two and three of that test.

In finding that the trust did not satisfy Complete Auto's first prong, the court observed that the mere presence of the beneficiaries in North Carolina was not a substantial nexus between the trust and the state[31] and that all other trust activity took place elsewhere.[32]

Discussing favorably[33] the decision of the Commonwealth Court of Pennsylvania in McNeil v. Commonwealth (2013),[34] the court found that Complete Auto's fourth prong was not met because, unlike the beneficiaries, the trust did not benefit from any services or legal framework provided by North Carolina.[35]

The court ended its Commerce Clause analysis by holding:[36]

> [B]ecause the application of G.S. § 105-160.2 fails to satisfy the first or fourth prongs of the Complete Auto test, the Court concludes that the portion of G.S. § 105-160.2 providing that a trust may be taxed on income that is for the benefit of a resident of this State violates the Commerce Clause of the United States Constitution and Article I, Section 19 of the North Carolina Constitution as applied to Plaintiff in this case where the only basis for imposition of the taxes is the beneficiaries' residence in the State of North Carolina.

Conclusion

At the end, the court said:[37]

> Ultimately, after a thorough review of the record in this action and consideration of the arguments of the parties, the Court concludes that Plaintiff has shown, beyond a reasonable doubt, that the portion of G.S. § 105-160.2 providing that a trust may be taxed on income that is for the benefit of a resident of this State is unconstitutional under the Due Process and Commerce Clauses of the United States Constitution and Article I, Section 19 of the North Carolina Constitution as applied to Plaintiff in this case where the only basis for imposition of the taxes is the beneficiaries' residence in the State of North Carolina.

At this point, I don't know if the North Carolina Department of Revenue will appeal.

COMMENT:

Caselaw

Introduction

Kaestner's consideration of whether the presence of resident discretionary beneficiaries is a constitutionally valid basis for taxing a nonresident trustee is the latest of nearly a century of cases. Below is a brief summary of relevant authorities.

Safe Deposit and Trust Company v. Virginia (U.S. 1929)

In this case,[38] the United States Supreme Court held that Virginia's assessment of a tax on the value of an inter vivos trust created by a Virginia domiciliary and having Virginia beneficiaries but a Maryland trustee violated the Due Process Clause. The Court stated:[39]

> Here we must decide whether intangibles—stocks, bonds—in the hands of the holder of the legal title with definite taxable situs at its residence, not subject to change by the equitable owner, may be taxed at the latter's domicile in another State. We think not.

Guaranty Trust Company v. Virginia (U.S. 1938)

Here,[40] the Court sustained Virginia's right to tax income received by a resident beneficiary where the trustee already had paid tax on the same income to New York. Justice McReynolds wrote:[41]

> Here, the thing taxed was receipt of income within Virginia by a citizen residing there. The mere fact that another state lawfully taxed funds from which the payments were made did not necessarily destroy Virginia's right to tax something done within her borders . . . . The challenged judgment must be Affirmed.

Mercantile-Safe Deposit and Trust Company v. Murphy (N.Y. 1964)

In this case,[42] the New York Court of Appeals (the highest court in the state), affirming an intermediate appellate court decision, held that the Due Process Clause prohibited New York from taxing the accumulated income of an inter vivos trust, funded in part during life and in part by a pourover of assets under the decedent's Will, that had no New York trustee, New York assets, or New York source income, even though the current discretionary beneficiary was a New York resident. Relying on Safe Deposit and Trust Company v. Virginia, the court stated that:[43]

> The lack of power of New York State to tax in this instance stems not from the possibility of double taxation but from the inability of a State to levy taxes beyond its border. . . . [T]he imposition of a tax in the State in which the beneficiaries of a trust reside, on securities in the possession of the trustee in another State, to the control or possession of which the beneficiaries have no present right, is in violation of the Fourteenth Amendment.

McCulloch v. Franchise Tax Board (Cal. 1964)

Here,[44] the Supreme Court of California held that California could tax the co-trustee/beneficiary on accumulated income distributed to him from a Missouri trust because the co-trustee/beneficiary was a California resident. In the course of the opinion, the court did say that, "the beneficiaries residence in California confers the essential minimum connection necessary for due process of law."[45]

As noted above, the Kaestner court chose not to follow McCulloch, and, as mentioned below, the pertinent California statute was amended in 1963 to eliminate taxation on this basis.

In the Matter of the Appeal of the First National Bank of Chicago (Cal. 1964)

A few months after the Supreme Court of California decided McCulloch, the California State Board of Equalization ruled that California could tax six trusts

being administered in Illinois because all beneficiaries were California residents.[46] It said:[47]

> Appellant also urges that section 17742 (formerly 18102) is unconstitutional if it purports to tax the non-California income of a foreign trust which is administered by a nonresident trustee. This argument has been fully answered by the California Supreme Court in McCulloch v. Franchise Tax Board, wherein the court held that California could constitutionally tax a Missouri trust on income which was payable in the future to a beneficiary residing in this state, although such income was actually retained by the trust. The fact that the resident beneficiary was also one of the trust's three trustees was not relied upon by the court in holding that the residence of the beneficiary afforded a constitutionally sufficient connection to bring the trust's income within California's tax jurisdiction.

Again, this ruling is not consistent with current California law.

Potter v. Taxation Division Director (N.J. 1983)

In this case,[48] the New Jersey Tax Court held that New Jersey could not tax undistributed income of an inter vivos trust, which was funded in part during life and in part by a pourover under the decedent's Will, based primarily on the residence of the settlor. The trust had no New Jersey trustees, beneficiaries, or assets.[49] The court dismissed the significance of the existence of resident contingent beneficiaries:[50]

> The fact that contingent beneficiaries reside in New Jersey does not alter this conclusion. These beneficiaries are taxable on trust income distributed to them or on undistributed income over which they have control. The state in which a beneficiary is domiciled may tax trust income distributed to the beneficiary. The fact that contingent beneficiaries are domiciled in New Jersey does not constitute a contact sufficient to empower New Jersey to tax undistributed trust income where the contingent beneficiaries have no right to the undistributed trust income.

Chase Manhattan Bank v. Gavin (Conn. 1999)

In this case,[51] the Supreme Court of Connecticut denied the trustee's request under both the Due Process Clause and the Commerce Clause for a Connecticut income-tax refund in an inter vivos trust that had a current resident noncontigent beneficiary. Regarding the Due Process Clause, the court held as follows:[52]

> [T]he critical link to the undistributed income sought to be taxed is the fact that the noncontingent beneficiary of the inter vivos trust during the tax year in question was a Connecticut domiciliary. The accumulated income eventually will be paid either outright to her when she reaches the age of forty-eight or, if she does not live that long, according to the exercise of her testamentary power of appointment or, in default of such exercise, to her then living descendants. Thus, during the tax year of 1993, as a Connecticut domiciliary she enjoyed all of the protections and benefits afforded to other domiciliaries. Her right to the eventual receipt and enjoyment of the accumulated income was, and so long as she is such a domiciliary will continue to be, protected by the laws of the state. We conclude that, just as a state may tax all of the present income of a domiciliary, irrespective of its place or origin or the nature of its source, a state may, on the basis of the same justification, tax the income of an inter vivos trust that is accumulated for the ultimate benefit of a noncontingent domiciliary, and that is subject to her ultimate power of disposition. Although the connection is more attenuated than in the case of a testamentary trust, it is sufficient for purposes of due process of law. Furthermore, just as the state may tax the undistributed income of a trust based on the presence of the trustee in the state because it gives the trustee the protection and benefits of its laws; it may tax the same income

> based on the domicile of the sole noncontingent beneficiary because it gives her the same protections and benefits. In both instances, the state has given something for which it can ask return, and there is a definite and sufficient link between the contact with the state and the income sought to be taxed.

The court did not focus on the beneficiary's residence in its analysis of the Commerce Clause.[53]

McNeil v. Commonwealth (Pa. 2013)

Here,[54] the Pennsylvania Commonwealth Court held that Pennsylvania's imposition of personal income tax on nonresident trustees of two trusts violated the Commerce Clause of the United States Constitution even though the trusts had a Pennsylvania settlor and Pennsylvania discretionary beneficiaries. The court dismissed the significance of the Pennsylvania residence of the discretionary beneficiaries for the following reasons:[55]

> [T]he beneficiaries' status in Pennsylvania is similar to that of Quill's customers, who resided in North Dakota and whose purchases of Quill's products were the trigger for the tax imposed in Quill. In finding the state tax unconstitutional in Quill, the U.S. Supreme Court focused on whether the presence of Quill, as the taxpayer, in North Dakota was sufficient, and not on the fact that there were North Dakota citizens participating and benefiting from Quill's sale of products in North Dakota. Our focus here, likewise, must be on whether the Trusts' presence in Pennsylvania is sufficient, and not on the fact that there are discretionary beneficiaries who are Pennsylvania residents and who may, at some time in the future, benefit from the existence of the Trusts.

Finally, the inter vivos trust in Chase Manhattan had a single, non-discretionary beneficiary to whom the trust was required to pay any accumulated income in quarterly installments and to whom the trust property would be distributed when the beneficiary turned forty-eight. That trust is distinguishable from this case, where the Trusts' beneficiaries are discretionary, the Trusts have no obligation to pay any distributions to the beneficiaries, and the present beneficiaries have no current or future right to the income or assets of the Trusts. In fact, the Trusts have no obligation to make any distribution until '20 years and 11 months after the death of the last survivor of Nancy and all my lineal descendants living at the time of creation of this trust,' or until '20 years and 11 months after the death of the last survivor of all my lineal descendants living at the time of creation of this trust.' Additionally, the Connecticut Supreme Court did not address any of the Complete Auto factors in making its determination. Therefore, the residency of the discretionary beneficiaries in Pennsylvania does not provide the physical presence of the Trusts necessary to establish a substantial nexus here.

Planning Points

Kaestner is consistent with five of the above eight cases—Safe Deposit (1929), Guaranty Trust (1938), Mercantile (1964), Potter (1983), and McNeil (2013). McCulloch (1964) and First National Bank of Chicago (1964) are to the contrary, but they have not reflected current California law for decades. Gavin involved a single resident noncontingent beneficiary rather than one or more discretionary beneficiaries. Although Kaestner involved a beneficiary who moved to North Carolina the foregoing five cases show that the combination of a resident testator or settlor with one or more resident discretionary beneficiaries does not warrant taxation. It seems that the presence of a resident beneficiary who is entitled to receive income currently should not justify current taxation of capital gains if principal distributions are discretionary.

Affected States

Introduction

Kaestner holds that a state's imposition of income tax on the accumulated ordinary income and capital gains of a nonresident trustee because the trust has one or more resident discretionary beneficiaries is unconstitutional. Some states recognize this principle. For example, as noted by the court in McNeil, a Pennsylvania regulation provides in relevant part that, "[t]he residence of the . . . beneficiaries of the trust shall be immaterial."[56] Similarly, an Iowa regulation provides in pertinent part that, "[t]he residence of the beneficiaries of a trust is also not relevant in determining situs."[57] Nevertheless, several states besides North Carolina purport to tax nonresident trustees on accumulated income where the trust has resident beneficiaries. Planners in those states should keep Kaestner and its predecessors in mind. The relevant tax provisions are below.

Alabama

An Alabama statute defines "Resident Trust" as follows:[58]

> A trust is a resident trust for a taxable year if it is a trust which meets both a. and b.:
>
> > a. The trust is created by the will of a decedent who was an Alabama resident at death or by a person who was an Alabama resident at the time such trust became irrevocable; and
> >
> > b. For more than seven months during such taxable year, a person, as defined in this section, who either resides in or is domiciled in Alabama is either a fiduciary of the trust or a beneficiary of the trust to whom distributions currently may be made.

According to Kaestner, the underlined language is not a valid basis for taxation.

California

A California statute provides in relevant part:[59]

> The tax applies . . . to the entire taxable income of a trust, if the . . . beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor.

The highlighted language was not in the statute for the years considered in McCulloch and First National Bank of Chicago.

Georgia

Georgia's tax statute is the closest to North Carolina's. The statute imposes the Georgia income tax on resident and nonresident fiduciaries, "[m]anaging funds or property for the benefit of a resident of the state."[60] All arguments brought to bear in Kaestner therefore should apply in a comparable Georgia case.

Michigan

In Michigan, a trust created by a resident testator or settlor is a "Resident Trust."[61] But, the tax return instructions specify that an inter vivos trust created by a Michigander will not be treated as a "Resident Trust" if three conditions are satisfied, one of which is that, "[t]he beneficiaries are all nonresidents."[62] Tax still should be avoidable if a trust has one or more resident discretionary beneficiaries.

Missouri

Missouri defines "Resident Trust" in the following way:[63]

> (2) A trust that:
>
> (a) Was created by will of a decedent who at his or her death was domiciled in this state; and

(b) Has at least one income beneficiary who, on the last day of the taxable year, was a resident of this state; or

(3) A trust that:

(a) Was created by, or consisting of property of, a person domiciled in this state on the date the trust or portion of the trust became irrevocable; and

(b) Has at least one income beneficiary who, on the last day of the taxable year, was a resident of this state.

I am not aware of an authority that specifies whether "income beneficiary" is confined to a beneficiary who is entitled to receive income currently or whether it extends to a beneficiary who may receive income on a discretionary basis. In any event, Kaestner suggests that the underlying language does not justify taxation.

North Dakota

A North Dakota regulation contains a nonexclusive list of factors to be used in determining whether a trust is a "Resident Trust."[64] The factors include whether, "[a] beneficiary of the trust . . . is a domicilary or resident of this state."[65] Kaestner gives the planner arguments for contesting the significance of this factor.

Ohio

The Ohio fiduciary income tax return instructions describe a "Resident Trust" as follows:[66]

An inter vivos irrevocable trust resides in Ohio if (i) at least one "qualifying beneficiary" [see R.C. 5747.01(I)(3)(c)] is domiciled in Ohio for all or a portion of the trust's taxable year and (ii) at any time the trust received assets from one or more of the following:

- An individual who was domiciled in Ohio for income tax purposes at the time he/she transferred assets to the trust; or
- An individual who was domiciled in Ohio for income tax purposes at the time the trust document became irrevocable—even if the individual was not domiciled in Ohio at the time he/she transferred the assets to the trust; or
- An estate of an individual who at the time of death was domiciled in Ohio for estate tax purposes; or
- An insurance company, pension plan or court award on account of the death of an individual, and at the time of the individual's death either (i) the individual was domiciled in Ohio for estate tax purposes or (ii) the owner of the insurance policy was domiciled in Ohio for income tax purposes.

Note: The above listing is not all inclusive. For additional information, see divisions (I)(3)(a), (I)(3)(e) and (I)(3)(f) of R.C. 5747.01.

As shown above, Ohio taxes an irrevocable inter vivos trust only if a "qualifying beneficiary is domiciled in Ohio for all or a portion of the trust's taxable year." An Ohio statute provides that "qualifying beneficiary" generally "has the same meaning as 'potential current beneficiary' as defined in section 1361(e)(2) of the Internal Revenue Code,"[67] which, in turn, says that:[68]

[T]he term 'potential current beneficiary' means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period).

Again, Kaestner indicates that the presence of a resident qualifying beneficiary should be irrelevant for Ohio income-tax purposes.

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

Dick Nenno

CITE AS:

LISI Estate Planning Newsletter #2339 (September 1, 2015) at http://www.leimbergservices.com

CITATIONS:

---

[1] This document is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought. Wilmington Trust is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Investment management and fiduciary services are provided by Wilmington Trust Company, operating in Delaware only, and Wilmington Trust, N.A., a national bank. Loans, retail and business deposits, and other personal and business banking services and products are offered by M&T Bank, member FDIC. Wilmington Trust Company operates offices in Delaware only. Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts. Investment Products: | Are NOT Deposits | Are NOT FDIC-Insured | Are NOT Insured By Any Federal Government Agency.

[2] Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dep't of Revenue, 2015 NCBC Lexis 39 (N.C.B.C. 2015). For a decision relating to the New York income taxation of the same trust, see In the Matter of Joseph Lee Rice III Family 1992 Trust, DTA No. 822892, 2010 N.Y. Tax Lexis 268 (N.Y. Div. Tax App. 2010).

[3] For comprehensive treatment of this subject, see Nenno, 869 T.M., State Income Taxation of Trusts. For thorough coverage of New York, see Nenno, Minimizing New York Income Taxes on Trusts After the 2014–2015 Budget Bill, 47 NYSBA Tr. & Est. L. Sec. Newsltr. 4 (Winter 2014).

[4] N.C. Gen. Stat. § 105-160.2 (emphasis added).

[5] Quill Corp. v. North Dakota, 504 U.S. 298, 306, 307, 308, 312 (1992).

[6] Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940).

[7] Kaestner, 2015 NCBC Lexis 39 at 11–12 (citations and internal quotation marks omitted).

[8] 2015 NCBCLexis 39 at 12.

[9] 2015 NCBC Lexis 39 at 12–13.

[10] 2015 NCBC Lexis 39 at 14–15.

[11] 2015 NCBC Lexis 39 at 15–18.

[12] 2015 NCBC Lexis 39 at 18 (internal quotation marks omitted).

[13] 2015 NCBC Lexis 39 at 19.

[14] J.C. Penney, 311 U.S. at 444.

[15] Kaestner, 2015 NCBC Lexis 39 at 20 (emphasis in original).

[16] McCulloch v. Franchise Tax Board, 390 P.2d 412 (Cal. 1964).

[17] Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999).

[18] Kaestner, 2015 NCBC Lexis 39 at 21.

[19] McCulloch, 390 P.2d at 419 (internal quotation marks omitted).

[20] Kaestner, 2015 NCBC Lexis 39 at 22–23.

[21] 2015 NCBC Lexis 39 at 23 (internal quotation marks omitted).

[22] 2015 NCBC Lexis 39 at 23.

[23] Gavin, 733 A.2d at 802.

[24] Kaestner, 2015 NCBC Lexis 39 at 24.

[25] Safe Deposit & Trust Co. v. Virginia, 280 U.S. 83 (1929).

[26] 280 U.S. at 92.

[27] Kaestner, 2015 NCBC Lexis 39 at 24–25.

[28] 2015 NCBC Lexis 39 at 25–26 (internal quotation marks omitted)

[29] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[30] Kaestner, 2015 NCBC Lexis 39 at 26–27 (citations and internal quotation marks omitted; emphasis in original).

[31] 2015 NCBC Lexis 39 at 28.

[32] 2015 NCBC Lexis 39 at 28.

[33] 2015 NCBC Lexis 39 at 29–30.

[34] McNeil v. Commonwealth, 67 A.3d 185 (Pa. Commw. Ct. 2013).

[35] Kaestner, 2015 NCBC Lexis 39 at 31.

[36] 2015 NCBC Lexis 39 at 31–32 (internal quotation marks omitted).

[37] 2015 NCBC Lexis 39 at 32 (internal quotation marks omitted).

[38] Safe Deposit & Trust Co. v. Virginia, 280 U.S. 83 (1929).

[39] 280 U.S. at 93.

[40] Guaranty Trust Co. v. Virginia, 305 U.S. 19 (1938).

[41] 305 U.S. at 23 (citations omitted).

[42] Mercantile-Safe Deposit & Trust Co. v. Murphy, 15 N.Y.2d 579 (N.Y. 1964), aff'g, 19 A.D.2d 765 (3d Dep't 1963).

[43] 15 N.Y.2d at 581.

[44] McCulloch v. Franchise Tax Board, 320 P.2d 412 (Cal. 1964).

[45] 320 P.2d at 419 (internal quotation marks omitted).

[46] In the Matter of the Appeal of The First National Bank of Chicago, 1964 Cal. Tax Lexis 39 (Cal. State Bd. Equalization 1964).

[47] 1964 Cal. Tax Lexis 39 at 6–7 (citation omitted).

[48] Potter v. Taxation Div. Dir., 5 N.J. Tax 399 (N.J. Tax Ct. 1983).

[49] 5 N.J. Tax at 401.

[50] 5 N.J. Tax at 405 (citation omitted).

[51] Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999).

[52] 733 A.2d at 802.

[53] See 733 A.2d at 803–806.

[54] McNeil v. Commonwealth, 67 A.3d 185 (Pa. Commw. Ct. 2013).

[55] 67 A.3d at 194 (citation and internal quotation marks omitted).

[56] 61 Pa. Code § 101.1.

[57] Iowa Admin. Code § 701-89.3(2).

[58] Ala. Code § 40-18-1(33) (emphasis added).

[59] Cal. Rev. & Tax Code § 17742(a) (emphasis added).

[60] Ga. Code Ann. § 48-7-22(a)(1)(C).

[61] Mich. Comp. Laws § 206.18(1)(c).

[62] Instructions to 2014 MI-1041 at 2.

[63] RSMo § 143.331(2) (emphasis added).

[64] N.D. Admin. Code § 81-03-02.1-04.

[65] N.D. Admin. Code § 81-03-02.1-04(2)(a).

[66] Instructions to 2014 Ohio Form IT 1041 at 4 (emphasis added).

[67] Ohio Rev. Code Ann. § 5747.01(I)(3)(c).

[68] IRC § 1361(e)(2).

Bloomberg BNA

Tax Management
Estates, Gifts and Trusts Journal™

Getting a Stepped-Up Income-Tax Basis and More by Springing — or Not Springing —The Delaware Tax Trap the Old-Fashioned Way

By Richard W. Nenno, Esq.
Wilmington Trust Company
Wilmington, Delaware[1]

INTRODUCTION

Estate planning attorneys throughout the United States long have fretted about the poorly understood aspect of the federal tax laws known as the Delaware tax trap ("the Trap"), which is codified in §2041(a)(3) and §2514(d). Although practitioners have had a vague notion that triggering the Trap might be beneficial in certain situations, they have been scared to death that a client's exercise of a power of appointment might inadvertently subject a trust to federal estate or gift tax.[2] Would a malpractice action be far behind? As a result, the goal has been to avoid triggering the Trap at all cost.

Times change.

It is true that planners still must avoid stumbling into the Trap for many trusts. For example, it would be disastrous for a client to spring the Trap in a trust that is not subject to federal generation-skipping transfer tax (GST tax) because it was irrevocable on September 25, 1985 (Grandfathered Trust) or that is exempt from GST tax as the result of allocation of GST exemption (Exempt Trust) if the client already has enough assets to exhaust his or her federal estate tax exemption, which is a lofty $5.43 million in 2015.[3] This is because springing the Trap would subject assets to a 40% federal transfer tax that otherwise

[1] This article is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought.

Wilmington Trust is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Investment management and fiduciary services are provided by Wilmington Trust Company, operating in Delaware only, and Wilmington Trust, N.A., a national bank. Loans, retail and business deposits, and other personal and business banking services and products are offered by M&T Bank, member FDIC.

Wilmington Trust Company operates offices in Delaware only. Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts.

[2] *See* 825 T.M., *Powers of Appointment — Estate, Gift, and Income Tax Considerations*; 850 T.M., *Generation Skipping Transfer Tax*; Les Raatz, *"Delaware Tax Trap" Opens Door to Higher Basis for Trust Assets*, 41 Est. Plan. 3 (Feb. 2014). *See also* Howard M. Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law* (Mar. 2012), www.actec.org/public/Documents/Studies/Zaritsky_RAP_Survey_03_2012.pdf.

[3] Rev. Proc. 2014-61, 2014-47 I.R.B. 860, §3.33.

would pass free of tax for one or more additional generations.

Similarly, given that the federal estate tax exemption and the GST exemption are equal at $5.43 million, that the federal estate tax rate and the GST tax rate are equal at 40%, and that a stepped-up income tax basis is available under §1014 for assets owned at death and under §2654(a)(2) for assets subject to a taxable termination, the decision to spring or not to spring the Trap for a trust that is neither grandfathered nor exempt for GST tax purposes (Nonexempt Trust) often will be tax neutral. But, it would be disadvantageous to trigger the Trap if doing so would subject trust assets to a state death tax.[4]

Nevertheless, following enactment of the American Taxpayer Relief Act of 2012,[5] clients sometimes might benefit by forgoing continued immunity from GST tax in order to obtain a stepped-up income tax basis. Thus, a client might want to spring the Trap for a Grandfathered Trust or an Exempt Trust to obtain a stepped-up income tax basis under §1014 to the extent the client has available federal estate tax exemption. Unused GST exemption might then be allocated to those trust assets.

Although commentators have developed ways to trigger the Trap by exercising nongeneral powers of appointment to confer presently exercisable general powers of appointment, they recognize that there is a crucial risk with this technique, i.e., the donee of the presently exercisable general power might exercise it and take the money.[6] Instead, I will focus on the original approach, viz., the successive exercise of nongeneral powers of appointment.

Accordingly, I will use the following definitions:

- First Power — a nongeneral lifetime or testamentary power of appointment granted by a Will or an inter vivos trust instrument.
- Second Power — a second or further nongeneral lifetime or testamentary power of appointment conferred by a First Power.

This article will:

- Review the Trap's history
- Describe how to spring and not to spring the Trap
- Discuss when to spring and not to spring the Trap
- Summarize how the Trap works under current Delaware law
- Note how the Trap works under the laws of some other states
- Identify related issues.

HISTORY

The Delaware Statute

Under Delaware statutory law, the exercise of a power of appointment usually begins a new perpetuities period.[7] The predecessor to this provision, which was enacted in 1933, provided:[8]

> Every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of a power of appointment, irrespective of whether such power is limited or unlimited as to appointees, irrespective of the manner in which such power was created or may be exercised, and irrespective of whether such power was created before or after the passage of this Act, shall for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted be deemed to have been created at the *time of the exercise and not at the time of the creation* of such power of appointment; and no such estate or interest shall be void on account of any such rule unless such estate or interest would have been void had it been created at the *date of the exercise* of such power of appointment otherwise than through the exercise of a power of appointment. (Emphasis added.)

The above provision offered the possibility, through the exercise of nongeneral powers of appointment in successive generations, of having a perpetual trust without the imposition of federal transfer tax.

Illustration: Fred died in 1934. In his Will, he created a trust for his daughter Alice for her life, giving her a First Power. At Alice's death in 1959, the trust

---

[4] *See* Richard B. Covey & Dan T. Hastings, *States With a Death Tax in Effect as of January 1, 2015*, Prac. Drafting App. A at 1203537 (Apr. 2015); *McGuireWoods LLP State Death Tax Chart* (Jan. 26, 2015), available at www.mcguirewoods.com/news-resources/publications/taxation/state_death_tax_chart.pdf.

[5] American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 112th Cong., 2d Sess., approved Jan. 2, 2013.

[6] *See* 825 T.M., *Powers of Appointment — Estate, Gift, and Income Tax Considerations*; James M. Kane, *Income Tax Planning Using the Delaware Tax Trap*, LISI Est. Plng. Newsltr. #2295 (Mar. 30, 2015), www.leimbergservices.com; Jonathan G. Blattmachr & Jeffrey N. Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the "Delaware Tax Trap,"* 24 Real Prop., Prob. & Tr. J. 75 (Spring 1989); Jonathan G. Blattmachr & Jeffrey N. Pennell, *Using the "Delaware Tax Trap" to Avoid Generation-Skipping Taxes*, 68 J. Tax'n 242 (Apr. 1988).

[7] Del. Code Ann. tit. 25, §501.

[8] 38 Del. Laws 198, §1 (1933).

ISSN 0886-3547

was not subject to federal estate tax because she held only a nongeneral power of appointment. By her Will, she exercised her First Power to create a trust for her son George, giving him a Second Power. Under the Delaware statute, the determination of whether Delaware's traditional rule against perpetuities was violated was measured from the date of Alice's death not from the date of Fred's death. Under this regime, assets could remain in trust perpetually and no federal estate tax would be due other than at Fred's death.

Congress's Response

To prevent this from happening, the predecessor to §2041(a)(3) was enacted in 1951.[9] Under it, a trust is subject to federal estate tax at the death of the donee of a First Power who:[10]

> [E]xercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, *for a period ascertainable without regard to the date of the creation of the first power*. (Emphasis added.)

The legislative history makes clear that the Delaware statute was Congress's target:[11]

> In at least one state [i.e., Delaware] a succession of powers of appointment, general or limited may be created and exercised over an indefinite period without violating the rule against perpetuities. In the absence of some special provision in the statute, property could be handed down from generation to generation without ever being subject to estate tax.

The Treasury Regulations

The determination as to whether the donee springs the Trap is based on:

- The instrument that created the First Power
- The instrument that exercises the First Power to create a Second Power
- Applicable local law.[12]

Consequently, even if state law provides that the exercise of a First Power to create a Second Power starts a new perpetuities period and even if the instrument granting the First Power does not limit its exercise, the donee may avoid invoking §2041(a)(3) by including appropriate limitations in the instrument exercising the First Power to create the Second Power. To avoid triggering the Trap, instruments exercising First Powers over Grandfathered Trusts in Delaware typically include language such as the following:

> I further direct that any power of appointment conferred upon any person under the provisions of this instrument may not be exercised in any manner which would vest an interest in trust beyond the expiration of twenty-one (21) years after the death of the last survivor of my spouse and my issue living on [date original trust became irrevocable]. If any such power is so exercised, I direct that it be declared void ab initio.

The regulations illustrate the application of the Trap as follows:[13]

> If . . . the decedent appoints the income from the entire [$100,000] fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the entire $100,000 will be includable in the decedent's gross estate under section 2041(a)(3) if the exercise of the Second Power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

Case Law

The only reported case that considered §2041(a)(3) is *Estate of Murphy v. Commissioner*,[14] in which the Tax Court held that the exercise of a First Power to create a Second Power did not spring the Trap because, under applicable Wisconsin law, the exercise of a nongeneral power of appointment did not commence a new perpetuities period. The IRS acquiesced in the result.[15] The Action on Decision explained that:[16]

> Section 2041(a)(3) refers to the creation of a power which under state law can be validly exercised so as to postpone vesting or suspend ownership "for a period ascertainable

[9] The corresponding federal gift-tax provision is §2514(d).

[10] §2041(a)(3). *See* Reg. §20.2041-3(e)(1).

[11] S. Rep. No. 82-382 (1951).

[12] Reg. §20.2041-3(e)(1)(ii).

[13] Reg. §20.2041-3(e)(2) (Citation omitted.)

[14] 71 T.C. 671 (1979).

[15] 1979-2 C.B. 2.

[16] AOD 1979-87 (May 1979).

ISSN 0886-3547

without regard to the date of the creation of the First Power." Since the Wisconsin rule measures the period from the creation of the first nongeneral power, the statute by its very words cannot apply. This conclusion is supported by Treas. Reg. §20.2041-3(e)(1)(ii). While an argument can be made that Congress intended to tax all creations of successive powers where vesting or ownership/power of alienation are affected, without regard to state law, such an argument ignores the very language of the Code and regulation. The regulation itself indicates that postponing of vesting and suspension of ownership/alienation power are mutually exclusive conditions of includability which are governed by the particular applicable state law. Finally, under Wisconsin law, ownership has not been suspended because the trustee was given the power to sell trust assets. The regulation, as it is written, appears to say that because local law is phrased in terms of the suspension of ownership/power of alienation, and if there is no such suspension under that local law, then section 2041(a)(3) cannot apply.

HOW TO SPRING AND NOT TO SPRING THE TRAP

Introduction

As noted above, §2041(a)(3) provides for estate taxation if a trust beneficiary:

> [E]xercises a power of appointment created after October 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

Hence, for a trust to be includable in the gross estate of the donee of a First Power created after October 21, 1942, the donee must:

- Exercise the First Power
- Exercise the First Power to create a Second Power
- Exercise the First Power to create a Second Power that, under applicable local law, can be validly exercised to do one of the following for a period ascertainable without regard to the date of the creation of the First Power:
  - Postpone the vesting of any estate or interest in such property; or
  - Suspend the absolute ownership or power of alienation of such property.

Conversely, the donee of a First Power will not fall into the Trap if the donee:

- Does not exercise the First Power
- Exercises the First Power but does not create a Second Power
- Exercises the First Power to create a Second Power that is tied to the date of creation of the First Power.

Beginning of Measuring Period

From the foregoing, it is apparent that the key to whether the exercise of a First Power to create a Second Power springs the Trap is whether the duration of trusts created by the Second Power will be based on the date of creation of the First Power or on the date of its exercise. If tied to the date of creation, the Trap should not be sprung; if tied to the date of exercise, the Trap should be sprung. I summarize where some states stand on this issue below.

End of Measuring Period

Some commentators suggest that the Trap makes it impossible for donees to exercise First Powers to create Second Powers over trusts created in states, such as Delaware, that allow perpetual trusts without adverse tax consequences. This concern was articulated in a 2009 article in the following way:[17]

> To avoid the Trap, it is necessary to specify a period during which vesting may be postponed, or absolute ownership or the power of alienation suspended, that begins on the date of the Second Power's exercise and ends on a date that cannot be ascertained without regard to the date of creation of the First Power. *Such a period must be finite.* (emphasis added).

As a result, several states set a maximum period (ranging from 360 years to 1,000 years) for the duration of trusts created by the exercise of nongeneral powers of appointment.[18]

Several comments are in order:

---

[17] Spica, *A Trap for the Wary: Delaware's Anti-Delaware-Tax-Trap Statute Is Too Clever by Half (of Infinity)*, 43 Real Prop., Tr. & Est. J. 673, 682 (Winter 2009).

[18] See below for some examples.

ISSN 0886-3547

- The fixed-period requirement appears nowhere in the authorities summarized above. This isn't surprising because perpetual trusts were not generally available when the authorities were developed, but the fact remains that a fixed period is not required by the tax laws or regulations. The primary authority cited by the author of the above article is an earlier article, which also cites meager sources.[19]
- The argument assumes that §2041(a)(3) requires the existence of a "fixed period" to avoid its application. In fact, by its terms, §2041(a)(3) only applies to a Second Power that can be exercised to suspend vesting for one type of period — a "period ascertainable without regard to the date of the creation of the first power." If the Second Power can be exercised to suspend vesting indefinitely and if this is not a "period," the section literally does not apply.
- Even if avoidance of §2041(a)(3) does require a "period" to demonstrate such period was ascertainable with regard to the date of the creation of the first power, Delaware, and other perpetual trust states, do have such a period — an indefinite one. The notion that a period may be indefinite is consistent with dictionary meanings of the word. For example, the *Oxford English Dictionary*[20] defines "period" as both "an indefinite portion of time" and as "any specified portion or division of time."
- It is difficult to distinguish, in any practical sense, among states that permit perpetual trusts and states with 1,000-year periods or states with 360-year periods with their definite periods of such inordinate length that they might as well be indefinite. Note that the foregoing fixed periods greatly exceed the IRS's "safe harbor" period (the common-law rule against perpetuities, 90 years, or the shorter of such periods) in the regulations for the exercise of nongeneral powers of appointment over Grandfathered Trusts,[21] which apply to any exercise of a power and not just to an exercise of a First Power that creates a Second Power.[22] The regulations suggest that if an ending period is essential to avoid the application of §2041(a)(3), the IRS will require such ending period to be no longer than the traditional period or 90 years. In informal discussions in 2003, IRS representatives confirmed this view with me. At that time, the IRS declined to issue a revenue ruling or private letter ruling on the Trap.
- Given that the determination of whether the Trap is triggered is based, in part, on the instrument exercising the First Power,[23] such instruments should place a maximum fixed period on trusts created by the exercise of Second Powers if the drafting attorney shares this concern.

WHEN TO SPRING AND NOT TO SPRING THE TRAP

Grandfathered Trust

The Trap is of particular concern for a donee who is exercising a First Power over a Grandfathered Trust because, if the power is exercised inadvertently, he or she might subject an otherwise tax-free trust to estate or gift tax. For example, if the donee exercises a nongeneral power of appointment over a $5 million Grandfathered Trust so as to spring the Trap, his or her estate would owe $2 million of federal estate tax ($5 million times 40%) that should not have been due. Nonetheless, the Trap rarely will be of concern for Grandfathered Trusts for at least two reasons.

First, just three states (Idaho, South Dakota, and Wisconsin) allowed perpetual trusts before September 26, 1985. Therefore, most Grandfathered Trusts expressly require all trusts (including those established through the exercise of powers of appointment) to terminate at the end of the common-law period.

Second, the GST tax regulations allow a donee exercising a nongeneral power of appointment over a Grandfathered Trust (whether or not he or she creates a Second Power) to extend the trust until the expiration of the common law rule against perpetuities, the passage of 90 years, or the end of the shorter of those periods.[24] If a donee complies with these regulations, he or she probably has no Trap concern.

On several occasions, the IRS ruled that exercises of First Powers over Grandfathered Trusts to create Second Powers would not cause the trusts to lose their tax-favored status.[25]

Nonetheless, as noted above, a client might intentionally trigger the Trap in a Grandfathered Trust to the extent that he or she has unused federal estate tax and GST tax exemption.

---

[19] Greer, *The Alaska Dynasty Trust*, 18 Alaska L. Rev. 253, 276 (Dec. 2001).

[20] *Oxford English Dictionary* (24th ed. 1985).

[21] Reg. §26.2601-1(b)(1)(v)(B)(2).

[22] *See* Reg. §26.2601-1(b)(1)(v)(B)(2).

[23] Reg. §20.2041-3(e)(1).

[24] Reg. §26.2601-1(b)(1)(v)(B)(2).

[25] *See* PLR 201029011, PLR 200535009, PLR 200243048, PLR 200206045, PLR 200124006, PLR 199912021, PLR 9351016.

ISSN 0886-3547

Exempt Trust

The Trap can pose a significant problem for Exempt Trusts. Thus, if the donee of a nongeneral power of appointment over a $5 million Exempt Trust exercises the power in a way that springs the Trap, the estate again would owe $2 million of federal estate tax that should have been avoided. Currently, over half the states authorize perpetual or very long trusts, and many Exempt Trusts take advantage of these statutes. Exempt Trusts typically also confer First Powers that enable donees to modify trust terms over time to adapt to changing circumstances. Assessing the potential impact of the Trap is crucial to this planning.

As discussed above, the donee of a First Power over an Exempt Trust should not create federal gift or estate tax liability if he or she does not exercise the First Power to create a Second Power or includes appropriate limiting language in the Will or instrument by which the power is exercised.

In a 2002 private letter ruling,[26] the IRS concluded that a donee's exercise of a First Power to create a Second Power did not cause an Exempt Trust to lose its zero inclusion ratio because all resulting trusts had to terminate within the common-law perpetuities period determined from the date of creation of the original trust.

Placing a fixed limitation on the duration of trusts created by the exercise of First Powers over Exempt Trusts puts a state that is trying to attract trust business at a serious competitive disadvantage. The problem is that once an Exempt Trust is established in one of those states, it cannot be moved to a state with a longer perpetuities period without adverse transfer-tax consequences, which will discourage wealthy families who want to preserve flexibility from creating the trust there in the first place.[27] This is particularly true for states that set relatively short fixed periods.

Theoretically, the Trap might be triggered in a state that still follows the common-law rule against perpetuities.

Illustration: Parent creates a trust for the lifetime benefit of Child, remainder to Grandchild, and grants Child the power to appoint trust property either outright or in further trust to Grandchild. As part of this power, Child can grant Grandchild a nongeneral power of appointment. The trust is subject to the laws of a jurisdiction under which Grandchild's exercise of a nongeneral power of appointment starts a new perpetuities period running. If Child exercises the First Power by creating a trust for Grandchild and granting Grandchild a Second Power, the property of Grandchild's trust will be includible in Child's estate under §2041(a)(3) because Child has exercised the First Power by creating a Second Power that may be exercised so as to suspend absolute ownership of trust property without reference to the date of the trust created by Parent.[28]

Therefore, the Trap must be considered by a donee exercising a First Power in almost every state. Given the prevalence of the issue, attorneys drafting new trusts or instruments exercising powers of appointment should include language to alert donees and their attorneys to the concern.

As mentioned above, though, it might be desirable to trigger the Trap over an Exempt Trust if a client has unused exemptions.

Nonexempt Trust

The Trap provides an interesting planning option for a Nonexempt Trust given the substantial increase in the federal estate tax exemption ($5.43 million in 2015).[29] An individual's total tax liability sometimes might be lower if trust assets are subject to estate tax and sometimes might be lower if they are subject to GST tax. Various mechanisms have been suggested to minimize a trust beneficiary's total transfer tax liability, but they usually depend upon the inclusion of a formula in the original trust instrument or the exercise of discretion by a trustee who might possess less than complete information.

The Trap might provide the ideal mechanism because it gives the donee the ability to choose between estate tax and GST tax in light of circumstances as they are at the time of the choice. Thus, if the donee's tax liability will be lower if the trust is subject to estate tax (which might be the case if the estate is below $5.43 million and if a stepped-up income tax basis is desirable), he or she may exercise a First Power to trigger the Trap. Conversely, if the donee's tax liability will be lower if a trust is subject to the GST tax (which might be the case if he or she lived in a state that has a death tax), he or she may refrain from exercising a First Power or exercise it in a way that does not spring the Trap.

---

[26] PLR 200219034.

[27] *See* Reg. §26.2601-1(b)(4)(i)(E) *Ex.* 4.

[28] *See* 825 T.M., *Powers of Appointment — Estate, Gift, and Income Tax Considerations.*

[29] Rev. Proc. 2014-61, 2014-47 I.R.B. 860, §3.33.

ISSN 0886-3547

CURRENT DELAWARE LAW

Rule Against Perpetuities

The common law rule against perpetuities has been abolished in Delaware. The basic rule is as follows:[30]

> No interest created in real property held in trust shall be void by reason of the common-law rule against perpetuities or any common-law rule limiting the duration of noncharitable purpose trusts, and no interest created in personal property held in trust shall be void by reason of any rule, whether the common-law rule against perpetuities, any common-law rule limiting the duration of noncharitable purpose trusts, or otherwise.

Trust interests in personal property may be perpetual, but trust interests in real property must be distributed "at the expiration of 110 years from the later of the date on which a parcel of real property or an interest in real property is added to or purchased by a trust or the date the trust became irrevocable."[31]

The 110-year limitation may be circumvented by contributing a parcel of real property to an entity because, "real property does not include any intangible personal property such as an interest in a corporation, limited liability company, partnership, statutory trust, business trust or other entity, regardless of whether such entity is the owner of real property or any interest therein."[32]

Powers of Appointment

Delaware law generally measures violations of the rule against perpetuities from the date of exercise — rather than from the date of creation — of powers of appointment. The basic rule is:[33]

> Every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of a power of appointment, irrespective of:
>
> (1) Whether such power is nongeneral or general as to appointees;
>
> (2) The manner in which such power was created or may be exercised;
>
> (3) Whether such power was created before or after the passage of this section,
>
> shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted be deemed to have been created at the time of the exercise and not at the time of the creation of such power of appointment. No such estate or interest shall be void on account of any such rule unless the estate or interest would have been void had it been created at the date of the exercise of such power of appointment otherwise than through the exercise of a power of appointment.

Regarding the above rule, another section provides:[34]

> [T]rusts created by the exercise of a power of appointment, whether nongeneral or general, and whether by will, deed or other instrument, shall be deemed to have become irrevocable by the trustor or testator on the date on which such exercise became irrevocable.

The law is mindful of not falling into the Trap through the exercise of First Powers over Grandfathered Trusts and Exempt Trusts in most situations. Accordingly, the general rule is reversed for these trusts as follows:[35]

> Notwithstanding any other provision of this chapter, and except as otherwise provided in subsection (b) of this section, in the case of a power of appointment over property held in trust (the "first power"), if the trust is not subject to, or has an inclusion ratio of zero for purposes of, the tax on generation-skipping transfers imposed pursuant to Chapter 13 of the Internal Revenue Code or any successor provision thereto and the first power may not be exercised in favor of the donee, the donee's creditors, the donee's estate or the creditors of the donee's estate, then every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of the first power, irrespective of:
>
> (1) The manner in which the first power was created or may be exercised, or
>
> (2) Whether the first power was created before or after the passage of this section,

---

[30] Del. Code Ann. tit. 25, §503(a).

[31] Del. Code Ann. tit. 25, §503(b).

[32] Del. Code Ann. tit. 25, §503(e). The subsection addresses what happens if such an entity ceases to exist.

[33] Del. Code Ann. tit. 25, §501. Rules are set for releasing powers of appointment. *See* Del. Code Ann. tit. 25, §502.

[34] Del. Code Ann. tit. 25, §503(c).

[35] Del. Code Ann. tit. 25, §504(a).

ISSN 0886-3547

shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted, be deemed to have been created at the time of the creation of, and not at the time of the exercise of, the first power. For purposes of applying the foregoing rule, if any part of an estate or interest in property created through the exercise of the first power includes another power of appointment (the "second power"), then the second power of appointment and any estate or interest in property (including additional powers of appointment) created through the exercise of the second power shall be deemed to have been created at the time of the creation of the first power. (citation omitted).

Elsewhere, it is provided:[36]

> Notwithstanding the foregoing, in the case of a power of appointment described in §504 of this title as a "first power," and subject to §504(a), trusts created by the exercise of the power of appointment, whether by will, deed or other instrument, shall be deemed to have become irrevocable by the trustor or testator on the date on which the first power was created.

But, the law recognizes that it might be desirable to spring the Trap over Grandfathered Trusts and Exempt Trusts:[37]

> Subsection (a) of this section shall not apply to the exercise of a first power or second power over property held in a trust that is not subject to, or has an inclusion ratio of zero for purposes of, the tax on generation-skipping transfers imposed pursuant to Chapter 13 of the Internal Revenue Code or any successor provision thereto if the instrument of exercise of any such power makes express reference to subsection (a) of this section and expressly states that subsection (a) of this section shall not apply to the exercise of the power or makes express reference to §501 of this title and expressly states that §501 of this title shall apply to the exercise of the power.

[36] Del. Code Ann. tit. 25, §503(c).

[37] Del. Code Ann. tit. 25, §504(b). The law addresses the manner in which powers of appointment may be exercised. *See* Del. Code Ann. tit. 25, §505.

STATUS OF THE TRAP IN SOME OTHER STATES

Leading Trust States

Introduction

A January 2014 article identifies the best trust states as follows:[38]

> In our view, the four top-tier jurisdictions for 2014 (listed by the year they adopted their perpetuities legislation) remain South Dakota, Delaware, Alaska and Nevada. We rank New Hampshire in fifth place.

As described above, the donee of a First Power over a Delaware trust can exercise the power to spring the Trap and get a stepped-up income-tax basis. This option does not appear to be available in Alaska, Nevada, New Hampshire, or South Dakota.

Alaska

A testator or trustor may create a perpetual Alaska trust,[39] but trusts created via the exercise of nongeneral powers of appointment are limited to 1,000 years.[40] The donee of a First Power over an Alaska Trust cannot spring the Trap because the duration of trusts created by First Powers and Second Powers relates back to the creation of the First Power under the following provision:[41]

> If a nongeneral power of appointment is exercised to create a new or successive nongeneral power of appointment . . . , all property interests subject to the exercise of that new or successive nongeneral . . . power of appointment are invalid unless, within 1,000 years from the time of creation of the original instrument or conveyance creating the original nongeneral power of appointment that is exercised to create a new or successive nongeneral . . . power of appointment, the property interests that are subject to the new or successive nongeneral . . . power of appointment either vest or terminate.

Nevada

A Nevada statute[42] allows trusts created by Wills, inter vivos trust instruments, and exercises of nongeneral powers of appointment to last for 365 years, but

[38] Daniel G. Worthington & Mark Merric, *Which Trust Situs is Best in 2014?*, 153 Tr. & Est. 53, 53 (Jan. 2014) (footnote omitted). The authors did not issue a comparable ranking in 2015.

[39] Alaska Stat. §34.27.075.

[40] Alaska Stat. §34.27.051(a).

[41] Alaska Stat. §34.27.051(c).

[42] Nev. Rev. Stat. §111.1031(1)(b), §111.1031(3)(b).

ISSN 0886-3547

the statute probably is unconstitutional because §4 of Article 15 of the Nevada Constitution provides that, "No perpetuities shall be allowed except for eleemosynary purposes," and because, in 2002, Nevada voters disapproved a ballot initiative to repeal this prohibition.[43] In this regard, a late 2014 article observes:[44]

> [W]e conclude that legislation authorizing perpetual or long-enduring dynasty trusts is constitutionally suspect in a state with a constitutional prohibition of perpetuities . . . .

A Nevada practitioner contends that a 1941 decision of the Supreme Court of Nevada — *Sarrazin v. First Nat'l Bank of Nevada*[45] — and a 2015 decision of the same court — *Bullion Monarch Mining, Inc. v. Barrick Gold Strike Mines, Inc.*[46] — mean that the constitutional limitation no longer is relevant.

The *Sarrazin* case was decided long before Nevada adopted a 365-year period for trust interests. Its entire description of the law of perpetuities in Nevada is as follows:[47]

> Section 4 of article XV of the constitution of Nevada reads: "No perpetuities shall be allowed except for eleemosynary purposes." There is no Nevada statute defining the rule against perpetuities. The common-law rule is usually stated thus: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest." *Other than the constitutional provision above quoted, there have not been called to our attention any other provisions, either constitutional or statutory, invalidating interests which vest too remotely, or forbidding restraints on alienation.* (citations omitted; emphasis added).

The above emphasized sentence is dictum at best because the court concluded that all interests in the trust in question would vest within the common law rule against perpetuities period.[48]

The *Bullion Monarch Mining* case involved the applicability of Nevada's rule against perpetuities to "commercial mining agreements for the payment of area-of-interest royalties."[49] Not surprisingly, the court held that it did not.[50] In the course of the opinion, the court discussed a 1974 case — *Rupert v. Stienne*[51] — as endorsing statutes that depart from the common law. Nevertheless, *Rupert*, which dealt with the "old common-law rule of interspousal immunity,"[52] did not involve a common law rule that had been codified in Nevada's constitution.

A decision of the Supreme Court of Nevada validating 365-year trusts might be helpful. It has been suggested that the court would uphold the statute in the interest of supporting Nevada's business development efforts. That would be a regrettable basis for such a decision if the law is to the contrary.

The best way to resolve the uncertainty would be for the voters to repeal the constitutional prohibition.

In any event, the following statute[53] prevents the donee of a First Power over a Nevada trust from triggering the Trap:

> For purposes of NRS 111.103 to 111.1039, inclusive, a nonvested property interest or a power of appointment arising from a transfer of property to a previously funded trust or other existing property arrangement is created when the nonvested property interest or power of appointment in the original contribution was created.

New Hampshire

In New Hampshire, a trust may be perpetual if the governing instrument expressly exempts it from the application of the rule against perpetuities and if the trustee or another person has the power to sell, mortgage, or lease trust property for any period beyond the period that would be required for an interest in the trust to vest in order to be valid under the rule against perpetuities.[54] Given that New Hampshire has no statute regarding the beginning date for measuring the validity of the exercise of a power of appointment or when a First Power becomes irrevocable, the Trap cannot be sprung in New Hampshire because, under the common law, the duration of trusts created by

---

[43] Robert H. Horowitz & Steven J. Sitkoff, *Unconstitutional Perpetual Trusts*, 67 Vand. L. Rev. 1769, 1773 (Nov. 2014).

[44] *Id.* at 1803. *Accord* Jonathon Blattmachr, Mitchell Gans & Lipkin, *What If Pepetual Trusts are Unconstitutional?* LISI Est. Plng. Newsltr. #2263 (Dec. 18, 2014), available at www.leimbergservices.com.

[45] 111 P.2d 49 (Nev. 1941). *See* Steven J. Oshins, *The Rebuttal to Unconstitutional Perpetual Trusts*, LISI Est. Plng. Newsltr. #2265 (Dec. 22, 2014), available at www.leimbergservices.com.

[46] *Bullion Monarch Mining, Inc. v. Barrick Gold Strike Mines, Inc.*, 345 P.3d 1040 (Nev. 2015). *See* Steven J. Oshins, *Unconstitutional Perpetual Trusts — Not So Fast Says the Nevada Supreme Court*, LISI Est. Plng. Newsltr #2297 (Apr. 6, 2015), available at www.leimbergservices.com.

[47] *Sarrazin*, 111 P.2d at 51.

[48] 111 P.2d at 53.

[49] *Bullion Monarch Mining*, 345 P.3d at 1041.

[50] 345 P.3d at 1044.

[51] *Rupert v. Stienne*, 528 P.2d 1013 (Nev. 1974).

[52] *Bullion Monarch Mining*, 345 P.3d at 1042.

[53] Nev. Rev. Stat. §111.1033(3).

[54] N.H. Rev. Stat. Ann. §564-B:4-402A, §564:24, §547:3-k.

ISSN 0886-3547

powers of appointment dates back to the creation of the original trust.[55]

South Dakota

South Dakota permits trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment to be perpetual.[56] Nevertheless, the donee of a First Power over a South Dakota trust cannot spring the Trap as a result of the following statute:[57]

> If a future interest or trust is created by exercise of a power of appointment, the permissible period is computed from the time the power . . . is created if the power is not a general power.

States Where Trap Cannot Be Sprung

Introduction

As just discussed, it appears that the Trap cannot be sprung in Alaska, Nevada, New Hampshie, or South Dakota. Below are other states where the technique also is not available.

Connecticut

Connecticut follows the Uniform Statutory Rule Against Perpetuities (USRAP). Thus, a trust created by a Will or inter vivos trust instrument[58] or by the exercise of a power of appointment[59] must vest at the expiration of the common-law rule against perpetuities or at the expiration of 90 years after creation. The Trap cannot be triggered because the date of creation relates back to the creation of the original trust under the following statute:[60]

> For purposes of sections 45a-490 to 45a-496, inclusive, a . . . power of appointment arising from a transfer of property to a previously funded trust or other existing property arrangement is created when the . . . power of appointment in the original contribution was created.

New Jersey

In New Jersey, trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment may be perpetual[61] but the donee of a First Power over a New Jersey trust cannot spring the Trap by reason of the following statute:[62]

> If a future property interest or trust is created by exercise of a power of appointment, the permissible period is computed from the time the power is exercised if the power is a general power exercisable in favor of the donee, the donee's estate, the donee's creditors or the creditors of the donee's estate, whether or not it is exercisable in favor of others, and even if the general power is exercisable only by will; in the case of other powers the permissible period is computed from the time the power is created . . . .

New York

Trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment in New York are subject to the common law rule against perpetuities.[63] A donee exercising a First Power over a New York trust cannot trigger the Trap pursuant to the following statute:[64]

> Where an estate is created by an instrument exercising a power of appointment, the permissible period of the rule against perpetuities begins:
>
> (1) In the case of an instrument exercising a general power which is presently exercisable, on the effective date of the instrument of exercise.
>
> (2) In all other cases, at the time of the creation of the power.

Another State Where Trap Can Be Sprung (Pennsylvania)

In Pennsylvania, trusts created by Wills, inter vivos trust instruments, and exercises of powers of appointment may be perpetual.[65] A donee exercising a First Power over a Pennsylvania trust may trigger the Trap under the following statute:[66]

> If a power of appointment is exercised to create a new power of appointment, any interest created by the exercise of the new power of appointment is invalid if it does not vest within 360 years of the creation of the original power of appointment, unless the exercise of the new power of appointment

---

[55] 850 T.M., *Generation-Skipping Transfer Tax.*
[56] S.D. Codified Laws §43-5-8.
[57] S.D. Codified Laws §43-5-5.
[58] Conn. Gen. Stat. §45a-491(a).
[59] Conn. Gen. Stat. §45a-491(c).
[60] Conn. Gen. Stat. §45a-492(c).
[61] N.J. Rev. Stat. §46:2F-9.
[62] N.J. Rev. Stat. §46:2F-10(a)(3).
[63] N.Y. Est. Powers & Trusts Law §9-1.1
[64] N.Y. Est. Powers & Trusts Law §10-8.1(a).
[65] 20 Pa. Cons. Stat. §6107.1(b)(1).
[66] 20 Pa. Cons. Stat. §6107.1(b)(3).

ISSN 0886-3547

expressly states that this provision shall not apply to the interests created by the exercise.

RELATED ISSUES

Fiduciary Powers

The regulations under §2041 define "power of appointment" expansively.[67] Consequently, attorneys advising trustees regarding trust modifications, exercises of decanting powers,[68] and changes of trust situs (as well as donees exercising First Powers) must be mindful of §2041(a)(3) and §2514(d). Nevertheless, the provision's legislative history indicates that they do not apply to powers exercised by trustees:[69]

> The existing statute contains a provision which was intended to cover this situation, but it is too broadly worded. Under it, for example, the exercise of an otherwise exempt power might be taxed if it were exercised by giving a trustee discretionary power to invade principal.

Creditor Rights

The practitioner should be aware of any creditor issues relating to the exercise of First Powers. Under Delaware law, for example, the exercise of a nongeneral power of appointment does not cause trust assets to be subject to creditor claims.[70] The exercise of a general power — lifetime or testamentary — only subjects trust assets to the claim of a creditor in favor of whom the power is exercised.[71]

Tax Payment

The planner should pay close attention to how federal estate tax will be paid if a donee triggers the Trap and how GST tax will be paid if a donee does not spring the Trap over a Nonexempt Trust. Charging all taxes to the residue of the probate estate will be ill-advised in almost every case. If the donee of a First Power triggers the Trap and thereby generates federal estate tax, §2207 is available. It provides:[72]

> *Unless the decedent directs otherwise in his will*, if any part of the gross estate on which the tax has been paid consists of the value of property included in the gross estate under section 2041, the executor shall be entitled to recover from the person receiving such property by reason of the exercise, nonexercise, or release of a power of appointment such portion of the total tax paid as the value of such property bears to the taxable estate. If there is more than one such person, the executor shall be entitled to recover from such persons in the same ratio. In the case of such property received by the surviving spouse of the decedent for which a deduction is allowed under section 2056 (relating to marital deduction), this section shall not apply to such property except as to the value thereof reduced by an amount equal to the excess of the aggregate amount of the marital deductions allowed under section 2056 over the amount of proceeds of insurance upon the life of the decedent receivable by the surviving spouse for which proceeds a marital deduction is allowed under such section. (Emphasis added.)

Similarly, if a taxable termination occurs in a Nonexempt Trust, §2603(b) is available. It provides:[73]

> Source of tax. *Unless otherwise directed pursuant to the governing instrument by specific reference to the tax imposed by this chapter* [§2601 et seq.], the tax imposed by this chapter [§2601 et seq.] on a generation-skipping transfer shall be charged to the property constituting such transfer. (Emphasis added.)

The tax clause in the client's Will should be coordinated with the above tax-recovery provisions.

Incapacity of Testator/Trustor

In many ways, the Trap is an ideal way to minimize the payment of federal taxes because it puts the decision as to whether to subject assets to federal estate tax or to GST tax in the hands of the person who is best able to make that determination. That might involve reviewing the situation periodically and signing appropriate estate planning documents, which grows difficult if the donee of a First Power becomes incompetent. With that in mind, donees of First Powers might want to include provisions in durable powers of attorney authorizing attorneys-in-fact to amend exercises of powers of appointment (which might be as minimal as specifying whether the duration of trusts will be measured from the creation rather than from the exercise of powers or vice versa) or might want to

---

[67] Reg. §20.2041-1(b)(1).

[68] *See* PLR 200744020 (exercise of decanting power over grandfathered trust did not fall within §2041(a)(3)).

[69] S. Rep. No. 82-382 (1951).

[70] *See* Del. Code Ann. tit. 12, §3536(d)(1)§3536(d)(2).

[71] Del. Code Ann. tit. 12, §3536(d)(1)§3536(d)(2).

[72] §2207.

[73] §2603(b) (emphasis added).

ISSN 0886-3547

include language in instruments of appointment authorizing court-appointed guardians to make appropriate decisions. It also might be prudent to include language in new trusts authorizing trustees to make appropriate distributions.

CONCLUSION

Flexibility is essential in the estate planning world. For decades, estate planning attorneys did their utmost to prevent trusts from being classified as grantor trusts for federal income tax purposes. Now, grantor trusts are the norm. Similarly, planners, who long have abhorred the Trap, now should add it to their planning palette. I hope that this article has alerted planners to the Trap's perils and possibilities.[74]

[74] In a future article, I hope to explore the circumstances, if any, in which the Trap option can be made available through the exercise of a merger or a decanting power, a nonjudicial settlement agreement, a change of situs, or a court proceeding.

Statement of Ownership

Tax Management Estates, Gifts & Trusts Journal (publication number 753-810), published Bi-Monthly (6 issues annually) at 1801 South Bell St, Arlington, VA 22202–4501 and having headquarters and general offices at 1801 South Bell St, Arlington, VA 22202–4501. The annual subscription price is $648.00.

Publisher, The Bureau of National Affairs Inc., 1801 South Bell St, Arlington, VA 22202–4501; Editorial Director, George R. Farrah, CPA; Managing Editor, Eric H. Rubin, Esq.

Owner: Bloomberg LP, 731 Lexington Ave, New York, New York 10022

Issue Date for circulation data below: 7/14/2015

	Average No. Copies Each Issue During Preceding 12 Months	No. Copies Of Single Issue Published Nearest To Filing Date
A. Total Number of Copies (Net Press Run)	1,925	1,850
B. Paid Circulation (By Mail and Outside the Mail) (1) Mailed Outside-County Paid Subscriptions Stated on PS Form 3541 *(Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies)*	1,670	1,602
(2) Mailed In-County Subscription Stated on PS Form 3541 *(Include paid distribution above nominal rate, advertiser's proof copies, and exchange copies)*	0	0
(3) Paid Distribution Outside the Mails including Sales Through Dealers and Carriers, Street Vendors, Counter Sales, and Other Paid Distribution Outside USPS®	52	49
(4) Paid Distribution by Other Classes of Mail through the USPS (e.g. First-Class Mail®)	17	18
C. Total Paid Distribution *(Sum of 15b(1), (2), (3), and (4))*	1,739	1,669
D. Free or Nominal Rate Distribution *(By Mail and Outside the Mail)*		
(1) Free or Nominal Rate Outside-County Copies included on PS Form 3541	0	0
(2) Free or Nominal Rate In-County Copies included on PS Form 3541	0	0
(3) Free or Nominal Rate Copies Mailed at Other Classes Through the USPS (e.g. First-Class Mail)	0	0
(4) Free or Nominal Rate Distribution Outside the Mail *(Carrier or other means)*	85	85
E. Total Free or Nominal Rate Distribution *(Sum of 15d (1), (2), (3), and (4))*	85	85
F. Total Distribution *(Sum of 15c and 15e)*	1,824	1,754
G. Copies not Distributed *(See Instructions to Publishers #4 (page #3))*	101	96
H. Total *(Sum of 15f and g)*	1,925	1,850
I. Percent Paid *(15c divided by 15f times 100)*	95%	95%

Publication Statement of Ownership will be printed in the 9/10/2015 issue of this publication.

I certify that the statements made by me above are true and complete. (signed) Jesse E. Copeland, Supervisor, Mailing Services, 10/01/2015

ISSN 0886-3547

Estate Planning
vol. 42
October 2015

Planning for New York Trusts to Escape State Income Tax

Trusts with no New York trustees, assets, or source income can avoid New York income tax, offering planning opportunities that extend beyond the state's borders.

RICHARD W. NENNO, ATTORNEY

New York fiduciaries pay a lot of New York income taxes. Thus, for 2011 (the latest year for which figures have been released), 43,310 resident estates and trusts paid approximately $218 million of New York income tax and 3,800 nonresident and part-year resident estates and trusts paid approximately $64 million of such tax.[1] This is remarkable because clear rules for avoiding the taxation of trusts have existed for many years.

In a nutshell

New York long has defined "Resident Trust" as a trust established by a New York resident testator or trustor. In 1992, the New York State Department of Taxation and Finance adopted a regulation confirming prior court holdings that the trustee of a trust created by a New York testator or trustor is not taxable if the trust has no New York trustees, assets, or source income,[2] thereby creating an exemption for an "Exempt Resident Trust." Subsequently, decisions from the State of New York Division of Tax Appeals and guidance from the Technical Services Division of the State of New York Department of Taxation and Finance indicated that Exempt Resident Trusts were not taxable and did not have to file tax returns.[3] The Exempt Resident Trust exemption was codified in 2003, effective 1/1/1996.[4] Relevant cases and rulings are discussed below.

In 2010, Governor Paterson proposed to repeal the exemption for Exempt Resident Trusts,[5] but his proposal was not enacted. Later, though, the New York State Department of Taxation and Finance announced that, effective 1/1/2010, new and existing Exempt Resident Trusts must file informational returns.[6] That reporting requirement was made statutory in 2014.[7]

The 2014-2015 New York budget bill[8] made two substantive changes to how New York taxes

RICHARD W. NENNO is Senior Managing Director and Trust Counsel at Wilmington Trust Company in Wilmington, Delaware.

trust income. First, the bill requires New York State and New York City residents to pay tax on accumulation distributions (which, as noted below, do not include capital gains) from Exempt Resident Trusts[9] and imposes reporting requirements on the trustees of such trusts.[10] Second, the bill classifies incomplete gift nongrantor trusts as grantor trusts for New York State and New York City income tax purposes.[11]

Early cases

A survey of the pertinent authorities is useful in understanding the planning ideas discussed later in this article.

Mercantile-Safe Deposit & Trust Company v. Murphy.[12] In the 1964 *Mercantile-Safe Deposit & Trust Company v. Murphy* decision, the New York Court of Appeals, affirming an intermediate appellate court decision, held that the Due Process Clause of the U.S. Constitution prohibited New York from taxing the accumulated income of an inter vivos trust, funded in part during life and in part by a pour-over of assets under the decedent's will, that had no New York trustee, New York assets, or New York-source income, even though the current discretionary beneficiary was a New York resident. Relying on the U.S. Supreme Court's 1929 *Safe Deposit and Trust Company v. Virginia*[13] decision, the court stated that:

> The lack of power of New York State to tax in this instance stems not from the possibility of double taxation but from the inability of a State to levy taxes beyond its border.... [T]he imposition of a tax in the State in which the beneficiaries of a trust reside, on securities in the possession of the trustee in another State, to the control or possession of which the beneficiaries have no present right, is in violation of the Fourteenth Amendment.

New York State taxes all New York taxable income of Resident Trusts but only New York-source income of Nonresident Trusts.

Mercantile is significant because it confirmed that the presence of a New York resident trustor and current discretionary beneficiary did not justify the income taxation of a nonresident trustee.

Taylor v. State Tax Commissioner.[14] In the 1981 case of *Taylor v. State Tax Commissioner*, a New York intermediate appellate court considered whether New York income tax was payable on gain incurred upon the sale of Florida real property held in a trust created by the will of a New York decedent. Although the will appointed two nonresident individual trustees and a New York corporate trustee, Florida law prohibited the corporate trustee from serving so that only the nonresident trustees served with respect to the Florida real estate. The sale proceeds of the Florida property were held by the New York corporate co-trustee in an agency account in New York. The court held on due-process grounds that New York could not tax the gain as follows:

> New York's only substantive contact with the property was that New York was the domicile of the settlor of the trust, thus creating a resident trust. The fact that the former owner of the property in question died while being domiciled in New York, making the trust a resident trust under New York tax law, is insufficient to establish a basis for jurisdiction.

Note that depositing the sale proceeds of the Florida real estate in an agency account at a New York financial institution did not affect the outcome.

Current rules—New York State

In New York State, a trustee must file a return if it must file a federal return, had New York taxable income, or was subject to a separate tax on lump-sum distributions.[15]

New York State treats a trust as a grantor trust if the trust is classified as a grantor trust for federal purposes,[16] and the Empire State permits trustees of nongrantor trusts to take a distribution deduction.[17] In 2014, New York State taxed the New York taxable income (including accumulated ordinary income and capital gains) of nongrantor trusts at rates up to 8.82% on such income over

[1] N.Y. State Department of Taxation and Finance, Office of Tax Policy Analysis, *Analysis of 2011 Personal Income Tax Returns* (May 2015), page 89, www.tax.ny.gov/research/stats/stat_pit/analysis_of_personal_income_tax_returns.htm.

[2] 20 NYCRR § 105.23(c).

[3] N.Y. TSB-M-96(1)I (7/29/1996), www.tax.ny.gov/pdf/memos/income/m96_1i.pdf.

[4] N.Y. Tax Law § 605(b)(3)(D)(i).

[5] 2009 N.Y. S.B. 6610, Part G.

[6] N.Y. TSB-A-11(4)I, 2011 N.Y. Tax Lexis 181 (7/27/2011), www.tax.ny.gov/pdf/advisory_opinions/income/a11_4i.pdf; N.Y. TSB-M-10(5)I, 2010 State Tax Today 145-10 (7/23/2010), www.tax.ny.gov/pdf/memos/income/m10_5i.pdf.

[7] N.Y. Tax Law § 658(f)(2), added by 2014 N.Y. Laws 59, part I, § 4 (3/31/2014).

[8] 2014 N.Y. Laws 59, Part I (3/31/2014). See N.Y. TSB-M-15(1)I, 2015 State Tax Today 31-32 (2/12/2015), www.tax.ny.gov/pdf/memos/income/m15_1i.pdf.

[9] 2014 N.Y. Laws 59, Part I, §§ 1 and 6 (3/31/2014).

[10] 2014 N.Y. Laws 59, Part I, § 4 (3/31/2014).

[11] 2014 N.Y. Laws 59, Part I, §§ 2 and 7 (3/31/2014).

[12] 15 N.Y.2d 579 (1964), *aff'g* 19 A.D.2d 765 (3d Dep't 1963).

[13] 280 U.S. 83 (1929).

[14] 445 N.Y.S.2d 648 (3d Dep't 1981).

[15] Instructions to 2014 N.Y. Form IT-205 at 2. See N.Y. Tax Law § 651(a)(2) and (e).

[16] See N.Y. Tax Law § § 611(a), 612(a); Instructions to 2014 N.Y. Form IT-205 at 6.

[17] See N.Y. Tax Law § 618; 20 NYCRR § 118.1; Instructions to 2014 N.Y. Form IT-205 at 7.

$1,046,350,[18] and the current rate schedule applies through 2017.

New York State defines "Resident Trust" as a trust that is created by a New York State testator or trustor as follows:[19]

> (B) a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or
>
> (C) a trust, or portion of a trust, consisting of the property of:
>
> (i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

Given that taxation is based on the testator's or trustor's domicile, the statutory resident test does not come into play.[20]

The statute describes when a trust is deemed to be "revocable" or "irrevocable":[21]

> For the purposes of the foregoing, a trust or portion of a trust is revocable if it is subject to a power, exercisable immediately or at any future time, to revest title in the person whose property constitutes such trust or portion of a trust, and a trust or portion of a trust becomes irrevocable when the possibility that such power may be exercised has been terminated.

A "Nonresident Trust" is a trust that is not a "Resident Trust."[22] New York State taxes all New York taxable income of Resident Trusts[23] but only New York-source income of Nonresident Trusts.[24] In New York State, trustees must make estimated tax payments for trusts.[25]

Exempt Resident Trust exemption. Importantly, as mentioned above, the New York Tax Law was amended in 2003, effective for tax years beginning in 1996, to codify an exemption for an Exempt Resident Trust. Hence, a Resident Trust is not subject to tax if there are no New York State trustees, assets, or source income.[26]

The Technical Services Division of the State of New York Department of Taxation and Finance has issued guidance on how to determine the residence of a corporate trustee and the circumstances in which resident advisors, protectors, and committee members will be treated as resident trustees.[27] In determining the location of the trust corpus, New York tax law provides that "intangible property shall be located in this state if one or more of the trustees are domiciled in the state of New York."[28]

Thus, if a trust only has nonresident trustees and intangible assets (e.g., stocks and bonds), the trust will meet the exemption. If a trust holds New York tangible personal property or real property, the trustee might consider placing it in a family limited partnership (FLP) or a limited liability company (LLC) to convert it into intangible personal property. Guidance on the circumstances in which this approach will succeed is discussed below regarding source income.

Planning tip. A single dollar of source income might prevent a trust from satisfying the Exempt Resident Trust exemption. Hence, to minimize tax, the trustee of a trust that holds assets that produce source income should consider dividing it into separate trusts, one of which holds the source-income assets and one of which does not. New York-source income is described below.

The 2014-2015 budget bill treats incomplete gift nongrantor trusts as grantor trusts for New York income tax purposes.

One might read the Exempt Resident Trust provision to say that a trust that has New York-source income but no New York trustee or assets is taxable just on the source income (not on the entire income of the trust), and this appears to be what the Appellate Division of the New Jersey Superior Court concluded in a 2015 case interpreting that state's similar rule.[29] But, the prudent course is to treat the provision as a safe harbor and to assume that a trust that does not satisfy all three tests will be taxed on all income.

In 2010, the New York State Department of Taxation and Finance announced a change in the filing responsibilities of trustees of Exempt Resident Trusts as follows:[30]

[18] N.Y. Tax Law § 601(c)(1)(A); instructions to 2014 N.Y. Form IT-205 at 10.

[19] N.Y. Tax Law § 605(b)(3)(B) and (C). See 20 NYCRR § 105.23(a) and (b).

[20] See N.Y. Tax Law § 605(b)(1)(B).

[21] N.Y. Tax Law § 605(b)(3), flush language at end. See 20 NYCRR § 105.23(a); instructions to 2014 N.Y. Form IT-205 at 2.

[22] N.Y. Tax Law § 605(b)(4).

[23] N.Y. Tax Law § 618. See 20 NYCRR § 118.1.

[24] N.Y. Tax Law §§ 631, 633; instructions to 2014 N.Y. Form IT-205 at 2. See N.Y. Tax Bull. TB-IT-615, 2011 State Tax Today 244-15 (12/15/2011), www.tax.ny.gov/pdf/tg_bulletins/plt/b11_615i.pdf.

[25] N.Y. Tax Law § 685(c)(6); instructions to 2014 N.Y. Form IT-205 at 4.

[26] N.Y. Tax Law § 605(b)(3)(D)(i). See 20 NYCRR § 105.23(c); instructions to 2014 N.Y. Form IT-205 at 2.

[27] N.Y. TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 (11/12/2004), www.tax.ny.gov/pdf/advisory_opinions/income/a04_7i.pdf.

[28] N.Y. Tax Law § 605(b)(3)(D)(ii).

[29] See Residuary Trust A U/W/O Kassner v. Director, Div. of Taxation, 2015 N.J. Tax Lexis 11 at 10 (N.J. Super. Ct. App. Div. 2015).

[30] N.Y. TSB-M-10(5)I, 2010 State Tax Today 145-10 (7/23/2010), www.tax.ny.gov/pdf/memos/income/m10_5i.pdf. See instructions to 2014 N.Y. Form IT-205 at 3.

[31] N.Y. TSB-A-11(4)I, 2011 N.Y. Tax Lexis 181 at 4 (7/27/2011), www.tax.ny.gov/pdf/advisory_opinions/income/a11_4i.pdf.

[32] N.Y. Tax Law § 658(f)(2), added by 2014 N.Y. Laws 59, Part I, § 4 (3/31/2014).

[33] N.Y. Tax Law § 612(b)(40), added by 2014 N.Y. Laws 59, Part I, § 1 (3/31/2014).

[34] 2014 N.Y. Laws 59, Part I, § 9 (3/31/2014).

> [U]nder the policy described in TSB-M-96(1)I, Resident Trusts, a resident trust that was not subject to tax because it met the conditions described in section 605(b)(3)(D) of the Tax Law was not required to file a return....
>
> Effective for tax years beginning on or after January 1, 2010, the policy in TSB-M-96(1)I is revoked, and a resident trust that meets the conditions of section 605(b)(3)(D) of the Tax Law will be required to file a New York State fiduciary income tax return if it meets the filing requirements for resident trusts.

In 2011, that department clarified that the new filing requirement applies to trustees of Exempt Resident Trusts that satisfied § 605(b)(3)(D)(i)'s requirements before 2010.[31]

> As of tax year 2010, even though the Trusts meet the conditions set forth in Tax Law § 605(b)(3)(D), they are required to file Form IT-205 Fiduciary Income Tax Return and attach Form IT-205-C New York Resident Trust Nontaxable Certification to Form IT-205.

Thanks to the 2014–2015 budget bill, this filing requirement now is imposed by statute. Hence, § 658(f)(2) of the N.Y. Tax Law provides:[32]

> Every resident trust that does not file the return required by section six hundred fifty-one of this part on the ground that it is not subject to tax pursuant to subparagraph (D) of paragraph three of subsection (b) of section six hundred five of this article for the taxable year shall make a return for such taxable year substantiating its entitlement to that exemption and providing such other information as the commissioner may require.

Throwback tax. As noted above, the 2014-2015 New York budget bill imposes a throwback tax on distributions of accumulated income to New York resident beneficiaries from Exempt Resident Trusts. The provision in question provides that the income on which such a beneficiary is taxed includes:[33]

> In the case of a beneficiary of a trust that, in any tax year after its creation including its first tax year, was not subject to tax pursuant to subparagraph (D) of paragraph three of subsection (b) of section six hundred five of this article (except for an incomplete gift nongrantor trust, as defined by paragraph forty-one of this subsection), the amount described in the first sentence of section six hundred sixty-seven of the internal revenue code for the tax year to the extent not already included in federal gross income for the tax year, except that, in computing the amount to be added under this paragraph, such beneficiary shall disregard (i) subsection (c) of section six hundred sixty-five of the internal revenue code; (ii) the income earned by such trust in any tax year in which the trust was subject to tax under this article; and (iii) the income earned by such trust in a taxable year prior to when the beneficiary first became a resident of the state or in any taxable year starting before January first, two thousand fourteen. Except as otherwise provided in this paragraph, all of the provisions of the internal revenue code that are relevant to computing the amount described in the first sentence of subsection (a) of section six hundred sixty-seven of the internal revenue code shall apply to the provisions of this paragraph with the same force and effect as if the language of those internal revenue code provisions had been incorporated in full into this paragraph, except to the extent that any such provision is either inconsistent with or not relevant to this paragraph.

The provision does not apply to distributions made before 6/1/2014.[34] The bill also imposes reporting requirements on trustees making accumulation distributions.[35]

Although the result might not have been intended, accumulation distributions do not include capital gains because the taxable amount is based on undistributed net income under the first sentence

[35] N.Y. Tax Law § 658(f)(1), added by 2014 N.Y. Laws 59, Part I, § 4 (3/31/2014).

of IRC Section 667(a).[36] Therefore, the accumulation tax will not be burdensome in many instances given that the largest tax savings usually involve capital gains. Also, the throwback tax does not reach income accumulated before 2014 or income accumulated before a beneficiary is born, reaches age 21, or moves to New York. In addition, there is no interest charge for the deferred payment of tax.

Incomplete gift nongrantor trust. As also mentioned above, the 2014-2015 budget bill treats incomplete gift nongrantor trusts as grantor trusts for New York income tax purposes. The statutory language is:[37]

> In the case of a taxpayer who transferred property to an incomplete gift non-grantor trust, the income of the trust, less any deductions of the trust, to the extent such income and deductions of such trust would be taken into account in computing the taxpayer's federal taxable income if such trust in its entirety were treated as a grantor trust for federal tax purposes. For purposes of this paragraph, an "incomplete gift nongrantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code, and (ii) the grantor's transfer of assets to the trust is treated as an incomplete gift under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder.

The provision does not apply to income of such trusts that were liquidated before 6/1/2014.[38] The validity of this provision is questionable unless or until *Mercantile-Safe Deposit & Trust Company v. Murphy* is overruled.[39]

Current rules—New York City

In New York City, a trustee of a Resident Trust for New York City tax purposes must file a return if it must file a New York State return.[40]

New York City treats a trust as a grantor trust if the trust is classified as a grantor trust for federal purposes,[41] and the city permits a distribution deduction.[42] In 2014, New York City taxed the city taxable income (including accumulated ordinary income and capital gains) of nongrantor trusts at rates up to 3.876% on such income over $500,000,[43] and the current rate schedule is not scheduled to change until 2018,[44] except that, beginning in 2015, the bracket amount for the top bracket is increased by $994 pursuant to the 2015-2016 budget bill.[45]

Like New York State, New York City defines "Resident Trust" as a trust that is created by a New York City testator or trustor as follows:[46]

> (c) City resident ... trust. A city resident ... trust means: ...
>
> (2) a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in such city, or
>
> (3) a trust, or a portion of a trust, consisting of the property of:
>
> (A) a person domiciled in such city at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or
>
> (B) a person domiciled in such city at the time such trust or portion of a trust became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.
>
> For the purposes of the foregoing, a trust or portion of a trust is revocable if it is subject to a power, exercisable immediately or at any future time, to revest title in the person whose property constitutes such trust or portion of a trust and a trust or portion of a trust becomes irrevocable when the possibility that such power may be exercised has been terminated.

---

36 See N.Y. TSB-M-14(3)(I), 2014 State Tax Today 96-38 (5/16/2014), www.tax.ny.gov/pdf/memos/income/m14_3i.pdf. See also Covey and Hastings, "Tax Changes in New York and Minnesota," Prac. Drafting 11569 (April 2014); Steiner, "Coping With the New York Tax Changes Affecting Estates and Trusts," LISI Estate Planning Newsltr. #2225 (5/19/2014), www.leimbergservices.com; Mensch and Karibjanian, "New York Tax Changes for Estates and Trusts," LISI Estate Planning Newsltr. #2222 (5/8/2014), www.leimbergservices.com.

37 N.Y. Tax Law § 612(b)(41), added by 2014 N.Y. Laws 59, Part I, § 2 (3/31/2014).

38 2014 N.Y. Laws 59, Part I, § 9 (3/31/2014).

39 15 N.Y.2d 579 (1964), *aff'g* 19 A.D.2d 765 (3d Dep't 1963).

40 N.Y. Tax Law § 1306(a), (e); Instructions to 2014 N.Y. Form IT-205 at 14

41 N.Y. Tax Law § 1303; Admin. Code City of N.Y. § § 11-1711, 11-1712.

42 See N.Y. Tax Law § 1303.

43 N.Y. Tax Law § § 1304(a)(3)(A), 1304-B(a)(1)(ii); Admin. Code City of N.Y. § § 11-1701, 11-1704.1; Instructions to 2014 N.Y. Form IT-205 at 16. See N.Y. TSB-M-10(7)I, 2010 State Tax Today 161-19 (8/17/2010), www.tax.ny.gov/pdf/memos/income/m10_7i.pdf.

44 N.Y. Tax Law § 1304(b)(3). See N.Y. TSB-M-15(2)I, 2015 State Tax Today 32-20 (2/13/2015), www.tax.ny.gov/pdf/memos/income/m15_2i.pdf.

45 N.Y. Finance Law § 54-f, N.Y. Tax Law § 1304(a), Admin. Code City of N.Y. § 11-1701(a), as amended by 2015 N.Y. Laws 59, Part B, § § 1 through 3 (4/13/2015). See New York State Department of Taxation and Finance, Summary of Tax Provisions in SFY 2015-16 Budget at 7 (April 2015), www.tax.ny.gov/pdf/stats/sumprovisions/Summary of 2015-16 Tax Provisions.pdf.

46 N.Y. Tax Law § 1305(c). See Admin. Code City of N.Y. § 11-1705(b)(3).

47 N.Y. Tax Law § 1305(d); Admin. Code City of N.Y. § 11-1705(b)(4).

48 N.Y. Tax Law § 1303; Admin. Code City of N.Y. § 11-1718.

49 See N.Y. Tax Law § 1301(b).

50 Admin. Code City of N.Y. § 11-1705(b)(3)(D).

51 Admin. Code City of N.Y. § 11-1712(b)(36), added by 2014 N.Y. Laws 59, Part I, § 6 (3/31/2014).

52 Admin. Code City of N.Y. § 11-1712(b)(37), added by 2014 N.Y. Laws 59, Part I, § 7 (3/31/2014).

53 N.Y. Tax Law § § 601(c)(1)(A), 1304(b)(3), and 1304-B(a)(1)(ii).

54 IRC Section 664(c)(1).

55 N.Y. Tax Law § 601(h). See Instructions to 2014 N.Y. Form IT-205 at 4.

56 DTA No. 822892, 2010 N.Y. Tax Lexis 268 (N.Y. Div. Tax App. 2010), www.dta.ny.gov. See Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dep't of Revenue, 2015 NCBC Lexis 39 (N.C.B.C. 2015) (Imposition of North Carolina income tax on accumulated income of portion of same trust having nonresident trustor and trustee based on resident beneficiary violated Due Process Clause and Commerce Clause).

57 See N.Y. Tax Law § 697(d).

58 DTA No. 821369, 2008 N.Y. Tax Lexis 139 (N.Y. Div. Tax App. 2008), www.dta.ny.gov.

59 2004 N.Y. Tax Lexis 259 (11/12/2004), www.tax.ny.gov/pdf/advisory_opinions/income/a04_7i.pdf.

A "Nonresident Trust" is a trust that is not a "Resident Trust."[47] New York City taxes all city taxable income of Resident Trusts; it does not tax Nonresident Trusts.[48] In New York City, trustees must make estimated tax payments for trusts.[49]

Also like New York State, New York City does not tax trustees of Exempt Resident Trusts but requires them to file informational returns:[50]

> (D)(i) Provided, however a resident trust is not subject to tax under this article if all of the following conditions are satisfied:
>
> (I) all the trustees are domiciled outside the city of New York;
>
> (II) the entire corpus of the trusts, including real and tangible property, is located outside the city of New York; and
>
> (III) all income and gains of the trust are derived from or connected with sources outside of the city of New York, determined as if the trust were a non-resident trust.
>
> (ii) For purposes of item (II) of clause (i) of this subparagraph, intangible property shall be located in this city if one or more of the trustees are domiciled in the city of New York.
>
> (iii) Provided further, that for the purposes of item (I) of clause (i) of this subparagraph, a trustee which is a banking corporation as defined in subdivision (a) of section 11-640 of this title and which is domiciled outside the city of New York at the time it becomes a trustee of the trust shall be deemed to continue to be a trustee domiciled outside the city of New York notwithstanding that it thereafter otherwise becomes a trustee domiciled in the city of New York by virtue of being acquired by, or becoming an office or branch of, a corporate trustee domiciled within the city of New York.

The 2014-2015 New York budget bill also added the throwback tax requirements[51] and the incomplete gift nongrantor trust rules[52] described above to the taxation of New York City trusts and their beneficiaries.

Aggregate tax effect. If a trust was a Resident Trust for New York State and New York City purposes in 2014, then the trustee was subject to tax at rates up to 12.696% on taxable income over $1,046,350.[53]

Charitable remainder trusts

A charitable-remainder trust (CRT) is exempt from federal income tax.[54] It therefore is exempt from New York State and City income tax.[55]

Based on this ruling, the safest course clearly is to have absolutely no participation by New Yorkers.

Cases and rulings

In addition to *Mercantile* and *Taylor*, New York courts and administrative agencies have issued numerous cases and rulings that involve the income taxation of trustees by New York State and New York City. Here is a sampling.

In the Matter of Joseph Lee Rice III Family 1992 Trust.[56] This 2010 decision of the New York State Division of Tax Appeals illustrates the importance of paying attention to detail. In 1992, the trustor, who resided in New York City, created an irrevocable nongrantor trust in which he named his attorney, also a New York City resident, as trustee. The trust initially was subject to New York State and City income tax because of the trustor's and the trustee's New York City residences. In 1995, the trustee moved to Florida but continued to file tax returns using his law firm's Manhattan address and to pay state and city tax.

Subsequently, it was discovered that the trustee should have ceased paying tax upon his move to Florida. The New York State Division of Taxation granted refunds for the open years—2001 through 2003, but the administrative law judge upheld the Division of Taxation's refusal to pay refunds for the closed years—1996 through 2000.[57] The amount of tax was not disclosed, but the trustee and the accountant might face liability for the tax erroneously paid for those years.

In the Matter of the Petition of the Amauris Trust.[58] This 2008 decision of the New York State Division of Tax Appeals considered the taxation of two trusts that were funded at the expiration of the initial ten-year term of a grantor-retained income trust (GRIT). The trustor was a New York resident in 1990 when he created the GRIT, but he resided in Connecticut at the end of the initial term in 2000. Because the trusts had source income, the establishment of the trustor's residence determined whether the trusts were taxed on all income or on source income only. Several million dollars was involved. The administrative law judge concluded:

> [S]ince the transfers were not effectuated until July 30, 2000, the ten-year anniversary of the Peterffy Trust, the Amauris and Niavius Trusts could not properly be taxed as resident trusts by the State of New York because, pursuant to Tax Law § 605(b)(3), Thomas Peterffy was a Connecticut and not a New York domiciliary at the time the stock was transferred to these trusts. As such, since the Timber Hill, Inc., stock was not transferred to the Amauris Trust and the Niavius Trust until July 30, 2000, at a time that the grantor of the Peterffy Trust was a Connecticut domiciliary, it is hereby determined that the Amauris Trust and the Niavius Trust were not resident trusts as defined by Tax Law § 605(b)(3)(C).

N.Y. TSB-A-04(7)I.[59] In 2004, the New York Technical Services Division considered whether proposed actions by a committee acting under

five irrevocable trusts entered into by John D. Rockefeller, Jr., and Chase National Bank in 1934 would enable the trustees to avoid New York State and City income tax as follows:

> The issue raised by Petitioner, JPMorgan Chase Bank, as Trustee of the 1934 Trusts, is whether the trusts, described below, will be subject to New York State or New York City income tax if (a) the Committee, described below, replaces the trustee with a trustee not domiciled in New York State, and (b) the two Committee members who are currently domiciled in New York State are replaced by individuals who are not domiciled in New York State.

A Resident Trust was not taxable once the resident trustee resigned in accordance with the governing instrument.

First, the five-member committee, which directed the trustee on investment and distribution matters, proposed to replace the New York corporate trustee with its Delaware affiliate. The ruling said that the residence of the proposed successor trustee should be determined as follows:

> [F]or purposes of section 605(b)(3)(D) of the Tax Law and section 105.23(c) of the Regulations, the domicile of the Proposed Successor Trustee will be the state where its principal place of business is located, as set forth in the above guidelines for determining the domicile of a corporation.

However, the ruling declined to decide this issue for the following reason:

> The determination of domicile is a factual matter that is not susceptible of determination in this Advisory Opinion. An Advisory Opinion merely sets forth the applicability of pertinent statutory and regulatory provisions to a specified set of facts.

Next, the two members of the committee who resided in New York proposed to resign. The ruling observed:

> An advisor to a trustee has been interpreted by the courts to include not only a person who has been designated by particular terminology in the trust instrument but also any other individual who, by the terms of the trust instrument, has been given power to direct or control a trustee in the performance of some part or all of that trustee's functions and duties, or who has been invested with a form of veto power over particular actions of a trustee through the medium or device of requiring that those actions be taken only with the consent and approval of such advisor.
>
> It is well settled under New York law that a grantor of a trust may limit a trustee's powers. In *Matter of Rubin*, the court addressed the status of advisors. The court held that the designation of an advisor is a valid limitation on a trustee's powers, and noted that the courts have generally considered an advisor to be a fiduciary, somewhat in the nature of a co-trustee. Another term that may be employed, said the court, is quasi-trustee or special trustee. The court's statement "since the relationship between the fiduciary and the advisor is that of a co-trustee, with the advisor having the controlling power, the fiduciary is justified in complying with the directives and will not generally be held liable for any losses," indicates a tacit acceptance of the characterization of the advisor as a trustee. However, an advisor that does not have any powers under the terms of the trust instrument to direct or control a trustee in the performance of some part or all of that trustee's functions and duties, and has not been invested with a form of veto power over particular actions of a trustee through the medium or device of requiring that those actions be taken only with the consent and approval of the advisor, will not be considered a co-trustee.
>
> Under the facts in this case, the Committee has been granted broad powers over the assets of the Trusts. For example, the Committee may direct the Trustee to take or refrain from taking any action which the Committee deems it advisable for the Trustee to take or refrain from taking. All of the powers of the Trustee under the Trust Agreements are subject to the directions of the Committee. Since the Committee is an advisor having the controlling power over the Trustee, following *Rubin*, supra, the members of the Committee are considered to be co-trustees of the Trusts. Therefore, for purposes of the first condition under section 605(b)(3)(D)(i) of the Tax Law and section 105.23(c) of the Regulations, the individuals comprising the Committee are considered to be trustees of the Trusts.
>
> However, the determination of whether Petitioner or any other investment management firms or former Committee members that may be retained by the Proposed Committee to provide investment advice or management services would also be treated as co-trustees of the Trusts for purposes of section 605(b)(3)(D)(i) of the Tax Law and section 105.23(c) of the Regulations is a factual matter that is not susceptible of determination in this Advisory Opinion. [Citations omitted.]

Regarding New York State income tax, the ruling concluded:

> In conclusion, Petitioner states that all real and tangible property included in the corpus of the Trusts, is located outside New York and all the income and gains of the Trusts are derived or connected from sources outside of New York State, determined as if the Trusts were a nonresident. Pursuant to section 605(b)(3)(D)(ii) of the Tax Law, any intangible property included in the corpus of the Trusts is located in New York State if any of the trustees are domiciled in New York State. Therefore, the determination of whether the Trusts will be exempt from New York State personal income tax for purposes of section 605(b)(3)(D) of the Tax Law and section 105.23(c) of the Regulations will depend on whether the Proposed Successor Trustee, any member of the Proposed Committee or any other investment advisor or manager that is considered to be a co-trustee is domiciled in New York State. The Trusts will meet the three conditions of section 605(b)(3)(D)(i) of the Tax Law and section

105.23(c) of the Regulations only if all of the trustees are domiciled outside of New York State. In the case of the Proposed Successor Trustee, pursuant to the concept of domicile with respect to an individual, the domicile of the corporation is the principal place from which the trade or business of the corporation is directed or managed. In the case of any member of the Proposed Committee or any other investment advisor or manager that is considered to be a co-trustee, pursuant to section 105.20(d)(1) of the Regulations, the domicile of an individual is the place which such individual intends to be such individual's permanent home.

Regarding New York City income tax, the ruling concluded:

> The New York City personal income tax is similar to the New York State personal income tax and is administered by New York State the same as Article 22 of the Tax Law. Accordingly, for the taxable years that the Trusts have not met the three conditions contained in section 605(b)(3)(D)(i) of the Tax Law and section 105.23(c) of the Regulations, New York State personal income tax is imposed on the Trusts, and if any of the trustees are domiciled in New York City, New York City personal income tax authorized under Article 30 of the Tax Law is imposed on the Trusts for those taxable years that a trustee is domiciled in New York City.

Planning tip. The author is often asked about the circumstances, if any, in which a New York resident advisor, protector, or committee member may participate in the administration of a New York Resident Trust having a nonresident corporate trustee without subjecting the trust to tax. Based on this ruling, the safest course clearly is to have absolutely no participation by New Yorkers. According to the Technical Services Division, serving in a fiduciary or nonfiduciary capacity might have no bearing on this analysis.

N.Y. TSB-A-03(6)I.[60] The New York State Department of Taxation provided guidance in 2003 on whether the donee of a power of appointment is the "transferor" to the appointive trust for New York income tax purposes in six situations. The ruling concluded that:

> [T]he residency of an appointive trust created by the exercise of a power of appointment is determined based on the domicile of the donor of the property who transferred the property to the trust. A person who transfers property held in trust to an appointive trust by the exercise of a general power of appointment over the trust property is considered the donor of the trust property for purposes of determining the residency of the appointive trust. Conversely, a person who transfers property held in trust to an appointive trust by the exercise of a special power of appointment over the trust property is not considered the donor of the trust property for purposes of determining the residency of the appointive trust. The donor of the special power of appointment is considered the donor of the trust property for purposes of determining the residency of the appointive trust. [Citation omitted.]

Planning tip. A trustee considering exercising a decanting power with the hope of escaping tax by changing the creator of the trust should keep this Advisory Opinion in mind because "[a]n exercise of the power to invade trust principal ... shall be considered the exercise of a special power of appointment...."[61]

Exempt Resident Trust exemption recognized

A variety of cases and rulings recognize the Exempt Resident Trust exemption.

N.Y. TSB-A-94(7)I.[62] In this 1994 ruling, a New York City resident established an irrevocable complex inter vivos trust in 1976. Although the sole individual trustee initially resided in New York City, he moved to Connecticut in 1985. During the years in question, the corpus consisted solely of intangible personal property (some of which was held by a New York financial institution), and the trust earned no source income.

Regarding New York State tax, the ruling said:

> [T]he Charles B. Moss Trust is a New York resident trust. However, since the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met, for the taxable years at issue, 1990, 1991 and 1992, no New York State personal income tax is imposed on such trust for said years.

Regarding New York City tax, the ruling concluded:

> The New York City personal income tax is similar to the New York State personal income tax and is administered by New York State the same as Article 22 of the Tax Law. Accordingly, since the Charles B. Moss Trust has met the three conditions contained in section 105.23(c) of the New York State Personal Income Tax Regulations and no New York State personal income tax is imposed on such trust for taxable years 1990, 1991 and 1992, no New York City personal income tax authorized under Article 30 of the Tax Law is imposed on such trust for such taxable years.

The tax preparer might have been at risk for the tax erroneously paid for the closed years of 1985 through 1989.

N.Y. TSB-A-96(4)I.[63] The issue in this 1996 Technical Services Bulletin was whether the trustees of a trust created by a New York City resident in 1961 had to pay New York State and City income tax on a large capital gain. Initially, the two individual trustees were New York residents, but, by 1988, both trustees were nonresidents. Regard-

[60] 2003 N.Y. Tax Lexis 313 (11/21/2003), www.tax.ny.gov/pdf/advisory_opinions/income/a03_6i.pdf.

[61] N.Y. Est. Powers & Trusts Law § 10-6.6(d).

[62] 1994 N.Y. Tax Lexis 310 (4/8/1994), www.tax.ny.gov/pdf/advisory_opinions/income/a94_7i.pdf.

[63] 1996 N.Y. Tax Lexis 528 (10/25/1996), www.tax.ny.gov/pdf/advisory_opinions/income/a96_4i.pdf.

ing New York State income tax, the ruling said:

> In this case, after 1988 the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met. First, after 1988 all of the trustees have been domiciled outside of New York State. Second, the corpus of the Trust consists of intangible assets some of which are held by Lazard Freres & Co. located in New York City. Third, none of the assets of the Trust were employed in a business carried on in New York State and all income and gains of the Trust were derived from sources outside of New York State, determined as if the Trust were a nonresident. With respect to the second condition, the situs of the intangible assets of a trust is deemed to be at the domicile of the trustee. Therefore, the situs of the corpus of the Trust is deemed to be outside of New York State.
>
> Accordingly, the Trust is a New York resident trust. However, for the taxable years that the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met, no New York State personal income tax is imposed on such trust for those years.

Regarding New York City income tax, it concluded:

> The New York City personal income tax is similar to the New York State Personal income tax and is administered by New York State the same as Article 22 of the Tax Law. Accordingly, for the taxable years that the Trust has met the three conditions contained in section 105.23(c) of the New York State Personal Income Tax Regulations, no New York State personal income tax is imposed on the Trust, and no New York City personal income tax authorized under Article 30 of the Tax Law is imposed on the Trust for those taxable years.

N.Y. TSB-A-00(2)I.[64] In a 2000 ruling, a New York City resident had created a Delaware LLC of which she was the managing member. She kept a 1% interest and contributed a 99% interest to a trust for the benefit of New York beneficiaries but appointed a nonresident individual as trustee.

The ruling identified the pertinent issues as follows:

> 3. Whether the Trust ... or Trustee(s) ... is subject to any New York State or New York City tax law or filing requirements or fees (i.e., Fiduciary Income Tax Return).
>
> 4. Whether the domicile of the Trustee(s) or Beneficiary affects the tax status of the Trust.

It found that the trustee was not taxable for the following reasons:

> Issue 3 ... In this case, the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations have been met. First, the trustee is domiciled outside of New York State. Second, the corpus of the Trust consists of intangible assets. The situs of the intangible assets of a trust are deemed to be at the domicile of the trustee. Therefore, the situs of the corpus of the Trust is deemed to be outside of New York State. Third, none of the assets of the Trust are employed in a business carried on in New York State and all income and gains of the Trust were derived from sources outside of New York State, determined as if the Trust were a nonresident.
>
> Accordingly, the Trust is a New York resident trust. However, for the taxable year that the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations are met, no New York State personal income tax is imposed on such Trust for those years. Further, no New York City personal income tax authorized under Article 30 of the Tax Law is imposed on the Trust for those taxable years.
>
> Issue 4
>
> The domicile of the Trustee of the Trust does affect the taxable status of the Trust. If the Trustee is domiciled in New York State, the Trust would not meet the three conditions contained in section 105.23(c) of the Personal Income Tax Regulations, and the Trust would be subject to New York State personal income tax. In addition, if the Trustee is a resident of the City of New York, the Trust would be subject to the New York City personal income tax authorized under Article 30 of the Tax Law. The domicile of the beneficiary does not affect the taxable status of the trust.

Planning tip. The significance of this technical services bulletin is that a New York City resident could manage trust investments indirectly as the managing member of an LLC in which the trustee held an interest that he or she could not have managed directly as trustee without subjecting the trust to tax.

N.Y. TSB-A-04(7)I. This 2004 ruling, summarized above, recognized that the trusts under consideration would qualify as Exempt Resident Trusts if the corporate trustee and the committee members were nonresidents.

In the Matter of the Petition of the John Heffer Trust.[65] The controversy in this 2006 decision involved a trust that a New York City resident created in 1973 naming individual trustees. In 1981, the last New York resident trustee resigned and was replaced by a nonresident trustee as provided in the trust instrument but without a court proceeding. Nevertheless, the trustees continued to file returns and to pay tax. In 2004, the trustees filed amended returns seeking refunds for 2000 (about $100,000), 2001 (about $6,000), and 2002 (about $100,000), which were denied by the Division of Taxation.

On appeal, the Division of Tax Appeals identified the issue as follows:

> Whether the resignation of a New York domiciled trustee of a New York resident trust, without court approval, was sufficient to satisfy the requirements of 20 NYCRR former 105.23(c), such that petitioner trust was no longer subject to New York personal income tax and was

[64] 2000 N.Y. Tax Lexis 118 (3/29/2000), www.tax.ny.gov/pdf/advisory_opinions/income/a00_2i.pdf.

[65] DTA No. 820351, 2006 N.Y. Tax Lexis 124 (N.Y. Div. Tax App. 2006), www.dta.ny.gov.

entitled to a refund of taxes paid for the years 2000, 2001 and 2002.

The Division of Tax Appeals reversed the determination of the Division of Taxation and granted the refunds for the following reasons:

> The John Heffer Trust clearly prescribed procedures for the resignation of a trustee and the appointment of successor trustees which were carefully followed in accordance with the intent of the grantor, thereby giving legal effect to the resignation of Sidney J. Silberman on November 20, 1981.
>
> Therefore, for the years 2000, 2001 and 2002, petitioner has established that it met the requirements of 20 NYCRR 105.23(c) and was not subject to income tax.

Although the trustees obtained refunds for the open years of 2000, 2001, and 2002, the author wonders whether they, the tax return preparer, or their advisors were at risk for tax erroneously paid for the closed years, going all the way back to 1981.

In the Matter of Joseph Lee Rice III Family 1992 Trust. This 2010 decision of the Division of Tax Appeals, summarized above, recognized that a Resident Trust ceased to be taxable as soon as the sole resident individual trustee became a Florida resident.

N.Y. TSB-A-10(4)I.[66] This 2010 Technical Services Bulletin addressed the tax-payment requirements of the surviving nonresident trustee of a New York Resident Trust due to the death of the New York resident individual co-trustee on 8/1/2008. The ruling concluded:

> Once a resident trust satisfies the conditions in Tax Law section 605(b)(3)(D)(i), it is no longer subject to further taxation by New York State so long as the trustee remains a non-domiciliary and the trust continues to meet the other conditions in section 605(b)(3)(D)(i). The Trusts must, however, accrue to the period of their taxable residence any income, gain, loss, deduction, items of tax preference or any ordinary income portion of a lump sum distribution accruing prior to the Trusts' change of tax status, regardless of the Trusts' method of accounting.

N.Y. TSB-A-11(4)I.[67] This 2011 Technical Services Bulletin considered the New York income tax consequences for Resident Trusts caused by changes of residences of the grantors and trustees. It concluded:

> Based on the information submitted, the Trusts never owned and do not currently own any real or tangible property in New York and they have no New York source income. Therefore, the Trusts met the second and third requirements of Tax Law § 605(b)(3)(D). However, because Trustee 1 was a New York resident, the Trusts did not meet the first requirement of Tax Law § 605(b)(3)(D) and initially were subject to New York State income tax only on the New York resident portions of the Trusts. When Trustee 1 resigned as trustee, leaving only Trustee [sic] 2, a Connecticut resident, as the sole trustee, the Trusts met all the requirements of Tax Law § 605(b)(3)(D). Accordingly, when Trustee 1 resigned as trustee, the Trusts were no longer subject to New York income tax.

Matter of Michael A. Goldstein No. 1 Trust v. Tax Appeals Tribunal of the State of New York.[68] This 2012 case illustrates the importance of thinking about the state income taxation of trusts at the outset rather than relying on a refund request. In *Matter of Michael A. Goldstein No. 1 Trust v. Tax Appeals Tribunal of the State of New York*, the trustees filed New York income tax returns for 1995, 1996, and 1997. As the result of an IRS audit, the trustees' taxable income was decreased. The trustees filed amended returns requesting New York income tax refunds in July 2006 that were issued in December of that year.

A single dollar of source income apparently will prevent a Resident Trust from meeting the Exempt Resident Trust exemption.

The Department of Taxation and Finance paid interest from July 2006 rather than from the dates of the filing of the original returns based on then N.Y. Tax Law § 688.[69] A New York intermediate appellate court confirmed that determination.

Planning tip. Although the New York statute in question was amended as of tax year 1999, the same issue might arise in another state. In addition, even though advance planning might not have prevented the problem in this case because it resulted from an IRS audit, trustees and their attorneys should consider potential state fiduciary income taxation while a trust is being created. Even though a trustee might later be able to pry refunds out of a state tax department for open years, the trustee might be forestalled for closed years and, as demonstrated by this case, unable to make the trust whole.

N.Y. TSB-A-14(6)S.[70] This 2014 ruling involved New York sales tax and the exercise of an IRC Section 675(4)(C) "swap" power. It described the situation and pro-

[66] 2010 N.Y. Tax Lexis 196 (6/8/2010), www.tax.ny.gov/pdf/advisory_opinions/income/a10_4i.pdf.

[67] 2011 N.Y. Tax Lexis 181 (7/27/2011), www.tax.ny.gov/pdf/advisory_opinions/income/a11_4i.pdf.

[68] 957 N.Y.S. 2d 433 (3d Dep't 2012).

[69] N.Y. Tax Law § 688.

[70] 2014 N.Y. Tax Lexis 27 (1/29/2014), www.tax.ny.gov/pdf/advisory_opinions/sales/a14_6s.pdf.

vided its conclusion at the outset as follows:

> Petitioner requests guidance on whether the substitution of property between himself and the trust is subject to sales and use taxes in New York.
>
> We conclude that the Petitioner and the trust are separate taxpayers capable of entering into a sale. Any substitution of property between the two entities would be a sale, because it would constitute a transfer of title or possession for consideration. Therefore, sales and use taxes are due on any substitution of property transferred between the petitioner and the trust.

N.Y. TSB-A-14(2)R.[71] This 2014 ruling involved New York's real estate transfer tax and the sale of the taxpayer's condominium apartment to her intentionally defective grantor trust (IDGT) in exchange for cash. It determined that the sale was subject to New York's real estate transfer tax for the following reasons:

> Although Petitioner originally had intended to transfer the condominium to her son in a non-taxable transaction, the form of the actual transaction would not qualify as such. Once the apartment is substituted for the cash as an asset of the IDGT, under the terms of the IDGT, Petitioner would no longer hold any beneficial interest in the real estate. This transfer of the Petitioner's condominium apartment to the IDGT fits within the statutory definition for RETT [(real estate transfer tax)] purposes of a conveyance of real property or interest therein. Further, in order for a conveyance to qualify for the exemption under Tax Law § 1405(4) as a gift, a property must be conveyed without consideration. Exemptions from the real estate transfer tax must be strictly construed. Here, in exchange for the conveyance of the condominium apartment to the IDGT, Petitioner would receive cash equal to the amount of the appraised value of the apartment. Thus, Petitioner is receiving cash consideration, and the conveyance of the apartment to the IDGT would be subject to RETT and the additional tax.

Source income

In New York, trustees of Nonresident Trusts are taxed on source income,[72] and a single dollar of source income apparently will prevent a Resident Trust from meeting the Exempt Resident Trust exemption.[73] The New York State Department of Taxation and Finance has announced that source income includes:[74]

- Real or tangible personal property located in New York State (including certain gains or losses from the sale or exchange of an interest in an entity that owns real property in New York State).[75]
- A business, trade, profession, or occupation carried on in New York State.
- A taxpayer's distributive share of New York State partnership income or gain.
- A taxpayer's share of New York State estate or trust income or gain.
- Any gain from the sale, transfer, or other disposition of shares of stock in a cooperative housing corporation in connection with the grant or transfer of a proprietary leasehold, when the real property comprising the units of the cooperative housing corporation is located in New York State.
- Any income received related to a business, trade, profession, or occupation previously carried on in New York State, including but not limited to covenants not to compete and termination agreements.[76]
- A New York S corporation in which the taxpayer is a shareholder.

That agency has said that the following items are not source income:[77]

- Income from annuities and pensions that meet the New York State definition of an annuity, unless the annuity is employed or used as an asset of a business, trade, profession, or occupation carried on in New York State.
- Interest, dividends, or gains from the sale or exchange of intangible personal property, unless they are part of the income received from carrying on a business, trade, profession, or occupation in New York State.
- Income received as a shareholder of a corporation that is a New York C corporation.

Contributing tangible personal property or real property to an entity to escape source-income classification. The trustee of a New York Nonresident Trust or of a Resident Trust that holds tangible personal property or real property might consider transferring the property into an FLP or LLC with the hope of converting it into intangible personal property that will not produce source income. In this regard, New York State treats the gain incurred upon the sale of interests in certain entities that hold New York real property as source income.[78]

Specifically, real property located in New York includes an interest in an entity (i.e., a partnership, limited liability corporation, S corporation, or nonpublicly traded C corporation with 100 or fewer shareholders) that owns real prop-

[71] 2014 N.Y. Tax Lexis 104 (12/4/2014), www.tax.ny.gov/pdf/advisory_opinions/real.estate/a14_2r.pdf. See Willens, Estate Planning Techniques Goes Awry, 13 Daily Tax Report J-1 (1/21/2015).

[72] N.Y. Tax Law § § 633 and 631.

[73] N.Y. Tax Law § 605(b)(3)(D)(i)(III).

[74] N.Y. Tax Bull. TB-IT-615, 2011 State Tax Today 244-15 (12/15/2011), www.tax.ny.gov/pdf/tg_bulletins/pit/b11_615i.pdf.

[75] See TSB-M-09(5)I.

[76] See TSB-M-10(9)I.

[77] Note 74 *supra*.

[78] N.Y. Tax Law § 631(b)(1)(A)(1).

erty in New York having a fair market value that equals or exceeds 50% of all the assets of the entity on the date of sale or exchange of the taxpayer's interest in the entity.[79] Only the assets that the entity owned for at least two years before the date of the sale or exchange of the taxpayer's interest in the entity are to be used in determining the fair market value of all the assets of the entity on the date of sale or exchange.

The gain or loss derived from New York sources from the taxpayer's sale or exchange of an interest in an entity is the total gain or loss for federal income tax purposes from that sale or exchange multiplied by a fraction, the numerator of which is the fair market value of the real property located in New York on the date of sale or exchange and the denominator of which is the fair market value of all the assets of the entity on the date of sale or exchange.[80] The New York State Department of Taxation and Finance has issued a Technical Services Bulletin that illustrates the operation of the provision and describes its application to trusts at the end.[81]

In re Ittleson.[82] This 2005 case, which did not involve a trust, illustrates source income. In 1986, a New York City married couple bought a Modigliani painting for about $1.5 million and hung it in their Manhattan cooperative apartment. The owners moved to South Carolina in December 1996, but the painting remained in the apartment, where it stayed until March 1997 when it was turned over to Sotheby's for auction. Sotheby's sold the painting for about $8.5 million in May 1997, producing roughly a $7 million gain. The Tax Appeals Tribunal stated the issue at the outset:

> Whether the Division of Taxation properly determined that the nonresident petitioners' gain from the sale of a painting was New York source income pursuant to Tax Law § 631(b)(1)(A) and, therefore, subject to New York personal income tax under Tax Law § 601(e).

In holding the gain to be taxable, the court concluded:

> In the present case, the physical presence of the Painting in New York at the time of sale and for a substantial period of years before that clearly satisfies the requirement of a "minimal connection" with the state. In addition, the manifest benefits of the laws of New York attaching to petitioners' ownership and sale of the Painting clearly are rationally related to the gain on the sale of the Painting which the state seeks to tax. This is no less true because high-end art auctions attract bidders from all parts of the world. There may well be cases in which the presence of tangible personal property in the state would be too ephemeral to satisfy the requirements of due process but this is not such a case.

Planning tip. The surviving owner had to pay about $500,000 of New York State and New York City income tax that probably could have been avoided if the Modigliani had left New York.

"Moving" trust to escape tax

As discussed at length above, a nongrantor trust created by a New York testator or trustor is not subject to New York income tax if the trust has no New York trustees, assets, or source income. For an existing trust to be able to stop paying tax, it sometimes is necessary to involve a New York court in changing a resident trustee to a nonresident trustee. The following cases are illustrative.

In re Bush.[83] At the beginning of this 2003 case, Surrogate Preminger summarized the issue as follows:

> In these companion proceedings, JPMorgan Chase Bank, as trustee of a trust created under an agreement dated September 30, 1952 between Harriet F. Bush, as grantor, and Donald F. Bush, as trustee, and JPMorgan Chase Bank, as trustee of a trust under the will of Donald F. Bush, both trusts being for the benefit of Edith B. Crawford, have petitioned for leave to resign and the appointment of J.P. Morgan Trust Company of Delaware as successor trustee. The court granted such relief by orders dated December 30, 2002. Petitioners' further requests—transfer of the situs of the trusts to Delaware, to avoid imposition of New York State fiduciary income tax—remain the sole issue before the court. All interested parties have consented to the requested relief.

In the course of the opinion, the surrogate noted that the court already had replaced the New York trustee with its Delaware affiliate. She then observed that "Petitioners' ultimate goal—elimination of the imposition of a New York fiduciary income tax—can be, and has been, satisfied without the requested transfer of situs." The surrogate therefore denied the trustee's request to transfer the trusts' situs from New York to Delaware.

---

[79] *Id.*

[80] *Id.*

[81] TSB-M-09(5)I, 2009 State Tax Today 91-26 (5/5/2009), www.tax.ny.gov/pdf/memos/income/m09_5i.pdf.

[82] N.Y. DTA 819283, 2005 N.Y. Tax Lexis 199 (N.Y. Div. Tax App. 2005), www.dta.ny.gov. See Burton v. New York State Dep't of Taxation & Fin., 2015 N.Y. Lexis 1529 (N.Y. 2015) (proceeds of nonresident's deemed sale of S corporation stock was New York-source income); In re Gleason, N.Y. DTA 823829, 2014 State Tax Today 60-34 (N.Y. Div. Tax App. 2014), www.dta.ny.gov (Connecticut resident's income from exercise of nonstatutory stock options was New York-source income); In re Linde, N.Y. DTA 823300, 2012 N.Y. Tax Lexis 42 (N.Y. Div. Tax App. 2012), www.dta.ny.gov (all income realized from nonresident partnership's sale of New York real property allocated to New York); N.Y. TSB-A-15(5)I, 2015 State Tax Today 118-19 (6/19/2015), www.tax.ny.gov/pdf/advisory_opinions/income/a15_5i.pdf (nonresident taxable on portion of gain from redemption of S corporation stock attributable to New York real property); N.Y. TSB-A-07(1)I, 2007 N.Y. Tax Lexis 11 (2/7/2007), www.tax.ny.gov/pdf/advisory_opinions/income/a07_1i.pdf (sale of interest in Georgia partnership not New York-source income).

[83] 774 N.Y.S.2d 298 (Surr. Ct. N.Y. Co. 2003).

In re Estate of Rockefeller.[84] Surrogate Roth was presented with a similar issue in this 2003 case. She began:

> The trustees of the trust established under the will of William Rockefeller ask the court to allow the corporate trustee, the Chase Manhattan Bank (now known as JP Morgan Chase Bank), to resign in favor of its affiliate, JP Morgan Trust Company of Delaware, and to change the situs of the trust to the State of Delaware. By order dated May 15, 2002, the request for the change of corporate trustee was granted. The sole issue remaining is whether under the circumstances presented changing the situs of the trust is also warranted.

After reciting the facts, the surrogate noted that:

> Petitioners' application for a change of situs was based on the trustees' desire to eliminate the high New York State fiduciary income tax payable by the trust. But that objective concededly is met by the resignation of the New York corporate trustee and the appointment of its Delaware affiliate, as a result of which the trust will no longer be taxable by this State. Petitioners nevertheless request a change of situs. [Citation omitted.]

Next, she observed:

> The income tax benefit obtainable by the substitution of the corporate trustee's Delaware affiliate is clearly in the interests of the beneficiaries. Indeed, the frequency with which such applications are made reflects an understandable eagerness on the part of persons interested in trusts to be rid of the high tax price payable where the fiduciary is a New Yorker. Although no formal tally has been made of the number of such applications, it is clear that their combined result—a loss of trust business by this state—is sufficiently serious to suggest that New York's high fiduciary income tax may be counterproductive to the state's overall economic interests. The New York Legislature is urged to evaluate the present fiduciary income tax scheme in light of its negative repercussions, including the trend embodied by applications such as the one presently before the court

Surrogate Roth denied the requested change of situs and put future petitioners on notice as follows:

> Petitioners' application to change the situs of this trust is accordingly denied. This decision puts future applicants on notice that, where the desired tax savings can be achieved by a change of trustee, a change of situs will not be allowed unless it would result in some benefit to the trust apart from the tax considerations themselves.

Planning strategies

As the analysis of relevant law and guidance indicates, tax savings can be achieved with appropriate planning.

Third-party trusts. New York testators and trustors should plan their third-party nongrantor trusts to qualify as Exempt Resident Trusts. This planning should *not* cease in light of the addition of the throwback tax rules for the reasons noted above[85] and because tax rates might go down in the future, beneficiaries might leave New York, and distributions might go to non-New York beneficiaries.

The potential tax saving for a New York State and City Resident Trust that incurred a $1 million long-term capital gain in 2014 was at least $105,991. If a trust will hold property that will generate source income, the testator or trustor might minimize tax by creating two trusts, one to hold assets that produce source income and the other to hold assets that do not generate such income.

Residents of other states should consider creating trusts in New York because the state does not tax trusts created by nonresidents.

Self-settled trust option—the DING Trust. Most domestic asset-protection trusts (APTs) are grantor trusts for federal income tax purposes under IRC Section 677(a) because the trustee may distribute income to—or accumulate it for—the trustor without the approval of an adverse party. But, if a client is willing to subject distributions to himself or herself to the control of adverse parties, he or she might use a type of domestic APT known as the Delaware Incomplete Nongrantor (DING) Trust to avoid income tax on undistributed ordinary income and capital gains imposed by jurisdictions that follow the federal grantor-trust rules.

In five 2013 private letter rulings,[86] numerous 2014 private letter rulings,[87] and eight 2015 rulings,[88] the IRS ruled that domestic APTs that followed the DING trust approach qualified as nongrantor trusts. Many—if not all—of the early rulings involved trusts created under Nevada law in large part because, at the time, Nevada was the only domestic APT state that allowed a trustor to keep a lifetime nongeneral power of appointment. In the meantime, Delaware has added that option.[89]

The trustor of a DING Trust might be able to receive tax-free distributions of the untaxed income in later years.[90] The 2014-2015 budget bill attempted to shut down the DING Trust for New York residents, but the technique still is viable for residents of other states. ■

---

[84] 773 N.Y.S.2d 529 (Surr. Ct. N.Y. Co. 2003).

[85] The 2015-2016 New York budget bill, 2015 N.Y. Laws 59 (4/13/2015), made no substantive changes in these provisions. See New York State Department of Taxation and Finance, Summary of Tax Provisions in SFY 2015-16 Budget at 7-9 (April 2015), www.tax.ny.gov/pdf/stats/sumprovisions/Summary of 2015-16 Tax Provisions. pdf.

[86] Ltr. Ruls. 201310002 through 201310006.

[87] Ltr. Ruls. 201440008 through 201440012, 201436008 through 201436032, 201430003 through 201430007, 201426014, and 201410001 through 201410010.

[88] Ltr. Ruls. 201510001 through 201510008.

[89] 12 Del. C. § 3570(11)(b)(2), as amended by 79 Del. Laws c. 198, § 1 (2014).

[90] See Schaller, "Reduce State Tax With DINGs, NINGs, WINGs, and Other ThINGs," 41 ETPL 23 (April 2014); Brown and Lambourne, "California ING Trusts: A Cautionary Tale of Your Future State Law?," LISI Inc. Tax Planning Newsltr. #63 (3/11/2014), www.leimbergservices.com; Rubacher and Goodwin, "DINGed, but not Dented," 152 Tr. & Est. 14 (July 2013).

42 Est. Plan. 12
December 2015

Good Directions Needed When Using Directed Trusts

A grantor can bifurcate some of a trustee's traditional duties—such as investment and distribution decisions—and reduce trustee fees accordingly.

RICHARD W. NENNO, ATTORNEY

Even when using a corporate trustee that offers a full array of trust services, including investment management, clients sometimes want to appoint not only a trustee but also an advisor, committee, or protector (not the trustee) to control certain trust decisions.[1] Here are some examples:

- A client wants to fund an inter vivos dynasty trust with stock in the family company but wants to continue to make decisions regarding the purchase, sale, and voting of such stock.
- A family has a long-standing relationship with a successful money manager and wants that manager (not the trustee) to make investment decisions for trust assets.
- A client wants someone other than the trustee to decide when to make income or principal distributions to beneficiaries.

In these situations, the client wants to minimize the trustee's involvement in some decisions and wants the trustee to lower its fees to reflect its reduced duties. Unfortunately, depending on the state law that governs these issues, even if a trust ("directed trust") directs the trustee ("directed trustee") to make investments or distributions on the direction of someone else ("directing person") and relieves it from liability for following such directions, the trustee might have considerable monitoring or other responsibilities. Thus, the directed trustee might be placed in the unenviable position of being pressured to charge low fees while being subject to substantial potential liability.

RICHARD W. NENNO is Senior Managing Director and Trust Counsel at Wilmington Trust Company in Wilmington, Delaware. This article, with commentary, is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought.

Key terminology

The terminology for multi-participant trusts can best be described as confused. The following definitions apply in the discussion that follows:

- *Direction investment advisor*—an individual or entity

(other than a trustee) that directs a trustee how to buy and sell trust assets, vote stock, borrow money, and make other investment decisions.

- *Direction distribution advisor*—an individual or entity (other than a trustee) that directs a trustee when to distribute income and principal to beneficiaries and, in many cases, when to exercise a decanting power, a power to adjust between income and principal, or a power to convert an income trust into a unitrust.
- *Protector*—an individual or entity (other than a trustee) that may amend the trust, replace trustees and advisors, receive trust information in quiet trusts, or carry out other supervisory duties.

This article focuses on the directed trust. It does not consider the "consent trust" (i.e., a trust in which a trustee makes investment, distribution, or other decisions only after obtaining the consent of an advisor, committee, etc.). Nor does it cover the "delegated trust" (i.e., a trust in which the trustee, pursuant to the governing instrument or state law, hires someone to assist with the trust's administration and in which the trustee retains potential liability for an agent's activities).

Throughout this article, references are made to provisions of the Uniform Trust Code (UTC) and the Uniform Probate Code (UPC). Because states and the District of Columbia often did not enact these provisions in proposed form, attorneys should study carefully the relevant statutes of all pertinent jurisdictions in a particular case.

State statutes

For directed trusts, many states follow UTC § 808(b)[2] or Third Restatement of Trusts § 75. Many other states, however, have statutes that greatly limit a trustee's liability, and two states take different approaches. Furthermore, a few states have no relevant statute. Exhibit 1 contains citations for these laws.

UTC/Restatement approach. The UTC differentiates between multi-participant trusts that have two or more trustees and multi-participant trusts that have a single trustee and advisors, protectors, committees, etc. The multi-trustee arrangement is covered by UTC § 703, under which:

- A co-trustee must participate in performing the trustee's function unless the co-trustee has properly delegated this performance to another trustee.
- A trustee may not delegate to a co-trustee performing a function that the settlor reasonably expected the trustees to perform jointly.
- Each trustee must exercise reasonable care to (1) prevent a co-trustee from committing a serious breach of trust and (2) compel a co-trustee to redress a serious breach of trust.

These continuing responsibilities make § 703 unsuitable for directed trusts.

The other arrangement is covered by UTC § 808(b), which provides:

> If the terms of a trust confer upon a person other than the settlor of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power *unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust.* [Emphasis added.]

Third Restatement of Trusts § 75 contains similar rules, it provides:

> [I]f the terms of a trust reserve to the settlor or confer upon another a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power and to comply with any exercise of that power, *unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries.* [Emphasis added.]

The UTC comment discusses § 808(b) as follows:

> Powers to direct are most effective when the trustee is not deterred from exercising the power by fear of possible liability. On the other hand, the trustee does have overall responsibility for seeing that the terms of the trust are honored. For this reason, subsection (b) imposes only minimal oversight responsibility on the trustee. A trustee must generally act in accordance with the direction. A trustee may refuse the direction only if the attempted exercise would be manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty owed by the holder of the power to the beneficiaries of the trust.

Both § § 808(b) and 75 are not comforting to directed trustees. This is because a directed trustee must devote considerable resources to ensure that the directing person's action is not "[manifestly] contrary to the terms of the trust" or "a [serious] breach of a fiduciary duty."

(Continued on page 18)

[1] See Flubacher, "Directed Trusts: Panacea or Plague?," 154 Tr. & Est. 49 (February 2015); Sherby, "In Protectors We Trust," 49 U. Miami Inst. on Est. Plan. ¶ 1300 (January 2015); Duncan and Sarafa, "Achieve the Promise—and Limit the Risk—of Multi-Participant Trusts," 36 ACTEC L.J. 769 (Spring 2011).

[2] The text of the UTC is available at www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2014.pdf (last visited on 10/13/2015). To determine which states have enacted the UTC, go to www.uniformlaws.org/LegislativeFactSheet.aspx?title=Trust Code (last visited on 10/13/2015).

EXHIBIT 1
State Directed Trust Statutes (8/27/2015)

Follows UTC § 808(b) and Third Restatement of Trusts § 75—directed trustee liable if direction is [manifestly] contrary to terms of trust or trustee knows direction is [serious] breach of fiduciary duty of directing person

State	Citation	Effective Date
Alabama	Ala. Code § 19-3B-808(b)	1/1/2007
Arkansas	Ark. Code Ann. § 28-73-808(b)	9/1/2005
District of Columbia	D.C. Code § 19-1308.08(b)	3/10/2004
Florida (if directing person is not co-trustee)	Fla. Stat. § 736.0808(2)	7/1/2007
Kansas	Kan. Stat. Ann. § 58a-808(b)	1/1/2003
Kentucky	Ky. Rev. Stat. Ann. § 386B.8-080(2)	7/15/2014
Maine	Me. Rev. Stat. Ann. tit. 18-B, § 808(2)	7/1/2005
Maryland	Md. Code Ann., Est. & Trusts §§ 14.5-808(b)(1)(II)(1) and (2)	1/1/2015
Massachusetts	Mass. Gen. Laws ch. 203E, § 808(b)	7/8/2012
Michigan	Mich. Comp. Laws § 700.7809(4)	4/1/2010
Montana	Mont. Code Ann. § 72-38-808(2)	10/1/2013
Nebraska	Neb. Rev. Stat. § 30-3873(b)	1/1/2005
New Mexico	N.M. Stat. Ann. § 46A-8-808(B)	7/1/2003
North Dakota	N.D. Cent. Code § 59-16-08(2)	8/1/2007
Oregon	Or. Rev. Stat. §§ 130.685(2) and 130.735(2)	1/1/2006
Pennsylvania	20 Pa. C.S. § 7778(b)	11/4/2006
South Carolina	S.C. Code Ann. § 62-7-808(b)	5/23/2005
Texas (charitable trusts only)	Tex. Prop. Code Ann. § 114.003(b)	1/1/2006
Vermont	14A V.S.A. § 808(b)	5/14/2009
Virginia (unless § 64.2-770(E) applies)	Va. Code Ann. § 64.2-770(B)	7/1/2006
West Virginia	W. Va. Code § 44D-8-808(b)	7/1/2011

Note. Might not apply if directing person is co-trustee

Has Protective Statute—directed trustee liable for deficient execution of direction, for willful misconduct, or not at all

State	Citation	Effective Date
Alaska (co-trustee or advisor)	Alaska Stat. §§ 13.36.072(c) and 13.36.375(c)	9/9/2013
Arizona (settlor, co-trustee, beneficiary, or third party; bad faith or reckless indifference)	Ariz. Rev. Stat. § 14-10808(B)	12/31/2008
Colorado (willful misconduct)	Colo. Rev. Stat. §§ 15-16-801 through 15-16-809	8/6/2014

EXHIBIT 1
State Directed Trust Statutes (8/27/2015), *cont'd*

Has Protective Statute—directed trustee liable for deficient execution of direction for willful misconduct, or not at all

State	Citation	Effective Date
Delaware (willful misconduct statute codified long-standing practice (see *Lewis v. Hanson*, 128 A.2d 819 (1957); statute upheld in *Duemler v. Wilmington Trust Co.*, 2004 Del. Ch. Lexis 206 (Del. Ch. 2004))	12 Del. C. §§ 3313, 3301(g), and 3317	7/3/1986
Florida (if directing person is cotrustee, willful misconduct)	Fla. Stat. § 736.0703(9)	7/1/2008
Georgia (settlor, advisory, or investment committee, other person (including cotrustee); investment decisions only; bad faith or reckless indifference)	Ga. Code Ann. § 53-12-303	5/27/2010
Idaho	Idaho Code §§ 15-7-501(2) and (5), and 15-1-201(34)	7/1/1999
Illinois (willful misconduct)	760 Ill. Comp. Stat. 5/16.3(f)(1) and 5/16.7	1/1/2013
Indiana (if terms expressly direct trustee to rely or relieve trustee from liability for relying on directions)	Ind. Code §§ 30-4-3-9(a), 30-4-1-2(11), and 30-2-14-9	9/2/1971
Kentucky (corporate trustees, investment decisions, authorized directions only)	Ky. Rev. Stat. Ann. § 286.3-275	7/15/1998
Maryland (willful misconduct, unclear when over does § 14.5-808(b))	Md. Code Ann., Est. & Trusts §§ 14.5-808(c) and 14.5-103(b)	1/1/2015
Minnesota (willful misconduct)	Minn. Stat. §§ 501C.0808, subd. 6, and 501C.0103(j)	1/1/2016
Mississippi (trustee, trust advisor, or trust protector)	Miss. Code §§ 91-8-808(b), 91-8-710, 91-8-1204, and 91-8-1205	7/1/2014
Missouri (bad faith or reckless indifference)	RSMo § 456.8-808(2), (8)	8/28/2012
Nevada	Nev. Rev. Stat. §§ 163.559, 163.5537, 163.5539, 163.554, 163.5541, 163.5543, 163.5545, 163.5549, 163.555, 163.5551, 163.5555, 163.5557; 2015 Nev. Stat. 524, §§ 42 through 43	10/1/2009
New Hampshire (trustee, trust advisor, or trust protector)	N.H. Rev. Stat. Ann. §§ 564-B:8-808(b), 564-B:1-103(23), (24), (27), 564-B:7-711, 564-B:12-1204, and 564-B:12-1205	9/9/2008

EXHIBIT 1
State Directed Trust Statutes (8/27/2015), *cont'd*

Has Protective Statute—directed trustee liable for deficient execution of direction, for willful misconduct, or not at all

State	Citation	Effective Date
North Carolina (co-trustee or other power holder, intentional misconduct if directed by power holder)	N.C. Gen. Stat. §§ 36C-7-703(g1) and 36C-8A-4	6/11/2012
Ohio (grantor, advisory or investment committee, or other person (including fiduciary))	Ohio Rev. Code Ann. §§ 5808.08(B) and 5815.25(B) and (C)	1/1/2007
Oklahoma (trust, advisory or investment committee, or other person (including co-trustee); investment decisions only; negligent execution)	Okla. Stat. tit. 60, § 175.19	2/19/1968
South Dakota	S.D. Codified Laws §§ 55-1B-1 through 55-1B-11	3/19/1997
Tennessee	Tenn. Code Ann. §§ 35-15-710, 35-15-808(b) and (e), 35-15-1201(a), 35-15-1204, and 35-15-1205	7/1/2013
Texas (noncharitable trusts only; willful misconduct)	Tex. Prop. Code Ann. § 114.0031	9/1/2015
Utah (investment decisions only; willful misconduct or gross negligence)	Utah Code Ann. §§ 75-7-906(4) and 75-1-201(35)	7/1/2004
Virginia (willful misconduct or gross negligence; if statute is incorporated into trust by settlor or nonjudicial settlement agreement)	Va. Code Ann. § 64.2-770(E)	7/1/2012
Washington (must act with good faith and honest judgment)	2015 Wash. Sess. Laws 115, §§ 6 through 16	7/24/2015
Wisconsin (willfull misconduct)	Wis. Stat. §§ 701.0808 and 701.0103(7)	7/1/2014
Wyoming	Wyo. Stat. Ann. §§ 4-10-808(b), 4-10-715, 4-10-717, and 4-10-103(a)(vi), (xii), (xxii), (xxiii), and (xxviii)	7/1/2007

Note: Unless otherwise indicated, statute does/might not apply if one trustee (not advisor, protector, etc.) holds power to direct another trustee.

EXHIBIT 1
State Directed Trust Statutes (8/27/2015), *cont'd*

Has Other Statute

State	Citation	Effective Date
Indiana (unless § 30-4-3-9(a) applies, directed trustee liable if direction violates terms of trust or fiduciary duty of directing person)	Ind. Code §§ 30-4-3-9(b), 30-4-1-2(11), and 30-2-14-9	9/2/1971
Iowa (unless trustee knows attempted exercise violates terms of trust or knows powerholder is incompetent)	Iowa Code §§ 633A.4207(2) and 633A.1102(11)	7/1/2000

Has Protector Statute

State	Citation	Effective Date
Alaska	Alaska Stat. § 13.36.370	10/8/2003
Arizona	Ariz. Rev. Stat. § 14-10818	12/31/2008
Delaware	12 Del. C. § 3313	8/1/2008
Idaho	Idaho Code § 15-7-501	7/1/1999
Illinois	760 Ill. Comp. Stat. 5/16.3, 5/16.7	1/1/2013
Michigan	Mich. Comp. Laws § 700.7809	6/18/2009
Mississippi	Miss. Code Ann. §§ 91-8-1201 through 91-8-1206	7/1/2014
Missouri	RSMo § 456.8-808	8/28/2012
Nevada	Nev. Rev. Stat. §§ 163.5547, 163.5549, 163.5553, and 163.5555	10/1/2009
New Hampshire	N.H. Rev. Stat. Ann. §§ 564-B:12-1201 through 564-B:12-1206	9/9/2008
North Carolina	N.C. Gen. Stat. §§ 36C-8A-1 through 36C-8A-11	6/11/2012
South Dakota	S.D. Codified Laws §§ 55-1B-1 through 55-1B-11	3/19/1997
Tennessee	Tenn. Code Ann. §§ 35-15-1201 through 35-15-1206	7/1/2013
Vermont	14A V.S.A. §§ 1101 through 1105	7/1/2009
Wisconsin	Wis. Stat. § 701.0818	7/1/2014
Wyoming	Wyo. Stat. Ann. §§ 4-10-710 through 4-10-718	7/1/2003

Has No Statute:

California	New Jersey
Connecticut	New York
Hawaii	Rhode Island
Lousiana	

(Continued from page 13)

The comment to § 808 describes this as "minimal oversight responsibility," but investment and trust officers who would provide such oversight can find it far more challenging to review someone else's investment and distribution decisions than to make those decisions themselves.

The comment to § 808 does, however, permit the terms of a trust to alter the provisions of § 808. Specifically, it states, "A settlor can provide that the trustee must accept the decision of the power holder without question. Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary." Time will tell if courts uphold these arrangements.

As shown in Exhibit 1, 21 jurisdictions—Alabama, Arkansas, the District of Columbia, Florida (if the directing person is not a co-trustee), Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Montana, Nebraska, New Mexico, North Dakota, Oregon, Pennsylvania, South Carolina, Texas (charitable trusts only), Vermont, Virginia (unless a statutory exception applies), and West Virginia—have statutes based on UTC § 808(b).

Protective approach. As shown in Exhibit 1, 27 states—Alaska, Arizona, Colorado, Delaware, Florida (if the directing person is a co-trustee), Georgia, Idaho, Illinois, Indiana, Kentucky, Maryland, Minnesota, Mississippi, Missouri, Nevada, New Hampshire, North Carolina, Ohio, Oklahoma, South Dakota, Tennessee, Texas (non-charitable trusts only), Utah, Virginia (if a statutory exception applies), Washington, Wisconsin, and Wyoming—afford more protection to directed trustees than UTC § 808(b) and Restatement § 75. For example, a directed trustee in a Delaware trust is liable for following a distribution or investment direction only if that trustee engages in willful misconduct. Some other states extend protection only to directed trustees in investment matters, some require the directed trustee to carry out the direction properly, and some place no restrictions on the directed trustee's conduct.

Other statutes. Two states—Indiana and Iowa—have statutes that do not fit into the above categories. Those statutes are summarized in Exhibit 1.

No statute. As shown in Exhibit 1, seven states—California, Connecticut, Hawaii, Louisiana, New Jersey, New York, and Rhode Island—currently have no directed trust statute, and the effectiveness of directed trust language in trusts governed by the laws of these states is unpredictable. In New York, for instance, one case held that a directed trust worked, but a later case held that it did not.

In *In re Estate of Rubin*,[3] the decedent's will named his son and daughter as co-executors but specified that, in the event of disagreement, they were to act as directed by two named individuals. On the son's request, those individuals directed that he be given sole check-writing authority and management responsibility over five commercial properties. Rejecting the daughter's claim that the arrangement violated her rights as co-executor, the court held:

> [T]he designation of advisors ... to make directives controlling the actions of the coexecutors in any disputes is a valid limitation upon the powers of such executors.

In *Matter of Rivas*,[4] the corporate trustee objected to a direction by the investment advisory committee formed under the governing instrument of a charitable trust to invest in the charitable donee's long-term investment pool. The court held:

> [T]his Court cannot allow the proposed investment of the Helen Rivas Trust corpus, as such investment in the LTIP is contrary to the Agreement and the intent of the settlor, may give rise to an impermissible division of fiduciary loyalties among the majority of the Advisory Committee, and would also violate the Prudent Investor Act.

Efforts began in New York several years ago to draft directed trust legislation, but its enactment is not in sight.

Directed trusts in the leading trust jurisdictions. In January 2014, two commentators, one of whom has South Dakota ties, listed the leading personal trust jurisdictions as follows:

> In our view, the four top-tier jurisdictions for 2014 (listed by the year they adopted their perpetuities legislation) remain South Dakota, Delaware, Alaska and Nevada. We rank New Hampshire in fifth place.[5]

Of these jurisdictions, two—Delaware (1986)[6] and South Dakota (1997)[7]—have offered directed trusts for some time; the other three—New Hampshire (2008),[8] Nevada (2009),[9] and Alaska (2013)[10]—introduced them in recent years.

Delaware's experience. Delaware's long-standing directed trustee law

[3] 143 Misc. 2d 303 (Surr. Ct. Nassau Co. 1989), *aff'd* 570 N.Y.S.2d 996 (2d Dep't 1991).

[4] 2011 N.Y. Misc. Lexis 14 (Surr. Ct. Monroe Co. 2011), *aff'd* 939 N.Y.S.2d 918 (4th Dep't 2012).

[5] Worthington and Merric, "Which Trust Situs Is Best In 2014?," 153 Tr. & Est. 53 (January 2014) (footnote omitted).

[6] 12 Del. C. § 3313(b). The statute codified a practice that started early in the 20th century (see Lewis v. Hanson, 128 A.2d 819 (Del. 1957), *aff'd sub nom.* Hanson v. Denckla, 357 U.S. 235 (1958), involving a revocable trust created in 1935; Stuart v. Wilmington Trust Company, 474 A.2d 121 (Del. 1984), involving a revocable trust with a trust advisory system starting in 1942).

[7] S.D. Codified Laws § § 55-1B-2(1) and 55-1B-5.

[8] N.H. Rev. Stat. Ann. § 564-B:8-808(b).

[9] Nev. Rev. Stat. § 163.5549.

[10] Alaska Stat. § § 13.36.072(c) and 13.36.375(c).

permits someone other than the trustee to make distribution decisions and investment decisions for particular assets (e.g., closely held stock) or with the hope of maximizing the trust's investment performance. The law clearly indicates that a trustee may follow the direction of an advisor authorized by the governing instrument to give such direction without breaching the trustee's fiduciary responsibility.[11] To recognize this diminished responsibility, Delaware corporate trustees customarily charge less to administer directed trusts than trusts over which they have investment duties.

Case law

The author has found only two cases that decided whether a directed trust statute afforded protection to a directed trustee. A third case is instructive.

Virginia. In *Rollins v. Branch Banking & Trust Co. of Va.*,[12] a Virginia trial court held that a trustee was not liable for the $25 million loss caused by the retention of stock as directed by the beneficiaries. But the court did not dismiss the beneficiaries' claim that the trustee had breached a duty to warn them about the deteriorating condition of trust investments, and the case was settled on this issue. The case's precedential value is uncertain because Virginia has revised its directed trust statute twice since it was issued. In light of *Rollins*, several states modified their statutes to relieve directed trustees from monitoring and other duties.

Delaware. In *Duemler v. Wilmington Trust Company*,[13] a Delaware Vice Chancellor ruled that a corporate trustee was not liable for the failure of a sophisticated (i.e., securities lawyer) investment advisor to direct it on an investment decision where the trustee forwarded relevant information to the advisor. The Vice Chancellor held:

> The Court ... finds that section 3313(b) of title 12 of the Delaware Code insulates fiduciaries of a Delaware trust from liability associated with any loss to the trust where a governing instrument provides that the fiduciary is to follow the direction of an advisor, the fiduciary acts in accordance with such direction and the fiduciary did not engage in willful misconduct. The trust agreement involved in this case appointed Plaintiff as the investment advisor to the Trust and, at all times, Plaintiff made all of the investment decisions for the Trust, including not to tender the securities in the Exchange Offer. In connection with Plaintiffs decision not to tender the securities in the Exchange Offer, Wilmington Trust acted in accordance with Plaintiff's instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information concerning the Exchange Offer. Accordingly, 12 Del. C. § 3313(b) insulates Wilmington Trust from all liability for any loss to the Trust resulting from plaintiff's decision not to tender the securities in the Exchange Offer.

New Hampshire. Even though it did not involve the apportionment of liability between a directing person and a directed trustee, the Supreme Court of New Hampshire's decision in *Shelton v. Tamposi*[14] is a cautionary tale for those who draft and administer directed trusts. In *Shelton*, the sole trustee (an individual) was in charge of distributions, and investment directors were responsible for investments.

The trustee contended that she could require the investment directors to sell illiquid investments to make funds available for distribution; the investment directors insisted that she could not. Affirming the lower court,[15] the New Hampshire Supreme Court sided with the investment directors. The case shows that the drafting attorney must make clear in the governing instrument who is in charge when investment and distribution decisions are placed in different hands.

Guidelines

In operation, the directed trustee executes the directed trust. Thus, the directed trustee buys and sells trust assets and makes other investment changes as directed by the direction investment advisor and distributes income and principal as directed by the direction distribution advisor.

The will or inter vivos trust instrument that establishes the directed trust must clearly identify the powers that are to be directed currently and over time. This should include administrative acts that are to be directed. For instance, if the direction investment advisor has the power to choose the entity that will have custody of trust assets, the governing instrument should contain language instructing the direction investment advisor to direct the directed trustee to sign custody agreements.

The *Shelton* case demonstrates the importance of having the governing instrument specify who has the deciding vote when investment and distribution decisions are made by different parties. The governing instrument also should cover what, if anything, a direction investment advisor or direction distribution advisor will be paid for services and the extent to which such an advisor will be reimbursed for out-of-pocket expenses.

---

[11] 12 Del. C. § 3313(b). Perhaps reflecting its early adoption, the Delaware statute uses "adviser" rather than "advisor" and "wilful" rather than "willful."

[12] 2001 Va. Cir. Lexis 146 (Va. Cir. Ct. 2001).

[13] 2004 Del. Ch. Lexis 206 (Del. Ch. 2004).

[14] 62 A.3d 741 (N.H. 2013).

[15] Shelton v. Tamposi, 2010 N.H. Super. Lexis 78 (N.H. Super. Ct. 2010).

A common arrangement in many Delaware trusts is to appoint a beneficiary as direction investment advisor and to authorize him or her to hire an investment manager. In such a case, the direction investment advisor might serve without compensation but be reimbursed for expenses, including investment counsel fees. Language in the governing instrument specifying that a direction investment advisor will receive "reasonable" compensation is too vague to be helpful.

The governing instrument should require the advisors and the directed trustee to share information that each party needs to fulfill responsibilities. For example, a directed trustee often must report asset values for nonmarketable assets on reports that must be filed with regulators. The direction investment advisor choosing such investments should be required to furnish their values on request.

To avoid confusion, the governing instrument should establish a procedure to confirm that directions have been given and received. To make sure that an advisor is willing and able to undertake his or her duties, the governing instrument should require an advisor to accept appointment in writing.

Because a direction investment advisor or a direction distribution advisor bears considerable responsibility for the ultimate success of a trust, the person given that responsibility must have resources to stand behind performance in case of dishonesty, negligence, inattention, etc. Advisors should be chosen with this in mind because, in a properly constructed directed trust, the directed trustee should not and will not be held liable in the event of catastrophe. Although the advisor's liability might be limited to cases of gross negligence, the advisor usually should serve in a fiduciary capacity. An entity, such as a limited liability company, sometimes is appointed as an advisor to limit the members' potential liability. Such an entity should be funded sufficiently to protect the trust and its beneficiaries.

Type of statute. Two Florida practitioners observed in a 2008 article[16] that:

> *Limit liability of directed trustee and advisor.* If the settlor wishes to have a true directed trust in which the trustee will follow the direction of an advisor, who may or may not be a co-trustee, without the trustee being required independently to evaluate the prudence of those directions, then the Delaware approach under which the trustee is liable for losses only in the event of "wilful misconduct" would appear optimal....
>
> In the case of a true directed trust that exonerates the directed trustee, the advisor should be held to a fiduciary standard of good faith that may not be waived in the governing instrument. Otherwise, it seems to us that the trust might fail, as no one would be acting in a fiduciary capacity with respect to the decisions in the hands of the advisor....
>
> *Scope of authority of the advisor.* We believe the South Dakota approach of defining certain types of trust advisors is very helpful because it permits a settlor to incorporate those definitions by reference, thus adding certainty to the scope of the advisor's authority. Any definition should make clear that the advisor may be designated for all or any part of the statutorily defined scope of duties....
>
> If the advisor is also a co-trustee, we believe the Florida approach of expressly excluding all other trustees from authority over and liability for following the directions (except in the case of willful misconduct) of the advisor is optimal.... If, on the other hand, the advisor is not a co-trustee, then we suggest that the approach in paragraph 1 above be followed.

Items to cover. In a 2011 article,[17] two Illinois practitioners identified the following five requirements for clarity as to legal and risk parameters in a multi-participant trust:

> 1. Where the trust will be administered and therefore the law of administration (which must be ascertained despite trust participants located and acting in multiple states).
>
> 2. Whether each non-trustee participant is a fiduciary or not and whether a fiduciary or not, certainty as to:
>
> a. the standard, if any, for the performance of its responsibilities and whether losses due to a failure to meet that standard attract liability; and
>
> b. what if any duties of trustees adhere to its assigned responsibilities.
>
> 3. The potential liability, if any, of the trustee or a non-trustee participant for the known or unknown acts or omissions of another participant.
>
> 4. Whether a trustee or non-trustee participant must follow a direction provided by another participant within the scope of the directing participant's responsibilities but

[16] Clarke and Zeydel, "Directed Trusts: The Statutory Approaches to Authority and Liability," 35 ETPL 14 (September 2008).

[17] Duncan and Sarafa, *supra* note 1.

[18] See Restatement (Second) of Conflict of Laws Ch. 10, Introductory Note (1971); UTC § 103(18) (2010).

[19] Restatement (Second) of Conflict of Laws (1971). In the portion of the article discussing conflict of laws, references to the "Restatement" refers to the Second Restatement of Conflict of Laws. Courts in Delaware, California, and the Ninth Circuit follow the Restatement: In re Peteris Family Inter Vivos Trusts, 77 A.3d 249 (Del. 2013) ("When confronted with a choice-of-law issue, Delaware courts adhere to the Restatement (Second) of Conflict of Laws."); Green v. Zukerkorn (In re Zukerkorn), 484 B.R. 182 (B.A.P. 9th Cir. 2012) ("Federal courts in the Ninth Circuit and California state courts both look to the Restatement (Second) of Conflicts [sic] of Law ... for the choice of law rules."); Waldron v. Huber (In re Huber), 493 B.R. 798 (Bankr. W.D. Wash. 2013) ("courts in the Ninth Circuit follow the approach of the Restatement (Second) of Conflict of Laws"). For citations of cases applying the Restatement in Arizona, California, Colorado, Connecticut, Delaware, Florida, Georgia, Illinois, Maryland, Massachusetts, Minnesota, Missouri, New York, Ohio, Pennsylvania, Texas, and Washington, see Abramson, Gary and Bogert, *Trusts & Trustees* § 294 at 46 n.10 (3d ed. 2014) (hereafter "Bogert on Trusts").

[20] Restatement § 268 cmt. e.

[21] Restatement § 269 cmt. d.

which the receiver knows, reasonably believes or should have known would violate the instrument, law or the direction giver's or the receiver's fiduciary responsibility.

5. More generally, whether a directed trustee is relieved of any responsibility with respect to a function assigned to a non-trustee participant other than to follow that participant's directions.

The same article identifies the following seven requirements for an effective multi-participant trust management structure:

1. Communication among the fiduciary participants as to, among other things, what they have done, what they have been told by beneficiaries or others, the assets in the trust from time to time and, in particular, the distributions requested, approved or made or of an election to convert to a unitrust or exercise a power to adjust.

2. Coordination among the trust participants, such as speaking with a consistent voice to beneficiaries, investing and liquidating assets according to the liquidity needs of the trust for expenditures and distributions, taking a consistent view as to the legal obligations of the trust to beneficiaries and others or the tax obligations of the trust.

3. Filling vacancies in trust participant positions and determining who if anyone must perform a vacant participant's functions pending appointment of a successor.

4. Time limits for a trust participant to exercise an approval or veto right or obligation, and whether after the expiration of such time, the action will be deemed approved or vetoed.

5. When more than one participant has the power to act or decide on a matter, certainty as to whether action must be taken unanimously, by majority vote or by any one of the empowered participants, and whether a dissenting participant need do more than voice an objection to the other participants to protect himself/herself from liability.

6. Expeditious, competent and final out-of-court resolution of any disagreement among trust participants.

7. Certainty as to the amount of compensation and reimbursement of expenses, if any, the non-trustee participants are entitled to receive.

Caveat

The relief provided to a directed trustee by even the most protective statute is not unlimited. A directed trust statute is a state-law creation and protects a directed trustee only from state-law claims. Specifically, it does not shield a directed trustee from claims arising under federal law (e.g., tax laws and anti-money-laundering penalties).

Conflict of laws—governing principles

If a resident of one state ("Home State") concludes that the needs of his or her family will be best served by creating a directed trust in another state ("Trust State"), then the attorney must take steps to ensure that Trust State law will apply in evaluating the directed trust arrangement and that the courts of the Trust State (rather than the courts of the Home State or some other state) will make that assessment. Given that the testator's/trustor's intent will be a court's starting point in analyzing these issues,[18] the governing instrument should designate the applicable law and the supervising court. Then the client and the attorney should take the steps described below to ensure that those designations will be honored.

What law applies? On this issue, the practitioner should consider the Second Restatement of Conflict of Laws[19] and the UTC. Under the Restatement, the effectiveness of a governing law designation in a trust is a function of the following:

- Whether the trust holds personal property or real property. (The Restatement refers to it as "movables" or "land," respectively.)
- Whether the trust is created by will or inter vivos.
- Whether the issue involves:

1. The "validity" of a trust provision.
2. The "administration" of the trust.
3. The "construction" of a trust provision.
4. Restraints on alienation of a beneficiary's interest.

It usually is apparent whether a trust is being funded with real or personal property and whether the governing instrument is a will or inter vivos document. Moreover, the effectiveness of a directed trust statute is not a matter of construction (which relates to the identification of the beneficiaries)[20] or of restraints on a beneficiary's interest. Although it might seem that the effectiveness of a directed trust is a matter of "validity," "validity" is not a catch-all category. This is because the Restatement has the following narrow definition of the term:

> Some questions of validity relate only to the trust provisions and not to the will as a testamentary disposition. A trust may be invalid, in whole or in part, because it violates the rule against perpetuities or a rule against the suspension of the absolute ownership or of the power of alienation; because it violates a rule against accumulations; because the purpose is illegal; because of an illegal condition, such as one promoting divorce or restraining marriage.[21]

Restatement—personal property. Restatement § 269 covers the law that is used to resolve questions involving the validity of provisions of a trust of movables created by will, and § 270 covers the law that is used to resolve questions involving the validity of provisions of a trust of movables created inter vivos. When analyzing the validity of a trust provision under § 269 or § 270, the following three questions need to be answered:

1. Is the question one of "validity"?
2. Does the Trust State have a substantial relation to the trust?

EXHIBIT 2
State Uniform Trust Code Statutes (8/31/2015)

State	UTC § 107	UTC § 108	UTC § 202	Effective Date
Alabama	Ala. Code § 19-3B-107	Ala. Code § 19-3B-108	Ala. Code § 19-3B-202	2007
Arizona	Ariz. Rev. Stat. § 14-10107	Ariz. Rev. Stat. § 14-10108	Ariz. Rev. Stat. § 14-10202	2009
Arkansas	Ark. Code Ann. § 28-73-107	Ark. Code Ann. § 28-73-108	Ark. Code Ann. § 28-73-202	2005
District of Columbia	D.C. Code § 19-1301.07	D.C. Code § 19-1301.08	D.C. Code § 19-1302.02	2004
Florida	Fla. Stat. § 736.0107	Fla. Stat. § 736.0108	Fla. Stat. § 736.0202	2007
Kansas	Kan. Stat. Ann. § 58a-107	Kan. Stat. Ann. § 58a-108	Kan. Stat. Ann. § 58a-202	2003
Kentucky	Ky. Rev. Stat. Ann. § 386B.1-050	Ky. Rev. Stat. § 386B.1-060	Ky. Rev. Stat. § 386B.2-020	2014
Maine	Me. Rev. Stat. Ann. tit. 18-B, § 107	Me. Rev. Stat. Ann. tit. 18-B, § 108	Me. Rev. Stat. Ann. tit. 18-B, § 202	2005
Maryland	Md. Code Ann., Est. & Trusts § 14.5-107 (reserved)	Md. Code Ann., Est. & Trusts § 14.5-108	Md. Code Ann. Est. & Trusts § 14.5-202	2015
Massachusetts	Mass. Gen. Laws ch. 203E, § 107 (reserved)	Mass. Gen. Laws ch. 203E, § 108	Mass. Gen. Laws ch. 203E, § 202	2012
Michigan	Mich. Comp. Laws § 700.7107	Mich. Comp. Laws § 700.7108	Mich. Comp. Laws § 700.7202	2010
Minnesota	Minn. Stat. § 501C.0107	Minn. Stat. § 501C.0108	Minn. Stat. § 501C.0206	2016
Mississippi	Miss. Code § 91-8-107	Miss. Code § 91-8-108	Miss. Code § 91-8-202	2014
Missouri	RSMo § 456.1-107	RSMo § 456.1-108	RSMo § 56.2-202	2005
Montana	Mont. Code Ann. § 72-38-107	Mont. Code Ann. § 72-38-108	Mont. Code Ann. § 72-38-203	2013
Nebraska	Neb. Rev. Stat. § 30-3807	Neb. Rev. Stat. § 30-3808	Neb. Rev. Stat. § 30-3813	2005
New Hampshire	N.H. Rev. Stat. Ann. § 564-B:I-107	N.H. Rev. Stat. Ann. § 564-B:I-108	N.H. Rev. Stat. Ann. § 564-B:2-202	2004
New Mexico	N.M. Stat. Ann. § 48A-1-107	N.M. Stat. Ann. § 46A-1-108	N.M. Stat. Ann. § 46A-2-202	2007
North Carolina	N.C. Gen. Stat. § 6C-1-107	N.C. Gen. Stat. § 6C-1-108	N.C. Gen. Stat. § 6C-2-202	2006
North Dakota	N.D. Cent. Code § 59-09-07	N.D. Cent. Code § 59-09-08	N.D. Cent. Code § 59-10-02	2007
Ohio	Ohio Rev. Code Ann. § 5801.06	Ohio Rev. Code Ann. § 5801.07	Ohio Rev. Code Ann. § 5802.02	2007
Oregon	Or. Rev. Stat. § 130.030	Or. Rev. Stat. § 130.022	Or. Rev. Stat. § 130.055	2006
Pennsylvania	20 Pa. C.S § 7707	20 Pa. C.S § 7708	20 Pa. C.S § 7712	2006
South Carolina	S.C. Code Ann. § 62-7-107	S.C. Code Ann. § 62-7-108	S.C. Code Ann. § 62-7-202	2006
Tennessee	Tenn. Code Ann. § 35-15-107	Tenn. Code Ann. § 35-15-108	Tenn. Code Ann. § 35-15-202	2004
Utah	Utah Code Ann. § 75-7-107	Utah Code Ann. § 75-7-108	Utah Code Ann. § 75-7-202	2004
Vermont	14A V.S.A. § 107	14A V.S.A. § 108	14A V.S.A. § 202	2009
Virginia	Va. Code Ann. § 64.2-705	Va. Code Ann. § 64.2-706	Va. Code Ann. § 64.2-711	2006
West Virginia	W. Va. Code § 44D-1-107	W. Va. Code § 44D-1-108	W. Va. Code § 44D-2-202	2011
Wisconsin	Wis. Stat. § 701.0107	Wis. Stat. § 701.0108	Wis. Stat. § 701.0202	2014
Wyoming	Wyo. Stat. Ann. § 4-10-107	Wyo. Stat. Ann. § 4-10-108	Wyo. Stat. Ann. § 4-10-202	2003

Note: The information in this appendix is derived from material that may be viewed at www.uniformlaws.org/LegislativeFactSheet.aspx?title=Trust Code (last visited on 10/13/2015).

3. Does the trust provision in question violate a strong public policy of the Home State?

As just mentioned, questions of validity relate to issues such as whether the trust violates the rule against perpetuities or the rule against accumulations. The Trust State has a substantial relation to the trust if, among other things, the trustor designated it as the place of the trust's administration, the trustee lives or does business in the Trust State when the trust is created, or the trust assets are located in the Trust State at that time.[22] According to the authorities, the strong-public-policy issues that jus-

[22] Restatement § 270 cmt. b.

tify a departure from § 269's or § 270's general rule involve trust provisions designed to defeat a surviving spouse's right of election and that violate a state's restrictions on testamentary gifts to charity,[23] which are not relevant here.

For an inter vivos trust, it also is necessary to determine whether the Trust State or the Home State has the most significant relationship to the matter at issue. Regarding this issue, § 270 directs us to § 6 of the Restatement, which provides:

> [T]he factors relevant to the choice of the applicable rule of law include
>
> (a) the needs of the interstate and international systems,
>
> (b) the relevant policies of the forum,
>
> (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue,
>
> (d) the protection of justified expectations,
>
> (e) the basic policies underlying the particular field of law,
>
> (f) certainty, predictability and uniformity of result, and
>
> (g) ease in the determination and application of the law to be applied.

Nevertheless, under the Restatement's framework, the effectiveness of a directed trust seems to fall within the administration category—not the validity category—because a comment under Restatement § 271 provides:[24]

> The term "administration of a trust," as it is used in the Restatement of this subject, includes those matters which relate to the management of the trust. Matters of administration include those relating to the duties owed by the trustee to the beneficiaries. They include the powers of a trustee, such as the power to lease, to sell and to pledge, the exercise of discretionary powers, the requirement of unanimity of the trustees in the exercise of powers, and the survival of powers. They include the liabilities which may be incurred by the trustee for breach of trust. They include questions as to what are proper trust investments. They include the trustee's right to compensation. They include the trustee's right to indemnity for expenses incurred by him in the administration of the trust. They include the removal of the trustee and the appointment of successor trustees. They include the terminability of the trust.

A trustor's designation of a state's law to govern questions regarding the administration of a testamentary trust[25] or inter vivos trust[26] of personal property will be respected, even if the designated state has no connection with the trust.

Restatement—real property. The law that governs questions of validity[27] and administration[28] for a trust that holds real property is the law that would be applied by the courts of the situs of the property. Accordingly, the ability of a testator/trustor to select the directed trust law of a Trust State for such a trust is limited.

UTC. Unlike the Restatement, the UTC does not contain different rules for trusts that hold real property and trusts that hold personal property, nor does the UTC distinguish between testamentary trusts and inter vivos trusts. UTC § 107 does set rules for determining which state's law applies in determining the "meaning and effect" of trust provisions.[29] But, the term "meaning and effect" seems to correspond most closely to matters of "construction" under the Restatement and therefore is not pertinent to our subject.

No UTC provision covers governing law for matters of "validity" or "administration," but § 107's comment suggests:

> Usually, the law of the trust's principal place of administration will govern administrative matters and the law of the place having the most significant relationship to the trust's creation will govern the dispositive provisions.

To determine a trust's "principal place of administration," UTC § 108(a) stipulates:

> Without precluding other means for establishing a sufficient connection with the designated jurisdiction, terms of a trust designating the principal place of administration are valid and controlling if:
>
> (1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction; or
>
> (2) all or part of the administration occurs in the designated jurisdiction.

Regarding the governance of the trust's "dispositive provisions," which seems to correspond to "validity" under the Restatement, § 107's comment refers to "the law of the place having the most significant relationship to the trust's creation." Section 107's comment offers the following guidelines to determine which state's law governs a trust's "dispositive provisions":

> Factors to consider in determining the governing law include the place of the trust's creation, the location of the trust property, and the domicile of the settlor, the trustee, and the beneficiaries. Other more general factors that may be pertinent in particular cases include the relevant policies of the forum, the relevant policies of other interested jurisdictions and degree of their interest, the protection of justified expectations and certainty, and predictability and uniformity of result. [Citations omitted.]

Recommendations. In light of the above discussion, a testator/trustor who wants Trust State law to determine the effectiveness of a direct-

[23] Restatement § § 269 cmts. c, i, 270 cmts. b, e; Scott, Fratcher and Ascher, 7 *Scott and Ascher on Trusts* § 45.4.2.4 at 3254–60 (5th ed. 2007) (hereafter "*7 Scott on Trusts*"); *Bogert on Trusts* § § 296 at 61-63, 297 at 70, 73–74.

[24] Restatement § 271 cmt. a (cross references omitted).

[25] Restatement § 271(a).

[26] Restatement § 272.

[27] Restatement § 278.

[28] Restatement § 279.

ed trust arrangement should designate Trust State law to govern matters of validity and administration, appoint a corporate trustee in the Trust State, and make sure that a significant part of the trust's management will occur in the Trust State. The corporate trustee should execute the governing instrument in the Trust State, and the testator/trustor might do so as well.

Conversely, the testator/trustor should minimize ties to the Home State by *not* designating the law of the Home State, *not* appointing a Home State corporate trustee, *avoiding* administration in the Home State, and *not* executing the governing instrument there.

Which state's courts should exercise jurisdiction?

To determine which state's courts should adjudicate questions involving the effectiveness of directed trust statutes, the practitioner must look to the Restatement, the UTC, and the UPC.

Restatement—personal property. For trusts of movables created by will or inter vivos, Restatement § 267 provides that:

> The administration of a trust of interests in movables is usually supervised ... by the courts of the state in which the trust is to be administered.

Comment c to § 267 indicates that the will or trust instrument may designate the state of administration, and comment d describes the implications of such a designation as follows:

> If the trust is to be administered in a particular state, that state has jurisdiction to determine through its courts not only the interests of the beneficiaries in the trust property but also the liabilities of the trustee to the beneficiaries, even though it does not have jurisdiction over the beneficiaries, or some of them....
>
> So also a court of the state in which the trust is administered may give instructions as to the powers and duties of the trustee, although the beneficiaries or some of them are not subject to the jurisdiction of the court, provided they are given opportunity to appear and be heard.

Comment e discusses the role of the court of primary supervision as follows:

> Where the trustee has not qualified as trustee in any court and the trust is to be administered in a particular state, the courts of that state have primary supervision over the administration of the trust. They have and will exercise jurisdiction as to all questions which may arise in the administration of the trust. Thus, if an inter vivos trust is created with a trust company as trustee, the courts of the state in which the trust company was organized and does business will exercise jurisdiction over the administration of the trust.

If the Home State court has jurisdiction over the trustee or the trust, comment e to § 267 suggests that it should defer to the Trust State's courts. The *Scott* treatise summarizes the applicable principles as follows:

> Trust administration is ordinarily governed by the law of the state of primary supervision, and the rights of the parties ought not depend on the fact that a court of some other state happens to have acquired jurisdiction. Such a court may give a judgment based on its own local law, or it may attempt to apply the law of the state of primary supervision but apply it incorrectly.[30]

Restatement—real property. For trusts that hold interests in land created by will or inter vivos, Restatement § 276 provides as follows:

> The administration of a trust of an interest in land is supervised by the courts of the situs as long as the land remains subject to the trust.

UTC. Under the UTC, establishing the "principal place of administration" of a trust is critical in determining which state's courts should handle trust questions because UTC § 202 provides in pertinent part:[31]

> (a) By accepting the trusteeship of a trust having its principal place of administration in this State ... the trustee submits personally to the jurisdiction of the courts of this State regarding any matter involving the trust.
>
> (b) With respect to their interests in the trust, the beneficiaries of a trust having its principal place of administration in this State are subject to the jurisdiction of the courts of this State regarding any matter involving the trust. By accepting a distribution from such a trust, the recipient submits personally to the jurisdiction of the courts of this State regarding any matter involving the trust.

Section 202's comment explains:

> This section clarifies that the courts of the principal place of administration have jurisdiction to enter orders relating to the trust that will be binding on both the trustee and beneficiaries.

UTC § 108(a), quoted above, specifies that a governing instrument's designation of a trust's principal place of administration will be respected if a trustee resides or has its principal place of business in the state or if trust administration occurs there.

UPC. The UPC's approach is a bit different. UPC § 7-203 provides:

> The Court will not, over the objection of a party, entertain proceed-

[29] See Exhibit 2 for state citations. See also UPC § 2-703 (2010) (meaning and legal effect of governing instrument generally is determined by local law selected in governing instrument).

[30] 7 *Scott on Trusts* § 45.2.2.6 at 3125.

[31] UTC § 202 (2010). See Exhibit 2 for state citations.

[32] The text of the UPC may be viewed at www.uniformlaws.org/shared/docs/probate%20code/2014_UPC_Final_apr23.pdf (last visited on 10/13/2015).

[33] See Alaska Stat. § 13.36.045; Colo. Rev. Stat. § 15-16-23; Haw. Rev. Stat. § 560:7-203; Idaho Code § 15-7-203; Mass. Gen. Laws ch. 203E, § 203; Mich. Comp. Laws § 700.7205; N.C. Gen. Stat. § 36C-2-203; Utah Code Ann. § 75-7-204. See also, In re Seneker Trust, 2015 Mich. App. Lexis 397 (Mich. Ct. App. 2015).

[34] See Alaska Stat. § 13.36.005; Colo. Rev. Stat. § 15-16-101; Haw. Rev. Stat. § 560:7-101; Idaho Code § 15-7-101; Mich. Comp. Laws § 700.7209; RSMo § 456.027(3); Neb. Rev. Stat. Ann. § 30-3816.

[35] 128 A.2d 819 (Del. 1957), *aff'd sub nom.* Hanson v. Denckla, 357 U.S. 235 (1958).

ings under Section 7-201 involving a trust registered or having its principal place of administration in another state, unless (1) when all appropriate parties could not be bound by litigation in the courts of the state where the trust is registered or has its principal place of administration or (2) when the interests of justice otherwise would seriously be impaired. The Court may condition a stay or dismissal of a proceeding under this section on the consent of any party to jurisdiction of the state in which the trust is registered or has its principal place of business, or the Court may grant a continuance or enter any other appropriate order.

Although § 7-203 and the rest of Article 7 do not appear in the 2010 version of the UPC,[32] at least eight states have statutes based on § 7-203.[33] UPC § 7-101 defines "principal place of administration" as follows:

> Unless otherwise designated in the trust instrument, the principal place of administration of a trust is the trustee's usual place of business where the records pertaining to the trust are kept, or at the trustee's residence if he has no such place of business. In the case of co-trustees, the principal place of administration, if not otherwise designated in the trust instrument, is (1) the usual place of business of the corporate trustee if there is but one corporate co-trustee, or (2) the usual place of business or residence of the individual trustee who is a professional fiduciary if there is but one such person and no corporate co-trustee, and otherwise (3) the usual place of business or residence of any of the co-trustees as agreed upon by them.[34]

Recommendations. To ensure that the courts of the Trust State will adjudicate disputes arising under the Trust State's directed trust statute, the governing instrument should designate the Trust State as the trust's situs and principal place of administration, appoint a corporate trustee in the Trust State, and fix as much administration there as possible. The client and the attorney again should minimize those contacts with the Home State by *not* designating Home State law, *not* appointing a Home State corporate trustee, and *avoiding* administration there.

If a client wants a trust to be governed by the law of a particular state and to have all issues involving the trust adjudicated there, he or she might include the following language:

"*This agreement creates a [Trust State] trust, and all matters pertaining to the validity, construction, and application of this agreement; to the administration of the trusts created by it; and to the effectiveness of restraints on alienation of beneficiaries' interests hereunder shall be governed by [Trust State] law. [Trust State] shall be the situs and the principal place of administration of all trusts hereunder, and the courts of [Trust State] shall have exclusive jurisdiction over any action brought with respect to any trust hereunder.*"

If the client wants the law that governs questions of administration and the supervising court to change if the trust's situs is moved to another state, the following sentence might be inserted after the above sentences:

"*However, if the successor trustee hereunder is located in any state other than the State of [Trust State], the situs and the principal place of administration of such trust shall become that of the location of the successor trustee, and thereafter the laws governing the administration of such trust and the effectiveness of restraints on alienation of beneficiaries' interests hereunder shall be those of the new situs and the courts of that state shall have exclusive jurisdiction over any action brought with respect to a trust hereunder.*"

Conflict of laws—an illustration

Some might be surprised to learn that directed trusts have been around for a long time. In its 1957 *Lewis v. Hanson* decision,[35] the Supreme Court of Delaware considered whether a Florida resident had validly exercised a power of appointment over a revocable trust containing directed trust provisions that she, while a Pennsylvania resident, had created in Delaware with Wilmington Trust Company in 1935. The court described its task as follows:

> [W]e think a more logical approach to what has now become a headlong jurisdictional collision between states is to consider first the question of what law governs the basic validity of the trust agreement and the exercise of the power of appointment, and whether or not under the applicable law the instruments are legally effective as such. We therefore take up first the question of essential validity of the trust and the exercise of the power of appointment.

The supreme court found that Delaware law rather than Florida law should determine whether Mrs. Donner had validly exercised her power of appointment:

> In determining the situs of a trust for the purpose of deciding what law is applicable to determine its validity, the most important facts to be considered are the intention of the creator of the trust, the domicile of the trustee, and the place in which the trust is administered.
>
> Generally speaking, a creator of an inter vivos trust has some right of choice in the selection of the jurisdiction, the law of which will govern the administration of the trust. This trust agreement was signed and the securities delivered to a trustee doing business in Delaware. We think that this circumstance clearly indicates the intent of Mrs. Donner to have the trust administered and governed according to the law of Delaware.
>
> Formerly, some courts emphasized the domicile of the settlor in deciding what law governed, but the more recent trend of decisions has placed considerably more emphasis on the location of the trust prop-

erty and its place of administration. The manifest intention of Mrs. Donner to create a Delaware trust with a Delaware trustee, the deposit of the trust assets in Delaware, and the administration of the trust in Delaware, make it clear that the situs of the trust created by the agreement of 1935 is Delaware, and that, therefore, its law determines its validity.

Not only is it the rule that the essential validity of an inter vivos trust having its situs in Delaware is governed by its law, but it is equally the rule that the validity of the exercise of a power of appointment reserved in such a trust agreement is to be determined in accordance with Delaware law. This is so because the appointments made by the exercise of the power are regarded in law as though they had been embodied in the original trust instrument, and as such as having been created by it.

We, therefore, hold that the law of Delaware determines the essential validity of this trust agreement and of the exercise of the power of appointment. [Citations omitted.]

The court rejected an argument that the trust and the exercise of the power of appointment were invalid as testamentary in character for failing to create present interests in persons other than the trustor at the outset and an argument that the trustor had created an agency relationship rather than a trust relationship with Wilmington Trust Company given the array of her retained powers.

The court then arrived at the critical issue for present purposes:

[T]he main thrust of the argument of the Lewis Group is directed to the provisions of the agreement providing for the designation of a trust advisor and the limitations on the power of the trustee to act only with the consent of or at the direction of the advisor.

By the agreement, Mrs. Donner reserved the right to change the original advisor named and, in fact, she did so on two separate occasions. The agreement, however, specifically confines the powers of the trust advisor as limitations on the exercise of the trustee's powers to (1) the power to sell trust property, (2) the power to invest the proceeds of any sale of trust property, and (3) the power to participate in any plan of merger or reorganization of any company in which trust proceeds have been invested. With respect to the exercise of all of the other specific powers granted to the trustee the consent of the trust advisor is not required.

The Supreme Court sustained the validity of the trust and the exercise of the power of appointment:

If it be assumed that the exercise by the trustee of the above enumerated powers had been conditioned solely upon the consent of Mrs. Donner herself, it is clear that that limitation would not have made the trust testamentary in character. It follows logically, therefore, that if Mrs. Donner could have limited the power of the trustee to act only with her consent without making the trust testamentary, the same limitation could have been imposed by requiring the consent of a third party.... Furthermore, a trust advisor is a fiduciary, somewhat in the nature of a co-trustee, and is sometimes described as a quasi-trustee. The resulting situation fundamentally is not unlike the appointment of co-trustees whose joint action is required in trust matters.

The agreement of 1935 by its terms reserves no power to Mrs. Donner herself over the control or management of the trust property, except such power as may come from her right to revoke the trust, change the trustee and change the advisor to the trustee. As far as the terms of the agreement itself are concerned, the trustee and the advisor were required to use their independent judgment in reaching decisions relating to the administration of the trust.

The terms of the agreement, therefore, do not compel the conclusion that Mrs. Donner retained such a measure of control over the management of the trust property that, as a matter of law, the Wilmington Trust Company, and the trust advisor named were actually her agents. The entire management of the trust is vested by the terms of the instrument in the trustee and the advisor. We think, therefore, that under the law of Delaware the agreement of 1935 created a valid inter vivos trust and not an agency relationship as the Lewis Group contends. [Citations omitted.]

Directed trust as a PTC alternative

Wealthy individuals sometimes explore creating private trust companies (PTCs) to serve as trustees of trusts for family members. PTCs are very expensive to form, involve potential registration with and regulation by the Securities and Exchange Commission and other state and federal agencies, and are vulnerable to disruption if key personnel depart. By establishing directed trusts with a corporate fiduciary, such families may avoid that expense and those regulatory headaches.

An appropriate corporate fiduciary may offer access to multiple investment, trust, tax, estate planning, and other officers so that if one of them leaves, the administration of trusts will not be harmed. The appointment of family members as direction investment advisors or direction distribution advisors will minimize the corporate trustee's fees and provide the control that is so important to many families.

CRTs and advisors

From time to time, the author is asked whether a charitable remainder trust (CRT) may have a direction investment advisor. In 1980, the IRS ruled that the investment of assets on the direction of invest-

[36] See Ltr. Rul. 8041100.

[37] See Ltr. Rul. 9442017.

[38] See Exhibit 1. See also Ausness, "When Is a Trust Protector a Fiduciary?," 27 Quinn. Prob. L.J. 277 (2014); Bove, "The Case Against the Trust Protector," 37 ACTEC L.J. 77 (Summer 2011); Tiernan, "Evaluate and Draft Helpful Trust Protector Provisions," 38 ETPL 24 (July 2011); Ruce, "The Trustee and the Trust Protector," 59 Drake L. Rev. 67 (Fall 2010).

[39] 418 S.W.3d 482 (Mo. Ct. App. 2013).

[40] 2014 U.S. Dist. Lexis 53083 (D.S.C. 2014).

[41] 56 F. Supp.3d 394 (S.D.N.Y. 2014).

[42] 152 So.3d 719 (Fla. Dist. Ct. App. 2014).

[43] 2014 Del. Ch. Lexis 190 (Del. Ch. 2014).

[44] 169 So.3d 1101 (La. Ct. App. 2015).

ment counsel would disqualify a CRT.[36] But, in 1994, the IRS ruled that a CRT, in which the trustee would invest on the direction of an investment manager, would qualify, provided that such manager exercised powers in a fiduciary capacity.[37] Attorneys should draft CRTs with this in mind.

The protector

Since the turn of the 21st century, the "protector," which long has been a feature of offshore trusts, has begun to appear in trusts created in the U.S., and states have begun enacting statutes defining the protector's role.[38] The protector sometimes becomes involved in decisions (e.g., directing investments or distributions) that traditionally have fallen within the domain of the advisor or committee and, at other times, is charged with responsibilities (e.g., replacing trustees and advisors, amending trust provisions, and changing situs) that used to require court involvement.

Careful drafting Is key. Given that protector statutes do not contain default powers, the governing instrument must clearly spell out the powers, rights, duties, and responsibilities of the trustee, the direction investment advisor, the direction distribution advisor, and the protector. Matters that should be addressed include:

- The protector's powers and duties, including power to enforce the trust.
- Whether the protector has ongoing monitoring responsibilities regarding the exercise of one or more powers (e.g., to remove an advisor or trustee).
- The amount and source of the protector's compensation.
- The extent to which the protector will be reimbursed for out-of-pocket expenses, including counsel fees and court costs incurred in carrying out duties.
- Whether the protector will serve in a fiduciary capacity for some or all duties.
- How successor protectors will be chosen.

Fiduciary or not fiduciary. Much has been written on whether a protector should serve in a fiduciary capacity. In the author's view, it depends on the power being exercised. Certainly a protector should serve in a fiduciary capacity if he, she, or it is discharging the powers of a direction investment advisor or a direction distribution advisor. Even a protector that is handling protector functions generally should be held as a fiduciary, but there are exceptions. For example, if a protector is given a power under IRC Section 675(4)(C) to swap trust assets in order to get grantor trust treatment, this power must be held in a nonfiduciary capacity.

Case law. In recent years, courts have begun to decide cases involving protectors. Relevant cases include:

- *Robert T. McLean Irrevocable Trust v. Ponder.*[39] Although the protector could replace the trustee, a Missouri intermediate appellate court held that he did not have a duty to monitor the trustee's activities to determine if he should exercise the power.
- *Schwartz v. Wellin.*[40] Given that the protector was not a "real party in interest" under South Dakota law, a federal district judge in South Carolina held that he could not prevent the individual trustees from terminating a huge South Dakota dynasty trust.
- *SEC v. Wyly.*[41] A federal district judge in New York held that the trustors' control over the protectors of foreign trusts caused the trusts to be grantor trusts for federal income tax purposes, so that the trustors owed the IRS billions of dollars in taxes.
- *Minassian v. Rachins.*[42] A Florida intermediate appellate court concluded that the trustee's appointment of a protector pursuant to the trust instrument and the protector's modification of trust terms during litigation was allowed to resolve the dispute because it was in accordance with the trustor's intent.
- *In re Kloiber.*[43] The Delaware Court of Chancery deferred deciding questions involving the effectiveness of the exercise of the protector's powers pending the outcome of a divorce proceeding in Kentucky.
- *In re Eleanor Pierce (Marshall) Stevens Living Trust.*[44] An intermediate appellate court held that the "protector" is allowed by Louisiana law and therefore upheld a protector's removal of a trustee.

Conclusion

Directed trusts can reduce trustee fees while having investment and distribution decisions made by those who are most likely to understand and carry out the grantor's intent. State laws vary regarding the protection afforded trustees who operate within the framework of directed trusts. The applicable laws need to be considered when creating directed trusts, and governing instruments should be drafted with sufficient specificity to best achieve the desired results. ■

A Practitioner-Friendly Guide to the Delaware Asset-Protection Trust

By Richard W. Nenno

Richard W. Nenno is a senior managing director and trust counsel in Wealth Advisory Services, a Wilmington Trust Company, Wilmington, Delaware, and a member of the Section Council. **This article, with commentary, is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. Wilmington Trust is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Investment management and fiduciary services are provided by Wilmington Trust Company, operating in Delaware only. ©2015 Wilmington Trust Company. All rights reserved.**

Since July 9, 1997, when Governor Thomas R. Carper signed Delaware's Qualified Dispositions in Trust Act ("Delaware Act"), Delaware and non-Delaware residents have been using the Delaware Act to save taxes, to protect assets, and to accomplish other purposes summarized below. This article highlights key features of this kind of trust.

Background

Under the common-law rule against self-settled trusts, an individual traditionally could not create a self-settled trust (that is, an irrevocable trust from which he or she could benefit) and protect trust assets from claims by his or her creditors. So, if a client created an irrevocable trust and gave the trustee discretion to use the income and principal for the client and his or her spouse and children, the client's creditors could reach all trust assets, even if the trust had a spendthrift clause.

As American society became increasingly litigious, interest developed in a trust in which the person creating the trust could retain some potential benefits that could not be reached by his or her creditors. Until 1997, this interest was satisfied only by a trust, often called an "asset- protection trust" (APT), created in a foreign jurisdiction.

The Delaware Act, 12 Del. Code §§ 3570–3576, gave birth to the Delaware APT. Besides Delaware, the states that now have some form of APT law are Alaska, Colorado, Hawaii, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, and Wyoming. New Delaware APTs are signed regularly.

The Delaware APT is not for every client. Instead, it is an option to consider along with other techniques for shielding assets, such as liability insurance, incorporation, tenancy-by-the-entireties property, homestead exemption, retirement plans, and IRAs.

Benefits of Delaware APTS

A trust that is structured as a Delaware APT can provide several benefits.

Save Taxes

Employ Tax Benefits. A client might be reluctant to give away assets to use part or all of his $5.45 million gift-tax exemption (and a deceased spouse's unused exemption) for fear that he will need the funds in later life. Although the tax treatment is less certain than for an outright gift or a gift to a third-party trust, the client should consider using a Delaware APT for these tax benefits because he may be a discretionary beneficiary of the trust and could get assets back in an emergency.

Reduce Federal Transfer Tax. A client will save federal transfer tax if he makes a gift that incurs gift tax, if he lives at least three years after making the gift, and if his estate must pay estate tax. If a client makes the gift through a Delaware APT, he might be able to get funds back from the trust if needed.

Avoid State Death Tax. If a client's state of residence imposes an estate or inheritance tax, he might be able to reduce that tax by making a gift before death. If the client makes the gift to a Delaware APT, he potentially could get funds back in the event of need.

Assure Favorable Tax Treatment for Grantor Trusts. A client's payment of income taxes attributable to a grantor trust is not a taxable gift, and inclusion in a grantor trust of a provision that gives the trustee discretion to reimburse the client for such taxes will not cause the trust to be included in the client's gross estate, provided that, as is true under the Delaware Act, the client's creditors may not reach trust assets by reason of the inclusion of that discretion. Rev. Rul. 2004-64.

Avoid State Income Tax. A client might try to use a type of Delaware APT commonly known as a "Delaware Incomplete Nongrantor Trust" (DING Trust) to avoid income tax on undistributed ordinary income and capital gains of a trust imposed by a state that has not adopted the federal grantor-trust rules (that is, Pennsylvania). Also, the IRS has ruled several times that APTs may be nongrantor trusts if they are structured so that distributions to the grantor are controlled by adverse parties. See, e.g., PLR 201510001. Consequently, a client might be able to avoid state tax on undistributed ordinary income and capital gains of a trust imposed by one of the 43 states that follow the federal grantor-trust rules. As a nongrantor trust for state tax purposes, the client's home state may not tax the trust because of a lack of contacts with the trust and Delaware would not impose a tax on income accumulated for non-Delaware beneficiaries. In later years, a client possibly could receive tax-free distributions of the untaxed income.

Effective in 2014, this option is not available in New York.

Obtain Asset Protection

General. Through success in business, savvy investing, or the receipt of a gift, inheritance, or personal-injury award, a client might own substantial assets outright. He could fund a Delaware APT with some of those assets to get protection from future creditor claims and business reverses.

Protect Young Adults' Assets. A client should encourage his or her children to put assets that they receive (or may withdraw from a trust) at majority in a Delaware APT. Although the children can receive distributions from the trust, they will not have the unlimited ability to squander them.

Provide Pre-Marital Planning. Because Delaware APTs are immune from claims by future spouses, a client's children can use them to shield assets from those claims without providing the financial disclosure that is required to implement effective pre-nuptial agreements.

Protect Vulnerable Persons. If a client is mentally, physically, or financially vulnerable, he should consider using a Delaware APT to protect assets.

Protect Estate-Planning Vehicles

Several common estate-planning vehicles, such as CRTs, GRATs, and QPRTs, are self-settled trusts and therefore are vulnerable to creditor claims. In fact, two courts have included the debtor's interest in a CRT in the bankruptcy estate, *In re Mack*, 269 B.R. 392 (Bankr. D. Minn. 2001); *Mennotte v. Brown*, 303 F.3d 1261 (11th Cir. 2002), and two other courts have included the debtor's interest in a QPRT in the bankruptcy estate. *In re Earle*, 307 B.R. 276 (Bankr. S.D. Ala. 2002); In re Ferrante, Nos. CC-14-1222-KiTaPa, CC-14-1223-KiTaPa, 2015 Bankr. LEXIS 2854 (BAP 9th Cir. Aug. 26, 2015). The Delaware Act extends protection to these arrangements.

Provide Options for NRAs

If a client is a nonresident alien (NRA), he should consider a Delaware APT for two purposes. First, a Delaware APT is a viable estate-planning and asset-protection option for an NRA, whether or not he has family members in this country. Second, if a client is considering immigrating to the United States, he might want to create a Delaware APT to take advantage of the favorable tax treatment afforded lifetime gifts by NRAs before immigration and to keep the ability to get funds back if needed.

Provide Protection for Existing Trusts

If a client has created a self-settled trust in a state where it does not have protection from creditors, he should explore moving it to Delaware. Similarly, for a number of reasons, a client might want to relocate a foreign APT to Delaware.

How to Create a Delaware APT (12 Del. Code §§ 3570(8), (11), 3571)

To create a Delaware APT, a client must establish an irrevocable trust that contains a spendthrift clause, designates Delaware law to govern the trust, and appoints at least one "qualified trustee." A "qualified trustee" is an individual who lives in Delaware (except the client) or a Delaware trust company that performs certain duties. The trust may have non-Delaware co-trustees and Delaware or non-Delaware advisers.

The Delaware Act specifically permits a client to have the power to

- • consent to or direct investment changes,
- • veto distributions,
- • replace trustees or advisers, and

- • effective in 2015, reacquire trust assets in a nonfiduciary capacity.

The Delaware Act also expressly authorizes a client to have one or more of the following:

- • the ability to receive income or principal under broad discretion or a standard,
- • the right to receive current income distributions,
- • an interest in a CRT, GRAT, or QPRT,
- • up to a 5% interest in a total-return unitrust,
- • a lifetime or testamentary power to appoint the principal in the trust to or for anyone except the client, the client's estate, the client's creditors, or the creditors of the client's estate,
- • the ability to be reimbursed for income taxes attributable to the trust on a mandatory or discretionary basis, or
- • the power to provide for the payment of taxes, debts, and expenses payable at the client's death.

Under the Delaware Act, any "understanding" that a client will receive money whenever he asks is void.

A Delaware APT can be funded with tenancy-by-the-entireties property without destroying protection from each spouse's separate creditors.

Drafting Issues

Unauthorized Provisions

Because not specifically permitted by the Delaware Act, a Delaware APT should not

- •
- • appoint the client trustee or co-trustee,
- • provide that the client will get trust assets back at a certain age or after a certain amount of time,
- • authorize the trustee, adviser, protector, or committee to terminate the trust, or
- • authorize the trustee to reimburse the client for gift taxes.

Unwise Provisions

Although permitted by the Delaware Act, a Delaware APT should not, in certain circumstances

- • appoint a co-trustee in the state where the client lives or works or
- • give the client the power to replace the trustee.

Funding Issues

General

A client should fund a Delaware APT with assets that he never expects to need. A rule of thumb for avoiding a fraudulent transfer is to fund a Delaware APT with one-third to one-half of a client's surplus assets that are not already exempt from creditor claims after he performs an analysis of existing and foreseeable assets and liabilities.

Intangible Property

The best assets to put in a Delaware APT are cash, stocks, and bonds.

FLP-LLC Interests

Interests in an FLP or LLC are good assets to put into a Delaware APT, provided that the client is not the general partner or a manager and that the entity does not own real estate outside Delaware.

Non-Delaware Real Estate

A client should not put real estate outside Delaware in a Delaware APT because it will give non-Delaware courts jurisdiction over the trust and a basis for applying non-Delaware law.

Putting non-Delaware real estate in an FLP or LLC and funding the trust with interests in that entity might help, but this strategy failed in a case involving an Alaska APT. *In re Huber*, 493 B.R. 798 (Bankr. W.D. Wash. 2013).

Custody

To prevent a non-Delaware court from having jurisdiction, the qualified trustee should have custody of all assets of a Delaware APT.

Federal Tax Consequences

Income Tax

A Delaware APT usually will be a grantor trust for federal income-tax purposes, which means that the client—not the trust—must pay all income taxes on interest and dividends that the trustee receives and on capital gains that the trust incurs. IRC § 677. The IRS has ruled several times, though, that such a trust is a nongrantor trust, which means that the trustee—not the client—must pay all such income taxes, if distributions to the client are controlled by adverse parties (for example, children who will receive assets that are not distributed to the client). See, e.g., PLR 201510001.

Gift and Estate Taxes

If the trust gives the trustee or someone else discretion to distribute trust funds to the client, and if the client retains lifetime and testamentary nongeneral powers of appointment and a power to veto distributions, he will not make a taxable gift when he creates a Delaware APT. Treas. Reg. § 25.2511-2(b). But, if a client does not keep those powers, he probably will make a taxable gift when he creates a Delaware APT, and the trust probably will not be included in the gross estate.

GST Tax

If the creation of a Delaware APT is a completed gift, and if the trust is not includable in the gross estate, a client can allocate GST exemption at the creation of the trust.

Distribution Issues

General

As mentioned above, a client should fund a Delaware APT with assets that he does not expect to need. If the Delaware APT gives the trustee discretion to use income or principal for the client, a Delaware corporate trustee will process requests for distributions in accordance with its usual procedures. For the trust to work, the client must give up control. So he should request discretionary distributions rarely, if

ever, and should not expect to use the trust as a checking account or to get money whenever he asks. If the client prefers, he may retain the right to receive regular income or unitrust distributions along with the ability to receive principal distributions on a discretionary basis.

Income Taxes

A Delaware APT typically will be a grantor trust for federal income tax purposes so that the client will have to pay income taxes on trust income and capital gains that he does not actually receive. The client should keep enough money to pay those taxes and should not ask the trustee every April to exercise its discretion to give the client money to cover them. Alternatively, the trust can direct the trustee to pay (or reimburse the client for) such taxes.

Moving Trusts to Delaware (12 Del. Code §§ 3570(10), (11), 3572(c), 3575)

The Delaware Act provides for the move to Delaware of self-settled trusts created in other states or abroad, and the time that the trust existed before it is moved counts toward the four-year period during which a creditor can pursue a claim against the trust. Thus, a client might be able to move an existing self-settled trust to Delaware that cannot be defeated under the Delaware Act.

Avoid Fraudulent Transfer

If a client makes a transfer, whether he gives money to children, establishes an FLP, or creates a Delaware APT, and does not keep enough assets to pay existing and foreseeable creditors, the client has made a fraudulent transfer and the transfer can be undone. So a client is a good candidate for a Delaware APT if he has surplus assets after performing a realistic assessment of existing and foreseeable assets and liabilities. Inversely, a client is a bad candidate for such a trust if he has—or is about to incur—a large obligation and wants to hide assets to avoid paying it. Nevertheless, if a client must meet a specific debt or claim, he may consider a Delaware APT for assets that are not needed to satisfy that obligation.

The Delaware Court of Chancery has held that creditors' efforts to set aside transfers to Delaware APTs as fraudulent transfers were time-barred. *TrustCo Bank v. Mathews*, 2015 Del. Ch. LEXIS 18 (Jan. 22, 2015).

To ensure that a client does not make a fraudulent transfer when establishing a Delaware APT, the qualified trustee probably will require him to provide background information and to complete a solvency letter.

Who May Defeat a Delaware APT (12 Del. Code §§ 3572–3573)

The Delaware Act bars original actions and actions to enforce judgments, including judgments entered outside Delaware, and it requires a creditor to bring an action against a Delaware APT in the Delaware Court of Chancery.

Under the Supremacy Clause of the U.S. Constitution, certain "super creditors," such as the IRS, the SEC, the FTC, and minor children seeking support can reach the assets of vehicles (for example, tenancy-by-the-entireties property and domestic APTs) otherwise shielded from creditors by state law. Under the Delaware Act, the following four categories of creditors can reach the assets of a Delaware APT.

Pre-Transfer Claims

If a creditor's claim arises before a client creates a Delaware APT, that creditor must bring suit within four years after creation of the trust or, if later, within one year after the creditor discovered (or should have discovered) the trust. The creditor also must prove by clear and convincing evidence that creation of the trust was a fraudulent transfer.

Post-Transfer Claims

If a creditor's claim arises after a client creates a Delaware APT, that creditor must bring suit within four years after the trust's creation and must prove by clear and convincing evidence that creation of the trust was a fraudulent transfer as to that creditor.

Family Claims

A spouse, former spouse, or minor child who has a claim resulting from an agreement or court order for alimony, child support, or property division incident to a judicial proceeding with respect to a separation or divorce can reach the assets of a client's Delaware APT at any time, but a spouse whom the client marries after creating the trust may not take advantage of this exception. A surviving spouse probably will not be able to reach the assets of a Delaware APT by electing against the client's will.

Tort Claims

A person who suffers death, personal injury, or property damage before the client establishes a Delaware APT for which the client is liable can reach trust assets at any time.

Consequences If a Delaware APT Is Defeated (12 Del. Code § 3574)

If a creditor proves that one of the above exceptions applies, a client's Delaware APT will be defeated only to the extent necessary to pay that creditor's claim and related costs, including attorney's fees. Thus, each creditor must bring a separate action against the trustee. Unless a creditor proves that the trustee acted in bad faith, that trustee can use trust assets to pay its costs to litigate the claim before satisfying the claim. A beneficiary (including the client) who received a distribution before a creditor brings a successful suit to defeat a Delaware APT can keep the distribution unless the creditor proves that the beneficiary acted in bad faith. The Delaware Act protects trustees, attorneys, and other advisers who work on a Delaware APT.

Infrastructure

An important factor in evaluating the effectiveness of Delaware APTs is that Delaware has a long-standing tradition of leadership in the trust industry. The original Delaware Act was written and enacted over a three-month period in 1997, and amendments have been drafted and enacted in short order. As noted above, the Delaware Court of Chancery has held that creditors' claims that transfers to Delaware APTs were fraudulent transfers were barred by laches. *TrustCo*, 2015 Del. Ch. LEXIS 18. In other situations, that court has upheld Delaware statutes in difficult cases, such as those that might arise if creditors were to challenge a Delaware APT.

Defending Delaware APTS

If a client lives in Delaware or is an NRA, creditors should not be able to reach the assets of his Delaware APT except in the situations mentioned above. If a client does not live in Delaware but is a resident of the United States, a Delaware APT should afford the same protection, but this cannot be guaranteed because issues under the U.S. Constitution might come into play. The danger is that a court in a state that does not recognize APTs might decide that its law—not Delaware law—applies and order the trustee to pay a creditor, even if the claim is not one that is recognized under the Delaware Act.

There are several reasons why a client's trust should stand even if he is not a Delaware resident or an NRA. They include:

- • A non-Delaware court may not enter a judgment that binds the trustee of a Delaware APT if it does not have jurisdiction over trust assets or a trustee.
- • A non-Delaware court should defer to Delaware courts on issues that involve a Delaware trust.
- • A judgment against a client is not binding on the trustee of the client's valid trust.
- • A non-Delaware court should apply Delaware law—not its own law—on questions involving a Delaware APT.
- • Delaware courts might not have to recognize (that is, give full faith and credit to) judgments that non-Delaware courts enter against a trust.
- • Delaware may set deadlines for the enforcement of judgments from other states.
- • Creditors should not be able to reach a Delaware APT if the client ends up in bankruptcy.

Conclusion

No court has considered how effectively a Delaware APT protects assets, so the Delaware APT is not yet fail-safe. But a properly designed and implemented Delaware APT will raise formidable obstacles for creditors. The Delaware APT also offers planning options, outside of creditor protection, that might be of great benefit to clients. n

6

ESTATE PLANNING WITH GRANTOR TRUSTS – STORM CLOUDS ON THE HORIZON

PRIVATE WEALTH & TAXATION INSTITUTE

Continuing Professional Education Series

Moving the Real Estate Empire to the Next Generation

Continuing Professional Education Series

Balancing Income Taxes and Transfer Taxes

By

Stephen M. Breitstone, Esq
Meltzer, Lippe, Goldstein & Breitstone, LLP
Mineola, New York
sbreitstone@meltzerlippe.com
www. meltzerlippe.com

David C. Jacobson, Esq
Meltzer, Lippe, Goldstein & Breitstone, LLP
Mineola, New York
djacobson@meltzerlippe.com
www. meltzerlippe.com

Presentation Overview

- Transfer Tax Planning
- Comparison of Freeze Techniques
- Negative Capital
- Grantor Trusts
- Gain Avoided or Deferred
- Basis Step Up
- President Obama's 2016 Budget Proposals
- Section 2704 - Possible Regulations
- Section 2701 - Deemed Gift
- Planning with Freeze Partnerships

Transfer Tax Planning

Introduction To Transfer Tax Planning

Transfer Tax Top Rates

- Federal estate, gift and GST tax 40%
- New York estate tax - deductible 16%
- Combined fed estate tax - approx. 50%

Estate Planning

- Transfer future appreciation
- Freezing value
- Leveraging exemptions
- Discounting values
- Maximizing basis

Lifetime Planning - the Trade Off

- Transfer future appreciating assets out of taxable estate
- No basis step-up
- *May not be a good tradeoff*

5

Income Tax Rates

Income Tax - Top Rates

• Ordinary income	39.6%
• Capital gains (long term) and dividends	20%
• Capital gains – prior depreciation	25%
• Capital gains 1245 and 1250 recapture	39.6%
• Net investment income tax (NIIT)	3.8%
• New York state	8.82%
• New York city	3.876%

Combined (NIIT, federal and state) - Top Rates

• Estate tax approx. (40% + 16% deductible)	50%
• Ordinary income tax (approx.)	52.22%
• Capital gain tax (approx.)	20 - 41.5%

6

Income Tax And Transfer Tax Illustration

Assets	
Real Estate (fmv)	$10,000,000
Real Estate (basis)	$1,000,000
Liabilities – Mortgage	($8,000,000)
Capital – Equity	$2,000,000
Estate Tax	
Equity subject to taxation	$2,000,000
Tax @ 50%	$1,000,000
Income Tax – Gain on Sale	
Real Estate is Sold for	$10,000,000
Gain subject to taxation	$9,000,000
Tax @ 20%	$1,800,000
Tax @ 25%	$2,250,000
Tax @ 41.5% Fed, NIIT, NYS & NYC	$3,735,000

Transfer tax is on net equity

Income tax is on gain realized, which includes non-recourse debt

7

Comparison Of Freeze Techniques

Comparison Of Freeze Techniques

- Grantor Retained Annuity Trusts (GRATs)
- Sale to Intentionally Defective Grantor Trusts (IDGTs)
- Partnership and LLC Freezes under Section 2701

9

Grantor Retained Annuity Trusts

Advantages

- Transfer of appreciation
- Can zero-out
- No valuation risk
- Low hurdle rate - 7520 rate for Oct. 2015 is 2%

Considerations and Risks

- Must survive term
- GST inefficient
- Negative Capital ?
- No basis step-up ?

10

Installment Sales To IDGTs

Advantages

- Transfer of appreciation
- Lowest hurdle rate – mid-term AFR for Oct. 2015 is 1.67%
- GST efficient

Considerations and Risks

- Property might depreciate
- Valuation
- Not eligible for Section 6166
- Negative Capital ?
- No basis step-up ?
- Income in Respect of a Decedent ?

11

Freeze Partnerships

Advantages

- Negative Capital – gain not triggered
- Basis step-up for frozen interest (including negative capital)
- Statutory guidelines under section 2701
- Section 6166 estate tax deferral

Considerations

- Highest hurdle rate
- Possible section 2701 deemed gift

12

Valuing Preferred Interest - Rev. Rul. 83-120

FMV Facts & Circumstances

- Yield
- Preferred return coverage
- Dissolution protection
- Voting rights
- Lack of marketability
- Underlying assets
  - Volatility
  - Income production
- Market conditions

Most Important

Rate is lower if issuer cannot redeem

Valuing Preferred Interest – Market Conditions

Sector	Mean	Median	Min	Max
Residential	6.79%	6.81%	6.62%	6.92%
Commercial	6.32%	6.25%	6.14%	6.64%
Data Centers	6.89%	6.79%	6.21%	7.83%
Industrial	7.41%	7.43%	6.80%	8.48%
Lodging	7.56%	7.59%	6.35%	8.82%
Mixed	6.81%	6.72%	5.69%	8.26%
Mortgage	8.79%	8.47%	7.58%	11.77%
Office	6.35%	6.50%	5.18%	7.20%
Retail	6.69%	6.56%	5.66%	8.11%
Single Family	5.14%	4.98%	4.95%	5.49%
Storage	5.84%	5.73%	5.28%	7.23%

- The information provided is a compilation of the returns for preferred stock issued by publicly reporting REITS in each sector as of March 1, 2015.
- The information provided is not meant to be used for specific privately held companies without further analysis of each issue making up the sector's returns. In order to apply a sector's returns they most be adjusted to make them comparable to the subject company to which they are being applied.
- Market data courtesy of Stephen Shulman and Associates

Comparison: Installment Sale v. Freeze Partnership

Trust	
Property sold	$10,000,000
Basis	$8,000,000
Built in gain	**$2,000,000**

Freeze Partnership	
Value	$10,000,000
Liabilities	$8,000,000
Equity	$2,000,000
Basis step-up	$9,000,000
Built in gain	**0**

Estate	
Installment note	$2,000,000
Basis	$1,000,000
Income Tax	possible IRD or Gain on $7,000,000 (liabilities in excess of basis)

15

Negative Capital

What is this Negative Capital?

- Liabilities in Excess of Basis

Is it logical?

- Negative Capital is an accounting concept, not an economic one

Determination of Gain or Loss

- Fair market value of property is deemed to be not less than the nonrecourse liabilities to which the property is subject. IRC § 7701(g)
- Phantom Gain

16

Phantom Gain

AB Partnership	
Assets	
Real Estate (fmv)	$10,000,000
Real Estate (adj. basis)	$1,000,000
Liabilities – Mortgage	($8,000,000)
Capital – Equity (cash proceeds from sale)	$2,000,000
Gain Subject to Taxation ($7mm phantom)	($9,000,000)
Tax on Gain if Real Estate is Sold For	$10,000,000
Tax @ 20%	$1,800,000
Tax @ 25%	$2,250,000
Tax @ 41.5% (Fed, NIIT, NYS and NYC)	$3,735,000

- $7mm phantom gain
- Tax liability with no cash to pay

17

Grantor Trusts

Grantor Trusts IRC § 671

Leveraged estate planning usually involves a transfer of appreciated assets to a grantor trust, but for grantor trust treatment would be an income tax recognition event

Completed Gift for Transfer Tax Purposes

- Grantor trusts enable grantor to make a completed gift for gift and estate tax purposes

Grantor Is Treated As Owner For Income Tax Purposes

- Grantor includes all items of income, deduction, and credit of the trust as though the trust were not in existence

Transactions Between Grantor and Trust are Ignored (such as Sale)

- Property transferred gratuitously to a grantor trust retains the grantor's cost basis.
- Transaction such as an asset sale between the grantor and a grantor trust cannot give rise to any taxable income because the transaction is treated as a transfer between the grantor and him/herself. Rev. Rul. 85-13

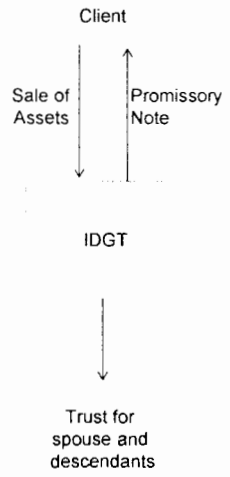
Sale to IDGT Overview

A Sale to an Intentionally Defective Grantor Trust (IDGT) is designed to transfer future appreciation to trusts for lower generation, typically family members, in a tax-efficient manner

- The Grantor sells assets to the IDGT in exchange for an interest-bearing note*
- If the assets sold to the IDGT appreciate in value at a rate in excess of the AFR, appreciation in excess of AFR passes free of transfer tax
- Transactions between the Grantor and the IDGT are typically ignored for income tax purposes
  - no sale is deemed to occur and no part of the gain inherent in the asset becomes taxable by reason of the sale

*IDGT should be funded prior to the sale. It may be funded with a gift. The value of the gift is typically equal to 10% of the value of the property sold.

Sale to IDGT Flowchart

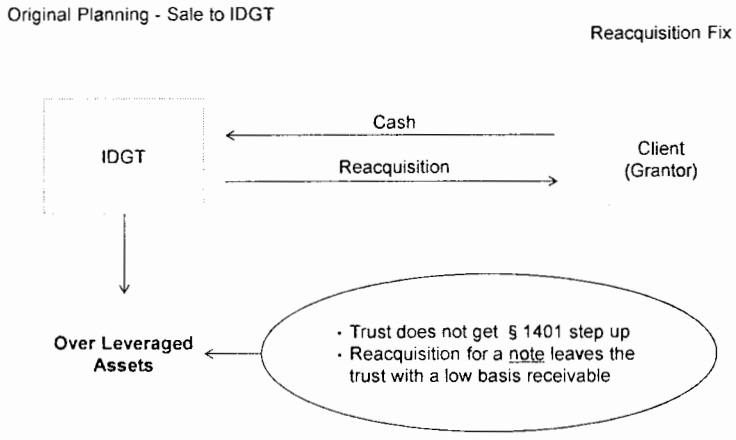


Assumptions

- Client sells $10 million worth of LLC units to IDGT
- IDGT gives Client 9-year promissory note, providing for 1.67% annual interest (AFR) during the term, and a balloon payment at the end of the term
- 8% annual growth rate
- Annual interest payments from IDGT to client are $167,000
- *Value of assets transferred at end of 9 years is $7,904,624*

21 21

A Fix For Bad Installment Sale Planning - Reacquisition



22

What Happens if Grantor Dies Before Note is Paid Off?

Lifetime termination of grantor trust status - tax consequences are well-settled

- The grantor has given up dominion and control, and the trust is now a separate taxable entity.
- Grantor is deemed to have transferred the assets and liabilities in the trust to the trust, for income tax purposes.
- Madorin v. Commr., 84 T.C. 667 (1985). See also Treas. Reg. 1.1001-2(c), Example 5 (1980), Rev. Rul. 77-402, 1977-2 C.B. 222 and TAM 200011005, G.C.M. 37228 (Aug. 23, 1977).

Death of grantor termination of grantor trust status - Sharp Disagreement

- Gain Triggered on Death of Grantor or Avoided?
- Basis Step-Up?
- Income in Respect of a Decedent?
  - There is no case, regulation or ruling that directly addresses the income tax treatment.

23

Gain Avoided or Deferred on Death of Grantor?

View 1 – No Gain on Death

In General, Death Is Not An Income Tax Realization Event

- Since death is not an income tax realization event, there cannot be any gain realized upon the conversion to a non-grantor trust by reason of death
- Proponents of this view rely on the following:
  - IRC § § 1001(a) and 1001(b) – there's no amount received in exchange for a lifetime gift, thus no gain realized; bequest should be treated the same as lifetime gift.
  - CCA 200923024 - "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the *death of the owner which is generally not treated as an income tax event*."
  - Crane v. Commissioner Crane v. Comm'r, 331 U.S. 1 (1947), where a beneficiary inherited property encumbered by a liability equal to the fmv, the Supreme Court did not treat the inheritance as a "sale." The proponents of this view conclude that a transfer of property to the trust at death in exchange for a promissory note should likewise not be a sale.

25

View 2 – Gain Triggered

Termination of grantor trust status as a result of grantor's death is a deemed transfer/sale of assets that triggers gain; same as lifetime termination of grantor trust status

Excess of liabilities over basis

- Madorin v. Commissioner, Rev. Rul. 77-402, and Treas. Reg. § 1.1001-2(c) Example 5.
- Does not qualify for Installment Method
  - Liabilities in excess of basis
  - Depreciable property to a related person

Outstanding Installment Note

- Consideration received
- Income in respect of decedent (IRD).
  - Generally, sales-type IRD consists of amounts received post-death from the completed sale of property pre-death. Rev Rul. 78-32
  - Should be able to reported under installment method § 453; thus, it should be IRD. Treas. Reg. 1.691(a)-5(a)
- IRD – 1014 step-up
- No direct authority for View 1 no gain on death

26

Tax Basis

What is the Basis of Trust Assets Following Grantor's Death?

- Property Acquired by Sale - Section 1012
  - The basis of property shall be the cost of such property
- Property Acquired from Decedent - Section 1014
  - The basis of property in the hands of a person ***acquiring the property from a decedent or to whom the property passed from a decedent*** shall . . . be the fair market value of the property at the date of the decedent's death . .
- Property Acquired by Gift - Section 1015
  - The basis shall be the same as it would be in the hands of the donor, or the fair market value if lower

28

Basis of Trust Assets at Death?
View 1 – Basis Step Up

The trustee is viewed as acquiring the assets by bequest or devise, and Section 1014 will determine basis, i.e., it will equal the estate tax value

- Section 1014(b)(1) does not depend on estate-tax inclusion.
- Trust assets receive a date-of-death value basis adjustment under Section 1014(b)(1), as property "in the hands of a person [i.e., the trust] acquiring the property from a decedent or to whom the property passed from a decedent."
- Grantor is deemed to own the trust assets for all income tax purposes under Rev. Rul. 85-13 and Madorin, which should include determination of basis.
- PLR 201245006 - Basis step up on grantor trust's corpus passing to grantor's issue at grantor's death.

29

Basis of Trust Assets at Death?
View 2 – Basis Equals Purchase Price

The deemed transfer should be viewed as a sale by the grantor to the trust, the trust's basis will equal the purchase price under Section 1012

- Upon termination of grantor trust status, the trust is now a separate taxpayer for Federal income tax purposes, and the purchase comes into income tax existence at that time.
- As an acquisition of an asset by purchase, the trust should take a cost basis in the asset equal to the outstanding principal amount of the note at the date of death.

30

View 2 – Cont.

Basis not stepped up under Section 1014

- CCA 200937028 - No basis step up under Section 1014 unless asset is included in the decedent's estate.
- The trust assets would not be entitled to a basis adjustment under Section 1014 because the property was (1) not "acquired from a decedent" and does not "pass from a decedent", (2) not pass pursuant to decedent's will or by intestacy, and (3) not included in the decedent's taxable estate
- Items of income in respect of a decedent (IRD) are not realized at death. Rather they are not entitled to a step-up in basis under Section 1014(a).

31

Uncertainty Creates Risk

Is a Section 1012 or 1014 step-up too much to ask?

- No tax on gain – ever
- No estate tax on trust assets
- Too good to be true?

Rev. Proc. 2015-37

- No more rulings on step up upon termination of grantor trust status upon death of grantor

IRS 2015–2016 Priority Guidance Plan

- Guidance on basis of grantor trust assets at death under § 1014

32

President Obama's 2016 Budget Proposals

2016 Budget Proposal

- Restore 2009 Estate, Gift, and GST Parameters
  - 45% highest marginal rate
  - $1 million gift tax exemption
  - $3.5 million estate and GST exemption
- Tax built-in appreciation transferred by gift or at death
  - Does not apply to charity or spouses
- Increase Top Capital Gain Tax Rate to 28%
- Grantor Retained Annuity Trust (GRAT)
  - 10 year minimum term; max term life expectancy plus 10yrs
  - Eliminate "zeroed-out" GRATs, with min remainder of 25%
  - Prohibit tax-free exchange of GRAT assets by Grantor
- Sale to Grantor Trusts
  - Estate or gift tax imposed on the portion of the grantor trust attributable to a sale or exchange
- Dynasty trusts limited to 90-year GST exemption

34

Section 2704 – Possible New Regulations

Section 2704 - Background

Section 2704 was enacted to limit the use of valuation discounts in connection with gifts of interests in family entities, to address the concern that restrictions on the transferred interests that had the effect of artificially reducing the value for transfer tax purposes

Restriction of Liquidation Rights - Valuation Discounts

- Restrictions on power to liquidate typically justify discounts in the value of the interests transferred
- "Applicable Restrictions" in family-controlled entities, they are ignored in valuation

"Applicable Restrictions" Are Ignored - § 2704(b)

- Restriction lapses after the transfer (in whole or in part), or
- Transferor (or member of family) has the right after such transfer to remove the restriction (in whole or in part)

Some Restrictions Are Not Ignored

- Restriction imposed, or required to be imposed, by any Federal or State law. Section 2704(b)(3)(B)
- Commercially reasonable restriction which arises as part of any financing by the entity with a person who is not related to the transferor or transferee, or a member of the family of either. Section 2704(b)(2); Treas. Reg. Section 25.2704-2(b).

36

Authority to Issue Regulations

- Section 2704(b) is titled "Certain Restrictions on **Liquidation** Disregarded"
- Section 2704(b)(4) includes broad legislative authority for the IRS to issue regulations that would disregard "other restrictions"

> "The Secretary may by regulations provide that **other restrictions** shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

- Section 2704(b) does not specifically limit the regulations to other "liquidation" restrictions:

37

Possible New Regulations

May include items considered in President Obama's prior Budget Proposals

- Additional Disregarded Restrictions
  - Presumably would be in addition to the existing restrictions on liquidation powers (e.g., restrictions on a transferee being able to become a full-fledged partner)
- Third Party Involvement in Removing Restrictions
  - Certain interests (to be identified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family

As of the date of this presentation, no regulations have been proposed

38

Section 2703 - Rights and Restrictions Disregarded

Section 2703 – Rights and Restrictions Disregarded

Unless the client establishes that the right or restriction qualifies for an exception to Code Sec. 2703, options, restrictive sale agreements and buy-sell agreements will be disregarded for transfer tax valuation purposes.

Rights and restrictions among family members is disregarded

- A right or restriction includes any option, agreement, or other right to acquire or use property at a price that is less than fair market value, or any restriction on the right to sell or use the property.
- The right or restriction may be part of a partnership agreement, corporate bylaws, or articles of incorporation, or may be implicit in the capital structure of an entity.

A right or restriction will not be disregarded for valuation purposes if it is

- a bona fide arrangement;
- not a device to transfer property to family members for less than full and adequate consideration; and
- comparable to similar arrangements entered into by persons in arm's-length transactions.

40

Section 2701 – Deemed Gifts

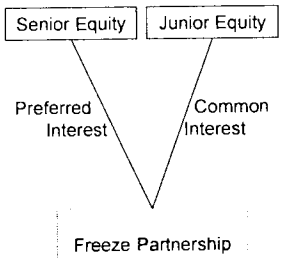
Introduction to Freeze Partnerships
Two Classes of Ownership

Preferred Interest

- Periodic cash distribution fixed (or tied to an established index) cumulative preferred return
- Liquidation preference - a priority distribution in a fixed amount upon liquidation
- Dividend Rate and Liquidation Preference is determined at the time of contribution to the entity (or recapitalization)
- The value of that interest is "frozen" as of that date

Common Interest

- Cash distributions only if there is any money remaining after payment of the preferred return
- Entitled to all of the future increases in the income from underlying assets
- *Appreciation in excess of preferred return inures solely to the common interest holders*



42

Section 2701

Is there a transfer?

- Gift
- Sale
- Capital contribution
- Reorganization

To or for the benefit of a "member of the family"?

- Generally, of an equal or lower generation
- Treas. Reg. Section 25.2701-1

Did the Transferor (or "applicable family member") retain an "applicable retained interest"?

- Applicable Retained Interest means distribution rights in family controlled entity and liquidation preference; or liquidation, put, call or conversion right
- Applicable Family Member means generally of an equal or higher generation

43

Section 2701 – Zero Value Rule

- If there is a transfer under Section 2701, the retained interest will be valued at zero for gift tax purposes
- Exception: the transferor retains
  - a "Qualified Payment Right"; or
  - a liquidation, put, call or conversion right.

44

Exception To Section 2701 Zero Value Rule

Straight Up Allocation Exception to Zero Value Rule

- All membership interests are of the same class
- All allocations are straight up
- Differences in voting rights are permitted
- Differences in liability permitted (e.g., GP v. LP)
- Marketable securities can be of a different class
- Vertical slice for fund managers

45

Section 2701 – Qualified Payment Rights

- Qualified Payment Rights
  - Periodic (at least annual) cumulative fixed payment rights
  - Valued according to fair market value (FMV)
- Lower of Rule
  - If a qualified payment right is held along with an extraordinary payment right the rights are valued as if each was exercised in the manner resulting in the lowest value for all such rights.
- Four Year Rule
  - Any payment of a qualified payment made (or treated as made) either before or during the four-year period beginning on the due date of the payment but before the date of the taxable event is treated as having been made on the due date.

46

Entity Level Valuation - Family Owned

- The 2701 Regulations promulgated in 1992 provide that all family owned preferred interests are valued as if held by a single person.
- Exception for Capital Contributions. *See*, Treas. Reg. 25.2701-3(b)(1)(i).
- Contrast Rev. Rul. 93-12 (recognizing intra family valuation discounts).
- Lack of marketability discounts should apply to junior equity interest.

47

Deemed Gift is Determined the Subtraction Method

Step 1 – Entity Value	
• Value all family-held interests as if held by one person (except capital contributions)	$1,000,000
• Each family member is considered to have the right to liquidate and sell	
Step 2 - Subtract the value of senior equity interests	
• Value determined as if held by one person (2701)	$0
➢ Maximizes the value of the gift	
Step 3 – Step 1 less Step 2	
• Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.	
• Apply certain discounts and other reductions as provided for by Treas. Regs. 25.2701-3(b)(4).	($100,000)
Step 4 – Subtract value of transferred interest.	
Remainder = Value of Gift	$900,000

48

Minimum Value Rule

Junior equity interests cannot be valued at less than 10% of:

- the total value of all equity interests in the entity, and
- the total amount of indebtedness of the entity to the transferor

49

Recapitalization Of LLC Caused Taxable Gift Under Section 2701

CCA 201442053

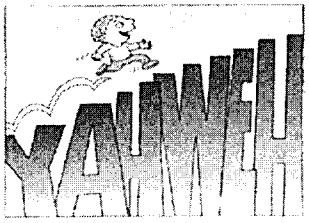
- Donor created an LLC and then gifted LLC interests to her children and grandchildren.
- LLC was then recapitalized - in exchange for children's agreement to manage LLC, all profits and appreciation would be allocated equally to children only, rather than to all members proportionately.
- After the recapitalization, Donor held only a right to distributions solely based on his capital account as it existed immediately before the recapitalization.
- The IRS stated that the recapitalization was a gift from Donor to Children under Section 2701.
- The IRS explained that a gift can occur indirectly through transactions such as a recapitalization. Citing Kincaid v US, 682 F.2d 1220 (5th Cir. 1982).
- Did not have to use § 2701 to find gift here. Compare grant of a profits interest under Rev. Proc. 93-17 – because grant of profits interest as compensation to child in business can trigger § 2701 deemed gift.

50

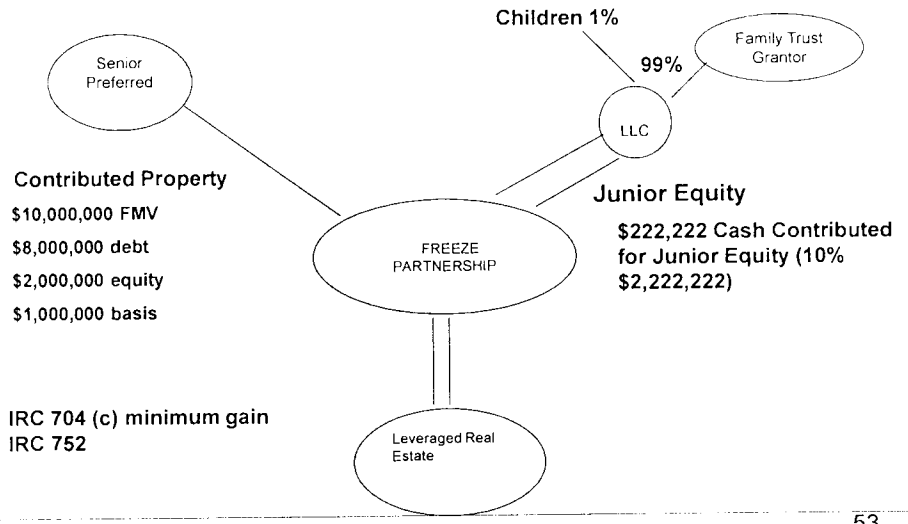
Planning with Freeze Partnerships

How To Structure

Liabilities Must be Allocated to Preferred to Obtain Step Up on Negative Capital



Structure To Keep Liabilities With Senior



53

Allocation Of Liabilities Among Partners

Section 752 governs allocations of liabilities among partners

- Recourse - who bears risk of loss?

Treatment of Nonrecourse debt – three tiered approach

- Tier 1 – Minimum gain
- Tier 2 – Section 704 (c) minimum gain
- Tier 3 – allocation based upon other significant partnership item with substantial economic effect

54

Optimizing The Plan

Goals

- Minimizing Qualified Payments
- Minimizing Value Retained
- Maximize Basis Step Up

55

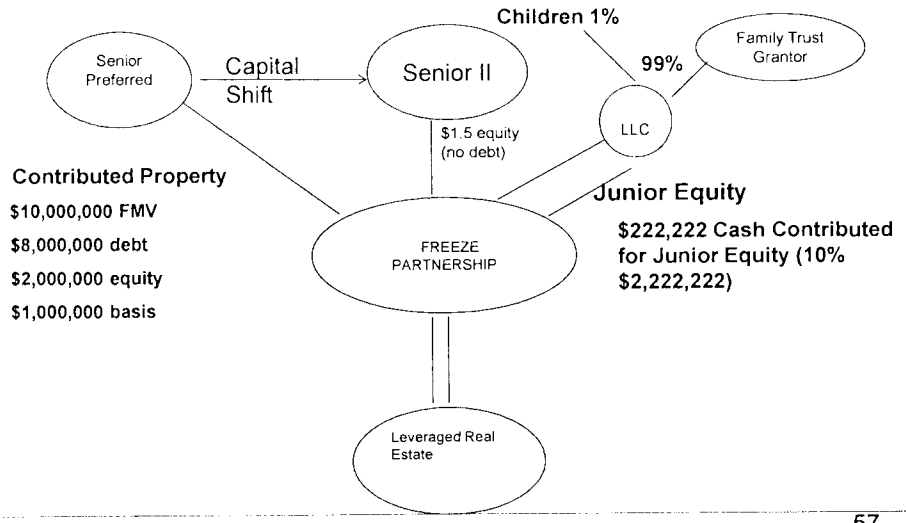
What is a Capital Shift?

The partners' interests in profits and losses may be altered or "shifted" in a number of ways during the course of a partnership's taxable year

- Shifts may result for many reasons, including for example:
  - All or a portion of a partner's interest may be sold, exchanged, transferred, or contributed to a trust, etc.
  - Partnership interests held by partnerships, corporations, or trusts may be distributed to partners, shareholders, or beneficiaries
  - Shifts may also result from an agreement among the partners to alter their interests in profits and losses
- Freeze Partnership Capital Shift
  - May decreased the value of the preferred interest for estate tax purposes, while leaving negative capital with Senior for step up

56

Capital Shift



57

Capital Shift

Sale of Senior II for AFR note

- Leaves negative capital with Senior for step up
- No step up on Senior II if sold to Grantor Trust except to extent of installment note
- Estate side concerns regarding IRD if note is outstanding at death.

58

Capital Strip
a/k/a Leveraging Up

Real Estate contributed to Freeze LP

Assets	
Real Estate (fmv)	$10,000,000
Real Estate (adj. basis)	$1,000,000
Liabilities – Mortgage	($8,000,000)
Net Equity	$2,000,000

59

Capital Strip

Balance Sheet

Assets (FMV)	$10,000,000
Mortgage	($8,000,000)
Equity	$2,000,000

Capital Accounts

Senior	$1,800,000
Junior	+ 200,000
	$2,000,000

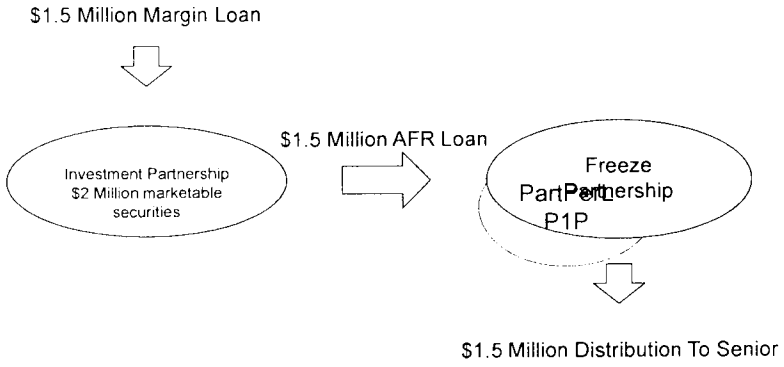
Preferred Return @ 6%

Senior	$1,800,000
	x 6%
	$108,000

60

Capital Strip

Borrow against separate stock portfolio

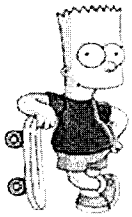


Capital Strip

New Balance Sheet	
Assets (FMV)	$10,000,000
Liability (Mortgage)	($8,000,000)
Liability (AFR Loan)	($1,500,000)
Equity	$500,000
Capital Accounts	
Senior	$300,000
Junior	$200,000
Preferred Return @ 6%	
Senior	$300,000
	+ 6%
	$18,000

Capital Strip

Preferred Return	($300,000 x 6%)	$ 18,000
Interest on Mid Term AFR Loan	($1.5mm x 1.67%)	$ 25,050
Total Leveraged Return to Senior		$ 43,050
Compare Unleveraged Return	($1.8mm x 6%)	$108,000
Compare Installment Sale	($2mm x 1.67%)	$ 33,400



63

Basis Consequences After Death Of Senior

- Basis in Loan to Freeze $1.5 Million
- Basis in Frozen Interest $9.8 Million
- Basis in Cash distributed $1.5 Million

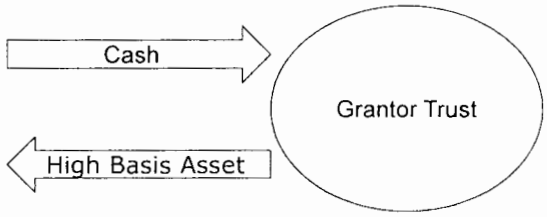
Senior Equity	$300,000
Mortgage	$8,000,000
Borrowing	$1,500,000
Basis	+ $300,000

64

Planning Opportunities

After stripping capital high basis assets can be transferred to Grantor Trust in Estate Planning Transaction

- Cash
- High basis assets purchased for cash



65

Debt Financed Debt Distributions

Non Qualified Nonrecourse Liabilities

- Considered related to the transfer to the extent not allocated to the transferor under Section 752 like principles but without tier one or tier two.
- Thus, allocated in accordance with the manner in which a significant item is allocated under nonrecourse debt regulations under Section 752. Treas. Reg. 1.707-5(a)(2)(ii).

66

Contributions Of Encumbered Property And Leveraged Distributions

Disguised Sale Rules of Section 707(a)(2)(B)

- Under regulations prescribed by the Secretary . . . If

  (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

  (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

  (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property . . .

67

Disguised Sale Rules - Treas. Reg. § 1.707-3(b)(1)

Contribution and distribution will be treated as a sale if the facts and circumstances indicate that

- (1) the transfer of money would not have been made but for the transfer of the property, and
- (2) the distribution was not dependent on the "entrepreneurial risks" of the partnership's operations.
- Additionally, if within a two-year period there is a contribution by and distribution to a partner, the transfers are presumed to be a sale of the property to the partnership.
- This presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale."

68

Disguised Sale Rules

Will Pre or Post Contribution Borrowings Be Deemed Disguised Sales?

- Categories of Borrowings
  - Recourse
  - Nonrecourse
  - Qualified Nonrecourse
  - Non Qualified Nonrecourse
  - See Treas. Reg. Section 1.707-5(b)

69

Disguised Sale Rules

Recourse Debt

- Recourse debt is allocated to the partner who bears the risk of loss (e.g., the guarantor)
- See *Canal Corp. v. Comm'r* 135 T.C. 9 (2010) (guaranties must not be illusory)

70

Disguised Sale Rules

Non Recourse Debt

- Qualified Nonrecourse
- Non Qualified Nonrecourse

71

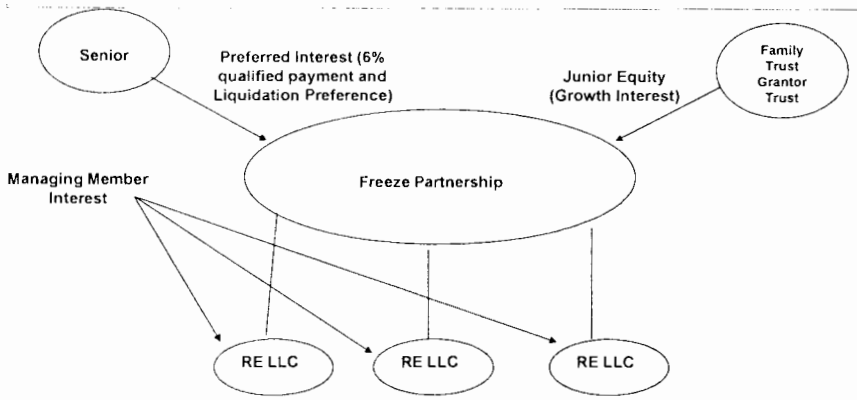
Debt Financed Debt Distributions

Qualified Nonrecourse

- Non incurred within 2 years of property contribution or if determined not incurred "in anticipation of the transfer" (Old and Cold).
- Rebuttable presumption that connected to the transfer if incurred within 2 years prior the transfer.
- Not old and cold (within past two years) but not in anticipation of the transfer.
- Liability allocated to capital expenditures to the contributed property.
- Liability incurred in the ordinary course of the trade or business.

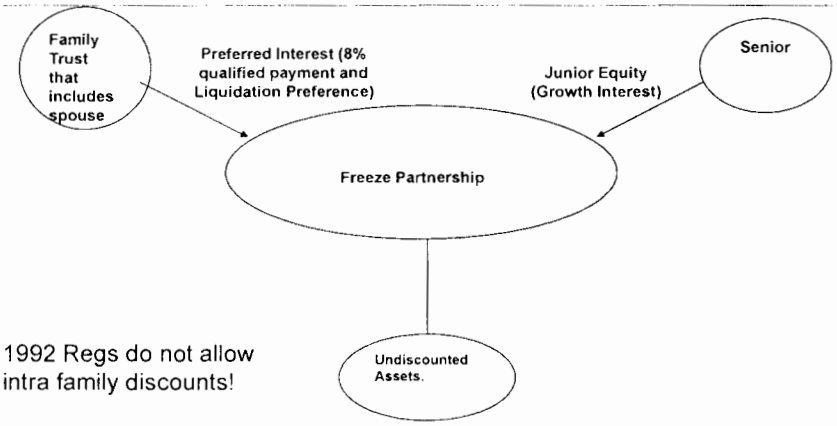
72

Simple Real Estate Partnership Freeze



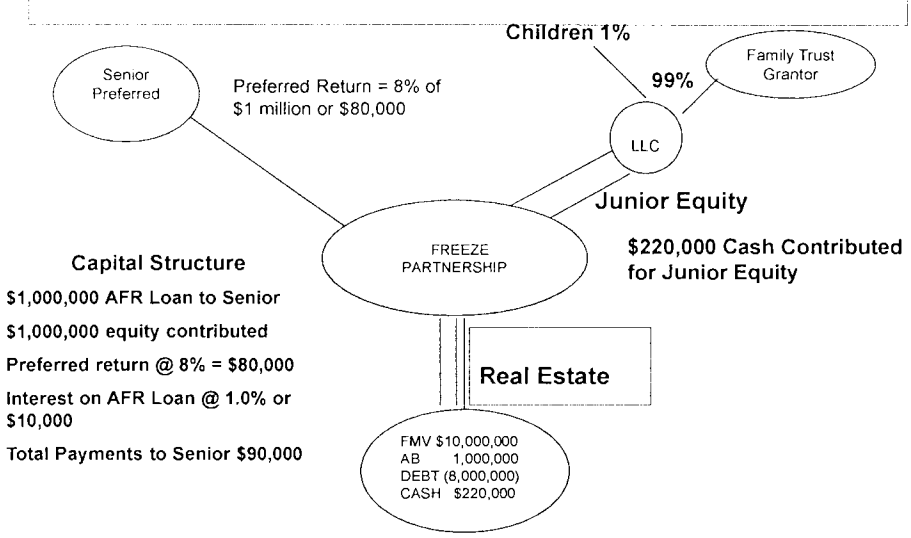
Rev. Rul. 93-12

Reverse Freeze
Remember When There Was A Return On Investment?



1992 Regs do not allow intra family discounts!

Leaky Freeze Solution



Capital Structure

$1,000,000 AFR Loan to Senior

$1,000,000 equity contributed

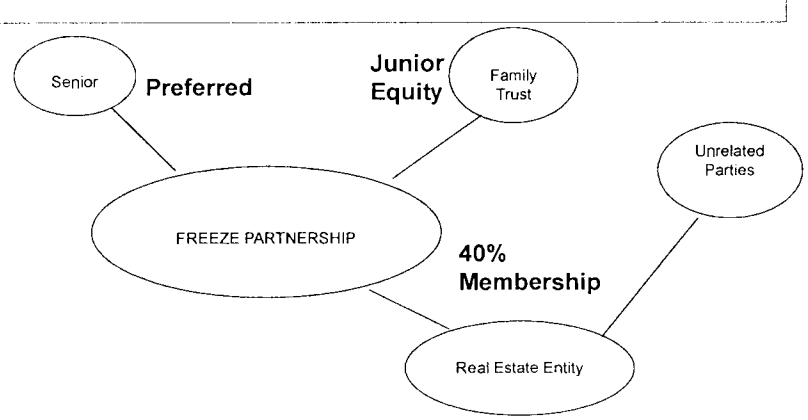
Preferred return @ 8% = $80,000

Interest on AFR Loan @ 1.0% or $10,000

Total Payments to Senior $90,000

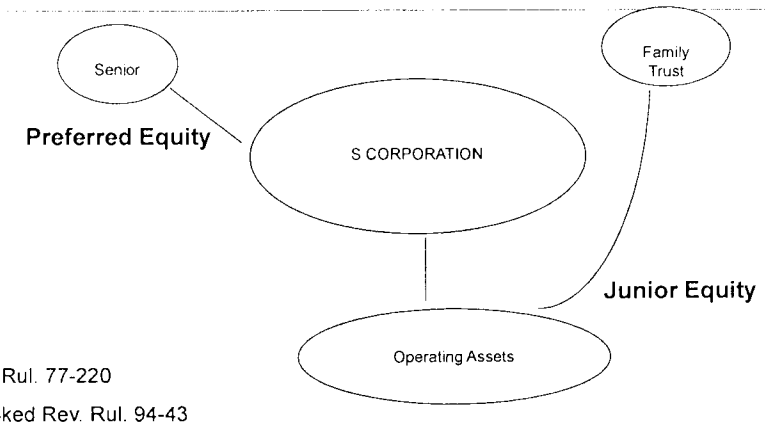
75

Best Discount Scenario
Contribution of Non-controlling Interest



76

S Corporation Freeze



- Rev. Rul. 77-220
- Revoked Rev. Rul. 94-43
- IRC Section 453(g) (related parties)
- Liquidation After Death IRC § 1239

77

Thank you.

By **Stephen M. Breitstone** & **David C. Jacobson**

Estate Planning With Grantor Trusts

Storm clouds on the horizon

Grantor trusts have been at the heart of most leveraged estate-planning techniques since the publication of Revenue Ruling 85-13.[1] In this ruling, the Internal Revenue Service established the now widely accepted premise that a transfer to and from a grantor trust is a disregarded (ignored) transaction for income tax purposes as long as the trust retains its grantor trust status. These transactions are ignored even though they're given full effect for purposes of estate, gift and generation-skipping transfer taxes. This lack of coordination between the income tax system and the transfer tax system has enabled transfers of assets, such as businesses and real estate, with a value that greatly exceeds the available transfer tax exemptions. This leveraging of exemptions enables the transfers of income and appreciation on much greater asset values. Leveraging exemptions with grantor trusts is at the forefront of transfer tax minimization planning for the ultra-high-net-worth client. One prevalent technique to take advantage of this leveraging effect is the installment sale to an intentionally defective grantor trust (IDGT).

In recent years, the Obama administration budget proposals have suggested the need to curtail this type of planning as a significant revenue raiser. (See discussion below.) However, there's been little support in Congress for those proposals. Nevertheless, an act of Congress may not be required to curtail or even eliminate certain of the currently perceived benefits of estate planning involving grantor trusts—especially the installment sales. The IRS' recent issuance of Revenue Procedure 2015-37 may be an indication that the golden age of planning with grantor trusts is coming to an end. There may indeed be storm clouds on the horizon.

Stephen M. Breitstone, left, is a partner, and **David C. Jacobson** is counsel, both at Meltzer, Lippe, Goldstein & Breitstone, LLP with offices on Long Island, N.Y. and in New York City

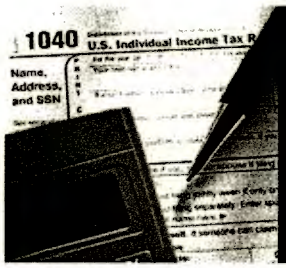
In anticipation of action by the IRS, it's important to understand the current treatment of grantor trusts, as well as likely changes or so-called "interpretations" of the law in this area. This area of the law is fraught with ambiguity and isn't as clear as many in the estate-planning community tend to assume. In particular, the tax consequences of termination of grantor trust status haven't been well understood by the government or advisors. There's developed much "lore" but little definitive "law" on this important topic.

In light of the uncertainty and possible changes that will clarify the law in a manner that's not favorable to the taxpayer (explained below), estate plans should be revisited with the view towards mitigating these risks. The use of freeze partnerships can accomplish much of the leveraging needed in these plans and do so without the risks associated with installment sales to IDGTs.

Potential Action by the IRS

On the death of the grantor, do grantor trust assets receive an Internal Revenue Code Section 1014 basis adjustment, even though the assets aren't includible in the grantor's gross estate? A definitive answer to this question has eluded practitioners for years. The IRS now appears poised to provide an answer.

On June 15, 2015, the IRS released Rev. Proc. 2015-37, which advised that, until the IRS resolves the issue, it will no longer issue individual private letter rulings on whether the basis of assets in a grantor trust must be adjusted to reflect their fair market value (FMV) on the grantor's death if those assets aren't includible in the grantor's estate. Soon thereafter, on July 31, 2015, the IRS and Treasury released the 2015-16 edition of their Priority Guidance Plan (PGP), which identifies the "basis of grantor trust assets at death under



section 1014" as a project that will be a priority for resource allocation. Although the PGP expressly refers to Section 1014, the forthcoming guidance is likely to address the flip side of this issue—namely whether gain is recognized on the grantor's death.

The addition of this issue to the no-ruling list and the PGP strongly indicates that the IRS is preparing more authoritative guidance on this question, thereby putting an end to the uncertainty. This guidance, especially if it's issued during the remainder of the Obama administration, will likely reflect some of the policies already expressed in the Obama budget proposals to the extent they can do so as interpretations of existing law. These proposals could significantly curtail leveraged planning with grantor trusts and would treat death as a realization event. While it's unlikely that administrative action could accomplish all of the objectives set forth in the budget proposals, it could severely impact planning with grantor trusts—especially installment sales.

> If the grantor trust status ends during the grantor's life, the grantor is deemed to have transferred the assets and liabilities in the trust to the trust.

Installment Sale to IDGT

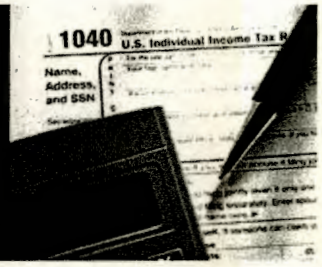
For estates that include large assets, such as commercial real estate or large interests in business entities, use of the federal applicable exclusion amount (currently $5.45 million) is insufficient to transfer these assets during lifetime, so that their growth and appreciation will occur outside of the estate, which would reduce transfer taxes. Estate tax planning for these large assets requires "leveraging" the exclusion. For example, lifetime gifts may be leveraged: (1) by using minority interest and marketability discounts; (2) through the statutorily sanctioned technique of grantor retained annuity trusts; and (3) by the seemingly ubiquitous technique of an installment sale to an IDGT. All of these techniques allow the growth and appreciation to be transferred on assets that may have value greatly in excess of available exemptions.

A brief review of this strategy will provide the context necessary to explain the risks. An installment sale to an IDGT is designed to transfer future appreciation to trusts for individuals, typically family members, in a tax-efficient manner. The trust is structured to cause the grantor to be taxed on the trust's income under the grantor trust rules,[2] while excluding the trust property from the grantor's gross estate for estate tax purposes. The grantor then sells assets to the trust, typically in exchange for an interest-bearing promissory note. As transactions between a grantor and grantor trust are ignored for income tax purposes, the sale to the trust is ignored for income tax purposes, and no gain or loss is recognized by the grantor (Rev. Rul. 85-13), even if the assets have significant built-in gains.

If the assets sold to the trust appreciate in value at a rate in excess of the note's interest rate, the appreciation in excess of the interest rate passes free of transfer tax. This creates significant opportunity for transfer tax leveraging. For example, the terms of the promissory note may include interest based on the historically low applicable federal rate, with interest-only payments and a balloon principal payment. And, if the asset sold is an interest in a closely held business, potential valuation discounts provide additional leveraging opportunities. The difficult question is whether the gain recognition avoided at the inception of this transaction is merely a deferral or is permanent. This issue must be linked to the question of whether there's a basis step-up under Section 1014 on the death of the grantor.

What Happens if the Grantor Dies?

In answering the question of whether there's a Section 1014 basis adjustment on the death of the grantor, the IRS may address related issues. For example, if the amount of liabilities assumed by the trust exceeds the adjusted basis of the property transferred, is there gain? If the grantor dies while the note is outstanding, does that death trigger taxable gain under IRC Section 1001(a)? Is the installment method available for reporting the gain under IRC Section 453? Is this gain treated as income in respect of a decedent (IRD) under IRC Section 691? No case, regulation or published ruling directly addresses these questions.



Given the importance of these issues to this ubiquitous estate-planning technique, it naturally follows that there's no shortage of commentators willing to opine—ourselves included.[3] We believe that there's a risk that the death of the grantor will trigger gains on some or all of these items and that a closer examination of these risks may also shed light on the IRS' impending action.

Termination During Grantor's Life

While there's disagreement regarding the effect of the termination of grantor trust status on the grantor's death, the income tax effects of terminating grantor trust status during the grantor's life are well settled. If the grantor trust status ends, the grantor is deemed to have transferred the assets and liabilities in the trust to the trust. The trust becomes a separate taxable entity for income tax purposes, and the grantor is taxed on consideration received by the grantor in excess of the basis in the property transferred.[4]

Termination on Grantor's Death

Despite the relative certainty regarding a lifetime termination of grantor trust status, there's sharp disagreement regarding the income tax consequences when the grantor trust status ends as a result of the grantor's death. Here are three prevailing views.

View 1: No gain on death of grantor. Proponents of this view state that there's no existing rule that expressly treats a transfer at death as a realization event for income tax purposes. And, as death isn't an income tax realization event, there can't be any gain realized at death, regardless of the deemed transfer resulting from the termination of grantor trust status.

Under IRC Section 1001(b), the term "amount realized" is defined as "including cash and the fair market value of other property received upon a sale or disposition of an asset." In the case of a lifetime gift, which ordinarily doesn't involve the receipt of any consideration, gain isn't recognized. And by analogy, bequests should be treated the same.

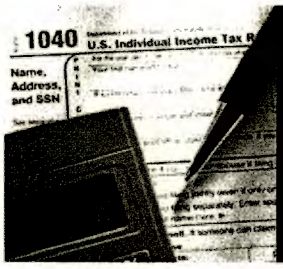
The U.S. Supreme Court case of *Crane v. Commissioner*[5] is often cited for the proposition that a testamentary gift shouldn't trigger gain. In *Crane*, a beneficiary inherited property encumbered by a nonrecourse liability equal to the FMV of the property. The property was sold several years later. In determining the amount of gain realized on the sale by the beneficiary, the court held that the beneficiary's basis in the property was equal to the appraised value at the time of inheritance. That is, the property received a basis step-up on the previous death of the decedent. Noteworthy is that *Crane* established the proposition that's now well settled that the basis step-up includes not just the equity value of the property transferred (there was none in *Crane* under the stipulated facts of the case) but also the nonrecourse liabilities to which the property was subject at death.

The proponents suggest that *Crane* implies that there wasn't a sale of the asset at death, and therefore, there was no gain realized at death. Within the context of a sale to a grantor trust, the proponents of this view argue that the death of the grantor should similarly not be treated as a sale, but rather as a bequest. But, they ignore the fundamental nature of the sale to grantor trust technique: It's a "sale" and can't be analogized to a bequest without an extraordinary leap of logic. They also ignore the well-established principle that if property is gifted but subject to liabilities in excess of basis, even a nominally gratuitous transfer will be treated as a part sale to the extent of that excess.

Whether the death of a grantor is characterized as a sale or a bequest isn't fully dispositive of the question of whether gain is realized at death.

Furthermore, whether the death of a grantor is characterized as a sale or a bequest isn't fully dispositive of the question of whether gain is realized at death. In fact, *Crane* itself suggests otherwise by finding that "amount realized" includes debt relief. Keep in mind that the debt in *Crane* didn't exceed the property's basis.

In addition to the overstatement of the holding in *Crane*, proponents ignore the importance of Treasury Regulations Section 1.684-2(e). This regulation states that when a foreign trust ceases to be treated as a grantor



trust as a result of the death of the grantor, the grantor will be deemed to have transferred the trust assets in a fully taxable transaction immediately before, but on the same date that, the trust is no longer treated as a grantor trust. It's a glaring exception to the no-gain-at-death rule. The mere existence of such an exception strongly suggests that the Supreme Court decision in *Crane* didn't establish a blanket no-gain-at-death rule.

The IRS' position regarding the income tax consequences of a grantor's death are purportedly found in Chief Counsel Advice 200923024. In this CCA, the IRS advised that a conversion of a non-grantor trust to a grantor trust isn't a transfer for income tax purposes (of the property held by the non-grantor trust to the grantor) that requires recognition of gain to the grantor. In response to the authorities that conclude there's a taxable event when grantor trust status is terminated during the grantor's life, the IRS stated that, "[w]e would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event."

An issue related to whether there's gain on the outstanding promissory note is whether the gain should be recognized as IRD under IRC Section 691 when the note is paid.

While CCAs may provide some insight into how the Office of Chief Counsel analyzes the issue, there's no assurance that the IRS will apply a particular CCA in other situations. Furthermore, the part of the CCA previously quoted is essentially dictum, as it's not essential to the advice given. In any event, CCAs are issued to field or service center employees and, pursuant to IRC Section 6110(j)(3), can't be used or cited as precedent. Nor is a CCA subject to the levels of review and vetting of a published revenue ruling or Treasury regulation—which are authoritative. Taxpayers and their advisors simply can't rely on CCAs as precedent.

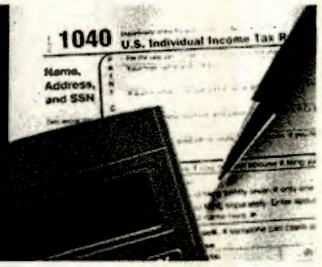
View 2: Gain on outstanding promissory note. Proponents of this view follow the same rules for termination of grantor trust status at death that apply during lifetime. If the grantor dies before the note is paid off, the death causes a realization of the portion of the grantor's gain attributable to the unpaid portion of the note.[6] This view suggests that the resulting realization of gain would be the same that would occur had the grantor trust status terminated during the grantor's lifetime.

View 3: Gain on third-party liabilities in excess of basis. Proponents of this view also argue that death causes a realization of gain to the extent that third-party liabilities secured by the trust assets exceed the basis in the assets. Again, proponents suggest that the resulting gain would be the same that would have occurred had the grantor trust status terminated during the grantor's lifetime. They find no reason to differentiate the outcome when grantor trust status is terminated as a result of the grantor's death. If the liability is recourse, then the gross value of the asset is reported on the estate tax return, for example, if real estate, then on Schedule A. The amount of the recourse mortgage is reported separately on the estate tax return on Schedule K. If the liability is nonrecourse, the net equity value of the property (net of the debt) is included in the gross estate and is only reported on the estate tax return. The view that death causes realization of gain, whether it be attributable to the unpaid portion of the note or third-party liabilities in excess of basis, assumes that the trust property wouldn't be entitled to a basis step-up under Section 1014(b)(1) because property in a grantor trust isn't "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." This point of view doesn't extend the fiction of Rev. Rul. 85-13. It doesn't "deem" the trust assets to have been included in the grantor's estate for income tax purposes. And, it doesn't agree that gain realization is avoided by reason of the basis step-up under Section 1014.

IRD

An issue related to whether there's gain on the outstanding promissory note is whether the gain should be recognized as IRD under IRC Section 691 when the note is paid.

Again, it's unclear how far the grantor trust fiction of Rev. Rul. 85-13 would be extended. The analogy to Treas. Regs. Section 1.684-2(e) is compelling.



As previously discussed, that regulation treats the termination of grantor trust status as a transfer by the decedent on the date of death, leaving the gain to be taxed in the decedent's final return. However, the "deemed sale" on the expatriation of assets isn't an actual sale and thus should be contrasted with the sale to the IDGT. For example, the sale to the IDGT may be entitled to deferral under the installment method. Therefore, we should look to the authorities governing actual sales for further guidance.

If an actual sale takes place, but its tax consequences are deferred until death under Rev. Rul. 85-13, should Section 691 IRD rules be applicable?

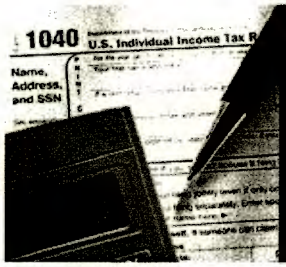
One may argue that Section 691 shouldn't be applicable because the gain wasn't realized during lifetime. Section 691(a)(4) treats an installment obligation as IRD when the gain was reported by the decedent but deferred under the installment method until after death. The argument would be that the installment gain that arises from the termination of grantor trust status isn't IRD because it wasn't "reported by the decedent." However, this argument ignores the compelling similarity to Treas. Regs. Section 1.684-2(e), which treats the gain as having been realized during lifetime. It also ignores Rev. Rul. 78-32, which found IRD treatment even when the gain on a sale of property wasn't realized during the decedent's lifetime.

In Rev. Rul. 78-32, there was a sale of property that was "fully baked" prior to death but which didn't close until after death. In Rev. Rul. 78-32, prior to death, a decedent entered into a binding executory contract for sale of real property and had substantially fulfilled the prerequisites to consummation of the sale. However, the decedent's executor completed the sale subsequent to death. In finding that the decedent was unconditionally entitled to the sales proceeds at the time of death, the IRS ruled that the gain realized from the sale was IRD. Actual consummation of the sale prior to death wasn't determinative.

In light of the similarity to Treas. Regs. Section 1.684-2(e), it's illogical to treat the sale to the IDGT as not having occurred during lifetime under Rev. Rul. 85-13. The sale to the IDGT occurs and is fully closed during lifetime. Asserting that the sale doesn't occur for tax purposes until after death makes little sense, especially in light of Rev. Rul. 78-32. At a minimum, a strong argument could be made that the fiction of Rev. Rul. 85-13, that the sale is disregarded as long as grantor trust status continues, shouldn't be extended to avoid IRD treatment. To conclude otherwise relies on an overly expansive reading of Rev. Rul. 85-13—beyond what was likely intended. Rev. Rul. 85-13 doesn't actually speak to what happens when grantor trust status ends. Rev. Rul. 85-13 was a results-oriented ruling designed to overrule the too-good-to-be-true ruling in the U.S. Court of Appeals for the Second Circuit decision in *Rothstein v. United States*.[7] In *Rothstein*, the court concluded that the taxpayer, on the purchase of property from a grantor trust, obtained a cost basis even though the purchase from the trust didn't result in recognition of gain. Rev. Rul. 85-13 was the IRS' attempt to disallow this result, which would have no doubt spawned a generation of abusive basis-creating transactions with grantor trusts. It's ironic that Rev. Rul. 85-13 is now being relied on to support another generation of basis-creating transactions—namely, the use of grantor trusts to avoid gain recognition permanently while arguably ensuring a full basis step-up on the death of the grantor—without gain recognition, IRD and estate tax inclusion. What's wrong with this picture? Our position is that Rev. Rul. 85-13 is being ascribed an expansive meaning that was never intended and that's not actually articulated in the ruling. It's also our view that imposing a gain-on-death rule would be harsh and contrary to taxpayer expectations and sound tax policy. Any attempt to impose such a rule would be highly ridiculed and subject to challenge. A more practical solution would be to treat the unrecognized gain as IRD, provided there's a method in the IRC to preserve that treatment, such as the installment method under IRC Section 453. Unfortunately, the installment method has limited application and couldn't provide a blanket shield against gain recognition on death.

Our position is that Rev. Rul. 85-13 is being ascribed an expansive meaning that was never intended and that's not actually articulated in the ruling.

The application of the installment method under



Section 453 has considerable appeal. The Treasury regulations provide that if an individual makes a sale before the individual's death, which is recognized under the installment sale rules of Section 453, then it should be treated as IRD.[8] One might argue that the sale that in fact occurred at the consummation of the estate-planning transaction should be ignored under Rev. Proc. 85-13 and that this precludes the application of Treas. Regs. Section 1.691(a)-5(a) because no gain was recognized during the grantor's lifetime. As discussed, this is probably an overly broad interpretation of Rev. Proc. 85-13, which didn't actually speak to what happens when grantor trust status ends whether or not that occurs on the grantor's death. It's difficult to ignore Rev. Rul. 78-32, which also involved a sale that didn't close until after death but was nevertheless treated as giving rise to IRD. Even if the transaction can be treated as an installment sale giving rise to IRD, the more difficult question is whether gain is recognized on death when the installment method isn't applicable. There are significant exceptions to the installment sale method of reporting gain. For example, gain from the transfer of assets with liabilities in excess of basis doesn't qualify for the installment method (to the extent of the liabilities in excess of basis). And, sales of depreciable property to a related person similarly don't qualify. If a sale to an IDGT falls under these exceptions, the gain (to the extent of liabilities in excess of basis or all gain if considered a sale to a related party) wouldn't be able to be deferred at death. Perhaps the IRS could simply deny the basis step-up, leaving the gain to be deferred until the assets are sold. Certainly, that would be a preferred outcome to gain recognition at death, which would be quite repugnant. The IRS would risk taxpayer revolt if it were to impose both an income tax and an estate tax on the same assets at death. However, that's the result provided for in the Obama budget proposals. Potentially, if the IRS could find a way to justify that treatment, it would do so during the remainder of the Obama administration.

The IRS would risk taxpayer revolt if it were to impose both an income tax and an estate tax on the same assets at death.

Basis Step-Up in the Trust Assets?

Related to the question of whether gain is triggered as a result of the grantor's death is whether the death of the grantor would give rise to a basis step-up under Section 1014. Do the trust assets receive a basis step-up under Section 1014(b)(1) because the trust is deemed to "acquire property from a decedent"? Or, is the basis step-up denied under Section 1014(b)(9) because the assets are excluded from the grantor's gross estate? Here again, there's no definitive legal authority and therefore disagreement among the commentators. Here's a comparison of the prevailing views.

View 1: Yes, there's a basis step-up under Section 1014. The trustee is viewed as having acquired the assets by bequest or devise, and as a result, the basis will equal the estate tax value under Section 1014. Section 1014(b)(1) doesn't depend on actual estate tax inclusion. Instead, the trust assets receive a date-of-death value basis adjustment under Section 1014(b)(1) as property "in the hands of a person [the trust] acquiring the property from a decedent or to whom the property passed from a decedent."[9] A variation of this view is that the deemed change of ownership for income tax purposes at the grantor's death (from the grantor to the trust) constitutes the receipt of property from a decedent for purposes of Section 1014 and that there should be a basis step-up even though the assets aren't included in the gross estate.[10] It's argued that the note, as well as the trust assets, receives a basis step-up under Section 1014, as the note is included in the decedent's gross estate. This position relies on the premise that the gain isn't recognized during the decedent's lifetime because the grantor trust ends at death, not before. As discussed, this ignores Rev. Rul. 78-32 and the regulations under Section 684.

In PLR 201245006 (July 19, 2012), a U.S. non-resident alien proposed to transfer U.S. situs assets (stock publicly traded in the United States) to an irrevocable grantor trust. Under the terms of the trust, all of the income is required to be paid to the taxpayer, making it a grantor trust under IRC Section 677(a). The IRS ruled

that the basis of property held in the grantor trust will be stepped up under Section 1014(a) on the taxpayer's death, despite the fact that the assets in the trust aren't subject to estate tax. At a panel conducted at a meeting of the Tax Section of the American Bar Association, an attorney from the Chief Counsel's office commented that the government was troubled by its own lack of coordination that resulted in the issuance of PLR 201245006 and CCA 200937028, which appear to directly contradict each other. In a matter of months after that meeting, the IRS issued Rev. Proc. 2015-37 to prevent any further contradictions. As stated, the inclusion of this item on the PGP during 2015 indicates that this issue will be resolved at some point definitively. Reliance on PLR 201245006 may be perilous at this point.

View 2: No, there's not a basis step-up under Section 1014. Under this view, the trust assets weren't "acquired from a decedent" and don't "pass from a decedent." The trust assets didn't pass pursuant to decedent's will or by intestacy. And, the grantor doesn't have rights over the trust that would result in inclusion of the trust assets in the grantor's estate for estate tax purposes. The termination of grantor trust status by reason of the grantor's death shouldn't be viewed as a testamentary transfer. And, because the trust assets aren't included in the gross estate, there's no step-up under Section 1014.[11] In regard to the outstanding promissory note, although it's included in the grantor's estate for estate tax purposes, to the extent it's IRD, it isn't entitled to a step-up in basis under Section 1014(a).

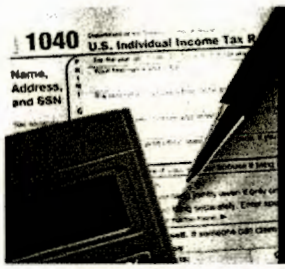
The grantor trust status is terminated on the grantor's death. As the trust then becomes a separate taxpayer for federal income tax purposes, the purchase comes into income tax existence at that time. The deemed transfer should be viewed as a sale by the grantor to the trust, and the trust's basis will equal the purchase price under Section 1012. Under Section 1012, the trust should take a basis in the asset that includes the outstanding principal amount of the note at the date of death.

Note that there are two distinct sides to this transaction—the transferor and the transferee. On the transferor side, there's a sale in exchange for a note. The note is the asset that in actuality is included in the transferor's estate. If the note doesn't get a basis step-up, the gain is preserved but the asset will be subject to both estate tax and income tax—a result that's generally abhorrent under our tax system except in the case of IRD—which can only apply if the installment method under Section 453 also is available. As stated, the installment method isn't available for liabilities in excess of basis and for sales of depreciable property to related parties. As to property subject to liabilities in excess of basis, it's difficult to imagine how these liabilities can be carried over to the estate absent a basis step-up because it's clear that this amount will be subject to income taxation for inter vivos transactions. The difficulties of obtaining this carryover treatment would likely require an act of legislature. Thus, at least as to liabilities in excess of basis or in the case of interests in a partnership, negative capital, it's hard to imagine how to avoid gain recognition on death even if the trigger is termination of grantor trust status. This suggests a similar treatment to that of lifetime terminations of grantor trust status—namely, gain is recognized to the extent liabilities exceed basis.

> Pending further guidance on this issue, it's imprudent to assume there's no gain recognized in planning for sales to IDGTs.

The other side of the transaction is the basis obtained by the former grantor trust, which is the purchaser. If one concludes that gain must be recognized by the estate to the extent of liabilities in excess of basis, it would be incongruous not to allow the trust to obtain a cost basis under Section 1012 to the extent of the liabilities assumed or to which the property is subject—but not on any equity value in excess of that amount. Note that *Crane*, which established that the basis of inherited property includes liabilities to which the property was subject, was decided under a predecessor to Section 1014—not Section 1012 (cost basis). Thus, *Crane* doesn't support the conclusion that on termination of the grantor trust status at death, the trust should obtain a cost basis for the liabilities. Nevertheless, that appears to be the correct result.

In sum, the correct result seems to be that the estate,



which is the deemed transferor of the assets, may be required to recognize gain—but such gain should be limited to the liabilities in excess of basis. But the trust, as the deemed transferee, should only attain a basis step-up to the extent of liabilities assumed or to which the property is subject in excess of basis.

IRS guidance may soon repudiate the conclusion that there's no gain recognition and that the trust obtains a full basis step-up. Pending further guidance on this issue, it's imprudent to assume there's no gain recognized in planning for sales to IDGTs (including gifts of property with liabilities in excess of basis). Moreover, existing plans should be revisited to the extent that they were structured in reliance on this treatment.

President Obama's Budget Proposals

Several of the Obama administration's prior budget proposals would end the sale to an IDGT as a viable estate-planning technique. The 2013 fiscal year budget proposal would have included all of the grantor trust assets in the grantor's gross estate for estate tax purposes. The 2014 and 2015 fiscal year budget proposals somewhat temper the approach by including in the gross estate only the portion in a grantor trust that's attributable to a "sale, exchange or comparable transaction" from the grantor.

The Obama administration's goals are evident in these proposals. It wants to eliminate the use of grantor trusts as a method of estate tax minimization. No one expects the current Congress to take action. As a result, in the final year of the presidency, the Obama administration is likely to take action on its own. It will likely do administratively what it can't do legislatively. For example, the IRS can issue revenue rulings and notices in an attempt to achieve as much of their goals as they can, including those related to gain on death, IRD and basis step-up.

Planning to Avoid the Risks

One option is for the grantor to pay off or unwind the installment note before he dies. This action avoids the entire question of whether there's gain on the death of the grantor relating to the installment note. Another option is for the grantor to reacquire the trust assets using cash. This may be the only option for assets subject to liabilities in excess of basis. If the assets are highly leveraged, it may be less expensive for the grantor to reacquire them for cash than to pay down underlying mortgage indebtedness. If the grantor reacquires the assets, the uncertainty regarding a basis step-up for grantor trust assets is entirely avoided because assets owned directly by the grantor will receive a basis adjustment. If the assets were previously transferred to the grantor trust and have since appreciated, a repurchase will leave the appreciation in the trust, which will accomplish the desired planning objective. An alternative may be to exchange the low basis appreciated assets for assets with a high basis more recently acquired by the grantor.

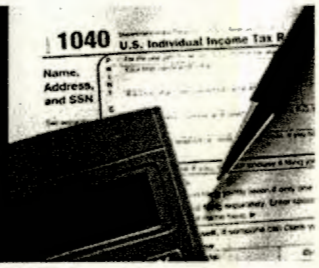
As to the assets reacquired or for new planning, the grantor should explore alternative planning techniques, such as the freeze partnership (FP), which avoid these risks altogether. The FP is a leveraging technique that if properly structured, can leave the built-in gains, including liabilities in excess of basis, in the estate to obtain a basis step-up while transferring appreciation to a trust.

FPs Under Section 2701

A partnership (or limited liability company (LLC)[12]) freeze under Section 2701, if properly structured, can avoid the tax consequences associated with transfers to grantor trusts, whether those consequences are incurred at inception or at the termination of the trust's grantor trust status. The FP technique typically doesn't depend on a transfer to a grantor trust to avoid the income tax consequences of its creation. For example, if the entity freeze involves a partnership, or LLC taxed as a partnership, the initial transfer would typically be treated as a contribution to a partnership rather than a transfer to a grantor trust. The rules governing contributions of appreciated property to partnerships are very different from the grantor trust rules. Contributions to partnerships in exchange for partnership interests are typically entitled to no recognition under IRC Section 721. Even if the property is subject to liabilities in excess of basis, in general, gain won't be recognized at inception under the interplay between Section 704(c) and Section 752.

The FP is the preferred method of planning when the client owns low basis leveraged real estate. Failure to appropriately plan for the inherent income tax consequences of property with liabilities in excess of basis can have devastating tax consequences as discussed above.

The FP technique can avoid this uncertainty and attendant risk. This technique should be carefully



considered among the alternative planning techniques for low basis leveraged real estate. A retained frozen interest in an FP will be entitled to a basis step-up on death. Moreover, if properly structured, the liabilities in excess of basis can be allocated to the frozen interest so that the basis step-up can eliminate the inherent gains attributable to liabilities in excess of basis or negative capital.[13]

The FP can thus transfer appreciation and, perhaps, values out of the estate without foregoing the basis step-up that's necessary to eliminate the phantom income attributable to liabilities in excess of basis (in the case of outright real estate ownership) or negative capital accounts (for real estate owned by a partnership or LLC).

Guidance Forthcoming

It's likely that there will be guidance forthcoming from the IRS that will refute the notion that the termination of grantor trust status on the death of the grantor will result in a basis step-up without gain recognition for both the estate and the trust. At this point, reliance on that notion is perilous. Planning to attain the maximum basis step-up is more important than ever given the current transfer tax system and the greatly reduced disparity between income tax and estate tax rates. There's a premium in the current environment on any planning that results in the maximum basis step-up.

Given the uncertainties and risks associated with the installment sale to the IDGT, especially when the assets transferred are low basis real estate with liabilities in excess of basis, practitioners should explore alternative techniques, such as the leveraged FP. They should also restructure existing plans that rely on the installment sale technique to mitigate these risks. One method to restructure these transactions is to have the grantor reacquire the assets by exchanging them for high basis assets or cash. It's not advisable to reacquire those assets for installment notes until there's definitive guidance from the IRS as to whether assets in the trust obtain a basis step-up. Absent a basis step-up, the notes in the trust may also result in an income tax liability to the trust.

As stated, the FP technique may be the preferred method of planning to avoid these income tax pitfalls. The FP is a less efficient transfer tax planning technique than the installment sale because the payments back to the grantor can't be measured based on the artificially low applicable federal rate. Nevertheless, there are techniques involving leveraging the partnership to mitigate that distinction. These techniques will be explored in greater detail in a subsequent article.

Endnotes

1. In Revenue Ruling 85-13, the Internal Revenue Service held that a sale between a grantor and a grantor trust wasn't a taxable event. In doing so, the IRS rejected the then-recent holding in *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), which had concluded that a taxpayer could enter into a sales transaction for income tax purposes with a grantor trust because the trust was a separate taxpayer. The ruling's rejection of *Rothstein* set the stage for modern estate-planning techniques.
2. The commonly referred to "grantor trust" rules are found in Internal Revenue Code Sections 671-679, which is in Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the IRC, entitled "Grantors and Others Treated as Substantial Owners."
3. Deborah V. Dunn and David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates," 95 *J. Tax'n* 49 (2001); 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," 96 *J. Tax'n* 149 (September 2002). Carol A. Cantrell, "Gain is Realized at Death," *Trusts & Estates* (February 2010), at p. 20; Jonathan G. Blattmachr and Mitchell M. Gans, "No Gain at Death," *Trusts & Estates* (February 2010), at p. 34.
4. *Madorin v. Commissioner*, 84 T.C. 667 (1985); Treasury Regulations Section 1.1001-2(c), Ex. (5); Rev. Rul. 77-402. Each of these authorities involves debt relief as consideration paid.
5. *Crane v. Comm'r*, 331 U.S. 1 (1947).
6. *See Frane Estate v. Comm'r.*, 998 F.2d 567 (8th Cir. 1993), in which the cancellation of an installment note occurred at the death of the borrower, and the court held that it constituted a disposition of the note that triggered gain that had to be recognized by the decedent's estate under IRC Section 691(a)(2).
7. *Rothstein, supra* note 1.
8. Treas. Regs. Section 1.691(a)-5(a).
9. *See* Private Letter Ruling 201245006 (July 19, 2012), in which there was a basis step-up on the grantor trust's assets that passed to the grantor's issue at the grantor's death.
10. *See* Blattmachr, Gans and Jacobson, *supra* note 3.
11. *See* Chief Counsel Advice 200937028, which states that there's no basis step-up under IRC Section 1014 unless the asset is included in the decedent's estate.
12. Limited liability companies are generally treated as partnerships for tax purposes.
13. For a more detailed discussion of this technique, *see* Stephen M. Breitstone, "Estate Planning for Negative Capital," *Trusts & Estates* (May 2012), at p. 26; Stephen M. Breitstone, "Estate and Income Tax Planning for the Long Term Real Estate Investor," 44th Annual Estate Planning Institute, Practicing Law Institute; and Stephen M. Breitstone and David C. Jacobson, "Moving the Real Estate Empire to the Next Generation, Balancing Income Taxes and Transfer Taxes," NYU 74th Institute on Federal Taxation.

Chapter 2

Moving The Real Estate Empire To The Next Generation

By: Stephen M. Breitstone, Esq. and

David C. Jacobson, Esq.

sbreitstone@meltzerlippe.com
djacobson@meltzerlippe.com

Meltzer, Lippe, Goldstein & Breitstone, LLP
190 Willis Avenue
Mineola, New York 11501
516.747.0300 x241
www. meltzerlippe.com

TABLE OF CONTENTS

Estate and Income Tax Planning for the Long Term Real Estate Investor[1]

INTRODUCTION

Formulating an effective estate plan for the successful real estate investor can impact whether the investor's holdings, which may result from a lifetime of efforts, can continue for succeeding generations. Planning in this area is multidisciplinary. The tax and/or estate planning attorney plays a key role on the estate planning team. Where the family and business dynamics are complex (which is frequently the case), a team approach is required. The team may involve lawyers, accountants, financial advisors and human and business relationship experts. Since this paper is written for a tax institute, the emphasis will be on the role of the legal and tax advisors. However, the role of human and business relationship experts should not be overlooked.

For many real estate owners, one of their key advisors will be their transactional real estate attorney. The real estate attorney may have great knowledge and wisdom as to the client's circumstances, idiosyncrasies, and areas of vulnerability. However, they may not have sufficient expertise as an estate planner. Yet for the estate planner to be effective, it is necessary

[1] Stephen heads the Tax and Trusts and Estates groups at Meltzer Lippe Goldstein & Breitstone; Stephen is a frequent lecturer and author of numerous published articles on taxation of real estate transactions and estate planning for real estate owners. He is a member of the advisory board for the NYU Institute on Federal Taxation and has taught Federal Taxation of Partners and Partnerships at Cardozo Law School. Stephen has a BS in Accounting from NYU business school, a JD from Cardozo Law School and LL.M. in Taxation from NYU Law School. Recent publications include, Carried Interest Bill - A Death Trap for Real Estate Partnerships, *Tax Notes, 6/22/09,* Carried Interest Bill - Impact on Real Estate Partnerships, *Tax Notes, 3/8/2010,* Mergers and Divisions of Real Estate Portfolios, a Changing Paradigm, *NYU 69th Institute on Federal Taxation, (2011)*; Income and Transfer Tax Planning for Negative Capital – The Entity Freeze Solution, *NYU 70th Institute on Federal Taxation, (2012);* Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context, *NYU 66th Institute on Federal Taxation 2008,* Estate Planning Strategy for Leveraged Real Estate, *Practical Tax Strategies March 2002.*

for that lawyer to gain an understanding of the individual client. Thus, a team approach can be most constructive assuming the professionals play well together.

Sometimes the income tax aspects of estate planning for the real estate client are given short shrift. A trusts and estates lawyer may have an understanding of the transfer tax side but may lack familiarity with certain income tax aspects (such as partnership taxation) which can be a critical element. Planning for the real estate client frequently involves dealing with concepts such as "loss carryovers", "phantom income" and "negative capital" – which are frequently present with the real estate client but are rarely found in other estate planning contexts. Application of mainstream estate planning techniques that may be appropriate for other business and investment interests to the real estate client may be perilous. As will be explained herein, mainstream techniques such as Grantor Retained Annuity Trusts ("GRATs") and installment sales to intentionally defective grantor trusts ("IDGTs") may fail to properly address the income tax considerations presented by the real estate client (whether the client knows it or not). These techniques may miss the opportunity to obtain a basis step up on phantom gain that results from liabilities in excess of basis. This arises where a property is depreciated over time and refinancings are use to cash out without current income taxation of the proceeds. Even worse, these techniques may, under some circumstances, inadvertently trigger phantom gain – which can be a significant problem especially since such gain should be able to escape taxation with proper planning. Moreover, such gain is "phantom" gain so there may not be liquidity to pay the income tax.

There are better techniques to deal with the unique income tax challenges frequently presented by the real estate client. One technique discussed herein is the freeze partnership – which is discussed in great detail herein - although this technique presents its own challenges.

THE NONTAX SIDE – BRIEFLY

One of the major challenges is to establish a plan for succession of management. Financing sources such as lenders and outside equity investors may insist that a plan for management succession will be in place. There is often a tension between the needs of the business to be managed effectively and the need to address the family concerns including perception of equity among successors and heirs. It is necessary to prepare appropriate documentation that provides rewards and incentives for management (whether or not family), to encourage appropriate expectations among family members and to maintain credibility with investors and business partners. Failure to provide for these concerns and others can undermine an otherwise viable business.

These agreements can also materially impact the ultimate income, estate, gift and generation skipping tax outcomes. For example, they can impact valuation subject to tax – but there are many other tax considerations that can impact the development of an appropriate estate plan for these types of assets.

FAMILY BUSINESS DYNAMICS

Many successful real estate businesses are also family businesses. Even where the founders are unrelated partners, there may be a strong temptation to bring family members into the business. If handled properly, this can help a business to flourish and continue into succeeding generations. However, if the right conditions do not exist, it can be a disaster. Many successful entrepreneurs are idealistic about their families – at least until reality sets in. Failure to provide for appropriate documentation of entity agreements can result in an unfortunate rude awaking.

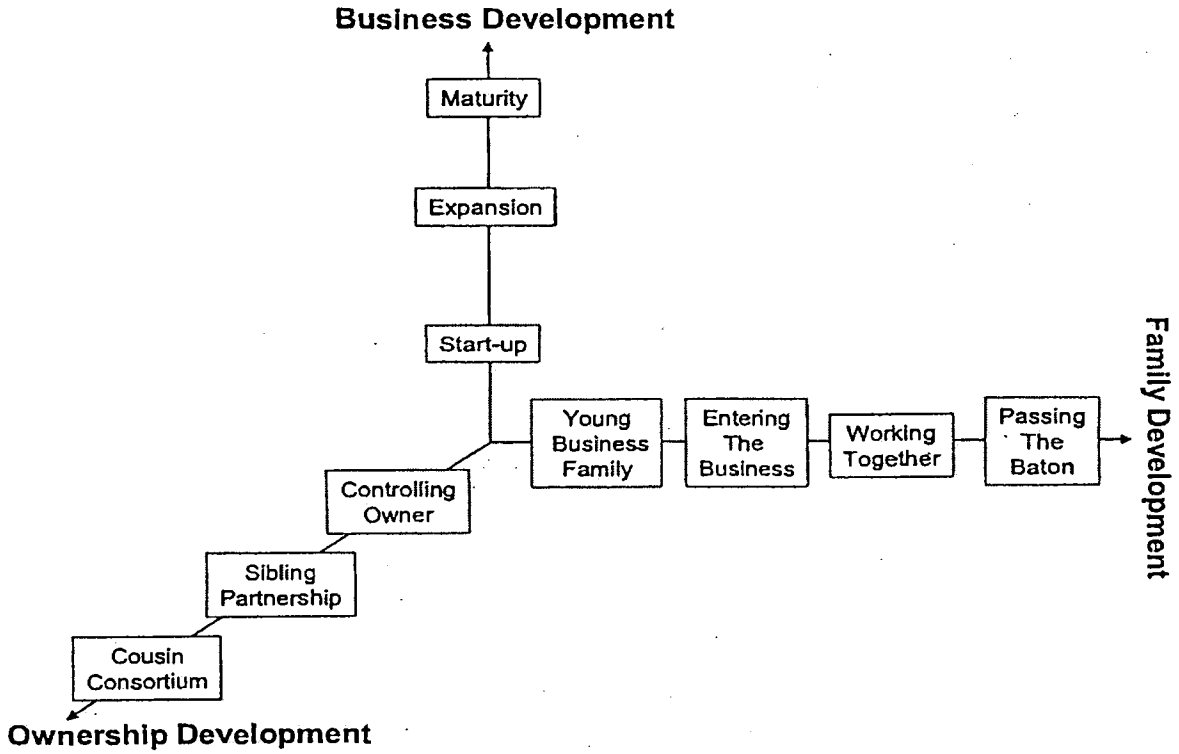
The personal attributes of the founder may not translate well into the next generation. The next generation may be faced with different challenges. For example, the

founder may be a true "developer" who creates opportunities and value. The second generation of owners may not have the same developer mindset and skills. However, the second generation may be more suited to maintain and grow the business. They may be more risk averse but more adept at building an organization. It is difficult to generalize.

Another challenge is the frequent need or desire to treat children equally. The following quote is instructive:

> "It is not always feasible for all of the children to be involved in the management of the business. The fact that they are siblings does not automatically make them good future managers. Identify the children who will participate in the future business early, and ensure that they are properly trained and receive proper skills development." *See* Developmental Model (Gersick *et al,* 1999).

As a business matures, the challenges that must be addressed in the entity agreements may likewise evolve and become more complex. The following diagram can be instructive of the conflicting considerations and dynamics that must be considered in drafting entity agreements:



See Rudolph B. van Buuren (Ph.D) The Life and Times of a Family Business: A case study.

As the foregoing diagram illustrates, the entity documents must be designed to allow for the development, growth and evolution of the family business dynamic. The needs of the business, and the tensions placed upon entity agreements, can significantly change as the business and the family dynamic evolves.

Drafting a set of entity agreements that can conform and adapt – or even drive – a particular succession plan can be a daunting task. However, it should be done at the earliest possible juncture. For example, if the plan is to gift or otherwise grant ownership interests to family members (as well as employees) the agreements, and the strictures and restrictions they entail, should be put into place before it becomes necessary to get disparate prospective owners to consent. Once they own their interests, they can present significant hurdles to implementing a

plan. The documents need to contain mechanisms to overcome the whims of the disparate family members.

POPULAR ESTATE PLANNING TECHNIQUES

Many of the mainstream estate planning techniques do not work well for the long term real estate holder. This is particularly true where the real estate is leveraged and has a low income tax adjusted tax basis. A brief discussion of the mainstream techniques, and the advantages and disadvantages for the long term real estate investor follows:

Grantor Retained Annuity Trusts ("GRATs") – GRATs have historically been viewed as very low risk. This is because they are creature of statute. The rules governing GRATs are, in general, set forth in section 2702 of the Code and the regulations thereunder. A grantor retained annuity trust is a trust where the grantor transfers property and takes back an annuity. The annuity is determined on the basis of certain assumptions including a rate of return based upon the interest rate determined under section 7520 of the Code. Section 7520 generally provides a rate equal to 120 percent of the mid term applicable federal rate determined under section 1274 of the Code. This rate is artificially low as will be discussed below. A comprehensive discussion of GRATs is beyond the scope of this article.

A few points are important to be made. First, GRATs are not a construct of crafty tax advisors and are thus less likely to be subject to attack. The GRAT minimizes the valuation risk since in the event of a valuation challenge the annuity payments are self adjusting. In general, if the grantor does not outlive the term of the GRAT, most or all of the assets in the GRAT will be included in the grantor's estate. GRATs do not work well for generation skipping tax planning since the generation skipping exemption cannot be allocated to the GRAT until the term of the GRAT expires – at which time the underlying assets will likely have appreciated. This is not an efficient use of the generation skipping exemption.

When it comes to maximizing a basis step up under section 1014 of the Code, the GRAT, like other gift tax completed grantor trusts, will not allow a basis step up in the underlying assets of the trust. For depreciable real estate, especially low basis real estate with liabilities in excess of basis, this can be a major disadvantage of the technique. This aspect will be discussed in greater detail below.

Installment Sales to Intentionally Defective Grantor Trusts ("IDGT") – Unlike the GRAT, the IDGT is not a creature of statute. Rather, it is a technique that has been gradually developed by estate planners. Thus, the outer bounds of propriety can be grey when designing a transaction using this technique. Like the GRAT the IDGT is a grantor trust. Thus, under well established law, a sale of assets by the grantor to the trust will generally not result in the recognition of gain for Federal and state income tax purposes. Note that for state and local transfer taxes this is not necessarily the case. However, the cessation of grantor trust could result in a taxable event – especially for liabilities in excess of basis.

A major disadvantage of the IDGT is the uncertainty of valuation. If there is a subsequent determination that the property transferred to the trust was undervalued, there could be an unintended taxable gift. This risk can be somewhat mitigated through the use of valuation clauses which are discussed in detail below. Similarly, if the property declines in value it could result in a loss of any gifting exemptions use to fund the trust initially.

A major advantage of the IDGT is that it can be generation skipping. Indeed, the allocation of exemption to the initial funding of the trust should allow significant leveraging of that exemption assuming the property appreciates.

Another major advantage of the IDGT is the low hurdle rate. Assuming the trust is adequately funded (so that the installment note taken by the seller is recognized as debt for tax

purposes), the debt should not need to accrue interest at greater than the applicable federal rate under section 1274 of the Code. A schedule of applicable federal rates is as follows:

REV. RUL. 2016 - 4 TABLE 1

- Applicable Federal Rates (AFR) for February 2016

Period for Compounding:

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.81%	.81%	.81%	.81%
Mid-term AFR	1.82%	1.81%	1.81%	1.80%
Long-term AFR	2.62%	2.60%	2.59%	2.59%

The Section 7520 rate is 2.2%

Assuming a note of a term of 9 years is used, a mid term rate would be used. The mid term applicable federal rate was 1.82% for February 2016. Thus, assuming the underlying assets either appreciate or accrue income at least 1.9 percent the technique should result in the transfer of wealth on the excess to the grantor trust.

The major disadvantage of the IDGT, like that of the GRAT, is the inability to obtain a basis step up under section 1014 of the Code for the asset transferred to the trust. Where the property has a low basis and/or liabilities in excess of basis, this can be a major disadvantage and may result in the client paying more in taxes than if he had not done any planning.

Lastly, if the assets that constitute an active real estate business are transferred into a grantor trust in exchange for an installment note, it may be possible to cause the estate to be denied the very valuable ability to pay estate taxes over 15 years under section 6166 of the Code. This will be discussed in greater detail below.

The Freeze Partnership or LLC – The freeze partnership or LLC avoids the income tax pitfalls of the GRAT and the IDGT. With the freeze partnership or LLC, the person doing the planning ("Senior") would transfer property into a partnership in exchange for a preferred or "frozen" interest. The junior equity would typically be transferred to a grantor trust. The junior equity would represent the growth potential in the underlying assets. The preferred or "frozen" interest would be retained in the estate of the grantor. Under income tax principals discussed in greater detail below, the liabilities in excess of basis and the capital value of the property contributed by the Senior, would be entitled to a basis step up under section 1014 upon the death of Senior. This is a distinct advantage of this technique over the GRAT and the IDGT. The disadvantage of this technique is that the hurdle rate is not the AFR or the 7520 rate. Rather it is a market return determined by appraisal. In structuring the plan, this higher hurdle rate can be a major disadvantage to this technique. Nevertheless, as discussed below, there may be ways of mitigating this disadvantage.

STRUCTURING THE ENTITY AGREEMENTS FROM A TAX PERSPECTIVE

FAMILY LIMITED PARTNERSHIPS AND FAMILY LLC: GENERALLY

"Family limited partnership" or "LLC"[2] are receiving scrutiny from the IRS as these entities are often perceived as artificially contrived to reduce valuation for individual

[2] Family LLCs are similar to FLPs in terms of the estate planning benefits that they offer, and are more commonly used. See Jim Schmidt, An Updated Look at Family Limited Partnerships, LLCs, (June, 2003), http://www.sw-cpa.com/bottomline/articles/2003-06/flp_update.htm. The differences between FLPs and Family LLCs are mainly legal differences, such as all members of an LLC having limited liability compared to only limited partners having

family members when the family at large enjoys the unrestricted benefits of the underlying assets. For example, as the IRS has successfully argued (at least in part) in some cases[3] there may be little actual business purposes to the structure., such as, in Holman v. Commissioner,[4] where the family partnership in question merely held a large block of stock in a single publicly held corporation. The tax court viewed the entity with some skepticism.

However, for an actively managed real estate portfolio, the existence of a well crafted partnership agreement or operating agreement that contains extensive restrictions on voting, participation in management of certain family members, and transferability, may be completely necessary for the ongoing viability of the business. A clear delineation of who is in control, the scope of their authority, and the rights and duties of each of the owners may be essential to keep in check the potential for infighting and tumult, which can be costly and disruptive. In these entities, the minority or noncontrolling owner does not have the unfettered control of the underlying assets whether or not there is family harmony at any given time. Ultimately, the interests held by these noncontrolling owners should have values no greater than those of other noncontrolling owners in a business or investment entity. The IRS is unlikely to presume that these entity agreements are merely window dressing to create the maximum disappearing estate and gift tax value through discounting and other valuation techniques.

The body of case law has provided significant guidance as to the valuation of interests in family controlled real estate business through a limited partnership or limited liability company. Recent cases involving the valuation of interests in closely held entities for estate and gift tax purposes allowed the following discounts:

---

limited liability in FLPs. See Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs"), (2002), http://www.estate-plan.com/pdf/Art_FLPLLC.pdf.

[3] See, e.g., See Holman v. Comm'r, 601 F.3d 763, 772 (8th Cir. 2010)(referring to the family partnership as a "wrapper").

[4] Holman v. Comm'r, 601 F.3d 763 (8th Cir. 2010).

Case	Year	Interest Transferred	Underlying Property	Lack of Control Discount	Lack of Marketability Discount
Estate of Richmond v. C.I.R., 107 TCM 1135	2014	23.44% shares of personal holding company (a C corporation)	Marketable securities	7.75%	32.1%
Estate of Koons v. C.I.R., 105 TCM 1567	2013	50.5% LLC interest	Primarily cash and other liquid assets; only a small portion of assets were illiquid (including real estate)	0%	7.5%
Tanenblatt v. C.I.R., TCM 2013-263	2013	16.67% LLC interest	Real estate	10%	26%
Estate of Gallagher v. Comm'r, T.C. Memo 2011-148	2011	15% LLC interest	Newspaper and media company	23%	31%
Estate of Giustina v. C.I.R., TCM 2011-141, rev'd, 114 AFTR2d 2014-6848 (9th Cir. 2014).	2011 (rev'd 2014)	41.128% limited partnership interest	Timberland	25%[5]	0%[6]
Holman v. Comm'r, 601 F.3d 763 (8th Cir. 2010)	2010	1999- 14.265% LLP interest 1999- 70.054% LLP interest 2000- 3.285% LLP interest 2001- 5.431% LLP interest	Marketable securities	1999- 11.32% 1999- 11.32% 2000- 14.34% 2001- 4.63%	12.5%
Pierre v. Commissioner,	2010	50% LLC interest	Cash and marketable	8%	30%

[5] In Giustina, the Ninth Circuit reversed and remanded the Tax Court's decision on other grounds, but upheld the Tax Court's application of a 25% lack of marketability discount to the limited partnership interest. 114 AFTR2d 2014-6848 (9th Cir. 2014). Originally, the Tax Court had applied the 25% discount to the income-based method of valuation, which it accorded partial weight. Id. The Ninth Circuit ruled that the Tax Court should accord the income-based method full weight, but upheld the Tax Court's reasoning to apply the 25% discount to this method. Id.

[6] The Tax Court disallowed a lack of control discount in its original decision, but foreseeably could permit it on remand. Estate of Giustina v. C.I.R., TCM 2011-141, rev'd, 114 AFTR2d 2014-6848 (9th Cir. 2014). Originally, the Tax Court reasoned, "...our calculations already assume there was a 75% chance that the owner of the interest would have been unable to garner enough support from the other limited partners to sell the timberland. The inability to cause the sale of the timberland is an aspect of lack of control. Thus, lack of control is already reflected in the 75/25 weighting." TCM 2011-141,*9. However, the Ninth Circuit overruled the Tax Court's reasoning about a hypothetical sale and its 75/25 weighting of valuation methods. 114 AFTR2d 2014-6848 (9th Cir. 2014). Therefore, on remand, the Tax Court could permit a lack of control discount or disallow it on other grounds.

Case	Year	Interest Transferred	Underlying Property	Lack of Control Discount	Lack of Marketability Discount
T.C. Memo 2010-106			securities		
Estate of Litchfield, T.C. Memo. 2009-21	2009	43.1% shares of an S corporation	Farmland, marketable securities, and a subsidiary corporation that owned and operated a public grain elevator and sold crop insurance and certain services	14.8%	25%
Litchfield	2009	22.96% shares of an S corporation	Farmland, marketable securities, and a subsidiary corporation that owned and operated a public grain elevator and sold crop insurance and certain services	11.9%	20%
Gross v. Commissioner, T.C. Memo. 2008-221	2008	22.25% limited partnership interest	Marketable securities	35% combined	
Astleford v. Commissioner, T.C. Memo. 2008-128	2008	50% general partnership interest	Real estate	30% combined	
Astleford	2008	30% limited partnership interest	Real estate	17.47%	22%

Nevertheless, the IRS has launched some successful attacks on family controlled partnerships and limited liability companies which, attacks have either greatly limited discounting or brought the assets back into the estate under IRC section 2036. A discussion of these authorities follows.

SECTION 2036: IRS ATTACKS OF FLP'S AND FAMILY LLC'S

The IRS has success in challenging some FLPs and Family LLC's where the fact patterns have provided a basis for including the assets of the entity in the estate of its founder under section 2036 of the Code. The success of the IRS in these cases represents not an indictment of this type planning – but rather a reflection of the fact that some taxpayers have done a really bad job of respecting and implementing their structures. The applicable maxim is that "bad facts make bad law".

Section 2036 requires that transfers with a donor retained life estate are included in the donor's gross estate, unless they are a bona fide sale for adequate and full consideration. Section 2036 provides that a donor has a retained life estate if that the donor retains (1) "the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income there from."[7]

Various court challenges against family partnerships were brought by the IRS prior to the late 1990s and early 2000s. However, these challenges had little success – at least not until the IRS began to assert that section 2036 applies to bring assets transferred into an FLP back into the donor's gross estate.[8] However, beginning in 1997[9] the Courts began to uphold the IRS's challenges that Section 2036 should be used to bring assets transferred into an FLP back into the donor's gross estate[10] based on the theories of an express or implied understanding that

---

[7] I.R.C. § 2036(a). See generally Stefan F. Tucker & Mary A. Mancini, 14th PLI Annual Real Estate Tax Forum 53 (2d Vol. 2011).

[8] See e.g., Hackl 118 T.C. 279 (2002); Shelly D. Merritt, Family Limited Partnerships After Hackl and Strangi: Still a Viable Planning Technique?, (November 12, 2003)., http://www.cobar.org/index.cfm/ID/20720/subID/4007/TAX/Family-Limited-Partnerships-After-Strangi-And-Hackl:-Still-a-Viable-Planning-Technique?/.

[9] See Estate of Schauerhamer v. Comm'r, 73 T.C.M. 2855 (1997) (holding that since the partner retained a right to the income of the contributed property the asset should therefore be included in the partner's estate),

[10] See e.g., Strangi v. Comm'r, 85 T.C.M. 1331 (2003), aff'd, 417 F.3d 468 (5th Cir. 2005); Kimbell v. U.S., 244 F.Supp.2d 700 (N.D. Tex. 2003), vacated and remanded, 371 F.3d 257 (5th Cir. 2004); Estate of Thompson v. Comm'r, 84 T.C.M. 374 (2002); Harper v. Comm'r, 83 T.C.M. 1641 (2002); Estate of Turner v. Comm'r, 102

the assets would be available to the donor (Section 2036(a)(1)) and actual beneficial enjoyment by the donor (Section 2036(a)(2)).[11]

The theory of the existence of an express or implied understanding that the assets are available to the donor has been successfully argued by the IRS when some or all of the following facts are present: the donor made a death bed transfer of assets into an FLP[12]; the donor transferred the majority of his/her assets to an FLP without retaining a sufficient amount for his/her support[13]; the donor occupied the transferred residence without paying rent[14], the donor commingled personal and partnership assets[15]; the donor used partnership assets for personal use[16]; and the donor received disproportionate distributions from the partnership.[17] For example, in Strangi[18], the Court held that since the donor transferred most of his assets to the FLP there was an implied understanding that the FLP would support him and since the donor continued to reside in his transferred residence without paying rent, the property was included in the donor's gross estate.[19]

Prior to Strangi, the IRS had limited success in using the theory that retained control constituted beneficial enjoyment which could support bringing transferred property back

---

T.C.M. (CCH) 214 (T.C. 2011) supplemented sub nom. Turner v. Comm'r, 18911-08, 2012 WL 1058162 (T.C. Mar. 29, 2012).

[11] See Tucker, supra note 8.

[12] See Harper, 83 T.C.M. 1641 at 1 (holding that the property was brought back into the decedent's estate where the FLP was formed when the taxpayer was 86 and was suffering from cancer).

[13] See, e.g., Thompson, 84 T.C.M. 374 at 16 (holding that the property was brought back into the decedent's estate where the decedent transferred the majority of his assets to the FLP and therefore there was an "implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived"); See also Strangi, 85 T.C.M. 1331 (2003)Strangi .(holding that since the donor gave 98% of his assets there was an implied understanding that his children and the partnership would be his primary source of support).

[14] See, e.g., Strangi, 85 T.C.M. 1331 (2003) (holding that there was an implied understanding because the donor occupied the transferred residence without paying rent for two years).

[15] See, e.g., Turner, 102 T.C.M. (CCH) 214 (T.C. 2011).

[16] See id.

[17] See id.

[18] See e.g., Strangi v. Comm'r, 85 T.C.M. 1331 (2003), aff'd, 417 F.3d 468 (5th Cir. 2005).

[19] See also Thompson, 84 T.C.M. 374 at 16 (holding that the property was brought back into the decedent's estate where the decedent transferred the majority of his assets to the FLP and therefore there was an "implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived")

into the donor's estate. For example, in U.S. v. Byrum, 408 U.S. 125 (1972), the Supreme Court held that the donor did not retain the right to control the beneficial enjoyment of the property transferred to a trust where he was a majority shareholder and had the right to elect directors, because he had a fiduciary duty "not to misuse his power by promoting his personal interests at the expense of the corporate interests."[20]

Strangi is perhaps the seminal case for the IRS successfully asserting that property transferred into an FLP should be included in the donor's gross estate if the donor retains control over the beneficial enjoyment of the property. In Strangi, the Tax Court held that the property was included in the donor's estate because (1) the donor "retained the right *acting in conjunction with other Stranco shareholders*, to the property because he could designate who can enjoy benefit from the property by acting together with other Stranco shareholders to revoke the partnership"[21] and (2) the donor placed his attorney in fact in a position to make distribution decisions".[22] The Tax Court distinguished this case from Byrum because in Byrum the donor had fiduciary duties to unrelated parties, there was an independent trustee, and the trust held an operating business and not only investment assets.[23]

However, the Service was not so successful in Mirkowski v. Comm'r, 95 T.C.M. 1277 (2008), where the Tax Court held that property is not brought back into the donor's estate under Section 2036(a)(2) where the donor was precluded from participating in all three of the following: determining income allocation, determining the amount of cash to distribute, and amending the agreement.[24]

---

[20] See U.S. v. Byrum, 408 U.S. 125 (1972).Merritt, supra note 9.
[21] See Strangi, 85 T.C.M. at 13.
[22] See id. at 15.
[23] See generally Strangi 85 T.C.M. 374.
[24] See generally Mirkowski v. Comm'r, 95 T.C.M. 1277 (2008).Edward J. Giardina, Just When You Thought Securities FLPs Were Dead: Mirkowski Beats Section 2036(a)(2), (April, 2010).

As stated above, Section 2036 does not apply and the transferred property is not brought back into the donor's gross estate when there is a bona fide sale for adequate and full consideration.[25] This issue was addressed in Kimbell v. Commissioner[26], where the Fifth Circuit Court of Appeals held that there is a three part test to determine whether there is full and adequate consideration when assets are transferred to a partnership in exchange for a partnership interest; (1) if the interests given to the partners are proportionate to the fair market value of the assets they contributed to the partnership, (2) if the capital accounts are properly maintained to reflect these contributions, and (3) if the distributions in liquidation of the partnership or of the partners' interests in the partnership are determined on the basis of their respective capital balances.[27]

As stated in Kimbell, even if the full and adequate consideration test is met, a separate bona fide test must then be passed. The following factors are used to determined when the bona fide test is met: if the donor retains sufficient assets outside the Partnership for his/her own support and there is no commingling of Partnership and personal assets[28]; if the Partnership formalities are satisfied and the assets contributed to the Partnership are actually assigned to the Partnership[29]; if the assets contributed to the Partnership include interests that require active management[30]; and if there are several credible non-tax business reasons for the formation of the Partnership,[31] "such as asset protection, reduction of transaction and transfer costs, preservation of the assets within the family, and mediation of disputes by arbitration".[32]

---

[25] See I.R.C. § 2036(a).
[26] Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).
[27] Id.
[28] See id. at 267.
[29] See id.
[30] See id.
[31] See id.
[32] See HAROLD WEINSTOCK & MARTIN NEUMANN, PLANNING AN ESTATE 427 (Thomson Reuters/West, 2010).

However the bona fide test is not met when the following factors are present: if the donor stands on both sides of the transaction; if the Partnership was established without the other family members; if there is co-mingling of personal and partnership funds and paying estate planning fees from the partnership; and if assets were not transferred to the partnership until months after its formation.[33]

Based on the opinions in the seminal cases of Strangi, Thompson, and Kimbell, there is a significant risk that Section 2036 can be used to bring assets transferred to an FLP or Family LLC back into the donor's estate if he retains the possession or enjoyment of, or the right to the income from, the property, or the right to designate the persons who shall possess or enjoy the property or the income. However, even if such interests are retained the property will not be brought back in the donor's gross estate if there was a bona fide sale for an adequate and full consideration.

PROPER VALUATION TECHNIQUE FOR FLP/FLLC: INCOME VS. NAV APPROACH

Many estate plans involve the formation and transfer of family owned limited partnerships ("FLP") or LLCs ("FLLC"). As discussed above, FLPs and FLLCs have the ability to generate significant advantages to the client. The client can transfer assets to the FLP/FLLC and maintain control over the assets through the General Partner or Manager position. The client than transfers the non-controlling interests, which represent the bulk of the value of the FLP/FLLC, out of his or her estate at significant a discount. Needless to say, the valuations of these FLLCs/FLPs have been extensively challenged by the IRS during audits and have resulted in numerous cases.

[33] See Turner, 18911-08, 2012 WL 1058162 at 17.

One issue of contention is the proper method of valuation to use in appraising interests in a FLLC/FLP. There are two primary methods of evaluation that appraisers use: The first is called the net asset value approach, or NAV approach. This approach, in simple terms, takes the fair market value of the underlying entities held by the FLLC/FLP, primarily calculated based on comparable assets that have been sold recently, sums them up, and then applies discounts to arrive at the valuation. The second approach is the Income approach. The income approach uses a different analysis; it takes the cash flow that the partnership generates and calculates the value based on that.

These two approaches, while both trying to determine the price that a willing buyer and seller would agree upon in an arm's length, market transaction, more often than not end up with different significant values. The IRS and taxpayers often argue about how much weight should be given to each valuation approach. Typically both approaches are done and then in many cases a controversy erupts between the IRS and the tax payer as to how much weigh to give to each of these approaches in averaging out a final valuation.

The courts have given fairly clear guidance as to when each approach is appropriate and how much to weigh each of approaches. The courts consider the net asset value approach more appropriate to a liquidation value. In other words, if someone were to buy the FLLC/FLP; with plans to liquidate the partnership and sell out the underlying assets, then the NAV approach would be the analysis used to determine what the FLLC/FLP is worth to the purchaser. On the other hand, the income approach is more suitable to someone valuing the FLLC/FLP in terms of a continuing enterprise and a going concern. Such a potential buyer would care more about the cash flow and rate of return. Therefore, the Courts have been clear that to the extent the FLP/ FLLC/FLP was operated and structured as an ongoing business that is how much weight should be given to the Income approach. To the extent the FLLC/FLP was

operated as a passive investment company that is how much weight should be given to the NAV approach. Public Letter Ruling 59-60, the seminal guidance from the IRS on valuations of entities, also makes the same point. In Section 5, it states that when valuing operating companies, the appraiser shall "accord primary consideration to earnings," and when valuing passive investment/holding companies the appraiser may weigh more heavily the underlying values of the company's assets. The following cases are illustrative:

Most recently, in Giustina,[34] the Ninth Circuit held that a 100% income-based approach was appropriate in valuing a limited partner's interest in a FLP that held timberlands, because the partnership was an ongoing business. In doing so, the Ninth Circuit reversed the Tax Court, which had accorded partial weight to the NAV approach by reasoning there was a 25% probability the partnership would liquidate. The Ninth Circuit found this approach "too speculative" because it required the assumption that a "hypothetical buyer" would obtain admission as a limited partner and convince other limited partners to support a decision to liquidate, even though no limited partner had previously discussed the sale of an interest.[35] The Ninth Circuit concluded that it was "clear error to assign a 25% likelihood to these hypothetical events," and, thus, inappropriate to assign any weight to the NAV method.[36]

Weinberg[37] dealt with a dispute as to the valuation of an interest in a Family Limited Partnership that owned an apartment complex. The taxpayer in this case argued that both the Income approach and the NAV approach were appropriate while the IRS argued that only the income approach was appropriate. The IRS supported its argument as the taxpayer did not have a controlling interest in the FLP and therefore the NAV approach "is inappropriate for valuing the subject interest ... because the partnership's underlying asset was income-producing

[34] Estate of Giustina v. Commissioner, 114 A.F.T.R.2d 2014-6848 (9th Cir. 2014).
[35] Id.
[36] Id.
[37] TCM 2000-51 (2000)

real estate. Respondent argues that the net asset value is irrelevant because a hypothetical buyer could not control the sale of the underlying property or the liquidation of the partnership."

The Court held that both the Income and NAV approach should be used, with a weighting of 75/25 for the Income and NAV. This weighting was proper as it "adequately reflected the attributes of this partnership." In supporting the 25% NAV weighting the Court says: "The net asset value should still be considered because the value of the underlying real estate will retain most of its inherent value even if the corporation is not efficient in securing a stream of rental income." However, the income approach was more appropriate as the FLP was operated as an ongoing concern and as such the cash flow analysis is more important than the liquidation value.

Andrews[38] was a dispute over the valuation of stock in several closely held corporations that were involved primarily in the ownership, operation, and management of commercial real estate properties. Among the contested issues was to what extent each of the NAV and income approaches should be used.

The Court identified that the corporations had characteristics as both passive investment companies and therefore NAV is appropriate and also as active operating companies and therefore income approach is appropriate. NAV is appropriate as "the value of the underlying real estate will retain most of its inherent value even if the corporation is not efficient in securing a stream of rental income. Income approach is appropriate because "The corporations are businesses, engaged in the maintenance and management of these real estate properties. Thus, some of the value attached to the corporations must be based upon the

[38] 79 TC 938 (1982), superseded by statute on other grounds, as stated in Estate of Jelke v. C.I.R., 507 F. 3d 1317 (11th Cir., 2007).

operating nature of the businesses, with attention paid to their earnings and dividend history, management, and prospects for growth."

Tanenblatt[39] was a dispute as to the valuation of an interest in an LLC which leased a building and operated it as a going concern. The IRS argued for a NAV approach to evaluate the LLC interest, asserting that the LLC was not a going concern, but a real estate holding company. However, the IRS's proposed valuation was based on the taxpayer's own valuation of the underlying asset, the building held by the LLC. For the building appraisal, the taxpayer had used an income-based approach.[40] The taxpayer argued that the income-based approach should also be used to evaluate the LLC interest.[41] The court ruled in favor of the IRS and allowed the NAV approach, but only because it saw no evidence that using the income-based approach would result in a different valuation.[42]

Thus, Tanenblatt was a narrow holding. The court stated that the taxpayer's LLC was a going concern, not a real estate holding company, and the valuation of a going concern normally would require weighing the income-based approach, as in Weinberg and Andrews.[43] The court upheld the NAV approach only because there was no evidence that using the income-based approach would result in a different valuation.[44]

Dunn[45] was a dispute as to the valuation of shares in a private company that rented out heavy equipment. The Tax Court had used both NAV and income approach, weighted 65/35. The Court of Appeals questioned if the NAV approach was appropriate at all as the company was clearly a going concern and ruled that a 85, income/15, NAV split was appropriate.

---

[39] Tanenblatt v. C.I.R., TCM 2013-263 (2013)
[40] Id. at *10.
[41] Id.
[42] Id. at *11.
[43] Id.
[44] Id.
[45] 301 F.3d 339 (2002), declined to extend on other grounds by Estate of Richmond v. C.I.R., TCM 2014-26 (2014).

The company was and had always been "a viable operating company" which "earned a significant part of its revenues from selling services as well as renting equipment" and that there were "significant active operational aspects to the company as of the valuation date." The Court found little likelihood that the company would be liquidated and therefore the NAV approach was not appropriate; "Liquidation would be expensive and time-consuming." The Court mocked the IRS's insistence on exclusively using a NAV approach: "Consequently, the Commissioner's insistence at trial that the value of the subject stock in Dunn Equipment be determined exclusively on the basis of the market value of its assets, undiminished by their inherent tax liability-coupled with his failure to adduce affirmative testimony of a valuation expert-was so incongruous as to call his motivation into question. It can only be seen as one aimed at achieving maximum revenue at any cost, here seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement-or, failing that, then a compromise judgment-somewhere between the value returned by the taxpayer (which, by virtue of the Commissioner's eleventh-hour deficiency notice, could not effectively be revised downward) and the unsupportedly excessive value eventually proposed by the Commissioner." "The Commissioner's legally and factually absurd contention at trial that no weight should be given to the Corporation's earnings-based value and that its value should be based entirely in an asset-based approach."

The Court ruled that there should be no adjustment for the "likelihood of liquidation" as that likelihood is built-in to both the income approach (that the assets will definitely be retained) and the NAV approach (that the assets will definitely be sold). The Court determined the weight to be given to each approach by calculating "the likelihood of liquidation vis-à-vis the likelihood of indefinitely retaining and using the assets."

In Knott[46] the Court, in valuing a partnership that owned a rental apartment project held that the NAV approach is not appropriate as: "[the partnership] was an ongoing business. There is no indication that the partners intended to liquidate ... as of the date of the trial, they had not done so. Thus, liquidation value is not an appropriate measure of value in this case." Also in Deputy[47], the Court held that the income approach was correct as "the income approach is the best approach for valuing [the LP], a long-established, financially successful, closely held operating company that has shown consistent profit and growth." "Generally, we agree...that an asset value approach is inappropriate in valuing a long-established, financially successful operating company."

PARAMETERS OF ENTITY AGREEMENTS

In 1990, Congress enacted Sections 2703 and 2704 to curtail certain types of tax avoidance. These strategies used restrictions in entity agreements to discount values of assets with no true loss in value or control to the owners. This allowed for the transfer of property to family members at a discounted value, and therefore lowering transfer taxes.[48]

In general, Section 2704(b) has not been a very effective tool for the IRS to combat valuation discounts. Taxpayers have figured out ways to structuring around this provision. The IRS has had greater success basing its attacks on Section 2703 to stop taxpayer use of discounted values for the assets without a real business purpose and without loss of actual value or control by the owners. Thus, the IRS has had limited success in applying section 2703

---

[46] TCM 1988-120

[47] TCM 2003-176, distinguished on other grounds by Kohler v. C.I.R., TCM 2006-152 (2006).

[48] Section 2703 was enacted because of the concern that taxpayers were using restrictions in entity agreements to lower taxes by artificially discounting values of the assets with no true loss in value or control to the owners. Section 2704 was enacted to prevent taxpayers from transferring property to family members at a discounted value, and therefore lowering transfer taxes, when there is no permanent restriction. See Rick J. Taylor, Discount Partnership Arrangements Still Can be Used to Reduce Transfer Taxes, vLex (June 1992) http://law-journals-books.vlex.com/vid/discount-arrangements-reduce-transfer-53337565.Rick J. Taylor, Discount Partnership Arrangements Still Can be Used to Reduce Transfer Taxes, vLex (June 1992) http://law-journals-books.vlex.com/vid/discount-arrangements-reduce-transfer-53337565.

to limit valuation discounts where there was clearly no business purpose for the FLP, such as when the only asset in the FLP was stock of a publicly traded company. These authorities are discussed in greater detail below.

1. IRS's Lack of Success Using 2704(b) to Disregard Restrictions in Determining Valuation

The IRS has not had success in using Section 2704(b) to challenge valuation discounts for transferred FLP interests. Section 2704(b) provides that when valuing a transfer of interest in a controlled[49] partnership or corporation ("entity")[50] to or for the benefit of a family member[51], applicable restrictions on the ability to liquidate the entity are disregarded.[52] The Treasury Regulations provide that "a restriction is an applicable restriction only to the extent that either the restriction [on an entity's ability to liquidate] by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer",[53] and the restrictions are more limiting than state law.[54] The following **however** are not considered applicable restrictions: any liquidation restriction that is less restrictive than state law,[55] even a restriction listing a term of years after which the partnership will dissolve;[56] "any commercially reasonable restriction which

---

[49] Control means at least 50% of the stock of a corporation, at least 50% of the capital or profits interests in a partnership, or in the case of a limited partnership the holding of any interest as a general partner. I.R.C. §2701(b)(2).

[50] "An individual shall be treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust, or other entity. If any individual is treated as holding any interest by reason of the preceding sentence, any transfer which results in such interest being treated as no longer held by such individual shall be treated as a transfer of such interest". §2701(e)(3).

[51] Family members include an individual's spouse, ancestors, lineal descendant's, brother, brother's spouse, sister and sister's spouse. I.R.C. §2704(c)(2).

[52] See Laurence Keiser, Shielding the Family Limited Partnership from IRS Attacks, The CPA Journal (2009).

[53] Treas. Reg. § 25.2704-2(b).

[54] See id.

[55] See id.

[56] See Kerr v. Comm'r, 113 T.C. 449, 473 (1999) aff'd, 292 F.3d 490 (5th Cir. 2002) (holding that a restriction listing a term of years that the partnership will dissolve by is not an applicable restriction as long as the restriction is less restrictive then state law and the state "law provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners, and the restrictions contained in . . . the partnership agreements are no more restrictive than the limitations that generally would apply to the partnerships under [state] law".)

arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or any restriction imposed, or required to be imposed, by any Federal or State law" as provided in Section 2704(b);[57] any restrictions against limited partnerships continuing beyond a certain point in time or the accomplishment of an event;[58] and any "restriction on the right of a limited partner or a member of an LLC to withdraw from the entity and receive value for his or her interest is not an applicable restriction if state law does not give the limited partner or member such a right at all."[59]

Various Court challenges to minimize valuation discounts under Section 2704(b) were brought by the IRS with no success. For example, in Kerr v. Comm'r, 113 T.C. 449 ("Kerr"), the Tax Court held that even though there was a transfer of FLP interests to the Kerr's children, immediately before the transfer the Kerr's and their children controlled the FLP, and the restrictions were applicable restrictions because the Partnership agreement stated that the FLP will liquidate only on December 31, 2043 or by agreement of all the partners, which limited the FLPs ability to liquidate, Section 2704 still did not apply because the liquidation restrictions were no more restrictive than the state laws that "provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners."[60]

---

[57] I.R.C. §2704(b)(2)(B).
[58] See John W. Porter, 41st Annual Heckerling Institute on Estate Planning 7 (2007).
[59] Louis A. Mezzull, Estate and Gift Tax Audits Luce, Forward, Hamilton & Scripps LLP (2007) http://www.bcepc.net/Bristol-MA/Library/Suggestions%20for%20estate%20%26%20gift%20tax%20audits.pdf.
[60] See idId. at 473. See also Estate of Jones v. Comm'r, 116 T.C. 121 (2001) and Knight v. Comm'r, 115 T.C. 506 (2000), have similar facts to Kerr I and the Tax Court also held that § 2704 did not apply because the liquidation restrictions were no more restrictive than the Texas state laws.

On appeal, the Fifth Circuit Court of Appeals[61] affirmed the Tax Court's decision that Section 2704 did not apply, but for a different reason. The Court held that there were no applicable restrictions because the University of Texas, a charity, was a third party partner. The Court held that it does not matter that the University of Texas stipulated that it would probably consent to remove the restriction because all that matters is the fact that the University is a non-family member and therefore does not meet the family member requirement in Section 2704(b).[62]

Court decisions, such as Kerr, and the enactment of restrictive statutes in most states, in effect, have reduced the effectiveness of section 2704(b) for the IRS to disregard liquidation restrictions.[63] Therefore, the Obama Budget Proposals for FY 2013 included certain proposals to expand the scope of Section 2704 by creating more categories of disregarded restrictions and thus to further limit valuation discounts those proposals have not as of the date hereof been enacted.[64] As of the date of this writing, no such provisions have been enacted and the Obama Budget Proposals for FY 2014 did not replicate the proposal.

The Treasury is working on proposed regulations for Section 2704, and has indicated that they will reflect many of the suggestions in the 2013 proposal.[65] Commentators have speculated that the proposed regulations may provide for a new disregarded restriction where a transferee is restricted from becoming a full partner (as opposed to an assignee) in the family-controlled partnership.[66] Furthermore, and in direct contrast to the Fifth Circuit's decision in *Kerr*, partnership interests held by charities (and, potentially, other entities which are not

---

[61] Kerr v. Comm'r, 292 F.3d 490 (5th Cir. 2002).
[62] See Kerr, 292 F.3d 490 at 494.
[63] See DEPARTMENT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS (2012).
[64] See id.
[65] Steve R. Akers, Speculation About Upcoming Section 2704 Proposed Regulation (June 2015).
[66] See id.

family members of the transferor) may be deemed held by the family.[67] In addition, there may be a safe harbor allowing a family-controlled entity to avoid Section 2704 by meeting standards promulgated in the new regulations.[68] The proposed regulations may offer consolation to taxpayers in situations where Section 2704 results in the value of the interest for transfer tax purposes exceeding its fair market value; in these situations, taxpayers may be allowed to use this higher value for marital and charitable deductions.[69] At a recent conference a senior Treasury official indicated that the proposed regulations may be issued before the end of 2015.[70]

2. IRS's Success Using 2703 to Disregard Restrictions in Determining Valuation

Unlike with Section 2704(b), the IRS has had some success in challenging to minimize valuation discounts regarding transfers of FLP interests under Section 2703. Section 2703(a)[71] provides the general rule that a transferor must disregard rights[72] or restrictions[73] on property[74] when valuing such property for estate tax, gift tax, and generation-

---

[67] Id.
[68] Id.
[69] Id.
[70] Id.
[71] The provisions of Section 2703 only apply to options and agreements entered into, or substantially modified, after October 8, 1990. The Treasury Regulations provide that "a right or restriction that is substantially modified is treated as a right or restriction created on the date of the modification. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless the addition is mandatory under the terms of the right or restriction or the added family member is assigned to a generation (determined under the rules of § 2651 of the Internal Revenue Code) no lower than the lowest generation occupied by individuals already party to the right or restriction. Treas. Reg. § 25.2703-1(c)(1).
[72] If property is subject to multiple rights or restrictions then the failure of one right or restriction to meet the exception of § 2703(b) has no effect on any other right or restriction. Treas. Reg. § 25.2703-1(b)(5).
[73] Rights or restrictions include: (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (determined without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property. I.R.C. § 2703(a). However, n easement that qualifies for a charitable deduction under Section 2522(d) or Section 2055(f) is not considered a right or restriction under Section 2703. Treas. Reg. § 25.2703-1(a)(4).
[74] The Court of Appeals for the Fifth Circuit held that property refers to the interests in a Family Limited Partnership, and not the actual assets. Therefore, the partnership form itself is not a restriction that must be

skipping tax purposes. However, Section 2703(b) gives an exception to this rule of disregarding rights and restrictions when valuing property if each[75] of the following three requirements are met:[76] (1) the right or restriction is a bona fide business arrangement; (2) the right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and (3) at the time the right or restriction is created, its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.[77]

The Statute and Regulations do not define bona fide business arrangement, but case law has determined the following: the maintenance of family ownership and control over the business is considered a legitimate business purpose;[78] and a business does not have to be actively managed to meet the bona fide business requirement.[79] However there is no bona fide business arrangement when "a partnership holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy",[80] and when the restrictions are for purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children.[81]

---

disregarded. See Strangi, Estate of v. Comm'r, 293 F.3d 279 (5th Cir. 2002); See also 34B Am. Jur. 2d Federal Taxation ¶ 147,952.

[75] "The restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for testamentary disposition". Lauder v. Comm'r, 64 T.C.M. 1643 (1992)(emphasis added); See also Treas. Reg. § 25.2703-1(b)(2).

[76] The exception is met if more than 50% of the property subject to the right or restriction is owned by individuals who are not family members of the transferor. Treas. Reg. § 25.2703-1(b)(3).

[77] I.R.C. § 2703(b).

[78] See St. Louis County Bank v. United States, 674 F.2d 1207, 1210 (8th Cir. 1982); See also Estate of Lauder v. Comm'r, 64 T.C.M. (CCH) 1643 (T.C. 1992); See also Estate of Bischoff v. Comm'r, 69 T.C. 32, 40 (1977).

[79] See Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (T.C. 2006) (holding that it is a bona fide business when the purpose is to enhance the liquidity of an otherwise illiquid asset).

[80] See Holman, 601 F.3d 763 at 770; See also Fisher v. U.S., 106 A.F.T.R.2d 2010-611 (S.D. Inc. 2010); See also Steve R. Akers, Holman v. Commissioner; Fisher v. United States, BESSEMER TRUST (October 2010) at 20; and planning for the future needs of decedent's estate is also considered a business purpose under Section 2703(b)(1). Amlie v. Comm'r, 91 T.C.M. (CCH) 1017, 1026 (T.C. 2006).

[81] See Holman v. Comm'r, 601 F.3d 763, 772 (8th Cir. 2010).

The non-device requirement is a two pronged test. First, the Court first must determine whether a natural object of the transferor's bounty is benefitting from the transfer. If this is not the case, then there is no issue. However, if a natural object of the transferor's bounty is benefitting then the Court must move to the second prong and determine if the transfer was for full and adequate consideration.[82]

The following are factors that the courts have used to determine whether the first prong is met and the agreement is a device and a testamentary substitute: the health or age of the decedent when entering into the agreement; the lack of regular enforcement of the agreement; the exclusion of significant assets from the agreement; the arbitrary manner in which the price term was selected, including the failure to obtain appraisals or seek professional advice; the lack of negotiation between the parties in reaching the agreement terms; whether the agreement allowed for adjustments or revaluation of its price terms; whether all the parties to the agreement were equally bound to its terms; and any other testimony or evidence highlighting that the agreement supported the decedent's testamentary plan.[83]

The following are considered to be less than full and adequate consideration: when a transferor owns a majority of interests in a Family Limited Partnership, he is considered to have retained the unilateral ability to amend or modify the restrictive provision and as a result, the terms of the restrictive provision are not binding on the transferor and should be disregarded when determining value for Federal gift tax purposes because otherwise it would be a device to obtain a higher valuation discount,[84] and options that allow transferors to purchase an interest in an entity at less than its pro rata value and redistribute the interests to their other children are

[82] See Estate of Gloeckner v.Comm'r, 152 F.3d 208, 214 (2d Cir. 1998).
[83] See True, 390 F.3d at 1220.
[84] See Smith v. United States, 02-264 ERIE, 2005 WL 3021918 (W.D. Pa. July 22, 2005).

considered.[85] However, a fixed price for a stock interest, whose value is uncertain due to a circumstance such as pending litigation is considered adequate consideration and not a device to transfer to the transferor's bounty for less than full consideration.[86]

Various court challenges to minimize valuation discounts were brought by the IRS prior to 2010. These challenges had no success because the Courts held that preserving a family business,[87] enhancing the liquidity of otherwise illiquid assets,[88] and even having a restriction that automatically converts shares with voting rights to shares with no voting rights upon a sale of the stock[89] are all considered business purposes in order to meet the safe harbor of Section 2703(b). However, in 2010 the Courts upheld the IRS's challenges that Section 2703 should be used to minimize valuation discounts when the FLP's only asset is publicly traded stock and there is no specific investment strategy.[90]

DEFINED VALUATION CLAUSES: GENERALLY

Transfers of real estate, or interests in entities that own real estate, raise many difficult valuation challenges. One of the principal advantages of the grantor retained annuity trusts under section 2702 is that if there is a valuation challenge, the annuity is allowed to self

---

[85] See Holman v. Comm'r, 130 T.C. 170, 197 (2008) aff'd, 601 F.3d 763 (8th Cir. 2010).

[86] See Alden Koste, The IRS Fished Its Wish; The Ability of Section 2703 to Minimize Valuation Discounts Afforded to Family Limited Partnership Interests in Holman v. Commissioner, 59 CATH. U. L. REV. 289, 305 (2009).

[87] See Church v. U.S., 85 A.F.T.R.2d 2000-804 (W.D.Tex.), aff'd, 268 F.3d 1063 (5th Cir. 2001), (where an FLP was created mainly to preserve the family's ranch as a family business. The partnership agreement contained term restrictions and restrictions on the sale of the partnership interests. In a favorable opinion for the taxpayer, the Court held that these restrictions could be considered in the valuation of Mrs. Church's partnership interests, and § 2703(b) was satisfied, because these restrictions are part of the property interest itself).

[88] See Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (T.C. 2006) (where the decedent's family put a right or restriction, through a settlement agreement, on the price of the decedent's stock due to uncertainty of the stock's value. The Tax Court held that this restriction should not be disregarded because the safe harbor of § 2703(b) was met. The Court held that (1) this was a bona fide business arrangement because the purpose was to enhance the liquidity of an otherwise illiquid asset, (2) this was not a device to transfer the property to the decedent's family for less than full and adequate consideration because the value was uncertain due to pending litigation, and (3) it was comparable to similar arrangements entered into in arm's length transaction because the family was able to show a similar agreement from 1994 that has similar terms).

[89] See Estate of Smith v. United States, 07-676T, 2012 WL 591506 (Fed. Cl. Feb. 13, 2012) (holding that this is not a restriction on "property and cannot be sold separately from the underlying stock. Therefore, there [can] not be a sale of the enhanced voting rights, only a sale of the stock to which those rights related").

[90] See Holman v. Comm'r, 130 T.C. 170, aff'd, 601 F. 3d 763, 772 (8th Cir. 2010); See also Fisher v. U.S., 106 A.F.T.R.2d 2010-611 (S.D. Inc. 2010)

adjust as the annuity amount is stated as a percentage of the assets transferred, not a fixed dollar amount. Thus, an inadvertent gift tax will not arise. Other techniques have historically been at a disadvantage since there were questions as to whether such a self-adjustment mechanism would be respected by the IRS. More recently, the cases have recognized the efficacy of certain types of valuation clauses. This respect for properly structured valuation clauses has taken a significant risk factor out of planning for difficult to value assets – such as real estate and interests in entities that hold real estate.

A defined valuation clause is used to minimize valuation uncertainty in connection with transfer tax planning.[91] In order to accomplish this, a donor must maximize his/her exemptions and credits. The exemption that has received the most judicial scrutiny is the lifetime gift tax exemption,[92] which allows the donor to make gifts up to the amount of the gift tax exemption ($5,120,000 for 2012), without having to pay any gift tax.[93] However, this would also apply to the annual gift tax exclusion and other credits and exemptions. When a donor wants to make a gift of cash, it is simple to figure out the amount that s/he can give without incurring any tax liability. However, when a donor wants to transfer an interest in a closely held corporation or family limited partnership, it is much more difficult to value the amount of the gift for gift tax purposes because the underlying value of the interests transferred are not readily marketable.

There are two principal types of defined valuation clauses: formula transfer clauses and formula allocation clauses, the latter of which is favored by the Courts.[94] The first type is a savings clause, which is also known as a formula transfer clause, and limits the amount

---

[91] The transfer of property during lifetime is subject to gift tax. See I.R.C. § 2512.

[92] See Scott A. Bowman, McCord v. Commissioner; Defined Value Clauses Redefined?, 33 ACTEC J. 169, 171 (2007). See Bowman, supra note 1, at 171.

[93] See I.R.C. § 2505(a)(1), as amended by 2010 Tax Relief Act §301(b)(1)(A).

[94] See Hamid M. Pour, Formula and Defined Value Clauses – the Fight against the IRS's Public Policy Arguments, (2010).

transferred. For example, a taxpayer may transfer to the trustees of a trust a fractional share of the property (where the fractional share is determined by a formula) and require that if the IRS finds a higher value that the excess be returned to the donor or deems that excess not to have been transferred in the first instance.[95] The second type is a "formula allocation clause" which completely transfers an asset, but allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees include charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values.[96]

Formula transfer clauses may be easier to administer, but the Courts have favored formula allocation clauses. We can infer from Christiansen and Petter[97] that formula allocation clauses are favored, especially where there is a third party who is adverse to a lower valuation, such as a charity, because (1) the Christiansen Court's main rationale for allowing such clauses is that there are mechanisms to ensure that values are accurately reported, and it is therefore not contrary to public policy and (2) the Petter Court states that they look negatively on a clause that tries to give property back to the donor.[98]

The courts have validated two different approaches to formula allocation clauses: the McCord-Confirmation Agreement Approach and the Petter-Finally Determined Gift Tax

---

[95] See id.
[96] See Petter – Defined Value Clause Upheld; "One-Two Punch" to IRS's Fight Against Defined Value Clauses (LEIMBERG INFO. SERVS., INC.), Jan. 14, 2010.
[97] See supra pp. 23-24.
[98] See Petter v. Comm'r, 653 F.3d 1012, 1022 (9th Cir. 2011); See also Petter, supra note 183.

Value Approach. The first approach was used in McCord and Hendrix to allocate the shares based on a confirmation agreement among the transferees. The advantages of the confirmation agreement approach are that the transferees decide how much they receive,[99] and the value is determined quickly.[100] The second approach was used in Christiansen and Petter to allocate the block of transferred assets based on values as finally determined for estate or gift tax purposes. There may be more certainty regarding the validity of these types of clauses, but disadvantages are that the transferees are not negotiating how much they receive and the value is not determined for a long time.[101]

1. Judicial Background of the Validity of Defined Valuation Clauses

Until recently the IRS had been successful in challenging the validity of defined valuation clauses.[102] For example, in Comm'r v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), the Fourth Circuit Court of Appeals held that a clause in a trust indenture[103] stating that if any federal court of last resort determined that any part of the transfer was subject to gift tax then the gift portion would not be included in the transfer and would remain in the donor's estate is not valid because it is a condition subsequent that violated public policy because it discourages the collection of tax, obstructed the administration of justice by requiring the court to pass on a moot case and caused any court opinion to be a mere declaratory judgment.[104]

---

[99] See Steve R. Akers, Defined Value Clause Updates Hendrix and Petter (2011).
[100] See Id.
[101] See id.
[102] See, e.g., Ward v. Comm'r, 87 T.C. 78 (1986); Harwood v. Comm'r, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986).
[103] A trust indenture is an agreement in the bond contract made between a bond issuer and a trustee that represents the bondholder's interests by highlighting the rules and responsibilities that each party must adhere to. *Trust Indenture*, INVESTOPEDIA (2012).
[104] The IRS, in Revenue Ruling 86-41, 1986-1 T.C. 300, also refused to recognize two different types of valuation adjustment clauses contained in a deed of a gift of real estate. The first clause provided that the transferee would reconvey to the transferor a sufficient portion of the real estate to reduce the value of the transferred interest to $10,000 as of the date of the gift. The second clause required that the transferee repay to the transferor an amount

However, beginning in 2006 the Courts started to give effect to defined valuation clauses. In McCord v. Comm'r,[105] 461 F.3d 614 (5th Cir. 2006), rev'd, 120 T.C. 358 (2003), the Fifth Circuit Court of Appeals gave effect to a formula allocation clause,[106] but did not discuss the public policy argument. Then, in Christiansen v. Comm'r, 586 F.3d 1061 (8th Cir. 2009), the Eighth Circuit Court of Appeals rejected the public policy argument against a formula disclaimer that had the effect of limiting the estate tax exposure of an estate regardless of what values the IRS used in the estate tax audit,[107] and in Petter v. Comm'r, 653 F.3d 1012 (9th Cir. 2011), the Ninth Circuit Court of Appeals affirmed the Tax Court's ruling that formula allocation provisions are not void as contrary to public policy in an inter vivos gift/sale transaction.[108] Taken together these cases validate defined valuation clauses for gift and estate tax purposes. However, defined valuation clauses that involve a condition subsequent in which the donor tries to take property back based on IRS redetermination still do not work.

The most recent decision to uphold defined valuation clauses is Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (T.C. 2012), where the Tax Court held that a defined valuation clause was valid even where there was no charitable donee receiving any part of the

---

equal to the excess of the value of the property over $10,000, as determined by the IRS. The IRS rejected both of those provisions because Rev. Rul. 65-144, 1965-1 C.B. 442, states that this would defeat the purpose of the gift tax provisions.

[105] See also Hendrix v. Comm'r, 101 T.C.M. (CCH) 1642 (T.C. 2011) (where Tax Court held consistently with McCord that a formula gift clause, in a gift to a family trust where the excess passes to a charitable donee, works where the clause limits the size of the portion of a transfer of stock passing to trusts for the transferors' descendants to a set amount while any excess value was to be transferred to a community foundation because (1) the gift agreement was negotiated at arm's length because the trusts assumed economic and business risk and where therefore at odds with the petitioner and the charitable donee and (2) the clause did not violate public policy because public policy is to encourage giving gifts to charity, which is consistent with Christiansen).

[106] In McCord v. Comm'r, 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003), the Fifth Circuit Court of Appeals held that the formula allocation clause in a gift that was based on a confirmation agreement between the donees was the necessary measurement for determining the value of the gifts.

[107] The court gave three reasons: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent expressing a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported.

[108] The Tax Court held that formula allocation clauses are not contrary to public policy because public policy encourages charitable gifts, the allocation clauses would be implemented fairly, the case involves a real issue and not just a declaratory judgment, and other regulations allow different types of formula clauses.

property. By doing so, the "Tax Court reconfirmed the distinction between the type of clause used in Procter (which is void because it involves a condition subsequent (i.e., the IRS redetermination) and the type of defined value clauses upheld in the more recent cases (which relies on a 'condition precedent' to transfer a 'fixed set of rights with uncertain value')". Although the IRS initial filed a notice of appeal with respect to the Tax Court decision in Wandry, it was subsequently withdrawn. The IRS has since published a nonacquiescence, meaning that the IRS will not follow the Wandry Tax Court opinion.[109]

GIFT TAX EXCLUSION

Historically, annual exclusion gifts[110] provided a method to seed estate planning transactions. Especially for those with large families, and with the use of "Crummy" powers, the annual exclusion would be a vehicle for funding a trust which could eventually enter into a leveraged estate planning transaction. Today, with the higher lifetime exemptions, there is less emphasis on using annual exclusion gifts for this purpose. Moreover, recent case law has raised question as to the viability of gifting of interests in family limited partnerships and limited liability companies to qualify for the annual exclusion. While they are not totally out of use, they are much less favored. Instead, the tendency is to use the annual exclusion to make cash gifts for incidental items and to use the lifetime exemption for the larger interests.

Nevertheless, for those situations where annual exclusion gifting of interests in family partnerships and limited liability companies is still contemplated, care must be exercised

[109] See Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (T.C. 2012), nonacq., 2012-46 (Nov. 13, 2012).

[110] Section 2503(b) gives a taxpayer an annual gift tax exclusion for gifts of present interests. The exclusion, currently at $14,000 per year per donee ($28,000 if the donor is married and elects to split gifts with his/her spouse), is adjusted for inflation and does not count towards the gift tax exemption of $5,430,000. Section 25.2503-3(a) provides that future interests include "reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time." Section 25.2503-3(b) provides that a present interests is an "unrestricted right to immediate use, possession, or enjoyment of property or the income from property".

in structuring the gift to avoid the pitfalls that have arisen in recent cases. These cases are discussed below.

1. Historical Background of Gifts of Limited Partnership Interests Qualifying for the Annual Gift Tax Exclusion

Historically gifts of a limited partnership interest were widely considered to be a present interest as long as it was transferred outright and not through a conduit of a trust. Even the IRS generally gave favorable rulings regarding the allowance of FLP interests qualifying for the annual gift tax exclusion.[111] However, in the early 2000's this trend began to change as the Courts held that certain requirements must be met in order for a gift of a limited partnership interest to be considered a present interest. For example, the Courts in Hackl,[112] Price,[113] and Fisher[114] held that there was no present interest, and therefore no annual gift tax exclusion allowed, where the donor transferred the interests to his/her children when (i) the operating agreements had too many restrictions on the transferability of limited partnership interests (and therefore did not give the donees a substantial present economic benefit from the actual limited partnership interests) and (ii) the limited partnership did not meet the three pronged test of (1) that the limited partnership would generate income at or near the time of the gifts, (2) that some portion of that income will flow steadily to the donees, and (3) that the portion of income flowing to the donees can be ascertained (and therefore there was no substantial present economic benefit from the income from the partnership interests). However, there would have been a present interest if the requirements had been met. For example, in Wimmer v. Comm'r, T.C.M. (RIA) 2012-157 (T.C. 2012), the Tax Court held that a donor can qualify for the annual gift tax exclusion when the FLP holds publicly traded and dividend paying stock, some portion

[111] See, e.g., I.R.S. TAM 8611004 (Nov. 15, 1985), I.R.S. TAM 9131006 (Aug. 2, 1991), TAM 9415007 (Jan. 12, 1994), TAM 199944003 (July 2, 1999).
[112] See Hackl v. Comm'r, 335 F.3d 664 (7th Cir. 2006), aff'g, 118 T.C. 279 (2002).
[113] See Price v. Comm'r, T.C.M. (RIA) 2010-002 (T.C. 2010).
[114] See Fisher v. United States, 1:08CV0908-LJM-TAB, 2010 WL 935491 (S.D. Ind. Mar. 11, 2010).

of the Partnership income was expected to flow steadily to the limited partners based on the fiduciary obligations of the general partners, and the stock was publicly traded so the limited partners could estimate their allocation of quarterly dividends on the basis of the stock's dividend history and their percentage ownership in the partnership, because the donee has a present interest in the income from the FLP interests.

Based on the aforementioned cases the following considerations should help ensure that gifts of FLP interests constitute present interests and qualify for the annual gift tax exclusion: avoid gifts of FLP interests themselves, and rather gift the property that will be placed in the FLP, give the donees Crummey powers, so that at least part of the gift will be considered a present interest, use put rights which allow the donee to sell the interest and therefore give them a present interest, give income-producing property and/or make regular distributions to the donees, and avoid very restrictive agreements regarding the transferability of the interests.[115]

REAL ESTATE HOLDINGS ARE ILLIQUID – METHODS OF DEFERRING ESTATE TAX PAYMENTS

One of the greatest difficulties in planning for real estate owners is that the real estate tends to be highly illiquid. The estate of the high net worth real estate owner may lack the funds to pay the estate taxes imposed upon what may be very significant values. Unlike the holder of a portfolio of marketable securities and cash, the real estate owner may not be able to readily raise the cash to pay an estate tax without incurring heavy losses through a fire sale. While there exists possibilities such as refinancing and life insurance planning, these options may not always be available and may be very costly. Moreover, even if they are available, there may be a desire to use these options for future needs of the business. Therefore, it is often necessary to rely upon methods to defer the payment of estate taxes.

[115] See Robert W. Malone & Jon R. Stefanik, Fisher and Price: The End of Annual Exclusion Gifts of FLP Interests, or Mere Child's Play?, TAXES-THE TAX MAGAZINE, Oct. 2011, at 28.

Note the availability of section 6166 deferral may be a central consideration in planning for the real estate client. In that regard, planning with IDGTs may impact the availability of section 6166 to the estate. For example, if active real estate assets are sold to a grantor trust in exchange for an installment note, the installment note is not considered an interest in an actively managed trade or business while the real estate may have been. Thus, if a major portion of the estate is comprised of real estate assets that would otherwise qualify for deferral of estate taxes under section 6166, the overuse of the installment sale to the IDGT could preclude section 6166 if real estate assets were transferred to an irrevocable trust in exchange for promissory notes which do not constitute the type of assets that qualify for such deferral.

There are three types of deferral listed in the Internal Revenue Code that allow a taxpayer to defer estate taxes beyond nine months after the date of death.[116] The first type of deferral is allowed when the executor can show reasonable cause or undue hardship.[117] The second type of deferral is allowed when the estate consists of reversionary or remainder interest.[118] The third type of deferral is allowed when a significant portion of the estate consists of an interest in a closely held business.[119]

1. First Type of Deferral: Section 6161 Reasonable Cause/Undue Hardship Deferral

Section 6161 allows an estate to defer estate taxes for up to 12 months if the executor can show reasonable cause or up to 10 years if s/he can show undue hardship. The requirements for the § 6161 deferral are broader than the § 6166 deferral as there is no

[116] See HAROLD WEINSTOCK & MARTIN NEUMANN, PLANNING AN ESTATE 36 (Thomson Reuters/West, 2010).
[117] I.R.C. § 6161.
[118] I.R.C. § 6163.
[119] I.R.C. § 6166.

requirement that the business must be closely held, there are no penalties for acceleration, there are no percentage requirements, and there are no active business requirements.[120]

The Treasury Regulations provide the following factors to be used to show reasonable cause and allow an estate to defer estate taxes for up to 12 months: the executor does not have control of the estate's liquid assets; a substantial part of the assets are comprised of rights to receive payments in the future (i.e. annuities, copyright royalties, contingent fees, or accounts receivable); a substantial part of the assets consists of assets that cannot be collected without litigation; or an estate has insufficient funds to pay the estate tax and has made reasonable efforts to convert the assets into cash.[121]

Undue hardship is more difficult to demonstrate than reasonable cause, and a general statement of hardship or an inconvenience to the estate is not enough. The Treasury Regulations provide two examples that illustrate undue hardship. One example is where a closely held business comprises a significant portion of an estate, but the percentage requirements of § 6166(a)[122] are not satisfied. The second example is that the assets must be sold at a sacrifice price or in a depressed market in order to pay the estate tax.[123]

The Treasury Regulations provide that an application for extension based on reasonable cause or undue hardship must be filed with the appropriate district director, who has the discretion to decide if and for how long a deferral is needed, on or before the date fixed for

---

[120] See LEAH LAPORTE, Keeping The Farm: Estate Tax Deferral And Closely Held Business Owners, 41 COLUM. J.L. & SOC. PROBS. 177, 203 (2007).
[121] Treas. Reg. § 20.6161-1(a)(1), examples 1-4.
[122] Treas. Reg. § 20.6161-1(a)(1).
[123] Treas. Reg. § 20.6161-1(a)(2).

the payment of tax.[124] If an extension is granted under Section 6161(a)(2) then interest is computed from the due date of the tax return to the date of payment.[125]

2. Second Type of Deferral: Section 6163 Reversionary or Remainder Interest Deferral

Section 6163 provides that if the value of a remainder or reversionary interest is included in the estate then the executor may postpone the payment of the estate tax attributable to such interest until six months after the termination of the precedent interest. For reasonable cause, an executor may extend this period for up to an additional three years.[126]

> The Treasury Regulations provide that notice of the exercise of the election to postpone the payment of the tax attributable to a reversionary or remainder interest should be filed with the district director before the date prescribed for payment of the tax. The notice of election may be made in the form of a letter addressed to the district director. There shall be filed with the notice of election a certified copy of the will or other instrument under which the reversionary or remainder interest, was created, or a copy verified by the executor if the instrument is not filed of record.[127]

If a deferral is granted under Section 6163, then interest is computed on the portion that is deferred from the due date of the return to the date that it is paid.[128]

3. Third Type of Deferral: Section 6166 Closely Held Business Deferral

Section 6166 was designed by Congress to create a safety valve to protect the integrity of illiquid closely held business interests of a decedent from the type of liquidity crisis

---

[124] An application containing a request for an extension of time for paying the tax shown on the return shall be in writing, shall state the period of the extension requested, and shall include a declaration that it is made under penalties of perjury. If the application is based upon reasonable cause, a statement of such reasonable cause shall be included in the application. If the application is based upon undue hardship to the estate, the application shall include a statement explaining in detail the undue hardship to the estate that would result if the requested extension were refused. At the option of the executor, an application for an extension of time based upon undue hardship may contain an alternative request for an extension based upon reasonable cause if the application for an extension based upon undue hardship is denied. Treas. Reg. § 20.6161-1(a)(2).

[125] See IRS Manual 20.2.10.1, http://www.irs.gov/irm/part20/irm_20-002-010.html.

[126] See I.R.C. § 6163.

[127] Treas. Reg. § 20.6163-1(b).

[128] See IRS, supra note 254.

that can result from the imposition of the estate tax. It does not reduce the amounts ultimately payable but it defers the obligation significantly. It provides, in summary, that in those instances in which a substantial part of a decedent's gross estate consists of a closely-held business venture, which the decedent had conducted in his lifetime, his personal representative may elect to pay that portion of federal estate tax which is attributable to that venture in equal annual installments over a period of time not to exceed ten years. The Section also provides that a personal representative may elect to defer payment of the first annual installment for a period not to exceed five years. During that deferment period, interest on the deferred tax is payable annually at a nominal rate[129] fixed by the statute.[130]

Only the estate tax attributable to the closely held business may be deferred and paid in installments. This amount is determined by the ratio that the closely held business amount bears to the amount of the adjusted gross estate.[131] The interest then accrues at a rate of 2% per year on estate tax attributable to the first $1,000,000 of taxable business value, adjusted for inflation.[132] The interest rate payable on the balance of the deferred estate tax is equal to 45% of the regular underpayment interest rates in Section 6601(a).[133] The interest payments are not deductible for either income tax or estate tax purposes.

The irrevocable election to pay the tax in installments must be made within the time for filing the estate tax return, which is nine months from the date of death.[134] The first installment does not have to be paid on the exact date that the original tax was due, but it must be

[129] I.R.C. § 6601(j)(1)(A) and (B).
[130] See Parrish v. Loeb, 558 F. Supp. 921, 923 (C.D. Ill. 1982).
[131] See I.R.C. § 6166 (a)(2).
[132] I.R.C. § 6601(j)(1)(A).
[133] I.R.C. § 6601(j)(1)(B).
[134] See I.R.C. § 6166 (d).

paid on the same day of the month as the original tax was due, with the remaining installments now due by this new date.[135]

The § 6166 election is more advantageous to the estate than the § 6161 election because it offers a 2% interest rate, has a longer deferral period, and you do not have to rely solely on the Secretary to decide the deferral period.[136]

a. **Four Section 6166 Requirements**

There are four requirements that the estate must meet in order to qualify for a Section 6166 deferral. The first requirement is that the decedent must have been a citizen or resident of the United States at the date of death.[137]

The second requirement is that the value of the closely held business must be at least 35% of the value of the adjusted gross estate.[138] When the estate owner owns more than one business, the value of each business in which the decedent owns at least a 20% interest may be aggregated to satisfy the 35% rule.[139] No attribution of family member's interest is allowed to help the decedent meet the 35% requirement.

The third Section 6166 requirement is that the interest must be in a business that is closely held,[140] which can be satisfied if the decedent is one of the following: a sole proprietor; a partner in a partnership with no more than 45 partners, or where at least 20% or more of the capital interest in the partnership is owned by the decedent; or a shareholder in a corporation with no more than 45 shareholders, or where 20% of the voting stock of the corporation is owned by the decedent.[141] In determining whether there are 45 or fewer partners or shareholders, all

---

[135] See STEFAN F. TUCKER & MARY A. MANCINI, 14th ANNUAL REAL ESTATE TAX FORUM 91 (2d Vol. 2011).
[136] See Laporte, supra note 249, at 205.
[137] See I.R.C. § 6166 (a)(1).
[138] See id.
[139] See I.R.C. § 6166 (c).
[140] See I.R.C. § 6166 (a)(1).
[141] § 6166(b)(1) Interest in closely held business

partnership or stock interests owned by the decedent's brothers, sisters, spouse, ancestors, and lineal descendants are deemed owned by the decedent.[142] In determining whether the 20% test is met, the decedent is deemed to own all partnership or stock interests owned by the decedent's brothers, sisters, spouse, ancestors, and lineal descendants.[143] This is called family attribution. There is a penalty for using the family attribution rules. The estate losses the five year deferral of principal and there is no 2% interest portion.[144]

The fourth requirement is that the trade or business must be active, rather than passive. The Revenue Rulings have held that management of investment-type activities generally do not generally constitute a trade or business.[145] In the 1970s and 1980s the IRS issued rulings, and the Courts held, that the rental of real estate without an owner having any active duties does not qualify for the § 6166 deferral.[146] However, if the lease of the real estate is subject to a crop

---

For purposes of this section, the term "interest in a closely held business" means—
(A) an interest as a proprietor in a trade or business carried on as a proprietorship;
(B) an interest as a partner in a partnership carrying on a trade or business, if—
(i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or
(ii) such partnership had 45 or fewer partners; or
(C) stock in a corporation carrying on a trade or business if—
(i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or
(ii) such corporation had 45 or fewer shareholders.

[142] § 6166(b)(2)(D) Certain interests held by members of decedent's family
All stock and all partnership interests held by the decedent or by any member of his family [within the meaning of section 267 (c)(4)] shall be treated as owned by the decedent.

[143] See id.

[144] § 6166(b)(7) Partnership interests and stock which is not readily tradable
(A) In general
If the executor elects the benefits of this paragraph (at such time and in such manner as the Secretary shall by regulations prescribe), then—
(i) for purposes of paragraph (1)(B)(i) or (1)(C)(i) (whichever is appropriate) and for purposes of subsection (c), any capital interest in a partnership and any non-readily-tradable stock which (after the application of paragraph (2)) is treated as owned by the decedent shall be treated as included in determining the value of the decedent's gross estate,
(ii) the executor shall be treated as having selected under subsection (a)(3) the date prescribed by section 6151 (a), and
(iii) for purposes of applying section 6601 (j), the 2-percent portion (as defined in such section) shall be treated as being zero.

[145] See Rev. Rul. 75-366, 1975-2 C.B. 472, Rev. Rul. 2006-34, 2006-26 I.R.B. 1171.

[146] See Smith v. Booth, 823 F.2d 94 (5th Cir. 1987, rev'g, A-84-CA-577, 1986 WL 83455 (W.D. Tex. Aug. 27, 1986) (holding that a net cash lease arrangement of real estate, where the owner has no duties, is considered a passive activity, and therefore does not qualify for the deferral); See also I.R.S. Priv. Ltr. Rul. 80-20-101 (Feb. 25,

sharing arrangement where the rent is based on the productivity of the farm and not a passive fixed rental, then § 6166 would apply.[147]

In 2006 the IRS provided clarity regarding what the active duty requirement meant. The ruling lists non-exclusive factors that will be looked at when determining whether a business is active, including: the amount of time devoted to the business; whether the owner maintained an office to perform the activities and has regular business hours specifically for that purpose; how involved the owner was in actively finding new tenants and negotiating and executing leases; the owner's involvement in services, such as landscaping, grounds care, or other services beyond the mere furnishing of leased premises; the extent to which the owner personally made, arranged for, performed, or supervised repairs and maintenance to the property, including without limitation painting, carpentry, and plumbing; and the extent to which the owner handled tenant repaid requests and complaints.[148]

The Ruling then applied the list of factors to five examples and held that there is an active trade or business when: an individual owns a strip mall and is responsible for the day to day work, but occasionally hires an independent contractor when he cannot do the work; an individual hires a property management company in which he had a 20% interest, which is a significant interest; a Partnership hires a general partner, with even a 1% interest, to perform management functions; and an individual owns 100% of the stock of a closely held business and the business conducts an active trade or business, and even the property leased to the business is available for the deferral as long as it is also used in the active trade or business, but there is no

---

1980) (where the IRS ruled that the property did not qualify under § 6166 when there was a lease agreement, from a parent to her children, that the children would pay all the taxes and maintenance expenses); See also Rev. Rul. 75-367, 1975-2 C.B. 472.

[147] See Rev. Rul. 75-366, 1975-2 C.B. 472.

[148] See Rev. Rul. 2006-34, 2006-1 C.B. 1171.

active trade or business when; an individual hires a property management company in which he had no interest.[149]

The IRS has ruled that if an agent takes over the active management of the real estate due to the owner's lack of health, regardless of whether the agent is a family member or a third party, then a deferral is available.[150] The IRS has also ruled that if someone, who is not sick, owns an apartment building portfolio that is managed by a third party then it can be considered an active business, regardless of whether the agent is a family member or a third party, if (i) he/she also owns an interest in the management company or (ii) he/she still performs some of the services. Otherwise, it is considered a passive interest.[151]

If a closely held business engages in both active and passive activities then only the value of the active business may be used to determine the percentage requirements, unless, as provided in I.R.C. § 6166(b)(9) "[i] a corporation owns 20 percent or more. . .of the voting stock of another corporation or [the] other corporation has 45 or fewer shareholders, and [ii] 80 percent or more of the value of the assets of [the other] corporation is attributable to assets used in carrying on a trade or business".[152]

b. **Four Types of Section 6166 Deferrals**

There are 4 types of § 6166 deferrals. The first type is the Section 6166(a) deferral, which is available for operating companies, partnerships, sole proprietors, and LLCs. If the estate meets the requirements of Section 6166(a), then the estate can defer payment of principal for five years and then pay it in up to ten annual installments, but must pay the following interest rates; (i) 2% on the deferred tax attributable to the first $1,000,000, (ii) 45% of

---

[149] Id.; See also NAVIGATING THE WATERS OF ESTATE TAX DEFERRAL AND PAYMENT TECHNIQUES IN ILLIQUID ESTATES, SP053 ALI-ABA 347 , 357-61
[150] See I.R.S. Priv. Ltr. Rul. 81-34-018 (May 1, 1981); See also I.R.S. Priv. Ltr. Rul. 81-34-012 (Apr. 30, 1981).
[151] See Rev. Rul. 2006-34, 2006-1 C.B. 1171.
[152] I.R.C. § 6166 (b)(9).

the regular underpayment interest rates on the remaining deferred tax, and (iii) a penalty rate of 5% on the amount of the payment for each month it was overdue if late payments are made within six months of the due date.

The second type is the Section 6166(b)(7) deferral, which can be elected if the decedent did not own enough to meet the percentage requirements of Section 6166(a), but is able to meet the percentage requirements through family attribution. When this type of deferral is elected the estate loses the preferential rate of 2% on the first $1,000,000 and the five-year deferral of principal payments, and must pay 45% of the regular underpayment interest rates on the full deferred amount.[153]

The third type is the Section 6166(b)(10) deferral, where stock in qualifying lending and finance businesses is treated as stock in an active trade or business company.[154] Here, the estate must pay the following interest rates; (i) 2% on the deferred tax attributable to the first $1,000,000, (ii) 45% of the regular underpayment interest rates on the remaining deferred tax, and (iii) a penalty rate of 5% on the amount of the payment for each month it was overdue on late payments paid within six months of the due date.[155]

The fourth type is the Section 6166(b)(8) deferral which is a holding company election available for a business that owns stock in another business.[156] In order to qualify for this type of deferral the executor must make an election,[157] the holding company's interest must meet the requirements of Section 6166(b)(1)(C); and the interest must exceed 35% of the gross

---

[153] See I.R.C. § 6166 (b)(7).
[154] See I.R.C. § 6166 (b)(10).Nelson M. Blakely, The 4 Types of Section 6166 Deferrals, SECTION 6166 (October 25, 2011), http://www.section6166.com/index.php?option=com_content&view=article&id=85&Itemid=67
[155] I.R.C. § 6166 (b)(10).
[156] See DENNIS I. BELCHER, 39th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING 5-22 (2005).
[157] See I.R.C. § 6166 (b)(8)(A).

estate.[158] If this election is made, then the 5 year deferral for principal payments and the 2% interest rate do not apply.[159]

A holding company can also qualify for a deferral under Section 6166(b)(9)(B)(iii) if the corporation owns at least 20% of the subsidiary or the subsidiary has less than 45 employees and at least 80% of the value of the subsidiary is attributable to assets used in carrying on a trade or business.[160]

An issue relevant to the Section 6166(b)(8) deferral is that the statute defines a holding company as "any corporation holding stock in another corporation"[161] and it is unclear as to how Section 6166(b)(8) applies to partnership and LLC holding companies. This was not a big issue when Section 6166 was enacted because most closely held businesses were organized as corporations, but now the issue has come to the fore because LLCs and LLPs are much more common, and even preferred. Congress did not intend for the amendments to penalize companies because of their choice of entity.[162] Therefore, the American Bar Association has proposed that Congress modify Section 6166(b)(8) to apply consistent criteria regardless of the choice of entity, and include a uniform definition of a closely held business.[163]

c. Three Ways in which Section 6166 Benefits are Lost

There are three ways in which the estate can lose its § 6166 benefits and be forced to make accelerated deferred payments. The first type of acceleration occurs when the estate distributes, sells, exchanges or otherwise disposes of 50% or more of the value of the closely

---

[158] See I.R.C. § 6166 (a)(1).
[159] See I.R.C. § 6166 (b)(8)(A).
[160] See I.R.C. § 6166 (b)(9)(A)(iii).
[161] I.R.C. § 6166(b)(8)(emphasis added).
[162] See Dennis I. Belcher, Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning, 41 REAL PROP. PROB. & TR, J. 73 (2006) (citing S. REP. NO. 98-369).
[163] See Memorandum from the Sections of Taxation and Real Property Trusts, & Estates Law of the American Bar Association Task Force (Apr. 4, 2012) *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/040512letter.authcheckdam.pdf.

held business interest.[164] When this happens the estate must pay the entire unpaid portion.[165] The following actions are not considered to be dispositions: certain redemptions of stock to pay death tax under § 303,[166] changes in form of doing business,[167] certain tax-free exchanges of stock in connection with reorganizations, under § 368 (a)(1)(D), (E) or (F) and § 355,[168] a transfer of property of the decedent to a person entitled to receive the property under the decedent's will, the applicable law, or a trust created by the decedent,[169] and the funds received in a sale of a portion of the assets of a closely held business and used to pay the mortgage and prevent foreclosure of the business property.[170]

The second type of acceleration occurs when the estate has undistributed net income. When this happens the estate must pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installments.[171]

The third type of acceleration occurs when the estate fails to make a timely payment of principal or interest. When this happens the estate must pay the entire unpaid portion. However, if the estate makes late payments within six months of the due date then there is no acceleration, however the estate is subject to penalties of 5% for each month it was not paid and loss of the 2% interest rate.[172]

---

[164] See I.R.C. § 6166 (g)(1).
[165] "Acceleration of payments is not automatic. If an estate triggers one of these acceleration clauses, the tax liability is only due upon notice and demand from the Service. Lake Shore Nat'l Bank v. Coyle, 419 F.2d 958 (7th Cir. 1969)." Laporte, supra note 249, at 200.
[166] See I.R.C. 6166(g)(1)(B).
[167] See Reg.§ 20.6166A-3(e)(2).
[168] See I.R.C. 6166(g)(1)(C).
[169] See I.R.C. 6166(g)(1)(D).
[170] See Rev Rul 89-4, 1989-1 CB 298.
[171] See I.R.C. § 6166 (g)(2).
[172] See I.R.C. § 6166 (g)(3).

d. Government Lien to Secure the Section 6166 Deferred Estate Tax

Section 6324(a) gives the government a general federal estate tax lien on the assets of a decedent's gross estate, but only lasts for ten years. This is an issue because under Section 6166 an executor can elect to pay the estate tax over a fourteen-year period, which leaves a period that the government has no lien. Therefore, Sections 6166(k)(1) and 6165 allow the IRS to require a surety bond, or gives the IRS a special lien that covers the duration of the deferral.[173]

In 2002 the IRS started to require a surety bond, or a special lien before an executor can elect a § 6166 deferral.[174] However the Courts did not approve. For example, in Estate of Roski v. Commissioner, 128 T.C. 113 (2007), the Tax Court held that the IRS could not make such a requirement and had to make the determination on a case by case basis.

Therefore, on November 13, 2007, the IRS issued Notice 2007-90 stating that they will determine whether they will require a bond or special lien on a case by case basis based on whether the estate poses a credit risk. Notice 2007-90 stated that regulations establishing factors that will be applied on a case by case basis will be forthcoming and listed the following factors that they will look at in the interim: duration and stability of the business; ability to pay the installments of tax and interest timely; and compliance history.[175]

The Business Planning Group of the Real Property, Trust and Estate Law Section of the American Bar Association Task Force made the following recommendations: to amend Section 6324 to extend the term of the general estate tax lien with respect to estate tax deferrals under Section 6166;[176] to amend Section 6325 to provide more flexibility regarding release,

---

[173] See I.R.S. Notice 2007-90.
[174] See id.
[175] See id.
[176] The Obama Budget Proposals for FY 2013 and again in FY 2014 have made a proposal to "extend the tax lien under §6324(a)(1) throughout the § 6166 deferral period". DEPARTMENT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS (2012), available at

subordination, and substitution of collateral for the estate tax liens; and to have a general policy to delay the bond requirement decision to secure deferred tax payment after expiration of the existing Section 6324 general lien.[177]

As of June 1, 2010, the Internal Revenue Manual at Sections 5.5.8.5, 4.25.1, and 4.25.2 give direction regarding the process for determining if a surety bond or special estate tax lien is required, lists factors that the IRS must look at, and gives the steps an estate must take to appeal such a requirement.[178]

In order to apply for the special lien Section 6324A requires a written agreement, signed by each person who has an interest in the designated property, consenting to the creation of the lien and designating a responsible person who shall be the agent for the beneficiaries of the estate and for the persons who have consented to the creation of the lien.[179] Section 6324A also provides that "the maximum value of the property which the Secretary may require as section 6166 lien property . . . [is] the sum of the deferred amount and the required interest amount",[180] and that "if at any time the value of the property covered by the agreement is less than the unpaid portion of the deferred amount and the required interest amount, the Secretary may require the addition of property to the agreement (but he may not require under this paragraph that the value of the property covered by the agreement exceed such unpaid portion). If property having the required value is not added to the property covered by the agreement (or if

---

http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf and DEPARTMENT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS (2013), available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.

[177] Memorandum from the Business Planning Group of the Real Property, Trust and Estate Law Section of the American Bar Association Task Force (Jan. 14, 2008) *available at* http://apps.americanbar.org/rppt/meetings_cle/2008/jointfall/Joint08/BusinessesAndBusinessPlanningGroup/CommentsToNotice2007-90.pdf.

[178] Lisa M. Rico, Borrowing for Postmortem Liquidity, Part 2—A Primer on IRC § 6166, Probate & Property (Jan./Feb. 2011), http://www.jdsupra.com/legalnews/borrowing-for-postmortem-liquidity-part-66944.

[179] I.R.C. § 6324A(c).

[180] I.R.C. § 6324A(b)(2).

other security equal to the required value is not furnished) within 90 days after notice and demand therefore by the Secretary, the failure to comply with the preceding sentence shall be treated as an act accelerating payment of the installments under section 6166(g)".[181]

There are several considerations that must be made before deciding to make a § 6166 election, including whether there is a possibility that the regular underpayment interest rates in § 6601(a) will increase.[182]

e. **Graegin Loans**

Section 2053 and Treasury Regulation Section 20.2053 allow an estate to deduct interest expense from a loan taken to pay estate taxes as long as (1) the interest expense must be actually and necessarily incurred in the administration of the estate;[183] (2) the amount of the estimated interest expense is ascertainable with reasonable certainty;[184] and (3) the expense will be paid.[185]

Estate of Graegin v. Comm'r, 56 T.C.M. (CCH) 387 (T.C. 1988), is the seminal case allowing an upfront estate tax interest deduction for a fixed term loan where prepayment is prohibited ("Graegin Loan"). In Graegin the decedent's estate was made up mostly of illiquid stock in a closely held business. Instead of selling the stock, the executor of the estate took out a fifteen year loan for $204,218 that required payment of interest and principal at the end of the loan term and prohibited prepayment of the loan. The Tax Court held that the executor was allowed to deduct upfront the amount of interest that would be paid on maturity of the note because (1) the expense was necessary because the estate lacked liquidity, (2) the amount of the estimated interest expense was ascertainable with reasonable certainty because the amount could

[181] I.R.C. § 6324A(d)(5).
[182] See Weinstock, supra note 32, at 411.
[183] Treas. Reg. § 20.2053-3(a).
[184] Treas. Reg. § 20.2053-3(d)(4).
[185] See id.

not be prepaid and could therefore be easily calculated, and (3) the interest on the loan would be repaid.[186]

In three recent cases the Courts have not allowed an upfront estate tax interest deduction for the interest expense in Graegin Loans because the estate had enough liquid assets to cover the estate taxes,[187] because the loan did not avoid having the illiquid assets sold[188] and because the loan was not "necessary"[189]. In particular, the Koons case involved an estate borrowing money to pay estate taxes from an LLC that in controlled. The Estate had no other significant assets except the LLC interest. The Court found the loan not "necessary" as the estate had the ability to force the LLC to make a cash distribution to it. Further, the loan was most likely to be repaid when it became due (18 years later) by cash the estate obtained from a distribution from an LLC, as there was no other source of cash. The Court looked negatively on the loan as it did not prevent any illiquid assets from having to be sold at a forced sale. However, the interest for Graegin Loans can still be deducted as long as all of the Section 2053 requirements are met and the estate can prove the loan is necessary to prevent a fire sale and there are no other viable liquidity options, as evidenced in the majority of the recent cases, which have followed the reasoning set forth in Graegin.[190]

---

[186] "In deciding that the loan was in fact *bona fide* [and would be repaid], the court noted the reasonableness of the loan terms, the approval of the loan arrangement by the probate court, and the presence of some non identity of interest due to the fact that the closely held business included an unrelated shareholder who would likely complain if interest payments were not made on the loan". Planning Ideas-The Graegin Note Revisited, CANNON INSIGHTS, July, 2010 *available at* http://www.cannonfinancial.com/resources/newsletter/CI-Planningtwo1110.pdf.

[187] Estate of Stick v. Comm'r, 100 T.C.M. (CCH) 194 (T.C. 2010).

[188] Estate of Black v. Comm'r, 133 T.C. 340 (2009)

[189] Estate if koons, 105 T.C.M (CCH) 1567 (2013)

[190] See Estate of Duncan v. Comm'r, 102 T.C.M. (CCH) 421 (T.C. 2011) (holding that the executor could deduct the loan interest even where the lender and borrower trusts had the same trustees and beneficiaries); See also Estate of Murphy v. United States, 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009); See also Keller v. United States, CIV.A. V-02-62, 2009 WL 2601611 (S.D. Tex. Aug. 20, 2009).

Special Income Tax Considerations for Real Estate Investors: Net Investment Income Tax – Section 1411

For tax years beginning after Dec. 31, 2012, individuals, trusts, and estates are subject to a surtax on "unearned income" (i.e., the tax is in addition to any other tax payable on that income) under § 1411. The surtax, also called the "unearned income Medicare contribution tax" or the "NII tax," is 3.8 percent of the lesser of (1) NII or (2) the excess of modified adjusted gross Income (MAGI) over the threshold amount. MAGI is adjusted gross income (AGI) plus any amount excluded as foreign earned income under § 911(a) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

The threshold amount for individuals is $250,000 for joint filers or surviving spouses, $125,000 for a married individual filing a separate return, and $200,000 in any other case. The threshold amount for individuals is not indexed for inflation. The threshold amount for trusts and estates is $12,300 in 2015,[191] and is adjusted for inflation.

NII includes income from passive activities and capital gains. It includes income from dividends, annuities, royalties, interest, and rents, unless such income is derived in the course of an "ordinary trade or business" and is not a passive activity within the meaning o f§ 469.[192]

Final regulations.

On Nov. 26, 2013, the IRS released final regulations and a notice of proposed rulemaking regarding the 3.8 percent net investment income (NII) tax. The final regulations include significant changes to the proposed regulations and address many concerns taxpayers had raised with the IRS, such as rules on regrouping, self rented property, self-charged interest income, and treatment of real estate professionals. The new rules provide safe harbors for rental real estate activities of a real estate professional and for self rented property.

Trade or business / rental real estate

As mentioned above, section 1411 applies to a passive activity if it is both a "passive activity" within the meaning of section 469 and constitutes a "trade or business" of the taxpayer.[193]

The final regulations leave open the definition of a real estate trade or business. The preamble acknowledges that in some, but not all, circumstances a single parcel of real estate may rise to the level of a trade or business. For example, a single property may require regular and continuous involvement rising to the level of a trade or business within the meaning of section

[191] Rev. Proc. 2014-61.
[192] Treas. Reg. § 1.1411-5(b).
[193] Treas. Reg. § 1.1411-5(b).

162. The preamble notes that the Treasury and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law.

Activity regrouping

The final regulations allow a regrouping "fresh start" under the passive activity rules for certain taxpayers. A taxpayer may regroup in the first taxable year beginning after December 31, 2012 in which (1) the taxpayer has MAGI that exceeds the applicable threshold amount and has NII. The final regulations allow taxpayers to regroup on an amended return provided the taxpayer was not subject to section 1411 on his or her original return and as a result of the regrouping, the taxpayer will owe tax under section 1411 for the taxable year.

Self-rented property

The final regulations clarify that property held in a separate entity from a commonly owned business may be treated as active income attributable to the trade or business and thus not subject to the tax under section 1411. The regulations also make it clear that gains from the disposition of such real property assets will not be subject to taxation under section 1411.

Self-charged interest

The final regulations provide generally that where a taxpayer derives self-charged interest from a nonpassive activity, the taxpayer, in general, will be permitted to exclude its allocable share of interest from NII. Allocable share is the taxpayers share of the deduction resulting from the payment of that interest.

Real estate professionals

Although the real estate professional exception under § 469 overlaps considerably with that under § 1411, they are not coterminous.

The regulations provide a safe harbor for real estate professionals that applies if the taxpayer participates in rental real estate activities for more than 500 hours per year, a lower standard than the § 469 safe harbor (which requires more than 750 hours and more than 50 percent of the taxpayer's time to be spent on rental real estate activities).[194]

A real estate professional who elects to group rental real estate activities under § 469[195] may also group the activities for purposes of the § 1411 safe harbor.[196] In contrast, if he elects to group rental activities with other trade or business activities under § 469,[197] he may not do so for

[194] Treas. Reg. § 1.1411-4(g)(7)(i).
[195] Treas. Reg. § 1.469-9(g).
[196] Treas. Reg. § 1.1411-4(g)(7)(ii)(B).
[197] Treas. Regs. §1.469-4(d)(1)(i)(A) or (d)(1)(i)(C).

purposes of the § 1411 safe harbor.[198] For example, he cannot count time spent on real estate brokerage services towards the 500-hour requirement in § 1411, even though he may be permitted to do so for the § 469 exception. The preamble to the final regulations confirms that many of the activities that will contribute to real estate professional status under § 469 are not taken into account under § 1411. Thus, it is clear the inquiry as to the application of § 1411 does not end with a determination that the taxpayer is a real estate professional under § 469.

The real estate professional exception in 1411 also requires "material participation" in the real estate rental activities, and applies the same definition of "material participation" as section 469.

The exceptions in sections 1411 and 469 are important to real estate professionals in different planning contexts. The real estate professional exception in section 469 is particularly important for taxpayers sustaining losses in their real estate activities, because classifying those losses as non-passive allows the taxpayers to offset non-passive income. In contrast, the real estate professional exception under § 1411 is more important for taxpayers with real estate rental gains, because classifying these gains as non-passive under 1411 allows the taxpayers to exclude them from the net investment income tax.[199]

Trusts and Estates

Grantor trusts are not subject to NII tax. Rather, NII is measured and the tax is imposed at the grantor level.[200] In contrast, non-grantor trusts generally are subject to NII tax, except for wholly charitable trusts,[201] foreign trusts, and certain other enumerated exceptions.[202]

For non-grantor trusts, NII is measured and taxed at the trust level,[203] except that a beneficiary is deemed to receive a proportionate amount of the NII to the extent it constitutes distributable net income (DNI)[204] and retains its character upon the deemed distribution.[205] Due to the disparity in the NII floors for individuals and trusts, the trust may consider distributing DNI that is NII to the trust beneficiaries.[206]

Whether the trust's income is derived in the ordinary course of business is determined at the trust level.[207] Similarly, whether the income is passive within the meaning of § 469 is determined at the trust level.[208]

---

[198] Treas. Reg. § 1.1411-4(g)(7)(ii)(B).

[199] *See e.g.*, Tony Nitti, "Final Net Investment Income Regulations: IRS Grants Relief To Real Estate Professionals." Forbes (November 27, 2013).

[200] Treas. Reg. § 1.1411-3(b)(v); Berra, José and Wilensky, Mark, "3.8% Tax on NII: Impact on Trusts & Estate Planning," Private Wealth Institute (2014).

[201] Treas. Reg. § 1.1411(a)(2), (e)(2).

[202] Treas. Reg. § 1.1411-3(b).

[203] Treas. Reg. §§ 1.1411-3(a)(1), (e); Berra, José and Wilensky, Mark, "3.8% Tax on NII: Impact on Trusts & Estate Planning," Private Wealth Institute (2014).

[204] As defined in § 652(a) and § 662(a). Treas. Reg. §1.1411-4(e)(1)(i).

[205] As defined in § 652(b) and § 662(b). Treas. Reg. §1.1411-4(e)(1)(i).

[206] Berra, José and Wilensky, Mark, "3.8% Tax on NII: Impact on Trusts & Estate Planning," Private Wealth Institute (2014).

[207] Berra, José and Wilensky, Mark, "3.8% Tax on NII: Impact on Trusts & Estate Planning," Private Wealth Institute (2014).

[208] Berra, José and Wilensky, Mark, "3.8% Tax on NII: Impact on Trusts & Estate Planning," Private Wealth Institute (2014).

The final § 1411 regulations do not resolve the question of which actor's activities should be considered in determining whether the trust "materially participates" in the operations within the meaning of § 469(h). However, as previously mentioned, the definition of "material participation" for 1411 purposes is meant to be the same as that in 469(h).[209]

Recent case law and IRS guidance indicate that the § 469 material participation exception should be satisfied if the trustee materially participates in the operations of the trust's underlying business.[210] The IRS maintains that only the trustee's activities should be considered,[211] whereas case law leaves open the possibility that activities of other trust employees may be considered.[212]

The most recent case is particularly relevant to real estate professionals. In *Frank Aragona Trust v. Commissioner,* 142 T.C. No. 9 (March 27, 2014), the Tax Court found that a trust materially participated in a real estate business and qualified for the "real estate professional exception" under § 469(c)(7). The trust owned rental properties, some of which it managed through a wholly owned LLC and others through entities in which it owned majority interests. The trust had practically no other types of operations except for the real estate activities. Three of the trust's six co-trustees were full-time employees of the LLC. Two of the co-trustees owned minority interests in the trust's other entities. The trustees were actively involved in the day-to-day rental operations. The court found that the trustees' activities, including their activities as employees of the LLC, should be considered in determining whether the trust materially participated in the real estate business. The court rejected the IRS's contention that a trust could never qualify for the real estate professional exception because it did not provide personal services "performed by an individual," as required by the regulations. The court held that a trust may satisfy this requirement if its trustees are individuals. Therefore, a trust is capable of performing "personal services." The court also rejected the IRS's argument that the activities of the co-trustees who owned minority interests in some of the entities should be partially attributed to their personal shares of the entities. The court provided several reasons, including that their interests as individual owners were generally compatible with the trust's goals for the jointly held enterprises to succeed. The court concluded that the trust materially participated in the real estate business and satisfied the § 469(c)(7) exception for real estate professionals.

Since the definition of "material participation" is the same for § 1411 purposes as it is for section 469 purposes, a trust should satisfy the § 1411 "material participation" requirement if an individual trustee is involved in the operations on a "regular, continuous, and substantial basis." However, other aspects of the § 1411 "real estate professional" exception differ from section § 469, as discussed above.

For planning purposes, real estate owners who would not otherwise satisfy the § 469(h) exception may wish to own the real estate through a trust. If the trust is managed by an active trustee who focuses exclusively on the real estate business, some of the otherwise passive income could be classified as active income, and would not be subject to the NII tax.[213]

---

[209] Treas. Reg. § 1.1411-4(g)(7)(ii)(A).

[210] See Mattie K. Carter Trust v. United States, 256 F. Supp.2d 536 (N.D. Tex. 2003); Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014); TAM 200733023; TAM 201317010.

[211] TAM 200733023; TAM 201317010.

[212] Mattie K. Carter Trust v. United States, 256 F. Supp.2d 536 (N.D. Tex. 2003); Frank Aragona Trust v. Commissioner 142 T.C. No. 9 (March 27, 2014).

[213] See discussion of Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (March 27, 2014), supra; Berra, José and Wilensky, Mark, "3.8% Tax on NII: Impact on Trusts & Estate Planning," Private Wealth Institute (2014).

ESTATE PLANNING FOR FOREIGN INVESTORS IN U.S. REAL ESTATE

Estate planning for the foreign investor in U.S. real estate may be considerably more complicated. Domestic and foreign income tax consequences must be factored into the equation. In addition, since the U.S. tax system may not dovetail with that of the investor's home country, care must be exercised to avoid double taxation. However, it is frequently possible to significantly reduce the income and estate tax burdens for the foreign investor. The below discussion is merely an introduction to this complex area.

A. There are various ways in which to structure a foreign investment in U.S. real estate the five most common are (1) without an intervening corporation, (2) through a single U.S. corporation, (3) through a foreign corporation, (4) through a combination of a U.S. and foreign corporation, or (5) through a private real estate investment trust (REIT).

1. **Ownership without an intervening corporation** – this is the most cost efficient form from a pure income tax standpoint but is relatively uncommon due to the disadvantages.[214] With this type of formation the foreign investor owns the real estate directly without a corporation. Under this structure if the activity rises to the level of a U.S. trade or business, under the current rental income (the net income after deductions for

[214] Jack Mandel & Alan I. Appel, Tax Structuring of Foreign Investment in U.S. Real Estate, Various Structures to Limit the U.S. Tax Exposure, Institutional Investment Real Estate Magazine, (2009). Available at http://www.bryancave.com/files/News/59b80ea0-b3ed-47e3-a60e-d31813d97347/Presentation/NewsAttachment/f6da66e8-ea16-4245-89c5-d465715c5b3c/MandelAppelArticlepdf.pdf

expenses) will be taxed under Section 871(b) at the federal level at a rate of 35%.[215] There may be additional state and local taxes imposed as well.

i. Advantages

1. Low U.S. federal capital gains rate (15%) on sale of the real estate – the rate could be 25% to the extent of prior depreciation.[216]

2. The ability to repatriate funds without incurring a second level of tax.[217]

ii. Disadvantages

1. The real estate is subject to U.S. estate tax on the death of the foreign individual.[218]

2. A lack of unanimity since the individual is obligated to file U.S. income tax returns with respect to the property.[219]

a. This is also an administrative burden.

2. **Single-tier U.S. corporate ownerships** – this is generally not advisable because although corporate level tax rates on current income are similar to

[215] Although the term "trade or business within the United States" is not defined in the Code a trade or business will be found to exist if there are regular, continuous and considerable business activities. See, *De Amodio v. Commissioner*, 34 T.C. 894, 905-06 (1960), aff'd, 299 F.2d 623 (3rd Cir. 1962) (concluding that the taxpayer had engaged in a U.S. business because the activities of the taxpayer's agent were considerable, continuous and regular, and that those activities which constituted more than the mere ownership of real property or receipt of income from real property, were attributable to the taxpayer).

[216] Jack Mandel & Alan I. Appel, Tax Structuring of Foreign Investment in U.S. Real Estate, Various Structures to Limit the U.S. Tax Exposure, Institutional Investment Real Estate Magazine, (2009). Available at http://www.bryancave.com/files/News/59b80ea0-b3ed-47e3-a60ed31813d97347/Presentation/NewsAttachment/f6da66e8-ea16-4245-89c5-d465715c5b3c/MandelAppelArticlepdf.pdf

[217] Id.

[218] Id.

[219] Id.

those under an individual ownership structure, there can be higher taxes on sale and repatriation of funds.[220]

i. The distributions by the U.S. corporation will be subject, under Section 1441, to a 30% withholding tax (subject to reduction by treaties) to the extent of earnings and profits and a U.S. shareholder level FIRPTA[221] tax to the extent distributions exceed earnings and profits.[222]

ii. If there are no assets in the corporation other than sale proceeds, the corporation can generally be liquidated and the proceeds repatriated free of a second level of tax.[223]

1. Thus, subject to certain restrictions, it may be possible for the corporation to retain earnings until the property is sold and avoid a second level of tax on the repatriation of funds.

iii. Disadvantages

1. This form does not shield against the U.S. estate tax being imposed on the death of the shareholder.

2. There is limited anonymity because the U.S. corporation's tax return requires the disclosure of the name, address, and taxpayer identification number of any person owning 50% or more of the stock of the corporation.

---

[220] Id.
[221] See, the Foreign Investment in U.S. Real Property Tax Act of 1980 (FIRPTA), Pub. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980).
[222] Jack Mandel & Alan I. Appel, *supra* note 3.
[223] Id.

3. **Ownership through a foreign corporation alone**

i. Disadvantages

1. Although the basic U.S. federal tax rates on operating income will be similar to the non-corporate and U.S. corporate ownership, the foreign corporation will be subject to an additional "branch profits tax" of 30% (subject to reduction by treaty) on, in general, its annual earnings and profits.[224]

   a. The effective federal tax rate would be approximately 56.5% after taking account of the deductibility of the basic income tax when computing the branch profits tax.[225]

2. Gain recognized on the sale of the real estate is taxed at the same rates as current income

3. Although the sale of the stock of the foreign corporation should be free of U.S. federal income tax the buyer will likely demand a significant discount in the price for taking over the inherent tax liabilities.[226]

4. Although there is no dividend withholding tax repatriation may be a factor in computing the branch profits tax.[227]

---

[224] I.R.C. § 884
[225] Jack Mandel & Alan I. Appel, *supra* note 3.
[226] Id.
[227] Id.

ii. Advantages

1. The stock of the foreign corporation is generally thought not to be subject to U.S. estate tax on the death of the individual.[228]

2. Similar to the single level U.S. corporate structure, this structure provides limited anonymity because the tax return requires the disclosure of the name, address, and taxpayer identification number of any person owning 50% or more of the stock in the corporation.

a. Note that a second foreign corporation could be interposed if greater anonymity is desired.

4. **Foreign and U.S. corporation combination structure** – this is the most common structure under which a foreign corporation is established whose sole asset is all of the stock of a U.S. corporation, which, in turn, acquires the real estate investment.[229] Although this two-tiered structure is more intricate than others its advantages make it useful despite the complexity.

i. Advantages

1. The complex branch profits tax will not be applicable since the operating asset (the real estate investment) and income generated from the asset reside in the U.S. corporation.[230]

---

[228] Id.
[229] Id.
[230] Id.

2. Anonymity can be preserved because although the U.S. corporation must disclose the identity of its 100% shareholder by name, only the identity of the corporation will be disclosed.

   a. The foreign corporation is under no obligation to disclose its shareholder since it is not engaged in a U.S. trade or business.

3. Assuming no operating income is to be distributed out of the U.S., once the property is sold by the U.S. corporation in a fully taxable transaction and one level of U.S. tax has been paid on the gain, the U.S. corporation can be liquidated. The cash as a result of the liquidation can be distributed to the foreign corporation free of any U.S. withholding tax. The foreign corporation is then free to distribute the cash to the ultimate shareholder free of an U.S. tax impact.[231]

   a. In addition the stock of the foreign corporation could be sold free of U.S. federal income tax although the buyer will likely demand a discount in the price for taking over the inherent tax liabilities.

[231] Id.

4. The conventional wisdom is that neither U.S. estate nor gift tax will apply to a lifetime gift or testamentary transfer of the stock in the foreign corporation.[232]

ii. Disadvantage

1. Under the structure of holding the real estate in a foreign corporation it is more likely that it will be possible to distribute refinance proceeds free of U.S. tax, however the same is not true under the foreign and U.S. corporation combination structure.[233]

5. **"Domestically-controlled" REIT** – although distributions from private REITs to non-U.S. investors are normally subject to FIRPTA tax there is an exception for "domestically-controlled" REITs.[234] The REIT must be structured in a way to demonstrate domestic control – U.S. investors must hold more than 50% of the capital of the REIT and non-U.S. investors cannot otherwise exercise control over the REIT.[235]

i. Advantage

1. Domestically controlled REITs are not considered to be U.S. Real Property Interests (USRPIs) under FRIPTA,

---

[232] Id.
[233] Jack Mandel & Alan I. Appel, *supra* note 3.
[234] White & Case, U.S. Real Estate Funds and "FIRPTA" Structures to Maximize Net Returns to Non-U.S. Investors, (Summer 2010).
[235] Id.

therefore foreign investors are not subject to tax under FIRPTA upon the sale of their shares in a REIT.[236]

ii. Disadvantage

1. Dividend distributions made by a REIT to a foreign investor attributable to gains from sales or exchanges under a REIT are considered USRPIs and subject to U.S. tax under FIRPTA.[237]

SPECIAL INCOME TAX CONSIDERATIONS FOR LEVERAGED ESTATE HOLDINGS

Historically, our tax and economic system have encouraged the use of leverage to finance expansion and growth in the real estate sector of the economy. The ability to cash out through refinancing without paying tax on the proceeds (at least at the time of the refinancing) and to finance improvements with indebtedness, which can result in depreciation deductions attributable to borrowed funds, have made leveraging a tax favored method of financing a real estate portfolio. The favorable treatment of leverage results in a deferral of the incidents of taxation – not an elimination. However, when assets are held until death, the deferral becomes permanent due to the basis step up allowed by section 1014 of the Code.

Estate planning for leveraged real estate requires special planning to continue the deferral until death. It is inherent in such planning that appreciation and growth must be shifted to succeeding generations. In general, when inter vivos gifts are made there is no basis step up. At the most fundamental level, there is a trade off between retaining assets until death to obtain the basis step up, on the one hand, and transferring assets during lifetime before they appreciate

[236] Deloitte, Introduction to the Taxation of Foreign Investment in U.S. Real Estate, (February 2010).
[237] Id.

but without the basis step up. For gifting transactions, there is generally, a carryover basis under section 1015 of the Code.

The delicate balance when planning for leveraged real estate is to achieve the basis step up on the deferred gain inherent in these assets while transferring the appreciation during lifetime. This type of planning is particularly challenging insofar as the income tax and the estate tax rules do not always interact harmoniously – particularly where there is "negative capital".

Dealing with negative capital or liabilities in excess of basis puts a greater emphasis on the income tax side of planning. Popular estate planning techniques, such as grantor retained annuity trusts (GRATs), installment sales to defective grantor trusts (IDITS), and outright gifts, may not work well for these assets since they can trigger unexpected income tax liabilities. These tax liabilities can be completely avoided if the asset is held until death due to the basis step up under section 1014 of the Internal Revenue Code (the "Code"). This can serve as a major disincentive and impediment to estate and transfer tax planning.

This scenario is relatively common for real estate interests where cash proceeds of refinancing have been taken or where the property has been fully depreciated. Worse yet, the triggering of this gain can often result in an income tax liability to the transferor that is greater than the potential estate tax savings, or, perhaps, the equity values that were the initial motivation for the creation of the GRATs, IDITS, etc.

The tax impact of negative capital can be illustrated as follows:

Liabilities in Excess of Basis
Illustrated

AB Partnership	
Assets	
Real Estate(fmv)	$10,000,000
Real Estate (adjusted basis)	$ 1,000,000
Liabilities	
Mortgage	($ 8,000,000)
Capital	
Equity (cash proceeds from a sale)	$ 2,000,000
Gain Subject to Taxation	($ 9,000,000)
Tax on Gain if Real Estate is Sold For	$10,000,000
Tax @ 20%	$ 1,800,000
Tax @ 25%	$ 2,250,000

Add State and Local Taxes and 3.8% Obamacare tax
Assuming 35% overall rate tax is $3,150,000

12

1. Public Holdings REITs, UPREITs, and Estate Planning

a. REITs Generally

Long term successful real estate owners may seek to raise funds for expansion in the capital markets by formation of a real estate investment trust ("REIT").

The Internal Revenue Code Sections 856 through 859 lay out the intricate organizational framework for a REIT. There are eight organizational requirements an entity must meet to be a REIT. The entity: (1) must be a corporation, trust, or association; (2) must not be an insurance company or financial institution; (3) must be taxable as a domestic corporation if it were not a REIT; (4) must elect to be taxed as a REIT; (5) must have centralized management by trustees or directors (6) must have at least 100 persons; (7) must own transferable shares or

certificates; and (8) does not have six individuals owning more than 50 percent of the value of the equity.[238]

b. **UPREITs Generally – Used to avoid gain recognition on negative capital**

There are certain income tax challenges to the formation of a REIT when the holdings are subject to liabilities in excess of basis. The liabilities in excess of basis can result in gain recognition upon the contribution of leveraged real estate to a REIT, typically a corporation, under section 357(c) of the Code. The frequent objective is to take advantage of the access of the REIT to the capital markets while continuing the deferral of gain on negative capital – perhaps until death. If the negative capital can be preserved, the estate planning for these assets is similar as that for other leveraged real estate with negative capital.

Certain transactional structures have been developed to allow deferral of the gain inherent in the negative capital. An example is the combination of a traditional REIT and a limited partnership, often referred to as the operating partnership (OP), which creates an UPREIT. In contrast to a traditional REIT, which invests in real estate assets directly, with an UPREIT the real estate assets are held by the OP, and the REIT conducts most of its operations through the OP as the OP's general partner.[239]

The structure of the UPREIT was created to accommodate real estate holders with "built-in gain" attributable to liabilities in excel of basis that would otherwise require gain recognition upon contribution of the property subject to the liabilities in excess of basis in connection with a normal corporate formation transaction governed by section 351. Section 351(a) of the Internal Revenue Code provides that, "no gain or loss shall be recognized if

---

[238] Brian K. Jordan, Real Property, Probate and Trust Law: Ups and Downs: A REIT Dilemma, 73 Fla. Bar J. 54 (July/Aug 1999).

[239] Bart Sheehan & Marshall D. Feiring, Background and Development of the REIT Industry, Practicing Law Institute, Financial Product Fundamentals, (July, 12 2012).

property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.[240] This rule however does not apply in the case of property transferred to an investment company.[241] A transfer is considered made to an investment company if: it results in a diversification of the transferor's interests and the transferee is or intends to become a REIT[242] For purposes of Treas. Reg. Section 1.351-1(c)(5) the contribution of cash in exchange for REIT shares and the contribution of appreciated property in exchange for other REIT shares is treated as a diversification of interests.[243]

As a result, if an existing owner contributes appreciated property to a REIT in exchange for REIT shares, even if the transaction is part of a public offering, it will be fully taxable to the existing owner.[244]

c. **Formation of an UPREIT**

Under the UPREIT structure an "umbrella" or "operating" partnership is formed to hold the real property to be securitized.[245] The umbrella partnership is formed by having the existing owners contribute their interests in the appreciated real property to the partnership in exchange for limited partnership interests.[246] If the real property is currently held by a property partnership then either: all or a portion of the existing-owner partners may contribute their property partnership interests to the umbrella or the property partnership itself may contribute its properties in exchange for the umbrella partnership units and then liquidate.[247]

---

[240] I.R.C. § 351(a)
[241] I.R.C. § 351(e)(1)
[242] Treas. Reg. § 1.351-1(c)(1)-(2).
[243] Rev. Rul. 87-9, 1987-1 C.B. 133 (cash was treated as diversifying asset).
[244] Gregory W. Goff & Iman Anabtawi, Umbrella Partnership REITs (UPREITs), 46-21 USC Law School Institutes On Major Tax Planning, 2105.
[245] Clifford E. Kirsch, UPREITs, §14:3.1 (Nov. 2011).
[246] Gregory W. Goff & Iman Anabtawi, Umbrella Partnership REITs (UPREITs), 46-21 USC Law School Institutes On Major Tax Planning, 2105.
[247] Id.

Simultaneously with the contribution, the newly formed REIT will raise cash from a public offering of shares. This capital is then contributed to the umbrella partnership in exchange for the general partnership interest in the umbrella partnership.[248] The umbrella partnership then uses the capital contribution by the REIT to either: repay debt carried on the properties contributed by the existing owners or to fund new acquisitions.[249]

Following the formation transactions of the UPREIT the existing owners receive pro rata distributions from the umbrella partnership on their limited partnership interests. Distributions are also passed through to the UPREIT's public shareholders.[250]

In addition to partnership interests, the umbrella partnership's agreement generally provides that limited partners may exchange their partnership interests for shares in the UPREIT on a one-to-one basis, or, at the UPREIT's election, an equivalent amount of cash.[251] Although this future conversion of umbrella partnership interest to UPREIT shares will be a taxable event, the original partner has the ability to time the exchange thus allowing for efficient tax planning and liquidity.

From an estate planning perspective UPREITS are a tremendous tool. Under section 1014 a post-death conversion of partnership interest to UPREIT shares or cash allows survivors to receive a "stepped up" basis in the partnership interest without incurring tax liability other than appreciation going forward.[252] As will be explained below, like other long term holders of leveraged investment real estate, the holder of UPREIT shares will benefit from the special estate planning techniques described below – namely, the use of the entity freeze under section 2701 of the Code.

---

[248] Id.
[249] Clifford E. Kirsch, UPREITs, §14:3.1 (Nov. 2011).
[250] Id.
[251] Bart Sheehan & Marshall D. Feiring, Background and Development of the REIT Industry, Practicing Law Institute, Financial Product Fundamentals, (July, 12 2012).
[252] Id.

d. Deferral of Taxable Gain

The original owner's of the appreciated property's tax recognition is deferred until the partnership either sells the property in a taxable transaction or when the owner converts his partnership interest to REIT shares or cash. In order to maintain control over tax deferral the property owner usually negotiates a standstill agreement where the REIT agrees not to sell the property in a taxable disposition for a certain period of time, usually five to ten years.[253] In order to further maintain control of the property owner and REIT may agree to a lesser remediation such as a best efforts attempt to facilitate an exchange under § 1031 rather than a sale, or the property owner may obtain a right of first refusal to repurchase the property.[254]

e. Drawbacks of the UPREIT Structure

Although the UPREIT structure has been used to circumvent adverse tax consequences for holders of appreciated real property it is not without fault. The structure presents the possibility for conflict between the UPREIT's public shareholders and the holders of the partnership units; such conflicts arise in four situations: (1) paying down debt on contributed properties, (2) the potential sale of contributed properties, (3) the choice of depreciation allocation methods with respect to contributed property with built-in gain under section 704(c) and (4) a potential merger or acquisition situations, particularly involving cash offers.[255] Under each of the above situations a conflict arises where: the holders of the partnership units wish to continue to defer tax liabilities on the contributed properties and their tax basis, and the UPREIT shareholders, who do not share such concerns, seek only to maximize the return on their investment in the UPREIT.[256]

---

[253] James P. deBree, Jr. UPREITs and DownREITs Gain Popularity, Commercial Investment Real Estate Magazine, (Mar/April 1998). http://www.ccim.com/cire-magazine/articles/upreits-and-downreits-gain-popularity
[254] Id.
[255] Clifford E. Kirsch, UPREITs, §14:3.1 (Nov. 2011).
[256] Id.

LEVERAGED ESTATE PLANNING WITH GRANTOR TRUSTS

Both GRATS and IDGTS are, if correctly drafted, known as grantor trusts within the meaning of Section 671. The consequences of being a grantor trust is that income earned by the GRAT or IDGT is deemed to be earned by the grantor, and thus taxed to the grantor. For income tax purposes no sale is deemed to occur as long as the trust remains a grantor trust. Rev. Ruling 85-13, 1985-1 C.B. 184.

The income tax paid by the grantor for the GRAT's/IDGT's income is, in effect, a further nontaxable gift. In addition, a transfer to a GRAT or IDGT is essentially ignored for income tax purposes. These characteristics generally enhance the tax benefits and estate planning objectives of the grantor. For instance, in general, a sale, even of leveraged real estate, to a GRAT or IDGT does not trigger a taxable gain to the grantor. Similarly, a gift of property subject to liabilities in excess of basis (or a partnership interest with a negative capital account) to a GRAT or IDGT is not a taxable event to the grantor, at least initially.

Contrast this with an outright gift of property with liabilities in excess of basis that will, at a minimum, be treated as a taxable sale of the property for the amount of the liabilities. The problem with this non-recognition-of-gain tax treatment is that the taxable event avoided when the GRAT or IDGT was created may be triggered later on the termination of the grantor trust status of the trust. With a GRAT, this occurs on the expiration of the GRAT's term unless there is a continuing trust that is a grantor trust. For an IDGT, termination occurs on the grantor's death or perhaps sooner.

The GRAT or IDGT transactions may forego a stepped-up basis on death. The stepped-up basis can extinguish the phantom income tax liability potential inherent in such leveraged real estate interests forever. This lack of a basis step-up is true for all lifetime gifts, and not getting it can be a reasonable tradeoff for saving estate taxes in some situations. In the

context of leveraged real estate with liabilities in excess of basis, however, the loss of a stepped-up basis can be fatal to an otherwise sensible plan.

a. Income Tax Challenges of GRATs and IDGTs

With the GRAT or the IDGT, the transfer is essentially ignored for income tax purposes.[257] Consequently, if there were a transfer that would otherwise generate income tax consequences, those consequences are avoided (or perhaps better stated, deferred) at inception. For example, a sale of appreciated property for an installment note may generate taxable gain unless the purchaser is a grantor trust as to the seller. Likewise, a sale of an appreciated asset to a trust would, absent the grantor trust rules, result in gain recognition. Contrast an outright gift to a trust that would not normally result in a taxable gain. Yet outright gifts are not usually considered optimal since they do not entail leverage. GRATs and IDGTs do involve leverage so that more appreciation may be transferred if the asset appreciates after the transfer. Lifetime gift exemptions, and other gift exemptions, can be significantly leveraged through these techniques contrasted with the outright gift.

Even an outright gift can trigger income tax consequences if the transferred asset is subject to liabilities in excess of basis. Nonetheless, if the transfer is made to a grantor trust, the income tax consequences can likewise be avoided, at least at inception.

The problem with transfers to grantor trusts is that if the trust ceases to be a grantor trust, the tax consequences that were avoided at inception may be triggered. The following paragraphs discusses when and if these tax consequences may be incurred.

As discussed above, both GRATs and IDGTs are, if correctly drafted, grantor trusts within the meaning of section 671. As a consequence of being a grantor trust, income earned by the GRAT or IDGT is deemed to be earned by the grantor and thus taxed to the

[257] *See Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984) and Rev. Rul. 85-13.

grantor. When the grantor sells assets to the grantor trust (or when assets are deemed sold where liabilities exceed basis) the grantor is treated as having retained ownership of the asset so that as long as the trust remains a grantor trust no sale is deemed to occur for income tax purposes.[258] Also note that while the grantor is treated as having retained ownership of the assets, the transfer can be deemed completed for gift, estate and generation skipping taxes purposes.

The corollary to this non-recognition-of-gain tax treatment is that the taxable event avoided at the time of transfer may be triggered later on the termination of grantor trust status. This termination occurs on the grantor's death, or perhaps sooner if grantor trust status is otherwise terminated.[259] As discussed below, there is some disagreement among commentators as to whether gain is triggered, or if a basis step-up is obtained, upon the death of the grantor.

Normally, when a gift is made there is no basis step-up under section 1015. Section 1015 provides that a donee's basis in gifted assets is the lesser of the assets' fair market value or the donor's basis in the assets. The lack of a basis step-up can be a reasonable tradeoff for saving transfer taxes in the long run. Yet where liabilities exceed basis, the loss of the step-up can significantly reduce the benefits of such planning. It is debatable whether it is even possible to transfer assets that are so encumbered to a succeeding generation without triggering gain on liabilities in excess of basis. In the context of leveraged real estate with liabilities in excess of basis, the loss of a stepped-up basis can be fatal to an otherwise sensible plan.

The use of GRAT or IDGT transactions may preclude the basis step-up that would otherwise occur upon the death of the grantor, which step-up would eliminate the phantom income attributable to liabilities in excess of basis or negative capital. This can be a

---

[258] Rev. Rul. 85-13.

[259] Some of the key features that would cause a trust to be a grantor trust include: (i) grantor or a nonadverse party having a power to direct the beneficial enjoyment of the trust income or principal without the approval or consent of any adverse party, (ii) grantor, in a non-fiduciary capacity, having the power to reacquire trust property, by substituting property of equivalent value without the approval or consent of any person in a fiduciary capacity, and (iii) grantor having the power to revest title to trust property. *See* IRC §§ 671-679.

major disadvantage when planning involves leveraged low basis real estate or interests in partnerships holding such assets.

b. Uncertain Tax Consequences of the Grantor Trust - Death of the Grantor

Upon the death of the grantor, do the grantor trust assets receive a section 1014 basis adjustment, even though the assets are not includible in the grantor's gross estate? A definitive answer to this question has eluded practitioners for years. The Service now appears poised to provide its own answer.

On June 15, 2015, the Service released Rev. Proc. 2015-37, which advised that, until the Service resolves the issue, it will no longer issue individual private letter rulings on whether the basis of assets in a grantor trust must be adjusted to reflect their fair market value upon the grantor's death if those assets are not includable in the grantor's estate. Soon thereafter, on July 31, 2015, the Service and Treasury released the 2015-16 edition of their Priority Guidance Plan, which identifies the "basis of grantor trust assets at death under section 1014" as a project that will be a priority for resource allocation. Although the priority guidance plan expressly refers to section 1014, the forthcoming guidance is also likely to address the flip side of this issue -- namely whether gain is recognized upon the death of the grantor.

The addition of this issue to the no-ruling list and the Priority Guidance Plan strongly indicates that the Service is preparing more authoritative guidance on this question, thereby putting an end to the uncertainty. This guidance, especially if it is issued during the remainder of the Obama Administration, will likely reflect some of the policies already expressed in the Obama Budget Proposals to the extent they can do so as interpretations of existing law. It is believed that these proposals could significantly curtail leveraged planning with grantor trusts and would treat death as a realization event. While it is unlikely that

administrative action could accomplish all of the objectives set forth in the budget proposals, it could severely impact planning with grantor trusts – especially installment sales.

c. What Happens If the Grantor Dies?

In answering the question of whether there is a section 1014 basis adjustment upon the death of the grantor, the Service may address related issues. For example, if the amount of liabilities assumed by the trust exceeds the adjusted basis of the property transferred, is there gain? If the grantor dies while the note is outstanding, does the death of the grantor trigger taxable gain under section 1001(a)? Is the installment method available for reporting the gain under section 453? Is this gain treated as income in respect of a decedent under section 691? ***There is no case, regulation or published ruling that directly addresses these questions.***

Given the importance of these issues to this ubiquitous estate planning technique, it naturally follows that there is no shortage of commentators willing to opine - the authors of this article included.[260] It is the view of the authors of this article that there is a significant risk that the death of the grantor will trigger a tax, and that a closer examination of these risks may also shed light on the Service's impending action.

d. Termination of Grantor Trust Status – During Grantor's Life

While there is disagreement regarding the effect of the termination of grantor trust status upon the grantor's death, the income tax effects of terminating grantor trust status during the grantor's life are well-settled. If the grantor trust status ends, the grantor is deemed to have transferred the assets and liabilities in the trust to the trust. The trust becomes a separate taxable entity for income tax purposes, and the grantor is taxed on consideration received by the grantor

[260] Deborah V. Dunn and David A. Handler, Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates," 95 J. Tax'n 49 (2001); Blattmachr, Gans & Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 96 J. TAX'N 149 (Sept. 2002). Carol A. Cantrell, Gain is Realized at Death, Trusts & Estates (February 2010); Jonathan G. Blattmachr and Mitchell M. Gans, "No Gain at Death," Trusts & Estates (February 2010).

in excess of the basis in the property transferred.[261] This can include liabilities in excess of basis and notes received for the trust.

e. **Termination of Grantor Trust Status – Upon Death of Grantor**

Despite the relative certainty regarding a lifetime termination of grantor trust status, there is sharp disagreement regarding the income tax consequences where the grantor trust status ends as a result of the grantor's death. Here is a comparison of the prevailing views.

View 1 - no gain on death of grantor. Proponents of this view state that there is no existing rule that expressly treats a transfer at death as a realization event for income tax purposes. And as death is not an income tax realization event, there cannot be any gain realized at death, regardless of the deemed transfer resulting from the termination of grantor trust status.

Under section 1001(b), the term "amount realized" is defined as "including cash and the fair market value of other property received upon a sale or disposition of an asset." In the case of a lifetime gift, which ordinarily does not involve the receipt of any consideration, gain is not recognized. And by analogy, bequests should be treated the same.

The Supreme Court case of Crane v. Commissioner, 331 U.S. 1 (1947) is often cited for the proposition that a testamentary gift should not trigger gain. In Crane, a beneficiary inherited property encumbered by a nonrecourse liability equal to the fair market value of the property. The property was sold several years later. In determining the amount of gain realized upon the sale by the beneficiary, the Court held that the beneficiary's basis in the property was equal to the appraised value at the time of inheritance. That is, the property received a basis step-up upon the previous death of the decedent. Noteworthy is that Crane did establish the proposition that is now well settled that the basis step up includes not just the equity value of the property

[261] Madorin v. Comm'r, 84 T.C. 667 (1985); Treas.Reg. §1.1001-2(c), Ex. (5); Rev. Rul. 77-402, 1977-2 C.B. 222. Each of these authorities involves debt relief as consideration paid.

transferred (there was none in Crane under the stipulated facts of the case) but also the nonrecourse liabilities to which the property was subject at death.

The proponents suggest that Crane implies that there was not a sale of the asset at death, and therefore there was no gain realized at death. Within the context of a sale to a grantor trust, the proponents of this view argue that the death of the grantor should similarly not be treated as a sale, but rather as a bequest. But they ignore the fundamental nature of the sale to grantor trust technique, that it is a "sale", and cannot be analogized to a bequest without an extraordinary leap of logic. They also ignore the well-established principal that if property is gifted but subject to liabilities in excess of basis to the extent of the excess even a nominally gratuitous transfer will be treated as a part sale to the extent of that excess.

Furthermore, whether the death of a grantor is characterized as a sale or a bequest is not fully dispositive of the question whether gain is realized at death. In fact, Crane itself suggests otherwise by finding that "amount realized" includes debt relief. Keep in mind that the debt in Crane did not exceed the property's basis.

In addition to the overstatement of the holding in Crane, proponents ignore the importance of Treas. Reg. §1.684-2(e) which is a close analogue. Section 682 provides that when a foreign trust ceases to be treated as a grantor trust, the grantor will be deemed to have transferred the trust assets immediately before, but on the same date that, the trust is no longer treated as a grantor trust resulting in gain recognition by the decedent. It is a glaring exception to the "no gain at death" rule. The mere existence of such an exception is conclusive that United States Supreme Court decision in Crane did not establish a blanket "no gain upon death" rule.

The Service's position regarding the income tax consequences of a grantor's death are purportedly found in Chief Counsel Advice 200923024. In this CCA, the Service advised that a conversion of a non-grantor trust to a grantor trust is not a transfer for income tax purposes (of

the property held by the non-grantor trusts to the grantor) that requires recognition of gain to the grantor. In response to the authorities that conclude there is a taxable event where grantor trust status is terminated during the grantor's life, the Service stated that "[w]e would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event."

While CCAs may provide some insight into how the Office of Chief Counsel analyzes the issue, there is no assurance that the Service will apply in other situations. Furthermore, the part of the CCA previously quoted is essentially dictum, as it is not essential to the advice given. In any event, CCAs are issued to field or service center employees, and pursuant to section 6110(j)(3), cannot be used or cited as precedent. Nor is a CCA subject to the levels of review and vetting of a published revenue ruling or Treasury Regulation – which are authoritative. Taxpayers and their advisers simply cannot rely on CCAs as precedent.

View 2 - gain on outstanding promissory note. Proponents of this view follow the same rules for termination of grantor trust status at death that apply during lifetime. If the grantor dies before the note is paid off, the death causes a realization of the portion of the grantor's gain attributable to the unpaid portion of the note.[262] This view suggests that the resulting realization of gain would be the same that would occur had the grantor trust status terminated during the grantor's lifetime.

Gain on third-party liabilities in excess of basis. Proponents of this view also argue that death causes a realization of gain to the extent that third-party liabilities secured by the trust assets exceed the basis in the assets. Again, proponents suggest that the resulting gain would be the same that would have occurred had the grantor trust status terminated during the grantor's

[262] See Frane Est. v. Comr., 998 F.2d 567 (8th Cir. 1993), where the cancellation of an installment note occurred at the death of the borrower, the court held that it constituted a disposition of the note that triggered gain that had to be recognized by the decedent's estate under IRC § 691(a)(2).

lifetime. They find no reason to differentiate the outcome where grantor trust status is terminated as a result of the grantor's death.

If the liability is a recourse liability, then the gross value of the asset is reported on the estate tax return, for example, if real estate then on Schedule A. The amount of the recourse mortgage is reported separately on the estate tax return on Schedule K. If the liability is a nonrecourse liability, the net equity value of the property (net of the debt) is included in the gross estate and is only reported on the estate tax return, for example, if real estate then on Schedule A.

Income in Respect of a Decedent. An issue related to whether there is gain on the outstanding promissory note which would actually be included in the grantor's estate, is whether the gain should be recognized as income in respect of a decedent under section 691 ("IRD") when the note is paid.

Again, it is unclear how far the grantor trust "fiction" of Rev. Rul. 85-13 would be extended. There is at least one authority that suggests that even if the sale did not in fact occur until after death – clearly after the grantor trust status has terminated, there may be an income tax consequence of the sale because it was "fully baked" prior to death. For example, in Rev. Rul. 78-32, prior to death, a decedent entered into a binding executory contract for sale of real property and had substantially fulfilled the prerequisites to consummation of the sale. However, the sale was completed subsequent to death, by the decedent's executor. In finding that the decedent was unconditionally entitled to the sales proceeds at the time of death, the Service ruled that the gain realized from the sale was IRD. Actual consummation of the sale prior to death was not determinative.

The argument has been made that the fiction of Rev. Rul. 85-13 that the sale is disregarded as long as grantor trust status continues should be extended to avoid IRD treatment. The argument is that since the sale is "deemed' not to have occurred for income tax purposes

during lifetime, and since the termination of grantor trust status occurs at death (rather than during the lifetime of the grantor trust) there can be no IRD. This argument relies on an expansive reading of the scope of Rev. Rul. 85-13 – beyond what was likely intended. Rev. Rul. 85-13 does not actually speak to what happens when grantor trust status ends. Rev. Rul. 85-13 was a result oriented ruling designed to overrule the too good to be true ruling in the Second Circuit decision in Rothstein v. United States.[263] In Rothstein the court concluded that the taxpayer, upon the purchase of property from a grantor trust obtained a cost basis even though the purchase from the trust did not result in recognition of gain. Rev. Rul. 85-13 was the Service's attempt to disallow this result which would have no doubt spawned a generation of abusive basis creating transactions with grantor trusts. It is ironic that Rev. Rul. 85-13 is now being relied upon to support another generation of basis creating transactions – namely, the use of grantor trusts to avoid gain recognition permanently while arguably ensuring a full basis step up upon the death of the grantor, without IRD and without estate tax inclusion.

What is wrong with this picture? It is the position of the authors of this article that Rev. Proc. 85-13 is being ascribed an expansive meaning that was never intended and which is not actually articulated in the ruling. It is also the view of the authors of this article that imposing a gain upon death rule would be harsh and contrary to taxpayer expectations and sound tax policy. Any attempt to impose such a rule would be highly ridiculed and subject to challenge. A more practical solution would be to treat the unrecognized gain as IRD, provided there is a method in the Code to preserve that treatment such as the installment method under section 453. Unfortunately, the installment method has limited application and could not provide a blanket shield against gain recognition upon death.

[263] 735 F.2d 704 (2n Cir. 1984).

The application of the installment method under section 453 has considerable appeal. The Treasury Regulations provide that if an individual makes a sale before the individual's death which is being recognized under the installment sale rules of section 453, then it should be treated as IRD.[264] It might be argued that the sale that in fact occurred at the consummation of the estate planning transaction should be ignored under Rev. Proc. 85-13 and that this precludes the application of Treas. Reg. 1.691(a)-5(a) since no sale is deemed to occur during the grantor's lifetime. As discussed, this is probably an overly broad interpretation of Rev. Proc. 85-13 which did not actually speak to what happens when grantor trust status ends whether or not that occurs upon the death of the grantor. It is difficult to ignore Rev. Rul. 78-32 which also involved a sale that did not close until after death but was nevertheless treated as giving rise to IRD. Nevertheless, even if the transaction can be treated as an installment sale giving rise to IRD the more difficult question is whether gain is recognized upon death where the installment method is not applicable. There are significant exceptions to the installment sale method of reporting gain. For example, gain from the transfer of assets with liabilities in excess of basis does not qualify for the installment method (to the extent of the liabilities in excess of basis). And sales of depreciable property to a related person similarly do not qualify.[265] If a sale to an intentionally defective grantor trust falls under these exceptions, the gain (to the extent of liabilities in excess of basis, or all gain if considered a sale to a related party) would not be able to be deferred at death under Treasury Reg. 1.691(a)-5(a). Perhaps the IRS could simply deny the basis step up leaving the gain to be deferred until the assets are sold. Certainly that would be a preferred outcome to gain recognition at death – which would be quite repugnant. The Service would risk taxpayer revolt if it were to impose both an income tax and an estate tax on the same assets at death. However, that is the result provided for in the Obama budget proposals. Presumably, if

[264] Treas. Reg. § 1.691(a)-5(a).
[265] IRC §453(e).

the Service could find a way to justify that treatment, it would during the remainder of the Obama administration.

f. Is There a Basis Step-Up in the Trust Assets?

Related to the question of whether gain is triggered as a result of the grantor's death, is whether death of the grantor would give rise to a basis step-up under section 1014. Do the trust assets receive a basis step-up under section 1014(b)(1) because the trust is "acquiring property from a decedent"? Or is the basis step-up denied under section 1014(b)(9) because the assets are excluded from the grantor's gross estate? Here again there is no definitive legal authority and therefore disagreement among the commentators. The following is a comparison of the prevailing views.

View 1 – yes, there is a basis step-up under section 1014. The trustee is viewed as having acquired the assets by bequest or devise, and as a result, the basis will equal the estate tax value under section 1014. Section 1014(b)(1) does not depend on actual estate-tax inclusion. Instead, the trust assets receive a date-of-death value basis adjustment under section 1014(b)(1) as property "in the hands of a person [the trust] acquiring the property from a decedent or to whom the property passed from a decedent."[266] A variation of this view is that the deemed change of ownership for income tax purposes at the grantor's death (from the grantor to the trust) constitutes the receipt of property from a decedent for purposes of section 1014, and that there should be a basis step up even though the assets are not included in the gross estate.[267] In addition to the trust assets, it is argued that the note also receives a basis step up under section 1014, as the note is included in the decedent's gross estate. This position includes the assertion that the note is not IRD, because section 1014(c) excludes IRD from receiving a basis step-up.

---

[266] See PLR 201245006, where there was a basis step-up on the grantor trust's assets that passed to the grantor's issue at the grantor's death.

[267] See Blattmachr, Gans & Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 96 J. TAX'N 149 (Sept. 2002).

It also relies upon the premise that the gain is not recognized during the decedent's lifetime since the grantor trust ends at death, not before.

In PLR 201245006, a U.S. non-resident alien proposed to transfer U.S. situs assets (stock publicly traded in the U.S.) to an irrevocable grantor trust. Under the terms of trust, all of the income is required to be paid to the taxpayer, making it a grantor trust under section 677(a). The Service ruled that the basis of property held in the grantor trust will be stepped up to under Section 1014(a) on the taxpayer's death, despite the fact that the assets in the trust are not subject to estate tax. At a panel conducted at a meeting of the Tax Section of the American Bar Association, an attorney from Chief Counsel's office commented that the government was troubled by their own lack of coordination that resulted in the issuance of PLR 201245006 and CCA 200937028 which appear to directly contradict each other. In a matter of months after that a meeting, Rev. Proc. 2015-37 was issued to prevent any further such contradictions. As stated, the inclusion of this item on the priority guidance plan during 2015 indicates that this issue will be resolved at some point definitively. Any reliance upon PLR 201245006 may be perilous at this point.

View 2 – no, there is not a basis step-up under section 1014. Under this view, the trust assets were not "acquired from a decedent" and do not "pass from a decedent". The trust assets did not pass pursuant to decedent's will or by intestacy. And the grantor does not have rights over the trust that would result in inclusion of the trust assets in the grantor's estate for estate tax purposes. The termination of grantor trust status by reason of the grantor's death should not be viewed as a testamentary transfer. And since the trust assets are not included in the gross estate, there is no step up under Section 1014.[268] In regard to the outstanding promissory note, although

[268] See CCA 200937028, which states that there is no basis step up under IRC §1014 unless the asset is included in the decedent's estate.

it is included in the grantor's estate for estate tax purposes, to the extent it is IRD, it is not entitled to a step-up in basis under Section 1014(a).

The grantor trust status is terminated on the grantor's death. As the trust then becomes a separate taxpayer for Federal income tax purposes, the purchase comes into income tax existence at that time. The deemed transfer should be viewed as a sale by the grantor to the trust, and the trust's basis will equal the purchase price under Section 1012. Under Section 1012, the trust should take a basis in the asset that includes the outstanding principal amount of the note at the date of death.

Note that there are two distinct sides to this transaction – the transferor and the transferee. On the transferor side, there is a sale in exchange for a note. The note is the asset that in actuality is included in the transferor's estate. If the note does not get a basis step up the gain is preserved but the asset will be subject to both estate tax and income tax – a result that is generally abhorrent under our tax system except in the case of IRD – which can only apply if the installment method under section 453 also is available. As stated the installment method is not available for liabilities in excess of basis and for sales of depreciable property to related parties. As to property subject to liabilities in excess of basis, it is difficult to imagine how the liabilities in excess of basis can be carried over to the estate absent a basis step up since it is clear that this amount will be subject to income taxation for inter vivos transactions. The difficulties of obtaining this carryover treatment would likely require an act of legislature. Thus, at least as to liabilities in excess of basis, or in the case of interests in a partnership, negative capital, it is hard to imagine how to avoid gain recognition upon death even if the trigger is termination of grantor trust status. This suggests a similar treatment to that which occurs for lifetime terminations of grantor trust status – namely, gain is recognized to the extent liabilities exceed basis.

The other side of the transaction is the basis obtained by the former grantor trust which is the purchaser. If you must conclude that gain must be recognized by the estate to the extent of liabilities in excess of basis, it would be incongruous to not allow the trust to obtain a cost basis under section 1012 to the extent of the liabilities assumed or to which the property is subject – but not on any equity value in excess of that amount. Note that Crane, which established that the basis of inherited property includes liabilities to which the property was subject, was decided under a predecessor to section 1014 – not section 1012 (cost basis). Thus Crane does not support the conclusion that upon termination of the grantor trust status at death the trust should obtain a cost basis for the liabilities. Nevertheless that appears to be the correct result.

In sum, the correct result seems to be that the only gain compelled to be recognized should the liabilities in excess of basis on the transferor side – namely the estate. But that the trust should only attain a basis step up to the extent of liabilities assumed or to which the property is subject in excess of basis.

The conclusion that there is no gain recognition and that the trust obtains a full basis step up may soon be repudiated by IRS guidance. Pending further guidance on this issue, it is imprudent to predicate planning on this treatment. Moreover, existing plans should be revisited to the extent that they were structured in reliance upon this treatment.

g. **President Obama's Budget Proposals**

Several of the Obama Administration's prior budget proposals contain the end of the sale to an intentionally defective grantor trust as a viable estate planning technique. The 2013 fiscal year budget proposal would have included all of the grantor trust assets in the grantor's gross estate for estate tax purposes. The 2014 and 2015 fiscal year budget proposals somewhat temper the approach by included in the gross estate only the portion in a grantor trust that is attributable to a "sale, exchange or comparable transaction" from the grantor.

The Obama Administration's goals are evident in these proposals. They want to eliminate the use of grantor trusts as a method of estate tax minimization. No one expects the current Congress to take action. As a result, in the final year of the presidency, the Obama is likely to take action on its own. The Administration will likely do administratively what it cannot do legislatively. For example, the Service can issue Revenue Rulings and Notices in an attempt to achieve as much of their goals as they can, including their goals related to gain on death, IRD and basis step-up.

h. **Planning to Avoid the Risks**

One option is for the grantor to pay off or unwind the installment note before the grantor dies. This avoids the entire question of whether there is gain on death of the grantor relating to the installment note. Another option is for the grantor to reacquire the trust assets using cash. This may be the only option for assets subject to liabilities in excess of basis. If the assets are highly leveraged it may be less expensive for the grantor to reacquire these assets for cash than to pay down underlying mortgage indebtedness. If the assets are reacquired by the grantor, the uncertainty regarding a basis step up for grantor trust assets is entirely avoided since assets owned by directly by the grantor will receive a basis adjustment. If the assets were previously transferred to the grantor trust and have since appreciated, a repurchase will leave the appreciation in the trust which will have accomplished the desired planning objective. An alternative may be to exchange the low basis appreciated assets for assets with a high basis more recently acquired by the grantor.

As to the assets reacquired, or for new planning, the grantor should explore alternative planning techniques, such as the freeze partnership, that avoid these risks altogether. The freeze partnership is a leveraging technique that if properly structured, can leave as much of the built in

gain, including liabilities in excess of basis, in the estate to obtain a basis step up while transferring appreciation to a trust.

i. Contrast Entity Freezes

The entity freeze under section 2701, if properly structured, can avoid the tax consequences associated with transfers to grantor trusts, whether those consequences are incurred at inception or at the termination of trust's grantor trust status. The entity freeze technique normally does not depend upon a transfer to a grantor trust to avoid the income tax consequences of its creation. For example, if the entity freeze involves a partnership, or limited liability company taxed as a partnership, the initial transfer would normally be treated as a contribution to a partnership rather than a transfer to a grantor trust. The rules governing contributions of appreciated property to partnerships are very different from the grantor trust rules. Contributions to partnerships in exchange for partnership interests are normally entitled to non recognition under section 721. Even if the property is subject to liabilities in excess of basis, in general, gain will not be recognized at inception under the interplay between section 704(c) and section 752, both of which are discussed in greater detail below.

FREEZE PARTNERSHIPS FOR LEVERAGED LOW BASIS REAL ESTATE INVESTMENTS

The partnership freeze is the preferred method of planning when the client owns low basis leveraged real estate. Failure to appropriately plan for the inherent income tax consequences of property with liabilities in excess of basis can have devastating tax consequences.

As discussed above, this type of scenario is relatively common for real estate interests where cash proceeds of refinancing have been taken or where the property has been fully depreciated. The triggering of this gain can often result in an income tax liability to the

transferor that is greater than the potential estate tax savings, or perhaps, the equity values that were the initial motivation for the creation of the GRATs, IDGTs, etc.

In planning for assets with these characteristics, the potential savings in estate, gift and generation skipping transfer taxes must be weighed against the loss of a basis step-up under section 1014 upon death – or even worse, the possibility of incurring an income tax on the built-in gain resulting from use of the planning technique. It is in this context that the benefits of the freeze partnership may take hold. Avoiding these negative income tax consequences can be far more valuable than where the offsetting cost of an increased hurdle rate applies to the freeze partnership. In fact, if properly structured, the costs of the greater hurdle rate can be greatly mitigated. Moreover, as in the context of the reverse freeze described below, the greater hurdle rate may even be a benefit that enhances the planning for certain types of assets – particularly, low yielding assets.

1. **Partnership Freeze Solution**

If there is one principle to take away from the foregoing discussion it is that where property is subject to liabilities in excess of basis and such property has been transferred to a grantor trust, the tax consequences upon the death of the grantor are somewhat uncertain. Respected commentators reason that upon the death of the grantor there would be no gain recognized and there may be a basis step-up. However, other commentators believe there may be gain recognition upon death and only in where gain is recognized will there be a basis step-up. It appears that the IRS view is that there would be no gain upon death and no basis step-up.

As described below, the freeze partnership technique can avoid this uncertainty and attendant risk. This technique should be carefully considered among the alternative planning techniques for low basis leveraged real estate. This is because a retained frozen interest in a freeze partnership will be entitled to a basis step-up upon death. Moreover, if properly

structured, the liabilities in excess of basis can be allocated to the frozen interest so that the basis step-up can eliminate the inherent gain attributable to liabilities in excess of basis or negative capital.

The freeze partnership can thus transfer appreciation and, perhaps, values out of the estate without foregoing the basis step-up that is necessary to eliminate the phantom income attributable to liabilities in excess of basis (in the case of outright real estate ownership) or negative capital accounts (for real estate owned by a partnership or limited liability company). Moreover, by employing the leveraging techniques described herein it should be possible to overcome the higher hurdle rates necessary to be paid under this technique. Alternatively, the higher hurdle rates can provide a planning benefit for low yielding assets through the use of the reverse freeze technique.

2. **Elements of the Freeze Partnership under Section 2701**

Briefly stated, the freeze partnership typically has two classes of partnership interests:

1. Preferred interest, which is entitled to a preferred return and a liquidation preference (like preferred stock).

2. Junior equity interest, which is entitled to growth and appreciation (like common stock).

In the normal freeze partnership, the preferred interest is typically retained and the junior equity interest must be worth at least 10% of the value of the partnership at the time of the transfer. The transaction is called a freeze partnership because the value of the preferred interest is frozen at the time the junior interest is transferred or otherwise acquired. Assuming the hurdle rate is met and the preferred return is paid, only the junior equity interest appreciates in value over time as the partnership assets appreciate in value.

Intra Family Transfers: Within the family context (meaning with a family controlled entity), section 2701 imposes certain requirements to avoid a deemed gift which can be as much as the entire value of the entity even though a preferred interest is retained. Section 2701 applies where the junior equity interest (or any equity interest under the literal wording of the statute) is transferred in a family controlled corporation or partnership to a member of the transferor's family (generally, of an equal or lower generation). Treasury Regulation section 25.2701-1 sets forth the general rules. Certain technical definitions apply.[269]

The Regulations Under Section 2701: Treasury Regulation section 25.2701-1(a) sets forth the scope of section 2701 as follows:

> *In general*—(1) *Scope of Section 2701.* Section 2701 provides special valuation rules to determine the amount of the gift when an individual ***transfers*** an equity interest in a corporation or partnership to ***a member of the individual's famil***y. For section 2701 to apply, the transferor or an ***applicable family member*** . . . must, immediately after the transfer, hold an ***applicable retained interest*** (a type of equity interest defined in §25.2701–2(b)(1))(emphasis added).

This excerpt highlights key terms which must be understood to work safely within the framework of section 2701. Those terms are "transfer", "applicable retained interest, "member of the individual's family", and "applicable family member."

The Requirement of a "Transfer": As a threshold matter, for section 2701 to apply there must be a "transfer." Even if no actual gift has occurred, as where there is a transfer for full and adequate consideration, there can be a transfer for purposes of section 2701 resulting in a deemed gift. The term "transfer" includes transactions such as contributions to the capital of a corporation (or partnership), recapitalization of a corporation (or a partnership), redemptions

[269] Partnership freezes are not the only estate freeze techniques which may be subject to Section 2701. If the IRS believes that a note to the grantor of an IDGT is equity rather than debt, it will argue that the trust is a preferred partnership interest subject to section 2701. Unless the retained interest includes a qualified payment right, the interest is valued at zero causing the transferred asset to be a taxable gift valued at full fair market value. *See Karmazin v. Comm'r*, T.C. Docket No. 2127-03. *See also* IRS Priv. Ltr. Rul. 9535026.

and certain other terminations of an interest in such entities. Thus the creation of a partnership among family members where each member contributes its share to capital must satisfy the requirements of section 2701 to avoid a deemed gift even if no gift was intended.

The Retained Interest: Another element necessary for section 2701 to apply is that the transferor must retain either (i) an "extraordinary payment right" or (ii), in the case of a controlled entity, a "distribution right." These terms are defined in section 25-2701-2 of the Treasury Regulations.

Extraordinary payment right is, in general, any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.[270]

Distribution right. A distribution right is the right to receive distributions with respect to an equity interest but not any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest.[271] Thus, it is by operation of this definition that partnerships that provide strictly proportionate allocations are generally not subject to section 2701.[272] Guaranteed payments, as such term is defined in section 707, are not considered distribution rights for purposes of section 2701. Under section 707, guaranteed payments are payments made to a partner by a partnership without regard to the income of the partnership. An example of a guaranteed payment is the payment of interest on capital invested by a partner.

---

[270] Treas. Reg. § 25.2701-2(b)(3).
[271] *Id.*
[272] Treas. Reg. § 25-2701-2(b)(4) provides as follows: "Rights that are not extraordinary payment rights or distribution rights. Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights."

Transferor - Applicable Family Member Definition: Section 2701 applies if there is a transfer by an "applicable family member" to a "member of the individual's family."[273] Applicable family members generally include the transferor, the transferor's spouse, either of their ancestors and the spouse of either of their ancestors.[274] Members of the transferor's family ("recipients") generally include the transferor, the transferor's spouse, any of their lineal descendants and the spouse of any of their lineal descendants.[275]

Requirement of Family Control: Note that section 2701 does not apply unless the entity in question is a controlled entity.[276] For purposes of Section 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer or by the transferor and the transferor's applicable family members either directly or by attribution.[277] In the case of a corporation, control means the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.[278] In the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership.[279] Any right to a guaranteed payment under section 707(c) of a fixed amount is disregarded in making this determination. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner.[280]

Look Through Rule: There is a "look through rule" which provides that an individual is treated as owning a proportionate share of equity interest held by a corporation, partnership, trust or other entity in which the individual holds an interest.[281] Family control of a

---

[273] IRC § 2701(a)(1)(B).
[274] IRC § 2701(e)(2).
[275] IRC § 2701(e)(1).
[276] IRC § 2701(b)(1).
[277] IRC § 2701(e)(3) (providing that an individual is treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust, or other entity).
[278] IRC § 2701(b)(2)(A).
[279] IRC § 2701(b)(2)(B)(i).
[280] IRC § 2701(b)(2)(B)(ii).
[281] IRC § 2701(e)(3).

top tier entity is not required by literal terms of section 2701(e)(3). Private Letter Ruling 9639054 seems to indicate that there is no look through if the top tier entity is not family controlled.[282] This is especially important with regard to a potential transfer of membership interests in a corporate general partnership or limited liability company that is the general partner or managing member of a private equity, venture capital, real estate or other fund entity. Typically, the managers of these funds will hold a carried interest and an investor interest in the same fund. Private Letter Ruling 9639054 has been cited for the proposition that if a fund manager holds a non-controlling interest in an entity that is a general partner of a fund structured as a limited partnership that fund manager will not be treated as holding control for purposes of section 2701. Unfortunately, there is an absence of authority that can be relied upon for this notion. A Private Letter Ruling can only be relied upon by the party who obtained it.

Non-Section 2701 Freezes: Section 2701 is not applicable unless the specific family control requirements are met. Thus, more aggressive, old-style freeze partnerships may still be used where the family members receiving junior equity interests are nephews or cousins. For example, payments do not have to be cumulative and there is no minimum value for the junior equity interests. However, even in these situations care must be exercised to avoid some of the valuation abuses of the past. There is a greater awareness of these types of abuses than there was prior to section 2701.

3. Structuring the Freeze Partnership: The Forward Freeze

In the typical situation, unless the provisions of section 2701 are followed, the preferred interest is valued at zero, thereby inflating the value of the transferred junior equity interest to the entire value of the partnership. This treatment acts as a penalty by artificially inflating the amount subject to gift taxation. Retained interests are given a zero value unless they

[282] IRS Priv. Ltr. Rul. 9639054 (June. 21, 1996).

include a right to receive a qualified payment.[283] Qualified payment rights are valued according to fair market value ("FMV"). If a qualified payment right is held along with an extraordinary payment right, the rights are valued as if each was exercised in the manner resulting in the lowest value for all such rights.

Qualified payments rights can be: (i) periodic dividends on cumulative preferred stock; (ii) any comparable payment from a partnership interest; or (iii) any other payment where an irrevocable election is made to treat the other payment as a qualified payment.[284] The payment of any qualified payment made (or deemed made) either before or during the four-year period beginning on the due date of the payment but before the date of the taxable event is treated as having been made on the due date.[285]

The extremely low rates of interest that are permitted in both the GRAT and the IDGT are in stark contrast with the rates of return required to be paid on a preferred interest in a section 2701 entity freeze. One source of guidance for how to determine the appropriate yield for a preferred interest in a closely held entity is set forth in Revenue Ruling 83-120.[286] While Revenue Ruling 83-120 predates section 2701, it is nevertheless instructive. In general, Revenue Ruling 83-120 adopts a facts and circumstances approach. However, it does specifically look to a number of criteria to determine the appropriate market rate of return. These criteria include yield, preferred return coverage, dissolution protection, and to a lesser extent, voting rights and lack of marketability. The liquidation preference apparently reduces the extent to which marketability has a negative impact on fair market value. Market conditions are thus the starting point for determining the appropriate return on preferred interests. One reputable appraisal firm

---

[283] IRC § 2701(a)(3)(A).
[284] IRC § 2701(c)(3).
[285] IRC § 2701(d)(2)(C); Treas. Reg. § 25.2701-4(c)(5).
[286] 1983-2 C.B. 170.

provided the following table which enumerates market returns on preferred stocks of certain publicly traded real estate holding entities:

Preferred Stock Returns in the Market

• Hotels	7.32% to 10.93%	Median – 8.96%
• Retail	6.81% to 9.97%	Median – 8.09%
• Multi-Family	6.64% to 8.22%	Median – 8.08
• Office	7.01% to 8.45%	Median – 7.73%

Market data courtesy of Anchin LLC

In the context of a privately held business entity, the lack of marketability and potentially greater risk profile would likely require somewhat higher rates of return – to be determined by appraisal. The comparatively high rates of return that must be paid on preferred interests to avoid the negative gift tax consequences under section 2701 are the reason the entity freeze is often referred to as a "leaky freeze." This term alludes to the fact that compared to other types of freeze techniques, where the returns that must be paid on the frozen interest are artificially low since they are tied to the AFR, the return that must be paid on the retained senior preferred interest to avoid a deemed gift under section 2701 must be a market rate of return for similar investments.

It may take considerable structuring to make the entity freeze work as a freeze. There are a number of methods of working around the high rate of return that must be paid on the preferred interests – if that is desired. With the modest size estate, the holder of the preferred interest may desire the higher rate of return. However, with the larger estate, the planning will typically warrant paying the lowest return possible on the retained preferred interest. Otherwise, the estate may continue to build.

Among the methods to reduce the payments in respect of the preferred would be leveraging up the equity. By increasing the debt in the capital structure there will be less equity to accrue the preferred return. Typically the debt would bear a lower rate of interest. In some instances, it may be possible to borrow from a related party or family member. In such instances it may be desirable to have the loan bear interest at the applicable federal rate. To illustrate this method assume that real estate is contributed to a Freeze LP with a fair market value of $10,000,000, an adjusted basis of $1,000,000, and it is subject to a mortgage of $8,000,000. The net equity is $2,000,000 and there are $1,800,000 in the senior/preferred capital account and $200,000 in junior/common capital account. If it is not leveraged then the preferred return at an 8% rate is $144,000. However, if it is leveraged and the Partnership takes out a $1,500,000 mid term AFR Loan and distributes the proceeds to the senior/preferred then the net equity is $500,000 and there are $300,000 in the senior/preferred capital account and $200,000 in junior/common capital account. The preferred return at a 9% rate is $27,000, and the interest on the AFR Loan (.95%) is $14,250, for a total leveraged return to senior/preferred is $41,250, which is $102,750 less than the unleveraged return of $144,000.[287]

Unleveraged		**Leveraged**	
Asset (FMV)	$10,000,000	Asset (FMV)	$10,000,000
Mortgage	($8,000,000)	Mortgage	($8,000,000)

[287] *See* Stephen M. Breitstone, *Estate Planning for Investment Real Estate: Don't Forget the Income Tax Side*, NYU, 71st Institute on Federal Taxation (2012).

Equity	$2,000,000	AFR Loan	($1,500,000)
		Equity	$500,000
Capital Accounts			
Senior	$1,800,000	Capital Accounts	
Junior	$200,000	Senior	$300,000
	$2,000,000	Junior	$200,000
			$500,000
Preferred Return	**$144,000**	Preferred Return	$27,000
		Interest on Loan	$14,250
		Total Return to Senior	**$41,250**

Alternatively, it may be possible to carve out small slice of equity that accrues the preferred return but is allocated the liabilities that result in the negative capital. Different possibilities exist. Below is a discussion of the disguised sale rules under section 707 of the Code. Leveraging up the capital structure shortly after the formation of the partnership can in some instances be considered to be a disguised sale. However, it should be possible in most instances to structure around disguised sale treatment.

One method to create a class of equity that accrues a preferred return but which is relatively "thin" would be to draft a partnership agreement where the lion's share of the equity is allocable to the common interests. A small slice of equity would be attributed to the preferred interest. By agreement, it may be possible to allocate all of the liabilities, and thus, negative capital to the preferred interest. A number of cases have held that where a taxpayer sells property encumbered by a liability but the buyer and seller agree that as between themselves, the seller shall have sole responsibility for payment of the liability, the liability is not "assumed or taken subject to" by the buyer within the meaning of Treas. Reg. § 15A.453-1(b)(3)(i).[288] These

[288] See Stonecrest v. Commissioner, 24 T.C. 659 (1955); see also Republic Petroleum Corp. v. United States, 613 F.2d 518 (5th Cir. 1980); United Pac. Corp. v. Commissioner, 39 T.C. 721 (1963); Estate of Lamberth v. Commissioner, 31 T.C. 302 (1958). In 1981, the Service issued Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) in an attempt to reverse the results in the Stonecrest line of cases. Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) requires that a wraparound mortgage be treated the same as if the buyer had assumed or taken the property subject to the seller's mortgage, even though title does not pass and the seller remains liable on the mortgage. However, the Tax Court

cases would seem to support allocating the liabilities to the preferred interest holder even though a relatively small portion of the equity accrues a preferred return.

Section 2701(d) provides for a deemed gift if and to the extent qualified payments are not paid within a four year period of when they were accrued. In general, the deemed gift will be the amount of the unpaid qualified payments increased by a compounding rate equal to the underlying payment rate of the qualified payment, provided the amount of the gift does not exceed the equity value of the underlying entity.[289]

If the requirements of Section 2701 are satisfied, the retained preferred interest will not be valued at zero but rather the fair market value of the retained preferred interest is deducted from the fair market value of the partnership capital. The difference is the gift tax value of the junior equity interest. This calculation is made in accordance with Treasury Regulation 25.2701-3. The regulations contain certain biases, which biases can have a significant impact upon the planning.

The Treasury Regulations employ the "subtraction method," a four-step method for determining the value of the transferred interest.

> Step 1 – Value the entire family-held interest.
>
> Step 2 – Subtract the value of senior equity interests held by the family.
>
> Step 3 – Allocate the remaining value among the transferred interests and other family-held subordinate equity interests.
>
> Step 4 – Apply certain discounts and other reductions as provided for by Treasury Regulation 25.2701-3(b)(4). The value of the junior equity interest, so determined, less any consideration paid for that interest, will be a taxable gift.

---

invalidated this temporary regulation in Professional Equities, Inc. v. Commissioner, 89 T.C. 165 (1987). See generally Silverman and Nocjar, PLI, Disguised Sale Rules (May 2011).

[289] IRC § 2701(d).

Notwithstanding the foregoing calculation, section 2701 deems the junior equity interest to have a value of not less than ten-percent (10%) of the sum of: a) the total value of all equity interests in the entity, and b) the total amount of indebtedness of the entity to the transferor.

SPECIAL VALUATION CHALLENGES UNDER SECTION 2701 REGULATIONS

Section 25.2701-3(b)(1) goes beyond the statutory requirements by imposing an additional valuation stricture. In determining the starting point for the subtraction method, the regulations require that the fair market value of all family held interests must be determined "by assuming that the interests are held by one individual, using a consistent set of assumptions." This assumption is apparently designed to preclude valuation discounts such as discounts for lack of control and lack of marketability from being applied in Step 1 of the subtraction method. If the entity is family controlled and all family held interests are deemed held by one individual that individual must not hold a minority or non-controlling interest. Likewise if all family held interests are considered to be held by one individual, it would normally be the case that that individual would have the ability to compel a liquidation of the entity. If an individual can compel liquidation there would normally be no discount for lack of marketability since that individual would usually have the ability to force a sale of the entity's underlying assets. Note that if a nonfamily member's consent would be required to compel liquidation, even if the entity is family controlled, the family may not have the ability to unilaterally compel liquidation.[290]

Step 1's requirement that all family-held interests be valued as though they are "held by one individual" probably represents a position which was once taken by the IRS but which has subsequently been reversed. For many years prior to the issuance of the section 2701

[290] *See generally* Milford B. Hatcher, Jr. & Gregory E. Kniesel, *Preferred Limited Partnerships – Now the FLPs of Choice?*, 89 J. Tax'n 325, 333 (Dec. 1998); Rev. Ruling 93-12. *See* Milford B. Hatcher, Jr., *Preferred Partnerships – The Neglected Freeze Vehicle* (2002).

regulations the IRS contended that all family-held interests should be aggregated for valuation purposes.

This so-called "family attribution" argument was still the formal litigation position of the IRS when the section 2701 regulations were issued in 1992. However, the courts had repeatedly rejected the IRS's family attribution argument.[291] Approximately one year after the promulgation of the section 2701 regulations the IRS relented and acknowledged in Revenue Ruling 93-12 that family attribution is inappropriate and that intra family discounting can be appropriate.[292]

The issuance of Revenue Ruling 93-12 was probably a turning point in tax planning. It spawned the widespread use of family partnerships and other family controlled entities to create discounts.

Since the issuance of Revenue Ruling 93-12 the IRS has attempted to constrain the use of family controlled partnerships and other entities to create discounts and to facilitate tax planning. More recently, the IRS has had some success upsetting ill conceived and poorly executed estate plans that attempt to create discounts by employing family partnerships where no significant business or nontax purpose was a driving force for the plan.[293] Nevertheless, the cases where the IRS has succeeded represent the exception to the general rule that there is no proper legal basis for the IRS to impose a family attribution rule absent an act of legislature. It is likely that the provision in Treasury Regulation 25.2701-3(b)(1) imposing a form of family attribution would be vulnerable to a judicial challenge. The "family attribution" approach taken

---

[291] *See Estate of Lee v. Comm'r*, 69 T.C. 860 (1978); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981) (en banc.); *Estate of Andrews v. Comm'r*, 79 T.C. 938 (1982); *Minahan v. Comm'r*, 88 T.C. 492 (1987) (costs assessed against the IRS for its continued litigation of family attribution); and *LeFrak v. Comm'r*, T.C. Memo. 1993-526.

[292] 1993-1 C.B. 202.

[293] See *supra* note 41

in Step 1 thus appears to be an historical vestige which reflects a position which is no longer being taken by the IRS and which has consistently been rejected by the courts.

It should be noted that under the subtraction method the absence of discounting may not have an overwhelming impact upon valuations. Ultimately, the undiscounted value would be attributed to the retained senior equity interest. Business appraisers tend not to impose large discounts upon preferred interests due to their inherent attributes.

The regulations contain an exception to the family attribution rule for "contributions to capital." In the case of a contribution to capital, Step 1 permits the use of fair market value as an exception to the family attribution rule. This exception seems to apply to property contributed to a partnership which would normally not be discounted upon contribution. Under normal partnership accounting principles, partners' capital accounts are credited with the fair market value of contributed property. This rule is set forth in the section 704(b) regulations.[294] Yet if the property contributed is an interest in an entity or a fractional interest, it would appear that normal valuation discounts would be applicable as the measure of the contribution to a freeze entity.

1. Income Tax Consequences of the Partnership Freeze

There are significant income tax consequences to the formation and operation of a freeze partnership or LLC. A command of the partnership income tax rules contained in Subchapter K of the Code is required to properly design and implement the freeze. The taxation of partnerships is one of the more complex areas of the Internal Revenue Code. Failure to involve a professional with the necessary income tax expertise can result in unintended and, perhaps, unfortunate tax consequences. Moreover, a working knowledge of Subchapter K can be valuable in maximizing this technique.

---

[294] Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

One of the principal concerns arises from the fact that this technique is most advantageous when planning for high leverage low basis property – especially real estate. This is where income tax planning and the estate planning converge. As already discussed, the stakes for obtaining a basis step-up upon death, and to avoid gain recognition during lifetime, are much greater for this type of asset. The freeze partnership can facilitate both objectives.

The objective is to structure contributions of appreciated property to the partnership so that the maximum amount of built-in gain and liabilities in excess of basis (or negative capital) will be allocated to the senior preferred interest. While Subchapter K has an operating framework that can facilitate this objective, it will not necessarily happen by itself. Careful structuring is required.

Contributions of appreciated property to a partnership are generally entitled to nonrecognition treatment pursuant to section 721.

However, there are two principal areas of sensitivity that can trigger gain. Care must be exercised to avoid a capital shift and a liability shift.

Capital Shifts

A capital shift results when a contribution of property by one partner enhances the capital value of one partner's interest at the expense of another's.

Determination of whether a capital shift has occurred in a recapitalization requires determining the amount each of the senior generation member and the junior generation member would receive if the partnership were to liquidate immediately prior to the recapitalization, assuming all of the partnership assets were sold on that date for their fair market values and the proceeds of the sale were distributed in complete liquidation of their partnership interests. If immediately following the recapitalization the same liquidation test were applied, the amounts

each of the partners would receive should remain unchanged. If members of the junior generation would receive more post-recapitalization than pre-recapitalization, then a shift of capital to such members has occurred. Such a shift of capital could result in a taxable gift or a taxable grant of a capital interest as compensation for services performed.

In a freeze partnership the junior equity interest has many of the characteristics of a partnership profits interest. While the grant of a mere profits interest in partnership is generally not considered a taxable event, if the profits interest is accompanied by a shift of partnership capital to the recipient, there will be a taxable event. This is the case whether or not the grant is in connection with the performance of services. If the grant is in connection with the performance of services, the recipient will be taxable on the value of the interest so received. If the grant is not in connection with the performance of services, it will likely be a gift. Within the context of a family controlled business entity it is possible there will be some combination of compensation and gifting.

The taxation of grants of a partnership interest for services presents significant conceptual difficulties for both the government and taxpayers. Yet these rules are directly relevant to the question of whether there has been a capital shift which impacts the taxation of freeze partnerships.

The taxation of compensatory grants of partnership interests has been one of the most difficult areas for the government to develop a comprehensive and intellectually pure set of strictures.[295] The taxation of grants of partnership profits interests, which is often integral to real estate partnership structures, has posed administrative and conceptual difficulties for at least four decades. The most recent administrative attempt to regulate this area came in 2005 and has

[295] *See generally* Stephen M. Breitstone & José L. Berra, *Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context*, NYU, 66th Institute on Federal Taxation, Chapter 8 (2008).

largely stalled.[296] Moreover, these transactions come dangerously close to the types of transactions that have been firmly in the sights of the Obama Administration through its proposals to increase the incidents of taxation of so-called "carried interests." While these measures have not passed as of the date of this writing, they may resurrect themselves in a subsequent Congress.[297]

Closely analogous to the taxation of the formation of a freeze partnership is the taxation of a partnership recapitalization. Either transaction can be subject to section 2701. If a junior equity interest is to be granted within the framework of an existing partnership in order to create the frozen preferred interests, it will likely be necessary to elect to book-up the capital accounts of the partners under section 1.704-1(b)(2)(iv)(f) and (g) in order to prevent an unintended capital shift. Such a book-up is a restatement of partners' capital accounts to reflect the liquidation value of their interests as the time of the book-up event. Generally, it is necessary for there to be a grant of a partnership interest in connection with a contribution of capital to the partnership, a grant of a compensatory profits interest or a liquidation or redemption of a partnership interest in connection with a distribution of capital in order to be able to book-up the capital accounts under this provision.[298]

---

[296] In 2005, when the proposed section 83 regulations were introduced, Treasury also issued a proposed revenue procedure that would make Rev. Proc. 93-27 and Rev. Proc. 2001-43, *Doc 2001-20855, 2001 TNT 150-11*, obsolete on finalization of the regulations (see Notice 2005-43, 2005-1) C.B. 1221, *Doc 2005-11236, 2005 TNT 98-37*). The new rules would apply to grants of compensatory profits interest issued on or after the date of the final regulations. As of this writing, the final regulations have not been issued and it appears that they are neither imminent nor likely to resemble the proposed regulations.
An in-depth discussion of past and present law governing the taxation of partnership interests is set forth in Breitstone & Berra, *Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context.*

[297] *See generally* Breitstone, *Carried Interest Bill -- Impact on Real Estate Partnerships*, 2010 TNT 45-5, March 9, 2010; Breitstone, *Carried Interest Bill -- a 'Death Trap' for Real Estate Partnerships*, 2009 TNT 118-8, June 22, 2009.

[298] Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)

Liability Shifts

Gain can also be triggered upon the contribution of property to a partnership or upon a recapitalization if there is a shift in the manner in which partnership liabilities are shared among the partners under the rules set forth in section 752 and the regulations there under. It should be noted that, in general, if the partnership liabilities are nonrecourse (meaning recourse is limited to the property that secures the debt) and are not guaranteed by any of the partners, a liability shift, in general, will not occur to trigger gain recognition at the time of contribution or reorganization. However, in other situations, a liability shift may occur.

Even if there is no liability shift upon the contribution of low basis leveraged property to a partnership, obtaining a full basis step-up that will eliminate the built-in gain attributable to liabilities in excess of basis requires additional structuring. If the junior equity is to be held by a grantor trust, or if the junior equity is to be issued initially to the senior generation and then subsequently gifted to the junior generation, a portion of the liabilities will be allocated to the junior equity. To the extent the junior equity is then transferred, the allocable share of liabilities will come along to the transferee. If the transfer is by reason of an outright gift to an individual member of the junior generation, such a gift may be treated as a part sale/part gift triggering immediate recognition of gain on the liabilities in excess of basis. This consequence can be avoided by making the gift or transfer to a grantor trust since the grantor will be considered to have retained ownership of the transferred interest for income tax purposes. However, since a portion of the liabilities will be deemed allocable to the transferred interest when the grantor trust status ends, such as upon the death of the grantor, a portion of the step-up may be lost. It is also possible that some gain will be recognized at that time, depending upon your views on this topic.[299] This is due to the fact that the grantor will be considered to have one

[299] *See* discussion supra at note 22.

partnership interest and one capital account. If the interest is actually owned by the senior generation or is deemed owned by that generation under the grantor trust rules, any junior interest given away will be considered to be a portion of the senior generation's initial partnership interest including a share of the liabilities that otherwise would have been allocable to the senior preferred interest. To avoid this result, at least two separate partnership interests must be created. One should be issued in exchange for the encumbered property. Normally, this will be the senior equity interest. The other interest should be granted to a different taxpayer in exchange for cash or other unencumbered assets. The interest can even be granted to a nondisregarded entity owned mostly by the senior grantor. Since that latter interest would be granted in exchange for unencumbered property or cash, it should not be allocated a share of the liabilities.

Even where the ultimate transferee of the junior interest is to be a grantor trust, it should be possible to structure the partnership so that the liabilities will remain allocated to the senior generation. For example, if the junior equity interest is initially issued to a nondisregarded entity such as an LLC, and that interest is granted in exchange for a contribution of capital by the junior family members or a grantor trust for their benefit, it should be possible to force all of the negative capital to remain with the senior generation. The death of the senior generation should result in a basis step-up that eliminates that negative tax history.

CONTRIBUTIONS OF LOW BASIS LEVERAGED REAL ESTATE TO A PARTNERSHIP

Generally, section 721 affords nonrecognition treatment upon the contribution of appreciated property to a partnership. This treatment applies whether the contribution occurs at the time of formation or to an existing partnership. It also applies regardless of the percentage of

the partnership received in exchange for the contribution.[300] If the contributed property has a fair market value in excess of its adjusted income tax basis, section 704(c) will come into play to require that certain allocations be made to avoid shifting the precontribution gain to the noncontributing partner.

Under section 752, an assumption of debt by the partnership from contributed property is treated as a distribution of cash to the contributing partner. Under the regulations, simultaneously with the deemed distribution there will be a deemed contribution reflecting the contributing partner's share of partnership indebtedness determined immediately after the contribution. If the partner is allocated a share of post-contribution indebtedness not less than the deemed distribution plus any basis in the contributed property there will be no gain recognition at the time of contribution. If the contributing partner's net debt share is reduced in connection with the contribution, and the contributed property is subject to liabilities in excess of basis, the contribution will result in a "debt shift." The net reduction in the contributing partner's share of debt can result in taxable gain under section 731(a). Under some circumstances, there can also be ordinary income if the property is subject to depreciation recapture under section 751.

Section 752 governs how the partnership indebtedness is allocated among the partners. Recourse debt is allocated to the partner who bears the economic risk of loss. A different set of rules applies for nonrecourse debt since the partners do not bear the risk of economic loss.

Normally when property is contributed subject to nonrecourse indebtedness, the default provisions of the section 752 regulations preclude such a debt shift. However, if the

[300] *Compare with* section 351 which conditions nonrecognition upon transfer or appreciated property to a corporation upon the transferors having "control" immediately after the contribution. Control is defined as ownership of 80 percent or more of the combined classes of stock immediately after the contribution.

property is subject to recourse indebtedness, if the indebtedness is guaranteed by one of the partners, or if the lender is a related party to the partnership, a debt shift is a possibility. Normally, in the context of a freeze partnership where the contributing partner is a member of the senior generation making a contribution in exchange for a preferred partnership interest, if the contributing partner is personally liable for the debt or is a guarantor, there will be no debt shift because the liabilities will be allocated to the contributing partners.

1. Allocations of Partnership Liabilities

Section 752 governs the manner in which partnership liabilities will be allocated among the partners. In general, section 752 maintains parity between inside and outside basis by coordinating adjustments to the partners' outside bases with increases and decreases in partnership liabilities. The liability-sharing rules of section 752 closely track the economic effect analysis under the 704(b) regulations.

The sharing of recourse liabilities is determined by identifying which partners would bear the economic risk of loss based on the consequences of a constructive liquidation (a hypothetical event in which all partnership assets become worthless and the partnership liquidates). Generally, this can be determined by asking, if the partnership defaulted on its obligation, to what extent (if any) would a partner be obligated to pay the liability from personal funds without the right to reimbursement.[301] If no partner would bear the economic risk of loss the liability is classified as nonrecourse. The rules governing the allocation of nonrecourse liabilities are very flexible and taxpayer friendly. The rules generally allow such liabilities to be allocated based on the manner in which the partners share the profits that would presumably be used to repay such liabilities.

[301] *See* IRC § 752(c); Treas. Reg. § 1.752-1(d)-(e).

Under section 752, a liability affects the outside basis only to the extent that it creates or increases the basis of the property or gives rise to a current deduction or a nondeductible non-capital expenditure.[302] A liability is recourse to the extent that any partner bears the economic risk of loss with respect to such liability.[303] A partner's share of partnership recourse liabilities equals the portion of such liabilities for which he bears the economic risk of loss.[304] In general, a partner bears the economic risk of loss with respect to a partnership liability to the extent that the partner would be obligated to make a net payment or a net contribution with respect to such liability upon a hypothetical liquidation of the partnership.[305] A partnership liability is nonrecourse to the extent that no partner bears the economic risk of loss for that liability.[306]

2. Allocations of Nonrecourse Debt

Under the section 752 regulations, nonrecourse liabilities are allocated in three tiers - the first two are priority tiers. The first tier looks to a partner's share of "minimum gain" as determined under section 704(b).[307] In general, minimum gain is the amount of gain that would be recognized if property subject to nonrecourse debt were sold for the amount of the indebtedness. That is the minimum amount of gain that would be recognized upon such a disposition. Each partner has a share of minimum gain which is based upon the previous nonrecourse deductions allocated to that partner and any proceeds from nonrecourse financings distributed to that partners.[308]

---

[302] *See* Treas. Reg. § 1.752-1(a)(4)(i) (liability defined); Rev. Rul. 88-77; Rev. Rul. 95-26, 1995-1 CB. 131 (short sale of securities).
[303] *See* Treas. Reg. § 1.752-1(i); Treas. Reg. § 1.752-2(f), Ex. 5.
[304] Treas. Reg. § 1.752-2(a).
[305] *See* Treas. Reg. §§ 1.752-2(b)(1), (5), (6); -2(b)(2)(i).
[306] Treas. Reg. § 1.752-1(a)(2).
[307] Treas. Reg. § 1.752-3(a)(1).
[308] Treas. Reg. § 1.704-2(g)(1)(i).

The second tier is a partner's share of partnership minimum gain as determined under 704(c) regulation concerning allocation of nonrecourse deductions. This tier is most relevant to the creation of freeze partnerships for leveraged appreciated real estate with low income tax basis. A partner's share of minimum gain is the amount of taxable gain that would be allocated to a partner under 704(c) principles if the partnership disposed of all property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of such liabilities and for no other consideration.[309]

In order to understand the allocation of nonrecourse indebtedness secured by appreciated contributed property, it is necessary to have some understanding of section 704(c). Section 704(c)(1)(A) requires that income, gain, loss and deduction with respect to contributed property be shared among the partners so as to take account of any difference between basis and value at the time of contribution. The Regulations provide detailed rules for allocation with respect to "704(c) property" which is defined as property which has a book value different from its tax basis at the time of contribution.[310] In general, such allocations must be made using a reasonable method that is consistent with the purpose of 704(c), i.e. to prevent shifting of built-in gain or loss.[311]

To understand the workings of section 704(c) it is necessary to understand how capital accounts are maintained under section 704(b) and the regulations there under.[312] The

---

[309] Treas. Reg. § 1.752-3(a).
[310] Treas. Reg. § 1.704-3(a)(3).
[311] Treas. Reg. § 1.704-3(a)(1).
[312] The regulation set forth three alternative methods that are deemed reasonable methods for allocations to reflect the reconciled book and tax bases.

Traditional Method

The first method is known as the "traditional method." The traditional method requires that any built-in gain or loss attributable to contributed property be allocated to the contributing partner to the extent possible. *See* Treas. Reg. § 1.704-1(b)(4)(i),-1(b)(5), Ex. 17. Under the traditional method, there is a prohibition upon allocating more than the normal tax items that would otherwise be available. This rule is known as the ceiling rule. Thus, if the book depreciation allocable to the noncontributing partners is greater than the available tax depreciation, the

limit on what can be allocated to the noncontributing partner would be the amount of tax deprecation. *See* Treas. Reg. § 1.704-3(b)(1).

If the ceiling rule applies, phantom income may be allocable to the noncontributing partners. This is because the noncontributing partners (generally the partners who contribute cash) may be deprived of the full depreciation deductions to which they would otherwise be entitled. This can create certain distortions that may be significant in structuring the partnership. Of course, if these distortions occur between a grantor and a grantor trust, this would not likely be a concern. Under the traditional method, ceiling rule distortions will be remedied only upon the sale or liquidation of the partners' partnership interests.

Traditional Method with Curative Allocations

The second section 704(c) method allowed under the regulations is the "traditional method with curative allocations." The regulations permit reasonable curative allocations to reduce or eliminate distortions attributable to the ceiling rule. A curative allocation is any allocation of tax items that differs from the allocation of corresponding book items. *See* Treas. Reg. § 1.704-3(c)(1). Generally, a curative allocation is considered reasonable only if it does not exceed the amount necessary to offset the effect of the ceiling rule and consists of tax items of the same type or character as the item limited by the ceiling rule. *See* Treas. Reg. § 1.704-3(c)(3). Notwithstanding the character restriction, a curative allocation of gain from sale of 704(c) property is generally considered reasonable to cure ceiling-rule limitations on depreciation. *See* Treas. Reg. § 1.704-3(c)(3). If the partnership does not have sufficient tax items to cure the ceiling rule disparity in the year it occurs, subsequent curative allocations to remedy the initial disparity are permitted only if made either (i) over a reasonable period (such as the property's economic life), or (ii) on the sale of the contributed property.

Remedial Allocation Method

The third section 704(c) method is the "remedial allocation method." This method is a variation of a deferred sale approach. Under a deferred sale approach, the partnership would be treated as if it had purchased the contributed property for its fair market value on the date of contribution, but the contributing partner's built-in gain or loss would be deferred until subsequent events, e.g., disposition of the property. Because of character and timing differences, the deferred sale approach was considered too generous to the contributing partner so instead the regulations provide for the remedial allocation method which accomplishes a similar result as the deferred sale approach with respect to the noncontributing partners. Noncontributing partners receive, in effect, a cost basis in their share of the contributed property. This approach eliminates ceiling rule distortions by creating fictional tax items that exactly offset the ceiling-limited items in amount and character. *See* Treas. Reg. § 1.704-3(d)(4). In the case of depreciable 704(c) property a special rule applies for the purposes of recovering book basis under the remedial allocation method. *See* Treas. Reg. § 1.704-3(d)(2),-3(d)(7), Ex. 1.

The remaining built-in gain or loss at the time of the distribution depends on the 704(c) allocation method used by the partnership. *See* Treas. Reg. § 1.704-4(a)(5), Ex. 2 (traditional method); -3 (remedial allocation method).

Section 704(c) can also trigger tax consequences that must be considered if the contributed property is to be distributed within the seven year period following its contribution. Section 704(c)(1)(B) may require recognition of gain if 704(c) property is distributed to another partner within seven years of contribution. Section 704(c)(1)(B) is intended to prevent circumvention of the 704(c) allocation rules when property contributed by one partner is distributed to another partner within seven years after contribution. If the provision applies, the contributor recognizes taxable gain or loss equal to the amount that would have been specially allocated to him under 704(c) upon a deemed sale of the property for its fair market value at the time of the distribution. *See* Treas. Reg. § 1.704-4(a)(1).

Like section 704(c)(1)(B), section 737 is intended to prevent circumvention of the 704(c) allocation rules. Section 737 can trigger gain recognition to a contributing partner when other partnership property is distributed to the contributing partner within the seven year period following the contribution. If the provision applies, the contributor recognizes a taxable gain equal to the lesser of the excess distribution or the partner's net precontribution gain. *See* IRC § 737(a).

Another section 704(c) rule impacts the ability to deduct losses attributed to contributed property. In 2004, Congress amended section 704(c)(1) to prevent a potential shifting of losses among partners in connection with a contribution of built-in loss property. Under section 704(c)(1)(C), a built-in loss may be taken into account only by the contributing partner and not by other partners. The term built-in loss is defined as the excess of the adjusted tax basis of the contributed property over the fair market value of such property at the time of contribution. With respect to non-contributing partners, such property is treated as having a basis equal to its fair market value at the

regulations under section 704(b) require capital accounts of partners who contribute appreciated property to be credited for the fair market value of the appreciated property – not the tax basis. It is thus necessary to maintain one set of books to reflect the fair market value of appreciated property and the depreciation deductions computed on the basis of that fair market value. Simultaneously, books must be maintained reflecting historical income tax basis and depreciation deductions calculated on that amount. Section 704(c) is designed to create allocations that will bring the book tax basis and historical cost tax basis into harmony – over time. If they are not ultimately brought into harmony, section 704(c) will, in general, require gain to be allocated to the contributing partner upon a disposition of the contributed assets.

The third tier of partnership liabilities is referred to as "excess nonrecourse liabilities," i.e. the residual category left after initially allocating the partnership's nonrecourse liabilities to the two priority tiers. These liabilities may be allocated in any manner consistent with the manner in which any significant partnership item is allocated provided the allocation of that item has substantial economic effect as determined under the regulations under section 704(b).[313]

A partner's share of nonrecourse liabilities equals the sum of his shares of partnership minimum gain, 704(c) minimum gain and excess nonrecourse liabilities. In accordance with the *Crane* rule, the regulations include the nonrecourse liabilities in the partnerships inside basis and the partners' outside bases. The underlying theory is that a partner who receives a disproportionate allocation of nonrecourse deductions should also receive a corresponding share of the *Crane* basis generated by the nonrecourse liability.

---

time of contribution. When the contributing partner's partnership interest is transferred or liquidated, any remaining section 704(c) built-in loss is eliminated. IRC § 704(c)(1)(C).

[313] *See* Treas. Reg. § 1.752-3(a).

3. Coordinating Sections 704(c) and 752

Upon the formation of the freeze partnership where leveraged real estate with a low income tax basis is contributed in exchange for the senior preferred interest, it is generally the case that the section 704(c) minimum gain will cause the nonrecourse debt to be allocated to the contributing partner. A partner who contributes property subject to a nonrecourse liability is allocated an amount of liability at least equal to the section 704(c) minimum gain (i.e. the excess of the nonrecourse liability over the tax basis of the property).[314] This taxable gain is the minimum amount that would be allocated to the contributing partner if the encumbered property were sold for no consideration other than relief of the nonrecourse liability.

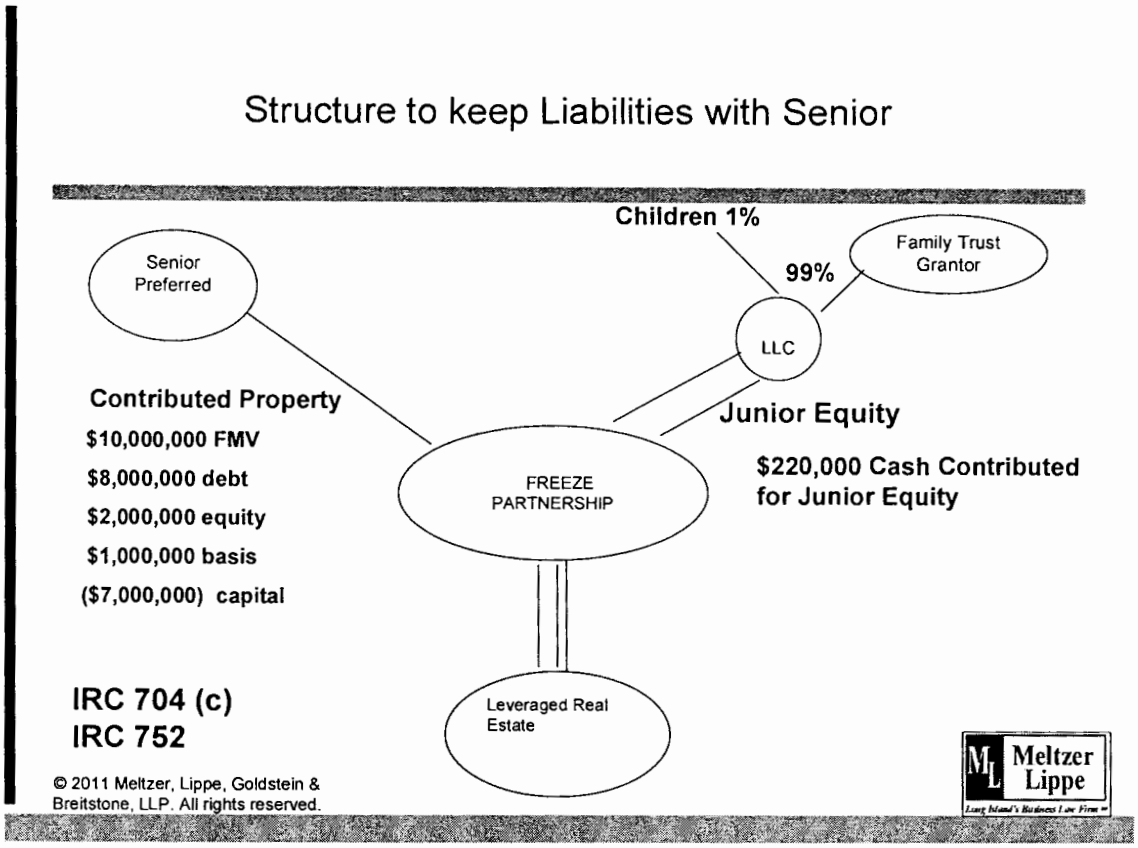
4. Allocating Liabilities to the Holder of the Preferred Interest

For the section 752 rules to work within the framework of a freeze partnership the entity must be treated as a partnership for income tax purpose at its inception. Thus, for example, if there is a partnership between the grantor and a grantor trust, the partnership will be a disregarded entity for income tax purpose leaving a lack of clarity as to how the liabilities are to be allocated. It is thus necessary to ensure that the partnership is not a disregarded entity. In order to obtain the maximum basis step up under section 1014 the liabilities must be allocated to the senior holder of the preferred interest. Only if the entity is treated as a partnership for tax purposes (not a disregarded entity) will it be clear that there will be a basis step-up to the estate for the entire share of liabilities in excess of basis of the contributed property that would have been treated as if transferred from the senior interest holder.

The following is an example of a structure that should be able to avoid these uncertainties:

---

[314] Treas. Reg. § 1.752-3(a)(2)



In this example, the partnership will not be a disregarded entity. It is structured so that it will be treated as a partnership for income tax purposes from its inception. This is accomplished by creating a nondisregarded entity to be the initial partner who will acquire the junior equity interest. There are a number of ways to accomplish this goal. However, it is important to note that only the low basis leveraged property should be contributed in exchange for the senior preferred ownership interest. Different property, presumably unencumbered property or cash, should be contributed to the nondisregarded entity formed to hold the junior equity interest. The nondisregarded entity would, in turn, contribute this property to the partnership in exchange for the junior equity interest. This other property can be contributed either by the grantor or by other family members. If it is contributed by the grantor, the grantor would receive, in exchange, an ownership interest in the nondisregarded entity. In the example, that is a 99% interest – although there is no magic to that percentage. The grantor could then

either gift or sell that interest to the grantor trust. All of the income tax items (except for the 1% owned by others) would flow through to the grantor either directly as the holder of the senior preferred interest, or indirectly from the nondisregarded junior equity interest holder through the grantor trust as grantor. The separate existence of the junior equity interest holder should be sufficient to treat the partnership as a freeze partnership with two partners for income tax purpose. One partner would be the grantor. By operation of the second tier rule for nonrecourse liabilities under section 752, all of the liabilities to which the contributed property was subject at the time of contribution would be allocated to the grantor's senior preferred interest. This interest would be included in the grantor's estate for estate tax purposes upon the death of the grantor which should result in a basis step-up for the entire liability share under section 1014.

5. Leveraging the Freeze - Rules Governing Disguised Sale of Property under Section 707(a)(2)(B)

Maximizing leverage in a freeze partnership can greatly improve the economics of the freeze. By adding debt into the partnership capital structure the equity required to assure a market value "qualified payment" stream can be minimized. This can make the freeze partnership much more competitive with installment sales to IDGT which only need to accrue interest at the applicable Federal rate of Section 1274 of the Code. However, additional leverage with the partnership freeze may raise challenges under the disguised sale rules of Section 707(a) of the Code.

6. Disguised Sales of Property Under § 707(a)(2)(B)

The disguised sale of property rules contained in Section 707(a)(2)(B) are of concern when contributing appreciated property to a freeze partnership. These rules are of particular concern where property is contributed within two years of a nonrecourse borrowing. It

is also of concern if qualified payments can be viewed as sale proceeds rather than a reasonable return on the senior preferred capital.

Congress enacted Section 707(a)(2)(B) in the Deficit Reduction Act of 1984.[315] Section 707(a)(2)(B) reads:

> Under regulations prescribed by the Secretary – . . . If (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated as a transaction [between the partnership and a partner not in its capacity as a partner] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership. (Emphasis added).

The regulations provide that: Where a contribution and distribution are not simultaneous, the transfers will be treated as a sale if the facts and circumstances indicate that (1) the transfer of money would not have been made but for the transfer of the property, and (2) the distribution was not dependent on the "entrepreneurial risks" of the partnership's operations.[316] Additionally, if within a two-year period there is a contribution by and distribution to a partner, the transfers are presumed to be a sale of the property to the partnership. The rationale behind this presumption is that if the partner's capital has been at risk in the partnership for more than two years, the transfers normally will not be recharacterized as a sale.[317] This presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale."[318]

---

[315] Pub. L. No. 98-69

[316] Treas. Reg. § 1.707-3(b)(1).

[317] Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

[318] Treas. Reg. § 1.707-3(c)(1).

A. There are a number of issues presented by the disguised sale rules in structuring freeze partnerships where leveraged low basis property is contributed. First, it must be considered whether the payment of a guaranteed payment on the senior interest or a preferred return could be treated as sales proceeds under the disguised sale rules.

B. In general, the disguised sale regulations do not treat a guaranteed payment for capital as proceeds from a sale of property. The term guaranteed payment for capital means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital.[319] (See 707(c)). A payment of money to a partner that is (i) characterized by the parties as a guaranteed payment for capital, (ii) determined without regard to the income of the partnership, and (iii) "reasonable" is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.[320]

a. Under the regulations a payment is "reasonable" if (1) the payment is made to a partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and (2) the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.[321]

b. A payment is reasonable in amount if the sum of any guaranteed payment for capital (and preferred return) that is payable for that year does not exceed the amount determined by multiplying the partner's unreturned

[319] Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)
[320] Treas. Reg. § 1.707-4(a)(1)(ii).
[321] Treas. Reg. § 1.707-4(a)(3)(i).

capital at the beginning of the year, or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid guaranteed payment or preferred return that is payable to the partner for any prior year) by the safe harbor interest rate for that year. The safe harbor interest rate equals 150-percent of the highest AFR (applicable federal rate) in effect at any time from the time that the right to the guaranteed payment for capital is first established pursuant to a binding written agreement.[322]

C. Of particular concern in structuring a freeze partnership is the treatment of preferred returns under the disguised sale rules. If the preferred return is not considered to be "reasonable" under the disguised sale regulations, the payments could be viewed as part of a disguised sale.

D. The final regulations define the term "preferred return" to mean a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain. A distribution of money to a partner that is characterized by the parties as a preferred return and that is "reasonable" is presumed not to be part of a sale of property to the partnership.[323]

a. This presumption can only be rebutted by facts and circumstances (including the likelihood and expected timing of the matching allocation of income or gain to support the preferred return) that clearly establishes that the transfer is part of a sale. Whether a preferred return is reasonable

[322] Treas. Reg. § 1.707-4(a)(3)(ii).
[323] Treas. Reg. § 1.707-4(a)(2).

is determined in the same manner as is a guaranteed payment for capital; thus, the safe harbor rate of 150% of the AFR applies.[324] Presumably, if the partners agree to a reasonable preferred return that is not expected to be matched with allocations of income until the distant future, the payment of the preferred return may be treated as disguised sale proceeds.

E. Under the regulations, a distribution of net operating cash flow is presumed not to be part of a sale of property contributed to the partnership. Transfers of money by a partnership to a partner during a taxable year will constitute operating cash flow distributions to the extent that (1) such distributions are not presumed to be guaranteed payments for capital, (2) such distributions are not reasonable preferred returns, (3) such distributions are not characterized by the parties as distributions to the recipient partner acting in a capacity other than as a partner, and (4) such distributions do not exceed the product of (a) the net cash flow of the partnership from operations for the year multiplied by (b) the lesser of the partner's percentage interest in "overall partnership profits" for that year and the partner's percentage interest in "overall partnership profits" for the life of the partnership. This presumption can only be rebutted by facts and circumstances that clearly establish that the distribution is part of a disguised sale transaction.[325]

F. As a safe harbor, in lieu of determining a partner's interest in "overall partnership profits" for a taxable year, the regulations permit the use of the partner's smallest percentage interest under the terms of the partnership agreement in any material

[324] Treas. Reg. § 1.707-4(a)(3)(ii).
[325] Treas. Reg. § 1.707-4(b).

item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year.[326]

7. **Impact of Borrowings on Disguised Sale Treatment**

It is possible to affect a disguised sale by borrowing against low basis property and then contributing the encumbered property to the partnership. Economically, this transaction can closely resemble a sale since the contributing partner is at least partially cashed out. In creating a freeze partnership it is essential to be aware that if a refinancing of the contributed property has occurred, the proceeds of the refinancing could be considered disguised sale proceeds. This is especially the case when the refinancing resulted in a cashing out by the contributing partner either within the two years prior to the contribution or within the two years following the contribution. The disguised sale rules do contemplate this scenario and provide that certain types of borrowings will not be considered part of a disguised sale.

One exemption under the disguised sale regulations applies to so called qualified liabilities. Under the regulations, qualified liabilities assumed or taken subject to or in connection with a transfer of property to a partnership generally are not treated as part of a sale. This rule applies to both recourse and nonrecourse loans whether incurred by a partner prior to contribution or by the partnership post-contribution. The two most important factors in determining whether a particular liability is qualified are (i) when it was incurred, and (ii) for what were the proceeds used.[327]

---

[326] Treas. Reg. § 1.707-4(b)(2)(ii).

[327] Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

The regulations contemplate four categories of "qualified liabilities."[328] The first type is a liability incurred by the partner more than 2 years before the contribution of the property to the partnership (or when there was a commitment to make the contribution).[329]

Second, a liability is qualified if the liability was not incurred in anticipation of the transfer of the property to the partnership but was incurred by the partner within the two-year period prior to the contribution.[330] However, there is a presumption that a liability incurred within the two-year period prior to the contribution was incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary.[331]

The third category of qualified liabilities is comprised of liabilities allocable under the interest-tracing rules of Treasury Regulation § 1.163-8T to capital expenditures with respect to the transferred property. Thus, acquisition or improvement debt constitutes a qualified liability.[332]

Under the fourth category, a liability is a qualified liability if the liability was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used or held, but only if all of the assets related to the trade or business are transferred, other than assets that are not material to a continuation of the trade or business.[333] Under this category there is an additional requirement that the liability cannot exceed the value of the property that secures it.[334] The rationale for the exemption for liabilities incurred in the ordinary course of business (accounts payable etc.) is that these liabilities are present in essentially all ongoing businesses. If by transferring them the partner was subject to adverse tax

---

[328] Treas. Reg. § 1.707-5(a)(6)(i).
[329] Treas. Reg. § 1.707-5(a)(6)(i)(A).
[330] Treas. Reg. § 1.707-5(a)(6)(i)(B).
[331] Treas. Reg. § 1.707-5(a)(7)(i).
[332] Treas. Reg. § 1.707-5(a)(6)(i)(C).
[333] Treas. Reg. § 1.707-5(a)(6)(i)(D).
[334] Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

consequences proprietors would opt out of entering into partnerships. Furthermore, this type of liability does not lend itself to "cashing out" one's investment.[335]

The disguised sale regulations also specify rules governing liabilities that are not qualified liabilities which may or may not be treated as part of a disguised sale. In general, these rules provide that in the case of a transfer of property in which the partnership assumes or takes subject to a liability other than a "qualified liability," the share of the liability shifted to other partners is treated as an amount realized from a disguised sale, regardless of whether the partner receives any cash from the partnership.

Generally, the rules for determining the portion of the liability treated as shifted to other partners depend on whether the liability is recourse or nonrecourse.[336] For liabilities that are recourse, the rules under § 752 and the disguised sale rules are the same.[337] The regulations under § 752 provide that a partner's share of a recourse liability equals that portion of the liability for which such partner (or an affiliate of the partner) bears the economic risk of loss.

However, the disguised sale rules diverge from the § 752 regime in their treatment of nonrecourse liabilities. As discussed below, the regulations under § 752 adopt a three-tiered approach to allocating nonrecourse liabilities. First, nonrecourse liabilities are allocated based upon each partner's share of partnership minimum gain as determined under the regulations under § 704(b). Second, they are allocated based upon each partner's share of § 704(c) minimum gain. Last, they are allocated in accordance with a residuary sharing method tied to partnership items that have significant economic effect.

---

[335] Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

[336] *See generally* Mark J. Silverman & Aaron P. Nocjar, Partnership Disguised Sale Rules, Practicing Law Institute – Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 90-94 (May 2011).

[337] Treas. Reg. § 1.707-5(a)(2)(i).

The disguised sale rules skip the first two tiers of allocations which makes it significantly more difficult to avoid disguised sale treatment for nonqualified liabilities incurred within two years before or after the encumbered property is contributed to the partnership.

If the disguised sale rules adopted a parallel set of rules to the § 752 regime, it would be simple to avoid disguised sale treatment in connection with the contribution of low basis high leveraged real estate to a freeze partnership. Just as the normal operation of the § 752 regulations make it relatively simple to avoid a liability shift upon the contribution of property encumbered by nonrecourse debt, it would also make avoiding a disguised sale relatively simple. However, the disguised sale regulations adopt a different tact.

In lieu of the normal three-tiered approach under the § 752 regulations, under the disguised sale rules, a partner's share of a partnership nonrecourse liability is determined under the third-tier allocation rule alone.[338] The third-tier allocation rule provides that a partner's share of the excess nonrecourse liabilities, those not allocated under Treasury Regulation § 1.752-3(a)(1) and (2), are determined in accordance with the partner's share of partnership profits, taking into account all facts and circumstances. Alternatively, excess nonrecourse liabilities may be allocated in accordance with the manner in which deductions attributable to those liabilities will be allocated among the partners.[339]

To avoid triggering the disguised sale rules, the contributing partner might attempt to utilize a "wraparound contribution." When a contributing partner contributes property encumbered by a liability but the buyer and seller agree that, as between themselves, the seller shall have sole responsibility for the payment of the liability, the liability is not "assumed or

[338] *See* Treas. Reg. § 1.707-5(a)(2)(ii) which incorporates Treas. Reg. § 1.752-3(a)(3) (the third-tier allocation rule).
[339] Treas. Reg. § 1.752-3(a)(3).

taken subject to" by the buyer under the installment sale rules.[340] Furthermore, the contributing partner who retains the liability may receive a "reasonable" guaranteed payment or preferred return from the partnership to ensure sufficient cash to service the debt.[341]

8. Leveraged Partnerships: Generally

Recent developments concerning the use of "leveraged partnerships" to avoid disguised sale treatment have a direct bearing on the structuring of a freeze partnership where leverage is employed to reduce the equity that accrues qualified payments. The leveraged partnership techniques are, in economic substance, very similar to a sale but without triggering gain. Where property is transferred to a freeze partnership, but the equity accruing the preferred return is "thinned" by leveraging the partnership, the cash distribution resulting from the leveraging can resemble a sale as well. The cases involving leveraged partnerships may thus be instructive.

A leveraged partnership transaction permits a corporation to effectively sell appreciated property for cash through a partnership interest without immediate tax consequences. The requisite steps to forming and completing a leveraged partnership transaction are as follows: (1) the owner of appreciated assets ("Owner") contributes the appreciated assets to the partnership while another partner ("Investor") contributes working capital (or assets) to the newly formed partnership;[342] (2) the partnership borrows money from a bank and the Owner personally guarantees the debt of the partnership, making it recourse to Owner; (3) the Owner's basis in her partnership interest will be increased by the amount of the recourse debt.[343] If the

---

[340] *See Stonecrest v. Commissioner* 24 T.C. 659 (1955).
[341] Mark J. Silverman & Aaron P. Nocjar, Partnership Disguised Sale Rules, Practicing Law Institute – Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 90-94 (May 2011).
[342] Farah N. Homsi, The Leveraged Partnership – Have Your Cake And Eat It Too, The Practical Tax Lawyer (Winter 2010), http://www.wolffsamson.com/files/ptxl1002_homsi.pdf
[343] Id.

Owner's basis was not increased by the debt, the distribution would likely result in a taxable gain to the Owner. (4) The partnership then distributes all or a portion of the loan proceeds to the Owner, which makes the Owner a minority partner by reducing the Owner's partnership interest.[344]

A properly structured leveraged partnership transaction can avoid the application of the disguised sales rules making the distribution to Owner of all or a portion of the loan tax-free.

In order to avoid the application of § 704(c)(1)(B) the partnership needs to hold the property for seven years before the original assets can be distributed to the Investor.[345] The same is true of different assets being distributed to the Owner.[346]

Under 704(c)(1)(B) if § 704(c) property is distributed to any partner, other than the contributing partner, within seven years of the original contribution, the contributing partner must recognize gain or loss in the amount and character that would have been allocated to her under § 704(c)(1)(A) had the property been sold to the distributee at its fair market value on the date of the distribution.[347]

9. Leveraged Partnership Exception to Disguised Sale

Under regulation 1.707-5(b) there is an additional rule providing an exception from the disguised sales rules for leveraged partnership transactions. The regulation provides that: if a partner contributes unencumbered property to a partnership, the partnership immediately incurs a liability and distributes all or a portion to the contributing partner within 90 days of incurring the liability (determined under § 1.163-8T), then the distribution to the partner

---

[344] Id.
[345] I.R.C. § 704(c)(1)(B)
[346] Id.
[347] Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

is taken into account only to the extent that it exceeds the partner's "allocable share" of that liability.[348]

The concept of "allocable share" of liability is crucial in a successful leveraged partnership transaction because the contributing partner's "allocable share" of liability will determine if any of the loan proceeds distributed to her will be deemed a disguised sale.

Under Treas. Reg. § 1.707-5(b)(2) the "allocable share" is determined by multiplying the partner's share of the liability by the following fraction: amount distributed traceable to the liability divided by total amount of the liability.[349]

Treas. Reg. § 1.707-5(a)(2) provides rules for determining the partner's share of liability by determining the partner's share of recourse and nonrecourse liabilities,[350] and the partner must be allocated enough of the liability to cover the distribution received.

If a partner guarantees a partnership nonrecourse liability to be "allocated" that liability, it is important to ensure that the liability guaranteed by the partner is actually a recourse liability as to that partner.[351]

A recourse liability is defined under Treas. Reg. § 1.752-1(a)(1) as one where, "any partner or related person bears the economic risk of loss for that liability under § 1.752-2."[352] The constructive liquidation test, set forth in Treas. Reg. § 1.752-2(b)(1), is applied in order to determine who bears the economic risk of loss associated with the recourse liability. The following events are deemed to occur concurrently in a constructive liquidation: (1) all of the partnership's liabilities become payable in full; (2) with the exception of property

---

[348] Treas. Reg. § 1.707-5(b); *see also* Treas. Reg. § 1.707-5(f) ex. 10
[349] Treas. Reg. § 1.707-5(b)(2)(i)
[350] Treas. Reg. § 1.707-5(a)(2).
[351] Farah N. Homsi, The Leveraged Partnership – Have Your Cake And Eat It Too, The Practical Tax Lawyer (Winter 2010), http://www.wolffsamson.com/files/ptxl1002_homsi.pdf
[352] Treas. Reg. § 1.752-1(a)(1).

contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero; (3) the partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership); (4) all items of income, gain, loss, or deduction are allocated among the partners; and (5) the partnership liquidates.[353]

Following the constructive liquidation if, and to the extent that a partner is ultimately responsible for paying a partnership liability, either directly to the creditor, through the partnership, or through the other partners, that partner bears the economic risk of loss.[354]

10. Leveraged Partnership Transaction as Applied to Canal Corp. v. Commissioner

In the past several years the IRS has taken a position that certain leveraged partnership transactions should be tested to determine the transaction's validity under the disguised sales rules.[355] Particularly in 2010 the IRS was successful in challenging Canal Corporation.[356]

In Canal Corp v. Comm'r Chesapeake's subsidiary WISCO contributed essentially all of its assets to a leveraged partnership created by WISCO and Georgia Pacific. The newly formed Georgia-Pacific Tissue LLC ("LLC") took out a loan and distributed the proceeds to WISCO, and the loan was guaranteed by Georgia Pacific and WISCO agreed to indemnify Georgia Pacific for any principal payments made pursuant to the guaranty.[357] The court held that the leveraged partnership transaction was a disguised sale by WISCO that resulted

[353] Treas. Reg. § 1.752-2(b)(1).
[354] Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 120 (West Publishing 4th ed. 2006)
[355] Ruder Ware, Structuring Decisions of Leveraged Partnership Transactions After Canal, Business Transactions Legal Update (May 4, 2011)
[356] *Canal Corp. v. Comm'r* 135 T.C. 9 (2010)
[357] Id.

in capital gain includible in Chesapeake's consolidated income for 1999 (when the assets were contributed to the LLC) rather than 2001 (when WISCO sold its LLC interest)[358] because: Georgia Pacific did not require the indemnity; the indemnity agreement did not obligate WISCO to maintain a certain net worth: the structure of the indemnity did not expose Chesapeake's assets to economic risk; the contractual provisions reduced the likelihood of Georgia Pacific invoking the indemnity against WISCO; the indemnity covered only the loan's principal, not interest; Georgia Pacific would first have to proceed against the LLC's assets before demanding indemnification from WISCO if WISCO had to pay the indemnity, WISCO would receive an increased interest in Georgia-Pacific Tissue LLC proportionate to any payment made under the indemnity; a Chesapeake executive represented to Moody's and Standard & Poor's that the only risk associated with the transaction was the tax risk; Chesapeake crafted the indemnity agreement to limit any potential liability to WISCO's assets; WISCO's net worth amounted to only 21 percent of the indemnified LLC liability; WISCO's assets after the transfer to the LLC only included a $151 million intercompany note between Chesapeake and WISCO and a corporate jet; and the value of WISCO's interest in the LLC would have been zero if the indemnity were exercised because the agreement required Georgia Pacific to exhaust its remedies against the LLC's assets before enforcing the indemnification.[359]

Chesapeake sought to apply the 10% net worth requirement from Revenue Procedure 89-12[360] to establish the WISCO was adequately capitalized and that Chesapeake

---

[358] Mark J. Silverman & Aaron P. Nocjar, Partnership Disguised Sale Rules, Practicing Law Institute – Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 90-94 (May 2011).

[359] Terrance Floyd Cuff, *Canal Corporation v. Commissioner*, *in* 70TH NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION, §13.45 (2011).

[360] 1989-1 C.B. 798, *modified by* Rev. Proc. 95-10, 1995-1 C.B. 501, *amplified by* Rev. Proc. 94-46, 1994-2 C.B. 688, *modified by* Rev. Proc. 92-87, 1992-2 C.B. 496, *supplemented by* Rev. Proc. 92-33, 1992-1 C.B. 782, *amplified by* Rev. Proc. 91-13, 1991-1 C.B. 477 ((holding that "a limited partnership would be deemed to lack limited liability for advance ruling purposes if a corporate general partner of the partnership had a net worth equaling 10 percent or more of the total contributions to the partnership").

would be found to bear the economic risk of loss. However, the court was not persuaded and advised that requirements for advance ruling purposes have no bearing on whether a partner will be treated as bearing the economic risk of loss for a partnership's liability. The Court held that there are no mechanical tests and the anti-abuse rules mandate a consideration of the facts and circumstances. The Court declined to establish a bright-line percentage test to determine whether WISCO bore the economic risk of loss with respect to liability.[361] The Tax Court ultimately found that the indemnity agreement should be disregarded because

> [i]t created no more than a remote possibility that WISCO would actually be liable for payment. Chesapeake used the indemnity to create the appearance that WISCO bore the economic risk of loss for the debt when in substance the risk was born by [Georgia Pacific]. We find that WISCO had no economic risk of loss and should not be allocated any part of the debt incurred by [Georgia-Pacific Tissue LLC].[362]

The decision in *Canal* is particularly controversial because § 752 contains an assumption that a partner is solvent when applying the economic risk of loss rules. Specifically § 752 provides:

> For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[363]

Although WISCO was a subsidiary of Chesapeake the court did not address certain factors related to § 752, such as: that WISCO was not created as part of the plan to limit Chesapeake's liability exposure;[364] that WISCO was not a shell corporation set up solely for the

---

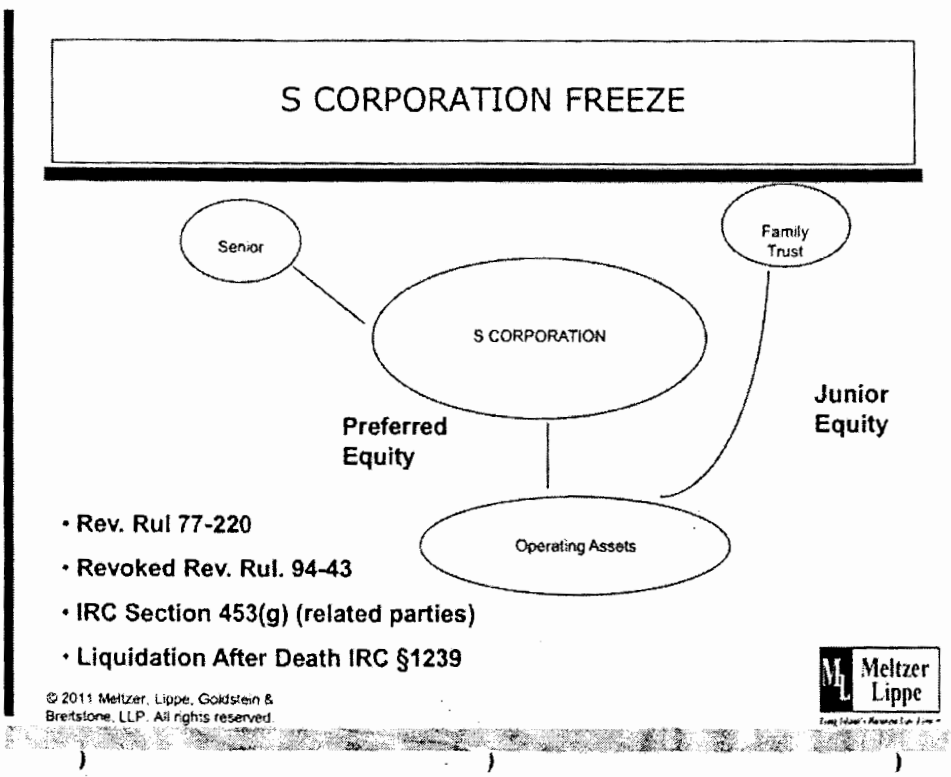
[361] Slip Opinion at 29.
[362] Slip Opinion at 29.
[363] I.R.C. § 752
[364] Terrance Floyd Cuff, *Canal Corporation v. Commissioner*, *in* 70TH NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION, §13.45 (2011).

transaction;[365] that WISCO had substantial capital even though it was considerably less than the amount of the indemnity;[366] and that the lender in *Canal*, Bank of America, was an unrelated third party which could have enforced the indemnity.[367]

The decision in *Canal Corp* has increased the risk of leveraged partnerships however advisors have viewed the outcome as a result of poor planning and structuring rather than a categorical rejection of the technique.[368]

FREEZE SPIN OFF TRANSACTIONS

The freeze may also be used to remove appreciation on real estate held by a corporation so that the corporate taxes could be minimized. Over time this technique may eventually result in a phase out of the corporation from the ownership of the real estate. While a phase out will generally not be totally tax free, it can significantly reduce and defer the pain of removing real estate from the corporate solution.



[365] Id.
[366] Id.
[367] Id.
[368] B 4, 2010) http://bl

In Cox Enterprises, Inc. v. Commissioner, T.C. Memo. 2009-134, a corporation ("Petitioner") that was in the newspaper publishing business and also owned and operated cable television and radio broadcasting stations, caused a second-tier wholly owned subsidiary ("KTVU Inc.") to contribute certain assets of one if its television stations to a newly formed partnership ("KTVU Partnership"). Petitioner was owned 98% by three trusts (the "Shareholder Trusts") whose income beneficiaries consisted of two individuals (the "Income Beneficiaries"); only after the death of the Income Beneficiaries could income be paid to their issue. In exchange for its contribution of assets, KTVU Inc. took back partnership interests in KTVU Partnership that entitled it to 55% of the profits and liquidation proceeds up to a specified amount, and 75% of profits and liquidation proceeds above such amounts. Two family partnerships (the "FLPs") that were owned by a combination of the Income Beneficiaries and their issue contributed cash to KTVU Partnership in exchange for the remainder of the profits and liquidation proceeds. The amount of cash contributed by the FLPs was determined by appraisal to be equal to the value of the partnership interests that the FLPs received. Prior to the transaction, Petitioner had attempted to sell KTVU but was unable to find a buyer. It was decided that contributing the television station to KTVU Partnership would benefit Petitioner by reducing its investment in the television business, and would also demonstrate the family's commitment to that line of business. The IRS did not dispute these business reasons in the court case.

The IRS determined by appraisal that the value of the partnership interest received by KTVU Inc. was $60 million less than the value of the television assets that it had contributed to KTVU Partnership. For purposes of the summary judgment motion that was the subject of this court case, the Petitioner did not dispute this value. As a result of the foregoing, the IRS argued that because the partners of the FLPs were the same individuals as the beneficiaries of the Shareholder Trusts, the transaction resulted in a constructive dividend from the Petitioner to the

Shareholder Trusts of this $60 million. The Petitioner filed a motion for summary judgment based on its arguments that (1) the transaction at issue is governed by Code sections 721 and 704(c) and thus Code section 311(b) is not applicable, and (2) because the Shareholder Trusts did not benefit from the transaction, the constructive dividend theory is not applicable.

In an opinion written by Judge Halpern, the Court agreed with the Petitioner and granted the motion for summary judgment. The Court found that the primary purpose of the transaction was not to provide an economic benefit to the FLPs and derivatively to the Shareholder Trusts as the IRS had argued. Instead, unlike the cases finding a constructive dividend, here there was a business purpose for the transaction. In addition, the parties attempted to structure the transaction in an arms' length manner. This was evident by the fact that the parties obtained an appraisal to try to determine the proper amount of cash that the FLPs had to contribute for their interest in the KTVU Partnership. In addition, the trustees of the Shareholder Trusts who agreed to this transaction were bound by fiduciary duties. Finally, although the remainder beneficiaries of the Shareholder Trusts did benefit from the transaction in that they now had immediate access to income from KTVU through the FLPs, the Shareholder Trusts themselves did not benefit from the transaction. *See* also PLR 9427023. Where the Service found Section 2701 inapplicable, when taking into account ownership through a grantor trust a corporation contributed business assets to a partnership between the corporation and the shareholders.

CONCLUSION

Estate and transfer tax planning for the long term real estate owner is a multidisciplinary process. It is necessary to develop and appropriate set of entity agreements that accomplish the needs of the business for succession planning and that also maximize valuatiuon opportunities for estate, gift and transfer tax planning. However, it is also necessary to give

special attention to the income tax concerns that are central to real estate ownership. One such concern is to maximize the basis step up upon death under section 1014 of the Code. Frequently used estate planning techniques may not work well for this purpose since they involve transfers to grantor trusts. The freeze partnership or limited liability company under section 2701 may be an optimal technique to not only freeze values that will be subject to estate, gift and generation skipping taxation, but it may also maximize the basis step up upon death – including that attributable to negative capital.

7

USING PARTNERSHIPS TO MAXIMIZE BASIS IN ESTATE PLANNING

MODERN USES OF PARTNERSHIPS
IN
ESTATE PLANNING

Paul S. Lee, J.D., LL.M.
Senior Regional Wealth Advisor
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

TABLE OF CONTENTS

Disclosure:
These materials do not constitute and should not be treated as, legal, tax or other advice regarding the use of any particular tax, estate planning or other technique, device or suggestion, or any of the tax or other consequences associated with them. Although reasonable efforts have been made to ensure the accuracy of these materials and the presentation, neither Paul S. Lee nor The Northern Trust Corporation assumes any responsibility for any individual's reliance on the written or oral information presented during the presentation. Each attendee should verify independently all statements made in the materials and during the presentation before applying them to a particular fact pattern, and should determine independently the tax and other consequences of using any particular device, technique or suggestion before recommending it to a client or implementing it for a client.

MODERN USES OF PARTNERSHIPS IN ESTATE PLANNING[1]

Paul S. Lee, J.D., LL.M.
Senior Regional Wealth Advisor
The Northern Trust Company
New York, NY
Email: PSL6@ntrs.com

I. INTRODUCTION

A. The New Tax Landscape

1. Generally

a. The year 2013, with the enactment of the American Taxpayer Relief Act of 2012[2] ("ATRA") and the imposition of the 3.8% Medicare contribution tax on unearned passive income or net investment income[3] (hereinafter, the "NIIT") that was enacted as part of the Health Care and Education Reconciliation Act of 2010 ("HCERA"),[4] which amended the Patient Protection and Affordable Care Act ("PPACA"),[5] marked the beginning of a significant shift in how estate plans should be structured.

b. For many years, estate planning entailed aggressively transferring assets out of the estate of high-net-worth individuals during their lifetimes to avoid the imposition of estate taxes at their deaths and consequently giving up a "step-up" in basis adjustment under section 1014 of the Internal Revenue Code of 1986, as amended (the "Code"). Because the estate tax rates were significantly greater than the income tax rates, the avoidance of estate taxes (typically to the exclusion of any potential income tax savings from the "step-up" in basis) was the primary focus of tax-based estate planning for wealthy individuals.

c. The enactment of ATRA marked the beginning of a "permanent" change in perspective on estate planning for high-net-worth individuals. The large gap between the transfer and income tax rates, which was the mathematical reason for aggressively transferring assets during lifetime, has narrowed considerably, and in some states, there is virtually no difference in the rates. With ATRA's very generous applicable exclusion provisions, the focus of estate planning will become less about avoiding the transfer taxes and more about avoiding income taxes.

---

[1] Portions of this material were initially prepared for the 50th Annual Heckerling Institute on Estate Planning, published by LexisNexis Matthew Bender, and are reprinted with the permission of the Heckerling Institute and the University of Miami. I would like to thank and acknowledge Richard B. Robinson of Robinson, Diss and Clowdus, P.C., Richard L. Dees of McDermott Will & Emery LLP, and Cristin C. Keane of Carlton Fields Jorden Burt, P.A., for their significant contributions to these materials.

[2] P.L. 112-240, 126 Stat. 2313, enacted January 2, 2013.

[3] § 1411 of the Internal Revenue Code of 1986, as amended (the "Code"). Hereinafter, all section references denoted by the symbol § shall refer to the Code, unless otherwise noted.

[4] P.L. 111–152, 124 Stat. 1029, enacted March 30, 2010.

[5] P.L. 111-148, 124 Stat. 119, enacted on March 23, 2010.

d. The new tax landscape for estate planners in 2013 and beyond is transformed by increased income tax rates, and the falling transfer tax liability, at both the Federal and state level. On the Federal side, the income and transfer tax provisions that became effective January 1, 2013, were enacted as part of ATRA, PPACA, and HCERA (the NIIT). In the states, many states increased their income tax rates,[6] and a number of states continued the trend of repealing their state death tax (estate and inheritance tax).[7]

e. A complete discussion of all of the provisions of the Federal laws and the state laws is beyond the discussion of this outline. So, this outline will limit the discussion to the most relevant provisions.

2. Pertinent Provisions of ATRA

a. Federal Transfer Tax Landscape

(1) Summary of the Pertinent Income Tax Provisions

(a) The top estate, gift, and GST tax rate is 40%.[8]

(b) The basic applicable exclusion amount[9] (sometimes referred to as the "Applicable Exclusion Amount" or the "Applicable Exclusion") for each individual is $5 million,[10] indexed for inflation after 2011[11] ($5.45 million for 2016).[12]

(c) Reunification of the estate, gift and GST tax system (providing a GST exemption amount equal to the basic Applicable Exclusion Amount under section 2010(c)).[13]

(d) Permanent instatement of the "portability" of a deceased spouse's unused exclusion amount ("DSUE Amount").[14]

---

[6] For example, the California enactment in 2012 of the Temporary Taxes to Fund Education, commonly known as Proposition 30 that raised the highest marginal income tax bracket to 13.3%.

[7] For example, (i) effective April 1, 2014, New York modified its state estate tax to immediately increase the state estate tax exemption from $1,000,000 to $2,062,500 per person and eventually have the exemption equal the Federal Applicable Exclusion amount by 2019; (ii) July 23, 2013, North Carolina repealed its estate tax (effective date of January 1, 2013), The North Carolina Tax Simplification and Reduction Act, HB 998, and on May 8, 2013; and (iii) Indiana repealed its inheritance tax (effective date of January 1, 2013), Indiana House Enrolled Act No. 1001.

[8] § 2001(c) (for transfers above $1 million) and § 2641(a)(1).

[9] § 2010(c)(2); Temp. Treas. Reg. § 20.2010-1T(d)(2).

[10] § 2010(c)(3)(A); Temp. Treas. Reg. § 20.2010-1T(d)(3)(i).

[11] § 2010(c)(3)(B); Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii).

[12] Rev. Proc. 2015-53, 2015-44 I.R.B. 615, Section 3.33.

[13] § 2631(c).

[14] § 2010(c)(4). Enacted as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296 ("TRA 2010"). § 101(a)(2) of ATRA struck the "sunset" provisions of TRA 2010 by striking § 304 of TRA 2010.

(e) Repeal of the "sunset" provision with respect the foregoing transfer tax provisions.[15]

(2) Applicable Exclusion Amount

(a) ATRA "permanently" provides for a cost-of-living increase to the Applicable Exclusion Amount but does not provide for a decrease even in the event of deflation.[16] The Applicable Exclusion Amount can grow to a very large number.

(b) By way of example, if the cost-of-living index increases at a compound rate of 2.80% over the next 10 and 20 years (the cost-of-living adjustment from 1985 to 2014 has averaged 2.81% and the median has been 2.80%[17]), the Applicable Exclusion Amount will grow as follows:

FORECASTED APPLICABLE EXCLUSION AMOUNT ($ MILLION)			
	2016	2026	2036
2.80% COLI	$5.45	$7.18	$9.47

b. Pertinent Income Tax Provisions

(1) Increase of the highest Federal ordinary income tax bracket to 39.6%.[18]

(2) Increase of the highest Federal long-term capital gain bracket to 20%.[19]

(3) Increase of the highest Federal "qualified dividend income" rate to 20%.[20]

---

[15] § 101(a)(1) of ATRA provides for a repeal of the "sunset" provision in the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38, ("EGTRRA"). The "sunset" provision of EGTRRA is contained in § 901 ("All provisions of, and amendments made by, this Act [EGTRRA] shall not apply... to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010," and the "Internal Revenue Code of 1986 ... shall be applied and administered to years, estates, gifts, and transfers ... as if the provisions and amendments described [in EGTRRA] had never been enacted.").

[16] Temp. Reg. § 20.2010-1T(d)(3)(ii).

[17] Determined and published by the Bureau of Labor Statistics.

[18] § 1 (for individuals with taxable income over $413,200 and married individuals filing jointly with taxable income over $647,850). *See* Rev. Proc. Rev. Proc. 2014-61, 2014-47 I.R.B. 860, Section 3.01.

[19] § 1(h)(1)(D) (for individuals with taxable income over $406,750, married individuals filing joint returns with taxable income over $457,600, and for estates and trusts with taxable income over $12,150). *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537, Section 3.01.

[20] § 1(h)(11) (allowing such income to be considered "net capital gain").

3. The Net Investment Income Tax (NIIT)

a. A full and complete discussion of the 3.8% excise tax on net investment income[21] (hereinafter "NIIT") is beyond the scope of this outline but a general understanding is important. Fortunately, there are a number of better resources for that discussion.[22]

b. For taxable years starting in 2013, section 1411 imposes a 3.8% excise tax net investment income on "net investment income"[23] ("NII") which includes:

(1) "Gross income from interest, dividends, annuities, royalties, and rents,"[24] (passive income), other than such passive income that is "derived in the ordinary course of a trade or business"[25] that is not a "Passive Activity or Trading Company" (as defined below);

(2) Gross income derived from a "Passive Activity or Trading Company," which is defined as:

(a) A trade or business that is "a passive activity (within the meaning of section 469) with respect to the taxpayer;"[26] or

(b) A trade or business that trades in "financial instruments or commodities (as defined in section 475(e)(2))."[27]

(3) Gain "attributable to the disposition of property other than property held in a trade or business not described"[28] as a Passive Activity or Trading Company; or

(4) Gross income from the investment of working capital.[29]

c. In arriving at NII, the Code provides for "deductions . . . which are properly allocable to such gross income or net gain."[30]

d. For individuals, the NIIT is imposed on the lesser of:[31]

---

[21] § 1411.

[22] *See* Richard L. Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1 & Part 2*, Tax Notes, Aug. 12. 2013, p. 683 and Aug. 19, 2013, p. 785, and Blattmachr, Gans and Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 Est. Plan. 3 (Apr. 2013).

[23] § 1411(c).

[24] § 1411(c)(1)(A).

[25] *Id.*

[26] § 1411(c)(2)(A).

[27] § 1411(c)(2)(B).

[28] § 1411(c)(2)(C).

[29] § 1411(c)(3), referencing § 469(e)(1)(B), which provides "any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business." *See* Prop. Reg. § 1.1411-6(a).

[30] § 1411(c)(1)(B).

(1) NII; or

(2) The excess of:

(a) "modified adjusted gross income for such taxable year"[32] ("MAGI"), over

(b) The "threshold amount"[33] ($200,000 for individual taxpayers, $250,000 for joint taxpayers, and $125,000 for married taxpayers filing separately).[34]

e. For estates and trusts, the NIIT is imposed on the lesser of:[35]

(1) The undistributed NII for the taxable year, over

(2) The excess of:

(a) Adjusted gross income (as defined in §67(e)),[36] over

(b) "[T]he dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year"[37] ($12,400 of taxable income for 2016).[38]

f. The threshold amount for individuals does not increase with cost-of-living adjustments, but the taxable income amount threshold for trusts and estates does.

g. With respect to a disposition of a partnership interest or S corporation shares, the net gain will be subject to the NIIT but "only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest."[39]

h. The following are excluded from the definition of NII:

(1) Distributions from "a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b),"[40] specifically referring to:[41]

---

[31] § 1411(a)(1)(A).

[32] § 1411(a)(1)(B)(i). Modified adjusted gross income is "adjusted gross income" as adjusted for certain foreign earned income. § 1411(d).

[33] § 1411(a)(1)(B)(i).

[34] § 1411(b).

[35] § 1411(a)(2).

[36] § 1411(a)(2)(B)(i).

[37] § 1411(a)(2)(B)(ii).

[38] *See* Rev. Proc. 2015-53, 2015-44 I.R.B. 615, Section 3.01(e).

[39] § 1411(c)(4)(A).

[40] § 1411(c)(5).

(a) A qualified pension, stock bonus, or profit-sharing plan under section 401(a);

(b) A qualified annuity plan under section 403(a);

(c) A tax-sheltered annuity under section 403(b);

(d) An individual retirement account (IRA) under section 408;

(e) A Roth IRA under section 408A; and

(f) A deferred compensation plan of a State and local government or a tax-exempt organization under section 457(b).

(2) Gain or other types of income that generally would not be taxable under the Code, including: [42]

(a) Interest on state and local bonds (municipal bonds) under § 103.

(b) Deferred gain under the installment method under § 453.

(c) Deferred gain pursuant to a like-kind exchange under § 1031 and an involuntary conversion under § 1033.

(d) Gain on the sale of a principal residence under § 121.

4. NIIT: Trusts and Interests in Pass-Through Entities

a. Generally

(1) If an individual, estate, or trust owns or engages in a trade or business, the determination of whether the income is derived in an active or passive trade or business is made at the owner's level.[43]

(2) If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation, the determination of whether the income is derived in an active or passive trade or business is made at the interest-holder level.[44] Provided, however, the issue of whether the gross income is derived from trading in financial instruments or commodities is determined at the entity level.[45]

---

[41] § 1411(c)(5) and Treas. Reg. §1.1411-8(a). *See also* REG-130507-11, Preamble and Proposed Regulations under Section 1411 (December 5, 2012), Fed. Reg. Vo. 77, No. 234, p. 72612-33 (hereinafter, "Preamble to § 1411 Proposed Regulations").

[42] *See* Preamble to § 1411 Proposed Regulations.

[43] Treas. Reg. § 1.1411-4(b)(1).

[44] Treas. Reg. § 1.1411-4(b)(2)(i).

[45] Treas. Reg. § 1.1411-4(b)(2)(ii).

(3) A trust, or any portion of a trust, that is treated as a grantor trust is not subject to NIIT.[46] The grantor will be deemed to have received all of the income from the trade or business. Hence, whether such trade or business is passive or active is determined at the grantor/owner level.

b. Non-Grantor Trusts

(1) The application of the NIIT to trusts that own closely-held business interests is controversial, and there is considerable uncertainty how a fiduciary that owns interests in a closely-held business can materially participate and thereby avoid the imposition of the tax.

(2) In *Mattie K. Carter Trust v. U.S.*,[47] the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees, and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument. In *Frank Aragona Trust v. Commissioner*,[48] the Tax Court held that the trust qualified for the real estate professional exception under section 469(c)(7) (deemed material participation) because three of the six co-trustees were full time employees of the trust-wholly owned LLC that managed the rental properties. In addition, the Tax Court also considered the activities of co-trustees that had co-ownership interests in the entities held by the trust, reasoning that the interests of the co-trustees were not majority interests, were never greater than the trust's interests in the entities, and were compatible with the trust's goals.

(3) Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary's activities are relevant. The IRS reaffirmed this ruling position in TAM 201317010. The ruling explains the IRS rationale as follows:

> The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).[49]

---

[46] Treas. Reg. § 1.1411-3(b)(1)(v).

[47] 256 F. Supp.2d 536 (N.D. Tex. 2003)

[48] 142 T.C. No. 9 (March 27, 2014).

[49] TAM 201317010. *See also* TAM 200733023 and PLR 201029014.

(4) At issue in the ruling were the activities of "special trustees" who did the day-to-day operations and management of the companies in question but lacked any authority over the trust itself. The ruling states:

> The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.[50]

(5) The need for a trustee to be active may affect the organization of business entities held in trust. For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager.

c. Pass-Through Entities

(1) The proposed Treasury Regulations issued in 2013[51] (the "2013 Proposed Regulations") provide that the exception for certain active interests in partnerships and S corporations will apply to a "Section 1411(c)(4) Disposition." A Section 1411(c)(4) Disposition is defined as the sale of an interest in any entity taxed as a partnership or an S corporation[52] (a "Pass-Through Entity") by an individual, estate, or trust if: (1) the Pass-Through Entity is engaged in one or more trades or businesses, or owns an interest (directly or indirectly) in another Pass-through Entity that is engaged in one or more trades or businesses, other than the business of trading in financial instruments or commodities; and (2) one or more of the trades or businesses of the Pass-Through Entity is not a passive activity (defined under section 469 of the Code) of the transferor.[53] Therefore, if the transferor (e.g., the trustee of a non-grantor trust) materially participates in one or more of the Pass-Through Entity's trades or businesses (other than trading in financial instruments or commodities), then some or all of the gain attributable to the sale of an interest in such entity would be exempt from the NIIT.

(2) The 2013 Proposed Regulations provide two possible methods of determining the amount of gain or loss from a Section 1411(c)(4) Disposition. The simplified method is available to a taxpayer if the gain of the transferor is $250,000 or less (including gains

---

[50] *Id.*

[51] REG-130843-13. Generally, effective for taxable years beginning after December 31, 2013.

[52] Prop. Treas. Reg. § 1.1411-7(a)(2)(i)

[53] Prop. Treas. Reg. § 1.1411-7(a)(3).

from multiple sales that were part of a plan).[54] If the gain exceeds $250,000, the transferor may use the simplified method if the sum of the transferor's share during the "Section 1411 Holding Period" (generally, the year of sale and the preceding two years) of separately stated items of income, gain, loss, and deduction of a type that the transferor would take into account in calculating NII is 5% or less than the sum of all separately stated items of income, gain, loss, and deduction allocated to the transferor over the same period of time, and the gain is $5 million or less.[55] Generally, the simplified method determines the amount gain or loss subject to NII by multiplying it by a fraction, the numerator of which is the sum of NII items over the Section 1411 Holding Period, and the denominator of which is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the same period.[56]

(3) If the transferor does not qualify for the simplified method,[57] then the 2013 Proposed Regulations provides that the gain or loss that the transferor would have taken into account if the Pass-Through Entity had sold all of its "Section 1411 Property" for fair market value immediately before the disposition of the interest.[58] Section 1411 Property generally is the property owned by the Pass-Through Entity that if disposed by the entity would result in net gain or loss allocable to the transferor (partner or S corporation shareholder) that would be considered NII of the transferor (deemed sale of the activities, on an activity-by-activity basis, in which the transferor does not materially participate).[59]

(4) These rules apply in to all entities taxed as partnerships (limited liability companies, limited partnerships, general partnerships, etc.) and S corporations.

d. Qualified Subchapter S Trusts

(1) A qualified subchapter S trust (QSST)[60] is an eligible shareholder of an S corporation. Generally, a QSST may have only one beneficiary (who also must be a U.S. citizen or resident)[61] who may receive income or corpus during the beneficiary's lifetime, and all of its income[62] must be distributed (or required to be distributed) currently to that beneficiary while the trust holds S corporation stock.[63] A trust that has substantially separate and

---

[54] Prop. Treas. Reg. § 1.1411-7(c)(2)(ii) (all dispositions that occur during the taxable year are presumed to be part of a plan).

[55] Prop. Treas. Reg. § 1.1411-7(c)(2)(i).

[56] Prop. Treas. Reg. § 1.1411-7(c)(4).

[57] The 2013 Proposed Regulations provide certain exceptions for situations when a transferor will be ineligible to use the optional simplified reporting method, notwithstanding qualifying for such. Situations of exception would include if the transferor held the interest for less than 12 months or if the transferor transferred Section 1411 Property to the Passthrough Entity or received a distribution of property that is not Section 1411 property during the Section 1411 Holding Period. *See* Prop. Treas. Reg. § 1.1411-7(c)(3).

[58] Prop. Treas. Reg. § 1.1411-7(a)(1).

[59] Prop. Treas. Reg. §§ 1.1411-7(a)(2)(iv), 1.1411-7(b), 1.469-2T.

[60] § 1361(d)(1)(A) treating such QSSTs as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

[61] § 1361(d)(3)(A).

[62] Fiduciary accounting income, not taxable income. Treas. Reg. § 1.1361-1(j)(1)(i).

[63] § 1361(d)(3)(B).

independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST as to each share.[64] If the trust holds other assets in addition to the S corporation stock, all of the fiduciary accounting income must be distributed, not just amounts attributable to the S corporation distributions.[65] The beneficiary of a QSST is taxed on all of the QSST's income and losses from the S corporation reported on the Schedule K-1 (as if the beneficiary was grantor of the trust for grantor trust purposes under Section 678 of the Code).[66] In contrast, when the QSST sells the S corporation stock, the QSST is taxable on any resulting gain.[67]

(2) For NIIT purposes, the material participation (or lack thereof) of the beneficiary of a QSST determines to what extent the Schedule K-1 income from the S corporation will be subject to NIIT at the beneficiary level. On the other, for sales of interests in an S corporation by the QSST, material participation (and the applicability of a Section 1411(c)(4) Disposition, as discussed above) is determined at the trust (trustee) level. The preamble to the 2013 Proposed Regulations provide, in pertinent part: [68]

> In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361–1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST... For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469... [T]hese proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level. This treatment is consistent with the chapter 1 treatment of the QSST by reason of §1.1361–1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons. First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust.

e. Electing Small Business Trusts

(1) An electing small business trust (ESBT) [69] is another non-grantor trust that is an eligible S corporation shareholder. Unlike a QSST, an ESBT may have multiple beneficiaries[70] who can have discretionary interests in the income and principal of the trust.[71]

---

[64] §§ 1361(d)(3) and 663(c).

[65] *See* PLR 9603007

[66] § 1361(d)(1)(B) and Treas. Reg. § 1.1361-1(j)(7)(i).

[67] Treas. Reg. § 1.1361-1(j)(8).

[68] Preamble to REG-130843-13.

[69] § 1361(c)(2)(A)(v).

[70] Must be individuals, estates, or charitable organizations described in § 170(c)(2) through (5). § 1361(e)(1)(A)(i) and Treas. Reg. § 1.1361-1(m)(1).

For income tax purposes, an ESBT is treated as two separate trusts: (i) a portion that holds S corporation stock (the "S portion"); and (ii) a portion that holds all other assets (the "non-S portion").[72] Notwithstanding the foregoing, the grantor trust rules take precedence over the ESBT rules.[73] The S portion is treated as a separate taxpayer, and income reported to the trust on the Schedule K-1 is taxed at the highest individual income tax rates for each type of income.[74]

f. For NIIT purposes, the S and non-S portions continue to be calculated separately for determining the amount of undistributed NII but are combined for purposes of determining if, and to what extent, the ESBT will be subject to the NIIT.[75] As discussed in more detail above, as with other non-grantor trusts, material participation (and the applicability of a Section 1411(c)(4) Disposition) is determined at the trustee level.

5. Disparity among the States

a. The state estate and inheritance tax (collectively, "state death tax") landscape has changed significantly since 2001 when almost every state had an estate and/or inheritance tax that was tied to the then existing Federal state death tax credit.[76] As the law stands today, the Federal state death tax credit has been replaced by a Federal estate tax deduction under §2058, and only 17 states still retain a generally applicable death tax.[77] In those states with a death tax, the rates and exemption can vary significantly. For example, Washington's estate tax provides for a top rate of 20% and an exemption of $2 million per person (indexed for inflation starting January 1, 2014 but only for the Seattle-Tacoma-Bremerton metropolitan area). Pennsylvania, on the other hand, provides for an inheritance tax rate of 4.5% for transfers to descendants, with almost no exemption. When taken in conjunction with the transfer tax provisions of ATRA (both the top Federal tax rate at 40% and the large Applicable Exclusion Amount), the combined Federal and state transfer tax cost to high-net-worth individuals has significantly fallen, when compared to 2001, by way of example.

b. State and local income tax laws and rates vary as well. A number of states have no state and local income tax (Florida, Texas, Nevada, New Hampshire, and Washington) and other states (California, Hawaii, Minnesota, New Jersey, New York, and Oregon) have relatively high income tax rates. When taken in conjunction with the income tax provisions of ATRA and the NIIT, the combined Federal and state income tax cost to most taxpayers has significantly risen since 2001.

c. Thus, the new estate planning landscape is characterized by significantly lower transfer tax costs, higher income tax rates, and significant disparity among the

---

[71] *See* §§ 1361(e)(1) and 1361(c)(2)

[72] § 641(c) and Treas. Reg. § 1.1641(c)-1(a).

[73] Treas. Reg. § 1.1641(c)-1(a).

[74] § 641(c)(1) and Treas. Reg. § 1.641(c)-1(e).

[75] Treas. Reg. § 1.1411-3(c).

[76] §§ 531 and 532 of EGTRRA provided for a reduction of and eventual repeal of the Federal estate tax credit for state death taxes under § 2011, replacing the foregoing with a deduction under § 2058.

[77] Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, and Washington. Iowa and Kentucky have an inheritance tax, but the exemption to lineal heirs is unlimited.

states when one compares the two taxes. As mentioned above, in 2001, for a New York City resident there was a 25% difference between the maximum transfer tax rate and the long-term capital gain tax rate. Today, that difference is approximately 13%.[78] In contrast, consider the tax rates in California. Because California does not have a state death tax, but currently has the highest combined income tax rate in the U.S., the difference between the transfer tax rate and the long-term capital gain tax rate is less than 3%.[79] Notably, the top combined ordinary and short-term capital gain tax rate in California is greater (approximately, 45% to 53%) than the transfer tax rate.

d. If one considers the "gap" (the difference between the transfer tax and the income tax rates) as a proxy for how aggressively estate planners will consider transferring assets out of the estate during lifetime, then one can see large differences among the states. On one side, there is California, where there is a very small or negative difference, compared to Washington where there is a very large gap (approximately 28% difference above the long-term capital gain tax rate).[80]

e. As a result, a reasonable prediction is that the consistency that has existed across the U.S. for similarly situated clients (distinguished only by the size of the potential gross estate) will exist no longer. Instead, estate plans will vary based on the state of residence of the client. For example, arguably California residents should be more passive in their estate plans, choosing more often than not, to simply die with their assets, than Washington residents. This is because the income tax savings from the "step-up" in basis may, in fact, be greater than the transfer tax cost, if any.

B. The New Paradigm in Estate Planning

1. Ascendancy of Income Tax

a. Given how large the Applicable Exclusion Amount will be in the future, it is clear that increasingly the focus of estate planning will move away from avoiding the transfer tax, and become more focused on the income tax. Much of the estate planning analysis will be about measuring the transfer tax cost against the income tax savings of allowing the assets to be subject to Federal and state transfer taxes.

b. The new "paradigm" in estate planning might have these features:

(1) Estate plans will vary significantly based upon many more variables:

(a) Time horizon or life expectancy of the client;

[78] New York has a maximum estate tax rate of 16%, when added to the maximum Federal tax rate of 40% and deducted pursuant to § 2058, the combined maximum transfer tax rate is 49.6%, compared to a maximum long-term capital gain tax rate of 36.5% for New York City taxpayers in the alternative minimum tax (20% Federal, 3.8% NIIT, 8.82% state, and 3.88% local).

[79] Combined long-term capital gain tax rate of 37.1% for California taxpayers in the alternative minimum tax (20% Federal, 3.8% NIIT, and 13.3% state).

[80] Washington does not have a state income tax.

(b) Spending or lifestyle of the client, including charitable giving;

(c) Size of the gross estate;

(d) Future return of the assets;

(e) Tax nature of the types of assets (for example, to what extent will a "step-up" in basis benefit the client and the beneficiaries?);

(f) Expected income tax realization of the assets (for example, when is it likely that the asset will be subject to a taxable disposition?);

(g) State of residence of the client;

(h) State of residence and marginal income tax bracket of the likely beneficiaries; and

(i) Expectations about future inflation.

(2) Estate planners will seek to use as little of a client's Applicable Exclusion Amount as possible during lifetime because it will represent an ever-growing amount that will provide a "step-up" in basis with little or no transfer tax cost at death. This conclusion assumes that "zeroed-out" estate planning techniques like installment sales to IDGTs and or "zeroed-out" grantor-retained annuity trusts[81] ("GRATs") can accomplish effectively the same amount of wealth transfer as a taxable gift but without using any or a significant portion of a client's Applicable Exclusion Amount. Wealth transfer is not accomplished when a taxpayer makes a gift and uses his or her Applicable Exclusion Amount toward that gift. There is wealth transfer only if and when the asset appreciates (including any appreciation effectively created by valuation discounts). That is essentially the same concept as an installment sale to an IDGT and a GRAT, except that those techniques require appreciation above a certain rate, like the applicable federal rate[82] ("AFR") or the section 7520 rate.[83]

(3) 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.

(4) 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.

(5) The state of residence of the client and his or her beneficiaries will influence the estate plan. For instance, if a client is domiciled in California, and his or her beneficiaries living 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

---

[81] Trust that provides the grantor with a "qualified annuity interest" under Treas. Reg. § 25.2702-3(b).

[82] § 1274.

[83] § 7520.

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?

(b) When that occurs, where is it likely that your beneficiaries (children and grandchildren) will reside?

2. Maximizing the "Step-Up" in Basis

a. One of the first steps in analyzing a client's situation is trying to measure the potential transfer tax costs against the income tax savings that would arise from a "step-up" in basis. Under the current state of law, this is not an easy endeavor. First, the Applicable Exclusion Amount will continue to increase. Both the rate of inflation and the lifespan of the client are outside the planner's control. In addition, as mentioned in the previous section, if the client dies in a state that has a death tax, the calculation of the transfer tax cost will be complicated by that state's exemption and rate. Third, the income tax savings of the "step-up" in basis must be measured in relation to the beneficiaries who may live in a different state than the decedent.

b. Although a "step-up" in basis is great in theory, no tax will be saved if the asset is at a loss at the time of death resulting in a "step-down" in basis, the asset has significant basis in comparison to its fair market value at the time of death, or the asset will not benefit at all because it is considered income in respect of a decedent[84] (IRD). Furthermore, even if the assets will benefit from a significant "step-up" in basis, the only way to capture the income tax benefits of the basis adjustment is to sell the asset in a taxable disposition. 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. In addition, even if the asset will be sold, there may be a significant time between the date of death of the decedent when the basis adjustment occurs and the taxable disposition, so some consideration should be given to quantifying the cost of the deferral of the tax savings. Finally, the nature of the asset may be such that even if the asset will not be sold in a taxable disposition, it may confer economic benefit to the beneficiaries. For example, if the asset that receives a "step-up" in basis is either depreciable or depletable under the Code,[85] the deductions that arise do result in tax benefits to the owners of that asset. In addition, 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.[86] These concepts and how certain assets benefit or don't benefit from the basis adjustment at death are discussed in more detail below.

c. Example: State of Residence and Nature of Assets

(1) Consider the following simplified situation. A married couple with a 10 year joint life expectancy has a joint taxable estate that is projected to be worth $23 million in the future, when the joint Applicable Exclusion Amount is projected to be $8.82 million ($16.64 million jointly). Assuming a quick succession of deaths and equalized estates

---

[84] § 691.

[85] *See e.g.*, § 1016(a)(2).

[86] *See e.g.*, §§ 731(a)(1) and 1368(b).

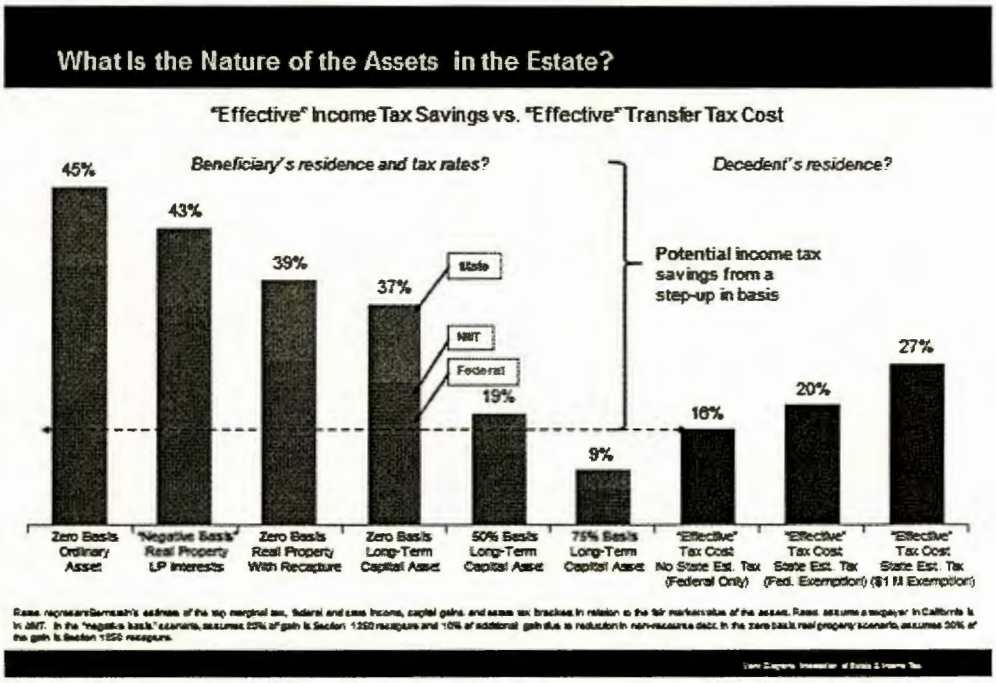
(making portability and community property issues moot), the total transfer tax cost would depend on the state in which the couple lived. The table below shows a summary of the death tax cost if the couple lived in a state with: (i) no death tax; (ii) a death tax with a rate tied to the now repealed Federal estate tax credit (maximum 16% tax above $10,040,000)[87] and an exemption equal to the Federal Applicable Exclusion Amount (e.g., Hawaii); and (iii) a death tax with a rate tied to the credit but with a $1,000,000 exemption per person (e.g., Massachusetts):

	No State Death Tax	State Death Tax (Federal Exemption)	State Death Tax ($1 Mil. Exemption)
Joint Taxable Estates	$23 million	$23 million	$23 million
Transfer Tax Cost	$3.7 million	$4.6 million	$6.3 million
"Effective" Tax Cost	16%	20%	27%

d. To calculate the "effective" transfer tax cost, divide the total transfer tax cost by the fair market value of the assets in the estate ($23 million). In this example, that tax cost ranges from 16% up to 27%. Whether that cost is too high or too low depends, in large part, on the nature of the types of assets that are likely to be in the estate and the state of residence of the beneficiaries. If the beneficiaries live in the state of California, a comparison of the cost versus the income tax savings on different types of assets can be illustrated by the following chart:[88]

[87] § 2011(b).

[88] Assumes the top marginal tax, federal and state income and capital gains. Rates assume a taxpayer in California is in AMT. In the "negative basis" scenario, assumes 20% of gain is Section 1250 recapture and 10% of additional gain due to reduction in non-recourse debt. In the zero basis real property scenario, assumes 20% of the gain is Section 1250 recapture.



(1) As one can see, and as is discussed in more detail in the next section of this outline, if it is anticipated that many of the assets in the estate will be zero basis ordinary assets like intellectual property or zero basis real property subject to recapture, then the estate plan should be focused on liquidity planning and allowing the assets to be included in the gross estate. If the assets are high basis assets or IRD assets, then getting the assets out of the estate (and reducing the transfer tax cost) should be the strategy. The graphic also makes clear that transfer tax costs and income tax savings might change significantly if the decedents died in a state with a death tax (with different exemptions) and if the beneficiaries lived in a state with no income tax. In addition, the income tax savings would also change if the sale of the asset would not be subject to the NIIT, if, by way of example, the beneficiary is below the thresholds or if the beneficiary is materially participating in the real estate venture.

(2) This simplified example assumes away one of the most important variables in determining the transfer tax cost, spending. The example assumes a joint estate of $23 million in 10 years. Higher or lower spending rates (along with longevity), will dramatically affect the gross estate and thus the transfer tax cost.

(3) When the income tax savings from the "step-up" in basis are sufficient to justify paying the transfer tax cost, the need for ensuring liquidity to pay the transfer tax liability becomes crucial. While the general trend for the future portends increasingly less transfer tax liability, the need for life insurance (and irrevocable life insurance trusts) continues in this new planning landscape.

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

(1) Benefit from a "step-up" (avoiding the inclusion cash or property that has a basis greater than fair market value)

(2) Benefit the most from the "step-up" (for example, very low basis assets, collectibles, and "negative basis" assets); and

(3) Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after "step-up" or depreciable/depletable assets giving rise to ongoing income tax deductions).

f. Notwithstanding these relatively simple set of goals, tax basis management can involve a large number of strategies, some of which are relatively straightforward and are broadly applicable to all clients regardless of the size of their estates. Other strategies are more complex and are only applicable to those clients with very large estates, who are willing to take on such complexity, but the tax benefits can be quite significant.

g. In considering tax basis management in estate planning, estate planners will need to take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around dying with the assets and benefiting from the "step-up" in basis. To the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a *Graegin*[89] loan.[90] For those clients who are likely to own assets that would not likely benefit from the "step-up" in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the "swap" power proactively if the assets are held in a grantor trust, as discussed later in this article.

h. When clients are in a situation where no estate taxes will be due, referred to as a "free-base" situation, then estate planners should 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). A "free-base" situation can arise when the assets includible in the estate are less than the decedent's remaining Applicable Exclusion Amount or a marital deduction transfer under section 2056 to the surviving spouse.[91] In these "free-basing"

---

[89] *Estate of Graegin v. Commissioner*, 56 T.C.M. (CCH) 387 (1988).

[90] *See* Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (7/14/11).

[91] Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the on-going income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust.

situations, practitioners will need to consider when valuations discounts are warranted and when the discounts should be removed.

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

(1) 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

(2) 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 Available Exclusion Amount above his or her assets.

j. Valuation Discounts On or Off?

(1) A common "free-base" situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, as mentioned above, the "step-up" in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the Applicable Exclusion Amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent "step-up" at the surviving spouse's estate. If a quick succession of deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.

(2) 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 Available Exemption Amount in order to increase the income tax basis of the assets.

(3) Family limited partnerships or other entities that create valuation discounts could be dissolved or restated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.

(a) 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.

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

(c) 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 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*,[92] the Tax Court applied 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 each 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 allows 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 gifts from the younger owners to the older owners than would terminating an old agreement and creating a new one.

(4) One option for eliminating valuation discounts with family limited partnership interests is to "convert" the limited partnership (or limited liability company) to a general partnership.

(a) Section 2704(b) of the Code will disregard certain "applicable restrictions" on the ability of the partnership to liquidate. However, an exception exists for "any restriction imposed . . . by any Federal or State law."[93] Since the effective date of section 2704 of the Code, many states have amended their limited partnership and limited liability company statutes to provide for significant restrictions on an owner's ability to liquidate his or her ownership interest in those entities, thereby rendering section 2704(b) inapplicable.[94]

(b) General partnership statutes, on the other hand, provide much more liberal provisions for liquidation and dissolution of a partnership and for the withdrawal of a partner. For example: (i) section 801 of the Uniform Partnership Act (UPA)[95] provides in a partnership at will, dissolution occurs upon a person's express will to withdraw; (ii) under section 601(1) of the UPA, a person is dissociated as a partner when the partnership has notice of the person's express will to withdraw as a partner; (iii) section 602(a) of the UPA points out that a person has the power to dissociate as a partner at any time, rightfully or wrongfully; and sections 701(a) and (b) of the UPA provide, upon dissociation, the partnership is required to purchase the person's interest in the partnership for a buyout price that is the *greater* of

---

[92] 140 T.C. 86 (2013); reversed on September 15, 2014, by the Fifth Circuit *Estate of James A. Elkins, Jr. v. Commissioner*, 13-60472.

[93] § 2704(b)(3)(B).

[94] *See, e.g.*, *Kerr v. Commissioner*, 113 T.C. 449 (1999) (The Tax Court held section 2704(b) of the Code was not applicable because the partnership agreement was no more restrictive than § 8.01 of the Texas Revised Limited Partnership Act, which generally provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the agreement or upon the written consent of the partners.), *aff'd* 292 F.3d 490 (5th Cir. 2002) (The Fifth Circuit affirmed the decision that section 2704(b) of the Code is inapplicable under section 2704(b)(2)(B)(i) of the Code. Section 2704(b)(2)(B)(i) provides that "the transferor or any member of the transferor's family, either alone or collectively, must have the right to remove the restriction" immediately after the transfer for the restriction to be one that would be disregarded. In the case, the University of Texas was a partner in the partnership.).

[95] Uniform Partnership Act, as adopted in 2007 and last amended in 2013, by the National Conference of Commissioners on Uniform State Laws (hereinafter, UPA).

liquidation value or the value based on a sale of the entire business as a going concern without the person.[96]

(c) Furthermore, nothing under section 2704(b) of the Code prohibits being less restrictive in the partnership agreement.

(d) Where retaining limited liability of a partner is important, the partner should consider utilizing a wholly-owned limited liability company that is treated as a disregarded entity for Federal tax purposes.[97] The use of disregarded entities is discussed in more detail later in these materials. In this instance, the partner would first contribute his or her limited partnership or limited liability company interest into the disregarded entity and then the limited partnership or limited liability company would "convert" to a general partnership. The conversion can be accomplished under a conversion power,[98] interest exchange[99] and dissolution, or other merger transaction.

(e) Because all of the limited partners and limited liability company members retain the same proportionate interest in the resulting entity, there is no gift for transfer tax purposes because of the "vertical slice" exception to section 2701 of the Code.[100]

3. Section 1014

a. General Rule: The "Step-Up" in Basis to Fair Market Value

(1) Generally, under section 1014(a)(1), the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is the "fair market value of the property at the date of the decedent's death."[101] The foregoing general rule is often referred to as the "step-up" in basis at death, under the assumption that assets generally appreciate in value. However, many assets depreciate in value, and this general rule will mean a loss of tax basis to fair market value at date of death (a "step-down" in basis). For purposes of this outline, I refer to the general rule of section 1014(a)(1) as a "step-up" in basis, whether the asset is appreciated or at a loss at the time of the decedent's death.

---

[96] The comment to section 701(b) of the UPA provides, "Liquidation value is not intended to mean distress sale value. Under general principles of valuation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern. Other discounts, such as for a lack of marketability or the loss of a key partner, maybe appropriate, however. For a case applying the concept, see *Fotouhi v. Mansdorf*, 427 B.R. 798, 803–05 (Bankr. N.D. Cal. 2010)."

[97] A single owner entity that has not elected to be classified as an association (corporation). See § 7701 and Treas. Reg. §§ 301.7701-1(a), -2(c)(2), -3(b)(1)(ii).

[98] *See* § 1141(a)(1) of the UPA

[99] *See* § 1131(a) of the UPA.

[100] *See* Treas. Reg. § 25.2701-1(c)(4).

[101] § 1014(a)(1).

(2) The Code goes on to say that if the executor of the estate elects an alternate valuation date under section 2032 or special use valuation under section 2032A, then the basis is equal to the value prescribed under those Code sections.[102]

(3) If land or some portion of such land that is subject to a qualified conservation easement is excluded from the estate tax under section 2031(c), then "to the extent of the applicability of the exclusion," the basis will be the "basis in the hands of the decedent"[103] ("carryover basis").[104]

b. New Sections 1014(f) and 6035 of the Code

(1) On July 31, 2015, the President signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[105] (commonly referred to as the "Highway Bill") into law. Among the non-expiring provisions in the Highway Bill are provisions that create new sections 1014(f) and 6035 of the Code.[106] Pursuant to these provisions, taxpayers acquiring property from a decedent whose estate was required to file a Federal estate tax return must report their adjusted tax basis consistently with the value of the property as finally determined for Federal estate tax purposes, or if not finally determined, the value as reported by the statement made under section 6035 of the Code. Specifically, beneficiaries cannot claim a higher basis than the estate tax value. Further, the executor is required to furnish the IRS and to each person acquiring any interest in property included in the gross estate a statement of value and any other information prescribed by the IRS.

(2) The text to Section 1014(f) of the Code is:

> (f) BASIS MUST BE CONSISTENT WITH ESTATE TAX RETURN.—For purposes of this section—
>
> (1) IN GENERAL.—The basis of any property to which subsection (a) applies shall not exceed—
>
> (A) in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, such value, and
>
> (B) in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, such value.
>
> (2) EXCEPTION.—Paragraph (1) shall only apply to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate.
>
> (3) DETERMINATION.—For purposes of paragraph (1), the basis of property has been determined for purposes of the tax imposed by chapter 11 if—
>
> (A) the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,

---

[102] §§ 1014(a)(2) and (3).

[103] § 1014(a)(4).

[104] § 1015.

[105] Pub. L. No. 114-41 (the "Highway Bill").

[106] § 2004 of the Highway Bill.

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

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

(4) REGULATIONS.—The Secretary may by regulations provide exceptions to the application of this subsection.

(3) The text to Section 6035 of the Code is:

SEC. 6035. BASIS INFORMATION TO PERSONS ACQUIRING PROPERTY FROM DECEDENT.

(a) INFORMATION WITH RESPECT TO PROPERTY ACQUIRED FROM DECEDENTS.—

(1) IN GENERAL.—The executor of any estate required to file a return under section 6018(a) shall furnish to the Secretary and to each person acquiring any interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe.

(2) STATEMENTS BY BENEFICIARIES.—Each person required to file a return under section 6018(b) shall furnish to the Secretary and to each other person who holds a legal or beneficial interest in the property to which such return relates a statement identifying the information described in paragraph (1).

(3) TIME FOR FURNISHING STATEMENT.—

(A) IN GENERAL.—Each statement required to be furnished under paragraph (1) or (2) shall be furnished at such time as the Secretary may prescribe, but in no case at a time later than the earlier of—

(i) the date which is 30 days after the date on which the return under section 6018 was required to be filed (including extensions, if any), or

(ii) the date which is 30 days after the date such return is filed.

(B) ADJUSTMENTS.—In any case in which there is an adjustment to the information required to be included on a statement filed under paragraph (1) or (2) after such statement has been filed, a supplemental statement under such paragraph shall be filed not later than the date which is 30 days after such adjustment is made.

(b) REGULATIONS.—The Secretary shall prescribe such regulations as necessary to carry out this section, including regulations relating to—

(1) the application of this section to property with regard to which no estate tax return is required to be filed, and

(2) situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

(4) The statement must be delivered within 30 days of the earlier of the date the return is filed or the date the estate tax return was due (with extensions). If the value is subsequently adjusted (e.g., by audit or amendment), a supplemental statement must be provided within 30 days. The penalty for each failure is $250, to a maximum of $3 million, and

if the failure to report was intentional, the penalty is increased to $500, with exceptions for reasonable cause.[107]

(5) If a taxpayer claims a tax basis on his or her income tax return in excess of the basis reported under section 1014(f) of the Code, a 20% penalty[108] is applied to the underpayment arising from the "inconsistent estate basis reporting."[109] The 6-year statute of limitations applies in the case of an overstatement of basis.[110]

(6) Note that section 1014(f)(1) of the Code limits application of the section to situations where Federal estate tax values have been determined. Section 1014(f)(3) defines "determined" in such a way that ordinarily a return would need to be filed. This is a more limited application than requested by the Obama Administration in its Greenbook.[111] Treasury and the IRS can be expected to push the language of the statute to its maximum scope when writing the regulations.

(7) These new provisions apply to estate tax returns (and related income tax returns) filed after July 31, 2015.[112] The IRS has issued Temporary Regulations that provide that executors and other persons required to file or furnish a statement under 6035(a)(1) and (a)(2) before March 31, 2016 do not need to do so until March 31, 2016.[113] On January 27, 2016, the IRS posted on its website an updated draft IRS Form 8971 (Information Regarding Beneficiaries Acquiring Property from a Decedent) and instructions. On March 4, 2016, the IRS published Proposed Treasury Regulations providing guidance on the basis consistency and reporting requirements.[114]

---

[107] §§ 6721, 6724(d)(1)(D), and 6724(d)(2)(II). The penalty under section 6721 if the Code for failing to file an information return was increased from $100 to $250 by the Trade Preferences Extension Act of 2015 (P.L. 114-27) on June 29, 2015. The penalty under section 6723 of the Code for failing to comply with a "specified information reporting requirement" does not apply, because "specified information reporting requirement" is a defined term limited under sections 6724(d)(3) of the Code, applying to circumstances which do not apply here.

[108] § 6662(a) (accuracy-related penalties on underpayments).

[109] § 6662(b)(8) and 6662(k).

[110] § 2005 of the Highway Bill and re-designated § 6502(e)(1)(B)(ii).

[111] Department of Treasury, General Explanation of the Administrations Fiscal Year 2016 Revenue Proposals (Feb. 2015), *Require Consistency in Value for Transfer and Income Tax Purposes*, p. 195.

[112] §§ 2004(d) and 2005(b) of the Highway Bill.

[113] T.D. 9757.

[114] REG-127923-15.

c. Section 1014(e): The One Year Conundrum

(1) Section 1014(e) provides that if "appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death,[115]" and the property is "acquired from the decedent by (or passes from the decedent to) the donor of such property (or spouse of such donor),"[116] then the property will not receive a "step-up" in basis and it will have the basis in the hands of the decedent before the date of death.[117]

(2) For purposes of the foregoing, the Code provides that carryover basis shall apply to any appreciated property "sold by the estate of the donor or by a trust of which the decedent was the grantor" but only "to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale."[118]

(3) This rule does not apply if the property passes to the issue of the original donor, and it is unclear whether this rule applies if the property is placed in trust where the original donor or donor's spouse is a potential beneficiary.[119] In *Estate of Kite v. Commissioner*[120] prior to her husband's death, the surviving spouse funded an inter-vivos QTIP trust for the benefit of her husband with appreciated assets. Her husband died a week after the QTIP trust was created and funded. The surviving spouse reserved a secondary life estate for the benefit of the surviving spouse, and the inclusion in her husband's estate was offset with a QTIP election. As such, after her husband's death, the appreciated assets were held in a marital trust for the surviving spouse, the original donor of the assets. Two other marital trusts were created for the benefit of the surviving spouse. The three marital trusts engaged in a series of transactions that effectively terminated the marital trusts, with a subsequent sale of the assets by the surviving spouse to the children for a deferred annuity. These transactions were at issue in the case, and the tax court concluded that a taxable gift was deemed to occur upon the sale of the marital trust assets under section 2519. However, in a footnote, the tax court provided that all of the assets in the marital trusts, including the appreciated assets gifted to him shortly before death, received a step-up in basis under section 1014.[121] The decision and the result of the case (in particular the with respect to section 1014(e)) have been criticized by a number of commentators.[122]

---

[115] § 1014(e)(1)(A).

[116] § 1014(e)(1)(B).

[117] § 1014(e)(1) (flush language).

[118] § 1014(e)(2)(B).

[119] *See* PLRs 200210051, 200101021, 9026036, and TAM 9302002.

[120] T.C. Memo 2013-43.

[121] "All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014." *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, footnote 9.

[122] See Jeff Pennell, *Jeff Pennell on Estate of Kite: Will it Fly?*, LISI Estate Planning Newsletter #2062 (Feb. 11, 2013) and John J. Scroggin, *Understanding Section 1014(e)*, LISI Estate Planning Newsletter #2192 (Feb. 6, 2014).

d. Community Property and Elective/Consensual Community Property

(1) The Code provides a special rule for community property. Section 1014(b)(6) provides that "property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate"[123] shall be deemed to have been acquired from or to have passed from the decedent.

(2) There are currently nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. There are two states that are separate property states but they allow couples to convert or elect to treat their property as community property: Alaska[124] and Tennessee.[125] Generally, these elective or "consensual community property" laws allow resident and nonresident couples to classify property as community property by transferring the property to a qualifying trust, and for nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary of such state, and specific language declaring the trust asset as community property.

(3) Clearly, for residents of separate property states, taking advantage of the "consensual community property" laws of another state has the potential for a basis adjustment under section 1014(b)(6). There has been no direct ruling on whether that would be the case under the laws of Alaska or Tennessee. However, a number of commentators have argued that assets in such "consensual community property" arrangements would, indeed, receive a full "step-up" in basis under section 1014(b)(6).[126] A professional fiduciary must be designated in Alaska or Tennessee in order to invoke the respective statutes and the administrative expense ought to be weighed against the potential benefit, taking into consideration the uncertainty.

4. The Tax Nature of Particular Assets

a. Generally

(1) Understanding how and to what extent assets will benefit from a "step-up" in basis is critical to the estate planning process. Obviously, certain assets like highly-appreciated assets will benefit more from the "step-up" in basis at death than cash (which has a basis equal to its face value which is equal to its fair market value) or property at a loss (a "step-down" in basis). Moreover, appreciated assets like gold that are considered "collectibles"[127]

---

[123] § 1014(b)(6).

[124] Alaska Stat. 34.77.010 et al. (Alaska Community Property Act).

[125] Tenn. Code Ann. § 35-17-101 et al. (Tennessee Community Property Trust Act of 2010).

[126] Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher. *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Probate and Tr. J. 615 (Winter 1999). *See also Commissioner v. Harmon*, 323 U. S. 44 (1944) (an Oklahoma income tax case involving elective community property), *McCollum v. U.S.*, 58-2 USTC § 9957 (N. D. Okla. 1958) (explaining what *Harmon* meant, and distinguishing it in the context of basis), and Rev. Rul. 77-359, 1977-2 C.B. 24.

[127] § 1(h)(4).

under the Code, benefit more from a step-up in basis than other appreciated capital assets because the Federal long-term capital gain tax rate for collectibles is 28%, rather than 20%.

(2) A list of asset categories or types starting with those that benefit the most from the "step-up" in basis and ending with those that benefit the least (or actually suffer a "step-down" in basis), might look like this:

(a) Creator-owned intellectual property (copyrights, patents, and trademarks), intangible assets, and artwork;

(b) "Negative basis" commercial real property limited partnership interests;

(c) Oil & gas investment assets (to be sold after date of death);

(d) Investor/collector-owned artwork, gold, and other collectibles;

(e) Low basis stock or other capital asset;

(f) Roth IRA assets;

(g) Oil & gas investment assets (to be held after date of death);

(h) High basis stock;

(i) Cash;

(j) Passive Foreign Investment Company (PFIC) Shares;

(k) Stock or other capital asset that is at a loss;

(l) Variable annuities; and

(m) Traditional IRA and qualified plan assets.

(3) A full discussion of every asset type listed above is beyond the scope of these materials, but a number of them deserve additional consideration and discussion. In addition, some assets listed above like traditional IRA, qualified plan, and Roth IRA assets cannot be owned by a partnership, so they are excluded from further discussion in this outline.

b. Creator-Owned Intellectual Property, Intangible Assets and Artwork

(1) Generally

(a) In the hands of the creator, intellectual property, intangible assets and artwork represent the type of asset that, from a tax standpoint, benefits greatly from the "step-up" in basis. For the most part, during the lifetime of the creator, these assets have little or no basis in the hands of the creator, and the sale, exchange, disposition, licensing or other exploitation of these types of assets are considered ordinary income to the creator. If the asset is transferred in a "carry-over" basis transaction like a gift, the tax attributes carry to the donee. On the other hand, if the creator of the asset dies with the asset, the asset is entitled to a "step-up" in basis and the asset becomes a long-term capital gain asset in the hands of the beneficiaries.

(b) Patents, copyrights, and trademarks are common assets, but intangible rights might also include the right of publicity, defined loosely as the right of an individual to have a monopoly on his or her own name, likeness, attributes, etc. In the case of well-known artists, actors, and celebrities, this right of publicity can be quite valuable. Some states, like New York, do not recognize a postmortem right to publicity,[128] while approximately 19 states have specifically codified the postmortem right to publicity. Notably, California[129] has codified the postmortem right to publicity, which lasts for a term of 70 years after the death of the personality. Further, the California statute specifically provides that such rights are freely transferable during lifetime or at death.

(c) As one can see, each of these intangible assets has its own peculiarities (for example, the duration of the intangible rights) that may affect its value at the date of transfer (whether during lifetime or at death) and that may affect whether the asset or particular rights can be transferred at all.

(2) Copyrights

(a) Under U.S. law, copyright protection extends to "original words of authorship fixed in any tangible medium of expression," which includes: "(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works."[130] The courts have ruled that computer software constitutes protected literary works.[131]

(b) Knowing the duration of an existing copyright is critical to understanding what value a copyright may have today and what value a copyright may have in the future. For works copyrighted on or after January 1, 1978, a copyright's duration is based

---

[128] *See, Milton H. Greene Archives Inc. v. Marilyn Monroe LLC*, No. 08-056471 (9th Cir. 8/30/12), *aff'g* 568 F. Supp. 2d 1152 (C.D. Cal. 2008). *See* http://rightofpublicity.com for a good discussion of statues, cases, and current controversies, maintained by Jonathan Faber of the Indiana University McKinney School of Law.

[129] Ca. Civ. Code § 3344.

[130] 17 U.S.C. § 102(a)(1)-(8).

[131] *See, e.g., Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1243 (3rd Cir. 1983).

upon the life of the author plus 70 years.[132] For works copyrighted prior to January 1, 1978, a copyright's duration was 28 years, with the author (and his or her estate) having the right to renew and extend the term for another 67 years (for a total of 95 years).[133]

(c) For works copyrighted on or after January 1, 1978, the author (or the author's surviving spouse or descendants if the author is deceased) has a right to terminate any transfer or assignment of copyright by the author 35 years after the transfer or assignment.[134] These termination rights apply "in the case of any work other than a work made for hire, the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will."[135] Because only the author has the right of termination during his or her lifetime, even if a gift is made of the copyright, the author's continued right of termination calls into question how the copyright can be irrevocably transferred (especially since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.

(d) Payments to the creator of a copyright on a non-exclusive license give rise to royalty income, taxable as ordinary income.[136] An exclusive license (use of substantially all of the seller's rights in a given medium) is treated as a sale or exchange. When the creator is the seller, it is deemed to be a sale of an asset that is not a capital asset,[137] so it is taxed at ordinary rates. By contrast, if the seller is not the creator, capital asset treatment under section 1221 is available if such seller is not a dealer.[138] Notwithstanding the foregoing, if the creator/author of the copyright, gifts the asset (carryover basis transaction), a sale or exchange by the donee is not afforded capital treatment either.[139] A gift for estate planning purposes, therefore, may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.

(e) In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a "step-up" in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset. Because the basis of the copyright included in the creator's estate is no longer tied to that of the creator, the asset no longer falls within the exclusion from capital asset treatment under section 1221(a)(3) and, thus, are capital assets in the hands of the creator's beneficiaries. The copyright is deemed to immediately have a long-term holding period even if it is sold within 1 year after the decedent's death.[140]

---

[132] 17 U.S.C. § 302(a).

[133] 17 U.S.C. § 304.

[134] 17 U.S.C. § 203(a).

[135] *Id.*

[136] § 61(a)(6). *See also* Treas. Reg. § 1.61-8. Rev. Proc. 2004-34, 2004-22 I.R.B. 964, allows certain taxpayers to defer to the next taxable year, certain payments advance royalty payments.

[137] § 1221(a)(3). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

[138] It could also be afforded § 1231 treatment (asset primarily held for sale to customers in the ordinary course of a trade or business).

[139] § 1221(a)(3)(C).

[140] § 1223(9).

(3) Patents

(a) Individuals who patent qualifying inventions are granted the "right to exclude others from making, using, offering for sale, or selling"[141] such invention for a specified term. The term for a utility or plant patent is 20 years, beginning on the earlier of the date on which the application for the patent was filed.[142] The term for a design patent is 14 years from the date of grant.[143]

(b) Similar to the taxation of copyrights, payments received for a transaction that is not considered a sale or exchange or payments received for a license will be considered royalty income, taxable as ordinary income.[144]

(c) A sale or exchange of a patent that does not qualify under section 1235 (discussed below), may qualify for capital gain treatment because the Treasury regulations specifically provide that a patent or invention are not considered "similar property"[145] to a copyright, which is excluded from capital gain treatment. However, for the sale of a patent to qualify for capital gain treatment under section 1221, the individual generally must be considered a non-professional inventor (otherwise the patent would be considered stock in trade or inventory in the hands of a professional inventor). Capital gain treatment under section 1231 is possible but only if the patent is considered to have been "used in a trade or business."[146] Often, however, patents held by individuals will not qualify as such. By consequence, generally, for individuals selling or exchanging a patent, the only avenue for capital gain treatment is under section 1235.

(d) Like the tax treatment of the creator of a copyright, if the creator dies with a patent, the asset is entitled to a "step-up" in basis to full fair market value under section 1014, and the asset is transformed into a long-term capital gain asset.

(e) Section 1235 provides that a "transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year."[147]

(f) Only an individual may qualify as a holder, regardless of whether he or she is in the business of making inventions or in the business of buying and selling

---

[141] 35 U.S.C. § 154(a)(1).

[142] 35 U.S.C. § 154(a)(2).

[143] 35 U.S.C. § 173.

[144] § 61(a)(6). *See also* Treas. Reg. § 1.61-8.

[145] "For purposes of this subparagraph, the phrase "similar property" includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law." Treas. Reg. § 1.1221-1(c)(1).

[146] § 1231(a)(3)(A)(i). The holding period is deemed to start when the patent is reduced to practice. *Kuzmick v. Commissioner*, 11 T.C. 288 (1948).

[147] § 1235(a).

patents.[148] Specifically, a qualified "holder" includes (i) the creator of the patent,[149] or (ii) "any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent,"[150] provided that in such instance, the individual is not an employer of the creator or related to the creator.[151] As such, a trust, estate, or corporation will not qualify as a holder under section 1235, although a transfer to a grantor trust would not likely disqualify a subsequent sale or exchange to capital gain treatment.[152] An entity taxable as a partnership does not qualify as a holder, but each individual in the partnership may qualify separately as such.[153]

(g) A sale or exchange by a qualified holder to a "related person" will not qualify for capital-gain treatment under section 1235.[154] A "related person" is generally defined by reference to section 267(b) and includes (i) the holder's spouse, ancestors, and lineal descendants (but not siblings);[155] (ii) a fiduciary of any trust of which the holder is the grantor; (iii) any corporation, partnership, or other entity in which the holder (and other related persons) own 25% or more of the ownership interests.[156]

(h) Because of the foregoing limitations of who can qualify as a holder and the related person limitations on who can be the transferee, many estate planning techniques involving patents are limited if capital gain treatment is to be retained.

(i) If a qualified holder sells his or her interest in a patent under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as IRD.[157]

---

[148] § 1235(a)(2) and Treas. Reg. § 1.1235-2(d)(3).

[149] § 1235(b)(1).

[150] § 1235(b)(2).

[151] § 1235(b)(2)(A)-(B).

[152] *See* Treas. Reg. § 1.671-2(c). If a holder sells his or her interest in a transfer qualifying under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as income in respect of a decedent.

[153] Treas. Reg. § 1.1235-2(d)(2). *See also*, PLRs 200135015, 200219017, 200219019, 200219020, 200219021, 200219026, 200506008, 200506009, and 200506019.

[154] § 1235(d).

[155] § 1235(d)(2)

[156] § 1235(d)(1).

[157] § 691 and Treas. Reg. § 1.691(a)(3).

(4) Artwork

(a) The taxation of artwork in the hands of the artist is the same as it would be for the creator of a copyright, as discussed above. Generally, all payments pursuant to a license and a taxable sale or exchange of the artwork give rise to ordinary income.[158] A third-party collector or investor in the artwork might qualify for capital gain treatment or section 1231 treatment, as long as the property is not held out for sale in the ordinary course of a trade or business (inventory).[159] Similarly, capital gain treatment is not available to a donee of the artist because the donee's basis is determined by reference to the artist's basis.[160]

(b) Artwork in the hands of a collector or investor (third-party other than the creator or a donee of the creator) is considered a collectible under the Code and would be subject to the 28% long-term capital gain tax, rather than 20%.[161] Under the Code, a "collectible" is any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property designated by the IRS as such.[162]

(c) As with copyrights and patents, the basis of property in the hands of a person acquiring property from a deceased artist is the fair market value of the property at the date of the artist's death or on the alternate valuation date, if so elected.[163] The artwork in the hands of the estate or the artist's beneficiaries becomes a capital asset, qualifying for long-term capital gain treatment.[164]

c. "Negative Basis"/"Negative Capital Account" Real Property Interests

(1) "Negative basis" is the colloquial phrase used to describe a situation where the liabilities in a partnership (as also shared by the partners) are in excess of the tax basis of the partnership assets (and in the basis of the partners' interests in the partnership). Note, the basis of an asset may not go below zero, so the phrase "negative basis" is technically incorrect. Even successful real property investment partnerships may have "negative basis" assets where the underlying developed real property has been fully depreciated and cash from refinancings has been distributed to the owners or partners.

(2) The following example illustrates how this "negative basis" problem can arise and how costly a taxable event would be from an income tax standpoint:

(a) Taxpayer buys an office building in 1983 for $10,000,000 (assume for purposes of this example, the entire purchase price is properly allocated to the office building, which is depreciable). Over the next 30 years, the property appreciates in value, the

---

[158] §§ 1221(a)(3) and 61(a)(6). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

[159] § 1221(a)(1).

[160] §§ 1221(a)(5)(B) and 1015.

[161] § 1(h)(4).

[162] §§ 1(h)(5)(A) and 408(m)(2).

[163] § 1014(a).

[164] *See* §§ 1221(a)(3) and 1223(9).

taxpayer fully depreciates the original basis of $10 million in the building to zero,[165] borrows against the property, and takes the loaned funds tax free. As a result in 2014, the office building is now worth $20 million, has zero adjusted tax basis, and has a mortgage on the building of $15 million ($5 million of net equity in the property).

(b) Note, because the property was placed in service in 1983, an accelerated method of depreciation was allowable on the property.[166] As such, a taxable sale of the property will be subject to recapture under the Code. Because the property was placed in service prior to 1986, recapture is under section 1245 (rather than section 1250, which generally applies to real property).[167] As such, the total amount of the depreciation deductions is subject to recapture as ordinary income.[168]

(c) If the building is sold for $20 million in a taxable transaction, the gain would break down as follows:

Amount Recognized:	$20,000,000
Adjusted Basis:	$ ------
Recapture:	$10,000,000 ordinary income
Long-Term Capital Gain:	$10,000,000 long-term capital gain

Assuming the taxpayer is in the highest income tax bracket and in a relatively high income tax state, like a New York City taxpayer, the ordinary rate would be approximately 45% and the long-term capital gain rate would be approximately 37%. The total tax liability would be $8.2 million. After repayment of the $15 million of debt, the taxpayer (who would net $5 million in cash from the transaction before taxes) would actually be in deficit by approximately -$3.2 million after the payment of income taxes.

---

[165] §§ 1016(a)(2), 168(a), and Treas. Reg. § 1.1016-3(a)(1)(i).

[166] Accelerated Cost Recovery System ("ACRS") was enacted in 1981 under the Economic Recovery Tax Act of 1982 ("ERTA"), P.L. 97-34. ACRS was later modified by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recover period was extended from 18 to 19 years, P.L. 99-121, § 103. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. Prop. Treas. Reg. § 1.168-4(a). The Tax Reform Act of 1986, P.L. 99-514, ("TRA 1986") dramatically changed the applicability of ACRS to real property investments and instituted the modified ACRS ("MACRS"). Notably, the "applicable recovery period" for most real property assets like buildings are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. § 168(c). In this example, because it was placed in service before 1984, the building would be considered 15-year real property, pursuant to which the applicable percentage of depreciation was 12% in the first year, reducing to 5% in from 11 to 15 years.

[167] § 1245(a)(5) before being amended by TRA 1986, defines "§1245 recovery property" to include all recovery property under ACRS, real or personal, other than certain types of 19-year (18-year for property placed in service after March 15, 1984, and before May 9, 1985; and 15-year for property placed in service before March 16, 1984) real property and low-income housing: residential rental property, property used "predominantly" outside the United States, property as to which an election to use straight-line recovery is in effect, and certain low-income and Federally insured residential property. The foregoing types of property are subject to recapture under Section 1250. In this example, the office building does not fall within the listed categories, and as such is subject to recapture under Section 1245.

[168] *See* § 1245(a)(2).

(d) Compare the result if the taxpayer died owning the building (assume for simplicity's sake, the building no longer has a mortgage). The building would get a "step-up" in basis under section 1014(a) to fair market value, the recapture and long-term capital gain tax problem would be eliminated. If the taxpayer has $5.34 million of Applicable Exclusion available, the maximum estate tax liability (assuming a top state death tax rate of 16% and state death tax exemption equal to the federal exclusion amount) is approximately $7.3 million (maximum blended rate of 49.6%). If the Applicable Exclusion Amount grows to $8 million for example, then the estate tax liability falls to a bit less than $6.0 million. If the foregoing building was in California, the income tax liability would be greater, and the estate tax cost would be even less because California does not have a death tax. With an Applicable Exclusion Amount of $5.34, the estate tax liability is less than $5.9 million.

(e) Property placed in service after 1986 will not have as egregious of an income tax problem because the gain would not have recapture calculated under section 1245. Rather, section 1250 would be the applicable recapture provision. "Section 1250 property" means any real property, with certain exceptions that are not applicable,[169] that is or has been property of a character subject to the allowance for depreciation.[170] Section 1250(a)(1)(A) provides that if section 1250 property is disposed of, the "applicable percentage" of the lower of the "additional depreciation" in respect of the property or the gain realized with respect to the disposition of the property shall be treated as ordinary income. In short, section 1250 provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income. [171] Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property.[172] As such, section 1250 recapture is typically not a problem for property placed in service after 1986. The Code does, however, tax "unrecaptured section 1250 gain" at a 25% tax rate. Unrecaptured section 1250 gain is essentially the lesser of all depreciation on the property or the net gain realized (after certain losses) to the extent not treated as ordinary income under section 1250.[173]

(f) From an estate planning perspective, it is important to remember that even if recapture is inherent in an appreciated property, it does not apply to a disposition by gift or to a transfer at death, unless the recapture would be considered income in respect of a decedent.[174]

(3) Today, most real property investments are not held individually, but are held typically in an entity taxable as a partnership (for example, a limited liability company or limited partnership). When real property investments are subject to refinancing followed by a distribution of the loan proceeds, the partnership debt rules under section 752 must be considered when determining the income tax cost of selling such property. Any increase in a partner's share of partnership liabilities (whether recourse or nonrecourse to such partner) is treated as a contribution of money by the partner to the partnership, resulting in an increase in the

---

[169] § 1245(a)(3).

[170] § 1250(c).

[171] § 1250(b)(1), (3), (5).

[172] § 168(b)(3)(A)-(B).

[173] § 1(h)(6).

[174] § 1250(d)(1) and (2).

partner's basis in his or her partnership interest ("outside basis").[175] Any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner, resulting in a decrease in the partner's outside basis.[176] A partner's outside basis may not be reduced below zero, so a deemed distribution of money that arises from a decrease in a partner's share of liabilities will give rise to gain recognition.[177]

(4) In the example described above, consider if a partnership owned a fully depreciated $20 million building. The partnership has $15 million of debt which is in excess of the basis in the building and in excess of the taxpayer's outside basis. Assume for this example that we can ignore other partners because they have relatively insubstantial interests in the partnership. When a partner has a negative capital account, so that the outside basis is less that the partner's share of partnership liabilities, it is also colloquially called "negative basis." As discussed, this is a misnomer because basis can never go below zero. [178] A transfer by the taxpayer, whether a taxable sale or a gift to a non-grantor trust, creates what is often referred to as "phantom gain" because the transferee takes over the transferor partner's negative capital account. It should also be noted that a partner who sells his or her partnership interest must include in income his or her allocable share of the partnership's recapture from depreciated partnership property.[179] The transfer results in a decrease in the transferor partner's share of liabilities, which in turn is treated as a distribution of money to the partner when the partner has an outside basis of zero, resulting in gain in a donative transfer or additional gain in the case of taxable sale.[180]

(5) When dealing with highly appreciated, depreciable assets like real property and partnership debt, taxable sales of the property and inter-vivos transfers of partnership interests can be problematic. [181] In many cases, given reduced transfer tax rates and growing Applicable Exclusion Amounts, it will make more economic sense to die owning these assets, than to transfer them during the partner's lifetime. The transfer of a partner's interest on death is a disposition that does not result in gain or loss recognition, even if the liability share exceeds outside basis.[182] The outside basis of the decedent receives a "step-up" in basis to fair market value (net of liabilities) but is also increased by the estate's share of partnership

---

[175] §§ 752(a) and 722. Treas. Reg. § 1.752-1(b).

[176] §§ 752(b) and 733. Treas. Reg. § 1.752-1(c).

[177] § 731(a) or 751.

[178] Partnership borrowings and payments of liabilities do not affect the capital accounts, because the asset and liability changes offset each other. See Treas. Reg. § 1.704-1(b)(2)(iv)*(c)*.

[179] §§ 751 and 453(i)(2). Under § 751, unrealized receivables are deemed to include recapture property, but only to the extent the unrealized gain is ordinary income. Treas. Reg. § 1.751-1(e) and (g).

[180] Rev. Rul. 84-53, 1984-1 C.B. 159, Situation 4.

[181] *See* Steve Breitstone and Jerome M. Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 Tax Mgmt. Memo. 311 (08/13/12).

[182] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

liabilities.[183] Further, if the partnership makes an election under section 754, the underlying assets in the partnership will also receive a "step-up" in basis.[184]

(6) Even if a section 754 election is not made, the estate or the successor beneficiaries of the partnership interest can get the benefit of a "step-up" in the underlying assets if the successor partner makes an election under section 732(d) and if the partnership distributes the assets for which there would have been a basis adjustment.[185] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance.[186]

d. Passive Foreign Investment Company (PFIC) Shares

(1) A PFIC is a foreign corporation, 75% or more of the gross of which is "passive,"[187] or the average percentage of assets that produce passive income of which is at least 50%.[188] The PFIC rules do not apply to any U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation.[189]

(2) The PFIC rules generally provide that when a U.S. shareholder receives a distribution from a PFIC, rather than treating them under the normal rules of U.S. taxation (e.g., dividend treatment), a special tax regime applies. Under the PFIC tax regime, distributions from a PFIC will be treated either as "excess" or "nonexcess" distributions.

(a) An excess distribution is any portion that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the 3 preceding years (or shorter if the shareholder has held the shares for less than 3 years).[190] All other distributions or portions thereof are treated as nonexcess distributions.

(b) With respect to nonexcess distributions, the normal rules of U.S. taxation apply, which generally results in dividend treatment.[191] However, the dividend

---

[183] §§ 1014(a), 1014(b), 742; Treas. Reg. §§ 1.1014-1(a), (b), and 1.742-1. The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

[184] § 743(a).

[185] § 732(d) and Treas. Reg. §1.732-1(d)(1)(i)-(iii). The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

[186] Treas. Reg. § 1.732-1(d)(2).

[187] § 1297(a)(1). Generally, "passive income" is foreign personal holding company income, as provided in § 954(c). § 1297(b).

[188] § 1297(a)(2).

[189] § 1297(e).

[190] § 1291(b)(2)(A).

[191] Prop. Treas. Reg. § 1.1291-2(e)(1).

will not be considered a qualified dividend taxable at 20% because a PFIC will never be a "qualified foreign corporation."[192]

(3) The portion of any distribution that is considered an excess distribution will first be allocated to each day in the shareholder's holding period for the shares.[193] Any portion so allocated to the current year and the non-PFIC years will be included in the year of receipt as ordinary income (not qualified dividends).[194]

(4) The portion of the excess distribution that is allocated to other years (the "PFIC years") is not included in the shareholders income, but is subject to a "deferred tax."[195] The deferred tax is added to the tax that is otherwise due. In computing the "deferred tax" the shareholder multiplies the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year.[196] The shareholder then adds all of the "unpaid" tax amounts for all of the PFIC years, and then computes interest on those unpaid tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate.[197] The deferred tax and interest are separate line items on the individual shareholder's income tax return.[198]

(5) The sale of PFIC shares are considered excess distributions to the extent the consideration for the sale is in excess of the shareholder's tax basis in the PFIC shares.[199] Thus, effectively the gain is treated as ordinary income, which is treated as realized ratable over the seller's holding period for purposes of determining the deferred tax and interest for prior years.

(6) U.S. shareholders of a PFIC may make a "qualified elective fund" (QEF) election to avoid the excess distribution regime. If the shareholder makes a QEF election, the shareholder must include in gross income a pro rata share of the PFIC's ordinary income and net capital gain each taxable year.[200] If a shareholder makes this election, he or she must have access to the PFIC's books and records so the allocable share of the PFIC's income and gain can be calculated.

(7) The death of a U.S. shareholder is not a taxable disposition of the PFIC shares if the death results in a transfer to a domestic U.S. estate or directly to another U.S. taxpayer.[201] By contrast, a transfer upon the death of a U.S. shareholder to a testamentary trust or to a foreign person will be considered at taxable disposition.[202] The proposed Treasury

---

[192] *See* § 1(h)(11)(C)(iii).

[193] § 1291(a)(1)(A).

[194] § 1291(a)(1)(B).

[195] § 1291(c).

[196] § 1291(c)(1).

[197] § 1291(c)(1), (2) & (3).

[198] § 1291(a)(1)(C).

[199] § 1291(a)(2).

[200] § 1293(a).

[201] Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A).

[202] Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B).

Regulations treat a transfer upon death as a transfer by the shareholder immediately prior to death and thus reportable in the decedent's last tax return.[203]

(8) If the PFIC shares are held in a grantor trust, the grantor's death is a taxable disposition unless one of the exceptions applies.[204]

(9) PFIC shares are nominally eligible for a "step-up" in basis. However, section 1291(e)(1) provides that a succeeding shareholder's basis in PFIC shares is the fair market value of the shares on date of death but then reduced by the difference between the new basis under section 1014 and the decedent's adjusted basis immediately before date of death.[205] Thus, a succeeding shareholder's basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent prior to death.

(10) The foregoing basis reduction rule does not apply to PFIC shares received by a succeeding U.S. shareholder upon the death of a nonresident alien decedent if the decedent was a nonresident alien during his or her entire holding period.[206]

e. Qualified Small Business Stock (QSBS)

(1) Section 1202 provides that a portion or all of the gain from the sale or exchange of "Qualified Small Business Stock" (QSBS) will be excluded from gross income, provided the QSBS has been held for more than 5 years.[207] The exclusion is generally 50% of the gain.[208] The exclusion is increased to 75% for QSBS acquired after February 17, 2009 and before September 28, 2010, and to 100% for QSBS acquired after September 27, 2010, and before January 1, 2014.[209]

(2) In addition to the gain exclusion provisions above, section 1045 allows a taxpayer who realizes gain on the sale of QSBS to rollover the gain, without gain recognition, into new QSBS within a 60-day period beginning on the date of the sale.[210] To qualify for non-recognition, the taxpayer may not be a corporation, must have held the stock for six months at the time of the sale, and must affirmatively elect to apply section 1045. If the taxpayer so qualifies, the taxpayer will only recognize gain from the sale to the extent the amount realized on the sale of the QSBS exceeds the cost basis of any QSBS purchased during the 60-day period beginning on the date of sale, less any portion of the cost already used to shelter the amount realized with respect to the sale of other QSBS.[211]

---

[203] Prop. Treas. Reg. § 1.1291-6(d)(2).

[204] Prop. Treas. Reg. § 1.1291-6(c)(3)(iv).

[205] § 1291(e)(1).

[206] § 1291(e)(2).

[207] § 1202(a)(1).

[208] *Id.*

[209] §§ 1202(a)(3) and (a)(4). There is also an exclusion of 60% with respect to QSBS of certain empowerment zone businesses. *See* §§ 1202(a)(2)(A) and 1397C(b).

[210] § 1045(a).

[211] § 1045(a)(1).

(3) Because of the gain exclusion and gain rollover aspects of QSBS, most taxpayers should seek to make inter-vivos transfers of these assets out of their gross estates to the extent they exceed their transfer tax exclusions (both state and Federal). Simply put, heirs will not benefit as much from a "step-up" in basis because of the gain exclusion features of QSBS, and as discussed below, QSBS status can be retained and transferred through donative transfers to donees.

(4) QSBS is stock of a C corporation that is a Qualified Small Business (QSB) in an active business, issued after August 10, 1993 (the date section 1202 was enacted by the Revenue Reconciliation Act of 1993), and that satisfies the original issuance requirement.[212] In order to be considered a QSB, the aggregate gross assets of the corporation must not have exceeded $50,000,000 after August 10, 1993, before the issuance of the stock, and immediately after the issuance of the stock.[213] Only U.S. corporations can qualify for QSB status.[214]

(5) A corporation will meet the active business requirement if the corporation uses at least 80% of its assets (measured by fair market value) in the active conduct of one or more qualified trades or businesses.[215] A qualified trade or business is any trade or business other than:

(a) Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;

(b) Any banking, insurance, financing, leasing, investment or similar business;

(c) Any farming business;

(d) Any business involving the production or extraction of products that would provide depletion deductions under sections 613 and 613A (e.g., oil, natural gas, minerals, etc.); and

(e) Any business operating a hotel, motel, restaurant, or other similar businesses.

(6) The original issuance requirement is met if the taxpayer acquired the stock at its original issuance for money, property, or services provided to the issuing corporation.[216]

---

[212] § 1202(c).

[213] § 1202(d).

[214] § 1202(d)(1).

[215] § 1202(e). Also, the U.S. corporation may not be a DISC, a corporation for which a Section 936 election is in effect, a regulated investment company, real estate investment trust, or real estate mortgage investment conduit, or a cooperative. § 1202(e)(4).

[216] § 1202(c)(1)(B).

f. A taxpayer that receives QSBS as a gift or by death retains its character as QSBS, and the taxpayer is treated as having acquired the stock in the same manner as the transferor with a tacking of the transferor's holding period.[217] If the transfer is by death, the QSBS receives a "step-up" in basis under section 1014, but appreciation after date of death would continue to be eligible for gain exclusion under section 1202.

g. If a partnership transfers stock to a partner, the partner is treated as having acquired the stock in the same manner as the partnership did.[218] As such, if the partnership met all of the QSBS stock eligibility requirements, the stock will be considered QSBS in the hands of the partner, and the partner's holding period will be deemed to include any time held by the partnership.[219]

h. As one might expect, the Code and the Treasury Regulations are silent as to whether stock retains its character as QSBS if it is transferred in an installment sale to an IDGT. Presumably, because the sale is ignored for income tax purposes and losing grantor trust status (whether due to death or otherwise) is akin to a donative transfer at that time, as discussed in more detail below, QSBS status passes to the IDGT.

C. Why Partnerships?

1. For many years the one of the primary reasons entities taxed as partnerships (general partnerships, limited partnerships, limited liability companies, etc.) were used in estate planning was to take advantage of valuation discounts. With the ascension of income tax planning, estate planning will become increasingly focused on: proactive tax basis management (maximizing the step-up in basis) and income tax deferral and avoidance.

2. Entities taxed as partnerships are the only vehicles flexible enough to allow families to change the basis of assets without death or a taxable event and also shift income among family taxpayers (including trusts and other business entities) without requiring a taxable gift. The hurdle that practitioners must overcome is the complexity of subchapter K, which can be daunting.

3. The remainder of this outline is focused on how partnerships can be used in the new estate planning landscape. It will discuss different partnership designs, elections, and provisions for estate planners to consider.

---

[217] §§ 1202(h)(1), (2)(A) and (B).

[218] § 1202(h)(2)(C).

[219] § 1202(h)(1). *See* Treas. Reg. § 1.1045-1(e)(3)(i).

II. TAX BASIS MANAGEMENT AND THE FLEXIBILITY OF PARTNERSHIPS

A. Generally

1. There are limited ways of changing the basis of an asset without having a recognition event for income tax purposes. The donee of a gift generally acquires "carryover" basis[220] increased by any Federal gift tax paid attributable to any appreciation in the property transferred.[221] Moreover, if the fair market value of the gift is less than the donor's basis, the donee's basis on a subsequent sale of the property will depend on whether the sale creates a gain or a loss. If the donee recognizes a loss, the donee's basis for purposes of determining the recognizable amount of such loss is the fair market value of the property at the time of the gift. If the donee recognizes a gain, the donee's basis for purposes of determining the recognizable amount of such gain is the donor's basis at the time of the gift. A sale at an amount somewhere in between the basis for determining loss and the basis for determining gain results in no gain or loss recognized. [222] As discussed above, the basis of most assets will get a "step-up" in basis if acquired from a decedent under section 1014(a).

2. Estate planners should consider using entities treated as partnerships for tax purposes to proactively manage the tax basis of the assets of families. The partnership rules provide sufficient planning flexibility to shift and change the basis of property through distributions (both non-liquidating and liquidating distributions) and the use of certain elections like the section 754 election. For example, a partnership could distribute a high basis asset into the hands of a partner with zero outside basis. The basis of the property in the hands of the partner generally would become a zero basis asset eligible for a "step-up" in basis on the subsequent death of the partner.[223] With a section 754 election, the "stripped" basis (i.e., the partnership's basis in the asset immediately prior to the distribution) would allow an upward basis adjustment to the other assets remaining inside the partnership.[224] Furthermore, because partnership debt can create tax basis to certain partners, the careful management of each partner's allocable share of that debt can increase or decrease basis.[225] Notwithstanding the general rules above, other provisions of subchapter K must be considered, including the "mixing bowl" transaction and disguised sale rules.[226]

3. Understanding and proactively using the subchapter K rules concerning the basis of assets inside a partnership and the outside basis that the partners have in their partnership interests thus can become a valuable tax-saving tool for the estate planner. In particular, estate planners should have a working knowledge of the following subjects pertaining to subchapter K and the income tax treatment of partnerships:

a. Unitary basis rules;

---

[220] § 1015(a).

[221] § 1015(d).

[222] § 1015(a) and Treas. Reg. § 1.1015-1(a)(1) & (2).

[223] §§ 732(a)(2) and 1014(a).

[224] § 734(b).

[225] § 752.

[226] §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

b. Non-liquidating "current" distributions of partnership property;

c. Liquidating distributions of partnership property;

d. "Mixing Bowl" transactions;

e. Partnership liabilities and basis;

f. Section 754 election and inside basis adjustments;

g. Partnership divisions; and

h. Anti-abuse rules.

B. Anti-Abuse Rules

1. In 1995, the IRS issued "anti-abuse" Treasury Regulations[227] that permit the IRS to recharacterize any transaction that involves a partnership if a principal purpose of the transaction is to reduce the present value of the partners' "aggregate Federal tax liability" in a manner inconsistent with the intent of subchapter K.[228] The breadth of these provisions are potentially infinite, but generally apply to artificial arrangements. The discussion herein focuses on only those arrangements that result in changes in tax basis in light of attempting to maximize the "step-up" in basis.

2. The Treasury Regulations provide that the following requirements are implicit in the "intent" of subchapter K:

a. The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;[229]

b. The form of each partnership transaction must be respected under substance over form principles;[230] and

c. The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income) or "the application of such a provision [of subchapter K] to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision."[231]

3. The Treasury Regulations provide that certain of the factors that may be taken into account in determining whether a partnership was formed or availed of with a principal

---

[227] Treas. Reg. § 1.701-2.

[228] Treas. Reg. § 1.701-2(b).

[229] Treas. Reg. § 1.701-2(a)(1).

[230] Treas. Reg. § 1.701-2(a)(2).

[231] Treas. Reg. § 1.701-2(a)(3).

purpose to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner inconsistent with the intent of subchapter K. Some of those factors are:

a. The fact that substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

b. The present value of the partners' aggregate Federal tax liability is substantially less than it would have been had the partners owned the partnership's assets and conducted the partnership's activities directly;

c. The benefits and burdens of ownership of contributed property are retained by the contributing partner, or the benefits and burdens of ownership of partnership property are shifted to the distributee partner, before and after the property actually distributed;

d. The present value of the partners' aggregate Federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction; and

e. Partners who are necessary to claiming a certain tax position but who have a nominal interest in the partnership, are substantially protected from any risk of loss, or have little or no participation in profits other than a preferred return that is a payment for the use of capital.[232]

4. Pertinent to the concept of changing the tax basis of property, the Treasury Regulations provide 2 examples of situations that generally indicate that basis shifts resulting from property distributions are allowable under the anti-abuse provisions:

a. The first example involves a liquidating distribution of appreciated, nonmarketable securities from a partnership without a section 754 election in place. The distribution resulted in a stepped-up basis in the securities. Because no section 754 was in place, there was no downward basis adjustment by the amount of untaxed appreciation in the asset distributed. The example acknowledges that the remaining partners will enjoy a timing advantage because the adjusted bases of the remaining assets were not adjusted downward. Further, the example provides that the partnership and the liquidating partner had as a principal purpose to take advantage of the basis shift. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[233]

b. The second example involves a liquidating distribution of an appreciated, non-depreciable asset, and depreciable property with a basis equal to its fair market value. The distribution resulted in a shift of basis from the non-depreciable asset to the depreciable asset (adding basis in excess of fair market value). This resulted in additional depreciation deductions and tax benefits to the liquidated partner. The example provides that the partnership and the liquidating partner had as a principal purpose the foregoing tax advantage to the liquidating partner. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.[234]

---

[232] Treas. Reg. § 1.701-2(c).

[233] Treas. Reg. § 1.701-2(d), Ex. 9.

[234] Treas. Reg. § 1.701-2(d), Ex. 10.

5. The Treasury Regulations do provide an example of an abusive situation. In that example, a partner contributes property with inherent loss to a partnership formed for the purpose by related parties, who contribute cash, used to purchase a nonmarketable security with a value and inside basis equal to the value of the contributed property. The contributor will have a section 704(c) allocation of the inherent loss and an outside basis equal to the value of the contributed loss property. The property is leased for three years to a prospective purchaser, who has an option to purchase at the value at the time of the contribution. Three years later, but before the sale under the option, the contributor receives a liquidating distribution of the other property with an inside basis equal to the value of the contributed property,[235] but that will have a distributed transferred basis equal to the basis of the contributed property, so that the contributor still has the original inherent loss. The sale by the partnership of the contributed loss property, recognizing the loss after the contributor has withdrawn from the partnership, results in a partnership loss that is allocated to the related partners since the loss that would have been allocated under section 704(c) to the contributor is no longer a partner. The Treasury Regulations conclude that this situation is abusive.[236]

6. Notwithstanding the existence of these anti-abuse rules, the IRS may also rely on non-statutory principles like substance-over-form, step-transaction, and sham-transaction doctrines to recast certain partnership transactions.[237]

7. In addition to the anti-abuse rules, some mention should be made about the codification of the economic substance doctrine under section 7701(o) of the Code.[238] It provides, in pertinent part, "In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if— the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction."[239] However, the Code provides an exception for "personal transactions of individuals" and "shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income."[240] It is unclear to what extent this provision could apply to the planning techniques discussed in this outline, particularly since this new paradigm in estate planning combines both transfer tax and income tax planning.

---

[235] This transaction might have a different result today. Section 704(c)(1)(C), enacted in the American Jobs Creation Act of 2004, P.L. 108-357, provides that contributed property has a "built-in loss," for purposes of allocating income to other partners, the inside basis will be treated as being equal to its fair market value at the time of contribution.

[236] Treas. Reg. § 1.701-2(d), Ex. 8. *See also* FSA 200242004 (Transfer of loss property to tax partnership, a sale of the partnership interest to unrelated party with no Section §754 election in effect, followed by sale of loss property by the partnership. The transaction was recharacterized under Treas. Reg. § 1.701-2 as sale of assets).

[237] Treas. Reg. § 1.701-2(i).

[238] Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010).

[239] § 7701(o)(1).

[240] § 7701(o)(5)(B).

C. Unitary Basis Rules

1. A partner has a "unitary basis" in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.) and even if the partner acquired the partnership interests in different transactions.[241] This is in contrast to the "separate lot" rules applicable to shares of corporate stock when such separate lots can be "adequately identified."[242]

2. Under this unitary basis concept, basis is generally allocated in property to the relative fair market value of different interests when determining such basis allocation is relevant (for example, the sale of a partnership interest or a distribution of property in redemption of a partnership interest). When, however, partnership liabilities exist, changes in a partner's share of debt must be taken into account (deemed distributions and contributions of cash under section 752) in determining basis (corresponding additions or reductions of outside basis under sections 722 and 733).[243]

3. A partner will have a split holding period in his or her partnership interest if the partner acquires his or her partnership interest by contributing assets with different holding periods or by subsequent contributions. The split holding periods are allocated generally in proportion to the fair market value of the property in question.[244]

4. Unitary basis is determined on a partnership by partnership basis even, so it seems, if a partner has an interest in 2 or more partnerships that are identical in all respects (including the interests of other partners) except, perhaps the assets in the partnership, there does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. This may have important planning implications in estate planning as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.

5. In estate planning, it is common for grantors to simultaneously own interests in FLPs individually and deem to own, for income tax purposes, FLP interests in an IDGT due to grantor trust status. This assumes that grantor trust status equates to the IDGT being disregarded or ignored for income tax purposes, and thus, the grantor will be treated for all income tax purposes as the owner of the trust assets. This apparently is the position of the government. Revenue Ruling 85-13[245] provides that a "defective grantor trust" will be "ignored" for income tax purposes. As discussed later in this outline regarding the use of disregarded entities in transfer tax planning, however, the cases, Code, and Treasury Regulations are not necessarily consistent with this interpretation.

6. In any case, assuming an IDGT may be "ignored" for income tax purposes, because of the unitary basis rule, subsequent contributions of high basis property by the grantor will result in proportional increases (in a pro rata FLP) to the outside basis of the IDGT

---

[241] Rev. Rul. 84-53, 1984-1 C.B. 159. *Cf.* PLR 200909001 (the unitary basis rule does not apply to publicly-traded partnership interests).

[242] *See* Treas. Reg. § 1.1012-1(c). Even if lots cannot be identified, then a first-in, first-out accounting convention is used to determine gain or loss.

[243] *See* Treas. Reg. 1.752-1.

[244] *See* Treas. Reg. § 1.1223-3.

[245] Rev. Rul. 85-13, 1985-1 C.B. 184.

partnership interests. Given that the FLP interests held by the IDGT will generally not benefit from a "step-up" in basis at the death of the grantor, this can have the advantage of increasing the basis of the FLP interests without requiring an additional transfer to the trust or estate tax inclusion. Of course, if the grantor has a power to swap assets of equivalent value, exchanging high basis assets for the FLP interests is likely to be more advantageous from a basis increase standpoint.

D. Current and Liquidating Distributions

1. Non-Liquidating "Current" Distributions

a. Cash Distributions

(1) Unless a distribution (or a series of distributions) results in a termination of a partner's interest in a partnership, it will be considered a non-liquidating or "current" distribution.[246] Since most FLPs are structured as "pro rata" partnerships,[247] it is important to recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,[248] unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.[249]

(2) Distributions of cash (including a reduction in a partner's share of liabilities and distributions of marketable securities[250]) to a partner reduces the partner's outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.[251] No loss is ever recognized on a current distribution.[252] Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner's interest.[253] The gain may be ordinary income if the distribution results in a disproportionate sharing of certain "unrealized receivables" and "inventory items" of the partnership (section 751 assets).[254] The definitions of these types of assets (sometimes referred to as "hot assets") include more things than might be obvious. Unrealized receivables include rights to payment for goods or services not previously included in income,[255] and recapture property, but only to the extent unrealized gain is ordinary income (as discussed above). "Inventory items" include any property described in

---

[246] Treas. Reg. § 1.761-1(d).

[247] This is generally due to the "same class" exception under § 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability)." Treas. Reg. § 25.2701-1(c)(3).

[248] § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b).

[249] § 731(a)(1) and Treas. Reg. § 1.731-1(a).

[250] § 731(c) and Treas. Reg. § 1.731-2.

[251] § 733(a) and Treas. Reg. § 1.733-1.

[252] §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. §1.731-1(a)(2).

[253] § 731(a).

[254] § 751.

[255] § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1).

section 1221(a)(1) (inventory or other property held for sale to customers in the ordinary course of business and any other property that would not result in capital gain or gain under section 1231 (accounts receivables).

(3) The holding period of any gain from the distribution of cash is determined by the partner's holding period in his or her partnership interest.[256] If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a non-recognition[257] transaction), the holding period of the property transferred is added to the partnership interest's holding period.[258] If the partner acquires the partnership interest at different times, the partnership interest will have different holding periods, allocated in proportion to the fair market value of the contributed property.[259]

(4) It should be noted that if a partner transferred his or her partnership interest in exchange for cash (or other property), the tax rate on capital gain may be different than if the partner received cash from the partnership in liquidation/redemption of the partnership interest. The planning opportunities that might arise as a result of this anomaly is discussed in more detail later in this outline.

(a) Upon a sale or exchange, the transferor recognizes gain under rules similar to section 1001.[260] The transferee of the partnership interest takes a cost basis in the partnership interest equal to the consideration paid,[261] and carries over the transferor's capital account and share of forward and reverse section 704(c) gain in the partnership assets, if any.[262]

(b) The character of the gain is capital subject to recharacterization under section 751(a). The transferor partner recognizes ordinary income or loss in an amount equal the income or loss that would be allocated to the partner if the partnership sold all of the partnership assets at fair market value.[263] Capital gain or loss is recognized in an amount equal to the gain or loss that would be calculated under section 1001 minus the ordinary income (or plus the ordinary loss) computed under section 751(a).[264]

(c) All of the foregoing provides for similar results to a cash distribution to a partner. For determining the rate of tax on the capital gain, on the other hand, one looks through to the underlying partnership assets.[265] Thus, depending on the assets held by

---

[256] *See* GCM 36196 and *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *aff'g* 7 T.C. 1088 (1946), *cert. denied*, 334 U.S. 819 (1948).

[257] § 721.

[258] §§ 1223(1), 1223(2) and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1.

[259] Treas. Reg. § 1.1223-3(a), (b) and (f), Ex. 1; *See* T.D. 8902, *Capital Gains, Partnership, Subchapter S, and Trust Provisions*, 65 Fed. Reg. 57092 (9/21/00).

[260] *See* § 741.

[261] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[262] Treas. Reg. § 1.704-3(a)(7).

[263] Treas. Reg. § 1.751-1(a)(2).

[264] *Id.*

[265] *See* § 1(h)(5)(B), (h)(9), and (h)(10). Treas. Reg. § 1.1(h)-1(a).

the partnership, the transferor partner may recognize capital gain at a 20%, 25%, and 28% federal rate.

b. Property Distributions

(1) Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,[266] unless the property is a marketable security (treated as cash)[267] or is a "hot asset" under section 751 (mentioned above). If the distributed property is subject to indebtedness, any net change (typically an increase) in the partner's share of liability is treated as a contribution (in most cases) or a distribution of cash by the partner, and the distributed property is distributed without recognizing any gain.[268]

(2) The basis of the distributed property in the hands of the partner is based on the tax basis that the partnership had in the property prior to the distribution (the "inside basis").[269] The basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction) and changes in liabilities because the distributed property is encumbered with debt.[270] This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. When multiple properties are distributed and the outside basis limitation is triggered, the outside basis is allocated first to section 752 property and any excess to other property.[271] All other distributed property once all outside basis has been exhausted will have a zero basis.

(3) Generally speaking, the character of the distributed property in the hands of the partner will be determined at the partner level, with the exception of unrealized receivables and inventory items, as defined in section 751.[272] This provision prevents a partner from converting an ordinary income item, like inventory in the partnership's hands, into a capital asset. The holding period of the distributed property includes the holding period of the partnership.[273]

---

[266] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). Although the "mixing bowl" rules may apply to trigger gain to a partner who contributed the distributed property. §§ 704(c)(2)(B) and 737.

[267] § 731(c) and Treas. Reg. § 1.731-2.

[268] Treas. Reg. § 1.752-1(e) and (g).

[269] § 732(a)(1) and Treas. Reg. § 1.732-1(a). Note, that if a Section 754 election is in place or if the partnership had a substantial built-in loss under Section 743(d), the inside basis includes any basis adjustment allocable to the partner under Section 743(b) but only as they relate to the partner. If the distributed property is not the property that was the subject of the basis adjustment under Section 743(b), the adjustment is transferred to the distributed property in the same class (capital gain or ordinary property). Treas. Reg. § 1.755-1(a).

[270] *See* Treas. Reg. §§ 1.732-1, 1.736-1(b)(1), and 1.743-1(d)(1).

[271] § 732(c)(1)(A)(i) and Treas. Reg. §1.732-1(c)(1)(i).

[272] § 735(a).

[273] § 735(b). Note, the holding period of the partner's interest in the partnership is generally irrelevant when determining the holding period of distributed property.

c. Partnership Inside Basis

(1) When gain is recognized on a distribution (cash in excess of outside basis) or when the basis of the distributed property is reduced because outside basis is less than the basis of the property prior to the distribution, absent a section 754 election, there is no adjustment to the partnership's inside basis. This gives may give rise to a temporary duplication of gain or to a loss of basis to the partnership (and to the partners).

(2) If a section 754 election is made, an adjustment of basis under section 734(b) occurs when a partner recognizes gain due to a distribution (or deemed distribution) of cash in excess of outside basis, or property is distributed that results in a reduction of basis on the distributed property.[274] The adjustment results in an increase to the inside basis of the partnership assets. The basis increase is allocated among two different classes of assets: (i) capital and section 1231 assets, and (ii) ordinary income property.[275] Any basis adjustment due to gain from a distribution of cash must be allocated to capital assets.[276] Any increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class in proportion to fair market values.[277] Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. Adjustments under section 734(b) are discussed in more detail later in this outline.

2. Liquidating Distributions

a. Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.[278] Liquidating distributions are treated the same as current distributions except a loss may be recognized,[279] and the basis of property distributed to a partner may be increased (discussed below).[280] The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities[281]) and section 751 assets (hot assets).[282]

b. In the estate planning context, most partnerships are structured as "pro rata" or single class share partnerships because of the "same class" exception under section 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, "[a] class is the same class as is (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to

---

[274] § 734(b)(1).

[275] Treas. Reg. §§ 1.755-1(a)(1) and 1.755-1(c)(1).

[276] Treas. Reg. § 1.755-1(c)(1)(ii).

[277] Treas. Reg. § 1.755-1(c)(1)(i).

[278] § 761(d).

[279] § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2).

[280] § 732(b), 732(c), and Treas. Reg. § 1.732-1(b).

[281] § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision.

[282] § 731(a)(2). Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3).

management and limitations on liability)."[283] In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (and perhaps with the same assets). In order to effectuate a disproportionate distribution of property to, for example, an older partner with limited outside basis (trying to maximize the benefit of the "step-up"), one would need to redeem a portion of the partner's interest (lower the percentage ownership), which would be considered a current distribution, or liquidate the partner.

c. When property is distributed in liquidation of a partner's interest, for purposes of determining the basis in the hands of the former partner, the Code provides the basis in section 751 assets cannot exceed the transferred basis.[284] However, basis of other property distributed can be increased if the liquidated partner's outside basis (reduced by cash distributed and adjusted for any change in the partner's share of liabilities as a result of the distribution) is greater than the inside basis of the assets distributed.[285] If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable or amortizable, the added basis can provide tax benefits in the form of ongoing deductions.

d. The basis adjustments to the partnership are the same as discussed with current distributions, in particular, if there is a section 754 election in place. With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution). This is because a liquidating distribution may result in a loss to the withdrawing partner,[286] and a property distribution may result an increased tax basis.[287] Another difference with liquidating distributions exists when there is a substantial basis reduction. Under section 734(a), an inside basis adjustment is not required upon a distribution of property to a partner, unless a section 754 election is in place or unless "there is a substantial basis reduction with respect to such distribution,"[288] which will exist if the amount exceeds $250,000.[289] There will be a substantial basis reduction when the sum of: (i) any loss recognized by the liquidating partner, and (ii) the excess of the basis of distributed property to the liquidated partner over the partnership's transferred inside basis, exceeds $250,000. For example, if a partner with an outside basis of $2 million is distributed an asset with an inside basis of $1 million in full liquidation of his or her interest, then under section 732(b) of the Code, the partner's basis in the distributed asset is now $2 million. Because the partner's basis in the asset now exceeds the partnership's basis in the asset by more than $250,000, there is a substantial basis reduction. Consequently, the partnership must reduce the basis of its remaining assets by $1 million as if a section 754 election were in effect.[290]

---

[283] Treas. Reg. § 25.2701-1(c)(3).

[284] § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i).

[285] § 732(b) and Treas. Reg. § 1.732-1(b).

[286] § 734(b)(2)(A) and Treas. Reg. §1.734-1(b).

[287] § 734(b)(2)(B) and Treas. Reg. §1.734-1(b).

[288] § 734(a).

[289] § 734(d). The subsection refers to § 734(b)(2)(A), which in turn refers to §731(a)(2) relating to liquidating distributions, and § 734(b)(2)(B), which refers to § 732(b) also relating to liquidating distribution.

[290] *See* IRS Notice 2005-32, 2005-1 C.B. 895.

e. Adjustments for the gain or loss on the partnership interest, or for distributed capital or section 1231 assets may be made only to the inside basis of capital or section 1231 assets, while adjustments to reflect a limitation on the basis of ordinary income property are allocated only to partnership ordinary income property. There may be a positive adjustment for ordinary income assets, and a negative adjustment for capital assets, or the reverse, but no positive adjustment for one capital or ordinary income asset, and negative adjustment for another.[291] Like the adjustments for current distributions, positive adjustments for a class are allocated to appreciated properties, first, in proportion to unrealized gain, and then to all properties in proportion to fair market value.[292] Similarly, reductions in partnership assets are allocated first to property that has declined in value in proportion to the unrealized loss, then to all properties in proportion to their adjusted basis.[293]

3. Distributions and "Hot Assets"

a. Section 751 was enacted to prevent partners from converting ordinary income to capital gain through sales or exchanges of their partnership interests or through distributions of partnership property. Generally, the Code provides that any consideration received by a partnership in exchange for his or her partnership interest that is attributable to unrealized receivables or inventory items ("hot assets") shall be treated as an amount realized in exchange for property other than a capital assets.[294] In other words, to the extent applicable, it converts what otherwise would be considered capital gain (sale of a partnership interest) to ordinary income.

b. Section 751(b) provides that if a partner receives a distribution of hot assets (sometimes referred to as "section 751(b) property") in exchange for all or part of his or her partnership interest,[295] or receives other partnership property (not hot assets) in exchange for all or part of his or her interest in such hot assets,[296] then the transaction will be considered a sale or exchange between the distributee partner and the partnership (as constituted after the distribution). Section 751(b) applies to both non-liquidating distributions as well as liquidating distributions.[297] In effect, section 751(b) only applies to distributions involving an exchange of interests in one class of property for another class of property (ordinary for capital/capital for ordinary). As such, section 751(b) does not apply to distributions of one partner's share of both section 751(b) property and other property.[298] Furthermore, if a partnership has only one class of property (e.g., no hot assets), then section 751(b) will never apply. Thus, any disproportionate distribution of partnership property that results in any partner receiving more or less than his or her proportionate share of the hot assets will trigger section 751(b).

c. If section 751(b) applies to a distribution, then income inclusion is required. If, by way of example, a partner receives a disproportionate distribution of section

---

[291] Treas. Reg. § 1.755-1(c)(2).

[292] Treas. Reg. § 1.755-1(c)(2)(i).

[293] Treas. Reg. § 1.755-1(c)(2)(ii).

[294] § 751(a).

[295] § 751(b)(1)(A).

[296] § 751(b)(1)(B).

[297] *See* Treas. Reg. § 1.751-1(b)(1).

[298] *See* Rev. Rul. 57-68, 1957-1 C.B. 207.

751(b) (hot assets), then the partner will realize capital gain. If, on the other hand, the partner a disproportionate distribution of other property, then the partner will realize ordinary income.

d. In determining whether there has been a disproportionate shift of hot assets or other property, the Treasury Regulations provide for a hypothetical transaction involving:

(1) Current distribution of partnership property relinquished by the distributee partner (the partner's decreased interest in section 751(b) property or other property) in order to determine the partner's tax basis in the relinquished property;[299] and

(2) Partnership sale of the increased share in the other section 751(b) property in exchange for the property relinquished by the partner.[300]

e. The Code provides two specific exceptions to section 751(b). It does not apply to distributions of property to a partner who contributed the property to the partnership.[301] Section 751(b) also does not apply to section 736(a) payments made to a retiring partner or a successor in interest of a deceased partner.[302]

f. Originally, the definition of "unrealized receivables" under section 751(c) only included rights to payments for services and rights to payments for goods. Since its enactment, 751(c) property has been expanded to include many additional types of property, the sale of which would result in the realization of ordinary income.[303] In particular, the following types of assets have been added as "unrealized receivables" for purposes of section 751:

(1) Section 1245 property, but only to the extent that ordinary income would be recognized under section 1245(a) if a partnership were to sell the property at its fair market value.[304] The amount is treated as an unrealized receivable with a zero basis. Section 1245 property includes property which allows for depreciation other than buildings or their structural components.[305]

(2) Section 1250 property but only to the extent that ordinary income would be recognized under section 1240(a) if a partnership were to sell the property at its fair market value.[306] Section 1250 property is any depreciable property other than section 1245 property.[307] Generally, gain which is treated as ordinary income under section 1250(a) is the

---

[299] *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(iii), and 3(iii).

[300] *See* Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(ii), and 3(ii).

[301] § 751(b)(2)(A).

[302] § 751(b)(2)(B).

[303] One court ruled that section 751(c) "invites a liberal construction by stating that the phrase 'unrealized receivables' *includes* certain specified rights, thereby implying that the statutory definition of term is not necessarily self-limiting." *Logan v. Commissioner*, 51 T.C. 482, 486 (1968).

[304] § 704(c) and Treas. Reg. §§ 1.751-1(c)(4)(iii), -1(c)(5).

[305] § 1245(a)(3).

[306] Treas. Reg. §§ 1.751-1(c)(4)(v), -1(c)(5), -1(a)(1)(i) and -1(a)(2)(ii).

[307] § 1250(c).

lower of: (a)" additional depreciation" taken after 1975, and (b) the gain realized on the disposition of the property.[308] "Additional depreciation" generally refers to section 1250 property held for one year or less, all depreciation taken (in that one year or less), and for section 1250 property held for more than one year, the excess of the depreciation taken over the amount of depreciation which would have been taken if the straight-line method of depreciation had been used. Since TRA 1986, the "applicable recovery period" for most commercial real property assets are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods.[309] Most importantly, the depreciation method for nonresidential and residential real property is straight line.[310] Thus, most commercial real property assets would fall out of the definition of "unrealized receivables" and would not be considered a "hot" section 751(b) asset.

(3) Amortizable section 197 intangibles (patents, copyrights, goodwill, going concern value, etc.), which by definition are held in connection with a trade or business or an activity described in section 212.[311] Amortizable section 197 intangibles are treated as property which is of the character subject to the allowance for depreciation,[312] and these assets are subject to section 1245 recapture.[313] Generally, this does not include self-created intangibles,[314] so intangible assets in the hands of the creator (or held by a donee of such intangible) would fall out of the definition of "unrealized receivables" and would not be considered a "hot" section 751(b) asset.

(4) Section 1248 stock of a controlled foreign corporation (CFC) to the extent that ordinary income would be recognized under section 1248(a) if a partnership were to sell the CFC stock at its fair market value.[315] The amount is treated as an unrealized receivable with a zero basis. The ordinary income under these circumstances is generally the "dividend," which is determined, in part, by the additional corporate income tax that would have been paid by the CFC if it had been taxed as a domestic corporation plus the tax which would have been paid by the taxpayer by including in gross income (as long-term capital gain).[316]

(5) Section 1254 property, which includes oil, gas, geothermal, or other mineral property, to the extent that ordinary income would be recognized under section 1254(a) if a partnership were to sell the property at its fair market value.[317] The amount is treated as an unrealized receivable with a zero basis. Section 1254 recaptures certain previously expensed amounts as ordinary income to the extent of gain realized on the disposition of section 1254 property. Amounts deducted under sections 263 (capital expenditures), 616 (development expenditures with respect to a mine or other natural deposit other than an oil or gas well), and

---

[308] § 1250(a)(1)(A).

[309] § 168(c).

[310] § 168(b).

[311] *See* §§ 197(c) and (d)(1).

[312] § 197(f)(7) and Treas. Reg. § 1.197-2(g)(8).

[313] *See* Treas. Reg. § 1.197-2(g)(8).

[314] § 197(c)(2).

[315] *See* § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(iv), -1(c)(5).

[316] § 1248(b) and Treas. Reg. § 1.1248-4.

[317] § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(ix), -1(c)(5).

617 (mining exploration expenditures), which otherwise would have been included in the property's adjusted tax basis, must be recaptured as ordinary income.[318] In addition, any amount deducted under section 611 (deduction for depletion) must be recaptured to the extent it reduced the tax basis (e.g., cost depletion) of the section 1254 property.[319] The calculation for section 1254 property is determined at the partner level, not at the partnership.[320]

(6) Section 617(f)(2) mining property to the extent of the amount that would be treated as ordinary income under section 617(d)(1) if a partnership were to sell the mining property at its fair market value.[321] The amount is treated as an unrealized receivable with a zero basis. Pursuant to section 617(a), a taxpayer can elect to deduct, as ordinary and necessary business expenses, expenditures paid or incurred during the taxable year and prior to the beginning of the development stage of the mine, for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral. In general, under section 617(d)(1), a portion of the gain recognized on the sale or other disposition of mining property is treated as ordinary income (the deducted exploration expenditures).

(7) Section 1252(a)(2) farm land to the extent that ordinary income would be recognized under section 1252(a)(1) if a partnership were to sell the property at its fair market value.[322] The amount is treated as an unrealized receivable with a zero basis. Section 1252 generally provides that, if a taxpayer has held farm land for less than 10 years and has elected to deduct soil and water conservation expenditures under section 175, then upon disposition of the land, the taxpayer is required to treat a portion of the gain as ordinary income.[323]

(8) Section 1253 property, to the extent that ordinary income would be recognized under section 1253(a) if the partnership were to sell the property at its fair market value. The amount is treated as an unrealized receivable with a zero basis. Under §1253(a), the transfer of a franchise, trademark, or trade name is not treated as a sale or exchange of a capital asset if the transferor retains any "significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark or trade name."[324]

(9) Partnership property subject to basis reduction under section 1017, relating to income from discharge of indebtedness that is excluded from income under section 108(a). These are reductions are treated as depreciation subject to section 1245 or section 1250 recapture.

(10) Market discount bonds to the extent that ordinary income would be recognized under section 1276(a) if a partnership were to sell the bonds at fair market value.[325] The amount is treated as an unrealized receivable with a zero basis. Section 1276(a) provides

---

[318] *See* § 1254(a)(1)(A)(i) and Treas. Reg. § 1.1254-1(b)(1)(i)(A).

[319] *See* § 1254(a)(1)(A)(ii) and Treas. Reg. § 1.1254-1(b)(1)(i)(B).

[320] *See* Treas. Reg. § 1.1254-5(b)(1).

[321] *See* Treas. Reg. §§ 1.751-1(c)(4)(i) and -1(c)(5).

[322] *See* Treas. Reg. §§ 1.1252-1(a), 1.751-1(c)(4)(vii), and -1(c)(5).

[323] § 1252(a).

[324] § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(viii), -1(c)(5).

[325] § 751(c) and Treas. Reg. § 1.751-1(c)(5).

that gain recognized upon the disposition of any market discount bond[326] is treated as ordinary income to the extent of "accrued market discount" on the bond. The term "market discount bond" means any bond having "market discount."[327] The term "market discount" means the excess of the stated redemption price of the bond over the basis of the bond immediately after its acquisition by the taxpayer.[328]

4. Mixing Bowl Transactions

a. Because both property contributions to and distributions from a partnership are generally non-recognition events, partnerships could be used to exchange property without recognizing income despite the fact that the properties would not have qualified as a like-kind exchange under section 1031. The partnership would be treated as a "mixing bowl" where assets are commingled and then the partnership is dissolved, each partner walking away with a different mixture of assets. As a result of this perceived abuse, Congress enacted the "mixing bowl transaction" provisions of sections 704(c)(1)(B) and 737. These provisions can be triggered when contributed property is distributed to another partner or if other property is distributed to a contributing partner.

b. Contributed Property to Another Partner-Section 704(c)(1)(B)

(1) If contributed property is distributed within 7 years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution.[329]

(2) The amount of such gain or loss will generally equal the lesser of (a) the difference between the fair market value of the contributed at the time the property was contributed and the contributing partner's basis in the contributed property, or (b) the difference between the fair market value of the contributed property and the inside basis of the partnership at the time of the distribution.[330] The reason for the latter limitation is the gain or loss is meant to be limited to the amount that would have been allocated to the contributing partner under section 704(c) had the partnership sold the asset.

(3) The character of any such gain or loss is determined by the character of the contributed securities in the hands of the partnership.[331]

(4) If the contributed property is exchanged for other property in a tax free exchange, the property received will be treated as the contributed property for the application of section 704(c)(1)(B).[332]

---

[326] *See* § 1278(a)(1).

[327] § 1278(a)(1)(A).

[328] § 1278(a)(2).

[329] § 704(c)(1)(B).

[330] § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a).

[331] Treas. Reg. § 1.704-4(b).

[332] Treas. Reg. § 1.704-4(d)(1)(i).

(5) The outside basis of the contributing partner and the inside basis of the contributed property and the "non-contributing" partner (distributee) are adjusted for any gain or lóss without the need for a section 754 election.[333]

(6) Similar to the general anti-abuse provisions mentioned above, the Treasury Regulations provides that "if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B),"[334] based on all the facts and circumstances, the IRS can recast the transaction appropriately. One example given in the Treasury Regulations deals with a partnership having a nominal outside partner for a number of years, and then prior to the expiration of the (now 7 years) section 704(c)(1)(B) period, adding a partner to whom it is intended the contributed property will be distributed. When the contributed property is distributed after the "mixing bowl" period has expired, the example provides that a taxable transfer is deemed to have occurred because the "mixing bowl" period is deemed to have been tolled until the admission of the intended recipient partner of the contributed property.[335]

c. Other Property Distributed to Contributing Partner- Section 737

(1) If a partner contributes appreciated property to the partnership and, within 7 years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.[336] The reason for this provision is to avoid deferral of the gain that would have been allocated to the contributing partner under section 704(c) because such gain would not be triggered unless the partnership actually sold the property in a taxable transaction. If section 737 is triggered, to avoid a doubling of the gain, the subsequent distribution of the property previously contributed by the same partner does not trigger gain.[337]

(2) Unlike section 704(c)(1)(B), this provision only applies to gain, not loss. As a result, in order to recognize any loss under section 704(c), the partnership would need to sell the asset in a taxable transaction.

(3) The amount of the gain is equal to the lesser of (a) "net precontribution gain"[338] (aggregate net gain, as reduced by any loss property, that would be realized under section 704(c)(1)(B) if all of the property contributed by the contributor within 7 years of the distribution (and still owned by the partnership) had been distributed to another partner;[339] (b) the excess of the fair market value of the distributed property over the outside basis of the partnership interest, determined with adjustments resulting from the distribution without regard to the gain triggered by section 737.[340]

---

[333] § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

[334] Treas. Reg. § 1.704-4(f)(1).

[335] Treas. Reg. § 1.704-4(f)(2), Ex. 2.

[336] §§ 704(c)(1)(B) and 737.

[337] § 737(d)(1) and Treas. Reg. § 1.737-3(d).

[338] § 737(b).

[339] *See* Treas. Reg. §§ 1.737-1(c)(1)(iv) and 1.737-1(e), Ex. 2.

[340] §§ 737(a)(1) and (2).

(4) The character of the gain is determined by reference to the "proportionate character of the net precontribution gain,"[341] which is to say, it is generally determined by its character in the hands of the partnership.

(5) The partner's outside basis and the partnership's inside basis in the contributed property are automatically adjusted without the need for a section 754 election.[342] Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner's outside basis.[343]

(6) Marketable securities are generally treated as cash for purposes of section 737.[344] In determining "net precontribution gain" under section 737, however, marketable securities contributed to the partnership are treated as contributed property.[345]

(7) Similar to the anti-abuse guidelines under section 704(c)(1)(B), the Treasury Regulations provide that transactions can be recast if, based on all the facts and circumstances, they are "inconsistent with the purposes of section 737."[346] The deemed abusive example provided in the Treasury Regulations involves a transaction, in an intentional plan to avoid section 737, where there is a contribution of property to a partnership (under section 721) immediately before a distribution of other property to the contributing partner (who also made a previous contribution of appreciated property). Gain under section 737 would be avoided because the contribution increased the outside basis of the contributing partner. Then the partnership liquidates the contributing partner's interest in a nontaxable distribution, returning the contributed property (temporarily parked in the partnership to avoid gain on the distribution of other property prior to the liquidation of the partner's interest).[347]

5. Disguised Sale Rules

a. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash within 2 years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed property under the "disguised sale" rules.[348]

b. Distributions within two years are presumed to be part of a disguised sale, and those more than two years are presumed not to be part of a disguised sale.[349]

---

[341] § 737(a) [flush language] and Treas. Reg. § 1.737-1(d).

[342] § 737(c) and Treas. Reg. § 1.737-3. The increase in inside basis is allocated to property with unrealized gain of the same character as the gain recognized. *See* Treas. Reg. §§ 1.737-3(c)(3) and 1.737-3(e), Ex. 3.

[343] § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1).

[344] §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a).

[345] Treas. Reg. § 1.731-2(g)(i)-(iii).

[346] Treas. Reg. § 1.731-4(a).

[347] Treas. Reg. § 1.731-4(b), Ex. 1.

[348] § 707(a)(2)(B).

[349] Treas. Reg. § 1.707-3.

c. Distributions in a transaction determined to be a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity, and not as a partner.[350]

6. Distributions of Securities

a. A distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[351] For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.[352]

b. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to the partner who contributed them;[353] (2) distributions of securities that were not marketable when acquired by the partnership;[354] and (3) distributions of securities from an "investment partnership" to an "eligible partner."[355]

c. An "investment partnership" is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[356] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[357] A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in such specified investments.[358]

d. An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[359]

---

[350] § 707(a)(2) and Treas. Reg. § 1.707-3.

[351] § 731(c).

[352] § 731(c)(2)(A) and (C).

[353] § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1).

[354] § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(1)(iii). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the partnership must have held the security for at least 6 months prior to the security becoming marketable, and the partnership must distribute the security within 5 years from the date the security became marketable.

[355] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[356] § 731(c)(3)(C)(i).

[357] § 731(c)(3)(C)(i)(I) through (VIII).

[358] § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i).

[359] § 731(c)(3)(C)(iii)(I).

e. If one of these exceptions do not apply and a distribution of marketable securities my result in gain to the distribute partner to the extent the value of the marketable securities exceeds outside basis.[360] The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by:

(1) "such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over;"[361]

(2) "such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value."[362]

f. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.[363]

g. If gain is recognized on the distribution of marketable securities under section 731(c), the tax basis of the distributed securities is increased by the amount of such gain, allocated to the distributed securities in proportion to unrealized appreciation.[364] If no gain is recognized, the basis of the marketable securities in the hands of the partner is the inside basis under the general rule of section 732. It's important to keep in mind that section 731(c) applies only for purposes of determining gain to the partner. The partner's outside basis is still determined under the general rules of section 733. As such, when gain is recognized upon a distribution of marketable securities, the partner's outside basis, by definition, is reduced to zero. Any gain recognized by the partner is not reflected in the partner's outside basis, rather it is reflected in the securities received.

h. If the partner receives other property in addition to marketable securities in the same distribution, the reduction in outside basis due to the marketable securities (cash) is taken into account first, with any remaining basis applied against the other property distributed.[365]

i. Even if a section 754 election is in place, any gain triggered from a distribution of marketable securities will not be reflected in the inside basis of any other partnership property. However, if a section 754 election is in place, the inside basis of partnership can be adjusted for any lost basis resulting from the limitation of the basis of the marketable securities in the partner's hands to the partner's outside basis (because outside basis is not adjusted to reflect the gain, as mentioned above).[366]

---

[360] § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1.

[361] § 731(c)(3)(B)(i).

[362] § 731(c)(3)(B)(ii),

[363] § 731(b).

[364] § 731(c)(4) and Treas. Reg. § 1.731-2(f)(1)(i).

[365] § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5.

[366] Treas. Reg. § 1.731-2(j), Ex. 6(iv).

E. Partnership Liabilities and Basis

1. The partnership rules make an important distinction between recourse and nonrecourse liabilities. In this context, generally, recourse liabilities increase basis only as to the partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners. A partnership liability is considered recourse if any partner or "related person" bear the economic risk of loss for the liability.[367] Conversely, a liability is considered nonrecourse to the extent no person or "related person" bears such risk of loss.[368]

2. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as contribution of cash by the partner in the partnership, thereby increasing basis.[369] Any decrease is treated as a distribution of cash to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.[370] If property that is subject to a liability is contributed to or distributed from a partnership, the transferee is deemed to assume the liability but only to the extent the liability is not in excess of the fair market value.[371]

3. A partner or related person will be deemed to bear the economic risk of loss for a partnership liability if the partner or related person would be obligated to make a payment to any person (like a third-party lender) or a contribution to the partnership upon a constructive liquidation of the partnership.[372] Whether such payment or contribution obligation exists (and the extent of such obligation) depends on all the facts and circumstances, like the existence of the following:

a. Contractual obligations like "guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;"[373]

b. Partnership obligations including "obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;"[374]

c. Payment obligations "imposed by state law, including the governing state partnership statute;"[375] and

---

[367] Treas. Reg. § 1.752-1(a)(1).

[368] Treas. Reg. § 1.752-1(a)(2).

[369] § 722 and Treas. Reg. § 1.752-1(b).

[370] §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c).

[371] Treas. Reg. § 1.752-1(e).

[372] Treas. Reg. § 1.752-2(b)(1)

[373] Treas. Reg. § 1.752-2(b)(3)(i).

[374] Treas. Reg. § 1.752-2(b)(3)(ii).

[375] Treas. Reg. § 1.752-2(b)(3)(iii).

d. Reimbursement rights a partner or related person may have from another partner or a person who is related to such other partner.[376]

4. In making a determination of whether a partner or related person has a payment obligation on a partnership liability and bears the economic risk of loss, it is assumed the partner or related person will be able to pay the obligations "irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation."[377]

5. The Treasury Regulations state that a person will be a "related person" to a partner if they have a relationship that is specified in sections 267(b) and 707(b)(1) but with a few modifications.[378] Including those modifications, a person is related to a partner if they are (in part):

a. Members of the same family (spouse, ancestors and lineal descendants);

b. An individual and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual;

c. A grantor and a fiduciary of any trust;

d. A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

e. A fiduciary of a trust and a beneficiary of such trust;

f. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

g. A fiduciary of a trust and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

h. A person and a charitable organization if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;

i. A corporation and a partnership if the same persons own more than 80% in value of the outstanding stock of the corporation and more than 80% of the capital interest or the profits interest in the partnership;

j. An S corporation and another S corporation (or C corporation) if the same persons own more than 80% in value of the outstanding stock of each corporation;

---

[376] Treas. Reg. § 1.752-2(b)(5).

[377] Treas. Reg. § 1.752-2(b)(6).

[378] Treas. Reg. § 1.752-4(b)(1).

k. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;

l. A partnership and a person owning, directly or indirectly, more than 80% of the capital interest, or the profits interest, in such partnership; or

m. Two partnerships in which the same persons own, directly or indirectly, more than 80% of the capital interests or profits interests.

6. To avoid double counting, the Treasury Regulations provide that persons owning interests (directly or indirectly) in the same partnership are not treated as related persons for purposes of determining their share of partnership loss.[379]

7. The Treasury Regulations further provide that if (i) a partnership liability is held or guaranteed by another entity that is a partnership, S corporation, C corporation, or trust; (ii) a partner or related person (directly or indirectly) owns 20% or more in such other entity, and (iii) a principal purpose of having such other entity act as a lender or guarantor is to avoid having the partner bears the risk of loss for all or part of the liability, then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of that partner's or related person's ownership interest in such other entity.[380] The ownership interest of the partner and related person are determined according to each entity in the following manner:

a. Partnership: highest percentage interest in any partnership loss or deduction for any taxable year;[381]

b. S corporation: percentage of outstanding stock owned by the shareholder;[382]

c. C corporation: percentage of the issued and outstanding stock owned by the shareholder based upon fair market value;[383] and

d. Trust: actuarial percentage interest owned beneficially.[384]

8. An otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that a partner or a related person holds an interest in the liability, referred to as "partner nonrecourse debt" in the Treasury Regulations.[385] In such case, the economic risk of loss is allocated to such partner (or related person) to the extent not otherwise allocated to another partner.[386]

---

[379] Treas. Reg. § 1.752-4(b)(2)(iii).

[380] Treas. Reg. § 1.752-4(b)(2)(iv)(A).

[381] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(1)

[382] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(2).

[383] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(3).

[384] Treas. Reg. § 1.752-4(b)(2)(iv)(B)(4).

[385] *See* Treas. Reg. § 1.704-2(b)(4).

[386] Treas. Reg. § 1.752-2(c)(1).

9. If a partner (or related person) pledges property outside the partnership (a direct pledge) as security for a partnership liability, the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[387] If a partner contributes property to a partnership solely for the purpose of securing a partnership liability (an indirect pledge), the partner is deemed to bear the risk of loss to the extent of the "net fair market value" of the pledged property.[388] Contributed property will not be deemed indirectly pledged unless "substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction."[389]

10. As with other partnership provisions, the Treasury Regulations contain anti-abuse rules that would disregard the form of the situation "if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise."[390] The Treasury Regulations discuss 2 situations:

a. Arrangements tantamount to a guarantee:[391]

(1) Partner or related person undertakes one or more contractual obligations so the partnership may obtain a loan;

(2) Contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(3) One of the principal purposes is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

b. A plan to circumvent or avoid the obligation, based on the facts and circumstances, of a partner (or related person).[392]

11. A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this outline, but the Treasury Regulations generally provide that a partner's share of such liabilities are the sum of:[393]

---

[387] Treas. Reg. § 1.752-2(h)(1).

[388] Treas. Reg. § 1.752-2(h)(2).

[389] *Id.*

[390] Treas. Reg. § 1.752-2(j)(1).

[391] Treas. Reg. § 1.752-2(j)(2). *See* CCA 200246014 (a guarantee was disregarded due to a number of facts including sever undercapitalization and the provisions of the guarantee set forth many waivers and defenses for the benefit of the purported guarantor).

[392] Treas. Reg. § 1.752-2(j)(3). An example is provided that involved a general partnership, minimally capitalized corporation as a partner and a deficit capital account restoration obligation. The obligations of the corporate partner and the capital account restoration obligation are ignored for purposes of Section 752.

[393] Sometimes referred to as the sum of tier one, tier two, and tier three allocations.

a. The partner's share of "partnership minimum gain"[394] (gain that would be realized if all property subject to nonrecourse liability is sold in full satisfaction of the liabilities and for no other consideration);[395]

b. Amount of taxable gain that would be allocated to the partner under section 704(c) (arising because the partner contributed property to the partnership and the partnership still holds the property) if the partnership disposed of all partnership property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration;[396] and

c. The partner's share of "excess nonrecourse liabilities" (liabilities not allocated above).[397]

12. A partner's share of "excess nonrecourse liabilities" is "determined in accordance with the partner's share of partnership profits" under all of the "facts and circumstances relating to the economic arrangement of the partners."[398] As a result, if an FLP has pro rata shares (as is common), and no partner has made a contribution of property to the partnership, then nonrecourse debt will also be shared pro rata.

F. Loss of Grantor Trust Status with Partnership Liabilities

1. Because grantor trust status will be terminated on the death of the grantor or "turned off" by the release of the power causing grantor trust status, [399] changing trustees,[400] or repayment of borrowed trust assets,[401] taxpayers must deal with having a trust that will ultimately be considered a separate taxable entity, a non-grantor trust. In the context of partnerships, this normally does not cause adverse tax consequences, but if there is partnership debt, it can, under certain circumstances, trigger gain.

2. When grantor trust is terminated during the lifetime of the grantor, a transfer is deemed to occur and the grantor may recognize gain to the extent the amount owed to the grantor exceeds the grantor's basis in the assets. This is one of the most problematic features of selling "negative basis" real property partnership interests to IDGTs. For this reason, practitioners advise against terminating grantor trust status while the debt is still outstanding and advise clients to pay off the debt prior to the death of the grantor if at all possible.

3. Gain can also result if grantor trust status is renounced and, due to the creation of a new taxpayer (the trust), it results in a reduction of partnership liabilities of the grantor or the IDGT. Outside basis of the partnership would no longer be calculated across all of the

---

[394] Treas. Reg. § 1.752-2(d)(1).

[395] Treas. Reg. § 1.752-3(a)(1).

[396] Treas. Reg. § 1.752-3(a)(2).

[397] Treas. Reg. § 1.752-3(a)(3).

[398] *Id.*

[399] *E.g.*, § 675(4)(C) power.

[400] *E.g.*, § 674(c) power.

[401] *See* § 675(c).

partnership interests and would thus be determined separately. If all of the partnership liabilities are nonrecourse, then no net reduction should occur to either the grantor or the trust. However, if the grantor had guaranteed some partnership debt thereby making such debt recourse as to the grantor, then the loss of grantor trust status would result in a net reduction of partnership liabilities with respect to the trust partner and a deemed distribution on the partnership shares owned by the trust. If there is insufficient outside basis in the trust shares, capital gain would be recognized by the trust.

4. The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest that is subject to liabilities renounces grantor trust status, the grantor is treated as transferring the partnership interest to the trust. When the interest transferred is a partnership interest and the grantor's share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor's share of the reduced liabilities.[402]

5. The Treasury Regulations also provide that if a taxpayer creates a grantor trust which purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust. The taxpayer's share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.[403]

6. The loss of grantor trust status due to the death of the grantor should not result in a reduction of partnership liabilities with respect to the IDGT. If anything, it may result in an increase of such liabilities and an increase in basis if the partnership had recourse debt as to the grantor.

G. Basis Issues with Transfers of Partnership Interests

1. Generally

a. When a donor makes a gratuitous transfer of a partnership interest to a donee and the donee is not a deemed to be the donor for income tax purposes (e.g., the donee is a grantor trust), then generally no gain or loss is recognized on the transfer,[404] and the donee has a transferred basis in the interest received, increased by any gift tax paid.[405] The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss.[406] Given the foregoing limitation with respect to losses, valuation discounts could, in fact, limit the ability of the donee to recognize a portion of a subsequent. In such cases, the partner

---

[402] Rev. Rul. 77-401, 1977-2 C.B. 122

[403] Treas. Reg. § 1.1007-2(c), Ex. 5. *See also* TAM 200011005.

[404] This assumes that the transfer is not considered a part sale/part gift transfer. Gain, possibly ordinary income under section 751(a) of the Code, but not loss, may be recognized with a part sale/part gift, but only when the sale price exceeds the outside basis of the partnership interest. *See* § 751(a) and Rev. Rul. 60-351, 1960-2 C.B. 208 (gift accelerated gain on an installment obligation). The sale price would be deemed to include any partnership liabilities deemed to have been transferred. *See* § 752(d), Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor trust converting to a taxable trust), and *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[405] § 1015(d).

[406] § 1015(a).

might be better off having received distributions of partnership assets in-kind and selling such assets, rather than selling the partnership interest itself. The tax difference between selling a partnership interest and selling distributed assets is discussed in more detail later in this outline.

b. If the donor transfers only a portion of his or her partnership interest, it bears to reason that only a portion of the donor's unitary outside basis is transferred. One would assume that a pro rata portion of the donor's outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of $100 and the donor gifts 55% to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of $55. Surprisingly, that does not seem to be the case.

c. In Revenue Ruling 84-53,[407] the IRS ruled in the context of calculating outside basis of a transferred partnership interest, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."[408] Under this calculation, if the gift of the 55% partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55% interest would actually transfer less than $55 of basis.

d. For example, assume a donor has a partnership interest that has a fair market value of $200 (the value represents a controlling interest in the partnership but reflects some discounts for lack of marketability) and an outside basis of $100. The donor gifts 45% of his or her partnership interest to a donee. Assume further that 45% transfer carries a valuation discount of 30%. As a result the gift tax value (fair market value) of the transfer is $63 (reflecting a 30% discount on an interest which has a value before the discount of $90). Under the formula of Revenue Ruling 85-53, the transferred interest has a fair market value of $63, and the fair market value of the entire interest is $200, resulting in only 31.5% of the donor's original basis having been transferred ($63/$200). After the transfer, the donee owns 45% of the partnership interest with an outside basis of $31.50, and the donor retains 55% of the partnership interest but has an outside basis of $68.50.

2. Estate Planning Implications

a. The income and estate planning implications are significant. In the example above, the result is the donor retains a disproportionate amount of the basis, and the donee receives less. If the donee is in a lower income tax bracket or resides in a state (or is a resident non-grantor trust of such state) that has no state income tax and if the donor is in a higher income tax situation, a taxable event like the sale of the partnership interests (or the sale of the assets of the partnership followed by a distribution of the assets) would generally result in less taxes to be paid when compared to having the donor be the sole taxpayer. In addition, if the donee is near death, then holding a lower basis asset provides more potential for a "step-up" in basis.

b. Often, however, the donor is in the senior generation and is wealthier than the donee. Under those circumstances, how can this distortion in basis be used, assuming it

---

[407] Rev. Rul. 84-53, 1984-1 C.B. 159.

[408] *Id.* The ruling relies Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

would be preferred that the donor retain less basis (for a potential "step-up" in basis) and the donee receive more basis. Consider the following:

(1) As in the above example, donor owns a partnership interest that has a fair market value of $200 and an outside basis of $100. Donor gifts 55% of his or her partnership interest to an IDGT. No basis allocation is actually required because the unitary basis rules provide that the donor continues to own the basis in all of the partnership interests owned by the donor and the IDGT.

(2) The donor then transfers a 45% interest to a non-grantor trust that provides features that make it an "incomplete gift, non-grantor trust." Most prevalently, practitioners have taken advantage of the laws of Delaware (Delaware incomplete non-grantor trust or "DING") and Nevada (Nevada incomplete non-grantor trust or "NING")[409] to eliminate state income tax on the assets in the trust. Putting aside the potential state income tax savings, a properly structured "incomplete gift, non-grantor trust" results in the following:[410]

(a) The trust not a grantor trust (although the grantor is a permissible beneficiary of the trust);

(b) Contributions to the trust by the grantor are not completed gifts for Federal gif tax purposes; and

(c) The assets of the trust are includible in the grantor's gross estate upon the grantor's death, although the corpus is subject to a testamentary special power of appointment held by the grantor.

(3) For basis purposes, based on Revenue Ruling 84-53, the non-grantor trust (the assets of which will be includible in the estate of the donor at death) has a partnership interest with an outside basis of $31.50 (although representing 45% of the donor's interest). The IDGT (the assets of which are not includible in the donor's estate), on the other hand, has a partnership interest with an outside basis of $68.50 (representing 55% of the donor's interest). Thus, a disproportionate amount of basis ends up passing with the partnership interest that is out of the donor's estate, while the partnership interest that remains in the estate is poised to get a disproportionately large "step-up" in basis (particularly, if as discussed above, certain measures are taken to reduce or eliminate the valuation discounts attributable to the partnership interest in the non-grantor trust).

---

[409] For a more complete discussion of NINGs and DINGs, *see* Peter Melcher and Steven J. Oshins, *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts*, Wealthmanagement.com, the digital resource of REP. and Trusts & Estates (Apr. 16, 2013), and Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013).

[410] *See* PLRs 201310002, 201310003, 201310004, 201310005, 201310006, 201410001-201410010, 201426014, 201430003–201430007, 201436008, 201436012, 201436013-201436014, 201436018, 201436024-201436027, 201436028-36032, and 201440008-201440012.

H. Section 754 Election and Inside Basis Adjustments

1. Generally

a. As discussed above, whether a partnership has a section 754 election in place has a direct bearing on the inside basis of the assets held by a partnership. Those adjustments to basis are made pursuant to section 743, when there is a sale or exchange of a partnership interest or a death of a partner occurs, and section 734, when there is a distribution to a partner.

b. Generally, the inside basis of partnership assets are not adjusted when a partnership interest is sold or exchanged, when a partner dies or when there is a distribution of property to a partners. These transactions can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partner dies or a partner sells his or her partnership interest, the transferee partner will have a basis in the partnership interest equal to fair market value or the cost of the sale. If that basis is greater than the inside basis of the assets, when the partnership sells those assets, additional gain will be allocated to the transferee partner. Similarly, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner's outside basis is less than the cash distributed, that gain essentially represents the liquidated partner's share of appreciation in the partnership. Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners. The adjustments under sections 743 and 734 attempt to adjust for those types of discrepancies. Adjustments can increase or decrease the inside basis of partnership property.

2. A section 754 election is generally made by the partnership in a written statement filed with the partnership return for the taxable year during which the transfer in question (sale, exchange, death or distribution) occurs.[411] Once the election is made, it applies to the year for which it is filed as well as all subsequent taxable years until and unless it is formally revoked.[412]

3. The adjustments under sections 743(b) are mandatory even in the absence of a section 754 election if the partnership has a substantial built-in loss immediately after the sale or exchange or upon death (adjustment under section 743(b)) or there is a substantial basis reduction with respect to a distribution (adjustment under section 734(b)).

(1) There is a substantial built-in loss if the partnership's inside basis on all partnership property exceeds the fair market value by more than $250,000.[413]

---

[411] Treas. Reg. § 1.754-1(b)(1). Under certain circumstances, there is a 12-month extension past the original deadline. Treas. Reg. § 301.9100-2.

[412] § 754 and Treas. Reg. § 1.754-1(a). An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election). Treas. Reg. § 1.754-1(c)(1).

[413] § 743(d)(1).

(2) There is a substantial basis reduction resulting from a distribution of property if the sum of the following exceeds $250,000: (i) a loss to the partner (only upon a liquidating transfer, as discussed above); and (ii) excess basis of the distributed property in the hands of the partner over the inside basis prior to the distribution.[414]

4. Adjustments under section 743(b) result in either:

a. An increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property"[415] or

b. A decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."[416]

5. A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.[417] The partner's previously taxed capital is:[418]

a. The amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets[419]; increased by

b. The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by

c. The amount of tax gain that would be allocated to the partner on the hypothetical transaction.

6. The inside basis adjustment under section 743(b) is then allocated among the partnership property under the rules set out in section 755.

a. Generally, section 755 seeks to reduce the difference between the fair market value of partnership assets and the adjusted tax basis of the partnership in such assets.[420]

b. In allocating the adjustment, to the extent the adjustment is attributable to property consisting of (i) capital assets and section 1231(b) property (capital gain property) and (ii) any other property, the adjustment must be allocated to partnership property of a like character (ordinary income property).[421]

---

[414] § 734(b)(2) and (d).

[415] § 734(b)(1).

[416] § 734(b)(2).

[417] Treas. Reg. § 1.743-1(d)(1).

[418] Treas. Reg. § 1.743-1(d)(1)(i)-(iii).

[419] Treas. Reg. § 1.743-1(d)(2).

[420] § 755(a).

[421] § 755(b).

c. The adjustment is allocated first between the capital gain property and ordinary income property, and then is allocated among the assets within these two asset categories.[422]

7. Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee). Section 734(b)(1) and (2) provides that increases or decreases are made to "partnership property."[423] In contrast, adjustments under section 743(b) "shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only."[424]

I. Partnership Divisions

1. Generally

a. Divisions of partnerships are generally not specifically defined in the Code or under state law. A partnership division is any transaction that converts a single partnership into two or more resulting partnerships. A division of a partnership can be accomplished in a number of different ways, sometimes referred to as, "assets-over, assets-up, and interests-over."[425]

(1) Assets-Over: Divided partnership contributes some of its assets (and perhaps liabilities) to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the interests in the recipient partnership to the partners.

(2) Assets-Up: Divided partnership contributes some of its assets (and perhaps liabilities) to some or all of its partners, and the partners then contribute those assets (and liabilities, if any) to the recipient partnership for interests in the recipient partnership.

(3) Interests-Over: Some or all of the partners in the divided partnership contribute a portion of their interest in the divided partnership to the recipient partnership in exchange for interests in the recipient partnership, followed by a liquidating distribution of assets (and perhaps liabilities) into the recipient partnership.

b. To avoid unintended transfer tax consequences, tax planners must be wary of the special valuation rules of Chapter 14, in particular, section 2701.

(1) Section 2701 includes a "transfer" of an interest in a family-controlled partnership to a member of the transferor's family, pursuant to which the transferor keeps an applicable retained interest.[426] "Transfer" is broadly defined and is deemed to include

---

[422] Treas. Reg. § 1.755-1(a)(1).

[423] § 734(b)(1) and (2).

[424] § 743(b) (flush language).

[425] Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43rd Annual Southern Federal Tax Institute (2008), Outline F, F-13.

[426] § 2701.

"a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[427]

(2) Importantly in this context, section 2701 does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer."[428] The Treasury Regulations provide the following example: "Section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate by 10 percent even if the transfer does not proportionately reduce P's interest in each class."[429] This exception is often referred to as the "vertical slice exception."

(3) In addition, section 2701 does not apply to any right with respect to an applicable retained interest if such interest is the same class as the transferred interest,[430] or the same as the transferred interest, without regard to non-lapsing differences in voting power (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).[431]

(4) Consequently, most divisions of partnerships for estate planning purposes (assuming no gifts are intended as a result of the division) will result in the partners in the divided partnership being the same partners in the recipient partners and retaining the same pro rata interest in both the divided and the recipient partnership.

2. Tax Treatment of Partnership Divisions

a. Partnership divisions are governed by section 708(b)(2)(B). The Treasury Regulations issued in 2001,[432] provide that the IRS will not respect the "interests-over" form of partnership division described above. In addition, while both an assets-over and assets-up method will be respected under the Treasury Regulations, there is a preference to treat the transaction as an assets-over transaction.[433]

b. In the assets-over form, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.[434] Parity of ownership interests will likely exist between the divided partnership and the recipient partnership because of the

---

[427] § 2701(e)(5).

[428] Treas. Reg. § 25.2701-1(c)(4).

[429] *Id.*

[430] § 2701(a)(2)(B).

[431] § 2701(a)(2)(C). Non-lapsing provisions that are necessary to comply with the partnership allocation requirements will be treated as non-lapsing differences with respect to limitations on liability. Treas. Reg. § 25.2701-1(c)(3).

[432] T.D. 8925, 66 Fed. Reg. 715 (1/4/01).

[433] *See* Treas. Reg. § 1.708-1(d)(3).

[434] Treas. Reg. § 1.708-1(d)(3)(i)(A). The transitory ownership by the divided partnership of all the interests in the recipient partnership is ignored. Treas. Reg. § 1.708-1(d)(5) Ex. 3-6.

Chapter 14 considerations mentioned above. As such, the distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distribution because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the "mixing bowl" transaction (as discussed above) will trigger any gain or loss.[435] Furthermore the preamble to the Treasury Regulations point out that when a division results in a pro rata division, there are no section 704(c) implications.[436] Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under section 752 because the division will not result in a change in the share of the liabilities of the partners.

c. The resulting basis that the partners have in their respective interests in the divided partnership and the recipient partnership depend on what assets and liabilities are contributed and distributed as a result of the division.

d. In a division, the Treasury Regulations provide that a "resulting partnership"[437] (a partnership that has at least 2 partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.[438] All resulting partnerships that are considered a continuation of the prior partnership are subject to all preexisting tax elections (for example, a section 754 election) that were made by the prior partnership.[439] Thus, in pro rata divisions where all of the partners retain the same ownership in the resulting partnerships, all of the resulting partnerships will be considered continuing partnerships, retaining all prior tax elections of the divided partnership.[440]

e. There is a narrow anti-abuse provision in the Treasury Regulations with respect to partnership divisions. It provides that if a partnership division is "part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent"[441] with the form, the IRS may recast the larger series of transactions in accordance with their substance.

3. Partnership Divisions in Tax Basis Management

a. The importance of tax-free partnership divisions in the new paradigm of estate planning cannot be overstated. The unitary basis rules applicable to partnership interests do not allow taxpayers to differentiate between low or high basis lots of partnership interests. The partnership division rules effectively allow taxpayers to segregate particular assets within a partnership into a new partnership and provide a separate outside basis in those assets through the new partnership. Because the basis of partnership property distributed in-kind to a partner is determined by the outside basis of the partner's interest, careful partnership divisions allow

---

[435] §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2).

[436] T.D. 8925, 66 Fed. Reg. 715 (1/4/01). Non-pro rata divisions are still being reviewed.

[437] Treas. Reg. § 1.708-1(d)(4)(iv)

[438] Treas. Reg. § 1.708-1(d)(1).

[439] Treas. Reg. § 1.708-1(d)(2)(ii).

[440] *See* PLR 9015016 (seven continuing partnerships with same owners in the same proportions).

[441] Treas. Reg. § 1.708-1(d)(6). *See also* Treas. Reg. § 1.708-1(c)(6)(ii) for an example of an abusive series of transactions that involved a partnership division and merger.

taxpayers to determine what the tax basis of the in-kind property will be upon distribution (rather than determined by an aggregate basis under the unitary basis rule).

b. Furthermore, divisions allow taxpayers to isolate the particular assets that they wish to benefit from an inside basis adjustment under sections 743 and 734, as the case may be. As mentioned above, the inside basis adjustments under section 755 are made at an entity level and apply across all of the assets within the partnership. Careful partnership divisions would allow taxpayers to determine what assets would be the subject of the inside basis adjustment and perhaps separately choose to make a section 754 election for the new partnership, rather than the original partnership.

J. Death of a Partner

1. Generally

a. The transfer of a deceased partner's interest in a partnership will not result in gain or loss, even if the deceased partner's share of liabilities exceeds outside basis.[442]

b. The estate's outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is net of partnership liabilities), plus the estate's share of partnership liabilities, minus any value attributed to items of IRD owned by the partnership. The Treasury Regulations provide, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691."[443]

c. Unless a section 754 election applies, no adjustment is made to the tax basis of the partnership property as a result of the partner's death. The lack of an inside basis adjustment puts the estate (or the successor in interest) at risk of being taxed on unrealized gain in the partnership at the time of the decedent's death.

2. Inside Basis Adjustments at Death

a. If a section 754 election is timely made or in place at the time of a partner's death, the estate or successor to the partnership interest gets the benefit of an inside basis adjustment over the partnership's assets under section 743.

(1) The inside basis adjustment will not, however, "step-up" the basis of partnership assets that would be considered IRD if held by the deceased partner individually and unrealized receivables of the partnership.[444]

---

[442] *See* Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995).

[443] Treas. Reg. § 1.742-1.

[444] §§ 1014(c), 691(a)(1), Treas. Reg. § 1.691(a)(1)-1(b), and *Woodhall v. Commissioner*, 454 F.2d 226 (9th Cir. 1972).

(2) The IRS has affirmatively ruled that the inside basis adjustment applies to the entire partnership interest that is considered community property upon the death of the deceased spouse/partner.[445]

(3) The inside basis adjustment is limited by the fair market value of the deceased partner's interest in the partnership. As such, to the extent that valuation discounts are applicable to the partnership interest, the inside basis adjustment will be limited to the extent of such discounts. To the extent little or no transfer taxes would be payable upon the death of a partner, practitioners may want to reduce or eliminate such valuation discounts, thereby maximizing the inside basis adjustment with a section 754 election. Further, because the inside basis adjustment under section 743 is applied to all of the assets in the partnership at the time of the death of the partner, the adjustment does not allow tax practitioner to proactively choose which asset will get the benefit of the "step-up" in basis. For this reason, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the "step-up" in basis and also choose the asset that they wish to receive the basis adjustment at death.

(4) As mentioned above, the adjustment under section 743(b) is the difference between the successor partner's tax basis in partnership interest (generally, fair market value at the date of death under section 1014(a), increased by the partner's share of partnership liabilities and reduced by items of IRD) and the successor partner's proportionate share of the basis of the partnership property. In calculating the partner's proportionate share of the partnership's tax basis, the Treasury Regulations assume a fully taxable hypothetical sale of the partnership's assets. This taxable sale is deemed to occur immediately after the transfer that triggers the inside basis adjustment. The IRS has ruled that the transfer in question, for purposes of section 743(b), is the date of the decedent partner's death.[446] As such, practitioners should consider what effect the death of the partner might have on the value of the partnership assets in determining the inside basis adjustment.

b. Even in the absence of a section 754 election, there is a mandatory downward inside basis adjustment if, at the time of death, the partnership has a substantial built-in loss (more than $250,000).[447] For example, if A owns 90% of a partnership. At the time of A's death, if the partnership owns property worth $9 million but with a tax basis of $10 million, then the partnership will be required to make a mandatory downward basis adjustment of $900,000 (assuming A's share the partnership's basis is 90% of the total basis).[448]

---

[445] Rev. Rul. 79-124, 1979-1 C.B. 224.

[446] Rev. Rul. 79-84, 1979-1 C.B. 223 (partnership interest owned by grantor trust).

[447] § 743(b).

[448] *See* IRS Notice 2005-32, 2005-1 C.B. 895.

3. Section 732(d) Election: Avoiding the Section 754 Election

a. As mentioned above, even with no section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within 2 years of the date of death and if the successor partner makes an election under section 732(d).[449] The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance.[450]

b. The basis adjustment is computed under section 743(b), which relates the basis adjustments due to sales or transfer of partnership interest (during lifetime, or more notably for this discussion, at death). The inside basis adjustment is made artificially to all of the partnership property owned on the date of death (for purposes of determining the transferred inside basis to the distributee with respect to the property distributed). In other words, it is allocated to all of the partnership property whether actually distributed or not.[451] If any property for which the distributee/transferee would have had an inside basis adjustment is distributed to another partner, the adjustment for such distributed property is reallocated to remaining partnership property.[452]

c. The election under section 732(d) can be a significant planning opportunity especially when planners would like to avoid having a section 754 election in place. As mentioned above, once the section 754 election is made, it is irrevocable unless the IRS gives permission to revoke the election. Because the inside basis adjustments under section 743(b) only apply to the transferees of the partnership interests (not to the partnership as a whole), having a section 754 election in place requires having a different set of basis calculations for the transferees of the interest. The book keeping requirements become quite onerous as partnership interests are often distributed at death to multiple trusts or beneficiaries and become even more so as additional partners pass away.

d. If the distribution of property is made pursuant to provision in the partnership agreement that requires a mandatory in-kind liquidation of the deceased partner's interest based on the partner's positive capital account balance, then the estate would have a good argument to say that the value of the partner's interest for purposes of section 1014(a) should not entail valuation discounts. This would, in turn, increase the inside basis adjustment on the assets claimed with the section 732(d) election. Giving the manager of the LLC or general partner of the partnership the discretion to determine what assets to distribute in liquidation of the partnership interest could give considerable planning opportunities to pick and choose which assets to receive the inside basis adjustment based on the needs of the distributee partner. While the assets received would likely not receive full fair market value (because, as mentioned above, the inside basis adjustment is artificially allocated across all of the partnership assets whether distributed or not), some planning opportunities could exist by distributing assets to other partners prior to the liquidation because the nominal inside basis adjustment that would have been allocated to those assets would be adjusted to the remaining partnership property.

---

[449] Treas. Reg. § 1.732-1(d)(1)(iii).

[450] Treas. Reg. § 1.732-1(d)(2).

[451] Treas. Reg. §§ 1.732-1(d)(1)(vi), 1.743-1(g)(1) and (5), Ex. (ii).

[452] Treas. Reg. §§ 1.743-1(g)(2) and (5), Ex. (iv).

K. Maximizing the "Step-Up" and Shifting Basis

1. Given the limitations of the basis adjustment at death, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner's death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner's outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the "step-up" in basis and also choose the asset that they wish to receive the basis adjustment at death.

2. Consider the following scenario: FLP owns 2 assets, one with very high basis and one with very low basis, neither of which is a marketable security. The assets have been in the FLP for more than 7 years. The partners consist of younger family members and a parent. Assume that the parent's outside basis in the FLP is zero. As discussed above, the traditional advice of allowing the parent to die with the FLP interest and making a section 754 election after death will likely create an inside basis adjustment that is limited by a significant valuation discount under section 743. Assume further that the partnership intends on selling the very low basis asset relatively soon. What might be a way to maximize the "step-up" in basis that will occur at the parent's death and also create tax basis for the low basis asset that will be sold? The partnership should make a section 754 election and distribute the high basis asset, in-kind, to the parent in full or partial liquidation/redemption of the parent's interest in the partnership. What is the result of this distribution?

3. Because the distribution is not cash or marketable securities, neither the partner nor the partnership will recognize any gain or loss upon a distribution of the property.[453] In addition, because the assets have been in the partnership for more than 7 years, there are no concerns about triggering any gain to another partner under the "mixing bowl" or the "disguised sale" rules. The basis of the distributed property in the hands of the parent is based on the tax basis that the partnership had in the property prior to the distribution. The basis of the distributed property will, however, be limited to the outside basis of the partner's partnership interest, as adjusted for cash distributions (reduction in basis) and changes in liabilities because the distributed property is encumbered with debt. This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. In other words, the basis of the asset now held by the parent is zero. Because the parent now owns the property individually and outside of the partnership, upon the parent's death, the property will get a full "step-up" in basis to fair market value, free of any valuation discounts.

4. Because a section 754 election was made, an adjustment of inside basis under section 734(b) occurs. The adjustment results in an increase to the inside basis of the partnership assets. The increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class (capital gain or ordinary) in proportion to fair market values. Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. The result, in this case, is the tax basis that was "stripped" from the high basis asset when it was distributed to the parent (and became a zero basis asset) is allocated to the only other remaining asset in the partnership (the low basis asset

[453] § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). This assumes the property distributed is not a "hot asset" under Section 751.

that will be sold). Thus, the low basis asset becomes a high basis asset, reducing or eliminating the gain to be recognized when it is sold. Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee).

5. The type of basis management discussed above is predicated upon a number of factors that must be that must orchestrated well in advance of the actual transaction. In particular, the movement of tax basis and the maximization of the "step-up" is predicated upon: (i) the selective use of the section 754 election (not necessarily at death but certainly upon distribution of assets in-kind); (ii) the isolation of the assets to be used in the basis shift; (iii) the avoidance of the triggering gain under the "mixing bowl" and "disguised sale" rules; and (iv) the manipulation of outside basis, so that the partner to receive the property has zero or very low basis in his or her partnership interest. As such, planners should consider evolving the partnership over time to put the taxpayers in the best position to take advantage of the type of flexibility that the partnership rules allow.

6. By way of example, practitioners should consider setting up a partnership that is funded with all manner of assets that might be used in this type of planning (high and low basis assets, depreciable and non-depreciable assets, closely held company interests, cash, etc.). The more assets the taxpayers contribute, the more options will be available in the future. The only type of asset planners should consider avoiding is marketable securities. This is because, generally, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property).[454] Thus, regardless of the basis in the marketable securities, a distribution may cause the distributee partner to recognize gain because of insufficient outside basis. However, as discussed later, there is an important exception to this rule that might allow practitioners to create a separate partnership holding only marketable securities and still allow the types of tax basis management discussed herein. Once the assets have been contributed, it is critical that the assets remain in the partnership for at least 7 years to avoid the "mixing bowl" and "disguised sale rule" problems.

7. As discussed in more detail above, distributions of marketable securities are generally treated as cash. There is, however, an important exception to this rule for distributions of securities from an "investment partnership" to an "eligible partner."[455] An "investment partnership" is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.[456] Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).[457] An "eligible partner" is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.[458] As such, if taxpayers wish to proactively manage the basis of marketable securities in the manner discussed

---

[454] § 731(c).

[455] §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

[456] § 731(c)(3)(C)(i).

[457] § 731(c)(3)(C)(i)(I) through (VIII).

[458] § 731(c)(3)(C)(iii)(I).

in this article, taxpayers must have a partnership that *from inception* has essentially only held marketable securities and has never engaged in a trade or business. Hence, practitioners should consider having taxpayers create partnerships that only hold marketable securities and having it hold the securities for at least 7 years.

8. During the 7 year period, if at all possible, the partnership should avoid making a section 754 election because of the limitations of the inside basis adjustment at death and the onerous record keeping requirements discussed above. Once the 7 year period has expired, then the assets of the partnership (that is hopefully free of a section 754 election) are ripe for proactive tax basis management. Once an opportunity arises for the type of planning discussed above (e.g., a potential sale of a low basis asset or the failing health of a partner), then the partnership can then proceed to isolate the appropriate assets in tax free "vertical slice" division. The assets to be carved out of the larger partnership into a smaller partnership would be those assets selected to receive the basis and those that would have their basis reduced upon distribution. Careful consideration should be given to reducing the outside basis of the distributee partner through disproportionate distributions of cash or shifting basis to other partners by changing the allocable share of partnership debt under section 752 (e.g., by converting nonrecourse debt to recourse debt through a guarantee by the other partners).[459]

9. Upon distribution of the higher basis assets to the distributee partner, the inside basis adjustment would be applied across all of the remaining assets in the partnership, but only those assets that have been spun off the larger partnership are in this partnership. Thus, allowing for a larger basis increase to those assets (rather than having the basis increase apply to all of the assets of the larger partnership and never creating an asset fully flush with tax basis). A section 754 election is required to effectuate the inside basis shift under section 734, but the election would only apply to the smaller, isolated partnership. As such, the record keeping requirements are kept to a minimum and are totally eliminated when and if the smaller partnership is dissolved and liquidated. Remember, in a vertical slice division, the isolated partnership is considered a continuation of the larger partnership, and the elections of the previous partnership follow to the new partnership. By keeping the larger partnership free of a section 754 election, it allows practitioners to selectively choose when and over what assets it would apply to in the future.

L. Family Partnership Examples

1. Example 1: Indemnifications and Divisions

a. The following hypothetical illustrates how easily partnerships can facilitate tax basis management in fairly typical estate-planning scenarios. The facts are as follows:

(1) Assume that Mr. and Mrs. Developer are married with three adult children. Exclusive of their home, vacation home, and other personal use assets, Mr. and Mrs. Developer have a net worth of approximately $25 million. Most of Mr. and Mrs. Developer's wealth derives from constructing, owning, and leasing "General Dollar" stores across Georgia, a state that does not have a state death tax. All of the General Dollar store properties are held by General Dollar Lessor, LLC, which is a wholly owned subsidiary of Mr. and Mrs. Developer's family partnership, "Developer Family Partnership, LLLP" (hereinafter "FLLLP"). Assume

[459] *See* Treas. Reg. § 1.752-2(b).

General Dollar Lessor, LLC has no assets other than the General Dollar stores that it owns and leases. FLLLP was formed many years ago to be the family "holding company."[460]

(2) General Dollar Lessor, LLC has a gross fair market value of approximately $31 million subject to recourse debt of $10 million which is secured by all of its assets (for a net value of $21 million). The debt also is personally guaranteed by Mr. Developer. Due to depreciation and past like-kind exchanges, the adjusted basis of the assets held by General Dollar Lessor, LLC is only $10 million.

(3) FLLLP owns $9 million in publicly-traded securities in addition to its ownership of 100% of General Dollar Lessor, LLC. Essentially, the $9 million in publicly traded securities was accumulated by investing cash flow and earnings distributed to FLLLP from General Dollar Lessor, LLC. In turn, FLLLP would distribute some of the cash flow and earnings to its partners (especially for them to pay taxes), but FLLLP would retain and invest any amounts not distributed to its partners. The aggregate adjusted basis of the FLLLP in the publicly-traded securities is $6 million. A significant portion of the securities have bases equal to their face values (e.g., bonds).

(4) The aggregate outside bases of the partners of FLLLP in their partnership interests is $16 million. The ownership of FLLLP is split roughly 70% to Mr. Developer and 30% to his three adult children as follows:

(a) Mr. and Mrs. Developer own 50% each in FLLLP GP, LLC, which in turn owns a 1% general partner interest in FLLLP. The outside basis of FLLLP GP, LLC in its GP interest in FLLLP is $203,000 (rounded). The non-discounted value of FLLLP GP, LLC's 1% GP interest in FLLLP is $300,000.

(b) Mr. Developer owns 69 limited partner "LP Units." These LP Units correspond to an aggregate 69% interest in FLLLP (1% per LP Unit). Mr. Developer's LP Units have a total outside basis of $13,997,000 (rounded) and a non-discounted value of $20,700,000.

(c) Each adult child owns 10 LP Units (corresponding to a 10% interest in FLLLP for each child). Each child's outside basis in his/her LP Units is $600,000 and the non-discounted value of each child's 10 LP Units is $3 million, respectively.

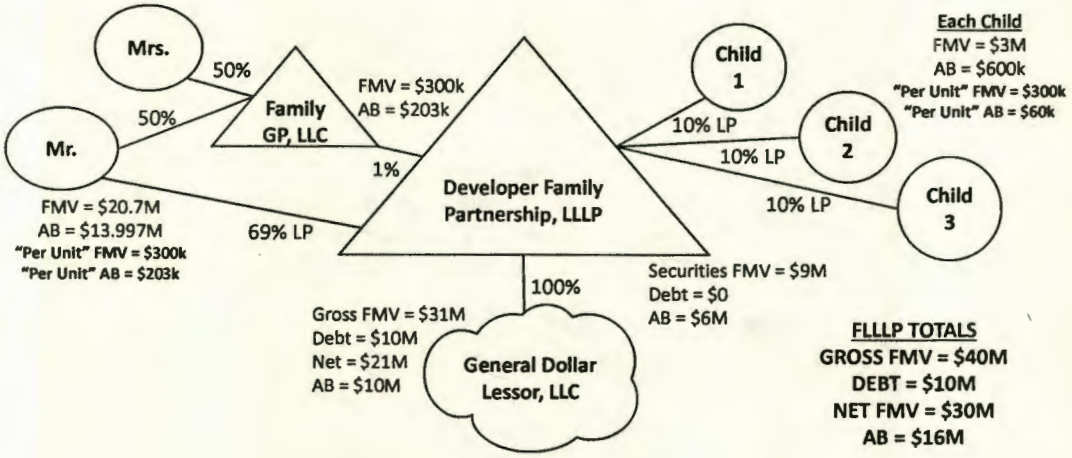
(d) Mr. and Mrs. Developer have their full $10.68 million applicable credit available and have a basic estate plan that leaves all of their assets to their three adult children and their families.

(5) A diagram of the FLLLP ownership structure is set forth below. In the diagram, individuals are represented by circles, partnerships (including entities treated as partnerships for income tax purposes) are represented by triangles, and disregarded entities are represented as clouds:

---

[460] If FLLLP has been in existence for more than seven years, and no appreciated or depreciated property has been contributed to the FLLLP by the partners within the past seven years, then the FLLLP will avoid the "mixing bowl" and "disguised sale" rules of §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b). *See* above for further discussion of these rules.

Family Partnership Hypothetical



(6) Based upon the foregoing facts, the capital accounts and bases of Mr. and Mrs. Developer and their children in their partnership interests (their "outside bases") in FLLLP are as follows:[461]

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Acounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000

b. Pursuant to the Treasury Regulations,[462] the $10 million debt of General Dollar Lessor, LLC is treated as "partner nonrecourse debt" with respect to Mr. Developer. The debt is treated as "partner nonrecourse debt" because it is guaranteed by Mr. Developer, and he therefore bears the economic risk of loss with respect to the loan if (as one is required to assume under the Treasury Regulations) General Dollar Lessor, LLC's assets became worthless and the liability became due. Accordingly, the debt of General Dollar Lessor, LLC is treated as recourse to Mr. Developer.[463] Therefore, the entire $10 million of the liability is allocated to Mr. Developer for purposes of determining his outside basis in FLLLP.[464] This is why Mr. Developer's aggregate outside basis in FLLLP ($14.2 million) is disproportionately higher than the aggregate outside basis ($1.8 million) of the children in FLLLP.

---

[461] *See* Treas. Reg. § 1.704-1(b)(2)(iv) for the rules regarding the maintenance of capital accounts for partners in a partnership. *See* § 705 and the Treasury Regulations thereunder for the rules regarding the determination of a partner's basis in his or her partnership interest. For the sake of simplicity, the capital accounts and outside bases of Mr. and Mrs. Developer and the children are aggregated here (including, of course, the capital accounts and outside bases of Mr. and Mrs. Developer held through Family GP, LLC).

[462] Treas. Reg. § 1.704-2(b)(4).

[463] Treas. Reg. § 1.752-1(a)(1).

[464] *See* Treas. Reg. § 1.752-2.

c. Assume that Mrs. Developer predeceases Mr. Developer and leaves all of her assets to him. Next, Mr. Developer dies leaving all of his partnership interests in FLLLP to his three adult children in equal shares. Further assume for this purpose that Mr. Developer's combined[465] partnership interests in FLLLP have a non-discounted value of $20 million. If Mr. Developer's combined partnership interests in FLLLP are discounted by 25% for estate tax purposes, then their value will be $15 million (75% of $20 million). This discounted estate-tax value results in very little step-up in outside basis in the FLLLP as compared to Mr. Developer pre-death outside basis of $14.2 million.

d. On the other hand, if prior to his death Mr. Developer's children had indemnified Mr. Developer for 30% (i.e., their combined percentage share of FLLLP) of any liability on the $10 million debt of General Dollar Lessor, LLC, then the outside bases of Mr. Developer and his children in FLLLP would have been as reflected in the table below:

	Developer (Includes Family GP, LLC)			Children		
	Capital Accounts	Outside Basis	Fair Market Value	Capital Acounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$4,200,000	$11,200,000	$21,000,000	$1,800,000	$4,800,000	$9,000,000

(1) Under the Treasury Regulations,[466] this simple step of indemnifying Mr. Developer for 30% of the $10 million debt—a step contemplated by the Treasury Regulations[467]—would shift a debt allocation of $3 million of the $10 million General Dollar Lessor, LLC debt to the children.[468]

(2) This shift would not change the percentage interests of the partners or the values of their partnership interests. As noted above, though, it clearly would increase by $3 million the amount of the potential basis step-up to Mr. Developer's estate upon his death even after taking into account the estate-tax valuation discount on Mr. Developer's partnership interests in FLLLP.

e. Moreover, proactive tax basis management could be taken a step further if, prior to Mr. Developer's death, the FLLLP implemented a "vertical slice" partnership division under section 708(b)(2)(B) (an "assets-over" transaction, as discussed above). Specifically, a "vertical slice" division of FLLLP would involve a pro rata distribution by the FLLLP of the

---

[465] That is, his 69% limited partner interest held directly in FLLLP and his 1% general partner interest held through Family GP, LLC.

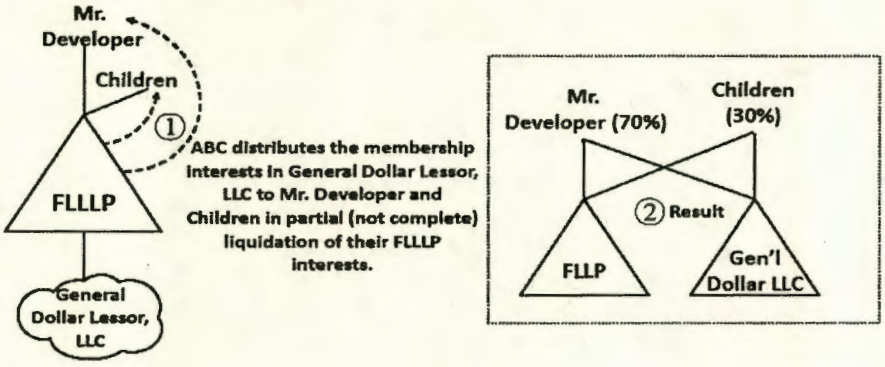
[466] Treas. Reg. §§ 1.752-1(a)(1) and 1.752-2.

[467] *See* Treas. Reg. § 1.752-2(b)(3) (stating that contractual obligations "such as . . . indemnifications" outside the partnership agreement are to be taken into account in determining the partners' economic risk of loss and shares of liabilities for outside basis purposes).

[468] Technically, under §§ 752(a) and (b), this shift in the allocation of the $10 million debt of General Dollar Lessor, LLC is treated as a constructive distribution of cash to Mr. Developer and a constructive contribution of cash by the children thereby decreasing and increasing, respectively, their outside bases. Because the shift is treated as a constructive distribution of cash to Mr. Developer, the advisor must keep in mind § 731(a)(1), which provides that a distribution of cash (constructive or otherwise) from a partnership to a partner that exceeds the partner's outside basis results in gain to that partner. Here, though, the $3 million constructive distribution is far less than Mr. Developer's outside basis.

membership interests in General Dollar Lessor, LLC to Mr. Developer and his children. The marketable securities would remain within the FLLLP while the real estate assets would remain within General Dollar Lessor, LLC. The diagram below illustrates such a division.

Family LLLP: "Vertical Slice" Division



(1) Thus, as a result of a "vertical slice" division of FLLLP, Mr. Developer and his children would own 70%/30%, respectively, of two separate partnerships: the FLLLP (which would own $9 million in securities) and General Dollar Lessor, LLC (which would own $31 million in real estate subject to debt of $10 million). As discussed above, this type of "vertical slice" division of FLLLP would not run afoul of the "mixing bowl" or "disguised sale" rules.

(2) Significantly, the partnership division would also avoid the special rule of section 731(c) that treats a distribution of marketable securities as a distribution of cash. This is because the division does not involve a distribution of the securities. Otherwise, under section § 731(c), a distribution of marketable securities with a fair market value in excess of a partner's outside basis can trigger gain to the partner.[469]

(3) The effect of a "vertical slice" division on the capital accounts and outside bases of Mr. Developer and his children with respect to FLLLP and General Dollar Lessor, LLC are set forth below:

[469] § 731(a)(1).

	Developer (Includes Family GP, LLC)			Children		
P'ship Division–FLLLP	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$4,200,000	$14,200,000	$21,000,000	$1,800,000	$1,800,000	$9,000,000
Spin Out Gen'l Dollar Lessor	$0	($10,000,000)	($14,700,000)	$0	$0	($6,300,000)
TOTALS	$4,200,000	$4,200,000	$6,300,000	$1,800,000	$1,800,000	$2,700,000
General Dollar Lessor, LLC	Capital Accounts	Outside Basis	Fair Market Value	Capital Accounts	Outside Basis	Fair Market Value
Initial Balances	$0	$10,000,000	$14,700,000	$0	$0	$6,300,000
Children Indemnify 30% Debt		($3,000,000)			$3,000,000	
TOTALS	$0	$7,000,000	$14,700,000	$0	$3,000,000	$6,300,000

f. With the marketable securities and real estate assets now segregated, upon Mr. Developer's death the discount taken with respect to the estate's partnership interest in FLLLP might be less, thus facilitating a higher step-up in basis in the securities. The estate's partnership interest in General Dollar Lessor, LLC would be subject to a significant discounting, but indemnification of Mr. Developer by the children (as discussed above) could prevent the discount from effectively nullifying the benefit of the basis step-up.

2. Example 2: In-Kind Distributions and Section 754 Election

a. Partner indemnification of debt is not the only means to engage in tax basis management with partnerships. In the right circumstances, the estate-planning advisor should consider in-kind distributions of property from a family partnership to one or more partners.

b. Consider the following hypothetical situation:

(1) Assume that ABC Family LLC owns raw land held for long-term investment. A has a 33.34% interest in ABC Family LLC, while each of A's adult children, B and C, have a 33.33% interest in ABC Family LLC. Each member of ABC Family LLC has an outside basis in his membership interest of $1.5 million.

(2) Assume further that the raw land held by ABC Family LLC is unencumbered and consists of the following three parcels of land: Parcel 1 has an adjusted basis of $4 million but a value of only $2 million; Parcels 2 and 3 each have an adjusted basis of $250,000 and a value of $5 million. Thus, ABC Family LLC is worth a total of $12 million and has an aggregate adjusted basis of $4.5 million in the land. Each member's interest in ABC Family LLC therefore is worth $4 million before taking into account any valuation discounts. Notice as well that the aggregate inside basis of ABC Family LLC in the raw land ($4.5 million) is equal to the aggregate outside basis (3 x $1.5 million = $4.5 million) of the members of ABC Family LLC.[470] Further assume that all capital contributions to ABC Family LLC are outside the seven year prohibition such that the "mixing bowl" and "disguised sale" rules are not implicated.[471]

[470] Typically, absent the death of a partner or a sale or exchange of a partner's partnership interest, the aggregate inside basis of a partnership in its property will equal the aggregate outside basis of the partners in their partnership interests.

[471] If ABC Family LLC has been in existence for at least seven years, and no appreciated or depreciated property has been contributed to the ABC Family LLC by the partners within the past seven years, then the ABC Family LLC will avoid the "mixing bowl" and "disguised sale" rules of Sections 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

c. Section 754 Election and Tax Basis Management

(1) Assume that A dies leaving his entire 33.34% membership interest in ABC Family LLC to his children, B and C. Assume that A's membership interest has an outside basis of $1.5 million and a value of $4 million at the time of A's death.[472] ABC Family LLC typically would make a section 754 election to optimize the estate's step-up in basis in A's membership interest. Pursuant to section 743(b), the election allows A's estate (which ultimately benefits B and C) to adjust its proportionate share of ABC Family LLC's inside basis in the land by a net amount of $2.5 million (i.e., an amount equal to the outside basis step-up in A's membership interest from $1.5 million to $4 million).[473]

(2) It is important to understand that the adjustment under section 743(b) is personal to the transferee partner (A's estate, and ultimately B and C). The adjustment is thus made to the transferee's (the estate's) *share of the inside basis* of the partnership in its property, not the partnership's basis in the property itself.[474] In the case of ABC Family LLC, the estate's share (as well as B's and C's respective shares) of the inside basis of the partnership in the land is as follows: Parcel 1 equals $1.334 million (one-third of inside basis of $4 million) and Parcels 2 and 3 equal $83,334 (one-third of inside basis of $250,000 in each parcel).

(3) Next, under section 755, the amount of the adjustment under section 743(b) ($2.5 million) must be allocated among the individual items of ABC Family LLC's property. The adjustment to the basis of items of partnership property is determined by reference to what would be the allocation of gains and losses to the transferee partner (A's estate) from a hypothetical sale of the partnership's property.[475] Moreover, the allocation of the adjustment across items of partnership property is made by reference to the net amount of the adjustment. Therefore, some items of partnership property (such as built-in loss property) may be subject to a negative adjustment while other items of partnership property (such as built-in gain property) are subject to a positive adjustment.[476]

(4) If, on a hypothetical sale, after A's death ABC Family LLC sold all of its property for its then fair market value, the gain and loss from such a sale would be allocated to A's estate as follows: $1.583 million gain [one-third of the built-in gain of $4.75 million ($5 million less adjusted basis of $.25 million)] from each of Parcels 2 and 3; and $.667 million loss (one-third of the $2 million built-in loss) from Parcel 1. Accordingly, the $2.5 million net adjustment under section 743(b) for the estate with respect to ABC Family LLC is allocated as follows:

(a) decrease the estate's share of inside basis in Parcel 1 to $.667 million (i.e., the estate's pre-adjustment share of inside basis of $1.334 million attributable to Parcel 1 less the estate's $.667 million allocable share of loss on a hypothetical sale); and

---

[472] For the sake of simplicity, this example assumes no discounted value on the 33.34% membership interest held by A's estate. Even if A's membership interest is subject to a valuation discount, however, the same principles illustrated here apply.

[473] *See* Treas. Reg. § 1.743-1(b).

[474] *See* § 743(b) (flush language).

[475] Treas. Reg. § 1.755-1(b)(1)(ii).

[476] Treas. Reg. § 1.755-1(b)(1).

(b) increase the estate's share of inside basis in Parcels 2 and 3 to $1.667 million each (i.e., the estate's pre-adjustment share of inside basis of $83,334 per parcel plus the estate's $1.583 million per parcel allocable share of gain from a hypothetical sale).

(5) The ultimate goal of these complicated adjustments is to ensure that if ABC Family LLC sold all of its assets for their fair market values at the time of A's death, the estate would benefit from the step-up in basis and (on a net basis) would not be allocated gain or loss from the sale. And, if we re-examine the facts of our hypothetical, we see that by virtue of the adjustments under section 743(b) this result is, in fact, produced. In particular, the estate's inside share of basis with respect to Parcels 1 and 2 has been adjusted to $1.667 million each. Thus, if Parcels 1 and 2 sell for their respective fair market values of $5 million each, the estate's one-third share of the proceeds from each parcel would be $1.667 million (one-third of $5 million), exactly equal to the estate's adjusted share of inside basis per parcel. Thus, no gain or loss with respect to the sale of either Parcel 1 or 2 will be recognized by the estate. Likewise, if Parcel 1 sold for its fair market value of $2 million, the estate's share of the proceeds would be $.667 million (one-third of $2 million), exactly equal to the estate's adjusted share of inside basis with respect to Parcel 1. Again, no gain or loss will be recognized by the estate with respect to the sale of Parcel 1.

d. Benefits to B and C as A's Heirs

(1) If we now examine ABC Family LLC from the perspective of B and C, the heirs to A's estate, we see that on balance the step-up in basis, the section 754 election, and the corresponding adjustments under section 743(b) benefit B and C. B and C benefit because $2.5 million of built-in gain within ABC Family LLC that would have been allocable to A prior to his death is now offset by the net $2.5 million adjustments made to Parcels 1, 2, and 3.[477]

(2) Upon closer examination, however, we also see that the result of the $2.5 million net adjustment is not entirely beneficial to B and C. First, there is no question that B and C benefit from the positive adjustment attributable to the estate's share of inside basis in Parcels 2 and 3. The adjustment reduces the taxable gain that B and C will report from a sale of either Parcel 2 or 3 by ABC Family LLC. On the other hand, though, the negative adjustment to the estate's share of inside basis in Parcel 1 is unfavorable. This negative adjustment reduces

[477] More specifically, B's and C's shares of inside basis in ABC Family LLC's property were $1.334 million each in Parcel 1 and $83,334 each in Parcels 2 and 3 prior to A's death. Without the Section 754 election and the corresponding adjustments under Section 743(b), B's and C's shares of inside basis simply would have reflected their inherited portions of A's inside basis prior to his death: B's and C's share of inside basis in Parcel 1 would have been $2 million each [$1.334 million plus $.666 million, which is one-half of A's former share ($1.334 million) of inside basis in Parcel 1]; and B's and C's respective shares of inside basis in Parcels 2 and 3 would have been $.125 million each [$83,334 plus $41,666, one-half of A's former share ($83,334) of inside basis in each of Parcels 2 and 3].

By virtue of Sections 754 and 743(b), however, B's and C's shares of inside basis in Parcels 1, 2, and 3 are as follows: B's and C's respective shares of inside basis in Parcel 1 are lower--$1.667 million each [$1.334 million plus $.3335 million, one-half of the estate's adjusted share ($.667 million) of inside basis in Parcel 1]; B's and C's respective shares of inside basis in Parcels 2 and 3 are higher--$.9175 million each [$83,334 plus $.834 million, one-half of the estate's adjusted share ($1.667 million) of inside basis in each of Parcels 2 and 3].

the amount of loss that B and C would report from a sale of Parcel 1 by ABC Family LLC had the section 754 election not been made.

(3) Put differently, the section 754 election and corresponding adjustments apply across every item of partnership property. There is no ability to pick and choose which assets to adjust so that built-in gain is reduced while built-in loss is preserved. Nonetheless, ABC Family LLC perhaps could have distributed the built-in loss property, Parcel 1, to A in partial redemption of A's 33.34% membership interest in order to better optimize the favorable aspects of the section 754 election.

e. Distributing Loss Property to Optimize Section 754 Election

(1) Under section 731, a current (i.e., non-liquidating) in-kind distribution of property (other than money) to a partner generally does not result in the recognition of gain or loss to the partnership or to the distributee partner.[478] Instead, the distributee partner takes a basis in the property equal to but not in excess of the distributing partnership's basis, and the distributee partner reduces his outside basis in his partnership interest by an amount equal to his basis in the distributed property.[479] Moreover, if the distributing partnership makes (or has in effect) a section 754 election and the distributed property had a basis in the partnership's hands higher than the distributee partner's outside basis in his partnership interest, then the excess results in a positive adjustment under section 734(b) to the distributing partnership's basis in its remaining assets.[480] Unlike the adjustments under section 743(b) (e.g., arising upon the death of partner), the adjustment under 734(b) is not personal to the distributee partner. Instead, where it applies, section 734(b) creates an upward or downward adjustment in the partnership's basis in its remaining property. Then, under section 755, the adjustment under section 734(b) is allocated across the partnership's remaining property according to unrealized appreciation or depreciation among classes and items of property (in accordance with the methodology set forth in the Treasury Regulations).[481]

(2) If we apply these rules in the context of ABC Family LLC, and assume that Parcel 1 (the built-in loss property) is distributed to A prior to his death, then we can produce a more favorable result to B and C (A's heirs) than is produced if Parcel 1 is not distributed and ABC Family LLC makes a section 754 election upon A's death.

(3) To wit, recall that ABC Family LLC is worth $12 million and that A, B, and C own membership interests in ABC Family LLC worth $4 million each (assuming no valuation discount).[482] A, B, and C have an outside basis of $1.5 million each in their membership interests. Parcel 1 is a built-in loss property with a basis of $4 million and a value of $2 million. Parcels 2 and 3 are each built-in gain properties with adjusted bases of $20,000 each and values of $5 million each.

---

[478] § 731(a)-(b). Under Section 731(c), though, an in-kind distribution of marketable securities can be treated as a distribution of money triggering gain (but not loss) to the distributee partner.

[479] §§ 732(a) and 733.

[480] *See* § 734(b).

[481] *See* Treas. Reg. § 1.755-1(c).

[482] Again, for the sake of simplicity, this example assumes no discounted value.

(4) Assume that ABC Family LLC distributes Parcel 1 to A prior to his death in partial redemption of his membership interest and also makes a section 754 election. Under the rules of subchapter K, the following results obtain:

(a) Under sections 731 and 732, A takes Parcel 1 with a value of $2 million and a basis of $1.5 million (exactly equal to A's outside basis in his partnership interest).

(b) Under section 733, A's outside basis in his interest in ABC Family LLC is reduced to zero.

(c) A's percentage interest in ABC Family LLC is reduced to 20% (because A is left with a membership interest worth $2 million in a partnership worth $10 million).[483]

(d) B's and C's percentage interests in ABC Family LLC increase to 40% each (because they each have membership interests worth $4 million in a partnership worth $10 million).

(e) *Most importantly*, an adjustment under section 734(b) in the amount of $2.5 million arises from the distribution of Parcel 1 to A (e.g., $4 million inside basis in Parcel 1 less A's $1.5 million outside basis in his membership interest immediately prior to the distribution).

(5) Then, under section 755, the $2.5 million adjustment under section 734(b) must be allocated across Parcels 2 and 3 in proportion to the unrealized gain in each parcel. The unrealized gain in each of Parcels 2 and 3 is the same: $4.75 million. ABC Family LLC therefore increases its inside basis in Parcels 2 and 3 by $1.25 million each. This leaves ABC Family LLC holding Parcels 2 and 3 worth $5 million each with an inside adjusted basis of $1.5 million each ($.25 million plus $1.25 million).

(6) Next, assume that A dies holding his 20% membership interest in ABC Family LLC and Parcel 1. A's membership interest had a non-discounted value of $2 million and a basis of zero. Parcel 1 had a value of $2 million and a basis of $1.5 million. A's estate steps up its basis in the ABC Family LLC membership interest from zero to $2 million. A's estate steps up its basis in Parcel 1 from $1.5 million to $2 million. Furthermore, under section 754, the $2 million step-up in the estate's outside basis in its membership interest in ABC Family LLC gives rise to a $2 million adjustment under section 743(b). That $2 million positive adjustment increases the estate's (and ultimately B's and C's) share of inside basis in Parcels 2 and 3 by $1 million each. This $1 million positive adjustment under section 743(b) is in addition to the $1.25 million positive adjustment under section 734(b) that previously had been made to Parcels 2 and 3 as result of the distribution of Parcel 1 to A.

(7) B and C thus inherit from A Parcel 1 with a value of $2 million and a basis of $2 million. There is no longer a trapped, built-in loss in Parcel 1. B and C also inherit from A his 20% interest in ABC Family LLC, leaving B and C owning 50% each of ABC

---

[483] As discussed above, non-pro-rata distributions of property in family partnerships almost always should result in adjustment of the partners percentage interests in the partnership. Otherwise, the special valuation rules of Chapter 14 will come into play.

Family LLC. Due to the combination of the adjustments under sections 734(b) and 743(b) though, Parcels 2 and 3 effectively have an adjusted basis to B and C of $2.5 million each determined as follows:

(a) Parcels 2 and 3 each had $1.5 million basis after the IRC § 734(b) inside basis adjustments (described above) upon the distribution of Parcel 1 to A.

(b) A's death gives rise to a $2 million adjustment under section 734(b) to the estate's share of inside basis in Parcels 2 and 3 which remain held by ABC Family LLC.

(c) Under section 755, this $2 million positive adjustment must be allocated across Parcels 2 and 3 to increase the estate's share of inside basis attributable to Parcels 2 and 3.

(d) The Treasury Regulations under section 755 allocate the $2 million adjustment in proportion to relative fair market values of assets inside ABC Family LLC.

(e) Because Parcels 2 and 3 have the same value ($5 million each), the estate's $2 million adjustment under section 743(b) is allocated equally between Parcels 2 and 3.

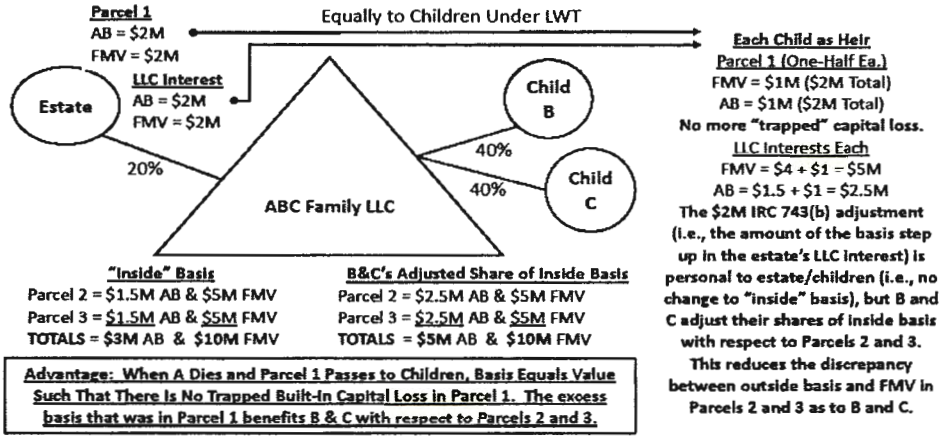
(f) Therefore, the estate's share of the inside basis of ABC Family LLC in Parcels 2 and 3 is $1 million each.

(g) B and C then inherit the estate's share of ABC Family LLC's $1 million inside basis in Parcels 2 and 3.

(h) When combined with ABC Family LLC's existing inside basis of $1.5 million each in Parcels 2 and 3, B's and C's inside shares of basis in Parcels 2 and 3 are now $2.5 million each.

(8) A diagram illustrating the ultimate results to A's estate and to B and C is set forth below:

ABC Family LLC Alternative Two: Step-Up at Death in Parcel 1 and LLC Interest



(9) As can be seen from the foregoing analysis and the diagram, the carefully planned distribution of Parcel 1 optimizes the results of the section 754 election. In other words, the basis and value of Parcel 1 in B's and C's hands is equal, avoiding receipt of property with built-in loss that can be realized only upon sale. Further, B's and C's inside shares of basis in Parcels 2 and 3 within ABC Family LLC are higher ($2.5 million each versus $1.835 each) than where Parcel 1 is not distributed and A dies holding a 33.34% interest in ABC Family LLC.

(10) In short, the carefully planned distribution of Parcel 1 re-allocated $2 million of excess basis to Parcels 2 and 3 to reduce their built-in gain, rather than trapping a large portion of that excess basis as built-in loss in Parcel 1.

M. Basis Planning with Charitable Entities

1. One of the tax benefits of having a partner that is a charitable entity is its tax-exempt status. When a charitable entity holds a partnership interest, however, due regard should be given to unrelated business taxable income[484] and excess benefit transactions.[485] Further, if the charitable entity is a private foundation, planners should consider the rules relating to self-dealing transactions[486] and excess business holdings.[487] A full discussion of these and other related rules is beyond the scope of these materials. For purposes of these materials, it is assumed that the charitable partner is a public charity, and the assets in the partnership do not give rise to unrelated business taxable income, excess benefit transactions, or private inurement issues.

---

[484] § 511.

[485] § 4958.

[486] § 4941

[487] § 4943.

2. As discussed above, Revenue Ruling 84-53 provides that when a partner transfers (gratuitous or taxable) a partnership interest and the interest carries a valuation discount, a disproportionately smaller amount of basis is transferred to the transferee. Further, as discussed in these materials, a tax basis "shift" is predicated upon the partnership distributing a higher inside basis asset (in-kind) to a partner whose outside basis in the partnership is lower than the distributed asset. With these rules in mind, a gift of a non-controlling partnership interest to a charitable entity may provide significant tax basis planning opportunities.

3. Consider the following highly simplified hypothetical:

a. Taxpayer creates a limited partnership and contributes to the partnership the following assets:

(1) Asset A with a zero basis and fair market value of $100; and

(2) Asset B with $100 basis and fair market value of $100.

b. As a result of the contribution, the taxpayer takes back a 1% general partnership interest and 99% limited partnership interest. Assume another person contributes and owns a nominal interest in the partnership to ensure that the entity is a partnership for income tax purposes, rather than a disregarded entity (see the discussion later in these materials). For purposes of this hypothetical, ignore the existence of this nominal partner. Outside basis in the taxpayers partnership interest is $100 and his capital account is $200. Assume for purposes of this example that the taxpayer's interest (prior to any transfer) in the partnership remains at $200 (no valuation discounts).

c. Taxpayer donates 50% of the limited partnership interest to charity (retaining the 1% general partnership interest and a 49% limited partnership interest). Assume the value of the limited partnership interest carries a 50% valuation discount. In other words, the value for income and gift tax purposes is $50.[488]

d. Under Revenue Ruling 84-53, the basis of charity's partnership interest is only $25, and taxpayer's outside basis is $75:

$$\frac{\text{Transferor's Adjusted Basis}}{\$100} \times \frac{\text{Fair Market Value (Discounted) Transferred Portion}}{\text{Fair Market Value Transferor's Entire Portion}} = \frac{\$50}{\$200} \qquad \text{Transferee's Adjusted Basis } \$25$$

e. Notwithstanding the foregoing, charity's capital account, under the Treasury Regulations,[489] is $100.

[488] Assuming the charitable entity is a public charity and the partnership does not have any "hot asset" under section 751 of the Code, the taxpayer will receive a $50 income tax deduction. *See* § 170(e)(1)(A).

[489] Treas. Reg. §§ 1.704-1(b)(2)(iv)(l) and 1.704-1(b)(5), ex. 13.

Transferor's Capital Account	x	Percentage Transferred	=	Transferee's Capital Account
$200		50%		$100

f. At least 7 years after the contribution of the assets, assuming the assets remain in the partnership and there has been no change in the values, the partnership liquidates charity's interest (according to its capital account balance) and distributes Asset B ($100 basis and fair market value of $100) to charity. Assume the LLC has a section 754 election in place at the time of the distribution of Asset B.

g. The basis of Asset B owned by charity has its basis replaced by charity's outside basis in the partnership. As a result, Asset B's basis is $25. Charity can then sell the Asset B and recognize the gain in a tax-exempt environment.

h. With the section 754 election, the $75 of basis reduction (basis strip) results in an increase in the basis to Asset A under section 734(b) of the Code. Asset A's basis goes from zero to $75. As discussed in in more detail above, the basis adjustment under section 734(b) is to partnership property, so if the partnership sells Asset A, the basis increase will benefit all of the remaining partners (the taxpayer and any transferees of the taxpayer's retained interest).

III. INCOME TAX AVOIDANCE AND DEFERRAL WITH PARTNERSHIPS

A. Generally

1. With the higher income tax rates, progressivity in the marginal income tax brackets provides an opportunity for taxpayers to take advantage of "running the brackets" and taxing income at lower effective tax rates. With the highest income tax rates becoming effective at $466,950 of taxable income for joint filers and the NIIT being applied when MAGI exceeds $250,000, the tax savings can be quite significant. At ordinary rates, "running the bracket" provides approximately $43,830 of tax savings (the difference between being taxed at the highest rate of 39.6% and the actual tax liability) for single filers and $54,333 for joint filers, and at long-term capital gain tax rates, the tax savings are $30,235 and $36,612, respectively:[490]

[490] Rev. Proc. 2015-53, 2015-44 I.R.B. 615.

STCG/Ordinary Rate	Single ($43,830 in savings)	Joint ($54,333 in savings)
10%	$0-$9,275	$0-$18,550
15%	$9,276-$37,650	$18,551-$75,300
25%	$37,651-$91,150	$75,301-$151,900
28% / 31.8%	$91,151-$190,150	$151,901-$231,450
33% / 36.8%	$191,151-$412,350	$231,451-$413,350
35% / 38.8%	$413,351-$415,050	$412,351-$466,950
39.6% / 43.4%	$415,051 and above	$466,951 and above

LTCG/QD Rate	Single ($30,235 in savings)	Joint ($36,612 in savings)
0%	$0-37,650	$0-$75,300
15%	$37,651-*$200,000 MAGI*	$75,301-*$250,000 MAGI*
18.8%	*$200,001 MAGI*-$415,050	*$250,001 MAGI*-$466,950
23.8%	$415,051 and above	$466,951 and above

2. As a result, taxpayers will increasingly look for opportunities to not only defer the payment of income taxes (which provides a present value economic benefit) but to have the income spread out over many taxable years and over multiples of taxpayers. This will provide the benefit of having the income taxed at a lower tax rate by running the brackets, and to also fully avoid the imposition of certain taxes like the NIIT (for such annual amounts that remain below $200,000 to $250,000 of MAGI).

A. "Splitting" Income with Partnerships

1. The most flexible vehicle available to practitioners to "split" income among taxpayers are entities taxed as partnerships. While an S corporation will spread the entity's income across the shareholders, the capital structure of an S corporation investment is limited to one class of stock so there is no ability to disproportionately allocate income to certain shareholders (who are taxed at lower marginal income tax brackets and who may not be subject to state income tax) to the exclusion of other shareholders (who are already at the highest income tax brackets and who may be residents of a high income tax state like California).[491]

2. Unlike S corporations, partnerships can be structured to provide different classes of ownership interests. In the family-owned entity context, if different ownership

[491] § 1361(b)(1)(D).

interests are utilized, careful consideration must be given to section 2701 because the "same class"[492] exception will not be available. Notwithstanding the foregoing, "preferred" partnership interests can be created that avoid the punitive effects of section 2701, namely the "zero valuation" rule.[493] These types of "preferred" interests include:

a. A "qualified payment"[494] interest (discussed in more detail later in the following article of this outline), which is an exception to the zero valuation rule;

b. A "deemed" or "electing" qualified payment, which is an exception to zero valuation rule;[495]

c. A "guaranteed payment" right under section 707(c), which is an exception to section 2701;[496] and

d. A "mandatory payment right," which is an exception to section 2701.[497]

3. Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, taxable income should follow with the preferred interest payment.

a. For guaranteed payment rights, the taxation to the partnership and the partners is relatively straightforward. A partnership that makes a guaranteed payment to partner is entitled to either deduct the payment as an ordinary and necessary business expense[498] of the partnership or capitalize[499] the expense as a capital expenditure, depending on the nature of the payment.[500] The partner receiving the guaranteed payment must include the payment as ordinary

---

[492] § 2701(a)(2)(B).

[493] § 2701(a)(3)(A).

[494] § 2701(c)(3)(A).

[495] These are specified amounts to be paid at specified times that nonetheless do not qualify as a "qualified payment" but which the taxpayer elects to treat as such. § 2701(c)(3)(C)(ii).

[496] Excluded from the definition of "distribution right" is "any right to receive any guaranteed payment described in section 707(c) of a fixed amount." § 2701(c)(1)(B)(iii). The Code defines guaranteed payments as "payments to a partner . . . for the use of capital" but only "to the extent determined without regard to the income of the partnership to a partner for . . . the use of capital." § 707(c). The Treasury Regulations go on to explain that a guaranteed payment is meant to provide the partner with a return on the partner's investment of capital (as opposed to payments designed to liquidate the partner's interest in the partnership). Treas. Reg. § 1.707-4(a)(1)(i).

[497] A "mandatory payment right" is a right to a required payment at a specified time. For purposes of Section 2701 it is considered neither an extraordinary payment right nor a distribution right. It includes a right in preferred stock requiring that the stock be redeemed at its par value on a date certain and it also includes a right to receive specific amount on the death of the holder. Treas. Reg. § 25.2701-2(b)(4)(i). The Service has also ruled that a mandatory payment right includes the right to redeem preferred stock at a stated value plus any accrued and unpaid dividends on the earlier to occur of a certain date or change in control of the company. PLR 9848006.

[498] § 162(a).

[499] § 263.

[500] § 707(c).

income[501] in the year in which the partnership paid or accrued the payment under its method of accounting.[502]

b. For the other types of preferred interests, the allocation of income is a bit more convoluted. Generally, the income allocated to the preferred payment depends on the distributive share of the partnership. The McKee, Nelson and Whitmire treatise provides that the Service expects a preferred return to be matched by a corresponding allocation of available income or gain.[503] The Treasury Regulations, in the context of the disguised sale rules, provide that a preferred return means "a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of gain."[504]

4. With the goal of disproportionately allocating income to lower taxed individuals, practitioners should make note of the "junior equity" exception to section 2701.

a. The Code provides that a distribution right does not include a right to distributions with respect to any interest which is junior to the rights of the transferred interest.[505]

b. The Treasury Regulations also exempt an interest that is of the same class, or a class that is subordinate to, the transferred interest.[506]

c. This is one of the most significant exceptions to section 2701 from a tax planning standpoint. Essentially, it is an exception for the transfer of the preferred or senior equity interest (with the retention of the junior equity or common interest by the transferor). As an exception to section 2701, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount. Equally as important, as mentioned above, the preferred return will carry a preferred allocation of the tax items of the partnership.

B. Non-Grantor Trusts: Distributions and Partnerships

1. As mentioned above, non-grantor trusts are taxed at the highest rates once taxable income exceeds $12,400. As such, non-grantor trusts carry an inherent income tax disadvantage when compared to how those same assets would grow if they were held by an individual or group of individual taxpayers. Trustee should consider whether making distributions to trust income might better serve the overall purposes of the grantor and the grantor's family, in terms of total wealth accumulation.

2. Even with trusts where the primary objective is to accumulate as much wealth in the trust as possible (for example, a "dynasty trust" or GST tax exempt trust), trustees may be

---

[501] *See* 61(a).

[502] § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

[503] McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 13.02[3][b][iii], at 3-19 (3d ed. 1997).

[504] Treas. Reg. § 1.707-4(a)(2).

[505] § 2701(c)(1)(B)(i).

[506] Treas. Reg. § 25.2701-2(b)(3)(i).

able to produce more total wealth by distributing trust income out to the trust beneficiaries, especially if the trust beneficiaries would be taxed at lower income tax rates, would not be subject to state income tax, and have sufficient Applicable Exemption Amount and GST exemption available to shelter whatever assets may accumulate in the gross estates of the beneficiaries. Given the potential number of taxpayers or beneficiaries a trust could spread the income across, the savings could be significant.

3. Trust distributions that carry out distributable net income ("DNI")[507] of the trust would effectively ensure taxation of the income to the beneficiaries. DNI determines the amount of income that may be deducted by the trust resulting from distributions and determines the character of the income items taxable to the beneficiaries.[508] Determining DNI for a trust requires first determining the taxable income of the trust and modifying that figure in a number of ways. With respect to capital gain, the Code provides, "[g]ains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not . . . paid, credited or required to be distributed to any beneficiary during the taxable year."[509] In other words, absent certain circumstances, capital gain is excluded from DNI and is taxable to the trust, rather than to the beneficiary receiving the distributions.

4. Often the governing instrument will give the trustee the authority to allocate gains between income and principal. Under the Treasury Regulations, however, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized."[510] The Treasury Regulations provide that capital gain is ordinarily excluded from DNI, with a number of notable exceptions:[511]

> *Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law)—
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of the distributable net income determined without regard to this subparagraph 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

---

[507] § 643.

[508] §§ 651(b), 652(a), 652(b), 661(a), 662(a) and 662(b).

[509] I.R.C. § 643(a)(3). *See* Treas. Reg. § 1.643(a)-3(a) regarding the treatment of capital gains and losses in the taxable year in which the trust or estate terminates.

[510] Treas. Reg. § 1.643(b)-1.

[511] Treas. Reg. § 1.643(a)-3(a).

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.[512]

5. Notwithstanding the limited discretion granted to fiduciaries under the foregoing provisions, given the potential limitations of including capital gain in DNI and the fact that many clients would prefer not to have the asset held personally by the beneficiaries, practitioners may be able to accomplish the same types of tax savings by utilizing a partnership structure where the beneficiary is a partner along with the trust. By way of example, the trust could from an entity taxable as a partnership like a limited partnership or limited liability company and distribute an interest in the entity to the beneficiary. Whether such distribution carries out DNI to the beneficiary is secondary to the fact that on an ongoing basis a proportionate amount of partnership income will be allocated to the beneficiary. While a preferred interest partnership structure can be utilized, as discussed above, and practitioners should be aware of the implications under section 2701 upon the creation of the preferred partnership with the beneficiary or the distribution of a preferred interest in the partnership to the beneficiary.

6. Given that any partnership interest held by a trust beneficiary will be in his or her gross estate for estate tax purposes, practitioners will want to consider utilizing IDGTs to minimize the estate tax impact but still retain the income tax benefits of having the partnership income taxed to the beneficiary-grantor. For example, the beneficiary may want to sell his or her partnership interest to an IDGT created by the beneficiary, as the grantor for grantor trust purposes.

C. Trust to Trust Preferred Partnership

1. Consider the following hypothetical situation:

a. Trust A is an irrevocable resident trust of State A, which is a no or low income tax state. Trust B is an irrevocable resident trust of State B, which is a high income tax state. Trust A and Trust B were created many years ago by grantors who are now deceased, and both trusts are held for benefit of the same beneficiaries. The terms of both trusts, particularly the provisions describing the beneficial interests of the beneficiaries, are substantially similar to each other. Trust A and Trust B each hold $10 million in publicly-traded securities.

b. Trust A and Trust B consolidate their assets by contributing them to a limited liability company (now holding $20 million), with Trust A receiving preferred interests in the LLC, and with Trust B receiving common interests in the LLC, as follows:

(1) The preferred interest held by A is structured as follows:

(a) $10 million liquidation preference (upon dissolution of the LLC, this amount will be paid to the preferred partner in cash or in-kind before any liquidating distributions are made to the common holder); and

[512]Treas. Reg. § 1.643(a)-3(b).. Since the issuance of the final regulations, the service has ruled that the exclusion and inclusion of capital gains in determining DNI was a reasonable exercise of discretion. *See* PLRs 200617004 and 200448001.

(b) An annual, cumulative preferential right to partnership cash flow equal to 10% of the liquidation preference ($1,000,000 annually).

(2) The common interest held by B retains all of the residual interest in any annual cash flow, liquidation proceeds, and earnings of the LLC after the preferred interest holders have been paid.

2. Each year, the LLC pays $1,000,000 of cash flow to Trust A. The portfolio of the LLC generates $1,000,000 or less of taxable income (capital gain and portfolio income). Assuming no tax items need to be allocated to Trust B under section 704(c) of the Code, all of the taxable income will be allocated to Trust A, the low or no state income tax Resident Trust. No income will be allocated to Trust B.

3. There are strong arguments to support the conclusion that when Trust A and Trust B create the preferred LLC described above, section 2701 of the Code either does not apply or at worst has no transfer tax consequences:

a. Section 2701 of the Code is gift tax provision. For it to apply, Trust A or Trust B must be making a gift to the other. For example, as a result of the formation of the LLC, Trust B is deemed to make a gift to Trust A. It is unclear whether an irrevocable trust can even make a gift like that. The original transfer to Trust B was made by a grantor or testator who is now deceased.

b. Perhaps, there is a deemed gift from the beneficiaries of Trust B to the beneficiaries of Trust A. As mentioned above, section 2701 of the Code provides that in determining whether a gift has been made and the value of such gift, when a person transfers an interest in a partnership to a "member of the transferor's family"[513] the value of certain "applicable retained interests" will be treated as zero.[514] "Transfer" is broadly defined and is deemed to include "a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership."[515] A "member of the transferor's family" means: (a) the transferor's spouse, (b) a lineal descendant of the transferor or the transferor's spouse, or (c) the spouse of any such lineal descendant.[516] For these purposes, an individual is treated as holding any interest to the extent held indirectly through a trust.[517] If the beneficiaries of Trust A are making a gift to the beneficiaries of Trust B, aren't they making a gift to themselves because they have the same beneficial interests in both trusts? For a taxable gift to occur, property must be transferred for less than adequate and full consideration in money or money's worth.[518]

c. Section 2701 of the Code does not apply to a transfer "to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the

---

[513] § 2701(a).

[514] § 2701(a)(1)(3)(A).

[515] § 2701(e)(5).

[516] § 2701(e)(1).

[517] § 2701(e)(3).

[518] § 2512(b).

transfer."[519] This is often referred to as the vertical slice exception. The Treasury Regulations provide, for interests held in trust:

> A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest.

d. In our hypothetical, the beneficial interest of the beneficiaries of Trusts A and Trust B are substantially similar. It would seem that even if Section 2701 of the Code applied, the vertical slice exception would also apply.

4. Out of an abundance of caution, practitioners should structure the preferred interest as a "qualified payment" interest (which is discussed in more detail later in this outline). A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[520] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed relationship to a specified market interest rate."[521] The Treasury Regulations provides that a qualified payment is:

a. "A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate."[522]

b. Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount."[523]

5. The preferred interest held by Trust A provides for a cumulative fixed annual payment of $1 million to Trust A, so it is considered a qualified payment interest. This avoids the risk of the zero valuation rule applying and reduces the value of any deemed gift from Trust A to Trust B under the subtraction method (as discussed in more detail later in this outline). When one runs through the attribution rules, given that the beneficiaries have substantially similar beneficial interests in both trusts, it is likely any net gift would be nominal (if section 2701 of the Code actually applied to this hypothetical).

6. Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, taxable income should follow with the preferred interest payment.

---

[519] Treas. Reg. § 25.2701-1(c)(4).

[520] § 2701(c)(3)(A).

[521] § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

[522] Treas. Reg. § 25.2701-2(b)(6)(i)(A).

[523] Treas. Reg. § 25.2701-2(b)(6)(i)(B).

a. As mentioned above, a partnership that makes a guaranteed payment to a partner is entitled to either deduct the payment as an ordinary and necessary business expense[524] of the partnership or capitalize[525] the expense as a capital expenditure, depending on the nature of the payment.[526] The partner receiving the guaranteed payment must include the payment as ordinary income[527] in the year in which the partnership paid or accrued the payment under its method of accounting.[528] If the preferred interest is structured as a guaranteed payment, then the partnership (and consequently Trust B as part of its distributive share as a partner), in the hypothetical above, is entitled to a deduction that can reduce other taxable income.

b. As mentioned above, for the other types of preferred interests, generally, a preferred return to be matched by a corresponding allocation of available income or gain.

D. Sale of Partnership Interests vs. Distributions In-Kind

1. Taxable Sale of Partnership Interests

a. If a partner sells his or her partnership interest in a taxable transaction, the transferor recognizes gain or loss in accordance with the rules of section 1001.[529] The transferee takes a cost basis in the acquired partnership interest,[530] but the transferee's capital account is not based on the consideration tendered. The capital account of the transferee carries over from the transferor partner.[531] The purchased partnership interest carries with it the transferor's share of section 704(c) gain (both forward and reverse) in the partnership's assets.[532]

b. The character of the gain recognized by the selling partner is capital subject to recharacterization under section 751(a) for "hot assets," as discussed in more detail above.[533] Capital gain or loss is recognized as it would be under section 1001 less the amount of ordinary income (or plus the amount of ordinary loss) recharacterized under section 751(a).[534]

c. Section 1(h) provides that the tax rate on the capital gain portion of the sale is determined by looking through to the partnership assets at the time of the sale.[535] As a result, the transferor partner may recognize capital gain at a 20%, 25%, and 28% rate (along with the NIIT, if applicable to the taxpayer) depending on the nature of the assets in the partnership.

---

[524] § 162(a).

[525] § 263.

[526] § 707(c).

[527] *See* 61(a).

[528] § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

[529] § 741.

[530] § 742.

[531] Treas. Reg. § 1.704-1(b)(2)(iv).

[532] Treas. Reg. § 1.704-3(a)(7).

[533] § 741.

[534] Treas. Reg. § 1.751-1(a)(2).

[535] § 1(h)(5)(B), (h)(9), (h)(10) and Treas. Reg. § 1.1(h)-1(a).

The capital gain will be short-term or long-term depending on the transferor partner's holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, as discussed above, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.[536] As a result, the sale of a partnership interest can result in ordinary income, short-term capital gain, and long-term capital gain at a multitude of different rates.

d. As discussed below, a distribution of assets, rather than a sale of the partnership interest (particularly when the partner is exiting the partnership) may result in much better results for the exiting partner. The distribution is not subject to the look-through rule of section 1(h).

e. As discussed above, if the partnership has a section 754 election in place, the inside basis of the partnership's assets will be adjusted based upon the value of the consideration furnished by the purchasing partner. This will essentially give the income purchasing partner a fair market value basis in each of the partnership assets (assuming no valuation discount), so that if the partnership were to sell the assets at that time, no additional gain or loss would be borne by the incoming partner.[537]

f. A partnership terminates for tax purposes (i) on the sale or exchange of 50% or more interests in the capital and profits of the partnership within any consecutive 12 month period,[538] or (ii) sale of all other partnership interests to one remaining partner or a single new partner.[539] When a partnership is terminated, there is a deemed transfer of the assets from the old partnership to a new partnership, followed by a transfer of the interests in the new partnership to the partners of the old partnership (exactly like the "assets-over" transaction described above for partnership divisions).[540] The primary downside of a technical termination is that the partnership's depreciable tangible assets (but not for section 197 intangibles) is treated as newly placed in service as of the date of the technical termination.[541] The successor partnership must depreciate the adjusted basis of tangible assets as newly acquired assets placed in service on the termination date. On the other hand, qualified property placed in service by the terminated partnership during the taxable year of termination may be eligible for the first year "bonus" depreciation under §168(k), as mentioned above.

g. Importantly, despite the foregoing downside, a technical termination does not create any new section 704(c) amounts,[542] and does not start a new 7 year period for purposes of the mixing bowl provisions.[543] The termination does not trigger application of

---

[536] Treas. Reg. § 1.1223-3.

[537] In fact, in this instance, the gain or loss would be allocated to the purchasing partner in an amount equal to the gain or loss that would have been allocated to the transferor partner had there been no taxable sale of the interest, and then the inside basis adjustment under section 743(b) then offsets the gain or loss allocated. The effect is the same. *See* Treas. Reg. § 1.743-1(j)(3)(ii), Ex. 2.

[538] § 708(b)(1)(B) and Treas. Reg. § 1.708-1(b)(2).

[539] § 708(b)(1)(A), Treas. Reg. § 1.708-1(b)(1) and Rev. Rul. 99-6, 1991-1 C.B. 432.

[540] Treas. Reg. § 1.708-1(b)(4).

[541] Treas. Reg. § 1.708-1(b)(4), § 168(i)(7)(B) (final flush language), and § 197(f)(2).

[542] Treas. Reg. §§ 1.704-3(a)(3)(i), 1.704-4(c)(3), and 1.708-1(b)(4), Ex. (iii).

[543] Treas. Reg. §§ 1.704-4(a)(4)(ii) and 1.737-2(a),

section 731(c) (distributions of marketable securities),[544] allows carryover of the inside basis adjustment under section 743(b) in assets of the terminated partnership.[545]

2. Liquidating Distributions

a. The treatment of distribution (both current and liquidating) is discussed in more detail above.

b. As mentioned above, if the liquidating distribution includes cash, then gain or loss is recognized based on the amount of outside basis on the partnership interest prior to the distribution. Ordinary income will be generated under Section 751(b) to the extent that certain "hot assets" are in the partnership.[546] To the extent the distributee partner recognizes capital gain, the gain will be taxed at 20% (never 25% or 28%) because there is no look-through rule under section 1(h).[547] As one author points out, "While there is no obvious reason why the higher capital gain rates can apply to dispositions of partnership interests but not to distributions, that is the way the statute is written."[548] If a section 754 election is in place, any gain recognized by a distributee will not be also be allocated to the remaining partners (thereby avoiding the higher capital gain tax rates in the future for the remaining partners). If the liquidating distribution does not include cash in excess of outside basis, no gain will be recognized but ordinary income may be generated under section 751(b).

c. If property in-kind is distributed, the outside basis of the partnership interest replaces the basis of the distributed assets.[549] Ordinary income assets take a carryover basis, with any outside basis remaining going to the capital gain and section 1231 assets distributed.[550] Assuming a section 754 election, if the distributed capital assets receive additional basis after the distribution (or if there is a substantial basis reduction with respect to such distribution exceeding $250,000), then the partnership must adjust the inside basis of the remaining assets downward by that amount.[551] If the distributed capital asset results in a basis reduction, the partnership will receive an upward inside basis adjustment if a section 754 election is in place.[552] All of these adjustments are made pursuant to section 734(b) and are therefore for the benefit of the partnership and the remaining partners. If the distribution in-kind is not in

---

[544] Treas. Reg. § 1.731-2(g).

[545] Former Treas. Reg. § 1.743-2, T.D. 8717, 62 Fed. Reg. 25498 (3/9/97). The provision was omitted when the Treasury Regulations were rewritten by T.C. 8747, 64 Fed. Reg. 69903 (12/15/99).

[546] One thing to note, however, section 751(b) only applies to "substantially appreciated" inventory. *See* §§ 751(b)(1)(A)(ii) and 751(a)(2). To the extent that inventory exists but is not substantially appreciated, a distribution of cash in liquidation of a partnership interest will be considered capital gain, but a taxable sale of such interest would generate ordinary income under section 751(a). "Substantial appreciation" is defined in section 751(b)(3).

[547] The rule only applies to the sale or exchange of an interest. *See* § 1(h)(9) and Treas. Reg. § 1.1(h)-1(a).

[548] Howard E. Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, 50 Tax Mgmt. Mem. No. 4 (2/16/09).

[549] § 732(b).

[550] § 732(c).

[551] § 734(b)(2)(B).

[552] § 734(b)(1)(B).

liquidation of the distributee partner's interest, the inside basis adjustment shifts results in a basis shift from the distributee partner to the non-distributee partners.[553]

3. Planning for FLPs: Sales vs. Distributions

a. Given the disparate treatment of taxable sales of partnership interests and distributions of partnership property, families in FLPs will often find distributions of assets in-kind more advantageous than a taxable sale of a partnership interest.

b. A number of strategies can be devised to take advantage of lower income tax bracket partners (including individuals or non-grantor trusts residing in no income tax states or private foundations). By way of example, one strategy might be distributing appreciated property to the lower income tax rate partner (not in liquidation of the partnership) prior to a taxable sale of the assets. This puts the appreciated property in hands of the lower income tax bracket partner

c. Another strategy might include a non-liquidating distribution of cash[554] in partial redemption of most of the departing partner's interest in the partnership (triggering gain), followed then by a taxable sale of the remaining partnership interest to another family taxpayer. This takes advantage of the no look-through feature of distributions, and with a section 754 election in place, a common inside basis adjustment in favor of the partnership under section 734(b) for the cash distribution, and then an inside basis adjustment in favor of the purchasing partner under section 743.

IV. CREATIVE USES OF THE APPLICABLE EXCLUSION WITH PARTNERSHIPS

A. Qualified "Cost-of-Living" Preferred Interests

1. As mentioned above, there are very good reasons for trying to retain as much Applicable Exclusion Amount as possible, even for very wealthy clients who have significant estate tax exposure. One technique that may be appealing is a traditional preferred freeze partnership, where the grantor retains a preferred interest in the partnership and gifts, or more likely, sells to an IDGT, a common interest in the partnership. The twist would be that the retained preferred interest would be adjusted for inflation to provide inflation-adjusted cash flow and ensure that the retained preferred interest in the gross estate would equal the grantor's Applicable Exclusion Amount on the grantor's death. Pursuant to this technique:

a. The retained preferred interest would be structured as a "qualified payment" interest under section 2701, so the zero valuation rule would not be applicable.

b. The liquidation preference of the preferred interest would be adjusted to provide for a cost-of-living increase, calculated in the same manner as the Applicable Exclusion Amount.

---

[553] *See* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax Law. 343 (2004).

[554] The partnership could borrow the proceeds to effectuate the cash distribution. Care should be given to ensure that undesirable partnership liability shifts do not occur in the transaction. Thus, taxpayers should consider borrowing on a nonrecourse basis but having certain remaining partners guarantee the debt.

c. The retained preferred interest would be structured so that the preferred holder would have the right to put the interest to the partnership for the liquidation preference (as adjusted for the cost-of-living increase) and at death, the partnership has the right to liquidate the preferred interest at the liquidation preference.

d. The gift or sale of the common interest would qualify for significant valuation discounts, in excess of those that would typically apply to a traditional single class or pro rata family limited partnership.

2. A qualified payment "means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate."[555] A payment will be treated as a "fixed rate" if the payment is "determined at a rate which bears a fixed relationship to a specified market interest rate."[556] The Treasury Regulations provides that a qualified payment is:

a. "A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate."[557]

b. Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount."[558]

3. A common inflation-sensitive interest rate investment is a Treasury Inflation-Protected Security (TIPS). TIPS, unlike certain U.S. savings bonds, adjust for inflation by providing inflation adjustments to the underlying principal amount and keeping the yield fixed. For example, if a $100,000 TIPS is issued with a 4% yield, then $4,000 of interest will be paid in the first year. Assume inflation is 3% in the ensuing year. The TIPS adjusted principal amount will be $103,000 but the yield remains at 4%. As a result, the ensuing year's interest payment will be $4,120. TIPS are an example of a larger category of investments under the Code, called inflation-indexed debt instrument ("IIDI").[559] An IIDI is defined as a debt instrument that has the following features:[560]

a. It is issued for U.S. dollars and all payments are denominated in the same;

b. Except for a minimum guarantee,[561] each payment is indexed for inflation or deflation; and

---

[555] § 2701(c)(3)(A).

[556] § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

[557] Treas. Reg. § 25.2701-2(b)(6)(i)(A).

[558] Treas. Reg. § 25.2701-2(b)(6)(i)(B).

[559] *See* Treas. Reg. § 1.1275-7.

[560] Treas. Reg. § 1.1275-7(c)(1).

[561] An additional payment made at maturity if the total inflation-adjusted principal paid on the IIDI is less than the IIDI's stated principal amount. Treas. Reg. § 1.1275-7(c)(5).

c. No payments are subject to any contingencies other than inflation or deflation.[562]

4. Terms of the Qualified "Cost-of-Living" Preferred Interests

a. The partnership will provide a cumulative preferential right to partnership cash flow. Typically, this preferential right will be a percentage of a stated liquidation preference amount (for example, 6% of $5.45 million-the current Available Exclusion Amount). In this instance, the liquidation preference would be structured similarly to take into account future inflation or deflation as TIPS would be adjusted.

b. The preferred payment will accrue annually and will be cumulative to the extent payments are not made in any given year. The payment is accrued and payable regardless of partnership profits. As such, while it is normally paid from net cash flow of the partnership, the lack of net cash flow in any given year will not affect the total amount that is due.

c. The preferred payment will go into arrears for up to 4 years after the due date without interest being due on the unpaid preference. After the 4 year period, the unpaid payments will accrue interest at the specified preferred rate (for example, 6%).

d. The partnership agreement will provide that payments may be paid from available cash, first, and, at the discretion of the general partner, with in-kind distributions of partnership property.

e. Upon dissolution, the preferred interest will receive liquidating distributions equal to the liquidation preference amount ($5.45 million as adjusted for inflation) before any distributions are made to non-preferred interest holders.

f. The partnership agreement will provide the partnership the right to call the preferred interest at the liquidation preference amount upon the death of the preferred holder. This effectively freezes the value for transfer tax purposes at the liquidation preference amount and at the taxpayers Applicable Exclusion Amount.

5. Chapter 14 Implications

a. Valuation of the preferred interest in the Subtraction Method under section 2701, because it is a "qualified payment," will be according to regular gift tax rules. It is unclear, however, what standard should be used in valuing the preferred interest. Or, said another way, how does one determine the appropriate preferred annual payment to minimize the gift tax consequences, if any, under section 2701?

b. As discussed above, to be a "qualified payment" the preferred interest must generally provide for a cumulative and annual payment that is determined at a fixed rate. While certain "bells and whistles" must be ignored, no other requirements are set out in the Code or the Treasury Regulations.

---

[562] A qualified inflation index is any general price or wage index that is updated and published at least monthly by an agency of the U.S. Government. The Treasury Regulations specifically mentioned the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U). Treas. Reg. § 1.1275-7(c)(3).

6. Revenue Ruling 83-120

a. Many commentators[563] and the IRS in rulings[564] have asserted that the appropriate standard for valuing the preferred interest is under Revenue Ruling 83-120,[565] pertaining to preferred corporate stock. The Revenue Ruling provides a methodology for valuing preferred interests, based upon 3 primary factors:[566] yield, preferred payment coverage and protection of the liquidation preference.

(1) Yield of the preferred interest is compared with the dividend yield of "high-grade, publicly traded preferred stock." The required credit rating is not explicitly stated in the ruling. The ruling does point out, however, that "If the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock."[567]

(2) The ruling provides that "Coverage of the dividend is measured by the ratio of the sum of the pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends."[568] Obviously, in the partnership context, due to pass-thru taxation under Subchapter K, concerns about pre-tax earnings and after-tax dividends are not relevant. Coverage is further supported if the partnership agreement provides that the preferred payment can be satisfied from both cash flow of the partnership and distributions in-kind of partnership assets.

(3) Protection of the liquidation preference is determined by comparing the value of the partnerships assets (net of liabilities) to the liquidation preference amount. In other words, what is the ratio of preferred interests in comparison to non-preferred interests?

b. From a planning perspective, dividend (preferred payment) coverage and liquidation protection are within the control of the planner (whereas the yield on publicly-traded preferred stocks is determined by the vagaries of the market at the time of the purported transfer). In other words, if a FLP is being recapitalized into a qualified payment preferred FLP, then how much dividend coverage or liquidation protection is a function of the sizing between the preferred and common interests. For example, dividend coverage and liquidation protection would be quite different if AB partnership, which holds $10,000,000 of assets is structured, as follows: (i) A holding a 7% preferred on a $5,000,000 liquidation preference amount and B holding the common shares, and (ii) A holding a 7% preferred on a $9,000,000 liquidation preference amount and B holding the common shares. In the first instance, the effective yield

---

[563] *See, e.g.,* Milford B. Hatcher, Jr. and Edward M. Manigault, *Warming Up to the Freeze Partnership,* Estate & Personal Financial Planning (June 2000).

[564] *See, e.g.,* PLR 9324018.

[565] Rev. Rul. 83-120, 1983-2 C.B. 170.

[566] The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. Rev. Rul. 83-120, 1983-2 C.B. 170 at Sections 4.01, 4.05 and 4.06.

[567] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.02.

[568] Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.03.

that must be paid from the portfolio is 3.5% per year and there is 2:1 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference), and in the second instance, the effective yield is 6.3% and there is a 10:9 ratio of liquidation protection ($10,000,000 of assets to satisfy a $5,000,000 liquidation preference). In the latter instance, the value of the preferred interest would most likely be much less than the liquidation preference of $9,000,000 because the required yield from the partnership is considerably higher (less dividend coverage) and there is very little cushion of liquidation protection.

7. The yield on a qualified "cost-of-living" preferred interest will be less than the yield on a liquidation preference that is fixed, just as the yield on TIPS is less than the yield on bonds that are not inflation-adjusted. This difference is referred to as "breakeven inflation." Breakeven inflation is the difference between the nominal yield on a fixed rate investment and the "real yield" on an inflation-adjusted investment of similar maturity and credit quality.

8. Practitioners may want to consider including a provision in the partnership or membership agreement providing that upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), the liquidation distribution shall be satisfied, to the extent possible, with assets that are most appreciated at the time of death. Whether a section 754 election is in place or not, these assets should be received without any tax consequences and with a full step-up in basis.[569]

B. "Busted" Section 2701 Preferred Interests

1. A "busted" section 2701 preferred interest involves the creation of a preferred interest in a partnership or limited liability company that is not a "qualified payment" under section 2701(c)(3) and gifting the common interest in a manner that mandates the "zero valuation" rule under the "subtraction method." Typically, the preferred interest payment is non-cumulative.

2. For example, taxpayer owns an LLC that holds $5 million in assets. Taxpayer recapitalizes the LLC into preferred and common interests. The preferred interests have a $5 million liquidation preference and an 8% non-cumulative preferred annual payment ($400,000). The preferred holder has the right to put the preferred interest to the LLC at any time for the liquidation preference. The LLC has the right to liquidate the preferred interest for $5 million at the death of the preferred holder. The taxpayer gifts the common interests to an IDGT.

a. The preferred interest is not a "qualified payment" under section 2701(c)(3). As such, the value of the gifted common interest will be determined using the "subtraction method" described in the Treasury Regulations,[570] with the preferred interest (family-held senior equity[571] interest) being assigned a value of zero in step 2 of the subtraction method.

b. The value attributed (with the preferred interest having a zero value) to transferred common interest may be entitled to valuation discounts. The Treasury Regulations provide if the value of the transferred interest would have been determined (but for section 2701)

---

[569] *See* § 736(b).

[570] Treas. Reg. § 25.2701-3.

[571] Senior equity interest is "an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest." Treas. Reg. § 25.2701-3(a)(2)(ii).

with a "minority or similar discount," the amount of the gift is reduced by the excess of a "pro rata portion of the fair market value[572] of the family-held interests of the same class" over "the value of the transferred interest (without regard to section 2701)."[573] The Service has ruled that "minority or similar discount" includes a "discount for lack of marketability" with respect to the transferred interest (when the preferred interest was valued at zero).[574]

3. If, for the sake of simplicity, we assume in this example, the gift of the common is calculated to be exactly $5 million. Why would a taxpayer consider making this gift? The answer lies in the calculation of the estate tax upon the taxpayer's death. The tentative federal estate tax (before credits) is essentially computed against the sum of the decedent's taxable estate,[575] and the "amount of adjusted taxable gifts."[576] The Treasury Regulations provide that if an individual (referred to as the "initial transferor") makes a transfer subject to section 2701, "in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor's estate may reduce the amount on which the decedent's tentative tax is computed under section 2001(b)... by the amount of the reduction."[577]

a. Assuming there has been no subsequent transfer of the retained preferred interest, the amount of the reduction is the "amount by which the initial transferor's taxable gifts were increased as a result of the application of section 2701 to the initial transfer."[578]

b. In other words, in our simple example, the amount of the reduction is exactly $5 million (the increase of the gift of the common). However, because the non-cumulative preferred can be liquidated at $5 million, the amount includible is also $5 million. As such, these two amounts should cancel each other out.

c. The Treasury Regulations provide the following example that makes it clear that the reduction in adjusted taxable gifts is frozen in value:

> P, an individual, holds 1,500 shares of $1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of $100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding common stock of X.[579]
>
> P continues to hold the preferred stock until P's death. The chapter 11 value of the preferred stock at the date of P's death is the same as the fair market value of the preferred stock at the time of the initial transfer. In computing the Federal

---

[572] The Treasury Regulations provide, the value is "determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701." Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

[573] Treas. Reg. § 25.2701-3(b)(4)(ii).

[574] Tech. Adv. Mem. 9447004.

[575] § 2001(b)(1)(A).

[576] § 2001(b)(1)(B).

[577] Treas. Reg. § 25.2701-5(a)(3).

[578] Treas. Reg. § 25.2701-5(b)(2).

[579] Treas. Reg. § 25.2701-5(d)(1)(i).

estate tax with respect to P's estate, P's executor is entitled to a reduction of $1,500,000 under paragraph (a)(3) of this section.[580]

4. The benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not. If no preferred payment is received, all of the appreciation effectively passes to the common interests. The preferred interest is frozen in value with a reduction for estate tax purposes that essentially "zeroes-out" the estate tax liability attributable to the preferred.

5. The benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not. If no preferred payment is received, all of the appreciation effectively passes to the common interests. The preferred interest is frozen in value with a reduction for estate tax purposes that essentially "zeroes-out" the estate tax liability attributable to the preferred.

6. Practitioners may want to consider providing for a provision in the partnership or membership agreement that provides upon liquidation of the preferred holder's interest at death (equal to the liquidation preference), it shall be satisfied, to the extent possible, with assets that are most appreciated at the time of death. Whether a section 754 election is in place or not, these assets should be received without any tax consequences and with a full step-up in basis.[581]

V. PARTNERSHIP ELECTIONS

A. Section 754 Election

1. There is significant discussion of the Section 754 election earlier in the outline. In particular, practitioners should be aware of the economic and practical implications of the election and the corresponding inside basis adjustments under Sections 734 and 743. It seems clear that to take full advantage of the flexibility that partnerships can provide from a tax planning standpoint, a section 754 election is necessary (particularly when distributing assets in-kind). However, the record-keeping requirements on an ongoing basis can be quite burdensome.

2. To reduce such burden, practitioners might consider using the partnership division rules to isolate the partnership assets that would be the subject of the planning and thereby limiting the assets over which the section 754 election would be applicable.

3. Practitioners should also consider the use of the election under Section 732(d), which might provide some of the same inside basis adjustments under the right circumstances, but without the requirement of a Section 754 election.

---

[580] Treas. Reg. § 25.2701-5(d)(3), Ex. 2.

[581] *See* § 736(b).

B. Section 704(c) Election

1. A full discussion of section 704(c) is beyond the scope of this outline, but estate planners should be aware of certain elections under section 704(c) that can be used under the correct circumstances that could shift income tax liabilities among different taxpayers.[582]

2. When a partner contributes property to a partnership that has a fair market value different (more or less) than its tax basis, section 704(c)(1)(A) ensures that the inherent tax characteristics associated with such difference will ultimately be allocated to the contributing partner. Upon contribution, the contributing partner's capital account is credited with an amount equal to the fair market value of the property, and when the contributed property is sold by the partnership, any inherent gain or loss (as calculated at the time of contribution) will be allocated to the contributing partner.[583] In that manner, section 704(c) ensures that the inherent gain or loss is not allocated to the non-contributing partners. As the Treasury Regulations provide, "The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution."[584]

3. When the contributed property is depreciable property (e.g., commercial real estate or equipment), section 704(c) attempts to put the non-contributing partners in the same position they would be if the depreciable property had been contributed when the tax basis was equal to the fair market value.

a. By way of example, partner A contributes depreciable property worth $1,000,000 and with a tax basis equal to $400,000. Assume, the property has a remaining depreciable life of 5 years. Partner B contributes $1,000,000 of cash. Partner A and B are equal 50% partners.

(1) For book purposes, the depreciable property is depreciated over the remaining 5 years based on the $1,000,000 book value. Assuming straight line depreciation that would be $200,000 per year.[585] For tax purposes, because the property only has $400,000 of tax basis, the partnership only has $80,000 of depreciation per year.

(2) Absent section 704(c), A and B would be allocated $40,000 each of depreciation per year. This would be $60,000 less depreciation than B would have been allocated had the property actually had a tax basis of $1 million (as assumed for book purposes). Said another way, for the same equal contribution to become an equal partner, B will have

---

[582] For an excellent article on using section 704(c) allocation in the family partnership context, see Thomas N. Lawson, *Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs*, 9 Est. Plan. No. 8, pg. 12 (Aug. 2009).

[583] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

[584] Treas. Reg. § 1.704-3(a)(1).

[585] Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) provides that book depreciation must bear the same relationship to book value that tax depreciation bears to adjusted tax basis. If adjusted tax basis is zero, book depreciation can be any reasonable method.

$60,000 more taxable income per year. In theory, A is effectively shifting taxable income to B because A has already enjoyed more of the depreciation previously.

(3) Section 704(c) attempts to cure this anomaly. The Treasury Regulations provide, "For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners."[586] As such, all of the tax depreciation must be allocated to B until B has received tax depreciation equal to his share of the book depreciation. In other words, all $80,000 of depreciation will be allocated to B each year.[587] As a result, A has more taxable income and is effectively "recapturing" the depreciation taken prior to the contribution.

(4) This method of allocation is sometimes referred to as the "traditional method."

b. As a result, in the family context, when dealing with depreciable property, under the "traditional method," section 704(c) serves to disproportionately allocate depreciation deductions to the non-contributing partner. Thus, families could form a partnership and use the traditional method of allocations under section 704(c) to their advantage particularly if the non-contributing partner is:

(1) A high income taxpayer (including a non-grantor taxable trust),

(2) Holding property that has basis and that is not depreciable (e.g., cash or marketable securities); or

(3) Has an investment that generates significant passive income each year.

4. You will note, in the previous example, B will be allocated $80,000 of tax depreciation per year, not the $100,000 that B would have received if the depreciable property had a tax basis of $1 million at the time of the contribution. Over the remaining 5 years, B will be allocated, in aggregate, $400,000 of depreciation deductions (which is $100,000 less than the $500,000 B would have received if the property had $1 million of tax basis). This result is due to what is referred to as the "ceiling rule."[588] The ceiling rule mandates that the partnership cannot allocate more depreciation than it actually has for tax purposes. The Treasury Regulations provide that partnerships can override the effect of the ceiling rule by making "curative" allocations or, alternatively, "remedial" allocations, as discussed in more detail below.

---

[586] Treas. Reg. § 1.704-1(b)(1).

[587] *See* Treas. Reg. § 1.704-3(b)(2), Ex. 1.

[588] Treas. Reg. § 1.704-3(a)(1). "The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule)."

5. A partnership may elect to make "reasonable" [589] curative allocations to correct distortions created by the ceiling rule. This is often referred to as the "traditional method with curative allocations."

a. Pursuant to this election, the partnership may allocate other tax items (not related to the contributed property) of income, gain, or deduction.[590] Thus, because B in the traditional method above will be allocated $20,000 less depreciation each year, if the partnership has other depreciable property, it could allocate $20,000 of other depreciation to B.

b. Alternatively, if the partnership does not have other depreciable property, it could allocate $20,000 of ordinary income to A, which has the same effect as an allocation of depreciation to B.[591]

c. Note, however, in the family context, whether an allocation of depreciation to B or ordinary income to A is economically holistically better to the family is dependent upon their individual circumstances of the taxpayers. What if A has significant net operating losses? What if B is a non-grantor trust subject to very high state income taxes?

d. There is no requirement that curative allocations must offset the entire distortion created by the ceiling rule, and curative allocations can be limited to taking depreciation from a specific set of assets or to specific items of income.[592]

e. Generally, curative allocations must be made over the remaining depreciation life of the asset, [593] but if the remaining depreciation life is very short in comparison to its actual economic life, under certain circumstances, the IRS could invoke the anti-abuse rule and invalidate the curative allocation.

6. The Treasury Regulations allow a third allocation method, often referred to as the "remedial allocation."[594]

a. Unlike curative allocations which are made from actual partnership tax items, remedial allocations involve the creation of notional tax items by the partnership (not dependent upon the actual tax items recognized by the partnership).[595] Furthermore, unlike curative allocations, remedial allocations must fully offset the disparity created by the ceiling rule.[596]

b. Under the remedial allocation method, if the ceiling rule results in a book allocation to a non-contributing partner different from the corresponding tax allocation, the partnership makes a remedial allocation of tax items to the non-contributing partner equal to the

---

[589] *See* Treas. Reg. § 1.704-3(c)(3).

[590] Treas. Reg. § 1.704-3(c)(1).

[591] *Id.*

[592] Treas. Reg. § 1.704-3(c)(1).

[593] *See* Treas. Reg. § 1.704-3(c)(4), Ex. 2.

[594] *See* Treas. Reg. § 1.704-3(d).

[595] *See* Treas. Reg. § 1.704-3(d)(4).

[596] Treas. Reg. § 1.704-3(d).

full amount of the limitation caused by the ceiling rule, and a simultaneous, offsetting remedial allocation of tax items to the contributing partner.[597]

c. From the partner's standpoint, remedial allocations have the same effect as other tax items actually recognized by the partnership from both a tax liability and outside basis standpoint.[598]

d. Unlike curative allocation, when it comes to depreciable property, the time period is different for remedial allocations. As discussed above, curative allocations are generally made over the remaining depreciable life of the property.[599] Under the remedial allocation method, a partnership must bifurcate its book basis in the contributed property for purposes of calculating depreciation.

e. The portion of book basis in the property equal to the tax basis in the property at the time of contribution is recovered generally over the property's remaining depreciable life of the property (under section 168(i)(7) or other applicable part of the Code).[600] With respect to the portion of the book value (fair market value at the time of contribution) in excess of the tax basis (the partnership's remaining book basis in the property), it is recovered using any applicable recovery period and depreciation (or other cost recovery) method, including first-year conventions, available to the partnership as if newly purchased property of the same type as the contributed property that is placed in service at the time of contribution.[601] As discussed above, for residential real property that would generally be 27.5 years. However, for certain types of qualified property (e.g., certain leasehold improvements), it could mean 50% bonus depreciation under section 168(k) in the first year.[602]

7. Generally, curative allocations will be more desirable than remedial allocations for families because curative allocations will be taken over the life of the remaining depreciable life of the contributed property. Furthermore, curative allocations do not have to fully negate the disparity in the ceiling rule. As such, families have the flexibility to tailor the use of curative allocations to the tax situation of the partners.

8. Anti-Abuse Rule for Allocation Methods

a. Echoing the general anti-abuse provisions discussed above, the Treasury Regulations provide that any "allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability."[603] It

---

[597] Treas. Reg. § 1.704-3(d)(1).

[598] Treas. Reg. § 1.704-3(d)(4)(ii).

[599] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).

[600] Treas. Reg. § 1.704-3(d)(2).

[601] *Id.*

[602] This provision currently requires extension each year and was recently extended by the Tax Increase Prevention Act of 2014, P.L. 113-295 (December 19, 2014) to include certain property placed in service through 2014.

[603] Treas. Reg. § 1.704-3(a)(10)(i).

also provides that any reference to partners above includes both "direct and indirect" partners, and an "indirect partner" is "any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation ... or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership."[604]

b. Example 3 in the Treasury Regulations describes a situation where the contributed property only has one year remaining in its depreciable life (although the economic life is 10 years) and the contributing partner has an expiring net operating loss.[605] The proposed curative allocation is to offset the entire disparity between book value and tax basis in the first year. The example concludes that the curative allocation is unreasonable because income would be allocated to a partner with a low marginal tax rate from a partner with a high marginal tax rate "within a period of time significantly shorter than the economic life of the property." However, the example goes on, if the partnership makes curative allocations over the economic life of the property (10 years) then the allocation would be deemed reasonable.[606]

c. It should be noted that the anti-abuse rules do not necessarily apply for state income tax purposes (although most state income tax regimes are tied to the Federal tax liability). When the anti-abuse rules refer to the present value of aggregate tax liability, it refers only to the Federal income tax. Therefore, there are likely allocations that would not result in any Federal income tax savings that would be deemed reasonable, but could result in significant state income tax savings (e.g., partners in high and low income tax states).

9. The Treasury Regulations do not require a particular election to apply curative or remedial allocations. However, the partnership agreement needs to reflect the allocation chosen by the partnership.

VI. PLANNING WITH DISREGARDED ENTITIES

A. Generally

1. A "disregarded entity" has come to mean an entity that is ignored for Federal income tax purposes (but is legally recognized for other purposes as a separate entity for state law purposes).[607] As the Treasury Regulations provide, "if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner." [608] Effectively, the entity is "disregarded as an entity separate from its owner if it has a single owner," [609] and this applies for "federal tax purposes."[610]Generally, there are three types of entities that are considered "disregarded" for tax purposes: (a) single-owner entities (like wholly-

---

[604] Treas. Reg. § 1.704-3(a)(10)(ii).

[605] Treas. Reg. § 1.704-3(c)(4), Ex. 3.

[606] *See also* Treas. Reg. § 1.704-3(b)(2), Ex. 2 for an example of an unreasonable use of the traditional method involving the contribution of property having on year of remaining depreciable life.

[607] Generally, a business entity that is not classified as a corporation (eligible entity), that has a single owner, and that has not elected to be taxed as an association taxed as a corporation. See Treas. Reg. § 301.7701-3(a) and -3(b)(1)(ii).

[608] Treas. Reg. § 301.7701-2(a).

[609] Treas. Reg. § 301.7701-3(b)(1)(ii).

[610] Treas. Reg. §§ 301.7701-1(a) and -2(c)(2).

owned LLCs) that have not elected corporate treatment, (b) qualified subchapter S corporation subsidiaries, and (b) qualified real estate investment trust subsidiaries. For purposes of these materials, only LLCs are discussed.

2. Despite the single owner requirement, the IRS has ruled that if an entity is wholly owned by two spouses as community property, it will nevertheless be considered a disregarded entity, provided the spouses report the entity as such.[611] The ruling does not require that the parties file a joint return. It further provides that a change in reporting position (presumably by either spouse) will be treated as a conversion of the entity (e.g., to a partnership). The ruling provides that the business entity must be "wholly owned" by the spouses as community property and "no person other than one or both spouses would be considered an owner for federal tax purposes."[612]

3. Further, the IRS has ruled that a state law partnership formed between an entity disregarded under the elective classification (wholly owned LLC of a corporation) regime and its owner (the corporation) is itself disregarded because it only has one owner for tax purposes.[613]

B. Are Grantor Trusts Disregarded Entities?

1. While many practitioners believe a grantor trust (grantor trust as to both the income and the corpus and over the entire trust[614]) is treated like a disregarded entity, the law is not clear.[615] In *Rothstein v. Commissioner*,[616] the taxpayer purchased property from his grantor trust with an installment note. The taxpayer then resold the property to a third party, computing the resulting gain using a cost basis arising from the original purchase from the grantor trust. While the IRS argued that the trust should be treated as a disregarded entity, the court held for the taxpayer. In coming to its conclusion, the court interpreted the phrase "shall be treated as the owner of the trust assets"[617] as applying only for purposes of including the trust's income and deductions.

2. Echoing the *Rothstein* ruling, Professor Jeffrey N. Pennell writes, as to grantor trusts being disregarded for tax purposes:[618]

> The Code and Regs, however, are not entirely consistent with that treatment. Instead, every grantor trust rule (§§673-677) begins by saying "The grantor shall be treated as the owner of any portion of a trust . . . ." The significance of this is found in §671:

---

[611] Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

[612] *Id.*

[613] Rev. Rul. 2004-77, 2004-31 I.R.B. 119.

[614] See Treas. Reg. § 1.671-3.

[615] *See* Mark L. Asher, *When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction*, 41 Tax. L. Rev. 253 (1986).

[616] 735 F.2d 704 (2nd Cir. 1984).

[617] § 671.

[618] *Jeffrey N. Pennell*, (Mis)Conceptions about Grantor Trusts, 50th Annual Southern Federal Tax Institute, Outline V, p. 1-2 (Oct. 2015).

> Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.

Notice that this does not mention losses, which are considered along with gains only in determining the trust's income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored...

In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor's income tax return, as if the trust's income (which includes net gain in excess of any offsetting losses), deductions, and credits belonged to the grantor.

The actual treatment, however, is as if the trust's DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in §642(h) ... And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending upon application of the portion rules.

As a result, the conclusion articulated by various authorities that the trust is "ignored" is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust, based on the government's ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust — that an exchange between the grantor and the trust is not a gain or loss realization event

3. Notwithstanding the foregoing, the IRS has ruled in Revenue Ruling 85-13,[619] on facts similar to *Rothstein*, that the taxpayer in question did not obtain cost basis when he purchased the assets from the grantor trust. Specifically, the ruling provides:[620]

> In Rothstein, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period

[619] Rev. Rul. 85-13, 1985-1 C.B. 184.

[620] *Id. See also* Rev. Rul. 88-103, 1988-2 C.B. 304 and PLR 8729023 (grantor and grantor trust will be treated as a single taxpayer for purposes of qualifying for involuntary conversion treatment under section 1033 of the Code), and Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (a taxpayer may exchange interests in a grantor trust—a Delaware statutory trust—for real property and qualify for like-kind treatment under section 1031 of the Code). *But see* Rev. Rul. 2004-88, 2004-32 I.R.B. 165 (disregarded entity will be treated as an entity separate from its owner for purposes of the TEFRA unified audit rules), Treas. Reg. § 1.001-2(c), Ex. 5 (if a grantor trust holds a partnership interest and the trust ceases to be a grantor trust, then it is treated as a disposition of the partnership interest, and Prop. Treas. Reg. § 1.108-9(c)(1), (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent)

the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.

The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.

4. Consistent with Revenue Ruling 85-13, the IRS has ruled that an LLC created by the taxpayer and the taxpayer's grantor trust will be treated as a disregarded entity because the LLC is deemed to have only one taxpayer-owner.[621]

5. For purposes of this outline and the discussion herein, the government's position under Revenue Ruling 85-13 (grantor trusts are ignored for income tax purposes) is assumed to be correct. In reality, the vast majority of practitioners treat grantor trusts as disregarded entities for all income tax purpose, having all tax items (including losses) reported by the grantor and ignoring all transactions between the grantor and his or her grantor trust. As such, it is assumed if all interests in an LLC are owned by a grantor and grantor trusts, the LLC is treated, at least for Federal income tax purposes, as a disregarded entity.

C. May Discounts Be Used When Valuing Interests in Disregarded Entities?

1. The critical issue for estate planning purposes is whether valuation discounts must be disregarded when valuing transfers (gifts, bequests, sales, and exchanges) of interests in disregarded entities to and among the grantor and grantor trusts. Does the "willing buyer/willing seller" standard[622] apply to transfers of interests in disregarded entities? In other words, just as transfers between a grantor and grantor trust are ignored for Federal income tax purposes, are they also ignored for Federal transfer tax purposes?

2. In *Pierre v. Commissioner*,[623] the Tax Court held the transfers of interests in a disregarded entity should be valued for gift tax purposes as transfers of interests in the entity, rather than transfers of the underlying assets of the entity. The Tax Court pointed out, "[s]tate law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." As such, the transferred interests in the disregarded entity would qualify for marketability and minority interest discounts. In the case at issue, however, the court

---

[621] PLR 200102037.

[622] *See generally* Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 and Rev. Rul. 59-60, 1959-1 C.B. 237.

[623] *Pierre v Commissioner*, 133 T.C. 24 (2009).

concluded that the step transaction applied, in part, because the entity was funded (cash and marketable securities) by the taxpayer less than two weeks prior to the transfers of the entity interests. The taxpayer transferred her entire interest in the wholly-owned LLC to two trusts (9.5% gift and 40.5% sale to each trust).

3. Importantly, the Tax Court in *Pierre* wrote:[624]

> While we accept that the check-the-box regulations govern how a *single-member LLC* will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond *classifying* the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (i.e., how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (i.e., whether an LLC should be taxed as a separate entity or disregarded so that the tax on its operations is borne by its owner). To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be "manifestly incompatible" with the Federal estate and gift tax statutes as interpreted by the Supreme Court.

4. In other cases, courts have generally supported the position that transfers of interests in disregarded entities are entitled to valuation discounts based on the rights of the transferee under applicable state law and under the LLC operating agreement.[625]

D. Conversion of Disregarded Entity to Partnership

1. Given that grantor trust status must necessarily terminate with the death of the grantor, all disregarded entities owned by a grantor and one or more grantor trusts will be converted to another type of entity upon the death of the grantor (unless, in theory, the grantor's interest is transferred to the trust and the trust is the only other member of the LLC). It is important then to understand the tax consequences of the conversion of the disregarded entity to (most likely) a partnership.

2. In Revenue Ruling 99-5,[626] the IRS provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. The ruling addresses 2

---

[624] *Id.*

[625] *See e.g., Estate of Mirowski v. Commissioner*, 95 T.C. Memo 2008-74 (Mar. 26, 2008). *But see Pope & Talbot Inc., et al. v. Commissioner*, 105 T.C. 574 (1995) (The court ignored the existence of a newly created partnership in valuing the tax paid upon a distribution of the interests to its shareholders under section 311 of the Code).

[626] Rev. Rul. 99-5, 1999-6 I.R.B. 8.

situations with respect to a wholly-owned LLC that is disregarded for tax purposes and that is initially owned by a single member A. The ruling assumes that the LLC has no liabilities, the assets are not subject to any indebtedness, and all of the assets are capital assets or property described in section 1231 of the Code.

a. In situation 1, B purchases 50% of A's ownership in the LLC for $5,000. The ruling concludes that the LLC is converted to a partnership when B purchases the interest in the LLC from A. The purchase of the LLC interest is treated for tax purposes as if B purchased 50% of each of the LLC's assets (which are, in turn, treated as if held by A for tax purposes). Immediately thereafter, A and B are deemed to contribute their respective interests in those assets to a newly formed partnership. Under such treatment, the ruling further provides:

(1) Member A recognizes gain or loss on the deemed sale under section 1001 of the Code. However, there is no further gain or loss under section 721(a) of the Code for the contribution of asset to the partnership in exchange for partnership interests in the newly formed entity.

(2) Under section 722 of the Code, B's outside basis in the partnership is $5,000, and A's outside basis is equal to A's basis in A's 50% share of the assets in the LLC. Under section 723 of the Code, the partnership's tax basis in the assets is the adjusted basis of the property in A and B's hands immediately after the deemed sale.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes his or her holding period in the assets held by the LLC, and B's holding period for the partnership interests begins on the day following the date of B's purchase of the LLC interest from A.[627] Under section 1223(2) of the Code, the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

b. In situation 2, B contributes $10,000 in the LLC for a 50% ownership interest in the LLC. In this instance, as in the previous situation, the ruling concludes that the LLC is converted to a partnership when B contributes the cash to the LLC in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to a newly formed partnership. Under such treatment and facts, the ruling provides:

(1) There is no gain or loss to A or B under section 721(a) of the Code.

(2) Under section 722 of the Code, B's outside basis is equal to $10,000, and A's outside basis is his or her basis in the assets of the LLC which A is treated as contributing to the new partnership. Under section 723 of the Code, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A 's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.

(3) Under section 1223(1) of the Code, A 's holding period for the partnership interest includes A 's holding period in the LLC assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section

[627] The ruling cites Rev. Rul. 66-7, 1966-1 C.B. 188.

1223(2), the partnership's holding period for the assets transferred to it includes A 's holding period.

3. Unfortunately, the foregoing ruling does not address (i) non-taxable transactions like sales or exchanges of a disregarded entity interests between a grantor and his or her grantor trust (situation 1 is a taxable sale) or (ii) contributions of assets to a disregarded entity by a grantor or grantor trust. Under those circumstances, how should the tax basis be allocated among the grantor and the grantor trust? It seems that given the IRS's position in Revenue Ruling 85-13 that grantor trusts are "ignored" or also disregarded, that the unitary basis rules would apply in such a way that if B was a grantor trust in the situations described in Revenue Ruling 99-5, B's outside would not be $5,000/$10,000 respectively. Rather, the aggregate basis of A (the grantor) and B (the grantor trust) would be allocated pursuant to the unitary basis rules, as discussed in more detail above (essentially B would receive a portion of A's basis in the transferred asset).

4. Further, the ruling does not address the conversion of a disregarded entity to a partnership when grantor trust status is lost and the trust holds only a portion of the entities interest.

E. Conversion of Partnership to Disregarded Entity

1. In Revenue Ruling 99-6,[628] the IRS provided guidance on the tax issues involved in a conversion of partnership to a disregarded entity. The ruling addresses 2 situations with respect to an LLC that is classified as a partnership but becomes a disregarded entity when a transaction consolidates all of the ownership with a single member. The ruling provides that the LLC has no liabilities, and the assets are not subject to any indebtedness.

a. In situation 1, A and B are equal partners in an LLC taxed as a partnership. A sell's his or her entire interest in the LLC to B for $10,000. The ruling concludes the partnership terminates under section 708(b)(1)(A) when B purchases A's entire interest. A must treat the transaction as a sale of A's partnership interests, and with respect to the treatment of B, there is a deemed liquidating distribution of all of the assets to A and B, followed by B treated as acquiring the assets deemed to have been distributed to A in liquidation of A's interests. Under such treatment:

(1) A has gain or loss resulting from the sale of the partnership interest under section 741 of the Code. As discussed above, section 741 of the Code provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in section 751 of Code (relating to "hot assets," unrealized receivables and inventory items).

(2) B's basis in the assets attributable to A's one-half interest in the partnership is $10,000 under section 1012 of the Code. B does not get to retain the holding period of the partnership on such assets deemed liquidated and distributed to A under section 735(b) of the Code. Rather, these are newly acquired assets, and B's holding period for these assets begins on the day immediately following the date of the sale.

---

[628] Rev. Rul. 99-6, 1999-6 I.R.B. 6.

(3) With respect to B's portion of the deemed liquidation, B will recognize gain or loss (if any) under section 731(a) of the Code (generally, no gain or loss except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, assuming there are no "hot assets" in the partnership). B's basis in the assets received in the deemed liquidation of B's interest is determined under section 732(b) of the Code (generally, the adjusted basis of B's interest in the partnership, reduced by any money distributed in the same transaction). Under section 735(b) of the Code, B's holding period for the assets includes the partnership's holding period for such assets.[629]

b. In situation 2, C and D are equal partners in an LLC taxed as a partnership. C and D sell their entire interests in the LLC to E, an unrelated person, for $20,000 ($10,000 each). As under the previous situation, the ruling concludes the partnership terminates under section 708(b)(1)(A) when E purchases all of the LLC interests. C and D must treat the transaction as a sale of their respective partnership interests, and with respect to E, there is a deemed liquidating distribution of all of the assets to C and D, followed by E treated as acquiring all of the former assets of the partnership from C and D.

(1) C and D have gain or loss under section 741 of the Code.

(2) E's basis in the assets in the partnership is $20,000 under section 1012 of the Code, and E's holding period begins on the day immediately following the date of the sale.

2. In typical estate planning transactions, a conversion from a partnership to a disregarded entity could occur in a taxable transaction (e.g., sale of a partnership interest from a non-grantor trust to another partner) or in a non-taxable transfer (e.g., the distribution of a partnership interest from a non-grantor trust to a beneficiary that is the only other partner or in a gratuitous transfer of the partnership interest (subject to gift or estate tax) to the only other partner. Presumably, the Revenue Ruling 99-6 would apply to the taxable transactions, but it's unclear how they might apply to the non-taxable transactions.

F. Disregarded Entities: Subchapter K and Capital Accounts

1. One of the practical benefits of utilizing disregarded entities with grantor trusts is that the income tax consequences of every transaction (transfers of partnership interests, contributions of capital, distributions, etc.) can be essentially ignored until there is a conversion event, whether that occurs because of the death of the grantor, relinquishing grantor trust status, or admitting a partner that is not the grantor for tax purposes. As long as 100% of the ownership interest is held by the grantor or grantor trusts, there are no complications relating to the allocation of built-in gains and losses under section 704(c) of the Code (or "reverse 704(c)" due to the admission of new partners), no recognition events due to the sale or exchange of a partnership interest, and no need to account for inside or outside basis.

2. Even if a partner has more than one interest in a partnership (held individually or through grantor trusts, presumably) that partner is deemed to have a single capital account. Maintaining capital accounts only becomes important when the disregarded entity is converted to a partnership or if there is a liquidation of the disregarded entity among the members. Keep in

[629] Except for inventory items. *See* §735(a)(2).

mind, the safe harbor Treasury Regulations provide that an allocation will have "economic effect" if, in part, the partnership maintains capital accounts under the Treasury Regulations,[630] and the partnership makes liquidating distributions in accordance with the partners' positive capital account balances.[631]

3. The Treasury Regulations provide that upon a transfer of all or a part of a partnership interest, the transferor's capital account "that is attributable to the transferred interest carries over to the transferee partner."[632] The Treasury Regulations contain a simple example[633] pursuant to which a partner sells half of the partner's interest in a general partnership (representing a 25% interest in the partnership) for $10,000. At the time of the transfer, the general partnership held $40,000 in cash and securities, and the transferring partner's capital account prior to the transfer was $11,000. The example provides, in accordance with the Treasury Regulations "the partnership agreement provides" the transferee "inherits 50 percent of"[634] the transferor's capital account balance. Thus, the transferee inherits a capital account of $5,500. In other words, the Treasury Regulations seem to take the position that the portion of the transferor's capital account that carries over to the transferee equals the percentage of the transferor's total interest that is sold. This is straightforward and logical when dealing with pro rata, single class partnership and with transfers that do not reflect valuation discounts. However, it is not as straightforward when one is dealing with different classes of partnership interests (preferred and common, by way of example), and the methodology set out above is not how tax basis is allocated.

4. As discussed above, in Revenue Ruling 84-53,[635] the IRS ruled in the context of calculating outside basis of a transferred partnership interest, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."[636]

5. As discussed in more detail above, each partner is deemed to have a single unitary basis for all interests held in a partnership. Similarly, each partner has a single capital account for all interests in the same partnership. The Treasury Regulations provide, "a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired." [637] If the methodology set forth in Revenue Ruling 84-53 would also apply to calculating capital accounts of transferred partnership interests, then some unusual capital account distortions would occur.

---

[630] Treas. Reg. § 1.704-1(b)(2)(iv).

[631] Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

[632] Treas. Reg. § 1.704-1(b)(2)(iv)(l).

[633] Treas. Reg. § 1.704-1(b)(5), Ex. 13.

[634] *Id.*

[635] Rev. Rul. 84-53, 1984-1 C.B. 159.

[636] *Id.* The ruling relies Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

[637] Treas. Reg. § 1.704-1(b)(2)(iv)(b).

6. If the fair market value of the transferred portion (in relation to the entire interest) is the appropriate formula, then the "willing buyer/willing seller" value used for transfer tax purposes would seem to be the appropriate value in calculating the transferred capital account. If that is the case, consider the following scenarios:

a. A owns a partnership interest, and has a capital account of 100. A gifts 30% of A's interest to a B. Assume, (i) the gift tax value of the 30% that A transferred is $20 (representing a 1/3 valuation discount); and (ii) A's entire interest before the transfer had a fair market value of $90 (10% discount for lack of marketability). Rev. Rul. 84-53 would seem to say, after the transfer, B's capital account is $22.22 ($20/$90x$100), and A's capital account is $77.78, even though B owns 30% of the partnership (the ruling compares the value transferred against the total value prior to the transfer). What if the partnership agreement allocates distributive share of profits according to capital accounts? Does that mean B only gets 22.22% of the profits moving forward and upon liquidation, presumably less than 30% of the partnership assets?

b. Same as above but, A gifts A's entire interest simultaneously to 4 transferees, 30% each to B, C, and D, 10% to E. Assume, the transfers all carried a 1/3 valuation discount each. Because the transfer is simultaneous and all of them have the same valuation discount, doesn't that mean B, C, D, and E a percentage of A's total capital account (30% each to B, C, and D, and 10% to E)? If the discounted values are strictly used against each transfer, then a portion of A's original capital account would not carry over to the transferees and would theoretically disappear (creating a capital shift to other partners).

7. In the disregarded entity context, consider the following related scenarios:

a. What if in the first scenario (A transfers to B a 30% interest), B is a grantor trust as to A, and the entity in question is initially a wholly owned LLC taxed as a disregarded entity. The "unitary" capital account rule would seem to imply that A, after the transfer, continues to have a capital account of 100, in some way allocated among A and B (the grantor trust, which owns 30%). After the transfer, B becomes a non-grantor trust. The IRS has taken the position that when grantor trust status is lost, it will be treated as if the grantor transferred the interest to the trust at that time. If that is the case, is the value of the deemed transfer at that time used to determine how capital account will now be allocated between A and B? Alternatively, does one follow Revenue Ruling 99-5 as a conversion from a disregarded entity to a partnership (the deemed transfer) which would treat B as having purchased 30% of the LLC's assets and then contributed them to the new partnership? Do you end up in the same place because the "purchase" price would be deemed to be a discounted value?

b. What if one is dealing with a wholly-owned LLC of A that is recapitalized into preferred and common shares? A transfers/gifts the preferred and common in separate transactions or simultaneously? What values does one use to allocate capital account? Certainly, Chapter 14 value under section 2701 of the Code can't be the answer because what if the preferred shares are deemed to have a zero value under section 2701 of the Code because they do not fall under the qualified payment interest exception? Does that mean the common shares get 100% of the capital account? What if the common is retained and the preferred is transferred under a reverse freeze (junior equity exception)?

8. Thus, due to the unusual results caused by using fair market value Revenue Ruling 84-53, the appropriate answer seems to be that capital accounts should be allocated according to a hypothetical liquidation after each transfer. This would be similar to an approach

that some partnerships employ called targeted allocations. Targeted allocations assume a hypothetical liquidation at the end of each accounting period where it is determined what each partner would receive if all of the partnership assets are sold for cash as each asset is valued under section 704(b) of the Code. The hypothetical cash proceeds are distributed in liquidation of the partnership under the distribution provisions of the partnership agreement. Once that amount is determined, each partner is allocated section 704(b) profits and losses so that the partner's capital account balance at the end of the period is equal to the amount of cash the partner would have received in the hypothetical liquidation. The IRS has not formally blessed targeted capital account allocations as qualifying under the economic effect equivalence rule.[638] Notwithstanding, this type of approach would solve many of the capital account distortions described above, but no direct guidance seems to exist on this issue.

G. Planning Opportunities with Disregarded Entities[639]

1. Inherent Leverage with No Income Tax Consequences

a. Because transfers of less than 100% of a disregarded entity to a grantor trust (another disregarded entity) will likely carry valuation discounts (see the discussion above), but liquidations must occur according to positive capital accounts, there is inherent wealth transfer leverage in any zeroed-out transfer to an IDGT or GRAT (if and when the disregarded entity or converted entity is finally liquidated). This assumes that the contribution or transfer to the trust carries a valuation discount, but the liquidation will occur on basis that does not include the discount. It further assumes the transfer and the ultimate liquidation is not subject to recharacterization under the economic substance doctrine under section 7701(o) of the Code or non-statutory doctrines like substance-over-form, step-transaction, or sham-transaction.

b. While grantor trust status is retained, the grantor will continue to be treated as if the grantor owned all of the assets for income tax purposes. This allows the assets in the IDGT or GRAT to grow without the burden of paying income tax, which is borne by the grantor. If the grantor also has a power to exchange assets of equivalent value under section 675(4)(C) of the Code, assets that carry a valuation discount can be exchanged to further increase the wealth transfer. For example, if the IDGT directly holds assets that have been liquidated from a disregarded entity, then those assets could be reacquired with shares in another disregarded entity but the value of which carries a discount. All of these transactions can be consummated without recognizing any gain or loss.

2. Disregarded Entities and S Corporations

a. S corporations cannot have more than one class of stock, which generally requires that all of the outstanding stock must have identical rights to distributions and

---

[638] *See* Treas. Reg. § 1.704-1(b)(2)(ii)*(i)* and Proposed Treasury Regulations under section 707(a)(2)(A) of the Code, REG-11452-14, 80 Fed. Reg. 43,652 (July 23, 2015). The preamble requests comments on the impact of targeted allocations on certain allocations but then provides "[n]o inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule."

[639] *See* Richard A. Oshins and David A. Handler, *Estate Planning with Disregarded Entities*, presented at the Society of Trust and Estates Practitioners Institute on Tax Estate Planning and the Economy (Jan. 2014) for an excellent discussion of the topic and additional planning opportunities including using a disregarded entity with a residence in lieu of a qualified personal residence trust and a tiered LLC strategy to maximize the leverage of an installment sale.

liquidation proceeds, but the S corporation may have voting and non-voting shares.[640] In addition, partnerships are not eligible S corporation shareholders.[641] Because of the single class of stock requirement, S corporation shareholders are not able bifurcate their economic interests into preferred and common interests and effectuate transactions similar to a preferred partnership freeze or reverse freeze.

b. S corporation shareholders may be able to create preferred and commons interests through a disregarded entity. Pursuant to this idea, S corporation shareholder would create a wholly-owned LLC that is treated as a disregarded entity and contribute his or her S corporation shares to the entity. The disregarded entity would then recapitalize its shares into preferred and common shares, thereby allowing the taxpayer to do a forward or reverse freeze transaction with his or her IDGT. While the taxpayer is alive and the trust remains a grantor trust, the individual taxpayer should continue to be deemed the eligible S corporation shareholder.[642] The IRS has ruled that an S corporation may be owned by a partnership or a limited liability company (or a combination of them) as long as the partnership and limited liability company are disregarded for income tax purposes.[643] If the disregarded entity is liquidated during the life of the grantor, then the S corporation shares will be distributed among the grantor and the trust, which will either remain a grantor trust or become either an electing small business trust[644] or a qualified subchapter S trust.[645]

3. If, however, the grantor dies prior to the liquidation of the disregarded entity, then an issue arises as to whether the entity will be deemed to have converted to a partnership (as an entity owned by a non-grantor trust and the estate of the taxpayer), thereby terminating the S corporation status of the corporation. This termination might be avoided, as follows:

a. If the operating agreement of the disregarded entity requires an immediate termination and liquidation upon the death of the grantor, then the LLC would, in theory, cease to exist and the assets (the S corporation shares) would immediately be divided among the estate of the decedent and the trust (that must also qualify as an ESBT or QSST).[646] In most forward freeze transactions, the grantor would hold a preferred interest that had a fixed liquidation amount, and the trust would hold any excess value. The value of the S corporation shares would need to be determined in allocating the fixed liquidation amount to the estate, with any excess shares passing to the trust.

b. Another possible way of avoiding S corporation termination is to ensure that upon the death of the taxpayer, the LLC shares held by the decedent would pass directly to

---

[640] *See* § 1361(b)(1)(D), Treas. Reg. § 1.1361-1(l)(1).

[641] *See* § 1361(b)(1)(B).

[642] *See* § 1361(c)(2)(A)(i) allowing grantor trusts of U.S. citizens and residents to be S corporation shareholders.

[643] PLR 200513001.

[644] § 1361(c)(2)(A)(v).

[645] § 1361(d)(1)(A) treating such qualified subchapter S trusts as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

[646] *See Guzowski v. Commissioner*, T.C. Memo 1967-145. A partnership that ceased to exist based on the stated term in the partnership agreement was not deemed to be the shareholder. The partners were deemed to be the shareholders.

the trust, thereby unifying 100% of the LLC ownership in the trust (which is either an ESBT or QSST). It appears that bequeathing the shares under the decedent's Will may still cause termination of S status. The IRS has ruled that if a corporation's stock is subject to the possession of the executor or administrator of the decedent's estate, the estate is considered a shareholder as of the date of death, notwithstanding the fact that applicable state law provides that legal title to the stock passes directly to the heirs under the Will.[647] However, termination might still nonetheless be avoided by providing that the LLC interests pass directly to the trust outside of probate. The operating agreement could provide an immediate transfer of the grantor's interest in the LLC to the trust, similar to a transfer on death provision or beneficiary designation. Whether a transfer on death provision in a revocable living trust (as opposed to under the Will) would also be effective is unclear.

c. Even if there is a deemed termination of S corporation status, The IRS has granted relief in circumstances where the S corporation stock was held by disregarded entities and the death of the grantor caused the termination. In PLR 200841007, the IRS concluded that a termination of S corporation status caused by the death of the grantor—during life the taxpayer had created grantor trusts that held shares in a disregarded entity that, in turn, owned S corporation shares—was inadvertent within the meaning of section 1362(f) of the Code. In the ruling, the taxpayer granted relief and S corporation status was maintained after the death of the taxpayer.[648] Of course, private letter rulings have no precedential value, so practitioners are advised to obtain a ruling in advance to ensure that S corporation status will not be terminated.

VII. CONCLUSION

The new tax environment has catapulted income tax planning, the "step-up" in basis, and tax basis management to the center of estate planning. Entities taxed as partnerships (including disregarded entities that become partnerships) are the most flexible planning tool available, allowing taxpayers to shift income, to take full advantage of the "step-up" in basis both inside and outside of the partnership, to change the basis of assets, and to move tax liability to different partners without requiring a gift. If practitioners are willing to take on the added complexity of subchapter K, the advantages to their wealthy clients can be significant.

---

[647] Rev. Rul. 62-116, 1982-2 C.B. 207.

[648] *See also* PLRs 200237014, 200237011, 9010042, and 8934020 where the IRS ignored momentary ownership of a newly formed corporation's stock by a partnership during the process of incorporating the partnership or taking remedial measures.

8

RETHINKING THE FABRIC OF ESTATE PLANNING

By **Avi Z. Kestenbaum** & **Amy F. Altman**

Have We Got It All Wrong?

Rethinking the fabric of estate planning

As estate practitioners, our mission is to provide clients with an estate plan that maximizes the transfer of wealth to specified heirs in a way that will improve their life course.[1] But, what if this goal is impossible to meet? What if, by maximizing the transfer of wealth, we aren't improving, but instead are diminishing the life course of our clients and their heirs, as well as deteriorating society in the process? To this end, the more important questions that we seek to analyze are ones that every estate planner should pose to his clients: Would you prefer to pass as much wealth as possible to your descendants? Or, would you rather give your heirs the greatest chance of truly being happy, well-adjusted, self-fulfilled and successful?

Whose Objectives are Being Served?

Let's consider, from a psychological and philosophical point of view, exactly whose objectives are being served when wealth transfers occur. Three distinct possibilities are: (1) the client's; (2) beneficiaries' for whom the plan is being created; and (3) society's at large (including government and charities).[2]

The client. In our experience, many clients assert that the act of creating an estate plan is a purely selfless endeavor and exclusively for the benefit of their descendants. This belief may stem from the fact that they won't be living when estate taxes will be due or when certain estate assets are transferred. However, estate planning may not be purely altruistic. Planning and implementing wealth transfers may fulfill the clients' physiological and emotional needs to be prudent about the assets they've worked so hard to maintain and to assure their legacy after death. Also, many clients who claim to create estate plans purely out of love for their heirs add contingencies before their heirs can benefit from their assets. Thus, even after their deaths, their preconditions take affect, a phenomenon commonly referred to as "dead hand control."[3]

The psychology behind dead hand control stems from a variety of sources, including the desire to be relevant forever and fear of death. By controlling the estate even after death, the client is able to fantasize about what life will be like after he dies, and how, even after death, he can exert great influence.[4] Additionally, this exercise may have the effect of easing his mind about the future. For others, the need to control may be connected to pride in the assets earned over their lifetimes.

Fear and distrust of descendants may be another motivating factor that spawns dead hand control. Some people don't believe their descendants will use the inheritance in a meaningful way or will continue their way of doing things. In many cases, dead hand control may serve an important purpose, especially when the person is actually correct about his descendants. However, each case is different and requires very deep and thoughtful self-discovery and assessment by the client and his estate planner (and perhaps his psychologist).

Whether or not our clients perceive the creation of their estate plans as fulfilling their own psychological need to control, most will agree that it's a prudent endeavor. They also believe that transferring as much wealth as possible to their descendants is the most desired outcome, and as planners we reinforce this notion with the complex structures we set up to minimize taxes and protect assets. But, is the transfer of

Avi Z. Kestenbaum is a partner and **Amy F. Altman** is an associate, both at Meltzer, Lippe, Goldstein and Breitstone, with offices on Long Island, N.Y. and in New York City. Avi is also an adjunct professor at Hofstra University School of Law in Hempstead, N.Y.

wealth really the most desirable outcome? Or, can an argument be made that maximizing the transfer of wealth actually isn't in their heirs' and society's best interests and if our clients knew this, they might plan things very differently?

The beneficiaries. On Jan. 9, 2015 *The New York Times* ran an article that discussed the murder of a wealthy "hedge-fund-running" father, Thomas Gilbert, by his 30-year-old son, Thomas Gilbert Jr. The murder occurred over a dispute about Gilbert Jr.'s trust fund allowance. The article raised the question of whether Gilbert Jr.'s behavior stemmed from being raised in an affluent household.[5] It further cited academic research that affluent children have higher rates of depression, anxiety and elevated levels of substance abuse and delinquent behaviors (such as stealing).[6]

Psychological research indicates that wealth can rob young children of their search for their own identity and self-worth; they aren't forced to find out how they can be productive in society because they don't have the need or hunger to do so.[7] As Andrew Carnegie once said, "The parent who leaves his son enormous wealth generally deadens his talents and energies of the son and leads him to lead a less useful and less worthy life than he otherwise would."[8] Likewise, research suggests that being in the workforce isn't just about earning a paycheck, but a source of personal satisfaction and development, which affluent children may miss out on.[9] It stands to reason that children who grow up expecting wealth without earning it themselves could lack motivation and self-confidence.

Perhaps even more troubling is the research that indicates that affluent children entering adulthood may also be sheltered from the basic everyday frustrations of life, such as changing a light bulb, shoveling snow or making their own meal. This sheltering could likely slow their maturity while they retain unfettered power over people whom they employ, as well as those looking to benefit from their fortune.[10]

Estate planners may argue that outright transfers of wealth are the problem and not transfers of wealth into trusts. Trusts with strict distribution provisions may reduce a beneficiary's lack of motivation because he can't simply secure a distribution from the trust whenever he wants one. Similarly, incentive trusts that set forth required goals and behaviors, which when accomplished, trigger a distribution, may mitigate the potential spoiling of a beneficiary. The settlor may create any rule or contingency he wants, such as a beneficiary completing higher education, starting a business or maintaining a status quo such as not committing a crime or using drugs. The settlor may also link distributions to the amount the beneficiary earns through his occupation. This may drive a beneficiary to work harder and motivate him further. However, some practitioners are critical of this planning tool because it may create resentment, is a recipe for litigation and, in some situations, may be difficult to monitor. Furthermore, clients should also be mindful that even trusts that are fully or partially discretionary may work only to protect those assets from creditor's claims, but may not be in the best interests of a beneficiary who feels entitled to live off of the trust at the expense of meeting his true potential.

> Successful transfers of wealth include a main ingredient far more valuable than money: human capital.

If large transfers of wealth, whether outright or in trust, have the potential to create generations that lack motivation and maturity, not to mention unhappy individuals with poor self-esteem, it raises the question of whether excessive transfers of wealth should be considered a good estate plan? Perhaps many of the plans we're recommending are harmful for the beneficiaries, as well as society at large.

Society. Aside from clients who are naturally philanthropically inclined, our experience is that the needs

of society seldom enter the framework when discussing estate planning with our clients. After all, the primary concern for most individuals is the well being of their own families and not humanity. In contrast, the Buffett-Gates Giving Pledge encourages billionaires to make a commitment to give most of their wealth to philanthropic causes. As of August 2015, 137 billionaires or former billionaires signed the pledge.[11] This begs the question of what will become of the descendants from those families who aren't so philanthropically inclined and the descendants of those who signed up for the pledge, who are still leaving exorbitant amounts to these heirs.

Hard work and philanthropy, as well as investing in human capital, must start when children are very young.

On Jan. 19, 2015, CNN.com's top news story stated, "The richest 1% will own more than all the rest by 2016," based on a study by the international agency Oxfam. But, the story didn't discuss what will become of the heirs of this unprecedented wealth. This quandary has become a hot topic for wealthy parents who are now rethinking the way they raise their children. Some have offered their children trips around the world—not for the purpose of exposing them to European cultures—but rather to expose them to poverty, slums and orphanages as a way to gain perspective on their privileged way of life.[12]

In fact, the very purpose of creating the federal estate tax was to prevent massive amounts of wealth from passing between generations.[13] Theodore Roosevelt, who was a believer in estate taxes, said: "We grudge no man a fortune in civil life if it is honorably obtained and well used. It is not even enough that it should have been without doing damage to the community. We should permit it to be gained only so long as the gaining represents benefit to the community."[14] The premise belying the purpose of the estate tax and Roosevelt's statement is that bloated fortunes will do little to advance, and will more likely impair, the beneficiaries' life course and would be better served aiding humanity.

The Vanderbilts, one of the wealthiest families in America's history, saw their vast fortune disappear within a few generations.[15] William Kissam Vanderbilt, grandson of Cornelius Vanderbilt, who retired to look after his yachts and thoroughbred horses said, "inherited wealth is a real handicap to happiness … It has left me with nothing to hope for, with nothing definite to seek or strive for."[16] His sentiments are now bolstered by academic research demonstrating the lack of motivation and incidences of mental health issues in affluent children.

Ways to Mitigate

Hard work and philanthropy may be the two most effective ways to mitigate the perils of prosperity.[17] Work can help level the playing field, ignite descendants' interests and help them learn to deal with deadlines and inevitable everyday frustrations. Philanthropy may make heirs see that their fortunes can be used to benefit worthy causes and may help foster a sense of responsibility.

An interesting case study involves Picasso's granddaughter, Marina Picasso, who lived on the edge of poverty during her childhood and later inherited a significant portion of her grandfather's estate. On Feb. 4, 2014, *The New York Times* published an article regarding her plans to sell off her grandfather's art to broaden her philanthropy.[18] Although most of the article focused on the worries of the art market, it discussed the juxtaposition of her childhood versus her current wealth. She recalled her father Paulo (Picasso's estranged son) begging Picasso for money and admits that planning the sale is an aggressive effort to "purge herself" of Picasso's legacy. As result of her difficult childhood she said: "I think because of it I developed my sense of humanity and my desire to help others."[19] Although she became suddenly wealthy at the age of 21 on the death of her grandfather, her struggles early in life forged her path towards philanthropic giving. Now that her five children are grown, (three of whom were adopted from Vietnamese orphanages), Marina devotes her time to humanitarian work.

Communication

The Institute for Preparing Heirs (IPH), an innovative training company that helps financial advisors,

estimates that only one-third of wealth transfers are "successful." They define successful transfers as those in which family harmony is intact after the transfer.[20] The IPH's studies of the so called "successful transfers" found that those families had a family mission statement and interactive discussions about the overall purpose of their wealth. Thus, according to the IPH, getting as many family members as possible to buy into the family mission, goals and purposes of wealth may elevate the chances of successful transfers.

In "Changing the Playbook" by Marvin E. Blum, p.x, this issue, Marvin discusses the importance of preparing heirs for the responsibilities associated with receiving an inheritance.[21] He uses the analogy of a large mansion resting on a tiny foundation to explain how unrealistic it is to expect unprepared heirs to handle a substantial inheritance. He believes that creating an education strategy will widen the proverbial foundation.

Human Capital

Successful transfers of wealth include a main ingredient far more valuable than money: human capital. "Human capital" is defined as the collective skills, knowledge and other intangible assets of individuals, such as habits, personality attributes and creativity, which embodies the ability to perform in the world to produce economic value (that is, skills and experiences that are unique to an individual).[22] That is, it's what a person wants his descendants to know about his life and values and how that information could help the next generations. It's the inheritance of a skill set, experience and values. A transfer of wealth versus an investment of human capital is analogous to giving a man a fish or teaching a man how to fish.

One of the best examples of the investment in human capital is Walt Disney. Walt was one of five children, four boys and a girl. He lived most of his childhood in Marceline, Mo., where he began drawing, painting and selling pictures to neighbors and family friends. While Walt's family wasn't wealthy, they noticed his ability to draw and cultivated his talent by sending him to take night courses at the Chicago Art Institute to improve his drawing skills.[23] Walt's family gave him the skills to create his lasting legacy.

While maximization of wealth is likely the clients' goal when they meet with estate planners, they may not realize that a more thorough analysis of their values, coupled with an open dialogue with their descendants, could lead to a better overall plan and the transfer of human capital or the skills and life experiences that are unique to them and their family. A mission statement can be one part of creating a successful transfer of wealth and may aide in the transfer of human capital. Transmitting this mission might include meetings and communications from the clients to their descendants on a variety of topics, including: (1) how to handle life's challenges; (2) general words of wisdom and advice from ancestors; (3) family history and experiences; (4) values and ethics; and (5) religion.

The concept of transferring human capital by means other than a traditional estate plan isn't a new phenomenon. Ethical wills have been around for hundreds of years and recently regained popularity.[24] An ethical will is a non-legal document, sometimes referred to as a legacy letter, in which a client may express an array of personal thoughts and directives, not just about his wealth but his personal values and life lessons. It's a way to have family members understand the reasons the client chose to dispense his assets in a certain way and may assist in ameliorating any potential conflict. Although ethical wills started as an oral tradition used by the Jewish people,[25] which was later formalized into written documents, it's now entered the 21st century with individuals creating PowerPoint presentations that include a slideshow of photographs. There's even an iPhone app dedicated to creating ethical wills.[26]

> Leaving descendants more assets than is necessary for their basic needs may be detrimental.

Family mission statements and ethical wills are supplements that can be extremely useful in turning a dry or packaged estate plan into a dialogue about the client's values and ultimately lead to a transfer of human capital from one generation to the next. Ideally, this process should create a fuller understanding for those charged with protecting and fulfilling their legacies.

Timing

Although it's now commonplace, the creation of an estate plan when a person is in good health is a historically new phenomenon. In the Middle Ages, there was a direct personal connection to death due to increased mortality rates and deadly plagues. The phrase, "memento mori, a latin term that means "remember you must die," was frequently used.[27] In the late 18th century, the creation of death bed wills became more common. As a result, they included more personal and immediate hands-on provisions than the packaged documents of today.[28] Only in recent decades, with increased life expectancies coupled with the prevalence of marketing by the estate planning industry and the rise of individual wealth, has the mindset shifted towards creating estate plans well in advance of illness or old age.[29]

Of course, trying to change the course of a family's path later in life when descendants may already be spoiled might be too late. In reality, hard work and philanthropy, as well as investing in human capital, must start when children are very young. But, there's no reason to compound the problems by transferring excessive wealth that might cause more harm than good.

Better Off With Less?

If our clients wish to create the most effective estate plans for their families, research suggests that heirs may be better off with less wealth. As planners, we need to be aware of this critical data and raise these issues in candid conversations with our clients. Additionally, greater learning, focus and research on this topic is necessary. While the greater use of mission statements, ethical wills, incentive trusts, open family dialogue and teaching descendants hard work and philanthropy may help, we must face the reality of what the data suggests: Leaving descendants more assets than is necessary for their basic needs may be detrimental. Instead, the transfer of human capital from one generation to the next may be the link towards a successful transfer of values and long lasting, self-sustaining prosperity, and this transfer should begin long before the estate-planning documents are signed.

Endnotes

1. Charles W. Collier, *Wealth in Families* (Harvard University 2006).
2. Disclaimer: Although we represent affluent clients for whom we structure plans and draft documents with the express goal of maximizing wealth transfers, rethinking the very purpose of estate planning is a worthwhile endeavor for our own knowledge and awareness as professionals. More importantly, armed with this insight, we can educate our clients about the true ramifications of their planning on their loved ones.
3. Ronald Chester, "The Psychology of Dead Hand Control," 43 *Real Prop. Tr. & Est. L.J.* 505 (Fall 2008).
4. *Ibid.* at pp. 515-516.
5. Ron Lieber, "Growing up on Easy Street has Its Own Dangers," *The New York Times* (Jan 9, 2015).
6. *Ibid.*
7. Kay S. Hymowitz, "Parenting the Privileged, Dynastic Wealth Can Hurt Children. Can Philanthropy Help?" *Philanthropy Magazine* (Winter 2013).
8. Andrew Carnegie, *The Gospel of Wealth, and Other Timely Essays*, The Century Co. (1900).
9. *Supra* note 7 at p. 6.
10. *Ibid.*, at p. 5.
11. The Giving Pledge, *http://givingpledge.org/index.html.*
12. *Supra* note 7.
13. Boris I. Bittker, Elias Clark, Grason M.P. McCouch, *Federal Estate and Gift Taxation*, Ninth Ed., Thomson West (2005).
14. Donald J. Davidson, "The Wisdom of Theodore Roosevelt," *Open Road Media* (Nov. 9, 2010).
15. Natalie Robehmed, "The Vanderbilts: How American Royalty Lost Their Crown Jewels," *Forbes* (July 14, 2014).
16. *Ibid.*, at p. 1.
17. *Supra* note 7, at p. 6.
18. Doreen Carvajal, "Picasso's Granddaughter Plans to Sell Art, Worrying the Market," *The New York Times* (Feb. 4, 2015).
19. *Ibid.*, at p. A1.
20. *Supra* note 7, at p. 9.
21. Marvin E. Blum, "Changing the Playbook," *Trusts & Estates* (February 2016), at p. x.
22. Human-capital. *Dictionary.com. Dictionary.com Unabridged.* Random House, Inc. *http://dictionary.reference.com/browse/human-capital.*
23. "D23," Walt Disney Archives, *About Walt Disney, https://d23.com/about-walt-disney/.*
24. Constance Gustke, "The Ethical Will, an Ancient Concept, Is Revamped for the Tech Age," *The New York Times* (Oct. 31, 2014).
25. Rabbi Jack Reimer, *Writing and Reading Ethical Wills, http://www.myjewishlearning.com/article/writing-and-reading-ethical-wills/.*
26. *Supra* note 22.
27. Karen J. Sneddon, "Memento Mori: Death and Wills," 14 *Wyoming L. Rev.* 2011 (2014).
28. *Ibid.*, at p. 518.
29. *Ibid.*, at p. 519.

callout

DISCLAIMER

Note to Readers

- This Presentation is not intended to be legal advice.
- Reading the materials does not create an attorney-client relationship.
- The outcome of each case stands on its own merits
- Pursuant to I.R.S. regulations, any conclusions, or comments contained herein is not intended or written to be used, and cannot be used by the reader, for the purpose of avoiding tax penalties.