Adaptable Planning Advice for 2012 and Beyond

Charles Darwin’s Theory of Evolution proffers that complex creatures evolve from more simplistic ancestors naturally over time not because of their strength, speed or smarts. Rather, Darwin's general theory presupposes that a species survives and thrives because of its genetic ability to adapt to change.

We live in highly insecure planning times, where wealth transfer planning must increasingly be adaptable if it is to survive with clients and their descendents. Clients today often feel insecure about transitioning wealth they may need for themselves in the future to family members in flux, while advisors clearly lack the tax law visibility necessary to confidently advise clients as to how best to plan.

Consider the growing list of client-centric planning challenges: clients are living longer; health care costs are skyrocketing; family circumstances are continually changing; a deficit-riddled America will soon face austerity; and market volatility abounds with “black swan” events occurring every few years instead of every one hundred years. And from an advisor’s vantage point, planning clarity regarding the transfer tax laws terminates altogether on 12/31/2012.

To name but a few of Congress’s available options regarding transforming our transfer tax system, Congress could:

- Vote to keep the current 35% transfer tax structure with an indexing $5.12 exemption (estate, gift and generation skipping transfer (GST) tax);
- Eliminate the “death tax” altogether which currently brings in only a trickle of tax revenue in exchange for an income tax revenue raiser on the rich;
- Continue the step-up in basis on appreciated assets upon death;
- Elect to have a 8939 carryover basis type of approach;
- Enact a Canadian style capital gains tax at death;
- Do nothing and allow the estate tax law to return to 2001 beginning in 2013, with a 55% transfer tax structure and a $1 million estate tax exemption;
- Adopt the President’s proposed plan to return to 2009’s $3.5 million estate and $1 million gift & GST tax exemptions; or
- Craft up some other short term political surprise altogether.

With such limited visibility and more planning vehicles under attack such as the President’s newly proposed plan to apply an estate tax to Grantor Trusts, prudent planning recommendations increasingly depend upon adaptable planning advice. From basic to advanced estate planning, flexibility, particularly regarding irrevocable trusts is becoming mission critical for there to be a productive planning outcome.

Adaptive Basic Estate Tax Planning Trusts

Disclaimer Trusts

The simplicity and planning flexibility of disclaimer trusts makes them particularly appealing in this uncertain environment. The essential elements under of a qualified disclaimer are:

- The disclaimer must be irrevocable and unqualified;
- Made in writing;
- Delivered to the transferor within nine months;
- The disclaiming party must not have accepted the interest or property being disclaimed;
- The interest disclaimed must pass to either the decedent's spouse or to a person other than the disclaimant.

***Planning Pointer*:** One potential drawback of the disclaimer trust is that the surviving spouse may not even make a disclaimer. Moreover, even if a disclaimer is made the disclaimed assets do not receive a step-up in basis and some planning control is necessarily relinquished since the surviving spouse cannot retain a limited power of appointment over the disclaimed trust.

Clayton Marital & One-Lung Trusts

Consider other flexible post-mortem planning techniques such as the One-Lung Marital Trust ("OLMT") and/or the Clayton Marital Trust ("CMT").

In a OLMT, the decedent's entire estate will be left to a marital trust where the executor can then make a partial QTIP election. Thereafter, there will be two identical trusts: one qualifying for the marital deduction and the other not qualifying for the marital deduction. A limitation of the OLMT is that the surviving spouse must be the sole beneficiary to the exclusion of the children.

A CMT like a OLMT also leaves the decedent's entire estate to a single marital trust, where the surviving spouse's income interest in the QTIP is contingent upon a QTIP election. Here again, the makes a partial QTIP election. With a CMT, however, any property that does not qualify for the marital deduction will pass to a separate bypass trust, where the terms and beneficiaries can be different from the QTIP trust and therefore can include the children.

***Planning Pointer*:** In both the OLMT and CMT the QTIP election does not need to be made until 15 months (9 months plus a 6 month automatic extension) after the decedent's death. In reality, the OLMT and CMT may be more flexible than a disclaimer trust which must be made within 9 months of the decedent's death.

Adaptive Advanced Estate Tax Planning Trusts

Spousal Lifetime Access Trust (SLAT)

Before routinely recommending an Intentionally Defective Grantor Trust (IDGT) or Grantor Retained Annuity Trust (GRAT), consider the benefits and flexibility of an irrevocable SLAT. Through the use of a SLAT, a husband, for example, can benefit his wife and fund the trust with his separate property for any amount up to his $5.12 million dollar transfer exemption for 2012.

During wife's lifetime, the trustee can be wife alone or in conjunction with an independent trustee, and can distribute income and principal to herself under an ascertainable standard. As a result, husband has indirect access to the trust's income and principal through his wife and upon wife's demise the assets can pass estate tax free to the children and/or grandchildren (assuming husband's GST tax exemption was properly allocated to trust contributions).

***Planning Pointer*:** Note, upon the wife's death the husband clearly loses his indirect access to the trust's income and principal. As such, consider having the wife create an Irrevocable Life Insurance Trust (ILIT) for the benefit of her husband to replace the wealth lost to the husband through the SLAT.

Do not use gift splitting in a SLAT as gifts by which the consenting spouse may have an interest in may not be split. Since the gift in the example above made by husband to the wife (via the SLAT) is not severable from the gift to the children/grandchildren as other beneficiaries, the gift cannot be considered as made one-half by husband and one-half by wife.

Should husband and wife both create SLATs for one another avoid the *reciprocal trust doctrine*, where trusts are viewed as part of the same plan and where the parties are left in the same economic position, by incorporating as many differences between the two trusts as possible. Seek to have drafting provisions which are substantially different between the trusts, including different assets or value of assets contributed, different trust creation and/or termination dates, different beneficiaries, different standards for distributions, different trustees, different testamentary powers and different powers to remove and replace a trustee.

Beneficiary Taxed Grantor Trust (BTGT)

The BTGT is designed to minimize transfer taxes and protect trust assets from creditors, while providing uncommon adaptability because the client can have beneficial enjoyment over the irrevocable trust property. In a BTGT an irrevocable dynasty trust is typically set up by a trusted third party such as the client's parents for the benefit of the client in a self-settled trust jurisdiction that has extended or revoked its perpetuities laws. The client is able to be the primary or sole beneficiary with an independent trustee which is often, but not necessary, an institutional trustee.

Initially, the trusted third party (ie. parent) contributes a nominal amount of money, for example $5,000 to the trust, and gives the client the ability to withdraw that amount using a Crummey withdrawal power which the client allows to lapse. By using a Crummey withdrawal power the client becomes the "owner" of the trust for income tax purposes, but not for estate tax purposes.

***Planning Pointer*:** Since the trust is a grantor trust with respect to the beneficiary the client can sell appreciated assets like a closely held business to the BTGT (just like to an IDGT) in exchange for a promissory note without any capital gains tax consequences. Moreover, because the trust was not created by the client, transfers to the trust are not subject to the normal statute of limitations on fraudulent transfers.

Adaptive Planning Pointers and Provisions

As clients contemplate making sizable gifts to irrevocable trusts to take advantage of this year's increased transfer tax exemptions, such trusts should consider incorporating the following adaptable features:

Defined Value Clauses: With mounting judicial ratification, defined-value clauses limit the quantity of assets gifted or sold until a final IRS determination of value can be made. Any excess value over the final determination amount typically passes gift tax free to a qualified charity.

Defined value clauses have been particularly helpful with the popular promissory note sale to a defective grantor trust strategy due to the large $5 million gift tax exemption and the potential size of the promissory note (upwards of $45 million based upon a $5 million gift tax exemption). Furthermore, a defined value transfer expressing the transferred assets as a dollar value rather than a percentage interest or number of units combined with a grantor retained annuity trust (GRAT) can provide a strategic solution to any valuation deficiencies raised by the IRS.

Powers of Appointment: Consider granting broad special powers of appointment exercisable by the primary beneficiary during lifetime and at death to essentially rewrite the trust among children, grandchildren, charities and friends. Also include the power to decant which allows the trustee to pay over the trust corpus from the existing trust (situs change) to a new trust created in one of the fifteen states that currently has a decanting statute for the existing trust beneficiary (ies) in order to cure trust issues and inadequacies, or to simply modernize the trust.

Trust Protectors: More important than ever in this time of tax and economic uncertainty is the role of the trust protector. Most often seen where the beneficiary has the ability to remove and replace a trustee, the use of trust protectors in irrevocable dynastic trusts are clearly on the rise, where their powers can include but are not limited to: oversight functions, mediation, trust modification and investment or other financial advice.

Careful consideration should be given as to what specific powers should be given, when to give them and in what capacity. While some statutes make clear that a trust protector is not a fiduciary that does not mean that courts will necessarily concur in the future if the trust protector acts like a fiduciary. Generally, it is safer to have the trust protector serve in a fiduciary capacity.

Further, as a result of potential estate and GST tax issues regarding self-settled dynasty trusts, many advisors are structuring dynasty trusts as a third-party trusts, but utilizing a trust protector with the discretionary ability to add the grantor as a beneficiary. This is most often accomplished by granting the trust protector the authority to add a new beneficiary from a broad class of individuals that includes the grantor (for instance grantor's grandparent's descendants). By not having the grantor named as an initial permissible beneficiary, some of the possible estate and GST tax issues associated with self-settled trust may be addressed. If the need should arise, the grantor could then be added as a discretionary beneficiary.

Trustee and Distribution Provisions: Think about allowing the primary beneficiary as sole trustee to make permissible discretionary distributions to themselves and to others pursuant to an ascertainable standard. Additionally, consider adding an independent trustee (perhaps springing) in order to make discretionary distributions to the primary beneficiary above an ascertainable standard and to hold tax-sensitive administrative powers. In all cases, make sure to prohibit the trustee from making distributions that discharge a legal obligation of support that may result in adverse gift and estate tax consequences for the trustee.

Among the more prevalent adaptable and prudent planning provisions found within irrevocable trusts are the following:

- Specify the grantor's intent, if there is a particular preference, or trust purpose;
- Offer guidance as to how the trustee should exercise distribution discretion;
- Think about permitting trust distributions for weddings, buying a home or car, starting a business and establish parameters around each;
- Consider choosing a trustee that has the time, fiduciary skill-set and administrative systems in place to adequately handle the demands of family members in flux;
- Provide direction for the trustee on whether or not to consider beneficiary resources;
- Designate priority among trust beneficiaries;
- Grant a beneficiary an automatic annual 5% of the trust or a $5,000 withdrawal power;
- Insert tie-breaker language where co-trustees are named;
- Allow the trustee to terminate an uneconomical trust;
- Permit the trustee to resign and establish a process for naming a successor trustee in the event that those named in the document are unable or unwilling to act;
- Allow the trustee to hold "S" corporation stock and preserve the "S" election;
- Give the trustee broad discretion regarding investment powers;
- Consider appointing a Trust Protector or Special Trustee where the trust owns a closely held business or where the grantor is concerned about a beneficiary's lifestyle choices or possible addiction to drugs or alcohol;
- Avoid frozen fee language and allow the trustee to receive reasonable compensation for services rendered ("published fee schedule" for institutions);
- Specifically indemnify and direct the trustee to retain a particular asset, concentrated or closely held position if the grantor so desires;
- Provide the trustee the power to 1035 exchange or sell an insurance policy.

Also, provide for adaptability with provisions that allow the trustee to change trust situs and governing law, invoke tax savings clauses, merge or divide the trust (i.e., GST exempt and GST non-exempt) and to the primary beneficiary for which a trust is established, consider granting a general power of appointment avoiding the GST tax, only upon condition that there be a reduction in the overall transfer taxes.

One other idea being suggested by some advisors with respect to avoiding a GST tax in this uncertain environment is to utilize at least two trusts; one set up with the 2001 indexed GST tax exemption amount of $1.36 million and another funded with $3.64 million (i.e., the balance between the current exemption amount of $5 million and the $1.36 million). This strategy of multiple trusts is recommended to hedge against potential changes to the transfer tax system should we return to the 2001 GST tax laws.

In the end, the only secure method of planning in today's insecure times is to ensure that the planning advice proffered and the wealth transfer planning vehicles used can adapt with circumstances that undoubtedly will change. And in keeping with Darwin's theory, over the course of time adaptable planning should survive to be the fittest.