Adaptable Estate Planning Advice

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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 successfully 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 ability to forecast the current transfer tax law, which is necessary to confidently advise clients as to how best to plan beyond year end.

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-percent transfer tax structure with an indexing of $5.12 million exclusion/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 Code Sec. 1022 carryover basis, Form 8939, type of approach;
- Enact a Canadian style capital gains tax at death;
- Keep "portability" or send it packing;
- Do nothing and allow the estate tax law to return to 2001 beginning in 2013, with up to a 60-percent transfer tax rate and a $1 million estate tax exclusion;
- Address the transfer tax issue retroactively after 12/31/2012;
- Adopt the President's proposed plan to return to 2009's $3.5 million estate and $1 million gift tax exclusions and the $1 million GST tax exemption; or
- Craft up some other short term political surprise altogether.

With limited ability to foresee the tax changes that ultimately will be enacted, and more planning vehicles under attack, such as the President's newly proposed plan to apply a transfer tax to grantor trusts, prudent planning recommendations increasingly depend upon adaptable planning advice. From basic to advanced estate planning, flexibility, particularly regarding irrevocable dynastic trusts, is becoming mission critical for there to be a productive long-term planning outcome.

Adaptive Postmortem Planning Trusts

Disclaimer Trusts

The simplicity and planning flexibility of disclaimer trusts makes them particularly appealing

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in this uncertain environment. The essential elements 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; and
- The interest disclaimed must pass to either the decedent's spouse or to a person other than the disclaimant.[i]

Planning Pointer: One potential drawback of the disclaimer trust is that the surviving spouse may choose not to make the disclaimer. Further, even if a disclaimer is made the disclaimed assets do not receive a step-up in basis when the surviving spouse dies. Finally, some planning control is necessarily relinquished since the surviving spouse cannot retain a limited power of appointment and effect control over beneficial enjoyment of the assets within the disclaimed trust.[ii]

Clayton Marital and One-Lung Trusts

Consider other flexible post-mortem planning techniques such as the One-Lung Marital Trust (OLMT) and/or the Clayton Contingent Marital Trust (CCMT).[iii]

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 CCMT, 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 executor makes a partial QTIP election. With a CCMT, 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 CCMT, the QTIP election does not need to be made until 15 months (nine months, plus a six-month automatic extension) after the decedent's death. As such, the OLMT and CCMT may be more flexible than a disclaimer trust because the disclaimer must be made within nine months of the decedent's death. Further, unlike the disclaimer approach, both the OLMT and CCMT can ensure that after the surviving spouse dies the assets of the trust pass to decedent's desired beneficiaries, and in each case, the trust can provide the surviving spouse with a limited power of appointment to rewrite the trust.

Adaptive Advanced Estate Planning Trusts

Spousal Lifetime Access Trust

Before routinely recommending an Intentionally Defective Grantor Trust (IDGT) or Grantor Retained Annuity Trust (GRAT), consider the benefits and flexibility of an irrevocable Spousal Lifetime Access Trust (SLAT). Through the use of a SLAT, for example, a husband in a stable marriage can benefit his wife as a beneficiary and fund the trust with his separate property for any amount up to his $5.12 million dollar transfer exclusion for 2012 without paying gift taxes.

During the wife's lifetime, the trustee can be the wife alone or in conjunction with an independent trustee, and the trustee(s) can distribute income and principal to the wife under an ascertainable standard. As a result, the husband has indirect access to the trust's income and principal through his wife and upon her demise the assets can pass estate tax free to the husband's descendants (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), which does not trigger the reciprocal trust doctrine (discussed below), for the benefit of her husband to replace the wealth lost to the husband through the SLAT.

Some commentators have suggested gift splitting in SLATS is permissible provided distributions to the beneficiary spouse are limited by an ascertainable standard and the beneficiary spouse has sufficient financial assets outside of the SLAT so that a distribution is very remote (see "Qualifying Trust Transfers for Split-gift Treatment" by William R. Swindle, July/August 2007, Vol. 81, No. 7, *FL Bar Journal*). Even so, the more conservative approach is to not use gift splitting in a SLAT as gifts in which

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the consenting spouse retains an interest may not likely be split. If the gift in the example above made by the 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.[iv]

What if the husband transfers some of his separate property assets to his wife who then turns right around and creates a SLAT for husband as beneficiary? In such a case, be wary of the step transaction doctrine since the assets and the economic risk should be owned and held exclusively by the grantor spouse for a reasonable period of time. Should the husband and wife both create SLATs for one another, seek to 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 meaningful differences between the two trusts.[v] Strive 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

The Beneficiary Taxed Grantor Trust (BTGT) (also known as a BDIT©) 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. A BTGT is an irrevocable dynasty trust that 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 necessarily, an institutional trustee.

Initially, the trusted third party (that is, the 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 as a beneficiary becomes the "owner" of the trust for income tax purposes, but not for estate tax purposes.[vi]

Planning Pointer: Since the trust is a grantor trust with respect to the beneficiary for income tax purposes 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.[vii] 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 dynasty trusts to take advantage of this year's increased transfer tax exclusions, clients and advisors alike should consider incorporating the following adaptable trust 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.[viii] Any excess value over the final determination amount typically passes gift tax free to a qualified charity. Note, however, that a recent tax court memo upheld a defined value clause without a charitable component by limiting the gift of partnership units to a stated dollar amount.[ix]

Defined value clauses have been particularly helpful with respect to the popular promissory note sale to a defective grantor trust strategy, due to the large $5.12 million gift tax exclusion and the potential size of the promissory note (upwards of $45 million, based upon a $5.12 million gift tax exclusion). Furthermore, a defined value transfer expressing the transferred assets as a dollar value, rather than as 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" trust assets in order to cure potential trust issues and inadequacies that might arise by allowing the trustee to appoint or distribute the trust corpus from the existing trust to a new trust for the benefit of permissible distributees or appointees. Note, although trustees arguably have the power to decant under applicable state common law, if the

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trust document does not specifically provide for decanting, it may be best to change the situs and governing law of the trust to one of the existing fifteen states which does explicitly permit decanting.

Trust Protectors: More important than ever in this time of tax and economic uncertainty is the role of the trust protector. A trust protector's role is primarily to ensure that the grantor's wishes are carried out and thereafter to monitor the actions or inactions of the trustee. 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 is needed as to what specific powers should be granted, when to grant them and in what capacity. While some statutes make clear that a trust protector is not a fiduciary, this 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.

As a result of potential estate and GST tax issues regarding self-settled dynasty trusts, many advisors are structuring dynasty trusts as third-party trusts, but utilizing a trust protector with the discretionary power 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 the descendants of grantor's grandparents). By not having the grantor named as an initial permissible beneficiary, some of the possible estate and GST tax issues associated with a self-settled trust may be

Among the more prevalent adaptable provisions used in 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;
- Provide for "virtual representation" for unascertainable or unborn beneficiaries;
- Allow the trustee to make loans to beneficiaries;
- Choose the trustee (individual and/or corporate) with the view to flexibility and fiduciary skill-set;
- 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-percent and $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 the trustee and use permissive retention language or direct the trustee to retain a particular asset, concentrated or closely held position;
- Provide the trustee the power to make a Code Sec. 1035 exchange or sell an insurance policy; and
- Grant a general power of appointment to the primary beneficiary to avoid the GST tax, only upon the condition that there be an overall reduction in transfer taxes.

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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 himself/herself 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 over and 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.

In addition, provide for adaptability with provisions that allow the trustee to change trust situs and governing law, invoke tax savings clauses, and merge or divide the trust (that is, into GST exempt and GST non-exempt trusts).

Unsure about whether the grantor or the trust should pay for the trust's tax consequences in a vacillating economic environment? Consider crafting the trust with an annual "toggle switch," by giving an independent trustee the ability to make loans to the grantor for adequate security and interest. If grantor trust status is desired, simply make a loan to the grantor. To switch grantor trust status off, have the grantor fully repay the trust loan.[x]

One final 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 $1.39 million and another funded with $3.73 million (that is, the difference between the current exemption amount of $5.12 million and the $1.39 million exemption amount). 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.[xi]

In the end, perhaps the surest 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 the legal, economic and familial 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.

ENDNOTES

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[i] Code Sec. 2518.
[ii] Examples 4, 5, and 6 of Reg. §25.2518-2(e)(5); and Code Sec. 2041(b)(1)(A).
[iii] *A. M. Clayton, Jr. Est.*, CA-5, 92-2 USTC ¶60,121, 976 F2d 1486 and Code Sec. 2056(b)(7).
[iv] Rev. Rul. 56-439, 1956-2 C.B. 605.
[v] *A. S. Lehman, Exr.*, CA-2, 40-1 USTC ¶9148, 109 F.2d 99, Cert. den.; *J. P. Grace Est.*, SCt, 69-1 USTC ¶12,609, 395 U.S. 316, 89 SCt 1730; *B. Bischoff Est.*, 69 TC 32, CCH Dec. 34,702 (1977).
[vi] Code Sec. 678 (a).
[vii] Rev. Rul. 85-13, 1985-1 CB 184.
[viii] *A. E.Petter Est.*, CA-9, 2011-2 USTC ¶60,623, 653 F.3d 1012 (2011), aff'g TC, 98 TCM 534, CCH Dec. 58,012(M), TC Memo 2009-280; *C.T. McCord, Jr., Est.*, CA-5, 2006-2 USTC ¶60,530, 461 F.3d 614 (2006), rev'g TC, 120 TC 358, CCH Dec. 55,149 (2003); and *H. Christiansen Est.*, 130 TC 1, CCH Dec. 57,301, reviewed by the Court, (2008), aff'd, CA-8, 2009-2 USTC ¶60,585, 586 F.3d 1061 (2009).
[ix] *J. Wandry*, 103 TCM 1472, CCH Dec. 59,000(M), TC Memo. 2012-88.
[x] Code Sec. 675(3).
[xi] Carlyn S. McCaffrey and Pam H. Scheider, "The Generation Skipping Transfer Tax," *Trust & Estates*, February, 2011.

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