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IRREVOCABLE TRUSTS

Taking the Pressure out of Pandemic Planning: Drafting Irrevocable Trusts with Flexible Mechanisms

Author: DAVID J. SPACHT

DAVID J. SPACHT is a member of Pryor Cashman's Trusts + Estates, Private Client and Tax Groups. He is experienced in all aspects of estate planning, international tax planning, charitable planning, tax controversy, and estate administration.

Given the potential reduction of the federal gift tax exemption in the years ahead, the socioeconomic uncertainties caused by the Coronavirus pandemic, and historically low interest rates, now is a good time to consider incorporating irrevocable trusts with flexible mechanisms into your estate plan.

Introduction

The Tax Cuts and Jobs Act, signed into law at the end of 2017 (the "2017 Tax Act"), **1** changed some of the methodologies for calculating personal and entity-level income taxes and nearly doubled the wealth that individuals can transfer without incurring a wealth transfer tax from an already historic high of $5,490,000 to $11,180,000 (technically the "Basic Exclusion Amount," but often simply referred to as the "exemption"). This shift significantly reduced the number of individuals who are presently subject to the wealth transfer tax.

The federal exemption will return to $5 million on January 1, 2026 (indexed for a cost of living inflation adjustment) when many provisions of the 2017 Tax Act expire, or perhaps even sooner if a new administration legislates preemptively, as some commentators believe likely. **2** Even before the outbreak of the Coronavirus pandemic, many Democratic candidates touted the idea of a reduced estate tax exemption and increased estate tax rates, and others, including Democratic nominee Joe Biden, promoted the idea outlined in Obama's green book proposal to eliminate the "step-up" in basis at death. **3** Now under the present circumstances, with the government relief provided by the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), the extension of PPP loans and other federal spending, the Congressional Budget Office projected a $1.1 trillion deficit this fiscal year, or 4.9% of G.D.P. **4**

Although a planning environment like the present, with increased exemptions and depressed asset values, would typically be an opportune time to transfer assets out of the reach of the wealth transfer tax system, many clients are hesitant to part with assets that they perceive will be needed during an economic downturn or, perhaps, a depression. For individuals whose wealth greatly exceeds their current state and federal exemptions, deciding whether to make outright or leveraged gifts may be easy. For individuals who are not subject to an estate tax under the current enhanced exemption levels, the thought of gifting may cause discomfort. Numerous factors, including the settlor's and beneficiary's states of residency, changing state and federal estate tax exemptions, federal and state tax rates and bracket delineations, life expectancies, and interest rates, to name just a few, complicate the ability of advisors to convey with precision the tax efficiencies of lifetime gifting plans.

By incorporating flexibility in the structure and mechanics of a settlor's irrevocable trusts, however, those who are uncertain about the future opportunity cost of their gifts may retain a degree of control to adapt their plans with changing family and legal circumstances. Even for those individuals who believe that they are unlikely to be affected by an estate or gift tax, several constants remain which should continue to drive *inter vivos* gifting, including planning to avoid or reduce income taxes, protect assets from claims of potential creditors of the settlor and beneficiaries, and even to cushion large gifts or gifts of hard-to-value assets.

A Recent History of the Wealth Transfer Tax System

Taxpayers faced a similar scenario in 2011 and 2012, when the $5 million exemption was slated to return to $1 million at the expiration of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 ("the 2010 Tax Act") on December 31, 2012. **5** Had the exemption reverted to $1 million, many individuals, even those with typical assets such as a primary residence or life insurance, for example, would have been justifiably concerned about an estate tax. Many taxpayers who anticipated an 80% reduction in the federal estate tax exemption took advantage of the opportunity to make large taxable gifts. Those taxpayers who reside in one of the states that impose an estate tax sought to achieve an even greater wealth transfer by reducing their state estate tax base without any commensurate usage of state exemption.

Despite this gifting opportunity, many advisors cautioned clients of the possibility that large gifts made during those years, when the gift was exempt from gift tax (or was taxed at a lower rate), might be "clawed back" into their taxable estates. This "clawback," it was feared, would result if the estate tax exemption in the year of the individual's death was lower than the amount available and utilized by a taxpayer to make lifetime gifts. The American Taxpayer Relief Act of 2012 (ATRA), passed on January 1, 2013, maintained a $5 million exemption amount, so the resolution of this concern never came to fruition.

Because the "clawback" issue never materialized, advisors faced similar concerns with gifting under the 2017 Tax Act's doubled exemption. The IRS issued final "anti-clawback" regulations, in November 2019, clarifying that additional estate taxes will not be imposed if a taxpayer who made a gift within current exemption levels dies after the 2017 Tax Act has sunset and the exemption used exceeds the exemption in place at death. [6] A taxpayer must first make taxable gifts that exhaust the taxpayer's original exemption before she will be able to achieve any benefit of the additional exemption after the sunset (this delta in exemption being referred to as "bonus exemption" and the exemption available after a reduction being referred to as "original exemption"). [7] For those individuals that decide to make gifts pre-sunset that are still within the limits of the original exemption, such individuals will have their remaining exemption available. Still, they will not be treated as having made gifts with their bonus exemption that was available at the time of the increased exemptions.

Planning for Changes in the Tax Law While Retaining Settlor Flexibility

Clients who may not be concerned about an estate tax at current exemption levels may still benefit from gifting to flexibly structured trusts that accomplish their non-tax objectives while also creating resiliency to law changes. By dispelling some common misconceptions, such as the idea that gifting necessitates relinquishment of all access and control of the transferred funds, advisors can make some of their clients feel comfortable with the idea of a lifetime gifting structure that is adaptable to unanticipated changes in the law or familial circumstances without sacrificing many of the trade-offs typically associated with relinquishing dominion and control of one's assets.

Planning for Retained Access to Trust Assets

Maintaining access and control.

Married individuals can take advantage of their increased estate tax exemptions while retaining access to the use and enjoyment of the transferred assets through the use of what are commonly known as Spousal Lifetime Access Trusts ("SLATs"). The fundamental structure involves the creation of a trust by one spouse (the "donor spouse") over which the other spouse is included among the class of discretionary beneficiaries (the "beneficiary spouse"). The donor spouse will have access to the enjoyment of the income and principal of the beneficiary spouse's trust during their marriage indirectly through distributions to the beneficiary spouse. The donor spouse is in jeopardy of losing indirect access to the trust principal upon the death of the beneficiary spouse, however, as the beneficiary spouse would no longer receive distributions.

As such, although having only one spouse fund a trust will provide full access while both spouses are alive and married, having both spouses create trusts enables the couple to minimize the risk of the donor spouse losing access to the assets upon the beneficiary spouse's death. Each spouse can serve as the trustee of the trust created for his or her benefit, provided that he or she is confined to making distributions to himself or herself pursuant to an "ascertainable standard" for the purposes of health, education, maintenance, or support. [8] An independent co-trustee with authority to make distributions to a spouse or descendant for any purpose, in his sole and absolute discretion, should also be appointed. [9]

The trusts are often structured so that the transfers made to them are completed gifts, the objective being the removal of assets and their future appreciation from the estates of the spouses, children, and potentially even more remote issue. [10] However, if each spouse's economic interest in the trusts is not sufficiently disparate, meaning that they are left "in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries," the trusts will be "uncrossed." Unless such trusts maintain a situs in a self-settled trust jurisdiction, this will result in the inclusion of the transferred assets in the settlor spouse's estate through the application of the so-called "reciprocal trust doctrine." [11] Therefore, to preserve estate tax savings and, possibly, credit protection benefits of the structure, the trusts must be drafted with distinctions sufficient to create a disparity between spousal economic interests. [12]

Maintaining access after death of the first spouse.

SLATs are designed to achieve several of the typical objectives of completed gift planning, including removing assets and appreciation from one's estate, preserving estate tax exemption in anticipation of a change in the law, achieving asset protection - but with the significant additional advantage of retained access to the funds transferred. Unless given special attention, one presumptive limitation of this structure, however, is the donor spouse will lose indirect access to the assets the settlor gifted after the beneficiary spouse's death. With exemption levels currently so high, many couples wishing to gift such large amounts may only agree to do so with the caveat that they can regain access to the funds, if necessary. There are several potential workarounds that may enable the donor spouse to retain access to the transferred funds, even after the beneficiary spouse's death.

Make loans to the settlor.

In September 2020, the mid-term applicable federal rate was 0.35%. With interest rates so low, intrafamily loans may be a tax-efficient wealth transfer mechanism that does not use any commensurate estate tax exemption. As such, a loan to the settlor spouse from the beneficiary spouse's trust may be another way of addressing the premature death of the beneficiary spouse.

In contrast to an outright distribution to the donor spouse, if the settlor were a discretionary beneficiary of the trust, a loan would not waste the settlor's gift tax exemption or any generation-skipping transfer tax exemption that was allocated in making the initial transfer to the trust. The currently low AFRs means that the settlor spouse can retain more of the loaned funds without requiring payment back to the trust if a portion of the loaned funds are invested and achieve even a relatively low rate of return. Further, a loan at below-market interest rates will cause the trust to be taxed to the settlor pursuant to **Section 675(2)** if a non-adverse trustee has the power to make the loan. **13** If such is the case, then any interest payable back to the trust as part of the note obligation will not result in income reportable to the grantor or the trust.

In making a loan back to the settlor, the trustees should ensure that the trust agreement provides a grant of the authority to do so. Even so, the trustees should notify the trust beneficiaries of the terms of the loan (especially if the beneficiaries are children from previous marriages and the loan does not bear adequate security), given that the return the trustees will see makes the investment on the AFR loan considerably less attractive than virtually any commercial investments and that the market loan rates will be several percentage points higher.

If there is any concern that the beneficiaries will later oppose the transaction based on inadequate security, the loan approach may not be attainable, given the risk of accusation of the trustee's breach of a fiduciary duty.

Redirecting trust assets back to the settlor.

In the majority of states that have not passed self-settled trust legislation, the settlor may not retain possession or enjoyment of transferred trust property without causing the transfer to be an incomplete gift or includable in the settlor's gross estate for estate tax purposes. **14** Moderately wealthy clients who may have been motivated to plan for reasons other than estate tax savings and who are not comfortable predicting with any confidence which spouse will die first, however, may still require access to the trust funds after the death of the first spouse.

In one of the 19 states that have enacted self-settled trust legislation, spendthrift trust protections extend to trusts created by a settlor for his or her own benefit. Under the common law of the other 31 jurisdictions that do not have such laws on the books, one can only achieve the same creditor protection by transferring one's assets to a trust of which he or she is not a current beneficiary. If a settlor's creditors are prohibited from reaching trust assets by way of state law creditor protections, then the settlor should not be deemed to have retained an interest in the trust assets that would result in estate inclusion pursuant to **Sections 2036** or **2038** . **15** Unmarried settlors who would like to maintain access to their transferred assets or for those not comfortable losing access to SLAT assets after the death of a surviving spouse may create trusts in one of these self-settled trust jurisdictions.

Many settlors engaging in such planning rely solely on the appointment of a corporate fiduciary located within the self-settled trust jurisdiction in which the trust is sited. There is still a degree of legal uncertainty surrounding the reliability of the creditor protection and estate tax planning using self-settled trusts in circumstances where the settlor does not reside in the state in which the trust has its situs. As the settlor ideally will never require access to the trust as a discretionary beneficiary, giving an independent party the authority to add the settlor as a permissible trust beneficiary should she require access to the trust funds after the death of the predeceased spouse may offer greater protections. [16] Under such a circumstance, the settlor will not become a trust beneficiary if and until she is added as a discretionary beneficiary if a loan from the trust or other access mechanism is inadequate. [17]

Planning for estate inclusion.

Given the current political environment of high exemption levels and socioeconomic environment of depressed asset values, many individuals are taking advantage of this opportunity to make use of an increased exemption if it should go away. Despite this drive to reduce one's taxable estate, the circumstances in place at the death of a donor, including state and federal income tax rates, maybe conducive to re-inclusion of estate assets in the donor's estate or even in the estate of a trust beneficiary or non-beneficiary third party.

It may be advantageous, therefore, to cause a portion or all of the trust assets to be included in the taxable estate of one or more of the estates of the settlor or trust beneficiaries if, at the time of the settlor's death, one or more of them have large portions of unused exemption remaining and the assets have greatly appreciated, or the income tax hit to a beneficiary from the sale of a highly appreciated asset would exceed that of any state and federal estate tax imposed on such asset at such time.

The typical tax goal in making a completed gift in trust is to "freeze" the valuation of the asset at the date of the transfer, utilizing one's available transfer tax exemption to shelter the asset (perhaps at a discounted valuation) and any appreciation from estate tax. However, one of the primary costs of such completed gift planning is the loss of a step-up in basis of any appreciated transferred assets at the settlor's death. By incorporating flexible mechanisms that can enable one to trigger estate inclusion if beneficial, one can better determine whether estate inclusion would result in less tax than the sale of an appreciated asset, depending on the value of the property and its basis at the time of the death of the powerholder. [18]

Mechanics of estate inclusion.

One mechanism that should be considered to achieve step-up in basis is authorizing a non-adverse trustee or trust protector to confer upon the settlor, a trust beneficiary, or even a non-beneficiary individual a testamentary general power of appointment ("GPOA"). A GPOA is a power of disposition held by the powerholder that is exercisable in favor of the power holder, the power holder's estate, the power holder's creditors, or the creditors of the power holder's estate. [19] The value of the property subject to the exercise of the GPOA would be includable in the estate of the powerholder. Any appreciated assets subject to the power will receive a step-up in basis at the powerholder's death to the fair market value of the property at the date of the powerholder's death, regardless of whether the power is exercised. [20]

Authorizing a trust protector to confer a GPOA eliminates some of the uncertainties present at the time of the trust's creation by allowing the trustee to determine the appropriate timing, individual, and assets over which to trigger estate inclusion. For example, a trust protector may confer a GPOA on an elderly relative of the settlor with a modest estate to achieve a step-up in basis at the time of the relative's death. **21** Choosing an individual whose estate is not in jeopardy of exceeding any state or federal estate tax exemptions in place at the time of his or her death would achieve a step-up in basis on the appreciated assets over which the power was conferred without a commensurate estate tax consequence to the settlor or the powerholder. Using an "upstream" GPOA will cause the powerholder to be deemed the "transferor" of such assets for GSTT purposes and will enable the executor of his or her estate to allocate any unused GSTT exemption to the assets subject to the GPOA.

Further, triggering estate inclusion by conferring a "downstream" TGPOA upon a settlor's child or individual considered to be of a lower generation for generation-skipping transfer tax purposes could also be helpful to avoid the imposition of a generation-skipping transfer tax at the termination of a trust passing to the settlor's grandchildren or other "skip persons." By triggering the inclusion of trust assets that are not exempt from generation-skipping transfer tax in the estate of an individual in a lower generation to the settlor who has sufficient estate tax exemption to absorb the asset, such individual will become the new transferor for GST purposes, which would change the character of grandchildren (or certain non-lineal descendants that are more than 37.5 years younger) from skip persons to non-skip persons.

When conferring a GPOA on an individual who is not a trust beneficiary, the protector risks that the power will be exercised to deprive those individuals who were intended to benefit from the trust property. When conferring a GPOA upon a family member or other trust beneficiary, the more likely risk, however, is the inadvertent exercise of the power to redirect trust assets to or among unintended beneficiaries. For example, without careful drafting, some boilerplate will provisions define a testator's "residuary estate" to include any property over which they possess an otherwise unexercised power of appointment.

To mitigate any risk that a conferred TGPOA would be exercised in a manner inconsistent with the settlor's intent, the powerholder can be given a limited or special power of appointment ("LPOA") restricted in its exercise to or among individuals who include the settlor's issue, or a class made up of other beneficiaries included in the trust's dispositive provisions that could later be converted into a GPOA by another individual. Alternatively, the trust may be drafted to permit the power to be exercised only among the powerholder's creditors or only with the consent of a non-adverse party whose consent to the exercise would not result in him or her making a taxable gift. **22**

Much like traditional disclaimer trust planning, the most flexible drafting approaches require active monitoring and proactive execution. For example, the drafting attorney may find it desirable to avoid using formula GPOA when drafting for maximum tax planning flexibility. Including a formula GPOA that would trigger gross estate inclusion is not only less flexible than a conferral approach, but also more complicated to administer and more restrictive to implement. For example, a basic formula provision requiring gross estate inclusion where the income tax saved by a step-up in basis would exceed the estate taxes saved ignores the intent of the future beneficiaries' desire to sell or retain the asset or the generation-skipping transfer tax consequences of inclusion.

In order to draft a comprehensive formula GPOA, the drafting attorney would need to take into account multiple variables, including (i) the amount of the assets subject to the power keyed to the power holder's remaining estate tax exemption, including their applicable exclusion amount, basic exclusion amount, and their deceased spousal unused exclusion amount; (ii) any state wealth transfer tax costs imposed on the power holder, as no state exemption exceeds the federal exemption and no state offers portability of a deceased spouse's exemption; (iii) the ordering of asset classes that would be most benefitted from a step-up in basis, starting with those most highly appreciated and those most likely to be sold or depreciated, and including those taxed at higher rates, such as collectibles and negative basis assets; and (iv) generation-skipping transfer tax issues. It can be done, but it is cumbersome and has the potential to be misapplied.

The settlor may also retain a "swap power" or a power of substitution, which would enable the settlor to reacquire the trust principal by substituting it with other property of equivalent value. If the settlor owns minimally appreciated assets, she may exercise this discretion to replace appreciated trust property that would benefit from a basis step-up at her death with such lesser appreciated assets. **23** Exercising a power of substitution is likely to be more advantageous than a direct distribution, as it enables the settlor to retain the creditor protection of assets held in trust while also maintaining estate tax and GST tax efficiencies.

Income tax planning during ongoing trust term.

Given the pandemic's impact on our personal and professional lives, many individuals are relocating from densely populated city centers to their vacation properties to enjoy larger yards and smaller neighborhoods or to be closer to parents or family members in other states to assist with childcare responsibilities. **24** Because of the adaptation of remote working technologies, more individuals are becoming untethered to their physical offices. This newfound agility is introducing more multijurisdictional issues into the estate planning process.

While escaping congested city centers for literally greener pastures is certainly one benefit of the "pandemic migration," moving to another state can also have distinct economic advantages. Relocating to Florida, for example, a state with sunny winters and no income or estate tax can be a simple way for a client to avoid additional state taxes. While many taxpayers may be hard-pressed to sever ties with their long-time home state completely, they may be able to sever the relationship of their preexisting trusts sited in their state of origin by taking a few concrete steps. The taxpayers' ties to their new states of residence may enable them to create new trusts with flexible income tax mechanisms.

Grantor vs. non-grantor trust status.

One significant way to achieve income tax savings is by manipulating whether the trust income is taxed on the settlor's income tax return or to the trust and its' beneficiaries. By toggling grantor trust status on or off, the settlor will be treated as the "owner" of either or both of the income and principal of a trust for income tax purposes and will be taxed directly on the income of the trust to the extent that the settlor holds particular interests or powers in the trust as proscribed by the grantor trust rules of **Sections 673** through **677** . **25** Although structuring trusts receiving completed gift transfers as grantor trusts was often a beneficial approach for many clients, it may no longer be the case.

Reasons to switch to non-grantor trusts.

Planning flexibly for income tax reduction or avoidance has become an increasingly vital component of a comprehensive estate plan, as the federal estate tax has application to fewer individuals and as the differential in rates is narrowing. Drafting trusts with income tax flexibility is essential to minimize the effect of compressed tax brackets, the net investment income tax on trust income, and to maximize one's itemized deductions, regardless of an individual's primary motivation for making transfers in trust.

For individuals who created a non-grantor trust while residents in a low-income tax state, but who later moved to a high-income tax state, it is essential to review whether the trust jurisdiction will shift with the individual if the settlor's spouse was a trustee. If the income tax residency of the trust remains in the low-income tax state, it may be advisable to retain taxation at the trust level, especially if the settlor moved to a high-income tax state and toggling on grantor trust status would result in the trust income following the settlor. If the settlor funded a grantor trust while a resident of a low or no-income-tax state but has since relocated to a state that imposes a higher income tax, the inverse might apply. It may be desirable to maintain the trust as a non-grantor trust or to toggle-off grantor trust status so that the trust income would not be subject to state income tax in the settlor's new state of domicile. **26**

Even if the settlor's non-grantor trust is subject to income tax in a high-income tax state, it may be advantageous for the trust to remain taxed as a non-grantor trust. Although a non-grantor trust will be taxed in the highest bracket very quickly ($12,950 of income in 2020), if the settlor anticipates that distributions will be made throughout the year, then sprinkling investment income among the settlor, a spouse, or children as discretionary trust beneficiaries, for example, would shift the trust's distributable net income to beneficiaries in lower tax brackets who may need additional funds and to those beneficiaries residing in states that do not impose a state income tax. **27**

Additionally, given the volatility in the financial markets and outlook for a more significant economic downturn, a settlor may no longer be able to pay the income taxes on the trust investments. **28** The 2017 Tax Act capped the federal itemized deduction for state and local income, sales, and property (SALT) taxes paid to $10,000 and increased the standard deduction to $12,000 for unmarried tax filers and $24,000 for joint filers. Taken together, many taxpayers in high tax states such as New York, New Jersey, or California, for example, who have SALT deductions over the limitation, may have seen an increase in their income taxes, which they are not interested in increasing further. Clients who may be taking a hit to their portfolios may not have the additional income they had pre-pandemic to support their customary lifestyles.

Further, it may be attractive to toggle-off grantor trust status for settlors looking to shore up cash ahead of a market dip or in preparation for an impending liquidity event. Although the settlor's payment of the income tax upon the sale of a trust asset is an opportunity to make a sizeable tax-free gift to the trust beneficiaries, the settlor may not desire or have the liquidity to pay for a significant tax obligation incurred by the trust.

For residents of high-income tax states planning to preserve their increased estate tax exemptions, then structuring new SLATs as non-grantor trusts in self-settled trust jurisdictions, many of which do not impose a state income tax, can provide the additional benefit of avoiding state income tax on the trust's income. Advisors should assist clients in running projections of the anticipated income tax bills using both approaches to determine which results in the greatest net savings.

Reasons to keep or switch to grantor trusts.

For settlors who have moved from states with higher income taxes to states with a less imposing income tax or no income tax at all, the settlor may want to retain their grantor trusts, toggle-off any preexisting non-grantor trusts, or move the tax situs of their old non-grantor trust to their new state of domicile. If the settlor resides in a state without a state income tax or is not taxed at the highest bracket, the settlor's payment of the trust's income taxes is often more tax-efficient than the trust's payment of the same (as undistributed trust income will be taxed at the highest rate bracket at only $12,950 of income). **29** The settlor's payment of the income taxes on the trust's income further reduces the settlor's gross estate without commensurate usage of additional exemption, enables the tax-free appreciation of trust assets, **30** avoids the potential of capital gains becoming trapped at the trust level, and would open the opportunity for the settlor to engage in sale transactions with the trust without triggering gain, increasing the opportunity for additional wealth transfers through sales to the trust should exemption levels dip.

Mechanics of toggling-off grantor trust status.

When a trust agreement is drafted with grantor trust powers such as the power of substitution or the settlor's ability to borrow from the trust at less than adequate security, grantor trust status may be toggled-off simply through the settlor's renunciation of the triggering powers. It may be that maintaining a power of substitution is desirable to obtain a basis step-up for appreciated trust assets, as described above, even though the grantor wishes to avoid grantor trust status. In such a circumstance, requiring that the right to substitute assets be made subject to the consent of an adverse party would prevent the power from triggering grantor trust status, while still providing basis planning flexibility. **31**

It may prove more challenging to terminate grantor trust status when the inherent nature of the trust's beneficiaries or its assets trigger grantor trust status. Without purposeful and intentional drafting, almost any trust created for the benefit of the settlor's spouse will be taxed as a grantor trust pursuant to **Section 677** , and toggling off grantor trust status may be challenging without defeating one or more of the settlor's other planning objectives. A SLAT, for example, is typically taxed as a grantor trust pursuant to **Section 677(a)** , because the trust income and principal may be distributed to the recipient spouse or accumulated for future distribution to the recipient spouse in the discretion of the trustees. **32** Additionally, a trust holding policies of life insurance on the lives of the settlor or the settlor's spouse will be taxed as a grantor trust for as long as the trust owns the policy, and any portion of the trust's income may be applied for the payment of the premiums. **33**

Taxation as a grantor trust pursuant to **Section 677** may be avoided if distributions to the settlor's spouse may be made only with the consent of an adverse party. **34** An individual is considered "adverse" if such a person possesses a "substantial beneficial interest" in the trust that would be adversely affected by their exercise or non-exercise of a power. **35** Identifying an individual who may hold an "adverse" interest may prove difficult, as the determination of "substantiality" is heavily fact-based to be made by the relative size of such an individual's interest in relation to the size of the trust corpus. **36** A settlor may have greater comfort relying on the appointment of a distribution committee made up of a class consisting of the discretionary trust beneficiaries who have the discretion to distribute income and/or principal between or among themselves. **37** If trustees must act by a majority vote, crafting flexible trustee removal and replacement provisions may enable the appointment of a de facto distribution committee to a trust that did not initially contemplate one. The distribution committee members will not have a GPOA if their exercise of the power is only exercisable in conjunction with another member of the committee who has a substantial adverse interest to the exercise of the power of the holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate. **38** Further, because none of the other distribution committee members have a power exercisable alone to vest the trust income or corpus in himself or herself, none of them are deemed to be the owner of the trust for income tax purposes pursuant to **Section 678(a)** . **39**

Given the possibility that some trustees may die or resign during the trust term, this approach necessitates vigilant monitoring and supervision. For example, if member(s) of the committee die or resign, the appointment of the necessary replacement adverse committee member(s) could easily slip through the cracks. If the committee is advertently reduced to only one member, the member's power of consent to distributions would no longer be checked by another trustee whose interest is substantially adverse to his or her own. If left unchecked, the sole committee member may be deemed to have a GPOA.

If the original trust terms or applicable state law permit decanting, a preexisting trust should be decanted to a trust that contemplates a more robust distribution committee structure. Such a structure should require that the committee must always consist of multiple members whose interests are adverse to each other and to the settlor's spouse. The trust should also provide that any additional distributions are frozen until the necessary committee positions are appointed. If it is not essential for a spouse to retain access to the trust funds, another approach could require that the settlor's spouse is automatically removed as a trust beneficiary after the last of included grantor trust provisions are renounced (discussed in greater detail below). This approach obviates the need for the appointment of a committee of adverse parties, whom, in many cases, would be limited to the settlor's children or more remote issue, who may not be ideal parties in the minds of the settlor to be in charge of the purse strings.

Planning for Divorce

With couples in quarantine for the foreseeable future, it may be that we see a rise in the number of divorces filed post-pandemic. If a settlor and her spouse divorce subsequent to the creation of a trust that was held, at least in part, for the benefit of the spouse, the settlor may intend under such a circumstance that the donee spouse is removed as a permissible beneficiary, or, at the least, that the beneficiary spouse pays the income taxes on any future distributions he or she receives from the trust.

For divorces that were finalized prior to December 31, 2018, Section 682 superseded any grantor trust provisions for income that was "paid, credited, or required to be distributed" to the spouse in a given tax year. **40** For divorces that were not finalized before December 31, 2018 (regardless of the date the trust was created), the settlor may still be taxed on trust income if the ex-spouse remains a beneficiary and income may be paid to or accumulated for the future distribution to him or her (without the consent of an adverse party). **41** For purposes of the grantor trust rules, a grantor is treated as holding any power or interest held by "any individual who *was* the spouse of the grantor at the time of the creation of such power or interest." **42** If one creates a trust under which her spouse is a beneficiary or trustee and the individuals later divorce, the settlor is treated as holding the interests and powers of the former spouse.

> **Planning Note:** The repeal of Section 682 will not sunset with the 2017 Tax Act in 2026, so planning with flexibility in the event of a divorce will remain an important consideration.

To sidestep unavoidable powers causing grantor trust status, one should integrate safeguards that are triggered in the event of a divorce. For example, the trust should include a "floating spouse" provision that removes the settlor's spouse as a beneficiary upon the filing of a petition for divorce. Even if the spouse is removed as a beneficiary, however, the trust may still qualify as a grantor trust if the beneficial enjoyment of the trust income or corpus is subject to a power of disposition exercisable by the grantor's ex-spouse without the approval or consent of an adverse party. **43** Such power of disposition would include an *inter vivos* limited power of appointment over accumulated trust income (grantor trust over the income portion only) or a testamentary or *inter vivos* limited power to appoint the accumulated income and remainder interest. **44** As such, it is crucial to draft a "floating spouse" provision broadly to automatically remove an ex-spouse from the trust for all purposes, including as a trustee and as a holder of any power of appointment to avoid triggering a **Section 674** grantor trust power. Further, the provision can be drafted to replace the old spouse with a new spouse as a trust beneficiary, if desired. **45**

If removing the spouse from the trust is not a viable option, activating a right to reimburse the settlor may be possible. [46] If the right of reimbursement for income taxes paid by the settlor was neither mentioned nor explicitly prohibited by the trust agreement, it may be a default power of the trustees pursuant to applicable state law or can be included in the marital property settlement agreement. [47] Such a provision could mimic the result of Section 682, in that the amount of the tax paid by the settlor may be reduced by the amount that would have been payable by the payee spouse as if Section 682 was never repealed. If the ex-spouse may not be removed and the right of reimbursement is not a viable option, the settlor may feel comfortable with continuing to pay the income taxes on the trust income if the trustee exercises his discretion to make distributions only among the class consisting of the settlor's issue.

Reporting the Gift

With clients scrambling to make year-end gifts, advisors must not only assist with the creation of appropriate trust structures but must also advise clients on how to efficiently coordinate gifts between spouses and maximize the client's transfer tax exemptions. Tax-efficient planning necessarily involves making the appropriate gift tax and generation-skipping transfer tax elections when preparing the client's gift tax return. Depending on the asset gifted and the size of the gifts, the decision-making process may be very different than in years past.

Gift-splitting.

When filing a gift tax return reporting a completed gift to a trust, clients are faced with the decision whether to make an election to "split-gifts" with a spouse. If the election is made to split gifts, all taxable gifts in the year elected are deemed to have been made one-half by each spouse, regardless of which spouse transferred the assets. [48] By splitting the gift, both spouses could use their annual exclusions and gift and generation-skipping transfer tax exemptions without first equalizing their estates. Further, although the amount of the gift that is split to a trust in which the spouse is a beneficiary is limited to the ascertainable portion of the transfer attributable to the non-spousal interest, splitting gifts also enables the consenting spouse to remain a discretionary beneficiary of a trust sheltered with her exemption without requiring her to be the settlor of a trust receiving the gift and, therefore, without necessitating that the trust has its situs in a self-settled trust jurisdiction. [49]

With a sense that the increased exemption may be significantly reduced in the near-term, one must consider whether splitting gifts (or even equalizing estates to make separate gifts) will risk unnecessarily wasting exemption. As discussed in greater detail above, an individual will not have taken advantage of the benefit of the currently high exemption levels unless he or she gifts an amount above the amount that the exemption will revert to in 2026, or even earlier. [50]

For married clients who may intend to make gifts that exhaust no more than a single spouse's current $11.58 million exemption, gift splitting will result in an inefficient usage of exemption because, as a marital unit, neither spouse will fully maximize his or her increased exemption available before exemption levels decrease. For example, if the donor spouse makes an $11.58 million gift before the end of 2020 and does not split gifts, the donor spouse will have used both his original exemption and his bonus exemption and, although the donee spouse will not make gifts large enough to have used any bonus exemption, she will still have the entirety of her original exemption available in later years. If, however, the donor spouse elects to split gifts, both the donor and the consenting spouses will have only used their original exemptions. In later years, neither spouse will have any exemption remaining. Assuming that the couple has sufficient assets to take advantage of the additional exemption, the election to split gifts will have cost them millions in additional taxes. If the exemption levels drop sooner and more drastically, the cost of splitting will be more dramatic.

For the same reasons, married clients who intend to make gifts in excess of a single spouse's current $11.58 million exemption should prepare to fully utilize one spouse's bonus exemption before the other spouse begins to make gifts or consents to split. However, for clients who can afford to make large enough gifts, splitting such gifts in excess of the bonus exemption in 2020 will also result in inefficient use of the exemption, and failing to split such large gifts will result in payment of gift tax. In such situations, the clients should consider each making separate gifts in 2020. If the less-monied spouse does not have the wealth necessary to make the gifts, the wealthy spouse may find that there is not enough time to make an equalizing gift to the less-monied spouse to use to make gifts before the year-end without risk of a resulting step-transaction. **51** If a step transaction is a concern or if the settlors contemplated a single trust plan, then the more monied spouse may consider making a smaller gift in 2020 to allow for a larger, splittable gift to be made in 2021 without triggering an estate tax. Of course, if the exemptions do not go down next year, there will be more time for settlors to put such gifting plans into effect. If the legislature changes the law retroactively to early 2021, then one may have missed the opportunity to use up the balance of the donor spouse's bonus exemption.

Late allocation of GSTT exemption.

The stock market is at all-time highs despite a global recession, and the suburban real estate market is bustling with a surge in demand from evacuating city dwellers. Individuals who have recently made gifts or who will be making gifts in anticipation of reduced exemption levels may be able to significantly leverage their unused GST exemption by making late allocations to trusts receiving gifted assets that one anticipates will decrease in value.

If, on the due date, the property has depreciated from the value on the date of the transfer, the allocation of GST exemption could take place at a later date. **52** The allocation in such a case would be effective at the lower value on the date of the late allocation instead of at the higher value on the date of the transfer because the allocation is not timely. **53** Because of the practical difficulty of valuing the trust assets on the same day that the return is filed, the transferor may elect to treat the allocation as having been made on the first day of the month of the late allocation to determine the fair market value of the trust assets.

For gifts made in 2019, the IRS has given taxpayers an automatic extension of time to file their timely filed gift tax return from April 15, 2020, until June 15, 2020. **54** With a timely filed extension, taxpayers will have until October 15, 2020, to file a return. For gifts made in 2020, returns will be due by April 15, 2021 unless the IRS grants similar extension relief.

For clients making gifts to trusts, it is incredibly important to be mindful of the date in which a gift tax return is due. If a trust is one to which the automatic allocation rules apply, whether because the transfer is a direct skip or because the trust to which an indirect skip is made is classified as a "GST Trust," a return must be filed before its due date to opt-out of the automatic allocation rules. If the automatic allocation rules apply, the client may not file a late return to re-allocate the GSTT exemption that was already automatically allocated.

Given the complexity of the rules governing when a trust is to be considered a "GST Trust," the taxpayer should either affirmatively elect to treat his trust as a GST trust to which the automatic allocation rules would apply, or opt-out of automatic allocation and file a notice of allocation to manually allocate exemption on the first return filed reporting the transfer to a new trust. Should the taxpayer opt-out of automatic allocation of exemption to the trust, the taxpayer may choose to allocate exemption on the timely return, or leave the allocation schedule blank, instead waiting to see whether the gifted asset values later decrease. Although one might wonder whether it always makes sense to make a late allocation because there is no technical deadline for doing so, one cannot make a late allocation after a taxable distribution occurs. Another risk with relying on a late allocation after the gift tax return due date is that the value of the trust could increase rather than decrease, nullifying the benefit of the delay and possibly even resulting in an increase in the amount of exemption required than would have been necessary had the return been timely filed.

Conclusion

There are many potential opportunities to assist clients who are facing personal and professional changes as a result of the effects of COVID-19 on society, public policy, and economics. Advisors should be mindful that some of these opportunities may be less attractive after the end of 2020.

1 Tax Cuts and Jobs Act, P.L. 115-97, 12/22/17.

2 The 2017 Tax Act implemented the Chained Consumer Price Index for All Urban Consumers ("C-CPI-U"), replacing the Consumer Price Index for All Urban Consumers ("CPI-U"). **Section 2010(c)(3)(C)** .

3 Senator Bernie Sanders has also put together draft legislation, known as the "The 99.8% Act," Senate Bill 309. If enacted in some form, the estate tax exemption would revert to $3.5 million with progressive tax rates and the gift tax exemption would revert to $1 million.

4 Irwin, "The U.S. Is About to Vastly Increase Its Debt. That's a Good Thing," *N.Y. Times*, 3/27/20, updated 8/21/20, at https://www.nytimes.com/2020/03/27/upshot/stimulus-national-debt-coronavirus.html?searchResultPosition=7; Moody's now expects it to be more like 10% to 12%. Fitch estimated it will be 13%. These numbers would exceed the previous post-World War II record for the deficit, which was in 2009, when it was 9.8% of G.D.P. https://www.nytimes.com/2020/03/27/upshot/stimulus-national-debt-coronavirus.html?searchResultPosition=7.

5 The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312 ("the 2010 Tax Act") established an estate tax exemption of $5 million, effective Jan. 1, 2010 through Dec. 31, 2012. **Sections 302(a)** , 101(a).

6 **TD 9884** , 84 Fed. Reg. 64,995 (11/26/19).

7 Prop. Reg. 106706-18.

8 **Reg. 25.2511-1(g)** .

9 A beneficiary who has the power to distribute assets to himself that is not limited by an ascertainable standard, will have a GPOA and will be required to include the assets in his gross estate for estate tax purposes pursuant to **Section 2041** . **Section 2041** includes an ascertainable standard exception for a power that is limited to the health, education, support, or maintenance of the decedent.

10 In order to make a completed gift for gift and estate tax purposes, the settlor must "have so parted with dominion and control as to leave him no power to change its disposition." **Reg. 25.2511-2(b)** .

11 *Estate of Grace*, 395 U.S. 316 324 **23 AFTR2d 69-1954** (1969).

12 A discussion of the particulars of drafting non-reciprocal trusts is beyond the scope of this article.

13 A grantor is taxable under ***Section 675(2)*** as the owner of any trust or portion of a trust over which the grantor or any non-adverse person has the power to lend trust income or corpus, directly or indirectly, to the grantor without both adequate interest and adequate security.

14 See **Rev. Rul. 76-103** ; **Rev. Rul. 77-378** ; and *Paolozzi*, 23 TC 102 (1954); **Sections 2036(a)(1)** , 2036(a)(2), 2038.

15 **Rev. Rul. 2004-64, 2004-2 CB 7** ; *Estate of Paxton*, **86 TC 785** (1986).

16 19 states have adopted self-settled trust legislation. Nine other states have adopted some more limited version of a self-settled trust legislation. The law in this area is not fully settled. There is the potential that the creation of a self-settled trust outside the settlor's state of residency could subject the trust assets to such spouse's creditor claims. As such, it may be prudent to provide that the independent person, preferably acting in a non-fiduciary capacity, can add any individual in the class of persons consisting of the descendants of the settlor's parents rather than specifying that the settlor may be added specifically.

17 Like a SLAT, perhaps the safest and best approach is to avoid using a self-settled trust at all. The trust can grant a non-fiduciary a limited power of appointment ("LPOA") that is exercisable among a broad class of individuals that includes the settlor or a discrete trust under which the settlor is a discretionary beneficiary. Unless there was a pre-arranged agreement to exercise the power, and that the beneficiary spouse would exercise it in such a manner, there should be no inclusion in the gross estate of the surviving spouse. *Cf.* **Rev. Rul. 2004-64, 2004-2 CB 7** . The trust to which assets are appointed may be more limited than it otherwise would have been, as it should not contain any additional powers of appointment exercisable by the original settlor in order to avoid the argument that the trust assets should be includable in the settlor's estate pursuant to **Section 2038** .

18 The basis of property inherited or acquired from a decedent is equal to its fair market value at death (or its value on the alternate valuation date, if elected). **Section 1014(a)** . Although colloquially referred to as a "step-up" in basis, the basis of property included in a decedent's estate may also be subject to a "step down" if the asset depreciated in value.

19 **Sections 2041(b)(1)** and **2514(c)** .

20 There are also some exceptions to this definition, including a power that is subject to an ascertainable standard relating to health, education, support, or maintenance, and a power that is exercisable jointly with the creator or with a person having a substantial adverse interest. **Sections 2041(b)(1)(A)** , (C).

21 It is recommended to have a non-fiduciary or a party acting in a non-fiduciary capacity confer the power, in order to reduce or avoid the possibility that the conferring party would be in breach of a fiduciary duty by conferring the power by, for example, increasing taxes or shifting tax liability from one person to another in an unanticipated way.

22 Although a trustee who has no beneficial interest in the trust does not have an adverse interest, as a fiduciary, his or her exercise or non-exercise could trigger a breach of a fiduciary. See **Reg. 20.2041-3(c)(2)** . A trust protector or other person acting who is not a fiduciary could be given the power to confer a GPOA, which also be revoked at a later date, if necessary or desirable.

23 Section 675(4)(C) and **Rev. Rul. 2008-22, 2008-16 IRB 796** . In this circumstance, it is also desirable for the settlor to authorize her power of attorney agent to swap assets in the event of the settlor's incapacity, as both the settlor and the trustee are involved in the transaction.

24 Haag, "New Yorkers Are Fleeing to the Suburbs: 'The Demand Is Insane,'" *N.Y. Times*, 8/30/20, at https://www.nytimes.com/2020/08/30/nyregion/nyc-suburbs-housing-demand.html

25 Section 671 ; Reg. 1.671- 2(d).

26 Trust-level taxation at the state level will depend on the laws of the settlor's new state of residence and potentially others to which the trust maintains a connection.

27 Sections 661 and **662** .

28 Rappeport & Smialek, "I.M.F. Predicts Worst Downturn Since the Great Depression," *N.Y. Times*, 4/14/20, updated 6/24/20, at https://www.nytimes.com/2020/04/14/us/politics/coronavirus-economy-recession-depression.html; Goldberg, "The New Great Depression is Coming. Will There Be a New New Deal?" *N.Y. Times*, 5/2/20, at https://www.nytimes.com/2020/05/02/opinion/sunday/coronavirus-new-deal-ubi.html.

29 Section 1(j)(2) .

30 The payment of the income tax by the Grantor is not a taxable gift. See **Rev. Rul. 2004-64, 2004-2 CB 7** .

31 Reg. 1.675-1(b)(4) .

32 Section 677(a) ; The scope of **Section 677(a)** is extremely broad. Almost any trust in which the settlor's spouse is or could be a future beneficiary is likely to qualify as a grantor trust under this Section. See *Helvering v. Evans*, 126 F.2d 270 **28 AFTR 1322** (CA-3, 1942).

33 Section 677(a)(3) . The settlor is treated as the owner of any portion of a trust from which income, without the approval or consent of any adverse party, is, or in the discretion of the settlor or a non-adverse party, or both, may be applied to the payment of premiums on policies of insurance on the life of the settlor or his spouse.

34 In order to be an adverse party, such individual must have a significant financial interest. The law is not settled as to what constitutes a significant financial interest that would qualify that individual as adverse.

35 Section 672(a) .

36 Reg. 1.672(a)-1(a) .

37 In such a case, the members of a distribution committee would have retained a substantial beneficial interest in both the income and principal of the trust. If they exercised their authority to make distributions to the settlor or the settlor's spouse, then their interest would be adversely affected. **Ltr. Rul. 201310002** , **Ltr. Rul. 200502014** , **Ltr. Rul. 200148028** .

38 Ltr. Rul. 200731019 , **Ltr. Rul. 200729025** , **Ltr. Rul. 201438010** .

39 *Id.*

40 Reg. 1.682(a)-1(a)(1)(i) . Section 682(a) applied to ordinary income with a carve-out for income determined to be allocated specifically for child support. As such, if a spouse is only a discretionary beneficiary of the trust without a mandatory right to a distribution (such as is commonly the case with a SLAT), it might be that such a trust never fell within the purview of Section 682.

41 The grantor trust provisions should remain applicable after divorce as **Section 677(a)(1)** takes a snapshot of the parties' marital status at the time of the creation of the interest. **Section 672(e)(1)(A)** ; **Section 677(a)(1)** . See **Section 672(e)** 's spousal attribution rule.

42 Section 672(e)(1)(A) .

43 Section 674(a) .

44 A limited power of appointment held by the grantor's ex-spouse would trigger grantor trust status because of the **Section 672** spousal attribution rules. The portion rule limits the grantor trust status under **Section 674(b)(3)** to the income portion of the trust. See **Reg. 1.671-3(b)(1)** . A testamentary power to appoint the remainder interest in a trust held by the grantor or the grantor's spouse will cause the principal portion of a trust to be a grantor trust. See **Section 674(a)** ; **Reg. 1.674(b)-1(b)(3)** .

45 See **Rev. Rul. 80-255, 1980-2 CB 272** .

46 Although the right of reimbursement will not by itself cause an estate inclusion issue, if the settlor and the trustees have a pre-arranged agreement that the trustee would exercise his discretion to do so, it could present a problem. See **Rev. Rul. 2004-64, 2004-2 CB 7** . Practitioners must also be mindful as to whether inclusion of a tax reimbursement clause will cause the trust to be available to the settlor's creditors. Arizona, Florida, Kentucky, Maryland, New Jersey, North Carolina, New York, Oregon, and Texas, to name some, have statutes protecting the settlors from estate inclusion in this regard.

47 New York, for example, includes such a right for *inter vivos* trusts. EPTL 7-1.11(a).

48 Section 2513 ; **Section 2652(a)(2)** .

49 If the consenting spouse is a beneficiary of the trust, the donor spouse may only elect to split gifts if the spouse's interest in the trust is ascertainable, severable, and de minimis. See **Rev. Rul. 56-439, 1956-2 CB 605** ; *Wang*, **TCMemo 1972-143** . Although this may be difficult to ascertain, gift splitting should be permissible under certain circumstances in which distributions the income and principal to the spouse are limited by an ascertainable standard. Nonetheless, even though the non-spousal interest may be split for gift tax purposes, a full one-half of the transferred amount shall be treated as having been transferred by the consenting spouse for GST purposes. **Reg. 26.2652-1(a)(4)** .

50 Prop. Reg. 106706-18.

51 The policy behind the step transaction is to negate unnecessary intermediate steps in a transaction that were taken in order to bypass undesirable tax consequences that would result if the steps had been skipped. In such a case the IRS may disregard the intermediate steps. *Smith*, **78 TC 350** 398 (1982). Application of the step transaction doctrine will result in a court either ignoring one or more of the various separate steps in the structure of a transaction or collapsing all steps into a single transaction. *Id.*

52 Reg. 26.2642-2(a)(2) .

53 Section 2642(b)(3) .

54 See IRS guidance at https://www.irs.gov/businesses/small-businesses-self-employed/covid-19-relief-for-estate-and-gift.