The New “Moderately Wealthy” – Clients with a Net Worth Under $11 Million

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A. Introduction

An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, P.L. 115-97 (December 22, 2017) (the "2017 Tax Act") and The American Taxpayer Relief Act of 2012, P.L. 112-240 (January 2, 2013) ("ATRA"), brought historically high basic exclusion amounts and GST exemption (currently $11,400,000), indexed for inflation, and portability. Thus, the 2017 Tax Act and ATRA have rendered trusts far less important in transfer tax planning than they were less than ten years ago. Without transfer tax incentives to use trusts in their estate plans, many estate planning clients and their advisors in 2019 have ample reason to ponder the utility of trusts for their surviving spouses, children and grandchildren. In the vast majority of cases, however, trusts for clients' children and more remote descendants (at least until they reach designated ages) remain viable and important.

B. Dead Hand Control

One of the main advantages of retaining assets in trust after the client's death is that, by carefully designing trust instrument's provisions, the estate planner can construct a dispositive arrangement lasting indefinitely and comporting precisely with the client's desires. In addition, the client can name the initial and successor Trustees whom the client trusts to carry out his or her wishes. The Trustee may be granted broad or narrow discretion over distributions. The Trustee may be given specific investment directions. A beneficiary may be given powers to withdraw trust assets upon reaching designated ages.

C. Trusts as Motivational Tool

An "incentive trust" is a trust that is designed not merely as a vehicle for investment management, funds distribution and, possibly, tax savings but, in addition, as a motivational tool—one that promotes and encourages "good" behaviors and tendencies and discourages or even punishes "bad" behaviors and tendencies. *See* Redd, *The Ultimate in Dead Hand Control – Incentive Trusts – Parts I and II*, TRUSTS & ESTATES (May and July 2015).

Instruments setting up incentive trusts typically contain a statement of purpose whereby the settlor states his or her desires in a humanistic, rather than a technical way, regarding family values, hopes and expectations. The settlor will then set forth the conditions upon which distributions should be made or withheld. For example, if a parent wants to encourage a child's academic success, a governing instrument may provide for distributions for school-related expenses if the child stays enrolled in an accredited, recognized and reputable college or university while actively pursuing a full-time course of study leading to graduation or to a diploma or degree and maintaining a particular grade point average. In contrast, a parent may provide that trust distributions to an incentive trust beneficiary should be reduced or eliminated in cases in which the beneficiary is charged with or convicted of committing certain categories of offenses, has a lavish lifestyle that could not be maintained without support from the trust, or makes large gifts to individuals or charities that he or she could not independently afford to make.

Incentive trusts can be difficult to administer. To make them effective, a strong-willed Trustee should be designated, and that Trustee needs access to records for verification. The governing instrument should make clear the applicable verification requirements and that the beneficiary's failure to provide mandatory information or submit to mandatory testing results in failure to meet the trust standards such that the beneficiary is not entitled to distributions.

D. Protection from Creditors' Claims

Trusts also offer an excellent method by which to protect a beneficiary's inheritance from the claims of his or her creditors. Asset protection may be achieved by means of a spendthrift clause, which prohibits a beneficiary from voluntarily or involuntarily assigning his or her interest in the trust, or by conferring extremely broad dispositive discretion on the Trustee, or by using a combination of these techniques. Depending on applicable state law and surrounding facts and circumstances, a beneficiary may be able to create and fund his or her own asset protection trust, but the likelihood of success of a trust created by the beneficiary as an asset protection vehicle, as compared to the likelihood of success of an asset protection trust created for a beneficiary by a parent or grandparent, is less certain.

E. Protection from Claims of Spouses and Ex-Spouses

Although there has been some erosion in recent years in this trust advantage, in general, unless the trust is administered essentially as the beneficiary's *alter ego*, assets held in trust are unlikely to be considered property subject to division between the beneficiary and his or her spouse in the event of a dissolution of their marriage. Additionally, while in many jurisdictions ex-spouses of a trust beneficiary are considered "exception creditors" outside the otherwise applicable protection of a spendthrift provision to the extent they seek access to trust property to satisfy the beneficiary's legal obligations to pay alimony or separate maintenance, a wholly discretionary trust may well avoid alimony or separate maintenance claims (because its status as a protective device does not rely on a spendthrift clause). At the very least, it can be said that a distribution in trust for a beneficiary will provide better protection from the claims of a beneficiary's ex-spouse than an outright distribution (which provides no such protection). Furthermore, assets held in a trust created for a beneficiary by a parent or grandparent should never be considered community property or subject to a surviving spouse's elective share rights.

F. Mechanism for Handling Business Interests

An owner of family business interests may use trusts as devices by which efficiently to hold such interests and to transmit such interests, or beneficial interests therein, among appropriate family members in a precise, customized and advantageous manner. The business owner may initially hold the business interests in his or her revocable trust. Provisions may be included in the trust instrument directing, generally or in great detail, the manner in which and by whom, as successor Trustee, such interests shall be administered in the event the business owner becomes incapacitated. Holding business interests in a revocable trust may be preferable to the business owner's holding such interests in his or her sole, individual name and relying on the attorney-in-fact under a durable power of attorney to administer the business interest or add it to the business owner's revocable trust if and when the business owner becomes incapacitated. Third parties, though generally comfortable dealing with successor Trustees under revocable trust instruments, frequently are reluctant to deal with attorneys-in-fact under durable powers of attorney.

At the business owner's death, the trust instrument may direct: (a) to or in trust for whom the business interest shall pass; (b) who, as Trustee or otherwise, shall have voting power with respect to voting interests in the business held in the trust; and (c) the manner in which the business interests shall be administered for the benefit of the beneficiaries and ultimately distributed or disposed of. In some cases, retaining the business interest in trust, at least initially, after the business owner's death, rather than distributing it directly to the next generation, should help guard against abuse of power by those who are not yet ready to wield it.

G. Providing a Nest Egg for Beneficiary

An outright distribution to a beneficiary may be squandered. A trust for a beneficiary, depending on how it is designed and managed, may be in place as an ultimate financial safety net for the beneficiary regardless of negative developments affecting the beneficiary.

H. Probate Avoidance

Another advantage of holding assets in trust for beneficiaries, rather than mandating immediate, outright distribution to them at the client's death, is easy, automatic probate avoidance in the event of a beneficiary's incapacity or death.

I. Disadvantages of Trusts

There are disadvantages of trusts for beneficiaries that an estate planning client and his or her advisors should consider. One drawback are the added costs associated with maintaining a trust. In addition to the costs, there are some additional complications arising from using trusts for beneficiaries as opposed to outright distributions. The Trustee must remain constantly vigilant about his, her or its fiduciary duties to current and remainder beneficiaries. Furthermore, there are severely compressed federal income tax rates for income accumulated and capital gains realized in nongrantor trusts. State income tax must be considered as well. Finally, the terms of a trust may become inappropriate depending on how circumstances evolve after the client's death. Depending on applicable law, it may be possible to resolve the problem through reformation, modification, decanting, a nonjudicial settlement or court action, but any of these solutions would involve complication and expense.

Ultimately, the anticipated value of the client's assets may be determinative. There is a point at which the size of a trust is just too small to justify the costs and complication of ongoing trust administration.

II. Utilizing Powers of Appointment for Income Tax and Non-Tax Purposes

A. Delaware Tax Trap

The so-called Delaware Tax Trap is an estate planning concept that, given the low estate tax exemption amounts of the past, was indeed a "trap" usually to be avoided. However, with the historically high basic exclusion amounts of today and the next several years, the trap may, in some cases, be an "opportunity."

In the past, as interest in long-term trusts increased, estate planners sought to set up trusts that would last beyond the time permitted by the common law rule against perpetuities by utilizing limited or general powers of appointment. Delaware's statutory framework allowed such long-term trusts to exist indefinitely through the exercise of limited powers of appointment in successive generations. Such technique allowed multi-generational transfers without ever subjecting the trust assets to federal transfer tax liabilities. In response to this tax avoidance technique, and to dissuade a holder of a limited power of appointment created under Delaware law from exercising such power in a manner to avoid the restrictions ordinarily imposed by the rule against perpetuities, Congress enacted Internal Revenue Code (IRC) § 2041(a)(3). Pursuant to this statute, property subject to a limited power of appointment (ordinarily, of course, not estate tax sensitive) may be includable in the holder's gross estate if the power is exercised by granting another power of appointment which under state law can be validly exercised to postpone the vesting of any interest in the property for a period ascertainable without regard to the date of the creation of the first power.

Today, because of the very high basic exclusion amount, a client's overall tax strategy in connection with estate planning may be focused on achieving the step-up in basis rather than avoiding estate taxes. In this environment, the Delaware Tax Trap is quite attractive and promotes great flexibility. If the holder of a non-general power of appointment exercises it in the manner described in IRC § 2041(a)(3), the trap is sprung and estate tax inclusion (and basis step-up with respect to the assets subject to the power) results. Perhaps, the exercise of such a power could be carried out by means of a formula to ensure that estate tax liability is not triggered. If the holder does not exercise such power, then the power remains an innocuous power the mere possession of which has no tax consequence.

B. Non-Tax Uses of Powers of Appointment

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

1. Refining Perpetual Trusts

With the repeal or extension of the Rule Against Perpetuities in many states, and the ability of grantors to create trusts invoking the law of those states, there has been much discussion of ever-lengthening trust terms or even so-called perpetual trusts. Perpetual charitable trusts have been allowed for hundreds of years, yet only a few last for longer than a century; so the viability of multi-century or longer trusts may be questioned. These long-term or perpetual trusts have been attacked on the ground that the number of beneficiaries will outstrip the ability of any Trustee to manage the trust and that the trust will become outdated. *See*, *e.g.*, From Here to Eternity: The Folly of Perpetual Trusts, Univ. of Michigan Public Law Working Paper, no. 259. Working Paper by the distinguished professor and long-time leader in the trusts and estates field, Lawrence W. Waggoner of the University of Michigan; and *Immortality and the Law: The Rising Power of the American Dead* (Yale University Press, 2010) by Ray D. Madoff, a thoughtful professor at Boston College Law School. Powers of appointment are the answer to much of the criticism. Through the judicious use of powers of appointment, a long-term trust may be refined as needed.

2. Powers to Appoint are Powers to Disappoint

Many clients want to give a senior generation almost, but not quite, unfettered access to trust assets. For example, the client may want the surviving spouse as trust beneficiary to be untroubled by the complaints of the children or grandchildren that the surviving spouse's lifestyle is too expensive yet do not want to give the surviving spouse an unlimited ability to divert trust assets. These concerns may also extend to trusts for children when assets are to remain in trust for grandchildren. A common response to this concern is to allow the senior beneficiary to appoint the trust assets at death among the junior beneficiaries. For example, a child is less likely to challenge a surviving spouse when the surviving spouse could decide that the child's siblings are more desirable remainder beneficiaries.

3. Moving Jurisdictions

Powers of appointment may also be used to move trusts from one taxing jurisdiction to another. In *Linn v. Department of Revenue*, 2013 IL App (4th) 121055 (December 18, 2013), the court held that Illinois could not tax an *inter vivos* trust created by an Illinois resident in 1961 where the trust assets were moved in 2002, by means of exercise of a power of appointment, to a Texas trust with a Texas Trustee, and no trust beneficiaries were in Illinois.

III. Minimizing Trust-Level Income Taxes

A. Drafting and Using Trust Provisions

Trust provisions can be designed and utilized to enable distributions to beneficiaries (especially those in a lower income tax bracket than the trust) and avoid trust-level income taxes. A trust document could provide for the mandatory distribution of trust income to a beneficiary. Alternatively, a trustee could make distributions judiciously carrying out "distributable net income" (DNI) with sufficiently broad dispositive discretion. The beneficiary may also be given a withdrawal power over a portion of the trust property. Increasing the ability to force distributions from the trust, however, must be balanced against the loss of creditor protection for any property subject to distribution. A power of withdrawal may be inappropriate, for example, if the beneficiary is financially irresponsible and the trust property should instead be preserved in trust.

In pursuing distribution strategies with a tax-saving strategy, a Trustee should be mindful of his, her or its fiduciary duties to all trust beneficiaries – current, future and remainder beneficiaries, vested and contingent. By increasing current trust distributions to carry out DNI to beneficiaries, the Trustee may be making distributions that are excessive in relation to the distributee's needs, the size of the trust and the standards set out in the trust's governing instrument for the making of distributions. Moreover, by maximizing current trust distributions with a singular focus on tax planning, the Trustee may be jeopardizing the interests of other or future or remainder beneficiaries by depleting the trust's asset base and depriving those other or future or remainder beneficiaries of their legitimate beneficial interests in the trust.

B. Distributions of Ordinary Income

Given the current framework of income taxation of individuals and trusts, if given the discretion and authority to do so, a Trustee may desire to make discretionary distributions so as to carry out as much of the trust's taxable income to trust beneficiaries as possible. IRC § 661. Since the applicable threshold amount for the top income tax rate of 37% is much higher and, therefore, more favorable, for individuals than for non-grantor trusts, distributions to trust beneficiaries in lower tax brackets can offer substantial savings. The differential can be even greater when also considering state income tax.

Trustees should not, however, overlook the potential impact of the "kiddie tax," which, after the 2017 Tax Act, imposes a trust's income tax rate on certain unearned income shifted from a trust to the child. IRC § 1(j)(4). The kiddie tax generally applies to children under age 18 at the close of the taxable year but may extend to a child who has not attained the age of 24 at the close of the taxable year if the child is a student. *See* IRC §§ 1(g)(2)(A), 152(c)(3). The changes made by the 2017 Tax Act to the kiddie tax expire on January 1, 2026.

C. Distributions of Capital Gain

As a general rule, capital gains are not included in DNI, except in the year the trust terminates. IRC § 643(a)(3). Capital gains and losses generally are allocated to principal and benefit (or disadvantage) the remainder beneficiaries of a trust or the residuary beneficiaries of an estate.

There are exceptions to the general rule which provide that capital gains will be included in DNI if they are: (a) allocated to fiduciary accounting income; (b) allocated to principal and "paid, credited, or required to be distributed to any beneficiary during the year" or (c) allocated to principal and "paid, permanently set aside, or to be used for [charitable] purposes specified in § 642(c)." IRC § 643.

With respect to items (a) and (b) above, Treas. Reg. § 1.643(a)-3(a) provides that "except as provided in 1.643(a)-6 [dealing with foreign trusts] and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary." Treas. Reg. § 1.643(a)-3(b) provides that capital gains will be included in DNI "to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law):

(1) Allocated to income (but, if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph Treas. Reg. §1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary."

IV. Ensuring the Availability of Basis Step-Up Other Than by Using Powers of Appointment

A. Basis Step-Up in General

While a primary goal of estate planners in the not-so-distant past was to avoid inclusion of the value of property in a decedent's gross estate, today, with a historically high basic exclusion amount, inclusion of the value of trust assets in a beneficiary's gross estate will more often be desirable. This inclusion will allow a step-up the basis of the assets to their fair market value as of the decedent's death (IRC § 1014(a)) thereby minimizing what could otherwise have been a sizable capital gains tax upon a sale or exchange of low-basis, high-value assets out of the trust. At the same time, so long as the value of the beneficiary's gross estate is equal to or less than his or her unused basic exclusion amount, no federal estate tax will result.

B. Planning for Basis Step-Up

Planning to achieve basis step-up in a sensible way while maximizing benefits involves consideration of a number of factors, including:

1. Types of Assets

Very low basis assets and collectibles, which are taxed at higher income tax rates, should be positioned so that they receive a basis step-up. Cash and property that has a basis greater than its fair market value will not benefit from a basis step-up.

2. State of Residence

An individual who lives in a high income tax state, such as California, and/or a state with no estate or inheritance taxes, such as Florida, may favor basis step-up rather than minimizing transfer taxes, while an individual who lives in a state with substantial state estate or inheritance taxes, such as Washington, or a state with no income tax, such as Texas, may favor an estate plan focused on transfer tax savings.

3. Expected Consumption

The extent and rate of consumption of resources by the individual(s) in question are relevant.

4. Expected Sales

Potential for selling particular assets, and timeframe in which such sales may reasonably be expected to occur, should be examined. For some assets, like closely-held business interests, the client may have no intention of ever selling the property. However, even if an asset will not be sold in the foreseeable future, beneficiaries can still benefit from a step-up in basis. For example, a step-up in depreciable or depletable assets will lead to more depreciation deductions, and a step-up in a partnership or S corporation interest may lead to more tax-free distributions from the entity.

5. Life Expectancy

The life expectancy of owners or potential owners of assets should be considered. In the context of income tax planning, impending death may be looked at as an "opportunity." *But see* IRC § 1014(e).

6. Rate of Reinvestment of Portfolio

If there is high turnover in an investment portfolio before the death of its owner or potential owner, there may be little unrealized appreciation in the investment portfolio at the owner's death.

7. Assets with Embedded Losses

To the extent an estate consists of assets whose fair market value of the death of the owner is less than their bases, the bases will step down to fair market value. IRC § 1014(a)(1).

Planning for basis step-up involves having property included in a person's gross estate so that it receives a basis step-up at death. IRC § 1014(b). Taking steps to ensure basis step-up may result in a greater benefit to the property owner's beneficiaries than making a lifetime gift to those beneficiaries if the basic exclusion amount and GST exemption would eliminate transfer taxes in any event and substantial income taxes would be avoided because of the basis step-up when the beneficiary sells the asset.

As saving income taxes becomes more beneficial to a particular client, the less likely that the client may wish to engage in making lifetime gifts. Such gifts will often decrease the amount of an estate that can obtain a basis step-up while achieving no transfer tax benefit. In addition, many estate planning professionals are unlikely today to advise most of their clients to engage in transactions that create valuation discounts for assets included in the gross estate, since the basis step-up will be greater if the fair market value of the assets is not discounted on the date of death.

C. Specific Planning Options

Techniques that a practitioner may utilize to include the value of assets in an individual's gross estate and receive a basis step-up include the following:

1. Making Outright Dispositions

The clearest, simplest and most direct method of causing inclusion in the gross estate of an individual of the value of assets is to give or distribute the assets to such individual. Of course, detailed in part I above, there are many non-tax reasons (the existence and weight of each of which will vary with each case) for not conferring outright ownership assets.

2. Purchasing or Receiving Distributions of Assets from Trusts or Partnerships

If certain property has been transferred into a trust, partnership or another vehicle that is not included (in whole or in part) in the transferor's gross estate, the transferor may be able to reacquire such property (by purchase or by receiving distributions) so that such property ends up included in the gross estate. Alternatively, the property could remain in the trust or other vehicle, but perhaps it could be modified so that the client has an interest in or power over the trust or other vehicle sufficient to cause inclusion of the value of such property in the client's gross estate under IRC § 2036(a).

3. Exercising IRC Section 675(4)(C) Power

If the client is the settlor of an irrevocable trust over which the client retained the power to reacquire assets in exchange for other assets of an equivalent value, the client could exercise such power to remove low basis assets from the trust in exchange for the client's high basis assets.

4. Using a Community Property Trust

IRC § 1014(b)(6) provides, in general, that a surviving spouse's one-half share of community property is considered to constitute property "acquired from or to have passed from the decedent." Thus, the basis of the surviving spouse's one-half share of community property is its fair market value at the date of the predeceased spouse's death.[1] Since, by reason of IRC § 1014(b)(1), the basis of the predeceased spouse's one-half share of community property would, quite naturally, be established under the general rule of IRC § 1014(a), the overall result of IRC § 1014 is that *both halves* of community property receive a basis equal to fair market value at the date of the predeceased spouse's death.

Married couples residing in community property states can very easily avail themselves of this remarkable benefit. Obtaining this benefit is more of a challenge for spouses living in common law property states.[2] It may be possible, however, if they are willing to transfer assets to an Alaska, Tennessee or South Dakota community property trust.[3] A community property trust is, essentially, a trust whose dispositive and administrative provisions mimic the beneficial interests and rights of spouses in community property not held in trust. Specifically, each spouse ultimately has control, during life and at death, unless or until intentionally relinquished, over half of the assets in trust. In addition, the governing instrument contains a declaration that the assets transferred to the trust are community property (Alaska and South Dakota) or that the trust is a community property trust (Tennessee). South Dakota law imposes a requirement that additional language be included in the governing instrument.

Unfortunately, there is no statute, regulation, ruling or case specifically and unambiguously saying that assets conveyed to a community property trust by a spouse or spouses domiciled in a common law property state are "community property" within the meaning of IRC § 1014(b)(6).

Three fundamental questions must be addressed in discerning whether assets placed in a community property trust by nonresidents of Alaska, Tennessee or South Dakota are "community property" within the meaning of IRC § 1014(b)(6). First, will property be recognized as "community property" for purposes of IRC § 1014(b)(6) if community property status was implemented by a voluntary act as opposed to automatically flowing from the owners' status of living in a community property state and being married? Second, is it possible for

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[1] IRC § 1014(a).

[2] For ease of reference, in this article, Alaska, Tennessee and South Dakota are not included within the term "common law property state" even though common law property is the default property ownership regime for spouses in all three states.

[3] *See* AS § 34.77.100; Tenn. Code Ann. §§ 35-17-101, *et. seq.*; S.D.C.L. §§ 55-17-1, *et seq.*

property to be recognized as "community property" for purposes of IRC § 1014(b)(6) if legal title to the property is held in trust? IRC § 1014(b)(6) became law in 1948, long before the proliferation of *inter vivos* trusts, and so it is reasonable to believe that Congress, in enacting IRC § 1014(b)(6), did not contemplate that community property could be owned, in a legal sense, by any person or persons other than spouses outright. Third, in answering the first two questions, is it relevant that the spouses are nonresidents of Alaska, Tennessee or South Dakota and are in fact residents of a common law property state?

The answer to the first question appears to be "probably." In *McCollum*,[4] spouses made a choice (a voluntary act), as then permitted by applicable state law, to own certain real estate as community property. Following the death of the first to die, the survivor asserted that IRC § 1014(b)(6) applied in determining the basis of the survivor's half of the property. The District Court agreed and distinguished *Harmon*,[5] a Supreme Court case that was somewhat analogous but did not concern IRC § 1014(b)(6).[6] Furthermore, in Revenue Ruling 77-359,[7] the Internal Revenue Service ruled that a legally enforceable agreement between husband and wife (again, a voluntary act) that certain property that had been separate property should henceforth be considered community property would be recognized for income tax purposes.

The second question seems to be answered definitively by Revenue Ruling 66-283.[8] In that ruling, a husband and wife had transferred their community property to a revocable trust. Under applicable state law, community property could be held in trust without losing its character as such. The Internal Revenue Service ruled that, at the death of the predeceased spouse, the basis of the surviving spouse's one-half share of the community property held in trust would be established under IRC § 1014(a) because of IRC § 1014(b)(6).

The answer to the third question seems the most elusive. If nonresidents of Alaska, Tennessee or South Dakota, residing in a common law property state, were to create in Alaska, Tennessee or South Dakota what was ostensibly a community property trust but whose validity was later determined *not* to be governed by the law of Alaska, Tennessee or South Dakota, IRC § 1014(b)(6) would be rendered inapplicable because there would be no community property. To minimize the possibility of this result, it would be important that the trust have a "substantial relation" to Alaska, Tennessee or South Dakota (a requirement seemingly satisfied because, under the applicable community property trust statute, the trust would be required to have an Alaska, Tennessee or South Dakota resident Trustee), that application of Alaska, Tennessee or South Dakota law not violate a strong public policy of the state with which the trust has its most significant relationship (a requirement less easily satisfied depending on the state with which the trust is considered to have its most significant relationship, the public policies of

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[4] *McCollum v. United States*, 58-2 U.S.T.C. ¶ 9957 (D. Okl. 1958).
[5] *Commissioner v. Harmon*, 323 U.S. 44 (1944).
[6] IRC § 1014(b)(6) was not enacted until four years after *Harmon* was decided.
[7] Rev. Rul. 77-359, 1977-2 C.B. 24.
[8] Rev. Rul. 66-283, 1966-2 C.B. 297.

that state and the strength of those public policies) and that the trust instrument operate as a valid post-nuptial agreement.[9]

If clients and their advisers approach the community property trust technique with sound judgment and careful attention to detail, it may in some circumstances be an excellent basis-boosting strategy.[10]

5. Unwinding Family Limited Partnerships

The client may own an interest in an entity such as a family limited partnership by which the client has removed appreciating assets from the client's gross estate in exchange for equity interests that can be discounted for estate tax purposes.[11] Some clients conveyed assets to a partnership and gifted interests in the partnership over the course of years, seeking to remove the value of assets from their estates and transfer wealth to the next generation during life at discounted values. In addition, the partnership agreement may have allowed the original contributors to retain voting control while gifting non-controlling interests to children and grandchildren. This technique has been used for decades to facilitate, in some cases, significant transfer tax savings.

However, in this era of historically large and growing basic exclusion amounts, the family may conclude that the partnership is no longer desirable. It may be possible to "unwind" the entity and bring the value of the underlying assets back into the client's gross estate. Of course, this technique is probably not advisable if the value of the assets to be brought back into the gross estate will likely cause the client to have some transfer tax exposure after taking into consideration the client's applicable exclusion amount.

In addition, there are insidious income tax consequences that may result from terminating a partnership. Specifically, IRC §§ 704, 737 and 731 present potential hurdles for younger generations wishing to terminate a partnership within seven years of formation when the partnership holds highly appreciated assets. If the partnership elects to sell its assets upon dissolution and distribute cash to the partners, IRC § 704(c)(1)(A) provides that gain from the sale of partnership assets "shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." Generally, this means that the partnership will allocate any built-in gain on property to the partner who contributed the property and any excess gain will be allocated pursuant to the partnership agreement or as the partners agree. *See* Donaldson, *Super-Recognition and the Return-to-Sender Exception: The Federal Income Tax Problems of Liquidating the Family Limited Partnership*, 35 Cap. U. L. Rev. 15 (2006).

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[9] *See* Restatement (Second) Conflict of Laws § 270 (1971). *See, also,* M. Read Moore and Nicole M. Pearl, *Coming Soon to Your State: Community Property*, 48 U. MIAMI HECKERLING INSTITUTE ON ESTATE PLANNING (2013).

[10] There are further caveats and complications involved in using community property trusts that are beyond the scope of this article. Additional issues include unanticipated gift tax consequences, whether one or both of the spouses desire all the consequences of a community property arrangement and possible loss or reduction of protection against creditors' claims.

[11] The Internal Revenue Code treats limited liability companies in the same manner as limited partnerships for tax purposes. *See* Treas. Reg. § 301.7701-2(c). This discussion uses the term "partnership" as inclusive of family limited partnerships and family limited liability companies.

If, however, the partnership wishes to distribute its remaining assets in-kind, a number of potential issues arise with respect to any gain on partnership property. IRC § 704(c)(1)(B) provides that a contributing partner recognizes gain on any property contributed to the partnership if the property is distributed to *another partner* within seven years of being contributed. For example, if Anne contributes property with a fair market value of $100,000 and a basis of $20,000 and that property is subsequently distributed to Bill in year six after partnership formation, Anne will recognize $80,000 of gain. If the contributing partner receives the same contributed property, there is no gain recognition (known as the "return-to-sender" exception). The return-to-sender exception also applies to assignees. Therefore, if Anne assigns her entire partnership interest to Cory, Cory is then deemed to have contributed the property for purposes of IRC § 704. When the partnership's assets are distributed, Cory will recognize gain unless and to the extent he receives the contributed property. Treas. Reg. § 1.704-3(a)(7), -4(d)(2). Application of IRC § 704(c)(1)(B) can be avoided if each partner has a proportional share of built-in gain and receives assets pro rata upon dissolution.

In addition to IRC § 704, IRC § 737 provides that a partner who contributes property with built-in gain to the partnership and subsequently receives an in-kind distribution from the partnership within seven years must recognize gain equal to the lesser of the IRC § 704(c) built-in gain or the excess of the fair market value of the property (other than cash) less the partner's adjusted outside basis in the partnership (the outside basis reduced by cash received from the same distribution). The return-to-sender exception applies to IRC § 737 recognition events, but, unlike IRC § 704, it does not apply to assignees of a partner's interest. Some argue that this could cause the assignee to recognize gain even if the assignee receives the assignor's contributed property. *See* Donaldson, *supra*.

Lastly, IRC § 731(a) provides that a partner will not recognize gain on distributions except to the extent the money distributed exceeds such partner's adjusted basis in the partnership just before the distribution. Marketable securities are treated as "money" under IRC § 731(c) for this purpose. The return-to-sender exception also applies to IRC § 731 recognition events but does not explicitly apply in the IRC § 731 context to assignees. *See* Donaldson, *supra*. Additionally, IRC § 731 lacks the seven-year limitation present in IRC §§ 704 and 737.

In applying the various gain recognition rules, IRC § 704 is applied first, followed by IRC § 731, and finally IRC § 737. *See* Treas. Reg. § 1.731-2(g)(1)(i); *see also* Donaldson, *supra*, for additional examples and application of the rules.

Thus, while partnerships continue to be a viable planning option, thought should be given to how long the original partners and their descendants anticipate the partnership will last and what assets are to be contributed to the partnership at the outset, or significant income tax consequences may arise.

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