The Moving Target: Planning for Clients with Net Worth Over $11 Million

Cannon Financial Institute, Inc.

Presents

The 2019 Estate Planning Teleconference Series

Tuesday, February 26, 2019

By:

Charles A. Redd

CHARLES A. REDD, PARTNER
STINSON LEONARD STREET LLP
7700 FORSYTH BOULEVARD
SUITE 1100
ST. LOUIS, MISSOURI 63105-1821
(314) 259-4534 - TELEPHONE
(314) 259-3952 - FACSIMILE
charles.redd@stinson.com

www.stinson.com

The seminar materials and the seminar presentation are intended to stimulate thought and discussion, and to provide those attending the seminar with useful ideas and guidance in the areas of estate planning and administration. The materials and the comments made by the presenter during the seminar or otherwise do not constitute and should not be treated as legal advice regarding the use of any particular estate planning or other technique, device or suggestion or any of the tax or other consequences associated with them. Although we have made every effort to ensure the accuracy of these materials and the seminar presentation, neither STINSON LEONARD STREET LLP nor the lawyer, Charles A. Redd, assumes any responsibility for any individual's reliance on the written or oral information presented in association with the seminar. Each seminar attendee should verify independently all statements made in the materials and in association with the seminar before applying them to a particular fact pattern and should determine independently the tax and other consequences of using any particular device, technique or suggestion before recommending the same to a client or implementing the same on a client's or his or her own behalf.

CHARLES A. REDD

CHARLES A. REDD is a partner in the St. Louis, Missouri, office of the law firm of STINSON LEONARD STREET LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now U.S. Trust, Bank of America Private Wealth Management).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar (Probate and Trust Committee), the Illinois State Bar Association (Section on Trusts and Estates), The Bar Association of Metropolitan St. Louis (Probate and Trust Section, member and past Chairman) and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the recently enacted Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Communications Committee (Past Chair); Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. Mr. Redd is listed in The Best Lawyers in America and is nationally ranked by Chambers and Partners in their High Net Worth guide. He frequently writes and lectures nationally on topics in the trusts and estates field.

* * * * * * * * *

TABLE OF CONTENTS

The Moving Target: Planning for Clients with Net Worth Over $11 Million

By: Charles A. Redd
Stinson Leonard Street LLP
St. Louis, Missouri

I. Portability

A. Introduction

Portability allows the deceased spousal unused exclusion amount ("DSUE amount") of a decedent to be available to a surviving spouse, provided an election is made on the predeceased spouse's timely-filed estate tax return.

Many practitioners now design estate plans that rely on portability to avoid federal estate taxes. The most straightforward form of a portability-based estate plan directs the assets of the predeceased spouse to the surviving spouse free of trust, rather than split between a marital disposition and a credit shelter disposition. In addition, since less assets are held in trust, if the surviving spouse is in a lower income tax bracket than a trust would have been, the assets that would have been held in a credit shelter trust will be subject to less income tax.

However, there are significant limitations regarding the utility of portability. The DSUE amount, unlike the basic exclusion amount, is not adjusted for inflation. Further, any income and appreciation accruing after the predeceased spouse's death are not sheltered by the DSUE amount. To utilize portability, an estate tax return must be filed even though an estate tax return may not otherwise be necessary. Treas. Reg. § 20.2010-2(a). Also, there is no portability for the GST exemption. Thus, for example, a surviving spouse may attempt to utilize a $22.8 million applicable exclusion amount (*i.e.*, the surviving spouse's own $11.4 million basic exclusion amount plus the predeceased spouse's basic exclusion amount of $11.4 million) and avoid estate tax, but any amount over the surviving spouse's own GST exemption (currently also $11.4 million) that is transferred in trust for children with remainder to grandchildren, or directly to grandchildren, may give rise to generation-skipping transfer tax. In addition, portability is not available for unmarried couples.

Also, the DSUE amount may be lost, even after an appropriate election is made on the predeceased spouse's estate tax return, if the surviving spouse remarries and the new spouse dies with little or no unused basic exclusion amount. Treas. Reg. § 20.2010-1(d).

Further, the state exemption amount in decoupled states (with the exception of Maryland; *see* MD Code, Tax-General, § 7-309(b)) is not portable. Thus, a portability-based estate plan may need to include provisions for the funding of a credit shelter trust at least up to the state exemption amount. In addition, to the extent possible, the credit shelter trust should be funded with property that is subject to the state estate or inheritance tax so that such property does not appreciate in value in the hands of the surviving spouse beyond the state exemption amount. Sloan & Abendroth, "Planning With Portability, When It Isn't Portable," MEETING OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, FALL 2013.

B. Calculation

Internal Revenue Code ("IRC") § 2010(c)(4) defines the DSUE amount as the lesser of:

- The basic exclusion amount (which is currently $11.4 million and is adjusted for inflation, IRC § 2010(c)(3)); or the excess of:
- The applicable exclusion amount of the last deceased spouse of the surviving spouse, over the amount with respect to which the tentative tax is determined under IRC § 2001(b)(1) on the estate of such deceased spouse (which is the tentative tax computed on the sum of the amount of the deceased spouse's taxable estate and the amount of the deceased spouse's adjusted taxable gifts).

C. Last Deceased Spouse

Note that the definition of the DSUE amount refers to the applicable exclusion amount of the "last" deceased spouse. The final regulations confirm that this prevents a person who is the surviving spouse of multiple spouses from "stacking" DSUE amounts. For example, W, who has a $10 million applicable exclusion amount (ignoring adjustments for inflation), survives H1 who dies with an $8 million applicable exclusion amount (after taking into consideration the estate tax on H1's estate). W, now with an $18 million applicable exclusion amount, marries H2, who has a $10 million applicable exclusion amount. H2 then predeceases W while still holding a $10 million applicable exclusion amount. Due to the definition of the DSUE amount, after H2's death, W's applicable exclusion amount is $20 million: W's basic exclusion amount of $10 million plus the $10 million of DSUE amount that W received from H2. After W survives H2, the $8 million in DSUE amount that W received from H1 expires. Treas. Reg. §§ 20.2010-1(d); 20.2010-3(a); 25.2505-2(a).

D. Order of Applying the Basic Exclusion Amount and the DSUE Amount

When a surviving spouse who holds a DSUE amount makes a taxable gift, the DSUE amount is used first in applying the surviving spouse's applicable exclusion amount to such taxable gift. If, in the above example, W made a $2 million taxable gift after W married H2, W's applicable exclusion amount would be reduced to $16 million, made up of W's $10 million basic exclusion amount and $6 million of DSUE amount remaining from H1 after the taxable gift. Therefore, when W survived H2, she was able to keep her entire $10 million basic exclusion amount. Treas. Reg. § 25.2505-2(b).

E. Prior Taxable Gifts

The final regulations also provide that, when W survives H2 in the previous example, her new applicable exclusion amount is not reduced by any amount of the first DSUE amount consumed by taxable gifts. Thus, when W survives H2, her applicable exclusion amount is actually $22 million (her $10 million basic exclusion amount, plus the $2 million taxable gift, plus the $10 million DSUE amount received from H2). Treas. Reg. § § 20.2010-2(b)(2).

F. Examination of Prior Returns

Under IRC § 2010(c)(5)(B), the Secretary of the Treasury may examine the deceased spouse's estate tax return to determine whether the surviving spouse has correctly calculated the DSUE amount. This power exists regardless of whether the statute of limitations for assessment under IRC § 6501 with respect to the deceased spouse's estate tax return has passed. However, the final regulations state that the Internal Revenue Service ("IRS") may assess additional tax on the return of the deceased spouse only if that tax is assessed within the period of limitations on assessment under IRC § 6501 applicable to the tax shown on that return. Treas. Reg. §§ 20.2010-2(d); -3(d); 25.2505-2(e); *see* the discussion of the *Sower* decision below.

G. Availability of Extension of Time to Elect Portability

The final regulations expressly state that an executor who did not file a return when the value of the assets reported on the return was under the threshold for filing an estate tax return can request relief to make the portability election if the requirements under Treas. Reg. § 301.9100-3 (allowing extensions of time when the taxpayer acts reasonably and in good faith and relief will not prejudice the interests of the government) are met. However, estates having a value above such filing threshold (regardless of whether there is a taxable estate) cannot obtain such relief. Treas. Reg. § 20.2010-2(a)(1).

The IRS in Revenue Procedure 2017-34, 2017-26 I.R.B. 1282, provided a simplified and streamlined procedure for obtaining an extension of time to elect portability. As further discussed below, the general rule is that a portability election must be made, if at all, on a timely, complete and properly prepared estate tax return. Treas. Reg. § 20.2010-2(a). Previously, the only method to extend the time for filing to elect portability was to request a private letter ruling under Treasury Reg. § 301.9100-3. This option is expensive, time consuming and not guaranteed.

Under the revenue procedure, the time within which such a return may be filed is extended to the second anniversary of the decedent's death. To qualify, the estate must meet all the following requirements:

- The decedent must have died after December 31, 2010;
- The decedent must be survived by a spouse;
- The decedent must have been a U.S. citizen or resident at death;
- The estate must not have been required to file an estate tax return because of IRC § 6018(a);
- The estate must not have filed the estate tax return timely;
- The estate must file a complete and properly prepared estate tax return; and
- The estate tax return must contain the following language across the top of page one:

> "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

If the estate does not meet all of the above requirements, the only method to request an extension to file for portability is via the private letter ruling procedure.

H. Effect of Portability Election Where DSUE Amount is Uncertain

Events arising after the filing of an estate tax return that elects portability may cause a DSUE amount to change or create a DSUE amount when none existed at the time of filing the estate tax return. For example, deductions may later become available that may cause the DSUE amount to appear or to be increased over the amount initially reported. The final regulations state that these adjustments may be taken into account in determining the DSUE amount available to the surviving spouse.

The estate tax return for the predeceased spouse should include a formula or written statement that provides, for example, that the DSUE amount desired is the largest DSUE amount after taking into account all asset values, credits and deductions that affect the computation of the DSUE amount as finally determined for federal estate tax purposes. Schiller, "Estate Planning at the Movies(R): Jeremiah Johnson Marks the Final Portability Regulations," LISI Estate Planning Newsletter #2316 (June 22, 2015) at http://www.leimbergservices.com.

I. Requirement of a "Complete and Properly Prepared" Estate Tax Return

The final regulations state that portability is properly elected as long as the executor has timely filed a complete and properly prepared estate tax return and did not elect out of portability. The return must be prepared in accordance with IRS instructions to be considered complete and properly prepared. Treas. Reg. § 20.2010-2(a)(7)(i). The IRS will consider whether a filed return is complete and properly prepared on a case-by-case basis.

An exception applies to the general requirement to file a complete and properly prepared estate tax return that will relieve the executor from including valuations and appraisals when the estate is not required to file an estate tax return under IRC § 6018. The exception applies to property passing under an estate tax marital or charitable deduction. If this exception is met, the executor needs only to exercise due diligence in determining the value of the property at issue rather than determining the actual fair market value.

However, the executor must still report the description, ownership and/or beneficiary of such property, along with all other information necessary to establish the right of the estate to the deduction. The exception is not available for certain property when the value of such property is needed to determine an estate or generation-skipping transfer tax benefit (but not to determine basis under IRC § 1014). The exception is also not available when less than the entire value of an interest in property is marital or charitable deduction property or when a partial disclaimer or a partial QTIP election is made and only part of the property affected is marital or charitable deduction property.

The IRS may issue later rulings to define further this exception. Treas. Reg. § 20.2010-2(a)(7)(ii).

J. IRS Will Not Disregard QTIP Elections When Portability Election Made Rev. Proc. 2016-49, 2016-42 I.R.B. 462 (October 17, 2016)

A QTIP election made on a federal estate tax return will not be disregarded solely because the decedent's executor also elected portability under IRC § 2010(c)(5)(A). Rev. Proc. 2016-49 provides an important clarification of a potential conflict between the ability of an executor to make a QTIP election in tandem with a portability election, and the IRS position, announced in Rev. Proc. 2001-38, that the IRS would treat a QTIP election as null and void if the election was unnecessary in order to reduce the federal estate tax liability of the decedent's estate to zero. Although Rev. Proc. 2016-49 confirms the procedures by which the IRS will disregard a QTIP election, it will not disregard QTIP elections solely because the executor has also made a portability election in accordance with the regulations under IRC § 2010(c)(5)(A).

Rev. Proc. 2016-49 treats a QTIP election as void when all three of the following conditions are met: (1) the estate's federal estate tax liability was zero, regardless of the QTIP election; (2) the executor neither made nor was considered to have made the portability election; and (3) the estate satisfies the procedural requirements provided by Rev. Proc. 2016-49, which includes filing a return (either a supplemental Form 706 for the decedent or a Form 706 or Form 709 for the surviving spouse) with a sufficient explanation for why the QTIP election should be treated as void.

In contrast, Rev. Proc. 2016-49 does not treat a QTIP election as void where: (1) a partial QTIP election was required to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary; (2) the QTIP election was stated in terms of a formula designed to reduce the estate tax to zero; (3) the QTIP election was a protective election under Treas. Reg. § 20.2056(b)-7(c); (4) the executor made a portability election, even if the decedent's DSUE amount was zero; or (5) a return has not been filed requesting that a QTIP election be treated as void.

K. Review of a Predeceased Spouse's Estate Tax Return Allowed for Adjustment of DSUE Amount *Estate of Sower v. Commissioner,* 149 T.C. No. 11 (September 11, 2017)

In *Sower*, the Tax Court addressed the extent of IRS' authority to examine a predeceased spouse's estate tax return, after the statute of limitations for assessing additional tax had expired, to determine whether the DSUE amount was calculated correctly. The executor of the estate of the predeceased spouse (Frank) had elected portability and had calculated the DSUE amount as $1,256,033. The IRS issued a closing letter to the executor stating the return had been accepted as filed and further stated that the return would not be reopened unless there was evidence of IRS administrative error.

The surviving spouse (Minnie) died the following year, and the executor filed an estate tax return claiming a DSUE amount of $1,256,033 from Frank's estate. Months later, the IRS began a review of the return filed by Minnie's estate. In connection with examining her estate tax return, the IRS also examined Frank's estate tax return and discovered that the preparer had omitted adjusted taxable gifts. Had adjusted taxable gifts been included, the DSUE amount would have been about $283,000. The IRS reduced the DSUE amount available to Minnie's estate accordingly. The IRS also adjusted Minnie's taxable estate for various other gifts and expenses, which left an estate tax deficiency for her estate of $788,165. Minnie's estate filed a timely petition for redetermination disputing the amount.

Minnie's estate argued the IRS lacked authority to recalculate Frank's DSUE amount. In response, the Court pointed out that the IRS has the power to examine the estate tax return of the predeceased spouse to determine the DSUE amount, regardless of whether the period of limitations on assessment has expired. The estate also maintained the DSUE amount calculation did not have to take into consideration Frank's lifetime taxable gifts because all such gifts were made before portability was enshrined in the law. The Court discarded this point as irrelevant. Next, the estate argued the IRS had essentially waived any right it had to recalculate the DSUE amount because Frank's estate had received a closing letter, and the closing letter should be considered a closing agreement as referenced and authorized in IRC § 7121. The Court refused to equate a closing letter with a closing agreement under IRC § 7121 and concluded that Frank's DSUE amount should be reduced by the aggregate amount of his lifetime taxable gifts. Minnie's estate also argued that reviewing Frank's estate tax return for the DSUE amount was an improper second examination. However, the Court disregarded this point as well. The Court held there was no second examination because the IRS did not obtain any new information. Lastly, the Court noted that there was no violation of the statute of limitations as to Frank's estate because the IRS did not assess any tax against Frank's estate, it was simply an adjustment of his DSUE amount, and the IRS only assessed estate tax against Minnie's estate. Ultimately, the Court found that the IRS acted within the bounds of its authority when it examined the return filed by Frank's estate to adjust the DSUE amount available to Minnie.

II. Whether to Make Gifts and, If So, the Most Strategic Ways to Do So

A. Taking Advantage of the Enhanced Basic Exclusion Amount

At this time, and for the indefinite future, individuals have a greatly enhanced, historically high basic exclusion amount. This large basic exclusion amount is scheduled to evaporate January 1, 2026, and could be taken away by legislation at any time before that date. Thus, clients having significant wealth who wish to maximize their use of what could be a fleeting opportunity to use the basic exclusion amount now in place should consider expeditiously making one or more lifetime taxable gifts that fully absorb such basic exclusion amount. Individuals making gifts sooner rather than later will remove more appreciation from their gross estate, which would be highly beneficial if the basic exclusion amount declines on January 1, 2026 or sooner. Making a gift, however, is always subject to the risk that a basis step-up upon the owner's death with respect to the gifted asset will be forfeited. Moreover, if the basic exclusion amount does not decline, an individual whose net worth is safely under the basic exclusion amount may regret having made a gift to remove post-gift appreciation and income with respect to the gifted asset(s) from his or her gross estate. *See generally*, Nelson & Nelson, "6 Question 2018 Gift Suitability Analysis," LISI Estate Planning Newsletter # 2631 (March 22, 2018).

B. Comparing Transferring Assets by Gift vs. Sale

If an individual makes annual exclusion gifts (IRC § 2503(b)) or gifts for educational expenses or medical expenses (IRC § 2503(e)), the value of the gifts themselves, along with all post-gift appreciation and income with respect to the gifted property, is permanently excluded from the donor's transfer tax (estate and gift tax) base. Otherwise, an individual's gifts are reflected, at gift tax values, on his or her federal estate tax return, as "adjusted taxable gifts" (or lifetime taxable gifts). In this circumstance, what is excluded from the donor's transfer tax base is post-gift appreciation and income with respect to the gifted property. The making of lifetime taxable gifts erodes the donor's basic exclusion amount. The making of annual exclusion gifts or gifts for educational expenses or medical expenses does not.

If an individual makes aggregate lifetime taxable gifts (after 1976) exceeding his or her available basic exclusion amount, he or she owes federal gift tax. If gift tax is paid with respect to a gift and the donor survives for three years or longer after having made the gift, such gift tax is excluded from the value of the donor's gross estate. IRC § 2035(b). The net result is that, if IRC § 2035(b) does not apply (because the donor survived the requisite three-year period, a 40% estate tax rate is effectively reduced to 28.6%. Whether paying gift tax and surviving for the requisite three-year period may be economically advantageous depends on whether the present value of the estate tax savings (which, in turn, depends on how much longer the donor lives) is greater or less than the value of the dollars used to pay the gift tax. Even if paying gift tax and surviving for the requisite three-year period could be economically advantageous, some individuals lack sufficient liquidity to pay gift tax on a significant gift, and many donors simply don't want to pay tax any sooner than necessary.

Additionally, what amounts to pre-paying estate tax potentially to take advantage of an effective 28.6% rate could backfire. The donor's consumption, or decline in the value of the donor's estate, during his or her remaining life could bring the donor's gross estate plus lifetime taxable gifts within the basic exclusion amount at the donor's death. The basic exclusion amount could be sufficient in any event to cause no estate tax to be due (who foresaw an $11 million basic exclusion amount?). The federal estate tax could be repealed.

By contrast, with a sale of assets (a transfer in exchange for full and adequate consideration), the consideration, except to the extent consumed, will compose a part of the seller's gross estate. The consideration, depending on its character, could grow in value, shrink in value or remain the same in value between the time it is received and the date of death of the seller. The consideration, except to the extent consumed, and depending on its value at the seller's death, may receive a basis step-up under IRC § 1014. The value of the sold property is excluded from the donor's transfer tax base. To the extent (if at all) that value exceeds the value of the consideration in the hands of the seller at the seller's death, the sale may be considered a successful estate planning maneuver. Since a sale is not a gift, the seller's basic exclusion amount remains unchanged, and no gift tax is payable, regardless of the size of the transaction. A sale may be preferable to a gift in a case in which an individual has used up his or her entire basic exclusion amount by making large gift and doesn't want to pay gift tax and/or may have an economic need (or believe he or she has an economic need) to receive consideration in exchange for the contemplated transfer. Of course, selling a low-basis/highly appreciated asset has significant potential disadvantages. Not only would the seller lose the ability to obtain a basis step-up with respect to the asset, but also the seller may incur significant income tax on the sale (unless the sale is to a "grantor trust.")

C. "Clawback" Issues

In response to IRC § 2001(g)(2), enacted as part of the 2017 Tax Act[1], in which the Secretary of the Treasury is directed to prescribe regulations to carry out IRC § 2001(g) with respect to the difference between the basic exclusion amount applicable at the time of a decedent's death and the basic exclusion amount applicable with respect to any gifts made by the decedent, the Secretary issued Proposed Reg. § 20.2010-1(c). REG-106706-18, 83 Fed. Reg. 59343 (November 23, 2018)

Proposed Reg. § 20.2010-1(c) is intended to ensure that, if a decedent uses the increased basic exclusion amount for gifts made while the 2017 Tax Act was in effect and dies after the sunset of the 2017 Tax Act (currently scheduled for January 1, 2026), such decedent will not be treated, on such decedent's estate tax return, as having made adjusted taxable gifts solely because the increase in the basic exclusion amount effectuated by the 2017 Tax Act was eliminated.

The mechanism by which Proposed Reg. § 20.2010-1(c) would achieve this result is to provide that, if the total of unified credits that were used in computing a decedent's gift tax on post-1976 gifts is greater than the unified credit that would be used, pursuant to IRC § 2010(c), to compute the estate tax on the decedent's estate, the credit that can in that circumstance be used to compute the estate tax is deemed to be the total of unified credits that were used in computing the decedent's gift tax.

This is a not unexpected, but nevertheless welcome, development.

D. Defined Value Clauses

In conjunction with the making of large lifetime taxable gifts to take full advantage of today's basic exclusion amount under the 2017 Tax Act but seeking to avoid the risk of actually incurring gift tax (especially where difficult-to-value assets are involved), the use of defined value clauses in documents effectuating gifts or sales would seem imperative. The Internal Revenue Service appears to despise defined value clauses, having litigated many cases in an effort to have them declared as void due to public policy considerations, but it has been decades since the Service has prevailed in a defined value clause case, and there are several relatively recent cases that provide a virtual roadmap for how to design an effective defined value clause that will almost eliminate the risk of incurring gift tax. *See Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009); *Estate of Petter v. Comm'r*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011); *Wandry v. Comm'r*, 103 T.C.M. (CCH) 1472 (2012).

[1] An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97, Enacted December 22, 2017.

III. Clayton QTIPs

A. Description and Background

A so-called Clayton QTIP trust is a trust for which a QTIP election at the death of the first spouse to die is eligible to be made and where, to the extent the predeceased spouse's executor does not make the QTIP election, any non-elected property, under the terms of the governing instrument, passes to a separate trust which is not required to have terms identical to the QTIP trust and is not required to meet the definition of a QTIP trust, *i.e.*, a traditional credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time.

This planning technique is named after *Estate of Clayton v. Comm'r*, 976 F.2d 1486 (5th Cir. 1992). *See also* Treas. Reg. § 20.2056(b)-7(d) and 7(h). In *Estate of Clayton*, the decedent's will created a family trust and a marital trust. The will provided that, if the executors failed to make a QTIP election with respect to the marital trust, any non-elected potential QTIP property would pass to the family trust. The will also provided that, to the extent the surviving spouse disclaimed any portion of the marital trust, that portion would pass to a third trust with terms similar to those of the family trust. The surviving spouse, as sole independent executor, made a QTIP election for an undivided .563731 interest in specified bonds, notes and cash. The Commissioner disallowed the marital deduction as to the QTIP portion and issued a notice of deficiency. The Court of Appeals for the Fifth Circuit considered the question of whether the effect of the testamentary provision that caused non-elected potential QTIP property to pass in a non-QTIP disposition rendered all potential QTIP property ineligible to be elected as QTIP property in any event. The Fifth Circuit ruled in favor of the surviving spouse and found that the provisions of the will did not affect the deductibility under IRC § 2056(b)(7) of the value of any potential QTIP property with respect to which a QTIP election was actually made because: (1) the property to which IRC § 2056(b)(7) applied was only the property with respect to which a QTIP election was actually made and not all property with respect to which such an election could be made; and (2) the election related back to the decedent's death.

Both the Tax Court and the IRS acceded to the decision of the Fifth Circuit. *See Estate of Spencer v. Comm'r*, 43 F.3d 226 (6th Cir. 1995) and *Estate of Robertson v. Comm'r*, 15 F.3d 779 (8th Cir. 1994). Treas. Reg. § 20.2056(b)-7(d)(3) provides that an income interest which is contingent on the election of the executor will not fail to be a qualifying income interest life if such an election is actually made.

B. Substantial Post-Death Planning Flexibility

1. <u>Implementation of the Clayton QTIP</u>. In a typical Clayton QTIP scenario, to the extent a QTIP election is not made with respect to a predeceased spouse's residuary estate, non-elected potential QTIP property passes to a traditional credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time. Income from that trust does not have to be paid to the surviving spouse. The trust may provide for wholly discretionary income and principal distributions among multiple current beneficiaries. In addition, the surviving spouse may have a non-general power of appointment over the assets of the trust. The surviving spouse must have a mandatory income interest only in the property with respect to which a QTIP election is made.

An executor generally has up to fifteen months (nine-month due date for filing the decedent's Form 706 plus an automatic six-month extension) after the decedent's death to assess the current situation and determine the appropriate QTIP election approach. The executor determines the amount of marital deduction desired relative to the size of the decedent's entire residuary estate. To the extent the executor refrains from making the QTIP election, the executor effectively shifts the disposition of property from a QTIP disposition to a credit shelter disposition. Treas. Reg. §§ 20.2056(b)-7(d)(3) and -7(h), Ex. 6, explicitly allow this technique to be implemented without disallowing causing forfeiture of the marital deduction.

The flexibility allowed in the Clayton QTIP context provides opportunities for tax savings based on asset characteristics, the age and health of the surviving spouse and the family's goals. An executor may elect portability and may make a QTIP election with respect to 100% of potential QTIP property thereby facilitating use of the predeceased spouse's GST exemption by means of the "reverse QTIP election" under IRC § 2652(a)(3) *plus* a full basis step-up as to the QTIP property at the death of the surviving spouse. On the other hand, an executor may prefer a traditional credit shelter trust approach that will allow for use of the predeceased spouse's GST exemption without "reverse QTIP election" and will in essence trade estate tax-free appreciation of property during the life of the surviving spouse for basis step-up at the surviving spouse's death.

A broad discretionary credit shelter trust dispositive scheme allows for income tax planning through the making of judicious distributions. In addition, income tax planning options may be enhanced by providing the surviving spouse with a broad non-general lifetime power of appointment over the credit shelter trust.

2. Comparison to a Contingent Disclaimer Plan. A similar result may be achieved by using a contingent disclaimer trust plan. In this scenario, at the death of the first spouse to die, the predeceased spouse's residuary estate is directed to be distributed outright to the surviving spouse (instead of a trust with respect to which a QTIP election could be made). If and to the extent the surviving spouse makes a qualified disclaimer (IRC § 2518), disclaimed property would pass to a credit shelter-type trust for the concurrent benefit of the surviving spouse and descendants living from time to time. Note, however, that, if the surviving spouse were to hold a non-general power of appointment not limited by an ascertainable standard, the disclaimer would not be qualified. Treas. Reg. § 25.2518-2(e)(2). Also, the time within which such a qualified disclaimer may be made is nine months after the predeceased spouse's date of death (IRC § 2518(b)) (as compared to the fifteen-month timeframe after the predeceased spouse's date of death within which a QTIP election decision may be made). In addition, the opportunity to make a qualified disclaimer may be inadvertently tainted by an acceptance of benefits by the surviving spouse before the disclaimer is finalized. IRC §2518(b); Treas. Reg. § 25.2518-2(d)(1).

IV. Design and Uses of Long-Term, Multigenerational Trusts

Trusts with a duration as long as applicable state law will permit (which duration in many states is "forever") continue to have all the transfer tax and income tax potential benefits as such trust have had since long before the 2017 Tax Act. With the 2017 Tax Act, clearly the impact of such benefits may be greatly increased. A large gift to a long-term irrevocable grantor trust fully utilizing a client's basic exclusion amount, to which the client's GST exemption is allocated, puts potentially very substantial value in a vehicle that for the indefinite future escapes estate tax, gift tax and generation-skipping transfer tax and enables the fine-tuning of income tax consequences (basis step-up using formula general powers of appointment for beneficiaries and minimizing income taxes for the trust and its beneficiaries after grantor trust status has ended through the making of judicious distributions).

Powers of appointment may also facilitate beneficial changes after creation of the trust. For example, 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).

A. Designing Dispositive Provisions

Long-term trusts can be structured in a variety of different ways to accommodate the settlor's desires and to enable flexibility to address unknown and unforeseeable future events.

Generally, the governing instrument of a discretionary trust is designed with permissive language, *e.g.*, the Trustee "may" (as opposed to "shall") make distributions. A trust instrument that employs a totally discretionary distribution scheme ordinarily leaves the determination of distributions entirely to an independent Trustee to avoid creating an enforceable right in a beneficiary to receive anything from the trust. The lack of standards or guidelines for the determination of when and how much will be distributed to the beneficiaries makes wholly discretionary trusts the most flexible for dealing with future family circumstances in long-term trusts.

Alternatively, a trust instrument may provide for one or more levels of entitlement by beneficiaries to distributions such as the right periodically to receive all of the trust's net income, a percentage unitrust amount or distributions of income and/or principal based on an ascertainable standard. The settlor can give the Trustee the power to make distributions in accordance with so-called "ascertainable standards," such as, "for the beneficiary's support, maintenance and education," "in the event of sickness, accident, misfortune or other emergency," etc. These provisions give the beneficiary an indication of what distribution amounts may reasonably be expected, as well as what additional financial support might be available. Ascertainable standard-based distribution schemes reduce flexibility, though, making it more difficult for the Trustee to deal with future changed circumstances than would be the case with a wholly discretionary trust – which could be of concern for settlors of long-term trusts.

The estate planner should also consider the income and transfer tax consequences to the beneficiaries in designing long-term trusts. Causing the value of low-basis, highly appreciated trust assets to be included in the beneficiary's estate may allow for a stepped-up basis with respect to such assets at the beneficiary's death. At the same time, so long as the value of the beneficiary's gross estate is equal to or less than his or her basic exclusion amount, no federal estate tax will result.

B. Mechanics of Administration: Trustees, Agents and Directors

Among the aspects of designing an estate plan that deserve the most attention, although often relegated to the status of an after-thought, is carefully identifying who would be most qualified and effective to carry out trust administration.

While it is true that a Trustee may usually engage agents and assistants to provide expertise in an area of trust administration in which the Trustee may be lacking in expertise, *e.g.*, investments, the Trustee is ultimately responsible for exercising prudence in selecting the agent, establishing the scope of the delegation and periodically reviewing the agent's actions. *See* Section 9 of the Uniform Prudent Investor Act. Trustees must possess the judgment to make prudent assessments and have the resolve to make and defend decisions in the face of possibly aggressive opposition. Additionally, unless the Trustee under consideration is a corporate fiduciary, the age, health and geographical proximity (to a beneficiary) of a proposed Trustee is important to take into account.

Use of a trust director in a long-term trust may also be helpful. Uniform Trust Code § 808(d) indicates that a trust director is a fiduciary: "A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty." A trust director is sometimes considered particularly when the Trustee will hold nontraditional assets, such as intellectual property, livestock, closely-held business interests, artwork, oil, gas and other minerals and certain real estate such as farm and ranch property, timberland and commercial property. The general duties of a Trustee holding nontraditional assets are presumptively similar to a Trustee's duties regarding other trust assets, but the management of these assets may require the involvement of a trust director with specialized knowledge concerning such assets. When employing a trust director, though, it is imperative that the trust instrument clearly identify the administrative tasks that are to be directed and the timeframe in which such direction is to apply. Ensuring there is a clear delineation of duties between the trust director and the Trustee (and perhaps, other fiduciaries as well) can help to avoid conflicts and misunderstandings in the future.

CANNON

FINANCIAL INSTITUTE

Certificate of Attendance

____

(Participant Name)

Has successfully completed the Cannon Financial Institute, Inc. course:

The Moving Target: Planning for Clients with Net Worth Over $11 Million

February 26, 2019

Laurie Frye
Professional Education Coordinator

<u>Continuing Education Credits for this course are as follows:</u>

- **Certified Public Accountant** — **1.5 credit hours**
  In accordance with the National CPE Registry of CPE sponsors, CPE credits have been granted based on a 50-minute hour. For information regarding available CPE credits please visit http://cpemarket.nasbatools.com/index.
  Instructional delivery method: Group-Live
  NASBA #103655; Field of Study –Specialized Knowledge & Application
- **Enrolled Agent (IRS)** — **2.0 credit hours**
  Cannon is designated as a qualified education sponsor by the IRS and can offer continuing education credit to Enrolled Agents. Cannon's agreement with the IRS' Office of Professional Responsibility does not constitute an endorsement by the IRS as to the quality of the programs or their contribution to the professional competence of the enrolled individual.
  Course # (VRUGV-T-00114-19-O)
- **Certified Financial Planner (CFP™)** — **1.5 credit hours**
  Course # 257925
- **Accredited Fiduciary Investment Manager (AFIM™)** — **1.5 credit hours**
- **Certified Wealth Strategists (CWS®)** — **2.0 credit hours**
- **Certified Investment Management Analyst (CIMA®)** — **1.5 credit hours**
  Course # 19CFI016
  If you hold the CIMA®, CIMC® or CPWA® certification, you may report this pre-accepted CE program online by logging into your My IMCA account at www.imca.org/user
- **Certified Trust Financial Advisor (CTFA™)** — **2.0 credit hours**
- **Chartered Life Underwriter & Chartered Financial Consultant (**No Individual State Insurance Credit Available)** — **1.5 credit hours**
- **Fiduciary Investment Risk Management Association (FIRMA®)** — **2.0 credit hours**

Any questions regarding CE credit, please contact Laurie Frye at (706) 353-3346.
Fax (706) 353-3994, Email lfrye@CannonFinancial.com
PO Box 6447, Athens, Georgia 30604

CANNON

FINANCIAL INSTITUTE

Certificate of Attendance

____

(Participant Name)

____

(Attorney Bar # or Social Security #)

Has successfully completed the Cannon Financial Institute, Inc. course:

The Moving Target: Planning for Clients with Net Worth Over $11 Million

February 26, 2019

CANNON FINANCIAL INSTITUTE, INC. CORPORATE SEAL GEORGIA

Laurie Frye

Laurie Frye
Professional Education Coordinator

Continuing Legal Education Credits for this course are as follows:
The following states have been approved for 1.5 hours of General Credit: (Course number is indicated in parenthesis):Alabama, Arkansas (TWE64018), California, Delaware, Georgia, Idaho, Illinois, Iowa (307424), Kentucky (192169), Louisiana, Maine (048514), Minnesota (267815), Mississippi, Montana (22353), Nebraska(170261), Nevada (39948), New Mexico, New York, North Carolina, North Dakota, Oregon (1048*270), Pennsylvania, Rhode Island, South Carolina, Tennessee (Distance Ed), Texas(174029442), Utah , Vermont, Virginia, Washington, Wisconsin, & Wyoming

These states have been approved for the following General Credit: Colorado – 2 hours, Florida - 2 hours (1806862N), Missouri –1.8 hours, Oklahoma – 2 hours, West Virginia – 1.8 hours

The following states either do not require/do not accept outside CLE Credit/or do not accept teleconference calls for CLE Credit: District of Columbia, Hawaii, Maryland, Massachusetts, Michigan & South Dakota
The following states have special circumstances:
Alaska-Attorneys can use this certificate to submit to Alaska State Bar
Arizona-On honor system
Connecticut-Attorneys can use this certificate to submit to Connecticut MCLE
Indiana & Ohio-Site Coordinators must apply for credit as the sponsor in order for participants to receive credit
Kansas–Attorney or Site may apply 30 days prior to program
New Hampshire- *NHMCLE does not approve or accredit CLE activities for the NH Minimum CLE requirement. NH attendees must self-determine whether a program is eligible for credit and self-report their attendance.*
New Jersey-Attorneys can use this certificate for New Jersey CLE for 1.5 General credits (Reciprocity Rule)
New York–Attorneys may use this certificate to report their attendance as it is accredited by Approved NY Jurisdictions: AL, AR, CO, DE, GA, KY, LA, MS, NM, NC, ND, OK,. Type of credit: Areas of Professional Practice 1.5 Credits
* In order for PA attorneys to receive credit they must listen to the teleconference in a live classroom setting. The teleconference site must also be listed on the PACLE website and the site must be open to any PA attorney who desires to listen to the program. Call PACLE at 1-800-497-2253 with questions on website listing.
****As required by the following State Bars, Cannon will submit the mandatory attendance rosters for the attorneys seeking CLE credits **ONLY** in the following states: Alabama, Delaware, Georgia, Idaho, Louisiana, Montana, Nebraska, Nevada, New Mexico, North Carolina, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Utah, Washington and West Virginia. ****

Any questions regarding CE credit, please contact Laurie Frye at (706) 353-3346.
Fax (706) 353-3994, Email lfrye@CannonFinancial.com
649-4 S. Milledge Ave., Athens, Georgia 30605

CANNON

FINANCIAL INSTITUTE

Participant Survey

We would love to hear your feedback for today's teleconference:

The Moving Target: Planning for Clients with Net Worth Over $11 Million

February 26, 2019
Please use this link to tell us what you think.

http://livewebcast.net/cannon/022619

Any questions regarding CE credit, please contact Laurie Frye at (706) 353-3346.
Fax (706) 353-3994, Email lfrye@CannonFinancial.com
PO Box 6447, Athens, Georgia 30604