The Cannon Estate Planning Teleconference Series

Participant Guide

CFI
1961

Balancing Income Tax Planning and Estate Tax Planning

Cannon Financial Institute, Inc.

Presents

The 2021 Estate Planning Teleconference Series

Tuesday, August 24, 2021

By:

Charles A. Redd

CHARLES A. REDD, PARTNER
STINSON 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 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 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 Bank of America Private Bank).

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, the Illinois State Bar Association, The Bar Association of Metropolitan St. Louis 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 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; 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. In 2018, he was inducted into the Estate Planning Hall of Fame® by the National Association of Estate Planners and Councils. Mr. Redd is listed in The Best Lawyers in America and is "Band 1" 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

Page

Balancing Income Tax Planning and Estate Tax Planning

By: Charles A. Redd
STINSON LLP
St. Louis, Missouri

I. INTRODUCTION

Income tax rates and estate tax exemptions and rates will inevitably rise and fall depending in substantial part on changes in our country's political and economic climate. Far more often than not, when an estate planner designs a plan, the planner doesn't know what the tax laws will look like when the plan is implemented. In addition, in some cases, the composition and aggregate value of a client's estate changes materially between the time when estate planning documents were signed and the client's death. Thus, building flexibility into estate plans so that post-death decisions can be made to minimize estate tax, or income tax, as appropriate, is paramount.

II. PORTABILITY AND CLAYTON QTIP TRUSTS

A. Portability

1. *In General*

One of the most important aspects of the 2012 Tax Act[1] for estate planning professionals is that it made portability permanent (to the extent anything emanating from Washington can be said to be "permanent").[2] The term "portability" is shorthand among estate planners to refer to the ability of a predeceased spouse's executor, by making an election on a timely-filed estate tax return,[3] to transmit to the surviving spouse the predeceased spouse's "deceased spousal unused exclusion amount" ("DSUEA"). As a result, measured by 2021 numbers, spouses with an aggregate net worth of up to $23,400,000, without having to reallocate ownership of assets between them before either of them has died, would be able to transfer all of their assets to any one or more persons, whether through judiciously timed gifts during life or testamentary transfers at death, and pay no federal gift or estate tax.

2. *Limitations*

There are several significant limitations regarding the utility of portability, including the following:

- The DSUEA, unlike the basic exclusion amount, is not adjusted for inflation.

---

[1] American Taxpayer Relief Act of 2012 (P.L. 112-240, H.R. 8, 126 Stat. 2313, enacted January 2, 2013).
[2] Portability was introduced into the law by Section 302(a)(1) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312, H.R. 4853, 124 Stat. 3296, enacted December 17, 2010), amending Internal Revenue Code Section 2010(c)).
[3] Treas. Reg. § 20.2010-2(a).

- Any income and appreciation accruing after the predeceased spouse's death are not sheltered by the DSUEA.
- There is no portability for the GST exemption.
- Portability is not available for unmarried couples.
- The DSUEA 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.[4]
- The state exemption amount in many decoupled states is not portable. Thus, some portability-based estate plans may need to include provisions for the funding of a credit shelter trust at least up to the state exemption amount.

3. *Major Advantage*

All that said, a major advantage of portability is that all assets that, at the death of the first spouse to die, would have passed under that spouse's estate plan, in the absence of portability, to a credit shelter trust using the traditional approach, instead pass to the surviving spouse and will be included in the surviving spouse's estate at his or her subsequent death – thereby generating a step-up in basis of the assets to their then fair market value[5] and minimizing future capital gains taxes when they are sold[6] – perhaps without subjecting the surviving spouse's estate to estate tax liability.

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 such a scenario, 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.

B. Clayton QTIP Trusts

1. *In General*

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.

---

[4] Treas. Reg. § 20.2010-1(d).
[5] IRC Section 1014(a).
[6] It is assumed that the value of assets will increase with the passage of time – a usually safe, but not rock-solid in all cases, assumption. Also worthy of note is that the value of assets only very rarely increases in a linear fashion.

2. *Background*

In *Estate of Clayton*,[7] 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 Internal Revenue Code Section 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 Section 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.

Subsequent court decisions concurred with, and the Internal Revenue Service acceded to, the decision of the Fifth Circuit.[8]

3. *Substantial Post-Death Planning Flexibility*

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.

---

[7] *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992).

[8] *See Estate of Spencer v. Commissioner*, 43 F.3d 226 (6th Cir. 1995) and *Estate of Robertson v. Commissioner*, 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.

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"[9] *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.

III. USING GENERAL POWERS OF APPOINTMENT AND OTHER STRATEGIES TO ACHIEVE BASIS STEP-UP

A. Testamentary General Powers of Appointment

1. *Introduction*

Post-2017 Tax Act,[10] not only do many clients anticipate having no estate tax issues, they reasonably believe their children and grandchildren will also have no such issues. Nevertheless, trusts for clients' children and more remote descendants (at least until they reach designated ages) remain as viable and important as ever. It is possible to design trusts for clients' descendants in a manner that will cause the value of the assets in such trusts to be included in their respective gross estates just up to the point beyond which estate tax would be incurred.

2. *Applicable Law*

IRC Section 2041(b)(1) defines a general power of appointment as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

Whether the holder of a testamentary general power of appointment chooses to exercise it, the property that was subject to the power will be deemed to have been acquired from the deceased powerholder and will, therefore, qualify for the step-up in basis.[11]

[9] *See* IRC Section 2652(a)(3).
[10] 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, (December 22, 2017).
[11] *See* Treas. Reg. §§ 1.1014-2(a)(4), (b)(2).

3. *Conferring General Powers of Appointment*

It is important to consider under what circumstances and to what extent it is wise to confer a testamentary general power of appointment with respect to property held in trust to generate basis step-up and income tax savings.

a. **By Formula**

A testamentary general power of appointment can be conferred by means of a formula in such a way that the power would be exercisable only to the extent holding such power would not, by itself, cause imposition of any estate tax. Such a formula could effectively be further refined in such a way so as to have effect only with respect to certain assets in a trust, or to subject to such power, first, those trust assets having a cost basis for federal income tax purposes as of the day before the powerholder's date of death that is the smallest percentage of fair market value as of the powerholder's date of death and, then, cascading, in order, to each asset having a cost basis for federal income tax purposes as of the day before the powerholder's date of death that is the next the smallest percentage of fair market value as of the powerholder's date of death until holding the power would no longer not cause any imposition of estate tax.

b. **Allowing an Independent Trustee or Trust Protector to Grant**

A trust instrument could also be drafted in such a way that an independent trustee or a trust protector may grant a general power of appointment (perhaps, a formula general power of appointment, as described above) to a beneficiary after having examined the income and transfer tax consequences of so doing. Conditioning the grant of a general power of appointment to the determination of an independent trustee or a trust protector may provide more flexibility than having the trust instrument itself confer the general power of appointment. Consider, however, whether a given independent trustee or trust protector will have the willingness and sophistication to grant a general power of appointment to a beneficiary and whether such independent trustee or trust protector will even be available when needed for such purpose.

c. **Decanting, Modification, Non-Judicial Settlements**

Even when the provisions of an irrevocable trust instrument would not allow or are affirmatively designed to prevent inclusion of the value of trust property in the gross estate of a beneficiary, there are various mechanisms that may be available under state law by which a general power of appointment could be added to a trust.

Decanting is the process by which a Trustee of an irrevocable trust with discretionary distribution authority may, without court approval, transfer the trust property into a new, separate trust. The governing instrument of the new trust has administrative and/or dispositive terms different from those contained in the original trust instrument. The decanting statutes in the various states whose laws authorize decanting vary widely. Under many such statutes, however, it would be possible (or would certainly appear to be possible) for a Trustee to decant to a new trust whose terms would confer a general power of appointment on a beneficiary, thereby generating basis step-up with respect to the assets of the trust at the beneficiary's death. Notice 2011-101, 2011-

52 I.R.B. 932, requests comments regarding the income, gift, estate and GST tax consequences arising from a decanting that changes a beneficiary's interest. Since the IRS has not yet issued decanting regulations, and has not listed decanting regulations in its latest priority guidance plan, any decanting that changes beneficial interests should be undertaken with care.

A result similar to the decanting result described above may also be achieved by means of judicial or non-judicial modification or non-judicial settlement. *See*, *e.g.*, Sections 111, 411, 412 and 416 of the Uniform Trust Code. In some states and under some circumstances, whether such a modification or settlement could be used to insert a general power of appointment may turn on whether such a change would be considered to violate a material purpose of the trust and could be properly approved by the court.

B. Other Strategies

Additional 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 (but are by no means limited to) 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 Section 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*

a. Overview

IRC Section 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.[12] Since, by reason of IRC Section 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 Section 1014(a), the overall result of IRC Section 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.[13] It may be possible, however, if they are willing to transfer assets to an Alaska, Tennessee, South Dakota or Florida community property trust.[14] 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 and Florida). South Dakota and Florida laws both impose requirements 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 Section 1014(b)(6).

b. Three Questions

Three fundamental questions must be addressed in discerning whether assets placed in a community property trust by nonresidents of Alaska, Tennessee, South Dakota or Florida are "community property" within the meaning of IRC Section 1014(b)(6). First, will property be recognized as "community property" for purposes of IRC Section 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 property to be recognized as "community property" for purposes of IRC Section 1014(b)(6) if legal title to the property is held in trust? IRC Section 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 Section 1014(b)(6), did not contemplate that community property could be owned, in a legal

[12] IRC Section 1014(a).

[13] For ease of reference, in this outline, Alaska, Tennessee, South Dakota and Florida 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.

[14] *See* AS § 34.77.100; Tenn. Code Ann. §§ 35-17-101, *et. seq.*; S.D.C.L. §§ 55-17-1, *et seq.*; Fla. Stats. §§ 736.1501, *et seq.*

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, South Dakota or Florida and are in fact residents of a common law property state?

The answer to the first question appears to be "probably." In *McCollum*,[15] 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 Section 1014(b)(6) applied in determining the basis of the survivor's half of the property. The District Court agreed and distinguished *Harmon*,[16] a Supreme Court case that was somewhat analogous but did not concern IRC Section 1014(b)(6).[17] Furthermore, in Revenue Ruling 77-359,[18] 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.[19] 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 Section 1014(a) because of IRC Section 1014(b)(6).

The answer to the third question seems the most elusive. If nonresidents of Alaska, Tennessee, South Dakota or Florida, residing in a common law property state, were to create in Alaska, Tennessee, South Dakota or Florida what was ostensibly a community property trust but whose validity was later determined *not* to be governed by the law of Alaska, Tennessee, South Dakota or Florida, IRC Section 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, South Dakota or Florida (a requirement seemingly satisfied because, under the applicable community property trust statute, the trust would be required to have an Alaska, Tennessee, South Dakota or Florida resident Trustee), that application of Alaska, Tennessee, South Dakota or Florida 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 that state and the strength of those public policies) and that the trust instrument operate as a valid post-nuptial agreement.[20]

---

[15] *McCollum v. United States*, 58-2 U.S.T.C. ¶ 9957 (D. Okl. 1958).
[16] *Commissioner v. Harmon*, 323 U.S. 44 (1944).
[17] IRC § 1014(b)(6) was not enacted until four years after *Harmon* was decided.
[18] Rev. Rul. 77-359, 1977-2 C.B. 24.
[19] Rev. Rul. 66-283, 1966-2 C.B. 297.
[20] *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).

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.[21]

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.[22] 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 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 Sections 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 Section 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.[23]

a. <u>IRC Section 704</u>

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 Section 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

---

[21] There are further caveats and complications involved in using community property trusts that are beyond the scope of this outline. 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.

[22] 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.

[23] *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).

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 Section 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 Section 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.

b. <u>IRC Section 737</u>

In addition to IRC Section 704, IRC Section 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 Section 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 Section 737 recognition events, but, unlike IRC Section 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.

c. <u>IRC Section 731</u>

Lastly, IRC Section 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 Section 731(c) for this purpose. The return-to-sender exception also applies to IRC Section 731 recognition events but does not explicitly apply in the IRC Section 731 context to assignees. Additionally, IRC Section 731 lacks the seven-year limitation present in IRC Sections 704 and 737.

In applying the various gain recognition rules, IRC Section 704 is applied first, followed by IRC Section 731, and finally IRC Section 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.

IV. DESIGN AND USES OF LONG-TERM MULTIGENERATIONAL TRUSTS

A. Introduction

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).

B. 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.

V. 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 remainder beneficiaries by depleting the trust's asset base and depriving those other or future 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.[24] 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.

[24] IRC Section 661.

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.[25] 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.[26] 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.[27] 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: (1) allocated to fiduciary accounting income; (2) allocated to principal and "paid, credited, or required to be distributed to any beneficiary during the year" or (3) allocated to principal and "paid, permanently set aside, or to be used for [charitable] purposes specified in section 642(c)."[28]

With respect to items (1) and (2) 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."

---

25 IRC Section 1(j)(4).
26 *See* IRC Sections 1(g)(2)(A), 152(c)(3).
27 IRC Section 643(a)(3).
28 IRC Section 643.

CANNON
FINANCIAL INSTITUTE

Participant Survey

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

Balancing Income Tax planning and Estate Tax Planning

August 24, 2021
Please use this link to tell us what you think.

https://join.pathlms.com/Cannon_Survey_082421

Pennsylvania Attorneys, please complete the required PA CLE survey found here, https://www.surveymonkey.com/r/CFI-PACLE

Any questions regarding CE credit, please contact Laurie Sebestyen at (706) 389-7645
Email lsebestyen@CannonFinancial.com
649 S. Milledge Ave., Ste. 4, Athens, Georgia 30605

CANNON

FINANCIAL INSTITUTE

Certificate of Attendance

____

(Participant Name)

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

Balancing Income Tax Planning and Estate Tax Planning

August 24, 2021

Laurie Sebestyen

Laurie Sebestyen
Professional Education Coordinator

- **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.
  Instructional delivery method: Group-Internet-Based
  NASBA #103655; Field of Study-Tax; Knowledge Level-Intermediate
- **Enrolled Agent (IRS)** — **1.0 credit hour**
  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-00148-21-O
- **Certified Financial Planner (CFP™)** — **1.5 credit hours**
  Course # 275024
- **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 # 21CFI007
  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 and Fiduciary Advisor (CTFA™)** — **2.0 credit hours**
- **Certified Retirement Plan Professional (CRPP™)** — **2.0 credit hours**
- **Certified Trust Operations Professional (CTOP™)** — **2.0 credit hours**
- **Certified Fiduciary and Investment Risk Specialist (CFIRS™)** — **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 Sebestyen at (706) 389-7645.
Fax (706) 353-3994, Email lsebestyen@CannonFinancial.com
649-4 S. Milledge Ave., Athens, Georgia 30605

CANNON

FINANCIAL INSTITUTE

Certificate of Attendance

____

(Participant Name)

____

(Attorney Bar # or Social Security #)

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

Balancing Income Tax Planning and Estate Tax Planning

August 24, 2021

CANNON FINANCIAL INSTITUTE, INC. CORPORATE SEAL GEORGIA

Laurie Sebestyen

Laurie Sebestyen
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 (TWE76638), California, Delaware, Georgia, Idaho, Illinois, Iowa (357009), Kansas, Kentucky(225619), Louisiana, Maine (057860), Minnesota (336449), Mississippi, Montana (32657), Nebraska, Nevada, New Mexico, New York, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee (Distance Ed), Texas (174114338), Utah, Vermont, Virginia, Washington, Wisconsin, & Wyoming

These states have been approved for the following General Credit: Colorado – 2 hours, Florida - 2 hours (2008261N), Missouri –1.8 hours (663462), 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, 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
Hawaii- Attorneys can use this certificate for Hawaii CLE for 1.5 General credits (Reciprocity Rule)
Indiana-Site Coordinators must apply for credit as the sponsor for participants to receive credit
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, DE, GA, KY, LA, MS, NM, NC, ND, OK. Type of credit: Areas of Professional Practice 1.5 Credits
****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, Illinois, Kansas, Louisiana, Montana, Nebraska, Nevada, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Washington, and West Virginia. ****

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

CERTIFICATE OF ATTENDANCE FOR CALIFORNIA MCLE

To be Completed by the Provider

Provider: Cannon Financial Institute (CA Provider #12179)

Subject Matter/Title: Balancing Income Tax Planning and Estate Tax Planning

Date and Time of Activity: August 24, 2021, 1:00-2:30 PM ET, 12:00-1:30 PM CT, 11:00AM-12: 30 PM MT,

10:00AM- 11:30 AM PT

Location: Teleconference

Length of Presentation: 1.5 Hours

ELIGIBLE CALIFORNIA MCLE CREDIT:

TOTAL HOURS: 1.5

Legal Ethics:

Elimination of Bias in the Legal Profession:

Competence:

To Be Completed by the Attorney after Participation in the Above-Name Activity

By signing below, I certify that I participated in the activity described above and am entitled to claim the following California MCLE credit hours:

TOTAL HOURS: ________________________

(You may not claim credit for the following sub-fields unless the provider is granting credit in these areas as listed above.)

Legal Ethics:______________________________

Elimination of Bias in the Legal Profession:______________________________

Competence: ______________________________

Attorney Signature:

REMINDERS: Keep this record of attendance for four years. In the event that you are audited by the State Bar, you may be required to submit this record of attendance. Send this to the State Bar only if you are audited. You must sign in on the Official Record of Attendance for California MCLE maintained by this provider in order for these hours to qualify for California MCLE credit.

CANNON
FINANCIAL INSTITUTE

Certificate of Attendance

____

(Participant Name)

____

(Colorado Attorney Registration #)

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

Balancing Income Tax Planning and Estate Tax Planning

(792993)

CANNON FINANCIAL INSTITUTE, INC.
CORPORATE SEAL
GEORGIA

August 24, 2021

Laurie Sebestyen

Laurie Sebestyen
Professional Education Coordinator

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

Colorado – 2.0 General Credits

****As required by the State of Colorado, attorneys must submit their own credits.

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

Virginia MCLE Board

CERTIFICATION OF ATTENDANCE (FORM 2D)

MCLE requirement pursuant to Paragraph 17, of Section IV, Part Six, Rules of the Supreme Court of Virginia and the MCLE Board Regulations.

Certify Your Attendance Online at www.vsb.org

MCLE Compliance Deadline - October 31. MCLE Reporting Deadline - December 15.
A $100 fee will be assessed for failure to comply with either deadline.

Member Name: ______________________________ **VSB Member Number:** ____________________

Address: ______________________________ **Daytime Phone:** ____________________

______________________________ **Email:** ____________________

____

City **State** **Zip**

Course ID Number: **NII0589**

Sponsor: **Cannon Financial Institute**

Course/Program Title: **Balancing Income Tax Planning and Estate Tax Planning**

Live Interactive * **Approved CLE Credits (Ethics Credits): 1.5 (0.0)**

Date of telephone/webcast:______________________________ **Location(s):** ______________________________

By my signature below I certify

___ I attended a total of ______________ (hrs/mins) of **approved CLE**, of which (______) (hrs/mins) were in **approved Ethics**. Credit is awarded for actual time in attendance (0.5 hr. minimum) rounded to the nearest half hour. (Example: 1hr 15min = 1.5hr)

___ The sessions I am claiming had written instructional materials to cover the subject.

___ I participated in this program in a setting physically suitable to the course.

___ I was given the opportunity to interact with the presenter (in real time if live interactive or other method if pre-recorded).

___ I understand I may not receive credit for any course/segment which is not materially different in substance than a course/segment for which credit has been previously given during the same completion period or the completion period immediately prior.

___ I understand that a materially false statement shall be subject to appropriate disciplinary action.

* NOTE: A maximum of 8.0 hours from pre-recorded courses may be applied to meet your yearly MCLE requirement. Minimum of 4.0 hours from live interactive courses required.

______________________ ______________________________

Date Signature

This form may be mailed to:

Virginia MCLE Board
Virginia State Bar
1111 East Main Street, Suite 700
Richmond, VA 23219-0026
(804) 775-0577
www.vsb.org

[Office Use Only: Webcast]