Trust Administration: Practical Tips for Advisers and Trustees

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A KEY ESTATE PLANNING GUIDE

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Article for More Information

- An article discussing trust administration and the use of a checklist to organize documentation can be viewed at: https://shenkmanlaw.com/uploads/2023/05/trust-administration-article-Feb-24-2023-complete.pdf

Color Coding

- Slides have some color coding to make it easier to focus on key points during our discussion.
- Green identifies proposed changes in the Biden Administration Greenbook. These are not current law and may never happen (but you never know!).
- Blue highlights key points or key words.
- Purple highlights sample language or details that might be helpful to you but which we will not discuss in this program. If you review these materials later the sample language will hopefully help you understand the concepts better. These have been included for follow up help to attendees. Many of the sample clauses illustrated were provided courtesy of Interactive Legal (ILS) drafting software.

Trust Administration: Obtain, Organize and Analyze Key Records

Some Basic Suggested Steps To Consider

Trust Administration Preliminary Steps – Representation

- Clarify who the adviser is representing. Everyone may think the attorney who drafted the trust is representing them too: trustee, beneficiary, trust protector, etc. Everyone may think the CPA completing a trust tax return has a responsibility to them.
- Clarify all of this in the engagement letter and even follow up communications.

Trust Administration Step 1
Analyze the Trust Document

- While this may be obvious to every professional adviser, it is not for many, if not most clients, and many advisers either do not take the time for this step or skip this step because the client “won’t authorize the time.”
- Practitioners should carefully weigh the potential negative implications to the client (and to the practitioner involved) from skipping this step. Do you want to be responsible for administering a trust without an annotated copy of all relevant trust documents?
- Step one is get a complete final signed copy of the trust instrument and any modifications or changes (e.g., trust protector actions, direction letters to trustees directing them to take certain actions, exercise of a swap power, back up for any tax reimbursements that have been made, etc.)
- Annotate, ideally with assistance of the attorney for the trust (often but not always the attorney that drafted the trust) the trust document and later actions/modifications so that you understand precisely what the guidelines are for the trust. Without this administering the trust might be a challenge in the best of circumstances (it could just be “hit or miss”).

Trust Administration Preliminary Steps – Annotate the Trust

- Create a trust annotation highlighting key persons and terms.
- Our approach: If we have a Word document of the final trust, we use that and if not, we convert a PDF of the trust document to Word. Highlight key provisions relevant to trust administration in yellow and add annotations to ourselves or the clients in green as steps to take to conform to the trust provisions.
- This analysis may vary depending on the use of the trust, the questions being asked, etc. For example, if the annotation is being requested by the trust's CPA we would focus annotations on distribution provisions, ties to various states (nexus), status as grantor or non-grantor trust, etc.
- This is important because the discussions about the trust when it is being planned are from a different perspective then the discussions about the trust after it is signed, and it is being administered.
- The goal is to create a roadmap that can be modified as new issues arise or facts change.

Trust Administration Preliminary Steps – Summary

- Create a trust summary of key persons and terms. Cross reference to section in the document and the pages where they appear. This presumes that you have a copy of the completed and fully executed trust (and any later actions pertaining to the trust) in your file. You really should!
- A simplified page or two summary can be valuable to all involved for a quick overview.
- For clients with many trusts a listing of each trust can be helpful, even essential.
- A schematic of the trust plan may be vital when there are several different trusts, trusts owning varying interests in different entities, and an array of note sales and other transactions. This is discussed and illustrated below.

Documents that Might Be Relevant to a Life Insurance Trust Plan

- Memorandum explaining the plan completed in advance of the plan implementation.
- Insurance projections.
- Insurance application.
- Insurance policies.
- Fully signed trust document.
- Gift between spouses before funding the trust (*e.g.*, from one spouse to the other if the couple has only a joint checking account).
- Trust bank account opening documentation.
- Crummey letters for the first year (and perhaps years thereafter).
- If significant funding is made to the trust, there could be an investment policy statement for investible assets.
- Documentation of a split-dollar loan or other financial arrangement to fund the trust (*e.g.*, a tier of GRATs the reminders of which may pass to the ILIT).
- A memorandum after the trust is completed addressing administration of the plan.
- Gift tax returns reporting gifts to the ILIT plan.
- If the current ILIT arose out of decanting of an old ILIT (*e.g.*, to effectively transform an old ILIT that paid out to beneficiaries at specified ages into one that holds assets for the beneficiaries' lives) the old trust, its funding and other documentation, the decanting instrument, and other documents.
- If the ILIT is to be funded each year, then documentation concerning each year's gifts and Crummey powers.

Sample Steps In A Trust Summary

1. Name of Trust.
2. Formed under name and date of agreement. A testamentary trust might be formed under a will, which could have been executed on one date and then come into existence on a later date. A formerly revocable trust would become irrevocable on, at the latest, settlor's death. It is good practice to record not only the date of the execution of a document but also the date on which it achieved its current status. In many cases, existing irrevocable trusts may have divided on the occurrence of a certain event (*e.g.*, death of the settlor or sale of a family business), so the prior trust is the instrument under which the trust in question is created. Some trusts might be the result of a merger with, or hold assets that were decanted from, another trust. Capturing a concise and organized historical background in the summary could help create a timeline for the trust and prevent a future need to review old files.
3. Trust Tax Identification Number.
4. Current Trustees. There may be multiple trustees. A modern trust may have a general, administrative, distributions, investment, insurance, charitable, special holdings, or other trustees or other fiduciaries, such as an investment or distribution adviser. Be certain to list each category of trustees or other fiduciaries, and the person(s) or institution(s) named to serve. It may also be useful to succinctly indicate the functions and responsibilities of each trustee or other fiduciary.
5. Successor Trustees
6. Powerholders. Modern trusts, especially often have an array of special function appointments, or persons designated to hold certain powers.
   a. These could include, among other possibilities, a trust protector with certain designated rights or powers, a person with the power to appoint trust assets to the settlor or others, someone authorized to make loans to the settlor.

Sample Steps In A Trust Summary

   a. A person may be designated to hold powers to determine or resolve matters such as who a descendant is, whether a person should remain a beneficiary despite the instrument's referring to their former name, and LGBTQ matters (*e.g.,* incorrect pronouns or names due to self-identification after a trust was drafted)
   b. A special powerholder may be appointed to assure compliance with religious precepts, such as a limited power of appointment to assure dispositions in accordance with Islamic law.
   c. All these powerholders could be identified with brief explanations of the powers and purposes of the appointment.

1. Trust assets. Identifying key trust assets will clarify the purpose of the trust and how it should be administered. For example, if the trust owns stock of a Subchapter S corporation, care will have to be taken to assure that the trust retains the right to hold that stock and not jeopardize subchapter S status.
2. Letters of Trusteeship. Indicate details (dates, court number, etc.) of any court provided documentation appointing one or more trustees (or other fiduciaries) for a testamentary trust.
3. Beneficiaries should be listed with key information and any special circumstances that may be relevant to the trust administration.
4. Summary of selected trust provisions. This could be a broad overview with references to the actual section or provision numbers of the trust for further details. For example, if income must be distributed to a spousal beneficiary, the trustee will have to be on notice for that. Those distributions might affect investment allocations and have specific income tax implications.

Trust Administration Preliminary Steps – “Closing Binder”

- Create a trust electronic compilation of all documents and a table of contents. See article on Trust Compilations in Leimberg Information Systems (LISI) Newsletter April 2023.
- It is helpful for complex trust plans to have a compilation of all relevant documents in logical order.
- The contents listing for this compilation is a great starting point for the exhibit list for the Form 709 gift tax return, if one needs to be filed.
- We have never found a single trust where documents or steps were not identified as missing or incomplete when creating such a compilation. We believe this is a vital step to assuring that no loose strings exist.
- Explain to the client that minor foot faults should be identified and addressed before an audit. The Smaldino and Sorensen cases are reminders of this.
- Proactively addressing any issues identified, thereby showing a good faith effort, may affect the demeanor of an auditor on a future audit.
- Some advisers use workflow programs (illustrated in following slides) to organize trust plans (we don’t).

Sample Workflow- 1

Example of Workflow & Project Management

Wanda Lucky Descendants' Trust

CLOSING CHECKLIST

Purchase of 99.99% Limited Partnership Interest in Smith Holdings I LP by the Trustees of Smith Descendants' Trust from the Trustees of John Smith Marital Trust

Action	*Responsible Party*[1]	*Target Date*	*Completed*
Creation and Funding of Marital Trust:			
1. Execution of Trust Agreement by John Smith, as Grantor, John Smith, as Investment Trustee, Jack Jones, as Independent Trustee, and Alaska Trust Company, as Administrative Trustee (the "Marital Trust").	MTHM, JS, JJ and ATC	Third week in June	Yes
2. Trustees of the Marital Trust open Bank/Brokerage Account and fund the Trust in an amount necessary to meet administration expenses, i.e., approximately $50,000.	JS and JJ	Third week in November	Account opened

Note:
1. Responsible Party generally means the person who must sign certain documents. We appreciate that John Smith and Wanda Lucky likely will be the persons who will ensure many of the steps will be taken.

Sample Workflow- 2

Example of Workflow and Project Management (cont'd)

	Action	Responsible Party[1]	Target Date	Completed
28	Prior to April 15, 2008, a gift tax return must be filed for David showing the initial contributions to the Management Trust, the Marital Trust and the Descendants' Trust, making a QTIP election for the contributions to the Marital Trust, and allocating David and Mary Smith's GST Exemption to the initial transfer to the Descendants' Trust.[3]	JJ, JS and MS		*Confirm dates contributions were made*
29	Interest on Promissory Notes to be paid annually on the anniversary of the date of the Promissory Note with principal payable on the maturation date. We will prepare a payment schedule.	JS and JJ		No

Key

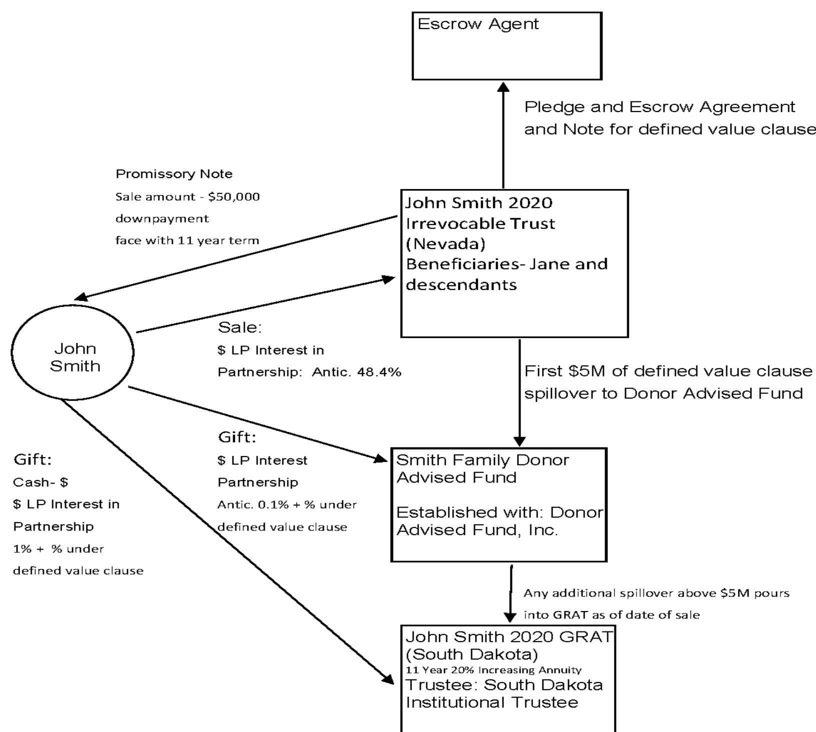
ATC	–	Alaska Trust Company
JJ	–	Jack Jones
JS	–	John Smith
MS	–	Mary Smith
MTHM	–	Milbank, Tweed, Hadley & McCloy LLP
WL	–	Wanda Lucky

Note:
3. The gift to the Descendants' Trust may be "split" with Mary. The gift to the Marital Trust may not be split but there should be no gift tax due with respect to the gifts to those trusts.

Trust Administration Preliminary Steps – Schematic

- Create a schematic of the plan. Many plans have so many moving parts that without a schematic it will be difficult or impossible for anyone to follow the sequence of the transaction.
- If a client has several trusts, consider creating an additional “snapshot” schematic showing the interaction of the various trusts and asset ownership. Providing a client with a simplified single page schematic representing their planning may help the client feel less overwhelmed with the planning implemented.
- We often create a schematic for each phase of the plan and as a plan evolves, create additional schematics showing the various steps. This can be invaluable in getting a quick picture of the planning at different points in time and the visual aide can help properly identify parties to various aspects of the transaction, the sequence that tax reporting and documentation must follow and more. One page of a sample sequence of schematics is illustrated on the next slide.

Sample Note Transaction Schematic with Defined Value Mechanism Waterfall



Modifying Trust Results and Deflecting Valuation Adjustments in Trust Administration

Big Picture

- There are many mechanisms that a trust (or trust plan) might incorporate that could change the tax results of the trust. When administering a trust practitioners must identify what mechanisms were used in the trust (or plan) and evaluate them to determine what implications, if any, they have to the trust. Without terra firma as to what the trust is, administration is not possible.
- In some instances, terra firma may not obtainable until an appraisal, future audit, or some other mechanism is known or resolved. That may itself require different steps in the trust administration process.
- The reason "trust plan" was also noted above is some of these modification, or adjustment mechanisms may not be contained in the actual trust document, but rather in the transfer documents. In many cases each will contain important mechanisms.
- Example: The assignment to a trust of LLC interests includes a Wandry mechanism. The trust instrument incorporates a disclaimer. The trust itself is QTIP-able and the gift tax return must be consulted to ascertain the status. There are many more examples, some of which are discussed below. The Key point is to understand what is involved in the trust plan and what impact it has and how that impact needs to be addressed in administration of that trust, tax reporting and more.

Avoiding an Unwanted Transfer via Disclaimer

- Does the trust have (or does state law provide) a disclaimer mechanism? Has that mechanism and the time limit to act been reviewed with the client?
- Some trusts include a provision permitting one beneficiary to disclaim on behalf of all trust beneficiaries. That should give 9 months to look for a disclaimer to disclaim which under Sec. 2518 would result in the exemption not being used and the assets being restored and assets reverting to the settlor.
- The above mechanism can be integrated into a new trust but for an old/existing trust the right may have to be included in the transfer documents. So, you may have to review ancillary documentation in addition to the trust.
- Other commentators suggest the above won't work for a pot trust and the trust must be solely for the person holding the power to disclaim. Others disagree. If this was done, then a LPOA may have to be exercised to get the trust where the client intended.
- If the trust contains such a disclaimer (many did in 2020-2021 when retroactive changes to the estate tax rules were proposed) then you might want to obtain corroboration that the disclaimer was not exercised (e.g., a letter from the person holding that power stating that they never exercised it). Without confirming this you cannot be certain whether the trust owns any assets.

Was a QTIP-able Trust Used?

- Some clients made transfers to a trust that will qualify for the marital deduction if a QTIP election is made on a gift tax return by the extended filing date. The trust may provide that if the election is not made the assets would pass to a non-marital deduction trust for the surviving spouse that would use exemption.
- Have you identified this attribute in the trust? Has this been reviewed with the client to determine what position should be taken? Can a trust be decanted and still disclaimed? For older transactions you need to confirm on the gift tax return reporting the gift transfers to this trust whether a QTIP election was made or not. That will have dramatic impact on which provisions of the trust govern its operation. You cannot properly administer such a trust without this knowledge.

Defined Value Clauses – 1A Wandry

- Determine whether, and if so what type of, defined value mechanism was used in each transaction and be certain that forms 709s, 1040s and 1041s, and other statements such as K-1s, and financial reports, and trust records properly reflect the existence of such a mechanism.
- The Sorensen case held that the Wandry clause used was ineffective because the taxpayers did not properly reflect the implications of the dollar value transfer on the corporation's stock ledger or in a later sale of stock to a third party. Failure to observe formalities may undermine the entire transaction.
- Defined value clauses - Wandry.
  - Defined value clauses endeavor to deflect a gift tax valuation challenge by defining the gift in a manner that mitigates the impact of an IRS valuation challenge.
  - Wandry clauses are the most common defined value mechanism approach because they were approved by the Tax Court, and they are simpler and less expensive to implement then waterfall mechanisms
  - A more complex approach may be safer.

Defined Value Clauses – 1B Wandry

- Sample Clause: I gift (sell) $_____ worth of LLC interests to the Smith Family Trust. Those interests have been estimated based on an appraisal to be ______% of the LLC. The actual percentage interest given/sold shall be determined by the value finally determined for federal gift tax purposes.
- Tax Court in *Wandry* T.C. Memo 2012-88 upheld the defined value mechanism based on the specific wording of the clause in the assignment documents.
- IRS issued a statement refusing to acquiesce to the Tax Court's conclusion, signaling strong disagreement of *Wandry* (Action on Decision 2012-004) – but not enough to appeal the case. It seems appropriate to recommend for a client to consider other options (see below), as Wandry is not the guarantee some practitioners might believe.
- *Wandry* approach results in only the intended dollar amount of the assets being transferred with any excess above that amount remaining in the transferor's estate.
- Any assets remaining in the transferor's estate are subject to future estate tax (and worse may trigger a Powell challenge causing even transferred interests to be pulled back into the estate).
- **Confirm that bank trust records, client and trust financial statements, all reflect the uncertainty of ownership interests if applicable under the precise mechanism used**.

Defined Value Clauses – 2 Christenson/Petter Waterfall

- Defined value clauses can be structured in a different manner than Wandry. Some commentators believe these approaches are safer. Some suggest this is correct especially after Sorensen, others disagree.
  - The client parts with 100% of the desired interests in the transfer. This contrasts with Wandry were some of the interests may not be transferred in the transaction.
  - I hereby transfer all of my rights and interests in XYZ, LLC pursuant to this transaction. I gift (sell) $______ worth of LLC interests to the Smith Family Trust. Those interests have been estimated based on an appraisal to be _______% of the LLC. The actual percentage interest given/sold shall be determined by the value finally determined for federal gift tax purposes as of the date of this transfer. Any interests in XYZ, LLC not transferred to the Smith Family Trust above shall pass to the Smith Family Donor Advised Fund, up to a maximum amount of $2 million dollars. Any excess value over the amounts transferred to the Smith Family Trust and the Smith Family Donor Advised Fund are hereby transferred to [Smith Family GRAT] [Smith Family Incomplete Gift Trust] [John Smith Marital Trust], etc.
  - The benefit of this type of waterfall clause is that the client has parted with all interests no matter what the values are. **Consider how to deal with income tax reporting**?

Defined Value Clauses – 3 Nelson Case

- Nelson case.
  - Nelson v. Commissioner, T.C. Memo 2020-81: the taxpayer's valuation adjustment mechanism failed because it did not use the requisite language of referring to: gift tax value as finally determined for federal tax purposes and instead had a reference to an appraised value.
  - The value used in a valuation adjustment mechanism must be based on the gift tax value as finally determined for federal gift tax purposes. In Nelson the value of a baule (a piece of art) was based on the appraisal. Use the language used in the case law like Wandry, don't vary from that.
  - **Practitioners should review the language and if it is wrong, either correct or advise counsel to correct the documentation if feasible. Also, consider what should be disclosed on a gift tax return**. If the language in the Wandry clause is not sufficient and a revision is made, should both documents be attached as exhibits for "adequate disclosure"?

Defined Value Clauses – 4
Double Wandrys

- One problem with a Wandry clause is that some portion of the equity interests the client is shifting out of their estate may remain in the estate if there is a valuation adjustment. That is because only a fixed dollar value is transferred. But as suggested earlier, a Wandry clause can be used to define one part sold/given and the balance otherwise disposed of (similar to a will that divides a married decedent's property into marital and non-marital deduction shares.)
- Having a residual interest in the estate could be particularly problematic if discounts are repealed, transfers to grantor trust included in the grantor's estate, and other changes enacted.
- One solution is to use the Petter/Christenson waterfall as discussed above.
- Another approach is to use what might be referred to as a "**double Wandry**." The "first" part of the Wandry is the traditional Wandry transfer. The "second" or "double" portion of the Wandry is to sign a secondary sale agreement that sells, effective as of the date of the initial transfer, any equity remaining in the client's estate, at the gift tax value as finally determined.
- This approach removes 100% of the desired interests from the estate and should do so without gift tax implications.

Defined Value Clauses – 5 Double King

- A King price adjustment mechanism increases the face amount of the note to equal any gift tax value as finally determined. So instead of changing the percentage of shares transferred, or allocating using a waterfall, the note on a sale is increased to reflect the proper value.
- This is based on a 10th Circuit case, King v. United States, 545 F.2d 700 (10th Cir. 1976). Some commentators do not suggest using a King clause because it is only a 10th Circuit case and may not be as secure as a Wandry clause, which is based on a Tax Court case. Other commentators suggest that since King adjustments are commonly used in the business world that there is significant merit to the technique. On the latter point, some commentators suggest that King adjustment mechanisms should be used in transactions that have a business context.
- In a client's haste to complete planning before changes in the law, if **a King note adjustment** mechanism is used, does the transfer have to wait to receive the valuation? Yes.
- But if the client is anxious to close the transfer, perhaps an estimate of value can be used. Then, when the appraisal is received the King note will be adjusted. The "second" or "double" adjustment will occur for gift tax value as finally determined in which case the note will be adjusted a second time.
- **CRITICAL to all of this, as confirmed by Sorensen, is accurate records and reporting of the particular method used including its nuances**.

Always Consider Trust Taxation in Trust Administration

Trust Tax Considerations Vital (and not always obvious)

- In many trust plans the status of the trust is determined at the planning stage:
  - Completed gift or incomplete gift.
  - Whether gifts to the trust will qualify for the gift tax annual exclusion, and if so, what steps may have to be taken to support that.
  - Grantor trust or non-grantor complex trust.
  - GST exempt trust with an inclusion ratio of zero, non-GST exempt trust with an inclusion ratio of one, or if unavoidable something in between.
  - Whether the trust assets might be included in the taxable estate of a person other than the settlor.
  - Whether the trust should be taxable in any particular state.

Trust Tax Considerations Vital (and not always obvious)

- But the variations and permutations of tax (and non-tax) factors that might affect trust administration are legion.
- Even if every tax nuance is carefully planned at inception have those factors been clearly communicated from, for example, the estate planning attorney to the CPA and the wealth adviser who need to understand these matters to perform their functions? In too many cases that does not occur due to client's trying to save money, one or more practitioners trying to retain more control, or simply from an oversight. Regardless, unless the entire planning team understands the goals and status of the trust, the administration of that trust may be less productive for the client.
- Finally, whatever the various tax (and other) characteristics at inception, given the myriad of ways trusts might be modified or tax status changed, no characteristic should be taken for granted and as circumstances change, they should all be re-evaluated.

Estate Tax Planning Considerations in Trust Administration

- Practitioners must monitor key tax strategies built into the trust and plan. First, review the trust and overall plan to determine what mechanisms are involved. Then review current facts and confer with the client to determine if action is advisable.
- Basis maximization can provide valuable income tax planning opportunities, and irrevocable trusts can be tailored to facilitate this through:
  - Distribution of assets to beneficiaries, e.g., a beneficiary of advanced age.
  - Use of powers of appointment, e.g., giving an elderly parent a general power of appointment to cause trust assets to be included in their estate and to achieve a basis step up during the grantor's lifetime or to trigger the Delaware Tax Trap per Section 2041(a)(3).
- **Swap powers** (see section 675(4)(c)) can provide more flexibility for income tax basis planning (i.e., basis step up) or accomplish several other important planning goals. The traditional application of a swap power is for an elderly or infirm grantor to swap cash into the trust in exchange for highly appreciated trust assets. Have assets appreciated? Has the power holder's health deteriorated? This should be monitored and documented to corroborate conformity to trust and tax law requirements if used. See more detailed discussion below.

Trust Protector Provisions

Caution in Order

Trust Protectors

- Be very careful in making any assumptions about any position referred to as a “trust protector” or “trust director.” **The terms and positions are used in very different manners by different practitioners**.
- Is the position a fiduciary or non-fiduciary?
- What powers does the position have?
- Are some of the powers held in a fiduciary capacity and some in a non-fiduciary capacity? Does that bifurcation work?
- Some draftspersons refer to a person holding a power to loan to the settlor a protector as well as a person holding a power to change situs and trustees. Those powers are quite different and need to be treated as such.

Trust Protectors

- If Trust Protectors are named in the instrument, what powers do they hold? There is no standardization to the powers given so that you must review them to ascertain what can be done.
- This position has become more common in irrevocable trusts. Giving a protector, acting in a fiduciary capacity or in a non-fiduciary capacity (you need to know which capacity the trust protector is serving in, as that may affect the ability to exercise various powers), the power to change the governing law and situs, and so forth, infuses flexibility to respond to future changes. Is a change warranted?
- Caution – naming a protector who is a fiduciary as opposed to someone merely holding a special limited power of appointment in a non-fiduciary capacity might subject a trust, once no longer a grantor trust, to state tax nexus based on the residence of the protector. One approach suggested to mitigate this risk is to "house" all ancillary functions (trust protector, investment adviser, etc.) inside an LLC formed in the trust friendly jurisdiction where the trust is based. Has this been reviewed?

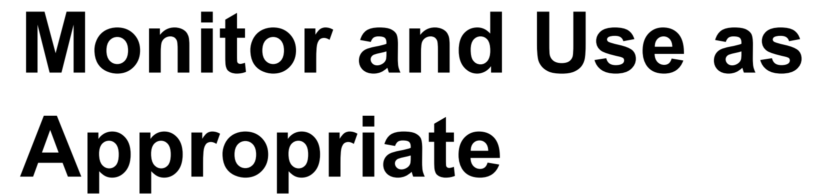
Trust Protector Possible Powers

- The power to remove Trustees.
- The power to appoint an individual, corporation or other entity with fiduciary powers to replace any removed Trustee, or to add a new additional co-Trustee.
- The power to appoint an individual, corporation or other entity who is not related or subordinate to the Grantor or the Beneficiaries with fiduciary powers to exercise powers granted in this Trust. Rev. Rul. 95-58 safe harbor.
- The power to change situs and governing law of the trust, correct scrivener's errors, modify administrative provisions that have no effect on the beneficial interests in the trust.
- The power to modify or amend the supplemental needs trust provisions herein to conform with any changes in applicable law.
- The power to restrict or eliminate the right of the Trustee to apply the income of this trust to pay life insurance premiums on the life of the Grantor and/or the Grantor’s spouse.
- Note that even if falling under the Rev. Rul. 95-58 safe harbor, it may not protect assets from claims of creditors of the Grantor who holds the power.

Trust Protector Possible Powers

- The power to change the name of the Trust and governing law.
- The power to demand an accounting and the right in the Trust Protector's sole discretion to submit same to a court or not.
- The power to direct the Trustee as to which beneficiaries, fiduciaries or other persons holding powers hereunder (whether in a fiduciary capacity) (individually or collectively "Notice Persons") shall or shall not be entitled to receive information concerning this Trust, including but not limited to periodic investment statements and other notifications, to the extent not inconsistent with applicable state law. While Grantor is alive and not disabled no such notifications shall be given to any Notice Persons hereunder other than the Grantor and the Trust Protector unless the Trust Protector authorizes same, or applicable state law requires otherwise. No trustee shall be liable for notifications following Grantor's disability until such Trustee has actual knowledge, or receives written notice from.
- The power to restrict or eliminate the powers granted to the Designator or the Appointer. These terms are explained and illustrated below.

Power to Add Charitable Beneficiaries



Permit Adding/Including Charitable Beneficiaries

- The trust might include a **right for a person, acting in a non-fiduciary capacity, to add a charitable beneficiary**. This right, during the grantor's lifetime, characterizes the trust as a grantor trust.
- With all the uncertainty over income and estate tax law changes, some have added a broader charitable designator provision. Review what is in the trust and consider whether action should be taken, if any. If the income tax rules for charitable contribution deductions become more restrictive, perhaps it will be advantageous from an income tax perspective to make the gifts out of a trust instead of by the individual once the trust becomes non-grantor.
- Does the power to add a charity end on the grantor's death? Some trusts permit it to continue in perpetuity since the purpose is not merely to trigger grantor trust status, but to add flexibility to planning. If the estate plan is successful, significant wealth will be shifted out of your client's estate to long term irrevocable trusts.

Permit Adding/Including Charitable Beneficiaries

- What resources will future generations direct to charity if their inherited wealth is in trust with no charitable beneficiaries?
- Does everyone involved know if a charity was added? The trustee making distribution decisions must understand that. For a non-grantor trust the tax benefits of charitable distributions might be material.
- Consider IRC Sec. 642(c) – can a trust get a FMV deduction for gifts in kind? IRC Sec. 642(c) is more limited than IRC Sec. 170.

Loan Provisions

Provision to Make Loans

- First **determine whether the trust is intended to be a grantor or non-grantor trust. A loan for less than adequate security to the settlor will characterize the trust as grantor**. This should be monitored during trust administration. How do you corroborate that if there is a loan to the settlor the security is adequate? Perhaps the better approach is not to have the trust make any loans to the settlor ever if it is non-grantor.
- It had been common to include a power to a person acting in a non-fiduciary capacity to make loans to the settlor of the trust. Adequate interest should be charged but adequate security is not necessary in a grantor trust according to the trust terms of most trusts. What does the trust permit? This too should have characterized the trust as a grantor trust. If the powerholder is designated as acting in a fiduciary capacity, unless that provision can be changed, e.g., through decanting, consider whether it will ever be feasible to make a loan.

Provision to Make Loans

- While grantor trust status might be achieved with a swap power, perhaps a loan provision should still be included, but now more for providing a means for the settlor to access trust principal than for grantor trust characterization. If the estate tax is repealed your client might be happier with the planning knowing that there is a means to provide the client access to trust funds, even if that is as a loan.
- Should you always include a loan provision to back stop issues some commentators perceive with swap powers not assuredly granting/creating grantor trust status?
- **If the trust makes a loan to the grantor document the loan with a written signed loan document, with arm's length terms including interest (will using an AFR assuredly suffice in this context)?**

Sample ILS Loan Provision

I appoint Mary Simpson as the Loan Director. During my lifetime, the Loan Director shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to compel the Trustee to loan some or all of the trust property to me without adequate security within the meaning of Code Sec. 675(2) although with adequate interest within the meaning of that section. I direct that this power is not assignable. In the event that Mary Simpson dies before I die, the successor Loan Director shall be such individual (other than me, any person acting as a Trustee under this instrument or anyone who is an adverse party within the meaning of Code Sec. 672) whom Mary Simpson shall have designated by instrument in writing. Any person other than Mary Simpson acting as a Loan Director hereunder shall also have the power to name a successor Loan Director by an instrument in writing. In the event that no one else is acting as a Loan Director hereunder, the oldest individual acting as a Trustee hereunder (or if none, the corporation or other entity acting as Trustee hereunder) shall be the Loan Director but acting only in a non-fiduciary capacity.

Decanting and Decanting Powers

A Powerful Tool That Changes Trust Administration

Express Decanting Power

- Practitioners can no longer assume that an irrevocable trust cannot be changed. If you can decant the trust, you may have the ability to make the trust more secure for beneficiaries, reduce or avoid state income taxation, etc. You might be able to change inefficient or undesirable trust administration provisions. **So, periodic reviews of the trust to determine what might be changed should now be considered**.
- Example: A CPA prepares Form 1041 for a trust and there is a costly tax bill to a high tax state. No longer should it simply be dismissed that the trust is "irrevocable." It may be feasible by decanting the trust, wrapping assets in an LLC, dividing the trust into two or more parts (with high tax state source income or situs assets in one trust all other assets in another trust) or other actions to reduce or even avoid state income taxation in that high tax state.

Express Decanting Power

- Many trusts give the trustee an express power to decant. If not, you have no choice but to rely on state law. The power may permit the trustee to merge the trust into a new and improved trust so administrative provisions can be modified to address future circumstances. Decanting can be used to add or remove a swap power, add an insurance trustee provision so insurance can be added to a trust that did not provide for it, and so much more.
- Even if the desired modifications can be accomplished with a trust protector action, or non-judicial modification by beneficiaries, **including broad express decanting powers directly in a new trust instrument may be advisable**.

Swap or Substitution Powers

Swap/Substitution Powers

- In a grantor trust periodically review the swap power and evaluate options to using it.
- This power can be used to create grantor trust status (income of the trust is taxed to the settlor). Section 675(4)(C).
- This could be useful to obtain a basis step up on death. It could enable the client to change his or her dispositive scheme and transfer the business to another heir. See above.
- If a capital gains tax on death is enacted, a reverse swap might prove beneficial. Shift appreciated assets into the trust (the opposite of what most clients try to do under current law) to avoid capital gains on death.

Make Swap Powers Practical

- The client/settlor must have property available to effectuate a swap. In many cases cash might be the easiest or preferable asset, but few settlors have addressed this. Practitioners can assist these clients in creating lines of credit to be "at the ready." Have counsel prepare documentation now to be in the on-deck circle to facilitate a swap if one might be needed to be completed quickly. For example, assignments, direction letters, consents, etc. can all be prepared in draft form to save time.
- Analyze trusts for highly appreciated assets as part of the annual review process.
- **Assure that if a swap is done that the terms of the trust are followed so that the transaction is in compliance with its requirements**.

Broader use of Swap Powers

- Some only consider swap powers in the context of swapping into an elderly grantor's estate to obtain a basis step up for low basis trust assets on grantor's death, but there are more planning options.
- But it also is an incredible tool to build in flexibility. Your client can transfer family business interests to an irrevocable trust, locking in valuation discounts available under current law. But, if your client later wants to return those assets to their name, the settlor can swap in an equivalent amount of cash and get the business back. Consider an irrevocable trust holding stock in a family business.
- Grantor/donor/parent wants to change the dispositive scheme. Can that stock be swapped out back into grantor's name for assets of equivalent value and then given or bequeathed to a different family member?

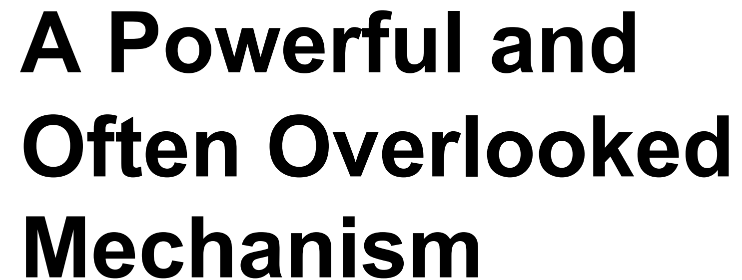
Swap Powers and Divorce

- **Example**: Wife started a widget manufacturing company and gifted 20% of the stock to an irrevocable trust for the children. Husband was named trustee. The business grew substantially. In the maelstrom of the divorce the status of the trust was overlooked. Post-divorce, wife wanted to reclaim her stock, since a 20% minority interest in the business out of her control would be an impediment to her selling the company. So, she attempted to swap a personal note to the trust in exchange for the stock. The now ex-husband, who remained the trustee, refused to honor the transaction. So, while a swap power could have been an important tool for flexibility had the issues been addressed during the pendency of the divorce, it may prove elusive.
- Where possible endeavor to evaluate with clients the possible implications divorce might have on the trust and the swap powers in advance.

Swap Powers and Divorce

- A similar fact pattern arose in a recent case. The trustee was the wife and mother of the daughter of the marriage who was the beneficiary of the trust. The couple divorced. The ex-husband tried to exercise swap power and now ex-wife trustee refused. He tried to swap in a note and the ex-wife/trustee objected saying it was not of equivalent value as required by the trust instrument. Schinazi v. Eden, 2016 WL 5867215. In the divorce the issue of trustee and trust actions should have been addressed. It may have been preferable for all involved to have had the wife/ex-wife resign as trustee in favor of an independent, and ideally an institutional, trustee.
- If a swap power is included in a trust, consider naming an independent trustee. The trustee may have to confirm that the value of the property being swapped into the trust is of equivalent value to the property being swapped out of the trust to the settlor. If a spouse is trustee for a trust with a swap power, as part of the divorce negotiations, consider naming an independent trustee to prevent the ex-spouse/trustee from unreasonably inhibiting the exercise of a swap or other powers.
- Even better, provide that upon a divorce any interest a spouse has should be terminated (i.e., Spouse deemed to be predeceased). Consider the impact on grantor trust status for income tax purposes. Practically, this may not be feasible, and it may raise conflict issues in the representation.

Administering Trusts with Powers of Appointment



Powers of Appointment

- Many trusts include powers of appointment (someone can designate how trust property will be distributed and to whom). This can provide flexibility. As part of the administration of the trust review the powers to determine if any should be exercised.
- Granting someone the power to transmute limited powers of appointment ("LPOA") into general powers of appointment ("GPOA") that can be used to cause some or all the trust assets to be included in the client's estate to qualify for a basis step up on death should that prove advantageous under a future tax system.
- Caution: A GPOA also means a step down in basis for depreciated assets which is not desirable.
- If the power holder dies without exercising a GPOA the property subject to the power is include in the power holder's estate and will be subject to a step-up in basis. Treas. Reg. Sec. 1.1014-2(b)(2).

Powers of Appointment

- Review and understand the details of the POA in the particular trust and any possible implications of its application. Note that this may change significantly from when the trust was created.
- How far can this go? Can the general power of appointment be granted only over appreciated assets?
- Might it be feasible to structure a tiered formula of sequential contingent general powers of appointment to secure a basis step up on assets exposed to the highest tax brackets first?
- For those living in a decoupled state, the cost of a state death tax must be factored into the analysis. Some practitioners might prefer not having the spouse serve as the trustee if these powers are granted.
- If the client is uncomfortable giving this person a general power of appointment over the trust assets, there are options to make this approach safer, see later slides.
- Will an institutional trustee ever convert a limited power of appointment “LPOA” to a GPOA? Perhaps never.
- Include in a trust that may grant an LPOA a named individual, such as the trust protector, who can grant or modify the terms of a LPOA and convert it to a general power of appointment.

Sample Optional General Power

Option to confer a general power on spouse:

Disinterested Trustee May Confer Power. The Trustee (excluding, however, any Interested Trustee) may at any time, prior to the death of my Wife, by an instrument in writing (1) confer upon my Wife a power exercisable by my Wife's Will or other signed writing that is acknowledged before a notary public, specifically referring to this power of appointment, to appoint all or part of the Family Trust to the creditors of my Wife's estate (other than any taxing authority), and the instrument conferring such power upon my Wife may require the consent of the Trustee (other than any Interested Trustee) to exercise the power, (2) revoke any such instrument previously executed, with or without executing a replacement instrument and/or (3) irrevocably relinquish the powers conferred under (1) and/or (2). Without limiting the Trustee's discretion, the Trustee may use the authority conferred by this paragraph to subject the trust property subject to the power of appointment to estate tax in my Wife's estate to obtain a basis adjustment under Section 1014 of the Code when it appears that it may reduce overall taxes to do so.

Powers of Appointment to Poor Elderly Family Member

- Include additional beneficiaries, e.g., an elderly family member who has a modest estate.
- Many clients have an elderly relative (the statistic is only for parents) who they may support and thus who likely has a modest estate (or why else would they need support).
- If the client provides financial assistance to this elderly family member there is likely some level of trust.
- What is the size of the exemption and the value of the elderly family members GPOA? Have family dynamics changed?

LPOA Converted to GPOA

- Grant the beneficiary a limited testamentary power of appointment over the trust assets (e.g., to the client's children or only to the person's creditors).
- Give the trustee (or another specified person) the authority to divide the trust into separate trusts and to use the power to create a sub-trust to which all highly appreciated assets can be transferred.
- Give the trustee or another designated person, perhaps acting in a non-fiduciary capacity, the right to convert the beneficiary's limited power of appointment into a general power of appointment over the appreciated asset sub-trust.
- This will cause inclusion in the beneficiary's estate of those appreciated assets and obtain the desired basis step up without the need to actually distribute those assets to the beneficiary and potentially years or decades before the surviving spouse dies.
- Caution – confirm that state law that governs the power will not expose the mere existence of an unexercised GPOA to the power holder's creditors. Consider whether that would be the law of the state governing the trust creating the power or the law of the state where the power holder resides?

Consent Requirement on GPOA

- If the GPOA includes a consent requirement be certain it is addressed.
- **Example**: Aunt Nellie is named as an additional beneficiary of an inter-vivos SLAT. She is given a GPOA to appoint trust assets. The client is a bit worried that she might add in other nieces and nephews.
- A possible solution to provide the client comfort is to make Aunt Nellie's exercise of the power subject to the consent of a non-adverse person.
- The person holding the consent power cannot have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors or the creditors of his or her estate. Treas. Reg. Sec. 20.2041-3(c)(2).
- The client's brother who is not a beneficiary of the trust is given the power to consent to Aunt Nellie's exercise of the GPOA before it can be effective.
- A trust with GPOA in state where disclosure is not required (Delaware, Nevada or South Dakota), i.e., where a quiet trust is permitted, may achieve this goal. There is no law confirming that a general power of appointment the holder is not informed of is valid for basis step up purposes. But consider case law on this.

Power of Appointment Practice Suggestions

- Complete an inventory of every power of appointment in every trust (will or even other document). Without an inventory of each power, it may be difficult not to miss one or not to evaluate them properly.
- In the listing include:
  - Instrument granting the power.
  - Page and provision.
  - Excerpt of the power (so the language is handy in the summary).
  - How it must be exercised if not clear in the above excerpt.
  - Powerholder name.
- Some practitioners might incorporate a listing of all powers in the powerholder's will so that they remain "on radar" to consider in the future if circumstances change.

Grantor SLATs: Access and Spousal Death

For All but Ultra-Wealthy Clients Access to Trust Assets May be Critical

Financial Implications to Settlor Spouse of Death of Beneficiary/Spouse

- Even if a spousal lifetime access non-grantor trust ("SLANT") permits distributions to a spouse with consent of an adverse party, it may not include the powers to benefit the donor spouse after the death of the beneficiary spouse as those powers would taint the trust as grantor.
- If instead the beneficiary/spouse is given a limited power of appointment to appoint the trust on death to anyone excluding herself, her estate, her creditors or creditors of her estate, could the initial trust be a non-grantor trust?
- Must consider risks of death of first spouse in a SLAT or SLANT. The economics of all of this may have changed from when the trust was funded. Has this been reviewed?
  - Financial modeling.
  - Life insurance.
- The CPA and/or wealth adviser on the planning team should ideally create forecasts to show potential impact of the trust plan so that financial gaps can be identified, and options considered.

Financial Implications to Settlor Spouse of Death of Beneficiary/Spouse

- In a Grantor SLAT consider whether the following have been provided as any of these mechanism might give the settlor spouse access if the beneficiary spouse dies:
  - Loan provisions.
  - Power to add a charitable beneficiary.
  - DAPT provision.
  - Hybrid DAPT provision.
  - SPAT – special power of appointment trust provision.
- Several of these concepts will be explored below as each may have a significant impact on how the trust is administered.

Domestic Asset Protection Trust (DAPT)

- The idea of a DAPT is simple. If Husband creates a trust for Wife and descendants, what if there is a divorce or Wife dies prematurely? How will Husband/settlor gain access if needed to trust assets. During Wife's life he can indirectly benefit from distributions or benefits provided to Wife. But if that access is terminated, how can he be assured of access? A DAPT solves that issue, but with increased risk, although that increased risk is not measurable.
- If the trust is formed and administered in one of the 19 states that permit self-settled domestic asset protection trusts (DAPTs), the settlor can be a beneficiary of his or her own trust.
- However, if the settlor resides in a state that does not permit these trusts, some advisers view it as risky, or even not viable, to create a DAPT in a state that does. Example: Client lives in NY or CA which do not permit DAPTs. Client creates a trust in AK which does naming a trust company in AK as trustee. Will that trust be respected by the IRS and creditors? There is no clear definitive answer.

Hybrid DAPT

- As with the DAPT the goal is to provide the settlor/donor/spouse access to trust assets other than indirectly through the spouse/beneficiary of the trust. But since DAPTs pose risks for those resident in states that do not have DAPT legislation, might there be a safer alternative? Some commentators suggest the hybrid-DAPT.
- There is a hybrid solution that might reduce the risk some experts perceive yet leave open the possibility of the settlor benefiting from the trust. Don't name the settlor initially as a beneficiary. Instead give someone the right to add as beneficiaries of the trust the descendants of settlor's grandparents. So, if your client/the settlor is not a beneficiary now, the trust should not face that risk. But the client has the possibility of being a beneficiary if your client needs access in the future.
- As with the DAPT discussed above the law on point is quite sparse.

Hybrid DAPT Provision - 1

- Did the trust grant the person who might be called the "Designator" the right/power to add descendants of Grantor's grandparents, including grantor, as a beneficiary of the trust?
- Sample Provision:

Power to Designate Additional Beneficiaries

- The Grantor appoints NAME as the Designator. During the Grantor's lifetime, the Designator shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity, and without the approval or consent of any person in a fiduciary capacity, to add as additional beneficiaries hereunder any person who is a descendant of Grantor's grandparents who is not already designated herein as a…

Hybrid DAPT Provision - 2

Power to Designate Additional Beneficiaries

- …Beneficiary. Further, the Designator may at any time remove any person so added by written notice to the General Trustee, so that from the date of such written notification that added descendant of Grantor's grandparents shall cease being a beneficiary hereunder. The Grantor directs that this power is not assignable. In the event that NAME dies before the Grantor dies, the successor Designator shall be such individual (other than the Grantor, any person acting as a Trustee under this instrument) whom NAME shall have designated by an instrument in writing. Any person other than NAME acting as a Designator hereunder shall also have the power to name such additional beneficiaries as hereinabove provided.

Hybrid DAPT Trust Administration Issues

- What if the person holding the power, the Designator, dies or becomes incapacitated, before exercising the power? Is a successor named? If not, this can be addressed as part of trust administration.
- Might a court infer an implied agreement between the Designator and the settlor? Financial forecasts demonstrating that the settlor/client likely has no need to access trust assets, so that it can be corroborated that triggering the provision adding the settlor/client back as a beneficiary is not anticipated perhaps that might deflect a challenge that there was an implied agreement. So, as part of the administration of the trust, consider creating such an analysis if it wasn't already done.
- If the settlor/client wants to trigger the hybrid-DAPT provision perhaps a discussion should be had as to what the need is and how long that need might be deferred by using other financial strategies.

SPATs

- So, there are risks using a DAPT, perhaps lesser risks using a hybrid-DAPT, but can a lower risk option be considered that might provide access to the settlor/client to trust assets? Perhaps. That possible lesser risk option is a special power of appointment trust ("SPAT"). This type of provisions can be integrated into the SLAT format to address risk of spouse's premature death.
- In a SPAT, the trust instrument gives a person a collateral power of appointment, allowing distribution of trust property to anyone in a class that includes the grantor (such as descendants of the grantor's grandparents).
- This permits that person, who should act in a non-fiduciary capacity, the power to direct the trustee to make a payment to the settlor. Since the settlor is never a beneficiary, and the trustee has no discretion to make a distribution to the settlor, some argue that this is less risky than a DAPT or hybrid-DAPT.
- A SPAT is not immune from a challenge that there was an implied agreement between the settlor or powerholder.
- Even though the settlor cannot be a beneficiary advocates of the SPAT nonetheless recommend the trust have situs in a DAPT jurisdiction.

SPAT – Administration of the Trust

- If the settlor wants to receive a payment from the trust such that the SPAT provision may be "activated" practitioners might consider the following steps:
  - Review with the client any possible options to provide needed cash without requesting the powerholder exercise the power.
  - If the powerholder is going to exercise the power ideally there should be no communications from the client/settlor to the powerholder.
  - Document the powerholder's independent decision, if possible, to mandate that the trustee make a distribution to the client/settlor.
  - Evaluate the tax impact of the payment to settlor.

Grantor Irrevocable Trust: Additional Ways to Provide Grantor Access - 1

- **Each of the means of providing access to settlor requires proper and careful administration of the provision.**
- **Loans**: Consider granting to someone the power, in a non-fiduciary capacity, to loan the grantor trust assets. Some might refer to this as a "loan director," but other titles might be used as well. A loan director can determine to loan funds to grantor of the SLAT without adequate security for the loan (but the loan director could be required to charge adequate interest to avoid tax issues). This mechanism provides the grantor another means to access trust assets should the grantor require them. Care should be taken to follow all formalities of a real loan and charge an appropriate interest rate.
- **Charity**: You might also infuse another means of the grantor indirectly "accessing" funds in a SLAT. Give someone, in a non-fiduciary capacity, the power to add charitable beneficiaries. This person might be called a "charitable director," but other titles might be used as well. A charitable director can determine to add charitable beneficiaries to a SLAT. This provides the grantor an indirect means of "access" to the SLAT by making a charitable donation the charitable director can add the charity to the SLAT and the donation can be made out of SLAT funds not the grantor's funds. However, the SLAT cannot pay a charitable pledge of the grantor. That should be confirmed.

Additional Ways to Provide Grantor Access - 2

- **Vacation Home**: A SLAT could own an interest in a vacation home. And if the grantor's spouse/beneficiary uses the vacation home, the grantor presumably can as part of the spouse's family. Bear in mind if that is to be done a limited liability company ("LLC") should be formed in the state where the trust is governed and administered. That LLC should be authorized to do business in the state where the vacation home is located. That LLC would own the vacation home property and in turn the trust could own some or all of the interests in the LLC. Be certain the client has the right to use the home without tax implications. Advise the client to be certain insurance reflects the trust as owner.0
- **Income Tax Reimbursement**: If the SLAT is structured to be a grantor trust (i.e., the grantor pays the income tax on trust income) consider including a discretionary income tax reimbursement clause. This permits the trustee of your SLAT, in the trustee's discretion (it cannot be mandatory) to reimburse the grantor for income tax paid on trust income. A tax reimbursement provision can add valuable flexibility and access to the grantor. Be certain that this is only used sporadically, the less the better. A calculation corroborating the tax amount being reimbursed should be created and kept in the trust records.

Non-Reciprocal SLATs

Be Alert to Differences Between Trusts During Operations

Checklist of Differences to Integrate into SLATs - 1

- Differences between spousal lifetime access trusts ("SLATs") are integrated into the trusts and plan care should be taken to assure that each trust is administered properly reflecting the different powers, distribution standards, etc. If the differences in the trusts suffice to avoid the reciprocal trust doctrine, but they are ignored in the administration of the SLATs neither the IRS or creditors may be bound by those ignored differences.
- SLATS should not have the spouses in the same economic position following the establishment of the two trusts as before. Have the trusts been operated in this manner? If there is a pattern of identical distributions from each trust to each spouse might that negate this?
- Different distribution standards in each trust is a common way to differentiate SLATs. For example, one trust could limit distributions to an ascertainable standard, while the other trust could be fully discretionary. However, limiting distributions to an ascertainable standard reduces flexibility, may prevent decanting and may expose the trust assets to a beneficiary's creditors. Are the trustees respecting the different distribution standards?

Checklist of Differences to Integrate into SLATs - 2

- Use different trustees or co-trustees. Has this been respected, or have they changed the trustees to now be identical?
- Give one spouse a noncumulative "5 and 5" power, but not the other. If done has this been respected in trust operations? Should a spouse holding a power partially exercise it to demonstrate its reality?
- As in *Levy* and PLR 9643013 (note that a PLR is not considered precedent), give one spouse a special power of appointment, but not the other. However, the absence of a power of appointment reduces the flexibility of the trust. This might be viewed as particularly significant considering the continued estate tax uncertainty. Do the client's wills, for example, reflect the appropriate exercise of powers only where they exist?

Checklist of Differences to Integrate into SLATs - 3

- Give one spouse the broadest possible special power of appointment and the other spouse a special power of appointment exercisable only in favor of a narrower class of permissible appointees, such as issue, or issue and their spouses. Do the client's wills, for example, reflect the appropriate exercise of powers only where they exist?
- Give one spouse a power of appointment exercisable both during lifetime and by will and the other spouse a power of appointment exercisable only by will.
- In the case of insurance trusts, include a marital deduction savings clause in one trust, but not the other.

Checklist of Differences to Integrate into SLATs - 4

- Create different vesting provisions for each trust. For example, the two trusts could mandate distributions at different ages, or in a state that has repealed or allows a transferor to elect out of the rule against perpetuities, one trust could be a perpetual dynasty trust. However, mandating distributions severely reduces the flexibility of the trust, throws the trust assets into the beneficiary's estate for estate tax purposes and exposes the assets to the beneficiary's creditors and spouses. Whatever terms are in the trust confirm that they are being respected when distributions are made.
- Instead of mandating distributions, give the beneficiaries control or a different degree of control, at different ages. For example, the ages at which each child can become a trustee, have the right to remove and replace his co-trustee, and have a special power of appointment could be different in each trust.
- Vary the beneficiaries. For example, one spouse could create a trust for the spouse and issue, and the other spouse could create a trust just for the issue. Note that if, for example, the husband creates a trust for his wife and their first child, and the wife creates a trust for her husband and their second child, the gifts could still be viewed as reciprocal. Is this being respected?

Checklist of Differences to Integrate into SLATs - 5

- Contribute different assets to each trust, either as to the nature or the value of the assets. Contributing different assets may not negate the application of the reciprocal trust doctrine, since the assets in a trust may be susceptible to change over time. However, if one trust is funded with non-liquid assets, or assets subject to contractual restrictions on sale (e.g., operating agreement restrictions on transfer of interests in an LLC) that may be viewed as a more meaningful difference in assets that may not be susceptible to ready modification. Have assets changed? Has this been monitored to maintain different plans?

What to do About Old ILITs, QPRTs, etc.

- Many practitioners drafted QPRTs (when interest rates were higher), typical or traditional ILITs for spouses, etc. Years ago, there was much less attention given to those trusts from a reciprocal trust doctrine perspective.
- Should anything be done now?
- Should one ILIT/QRPT or other trust be decanted to change its terms?

Administration of Irrevocable Trusts and Form 709

Proper Filing of Form 709 is Critical to the Success of Many Trust Plans

Gift Tax Returns Critical To Many Trust Plans

- Determining if filing Form 709 is required or determining whether to intentionally trigger a filing of Form 709 by advising the client to make a gift above the annual exclusion, and what to disclose on Form 709, are a critical part of the trust administration process. Example: to report gifts between spouses to retitle assets, or a note sale, recommend the client make a taxable gift (assuming no others in the year) to an heir $1,000 above the annual exclusion amount.
- There are common mistakes made on Form 709 as well as concerns with many returns as to whether matters are disclosed consistently with the underlying transactions.
- Consider obtaining from the attorney a trust compilation as discussed earlier in this presentation to assure the return preparer understands which documents were created for the transaction so that the return preparer can determine what to disclose.
- Before beginning to prepare the gift tax return obtain and review memoranda and schematics that should have been created for the transaction and which explain the transaction. You will do a much better job at less cost if prepared.

The Most Important Point of this Presentation on Trust Administration

- The client and all advisers should treat the preparation and review of the gift tax return not merely as meeting a compliance requirement but importantly as an opportunity for a second look with a fresh view (since likely time has passed since the completion of the transactions) of the entirety of all transactions to identify improvements that can be made, missing documents, documents that may have a signature or dating issue, and other steps or documents that were overlooked or just not completed when the transaction was done.
- This can be an incredibly valuable step in trust and plan administration.

Be Sure to Meet Adequate Disclosure Requirements

- IRC Sect. 6501(c)(9): If a gift is “adequately disclosed” after 3 years, the IRS cannot re-evaluate the transfer for gift or estate tax purposes.
- Gifts not adequately disclosed may be subject to challenge indefinitely.
- Be certain the client’s attorney gets the CPA, if the CPA is preparing the return, a closing package/binder on the plan with all documents. Too often this does not happen, and the CPA does not have all the documents from the transaction from which to select what the return preparer believes should be included in the Exhibits for adequate disclosure.

Adequate Disclosure in Brief

- Description of transferred property.
- Consideration received by transferor.
- Identity & relationship between transferor and transferee(s).
- Valuation of transferred property.
- Copy of trust instrument.
- Statement describing any position contrary to proposed, temporary or final Treasury Regs or revenue rulings.

Treas. Reg. Sec. 301-6501(c)-1(f)(3): Elements of a Qualified Appraisal

- **Date of transfer**, date of appraisal and purpose of appraisal.
- Description of transferred property.
- Description of assumptions, conditions and restrictions affecting appraisal.
- All information considered in determining value.
- Procedures followed and underlying reasoning.
- Valuation method used, rationale for method.
- Specific basis for valuation.

Treas. Reg. Sec. 301-6501(c)-1(f)(2)(iv): Detailed Description in Lieu of Qualified Appraisal

- If a client wants to save money by avoiding a qualified appraisal, make sure the client understands the substantial additional compliance measures required.
- Financial data (e.g., balance sheets, with explanations of adjustments.)
- Restrictions on transferred property considered.
- Description of any discount claimed in valuing the interests
- If actively traded stocks: identify exchange where interest is listed, CUSIP, value is highest/lowest quoted selling price on valuation date.
- If not traded: identify net asset value, discounts, pro rata value of entity transferred, FMV of interest and to whom it was transferred and their relationship to the transferor.

Appraisal Should Set Forth Revenue Ruling 59-60 Factors

- Nature of company, capital structure.
- Operating and investment assets & management.
- Current and prospective economic conditions.
- Book value and financial condition of business.
- Earning capacity of the company.
- Balance sheets, detailed profit & loss statements.
- Dividend paying capacity.
- Goodwill or other intangible value.
- Arms-length sales of the same stock.

Disclosures of Valuation of Discounts on Transferred Property

- IF DISCOUNTS - Check the box at the top of page 2 of Form 709:

Form 709 (2019) JACK TEST 123-45-6789 Page 2

SCHEDULE A **Computation of Taxable Gifts** (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation .... Yes [X] No [ ]

B [ ] ◀ Check here if you elect under section 529(c)(2)(B) to treat any transfers made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1 - Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. See instructions.

Valuation Discounts – Another Word about "the Box"

- The box for discounts has always been a dicey topic for operating businesses, the value of which tends to be based on a multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA).
- The EBITDA multiplier (a form of a price-to-earnings ratio) tends to be derived from results of publicly-traded companies, which have discounts for lack of control baked into them instead of being separately stated. Does that mean the box should be checked?

Be Alert to Variations on *Wandry* & the Impact on 709 preparation

- Review valuation adjustment clauses carefully to understand precisely what the mechanism is. There are MANY types of mechanisms, and many lawyers have very different approaches to how they structure a valuation adjustment mechanism. You must understand what was done to properly prepare the return. For accountants, if the mechanism doesn't make sense CALL the attorney who prepared it and obtain an explanation. You will find in some instances that the mechanism may have been mishandled.
- Determine whether there are any mechanisms which would pour excess value into a non-taxable receptacle. Be sure you understand each component to the transaction.
- Exercise additional caution in disclosing the contours of the transaction and do not disclose anything inconsistent with the transaction documents.
- Attach instruments incorporating the defined value mechanism. This may be in various instruments assignments, sale or transfer agreement, etc. so be certain you have the correct instruments and all of them if more than one reflects this.

Additional comments on disclosing *Wandry*-type transfers

- Strongly recommended for preparers to attach a complete copy of the trust instrument – even if trust previously provided on prior gift tax return.
- Include all attendant documents related to the operation of the defined value mechanism: e.g., GRAT instrument, sales agreements, etc. As noted above there is a wide variety of formula and valuation adjustment approaches.
- **Some practitioners intentionally structure each transaction for the same client using a different mechanism or variation of the same mechanism to make it harder for the IRS to unravel all of them on audit with one approach.**
- When a Wandry formula is used, include statement that the assets are **estimated** to be X units, but the purchase price is **fixed** at $Y.
- Based on the Nelson case be certain that the language in the documentation provides for an adjustment based on gift tax value as finally determined. If there is any doubt immediately CALL the attorney who prepared the documentation to discuss.

Defined Value Mechanisms: Important Considerations

- The Greenbook proposes eliminating defined value mechanisms.
- Pouring Excess to GRATs.
  - Disclose funding of the GRAT with any other assets.
  - Calendar dates for annuity payments.
  - Does this work after CCA 202152018?
  - Make sure there is some excess value so the regulatory exception can apply.
- Spillover to Charities.
  - Consider reporting potential charitable contribution on donor's Form 1040.
  - Will potential refund claim need to be filed.
  - UBIT issues?
  - Note that basis must be reported or no deduction at all.

Must SALES be Disclosed? Consult Treas. Reg. Sec. 25-2512-8

- For those wondering if SALES must be disclosed, consider this language from the regulation:
  - Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore.

Potential Sale on Redetermination of Value for Gift Tax purposes

Use CAREFUL language to describe what was sold, possibly as follows:

Part I - Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusio

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN
1	JACK FAMILY TRUST C/O TRUSTEE 12-7202100 THAT PERCENTAGE OF INTERESTS IN THE ENTITY DEEMED TO HAVE BEEN SOLD BY OPERATION OF THAT CERTAIN [ASSIGNMENT INSTRUMENT] EXECUTED ON [ORIGINAL DATE OF THE TRANSACTION], BETWEEN, AND AMONG JACK AND THE TRUSTEES OF THE JACK TRUST AND THE JILL TRUST, AS MAY BE ADJUSTED UPON A FINAL DETERMINATION FOR FEDERAL GIFT TAX PURPOSES OF THE FAIR MARKET VALUE OF THE INTERESTS IN THE ENTITY AS OF [ORIGINAL DATE OF THE TRANSACTION].

Potential Sale of Undetermined Value of Shares in Business e.g., Double Wandry

- If a Wandry transfer is made the interests remaining with the donor/transferor may create a Powell issue of estate inclusion (the decedent in conjunction with…under Code Sec. 2036). Some practitioners address the Powell issue of a Wandry clause by having the transferor execute a simultaneous sales agreement selling any such remaining interests on the date of the primary transfer for the gift tax value as finally determined. If this approach was used, which the preparer of the gift tax return must understand, that sale may also be reported as a non-gift transaction on the gift tax return. If that is to be reported, consider:
  - Reference the Assignment Document and qualified valuation report.
  - Include a copy of trust agreement, promissory note, sales agreement, etc.
  - Report the sale on the appropriate section of Schedule A.
  - The transferor has estimated in good faith that NO interests are being sold so both the fair market value & the basis is $0.

It Is Not Just About the Gift Tax Return

- The Gift Tax return is not the only tax filing that will include reference to the transactions, and consideration should be given to how the following income tax returns should reference the defined value mechanism:
  - Entity income tax return.
  - Individual income tax return(s).
  - Fiduciary income tax return(s).
- If the attorney prepares the gift tax return will the CPA who prepares the income tax returns be aware of how to report and what to report?

Proposed language about preliminary allocation of interests

- Too often income tax returns don't reflect the gift tax valuation adjustment mechanism, be sure they do.
- Each income tax return should include language such as the following:
  - The preliminary allocations of interests in the Entity to the Individual(s) and/or the [NAME] Trust(S) based upon the valuation performed by [third party valuation professional], a third party valuation professional, in accordance with Revenue Ruling 59-60 and other regulations and rulings where appropriate, is for administrative convenience only with respect to the value and percentage of the Entity interests until the fair market value of the Entity interests is finally determined for federal gift tax purposes.

Charitable Gifts as the Non-Taxable Receptacle

- A common gift tax return oversight is the failure to report charitable gifts.
- If any omitted charitable gifts constitute a substantial understatement of gifts, the statute of limitations may be extended from a three-year period to a six-year period IRC 6501(e)(2).
- Consider implications of charitable disclosures if the return has one gift $1,000 above the gift tax annual exclusion amount to require reporting and a huge note sale transaction that is reported as a non-gift item.
- Especially problematic if charity is used in valuation adjustment clauses (e.g., as part of the waterfall on a note sale transaction).

Defined Valuation Mechanism with Charitable Spillover

- Report the potential charitable gift on Schedule A Part 1, showing $0 gift tax value and $0 basis.
- Complete Schedule A Part 4, line 7:

Form 709 (2019) JACK TEST 1

Part 4 - Taxable Gift Reconciliation

1	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3		
2	Total annual exclusions for gifts listed on line 1 (see instructions)		
3	Total included amount of gifts. Subtract line 2 from line 1		
Deductions (see instructions)			
4	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers ______ of Schedule A	4	
5	Exclusions attributable to gifts on line 4	5	
6	Marital deduction. Subtract line 5 from line 4	6	
7	Charitable deduction, based on item numbers STMT 1 less exclusions	7	0.
8	Total deductions. Add lines 6 and 7		
9	Subtract line 8 from line 3		
10	Generation-skipping transfer taxes payable with this Form 709 (from Schedule D, Part 3, col. G, total)		
11	**Taxable gifts.** Add lines 9 and 10. Enter here and on page 1, Part 2 - Tax Computation, line 1		

Defined Valuation Mechanism with Charitable Spillover

- Report the potential charitable gift on Schedule A Part 1, showing $0 gift tax value and $0 basis:

SCHEDULE A, PART I CONTINUATION SHEET

Part 1 - Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusi

A Item number	B ● Donee's name and address ● Relationship to donor (if any) ● Description of gift ● If the gift was of securities, give CUSIP no. ● If closely held entity, give EIN
1	CHARITY THAT PERCENTAGE OF INTERESTS IN THE ENTITY DEEMED TO HAVE BEEN DONATED TO [CHARITABLE ENTITY] BY OPERATION OF THAT CERTAIN [ASSIGNMENT INSTRUMENT] EXECUTED ON [ORIGINAL DATE OF THE TRANSACTION], BETWEEN, AND AMONG TAXPAYER AND THE TRUSTEES OF THE [ ] TRUST, AS MAY BE ADJUSTED UPON A FINAL DETERMINATION FOR FEDERAL GIFT TAX PURPOSES OF THE FAIR MARKET VALUE OF THE INTERESTS IN THE ENTITY AS OF [ORIGINAL DATE OF THE TRANSACTION].

Defined Valuation Mechanism – Excess to Spouse or Marital Trust

- The gift tax return preparer should report the potential marital gift on Schedule A Part 1, showing $0 gift tax value and $0 basis.
- Further, the gift tax preparer should reference the specific item number of the potential marital gift on Schedule A Part 4, line 6.

GST Exemption in Trust Administration

Consider How GST Exemption Might be Allocated to Various Transfers

- It may be important to provide a prioritization of which trusts get GST allocation and in what order, especially in case there is a valuation adjustment that affects the allocation anticipated on the return. Too often this is ignored.
- The first trust that you certainly want to treat as a GST trust, to which you want to allocate GST exemption, should be elected to be treated as a GST trust.
- The remaining trusts should have an election not to be treated as GST trusts so that a Notice of Allocation can better control the manner in which GST exemption is allocated.
- Include a Notice of Allocation stating the donor's intention that GST exemption allocations should be done by formula which will change if values are modified on audit.
- This affects the gift tax returns and if there is an adjustment such that one or more trusts might have an inclusion ratio of more than zero then division of those trusts and other steps may be warranted once that is known.
- Note that the Greenbook proposes capping the duration of GST allocations to in general terms, the lives of grandchildren.

EXAMPLE: Allocating GST Exemption Among Multiple Trusts

- Suppose the client made transfers to a grantor trust to which a family business interest was transferred, and separately to a simple life insurance trust owning term life insurance. This might be the reporting approach you want to take if GST exemption is limited to assure that if there is a revaluation of the business that trust is protected by an allocation of GST exemption over the ILIT:
  - FIRST: protect the trust holding the family business by reporting it as a GST Trust to which exemption is automatically allocated.
  - SECOND: opt out of automatic allocation for the ILIT and allocate GST exemption up to the donor's remaining GST exemption, using a formula allocation.

GRATs and Grantor Retained Interest Trusts

- For trusts that are includable in the Grantor's estate (e.g., GRITs, GRATs) - the inclusion ratio is not calculated until the estate tax inclusion period (ETIP) closes.
- When ETIP closes - taxpayer may allocate GST exemption to the value of the remainder interest as if the gift had been made on the day the ETIP closes (taking into account any prior allocations).
- This is rarely done as it is inefficient as by then property hopefully will have appreciated (and if it has declined, has too much exemption been allocated?) However, if it is anticipated that GST exemption may be reduced in 2026 by half, perhaps then allocation should be considered.

Reporting Transfers for Married Taxpayers

Relinquishment of Interests in Joint Property

- Consider intra-spousal gifts in light of the Smaldino case.
- Too often clients and even counsel give little or no attention to who owned which assets before the plan. That can be problematic.
- Say all assets were in wife's name and those assets are divided so each spouse can fund a SLAT. But because of worries about the effective date of law changes the couple only waits a week after division to make their gifts.
- There are pros/cons of disclosing intra-spousal transfers.
- Be wary of the step transaction doctrine.
- Since not required – unclear if disclosure will toll statute of limitations as to whether ownership was relinquished.
- Failure to relinquish asset could disrupt planning.

Spousal Lifetime Access Trusts (SLATs) – Reciprocal Trust Doctrine

- SLATs have become perhaps the default plan in the current environment. But they are not without risk.
- SLATs should be sufficiently different to reduce the risk of a reciprocal trust challenge. In fact, consider one SLAT and one SPAT as one differentiation between the trusts.
- Created at different times, with different assets and trustees & different terms (e.g., powers of appointment, distribution standards, etc.)
- **Practitioners preparing gift tax returns might consider whether to obtain corroboration for their gift tax file as to the differentiation of each SLAT and the respective planning.**

Gift Tax Return Reporting Should Dovetail the SLAT Strategy

- Most gifts to SLATs may not be split – maybe the spouses should not elect to split at all (may be possible if HEMS standard, etc., but should you?)
- Assets conveyed should be identified as those owned by the donor spouse individually (i.e., not joint assets.)
- Consider making overt disclosure on a gift tax return to marital deduction savings clause embedded in the terms of an insurance trust.

Be Alert for The Inter Vivos QTIP Backdoor for the Reluctant Client

- Reluctant clients may have used a safety valve in their trust plan. Their trust may have been drafted with specific language allowing the trust to qualify for an inter vivos QTIP election, as described in Code Sec. 2523(f):
  - The trust must grant to the donee spouse a qualifying income interest for life; and
  - The donor must make a QTIP election on a timely filed gift tax return.
- The key step is determining whether a QTIP election should be made for this QTIP looking trust or whether the trust should be permitted by avoiding the QTIP election to create a completed gift using exemption.
- Preparer and planner should be coordinated to ensure timely elections if desired.

Reporting Note Transactions

Substituting Higher-Interest for Lower-Interest Notes

- If possible, get involved in the structure and planning of the note refinance. Many commentators believe that no "consideration" is necessary. Other suggest that whether or not required, a principal payment should be made, the term shortened, or perhaps additional collateral given.
- Consider disclosing note restructure transactions as non-gift transaction.
- Failure to disclose could result in the statute of limitations not tolling.
- Consider income tax issues if the trust was a non-grantor trust.

Documentation to Include in Disclosing Note Refinance

- Original Note – should include no prepayment penalty provision or documentation resolving such provision. Be sure the client's attorney has reviewed the note and confirmed this. This is why you may want to include the original note in the Exhibits to the gift tax return.
- New Note – fully executed.
- Modification of Pledge and Escrow Agreement (if original Note was part of sale). This is often overlooked. It is not merely about creating a new note but also must include addressing all ancillary documentation relating to that note.
- Novation Agreement – confirms the original agreement notwithstanding cancellation of the original Note.

Trust Administration

Conclusion

- The tax law and planning environment are and likely always will be in a state of flux.
- Administration of trusts is a vital step to the success of any plan but many, perhaps most, clients do not appreciate the technical, detailed and involved nature of proper trust administration.
- Practitioners should endeavor to guide clients to have at least an annual review meeting with all their professional advisers to review all aspects of a plan. If this is done on an ongoing basis the process will be simpler and less costly then if a client merely shows up when there is a problem and then wants the adviser to fix it.
- Using a comprehensive trust compilation and checklist can facilitate the proper administration of a trust.

Additional information

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