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THE SUNSET IS GONE, BUT FLEXIBILITY IN PLANNING REMAINS KEY

By

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I. Introduction.

A. Historical Context.

1. In 1979, the estate and gift tax exemption was only $147,000 per person with a top tax rate of 70%. That exemption amount increased steadily over time until it reached $5,490,000 per person in 2017 with a top tax rate of 40%.

2. In 2018, the Tax Cuts and Jobs Act ("TCJA") temporarily doubled the transfer tax exemption amounts to $11,180,000 with a top tax rate of 40%, indexed for inflation.[1] Planners and clients alike enjoyed the temporarily increased exemption, but all were aware that the exemption was scheduled to sunset in 2026 and would be cut approximately in half.

3. By 2025, the exemption amount, with inflation adjustments, had climbed to $13,990,000 per person, and sunset was looming on the horizon.

4. On July 4, 2025, the One Big Beautiful Bill Act ("OBBBA" aka "OB3") was enacted. Under OBBBA, on January 1, 2026, exemption amounts will increase to $15,000,000 per person and then continue to be indexed for inflation in future years. Unlike the TCJA, OBBBA increased the exemption amount indefinitely.[2]

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* This outline is drawn from Kim Kamin and Jonathan Lee's article, *Gifting Decisions and Planning with Flexibility Under OB3* (August 15, 2025) for the UHNW Institute and from materials prepared by Kim Kamin, Stephen Liss, and Christopher Siegle for the UCLA CEB Program, "Planning in Anticipation of TCJA 2.0" (April 25, 2025), based on Kim Kamin's presentation at Notre Dame 50th Tax and Estate Planning Institute, "Planning for Expected Exemption Sunset" (Sept. 26, 2024), as modified for the Great Plains Federal Tax Institute, "Planning with Optionality Ahead of TCJA Scheduled Sunset" (Dec. 6, 2024), and then for Kim Kamin and Stephen Liss's presentation at ABA Real Property Trust & Estate Law Section Virtual CLE Conference, "Wait, What Just Happened? Flexible Planning in an Age of Uncertainty" (Feb. 11, 2025). The author thanks Stephen Liss, and Christopher Siegle for their collaboration and thanks Angel Russell-Johnson of Gresham Partners LLC for her assistance with these materials.

[1] H.R.1 - *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*. P.L. 115-97, 115th Congress (2017) (https://www.congress.gov/bill/115th-congress/house-bill/1/text). Adopted 12/22/2017, effective 1/1/2018. Note that the inflation-adjustment uses a more modest calculation than the one used prior to enactment of the TCJA.

[2] While estate planners and clients are celebrating the increased exemptions, they are projected to reduce federal tax revenue by more than $240 billion between 2025 and 2034 while also significantly increasing the federal deficit. *See* E. York and G. Watson, *Making the Tax Cuts and Jobs Act Permanent: Economic, Revenue, and Distributional Effects, Tax Foundation* (February 26, 2025), https://taxfoundation.org/research/all/federal/tax-cuts-and-jobs-act-tcja-permanent-analysis/ (estimates that revenue loss attributable solely to estate taxes over this time period would be $240.5 billion); G. Watson, H. Li, E. York, A. Muresianu, A. Cole, P. Van Ness, A. Durante, *One Big Beautiful Bill Act" Tax Policies: Details and Analysis* (July 4, 2025), https://taxfoundation.org/research/all/federal/big-beautiful-bill-senate-gop-tax-plan/ (estimates total deficit increase of nearly $3.8 trillion on a dynamic basis over the next decade).

5. The increased exemption in lieu of sunset eliminates the year-end pressure that many clients and estate planners were feeling. However, it's helpful to recall that gift tax exemptions have never decreased.

6. Please refer to Addendum A for the history of the transfer tax exemptions, annual gift exclusions and tax rates.[3]

7. Although OBBBA indefinitely increased the exemption, future developments could range from a full repeal of the estate tax to the introduction of a new wealth tax. No one knows for certain what the transfer tax rules will be in the future.

B. Wealth Transfer Planning Orientation.

1. Because future tax law changes are unknown, advisors should embrace the current tax structure and any future legislative changes as an opportunity to engage in thoughtful wealth transfer strategies that accomplish present goals and adapt to future, often unpredictable needs.

2. This begins with attempting to fully understand the client's family structure, their goals for the wealth, and their feelings about paying taxes.

3. Many clients do wish to maximize their transfer tax planning to avoid paying unnecessary transfer taxes and to maximize what can be passed to their descendants. For billionaire and centimillionaire clients, the desirability of gifting at current exemption levels should be fairly straightforward. For ultra-high-net-worth clients with less wealth, the choice isn't as clear. The reality is that even families with $30 to $50 million in assets can expect liquidity and cash-flow needs that may impede their ability to make full exemption gifts. Whether large gifts are prudent depends on many factors, including a client's age, earning potential, investable asset base, and spending needs.

C. Goal of Materials. This outline aims to highlight the range of issues and opportunities estate planning professionals should consider for their clients. The topics covered in this outline are necessarily broad, and the materials reference additional resources for a more in-depth analysis.

II. Inherent Uncertainty of Estate Planning.

A. Built-In Uncertainty. Experienced estate planners recognize that the planning process is inherently uncertain. One cannot know how long a client will live, what the estate tax laws will be at the time of a client's death, or even if there will be an estate tax.[4] It's also challenging to determine what the value of a client's estate might be at the time of their death or the amount of assets they will need to access to live comfortably for the rest of their life. Determining this amount largely depends on their spending habits, investment performance, and future risk-taking. Moreover, family structures often change over time due to events such as marriage, divorce, remarriage, having or adopting children, and the death of family members. It's virtually impossible to predict what a client might want the trust to do in the future due to changing laws, changing norms, and changing circumstances.

B. Risk of Rushing. Planning in haste, or with clients who aren't fully engaged, can lead to governing trust instruments that don't adequately serve the family and their future needs. Despite this, many estate planners don't have the luxury of time when they are advising and drafting. For example, when exemptions were threatened in the past (such as in 2012 and again in 2021), many recall how

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[3] The table is derived from one created initially by Schiff Hardin LLP, now ArentFox Schiff LLP. Note that technically estate and GST-tax exemptions did "decrease" in 2011 immediately following the one-year repeal of the estate and GST tax in 2010.

[4] Death Tax Repeal Act, H.R.1, 119th Cong. 2025.

this sense of urgency led some clients to execute hastily drafted trust agreements. The results were often funded, irrevocable trusts with poor terms and limited flexibility.[5]

C. Tools to Modify. Fortunately, various tools can be employed to modify trusts, whether the trust instruments were the product of rushed planning, used outdated drafting practices, or simply no longer apply to the family's circumstances. Some of the tools that will be discussed below include powers of appointment, Trust Protectors, trust merger, decanting, and non-judicial settlement agreements.

D. IRS on Modification. Drafting trusts to maximize flexibility is of the utmost importance, more so because of recent developments that signal that certain modification techniques may be better than others from a gift tax standpoint. Chief Counsel Advice 2023-52018 ("CCA 202352018") signaled that the Internal Revenue Service ("IRS") will be paying close attention to any modification techniques where the trust beneficiaries must consent or may fail to object to the modification.[6]

E. Tax Court Cases. Additionally, two recent tax court cases provided clarification on the potential gift tax consequences of terminating qualified terminable interest property (QTIP) trusts and how closely the IRS is assessing each case.

1. In *Anenberg*, the tax court rejected the IRS' position that a QTIP trust termination and subsequent sale resulted in a taxable gift. The court emphasized that a transfer alone isn't sufficient to create gift tax liability, citing precedent that defines a gift as proceeding from "detached and disinterested generosity" or similar impulses.[7]

2. In *McDougall*,[8] the court held that the surviving spouse did not make taxable gifts to his children under Internal Revenue Code ("IRC") Section 2501, even if there was a transfer of property under IRC Section 2519 when the QTIP trust was commuted, because the surviving spouse made no gratuitous transfers. The exchange of trust property for promissory notes did not constitute a gift. However, the children made taxable gifts to the surviving spouse of their remainder interests in the trust under IRC Section 2511. The court rejected the taxpayers' argument that the transactions resulted in offsetting reciprocal gifts. *McDougall* clarifies the gift tax treatment of QTIP trust commutations and highlights the potential gift tax liability for remainder beneficiaries when terminating such trusts early.

III. Understanding the Opportunity.

A. Client Capacity and Desire. The first step in any gift planning will be to determine the client's financial capacity to make gifts and their feelings about doing so. Feelings can vary significantly depending on the size and nature of the client's estate, their perspective about parting with full dominion and control over their assets, their current thinking on the purpose of their wealth, and their views on taxation.

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[5] The psychological framing of potential sunset or statutory changes as "use it or lose it," creating loss aversion, is discussed in greater detail in an article by Kim Kamin and Jonathan Lee, *TCJA 2.0 Implications for 2025 Gifting: Clients Who Can Afford to Gift Should Do So Now*, Investments & Wealth Review, March/April 2025, which was based on the authors' prior article *Do Your Clients Still Want to Plan For 2025 Exemption Gifting?* Trusts & Estates, Vol. 164, No.1, January 2025.

[6] Under CCA 202352018, even a beneficiary who expresses an objection in writing may not be sufficient to avoid the implication that a gift was made. There is some speculation that the IRS may require beneficiaries to object in court. If so, that kind of proceeding would likely be an expensive and pointless exercise that may not be in the best interest of the beneficiary.

[7] *Estate of Anenberg v. Commissioner*, 162 T.C. 199 (2024).

[8] *Estate of McDougall v. Commissioner*, 163 T.C. 112 (2024).

B. Confirm Remaining Exemption. Before making any gifts that rely on the client's transfer tax exemptions, it's important to verify how much exemption the client has available. This seems like a simple question, but many clients are unaware of their remaining exemption and have not kept proper records. Even if the client has only worked with one estate planner, exemption may have been used without their knowledge.

C. Different Gift and GST Exemption Mismatch. To further complicate the matter, some transfers may use gift tax exemption without using GST exemption. Direct gifts to children to help purchase a home or start a business are common examples. It's equally common for transfers to use GST exemption, but no gift tax exemption. A pot trust (like an ILIT) using Crummey powers for annual exclusion gifts often produces this result.

D. Risk of Surpassing Exemption. Without a clear and accurate record of the client's previous gifting history, the client might make a gift that surpasses their available lifetime gift exemption, triggering immediate 40% gift tax. Advisors might try to reassure clients by pointing out that paying gift tax is often more efficient than paying estate tax because the gift tax is tax-exclusive (assuming both tax rates remain relatively stable and that the client is wealthy enough to owe estate tax at death). However, this reassurance may fall flat, especially if the gift tax owed is substantial or the client feels their advisor is responsible for the mistake.

E. Gift Tax Return Transcripts. To confirm that all prior gift tax returns are accounted for, a transcript can be obtained from the IRS. This transcript will list all the Form 709s filed to date. If a copy of a specific Form 709 isn't available, it can also be requested from the IRS. However, if the firm isn't set up for e-filing returns, it may take a few weeks to process the application for access to the online system.

F. Common Unreported Transactions. Even if all prior gift tax returns are available, a client could have made other, unreported transfers that use up gift or GST exemption. Commonly unreported transactions include:

1. Holiday presents, both cash and non-cash.
2. Payments of trust-owned life insurance premiums that rely on Crummey withdrawal rights with the expectation that they qualify for the annual exclusion.
3. Even if all Crummey gift transactions are properly papered, gifts to insurance trusts can still use GST exemption, and that usage may not appear on a gift tax return.
4. Transfers of privately held companies intended as annual exclusion gifts often don't qualify as present interest gifts.[9]
5. A sale to a grantor trust or a swap of assets may not be reported, in which case the IRS is free to challenge the value of any transferred property.
6. Gifts of hard-to-value assets may still be open to audit if the adequate disclosure requirements are not met, or if that gift was made within the last three years.
7. Allowing children to use assets rent free could be a gift.
8. Zero-interest-rate loans have a gift element.
9. Clients may forgive loans and not inform their attorney.
10. Anything that triggers IRC Section 2701 may constitute a taxable gift.

[9] *See* Stephen Liss, *Maybe Price is Right: Making Annual Exclusion Gifts of Non-Controlling Interests*, Practical Tax Strategies, July 2010.

11. A gift to a GST Trust to which the automatic allocation rules apply may not be reported at all if using annual exclusion, or the gift can be misreported as using no GST exemption.

G. Avoid Mixed Inclusion Ratio Trusts. If a client makes a gift in excess of their remaining GST exemption into a trust that isn't designed to require the trustee to allocate non-exempt property to a separate identical trust automatically, the result is a trust with a partial inclusion ratio (aka a mixed inclusion ratio). As a result, any distribution to a non-skip person wastes GST exemption, and any distribution to a skip person triggers some GST tax. Frustratingly, the inclusion ratio of a trust must be tracked and recalculated after each new transfer. Overall, it's a difficult situation to administer and can likely result in a qualified severance, which can be a cumbersome and expensive project, causing the client further annoyance.

H. Watch Automatic GST Allocations. Automatic allocations may be made to a trust that received only annual exclusion gifts, so it can be extremely difficult in some situations to ascertain how much GST exemption has been utilized. This is one example where having a coordinated team of advisors can be helpful. The financial planning advisors, tax preparers, and estate planning attorneys should work together to track all annual gifts.

IV. Fundamentals for Planning with Unused Gift and GST-Exemptions.

A. Haste Makes Waste. Estate planners should provide thoughtful recommendations to clients on when gifting is appropriate and how it should be approached. Clients who rush into gifting, whether for business, familial, or tax reasons, often make less advantageous decisions. For example, a client might quickly gift to a trust that isn't GST exempt—thereby losing value for future generations.

B. Addressing Access. For all but the wealthiest of clients, giving away assets at the current exemption levels can be stressful. A completed gift requires the settlor to so part with dominion and control to leave no ability to change the disposition. Whether such large gifts are prudent depends on the client's age, earning potential, investable asset base, and spending needs. A client should always understand their future options in case they or their spouse needs to access any of the gifted assets in the future. Future access must be balanced against the desirability of making completed gifts for transfer tax purposes and the risk of having a retained interest under IRC Sections 2036 and 2038.

C. What Should be Given? Once the donor decides to make a gift, the donor must identify the proper vehicle and the proper asset(s). Many factors should be considered when selecting an asset, including: (i) risk tolerance; (ii) the foregone income attributable to the gifted asset; (iii) the post gift appreciation that can be achieved; (iv) the complexity of continued management of the asset; and (v) whether the asset is hard to value, like minority or non-controlling interests in real estate or privately held business interests. Additionally, donors must weigh getting the most value from a gift against potential tax pitfalls that could be triggered. For example, an S Corporation or LLC may be recapitalized into voting and nonvoting shares, but the donor must avoid a deemed gift (which isn't the intended outcome) for violating IRC Section 2704 and estate tax inclusion under IRC Section 2036(b). Valuing hard-to-assess assets can be both an advantage and a challenge. The complexity offers opportunities to obtain valuation discounts due to lack of control, lack of marketability, or minority interests.

D. Grantor Trust Flexibility. Grantor trusts provide many benefits, which are fully fleshed out in a subsequent section. A primary benefit is the flexibility that they can provide the grantor when deciding which assets to gift. For example, grantor trusts provide the grantor with the power of substitution (also known as a swap power).[10] This power allows the donor to make a gift of cash or marketable securities—straightforward, easy-to-value assets. Thereafter, and with some reasonable amount of time for seasoning the gift, the grantor can reacquire the cash or marketable securities in

[10] *See* IRC 645(4)(C).

exchange for other difficult-to-value assets of equivalent value. This exchange isn't a gift, and therefore, there is no reporting requirement or disclosure necessary. Of course, the trustee has a fiduciary duty to ensure the substituted property is of equivalent value.[11] Understanding the flexibility that can be built into a trust at the drafting stage is a fundamental step to determining how and when to use one's exemption.

E. Lifetime Family Trusts (aka Spousal Lifetime Access Trusts ("SLATs")). Unsurprisingly, some trust structures provide more flexibility than others. Rather than waiting until death to utilize their estate and GST exemptions by funding a testamentary family trust as is standard in an A/B plan, clients who can afford to utilize their gift and GST exemptions during life can establish a family trust as a lifetime trust. To signal to clients that the trust assets are available to the beneficiary spouse during life if needed, in the past decade or so, such trusts have become known as SLATs. SLATs are one of the most common ways to lock in as much of the client's exemption as possible. This approach involves one spouse using separate property to set up an irrevocable grantor trust that essentially mirrors what the testamentary family trust under the revocable living trust would provide. It names the other spouse as the primary beneficiary and the settlor's descendants as permissible beneficiaries. The trust can also name other family members (such as parents or siblings) as permissible beneficiaries. Generally, each spouse will create a SLAT for the benefit of the other. However, this raises the issue of the reciprocal trust doctrine. When two trusts are viewed as too similar, they are analyzed as though each spouse created a trust for their own benefit and the assets are included in the estate of each of the spouses under IRC Section 2036(a)(1).[12] If the trusts are too similar, they could be treated as if each spouse created a trust for their own benefit, causing the assets to be included in their estates. To avoid this outcome, it's crucial to differentiate the trusts by varying factors such as timing, jurisdiction, contributed assets, powers of appointment, and trustee structures. This is a non-exhaustive list, but most attorneys try to differentiate the trusts in several ways as opposed to one. Unfortunately, the effectiveness of the protective differences can only be established when one spouse dies. The estate tax return (IRS Form 706) requires disclosure and attachment of the SLAT. The only way to completely avoid this risk is for a spouse not to be a beneficiary of the trust created by the other spouse.

F. Drafting with Flexibility. A well-crafted trust, SLAT or otherwise, should address the immediate needs of the beneficiaries while safeguarding their interests across generations. Below are some recommendations for drafting trusts with flexibility in mind.[13]

V. Flexibility for Beneficiaries, Distributions, and Planning for Divorce.

A. Pot Trusts and Separate Trusts. GST-exempt trusts funded with large sums are often designed as one-pot trusts while the settlor is still living. At the settlor's death (or the second to die of the settlor and their spouse, particularly when the surviving spouse is a permissible beneficiary and/or holds a power of appointment), the pot trust is usually divided into sub-trusts for each family line. After the trust divides into a separate trust for each child, the child's own descendants should ideally be named as permissible beneficiaries. This permits the trustee to make distributions to grandchildren or more remote descendants when necessary and desirable. The trusts certainly can clarify that the eldest generation has priority, so the trustee doesn't need to worry about equalizing interests or competing with demands from the younger generation.

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[11] 2008-16 I.R.B. 796 (April 21, 2008).

[12] For more on the reciprocal trust doctrine, *see* Cheryl E. Hader, *Planning to Avoid the Reciprocal Trust Doctrine*, Estate Planning Journal, Oct. 1999.

[13] For a general discussion about drafting to maximize flexibility, *see* Louis S. Harrison, Kim Kamin & Martin M. Shenkman, *The Gumby Trust: Creating Flexibility*, Trust & Estates (Sept./Oct. 2018) https://www.wealthmanagement.com/estate-planning/gumby-trust-creating-flexibility.

B. Flexible Distribution Standards. Some clients may wish to limit distributions to beneficiaries to ascertainable standards such as health, education, maintenance, and support ("HEMS"). To build in additional flexibility, it's preferable for an independent trustee to be authorized to make distributions using a non-ascertainable standard such as sole and absolute discretion or best interests. This requires either appointing an independent trustee at the outset or enabling a fiduciary appointer (such as the settlor, the settlor's spouse, or a primary beneficiary) to subsequently appoint an independent trustee.[14] Please refer to Addendum B1 for sample broad distribution provisions.

C. Independent Trustee. Typically, the term "independent trustee" refers to an individual or corporate trustee who is neither a beneficiary of a trust nor a related or subordinate party, as defined in IRC Section 672(c), with respect to the settlor or to any beneficiary of the trust.[15]

D. Anticipating Divorce. [16]

1. Building in flexibility to consider potential divorce is an inevitable aspect of the estate planner's role in planning for the modern family. Studies show that 40-50% of first marriages in the United States end in divorce.[17] Those in subsequent marriages face a much higher divorce rate —with an estimated 67% of second marriages and 73% of third marriages ending in divorce.[18]

2. Accordingly, estate planners should help clients plan for the contingency of divorce and ensure that divorced clients understand their options. Although couples in second marriages may consider a prenuptial agreement, an increasing number of couples in first marriages are doing so as well.[19] Such agreements can keep assets separate during the marriage and ensure waiver of any elective share rights. The Uniform Probate Code ("UPC") provides for revocation upon divorce of any provisions in favor of the ex-spouse in a will or through non-probate assets beneficiary designations.[20] Most states have adopted this presumption that divorce revokes any

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[14] For a detailed discussion of the powers a grantor or beneficiary can retain without risking estate tax inclusion and those that must be delegated to an independent trustee, *see* Steve Akers, *Trustee and Beneficiary Powers that Won't Create a Tax Disaster*, Nov. 2022. Steve Akers, Bessemer Trust, has maintained and widely disseminated various versions of these materials for over 20 years for which the authors have long been grateful.

[15] IRC § 672(c) defines a "related or subordinate party" as the grantor's spouse (if living with the grantor), parent, issue, sibling, employee, controlled corporation (or any employee of a controlled corporation), or any subordinate employee of a corporation in which the grantor is an executive. While the section refers only to the "grantor" and not a "beneficiary", conservative practitioners define an "independent trustee" to also exclude a related or subordinate party of either the grantor or a beneficiary. *See* Stephen Liss, *Successor Trustees and Section 672(c): A Prison of Our Own Making?*, North Carolina Bar Association 46th Annual Estate Planning & Fiduciary Law Program (July 25, 2025) (explaining the history of the more conservative approach).

[16] This section of the outline is from Section II(B) of Kim Kamin, *A Potpourri of Estate Planning Considerations for Modern Families*, Montana Tax Institute (Oct. 13, 2013), based on Stephan R. Leimberg, Kim Kamin & Wendy S. Goffe, *The Tools & Techniques of Estate Planning for Modern Families* (ALM Leimberg Library, 4th Ed. 2024), Ch. 2.

[17] Christy Bieber, *Revealing Divorce Statistics in 2023*, Forbes (Aug. 8, 2023), available at https://www.forbes.com/advisor/legal/divorce/divorce-statistics/; *See also* Jessica Schrader, *Why Relationships Fail: Poor personal need management could explain relationship failure*, Psychology Today (Oct. 30, 2022), available at https://www.psychologytoday.com/us/blog/new-gps-intimate-relationships/202210/why-relationships-fail#:~:text=At%20best%2C%20the%20marriage%20or,the%20third%20round%20of%20nuptials (noting the failure rate for first marriages to be roughly 48% according to the National Center for Health Statistics).

[18] *Id.*

[19] Jonnelle Marte, *Why you're more likely to have a prenup than your parents were*, Wash. Post (Aug. 4, 2017), available at https://www.washingtonpost.com/business/economy/why-youre-more-likely-to-have-a-prenup-than-your-parentswere/2017/08/04/51361598-77d8-11e7-9eac-d56bd5568db8_story.html.

[20] UPC § 2-804.

bequests to a former spouse in a will that predates the divorce. An increasing number apply this to life insurance, retirement plans, and transfer-on-death account beneficiary designations.

3. Trusts are a valuable planning tool before divorce for several reasons. They offer asset protection, enable the settlor to maintain effective control over transferred assets, provide financial security for trust beneficiaries, reduce the need for future contact between divorcing parties, and may offer tax benefits for transfers into trusts from both income tax and transfer tax perspectives.

4. Keeping property for descendants in a lifetime spendthrift trust can be an effective way to safeguard those assets from future creditors, including divorcing spouses.[21] However, practitioners must still take care to research whether their jurisdiction treats spouses as exception creditors who can receive alimony even from a spendthrift trust or the jurisdiction has other precedent for attacking spendthrift trusts in the context of a divorce.[22]

5. Many clients overlook the fact that if they create SLATs and later divorce, the SLATs may continue to be a grantor trust even after a divorce. This could be an undesirable result depending on the circumstances.[23] SLATs are increasingly becoming an issue in divorces where one spouse alleges that they were not fully informed about the implications of gifting and losing access to the assets. Where both spouses have non-reciprocal SLATs that have grown to roughly the same size, this can help alleviate some of the concern. However, being a beneficiary of an irrevocable trust is certainly not the same as having full access to the trust's assets.

6. Some practitioners have advocated for treating a spouse as *immediately deceased* upon divorce – or even upon the filing of a divorce action. Because a large percentage of filed divorces reconcile, not all divorce is contentious, and clients are terrible at predicting in advance what they might want in the event of a divorce, it may be best for trusts to take a scalpel rather than a machete approach to disinheriting a spouse in the event of divorce. The alternative would be that upon the filing of a divorce action; the spouse is no longer able to act as a fiduciary appointer or remover and is no longer able to exercise lifetime or testamentary powers of appointment. If someone from the settlor's side of the family or an independent third party (such as a Trust Protector) who can be fair and reasonable in such circumstances is empowered with control of whether to remove the divorcing/divorced spouse, this can provide better optionality in the event of a divorce.

VI. <u>Building in Flexibility With Powers of Appointment.</u>

A. <u>Powers of Appointment Overview</u>.

1. Powers of appointment are among the most powerful tools for adding flexibility to a trust because they enable the settlor to give a powerholder the option to direct how trust assets are distributed in the future.[24] Powers of appointment typically enable the powerholder to alter

[21] *See* Kim Kamin & Wendy S. Goffe, *The Tools & Techniques of Estate Planning for Modern Families* (Leimberg Library, 4th Ed. 2024), Ch. 2.

[22] *See, e.g.*, *Jones v. Jones*, No. 21-P-655 (Appeals Ct. of Mass., 2023).

[23] Under IRC § 677(a)(1), a grantor is treated as the owner of any portion of a trust if the income may be distributed to the grantor's spouse. And under IRC § 672(e)(1), the so-called spousal unity rule, a grantor is treated as holding any interest held by an individual who was a grantor spouse at the time the interest was created.

[24] Jonathan Blattmachr, Kim Kamin and Jeffrey M. Bergman, *Estate Planning's Most Powerful Tool: Powers of Appointment Refreshed, Refined, and Reexamined*, Real Property, Trust and Estate Law Journal, vol. 47, no. 3, 2013, pp. 529–82.

beneficial interests and other terms of the trust as a non-fiduciary and without having to take fiduciary duties into account in the exercise.[25]

2. There are two general categories of powers of appointment, each with different transfer tax consequences: (i) general powers of appointment — which allow the powerholder to appoint property to themself, their estate, or the creditors of either; and (ii) special powers of appointment — which don't allow the powerholder to appoint the property to themself, or to their estate, or to the creditors of either. Holding a general power of appointment can make the trust assets subject to the power taxable in the powerholder's estate. Holding a special power of appointment does not make the trust assets includable in the powerholder's taxable estate.

3. Special powers of appointment are then further divided into two categories: (i) broad special powers, and (ii) limited special powers. A broad special power enables the powerholder to exercise the power in favor of any person or entity, other than the powerholder, their estate, or the creditors of either.[26] Limited special powers of appointment can be any subset of that, such as permitting the power to be exercised in favor of surviving spouses, descendants, and/or charities.

B. Utilizing Limited Powers of Appointment.

1. Many clients initially think they want assets to remain in their family lines, so irrevocable trusts often limit a beneficiary's power of appointment only to descendants. However, there are many advantages to expanding the class of permissible appointees, as families' needs and the world change over time.

2. Ideally, if a client wishes to limit the scope of an appointment, the list of permissible appointees would include a spouse or other lifetime partner (at least in a continuing limited access trust), and also permit the powers to be exercised in favor of charitable organizations (such as a family foundation or Donor Advised Fund) for income tax reasons. When defining permissible charitable organizations, consider using a definition that doesn't require the organization to be eligible for a deduction for income and estate taxes, as this is more narrow than necessary.[27]

C. Utilizing Broad Special Powers of Appointment.

1. In order to maximize flexibility, whenever appropriate, an irrevocable trust should grant to the primary beneficiary (or to a trusted third-party powerholder) both broad special lifetime powers of appointment and broad special testamentary powers of appointment.

2. Broad special powers enable the powerholder to define family on their own terms and to use their judgment at the time of exercise to determine for themselves how the trust assets can be used.

3. For example, a beneficiary with a lifetime power of appointment that is broad enough can direct the trustee to make distributions of trust assets enabling the beneficiary to make annual

[25] However, if the powerholder is also a trustee of the trust or a fiduciary for the trust beneficiaries, then strong arguments could be made that it would be a breach of their fiduciary duty to exercise the power in a way that harms the beneficiaries or otherwise is detrimental to their best interests.

[26] *See* IRC §§ 2041, 2514.

[27] For more on this issue, *see* Kim Kamin, *Charitable Giving with Noncharitable Trusts*, Kansas City Estate Planning Symposium (April 24, 2025); expanding upon Kim Kamin, *Considerations for Charitable Giving with Noncharitable Irrevocable Trusts*, Wealth Strategies Journal (March 13, 2023) which updated and expanded upon Kim Kamin and Kirk Hoopingarner, *Charitable Giving with Noncharitable Trusts*, Trusts & Estates Magazine, Volume 160, #10 (Oct. 2021).

exclusion or exemption gifts to individuals or to direct that trust assets be donated to charity to get a deduction at the trust level for a non-grantor trust.

4. A powerholder who is independent and also not a fiduciary can exercise a broad special lifetime power of appointment to direct the assets to a new trust with different terms and different beneficiaries.

5. Similarly, a primary beneficiary powerholder with broad special testamentary powers of appointment can direct the assets go to new trusts with new terms for new beneficiaries, subject only to the perpetuities period of the original trust.

6. Additionally, a number of reputable estate planning attorneys are also comfortable that powers of appointment can permit the powerholder to appoint property to a new trust in which the powerholder has similar rights or powers, as long as those rights or powers are no broader than in the original instrument. However, there is some debate about whether doing so may be a general power of appointment.

7. One benefit of granting broad enough powers of appointment in a lifetime gift trust (like a SLAT) is that such powers can be used to create flexibility to exercise such powers in favor of a trust where the settlor can be a beneficiary. While there should, of course, never be a prior agreement to do so, under certain trust structures a beneficiary spouse can exercise their lifetime or testamentary power of appointment in favor of the original settlor spouse. When the spouse (or any other beneficiary) is granted the ability to exercise a power of appointment in favor of the original donor spouse and later chooses to do so, that approach arguably should work. The original gift should be respected as an irrevocable transfer, with the appreciation from the date of transfer to the date of death out of the settlor's estate. However, the fact that there are no cases on point despite the widespread practice of enabling such powers speaks volumes.

8. As always, when discussing flexibility and optionality with clients, advisors should be mindful of the IRS' watchful eye. In addition to considering the reciprocal trust doctrine, the IRS may also look for step-transactions. For example, the IRS may determine that one spouse made a gift to the other solely to facilitate that spouse's immediate gift to a trust for the benefit of the first spouse. As such, some advisors may take a more conservative approach when granting spouses a lifetime power of appointment and limit such power to exclude the settlor spouse.

D. <u>Utilizing General Powers of Appointment.</u>

1. General powers of appointment can also be utilized in certain circumstances to enable flexibility in tax planning. Because a general power of appointment triggers inclusion in the powerholder's gross estate,[28] general powers are typically utilized only: (i) to implicate the marital deduction, (ii) to obtain a step-up in basis at the powerholder's death, (iii) to utilize the powerholder's remaining exemptions, and/or (iv) to avoid the imposition of a GST tax at the powerholder's death if the trust assets would be subject to the tax. This can be accomplished either via a formula that is built into the trust or by permitting an independent trustee or Trust Protector to later grant a general power to a beneficiary.

2. Some drafters utilize a formula testamentary general power of appointment (also known as an optimal basis increase trust) as way to obtain a basis adjustment for credit shelter trust assets under IRC Section 1014 at the death of the surviving spouse for assets that have significant appreciation or are subject to high income tax rates, while preserving carryover basis for loss

[28] IRC. § 2041(a)(2).

assets. Since the purpose is to get a basis adjustment, this strategy isn't appropriate only for trusts that have significant appreciation of low basis assets.

3. Formula general powers of appointment are permitted by the IRS. A power of appointment may apply "as to part of an entire group of assets or only over a limited interest in property."[29] While this language by itself arguably sanctions formula powers, there are also other analogous tax provisions supporting a formula to determine if property is includible in one's taxable estate—such as the capping rules for GST funding purposes and the formulaic calculation of the marital deduction under IRC Section 2056(b)(5).[30] On the other hand, formula language can present significant drafting complexities which may drive up legal costs and make it a less appealing option than others.[31]

4. Another long time approach to provide flexibility to take advantage of basis step-up involves giving an independent trustee or a Trust Protector the power to grant the surviving spouse or another trust beneficiary a general power of appointment, at least up to the extent of such beneficiary's unused exemption amount. The power, however, doesn't need to be limited only to the unused exemption amount in case the basis step-up benefits might outweigh any estate tax concerns. There need not be any limits on the ability for the independent party to add the power, but it's increasingly common for the general power of appointment itself that is granted to be structured pursuant to a formula.[32]

5. A general power of appointment should be employed only if the cost of estate tax inclusion is less than the income tax saved by increasing tax basis. This is determined by analyzing: (i) the difference between estate taxes incurred and any income tax savings if the property is included in the gross estate; (ii) the amount of appreciation in each asset; (iii) which assets are likely to be sold; (iv) the federal and state income tax rates at the time of any potential sale; (v) the depreciation rate with respect to depreciable property owned by the trust; and (vi) whether having a general power of appointment facilitates the desirable use of the powerholder's own GST tax exemption to be applied to the trust property.[33]

6. There is some concern that an instrument which provides for automatic segregation into a new trust of non-exempt property could cause problems if the GST-exempt and non-exempt trust have differing terms. For example, if the non-exempt trust includes general powers or withdrawal rights, the argument is that the settlor has retained control to change where the assets end up based on whether they do or don't allocate GST-exemption.[34] To avoid this, the

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[29] Treas. Reg. § 20.2041-1(b)(3).

[30] This analysis was outlined at length in Robert J. Kolasa, *Formula General Powers of Appointment to the Rescue*, WealthManagement.com (April 17, 2019) https://www.wealthmanagement.com/estate-planning/formula-general-powers-of-appointment-to-the-rescue?successfulPurchase=true/.

[31] *See e.g.*, Michael A. Yuhas & Carl C. Radom, *The New Estate Planning Frontier: Increasing Basis*, 122 J. TAX'N 4 (2015).

[32] *Id*.

[33] Please note that the amount of estate tax incurred will be dependent on a number of factors (*e.g.,* elections made by the executor and administrative expenses incurred by the estate).

[34] For example, in PLR 202507005 and PLR 202531005, the IRS granted taxpayers an extension of time to allocate GST exemption to transfers made to trusts. However, the IRS raised additional issues by suggesting the settlor may retain control of beneficial interests by making a late allocation. In both rulings, the IRS included the following statement: "*Except as expressly provided herein, we neither express nor imply any opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express*

trust agreement should (i) automatically segregate any non-exempt property into a separate identical trust; (ii) the initial trust should not grant a general power of appointment over non-exempt property; and (iii) a Trust Protector, if any, otherwise an independent trustee could be empowered to later grant a general power of appointment to the primary beneficiary of the non-exempt trust.

E. Method of Exercising Powers of Appointment.

1. To maximize client privacy, drafters should not require testamentary powers of appointment to be exercised by will. Instead, the powerholder should be able to exercise the power via a revocable living trust or other separate document. The instrument exercising the power of appointment can require all the formalities that would be needed for a trust amendment, such as the requirement to be a written and signed document delivered to the trustee and kept with the trust records, which specifically references the exercise of the power.

2. In cases where the testamentary power of appointment must be exercised by a will and that cannot easily be changed, the exercise should be in a separate codicil instead of in the main will. In some circumstances, this may afford the powerholder additional privacy. The codicil is likely to still need to be filed in court in the county where the decedent resided upon death, but this approach increases the likelihood of minimizing broader circulation of the specific terms of the exercise.

3. Another recommendation is for the terms of the new trust to be contained not in the will itself but in a separate trust instrument. Often, such instruments are described as appointment trusts and utilize a name identifying them as such.

4. Please refer to Addendum B2 for sample broad special lifetime and testamentary power of appointment provisions where the testamentary powers don't need to be exercised by a will.

F. Granting General Powers of Appointment. Because many independent trustees or Trust Protectors won't want the pressure of having to do the analysis to determine whether or not to grant a general power of appointment, it has become increasingly common for drafters to add language requiring the independent trustee or Trust Protector to consider granting a general power of appointment only when a trust beneficiary has requested them to consider it. Additionally, any fiduciary that has the authority to confer a general power should be exculpated for liability for any decision to exercise or not exercise the power. Sample language allowing an independent trustee the discretion to grant a general power of appointment is in Addendum B3.

VII. Flexibility with Fiduciary Appointers/Removers and Trust Protectors.

A. Fiduciary Appointers and Removers. For added flexibility, it helps when there is a clear order set out for who can appoint and remove trustees or other fiduciary or non-fiduciary roles under the instrument. Often these powers can be held by the settlor, the settlor's spouse, and then each adult primary beneficiary, subject to certain limitations (such as never permitting any settlor, beneficiary or related or subordinate party to both remove a fiduciary and appoint them with anyone who wouldn't qualify as an independent/disinterested fiduciary).[35] For additional flexibility, it's best to contemplate that a divided trust structure is permissible and could be implemented at the outset or

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no opinion as to whether Donor's power to alter [beneficiary's testamentary power of appointment/the child's withdrawal rights] by changing the portion of the trust that is exempt from GST tax (through a late allocation of GST exemption) would cause the trust to be includible in the donor's estate under [IRC] § 2036(a)(2) and § 2038. We further express no opinion as to whether Donor's retained indirect power causes any portion of Trust to be subject to an estate tax inclusion period under [IRC] § 2642(f). We therefore express no opinion as to the effect of an allocation of GST exemption made pursuant to this grant of relief."

[35] *Trustee and Beneficiary Powers that Won't Create a Tax Disaster*, *supra*.

at a later time. Please refer to Addendum B4 for sample fiduciary appointment and divided trust provisions.

B. Trust Protectors.

1. Trust Protectors have been utilized for centuries in English trusts, and over the past 25 years have also become standard in most U.S. irrevocable trusts. Generally, a Trust Protector is given certain powers to modify an irrevocable trust and may also be empowered to take other actions regarding a trust.

2. Generally, a Trust Protector is an independent party (i.e., someone other than the settlor, trustee, or beneficiary) who is granted specific powers to make modifications that range from administrative to substantive. Drafters should also consider requiring that the Trust Protector not be a related or subordinate party, as defined in IRC Section 672(c), with respect to the settlor or any beneficiary of the trust.[36]

3. Typically trust instruments permit the Trust Protector to amend the trust without requiring notice to the beneficiaries or enabling them to object, and, therefore, without triggering gift tax issues raised in CCA 202352018.

4. Despite their widespread use, there is no consensus on what powers a Trust Protector can be permitted to hold and no settled case law on when the role must be fiduciary in nature. If the role of Trust Protector is fiduciary in nature, then certain duties of care are owed to the trust beneficiaries, and liabilities may attach for breach of such duties.[37]

5. To maximize future flexibility, ideally, all irrevocable trust instruments should include provisions for naming a Trust Protector who can amend or restate the irrevocable trust instrument within certain guidelines. Because every revocable trust at some point becomes irrevocable, Trust Protector provisions should always be included in revocable trusts too.

6. Currently, 38 states have statutes that use and define the term Trust Protector. As of 2024, 36 states, including the District of Columbia, have adopted the Uniform Trust Code ("UTC"). UTC Section 808 Power to Direct, only adopted by eleven states, defines a Trust Protector as "a person other than the trustee or beneficiary who holds power over some aspect of a trust."[38] In addition, the UTC states that Trust Protectors or others who have the power to direct are presumed to be fiduciaries.[39] Specifically, the UTC provides that, "[a] person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries."[40]

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[36] Alexander Bove, Jr., *A Protector by Any Other Name...*, Estate Planning and Community Law Journal of Texas Tech University School of Law, Vol. 8, No. 1 (June 1, 2016), available at SSRN: https://ssrn.com/abstract=2814577; *See also* Kathleen R. Sherby, *In Protectors We Trust: The Nature and Effective Use of "Trust Protectors" as Third Party Decision Makers*, § 2.2, University of Miami Heckerling Institute on Estate Planning (2015).

[37] *Id*.

[38] UNIF. TR. CODE § 808(d) (Unif. Law Comm'n 2000).

[39] *Id*.; *see also* Howard S. Krooks and Cozen O'Connor, *Trust Protectors: The Good, the Bad and the Ugly*, Stetson 2024 National Conference on Special Needs Planning and Special Needs Trusts – October 17, 2024.

[40] UNIF. TR. CODE § 808(d) (Unif. Law Comm'n 2000).

7. Overall, advisors should be cautious and know the state law that applies to the Trust Protector. In most cases, the trust can be drafted to overcome most deficiencies in the relevant state statute. If that is not possible, consider another jurisdiction.[41]

C. Common Uses of a Trust Protector.

1. Changing Governing Law. A Trust Protector is often given the power to change the trust situs and governing law. Because clients and their trusts are increasingly mobile, a well-drafted trust should allow a Trust Protector to change a trust's governing law. To avoid the need to appoint and engage a Trust Protector, often an independent trustee can also be empowered to change the trust situs and governing law. Please refer to Addendum B5 for sample language changing trust situs and governing law.

2. To Maintain Privacy of Trust Administration. Utilizing a Trust Protector allows the trust to maintain its privacy because modifications can be made without the time, expense, and public records of a court proceeding. While a Trust Protector cannot prevent the trustee or beneficiaries from going to court, but having one in place does reduce the likelihood and necessity of a court proceeding.

3. To Provide Flexibility in the Administrative Terms for Long-Term Trust. As trusts last longer and longer, trust provisions must adjust with the times. The Trust Protector can have the power to: (i) expand the trustee powers; (ii) expand or narrow powers of appointment; (iii) clarify the tax provisions or make other changes to address changes in the tax laws; add beneficiaries; (iii) change the ultimate contingent beneficiaries; (iv) interpret the terms of the trust to facilitate a trust merger; or (v) modify distribution provisions for various reasons (*e.g.*, to protect a beneficiary with special needs and avoid disqualifying them for public benefits). Typically trust instruments permit the Trust Protector to amend the trust without requiring notice to the beneficiaries or enabling them to object, and, therefore, without triggering gift tax issues raised in CCA 202352018.

4. To Add or Change Beneficiaries. As long as the Trust Protector isn't a fiduciary, they can have the power to: (i) turn off grantor trust status; (ii) add beneficiaries; (iii) change the ultimate contingent beneficiaries; or (iv) modify distribution provisions for various reasons. Arguably, even a Trust Protector who is a fiduciary could modify distribution provisions under certain circumstances, such as to protect a beneficiary with special needs and avoid disqualifying them for public benefits.

5. To Monitor the Trust. Some practitioners believe that a Trust Protector should be named at the outset upon the execution of a trust to monitor the administration of the trust. This can be quite challenging since the Trust Protector isn't a co-trustee and therefore not privy to the day-to-day administration of the trust. Some courts have also determined that, unlike a trustee, a Trust Protector has no standing to bring an action in court. This could cripple the Trust Protector's ability to act but it does not prohibit the Trust Protector from flagging issues for the trust beneficiaries.[42] If a settlor wants an individual or entity to monitor the trustee, the settlor should

[41] Alexander Bove, Jr., *A Protector by Any Other Name...*, Estate Planning and Community Law Journal of Texas Tech University School of Law, Vol. 8, No. 1, (June 1, 2016) available at SSRN: https://ssrn.com/abstract=2814577.

[42] *Schwartz v. Wellin*, No. 2:13-cv-3595-DCN, 2014 WL 1572767 (D.S.C. Apr. 17, 2014) (where Trust Protector filed suit against trustees, suit was dismissed since the Trust Protector lacked standing as he was neither a trustee nor a beneficiary).

appoint a co-trustee or, better yet, avoid appointing a trustee whom the settlor worries must be supervised by a third party.[43]

6. Trust Protector as Enabler or Surgeon. A Trust Protector need not be appointed at the outset. Instead, the party empowered to appoint successor trustees (often the Trustee Appointer or Fiduciary Appointer as described above) can name a Trust Protector when necessary to make substantive trust revisions, like to decant a trust. Once the process is complete, the Trust Protector can resign and should be released from liability.

7. Please refer to Addendum B6 for sample language enabling a Trust Protector.

VIII. Flexibility with Grantor Trusts.

A. Introduction. A grantor trust is one where the grantor retains certain powers or control over the trust assets, making the grantor responsible for paying the trust's income taxes. Using grantor trusts is essential to maximize the benefits of gifting assets that can appreciate outside the donor's estate during their lifetime without an income tax drag on the trusts' growth. Notably, grantor trusts always outperform non-grantor trusts in overall financial benefits, even when the grantor resides in a state with income taxes.

B. Power to Substitute.

1. The most common way to make a trust a grantor trust for income tax purposes is for the grantor to retain the power to reacquire trust assets by substituting other property of an equivalent value under IRC Section 675(4)(C). The swap power is considered the most powerful grantor trust power, and it can create a great deal of flexibility.[44]

2. For example, suppose a client wants to make an additional gift before the end of 2025, but the assets in their estate for gifting are low basis and illiquid. Assume further that the same client established an irrevocable grantor trust years ago that now has significant cash or other liquid assets. If the trust contains a swap power and the trustee has sufficient evidence to support that the assets being swapped are of equivalent fair market value, the client could swap illiquid assets into the old trust in exchange for its liquid assets. There would be no capital gains tax on such an exchange.[45]

3. With liquid assets in hand, the client could then gift those assets to a new trust. While the client could simply gift illiquid assets to a new trust, that would require a full qualified appraisal to determine and report fair market value on the gift tax return. Concerns about the valuation requirement for the new trust can be mitigated (though depending on the facts not eliminated entirely) by first swapping with the existing trust.

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[43] *Robert T. McLean Irrevocable Tr. v. Ponder*, 418 S.W.3d 482 (Mo. Ct. App. 2013) (court refused to hold the Trust Protector liable for failing to monitor the trustees or direct their activities; court deferred to the trust instrument, which granted the Trust Protector the ability to remove and appoint trustees; Trust Protector was granted no other powers; court held that the Trust Protector's powers were limited by the trust instrument and no other powers were implied by law or the trust instrument).

[44] *See generally* Rev. Rul. 2008-22, modified by Announcement 2008-46 (clarifying that a substitution power does not by itself cause the value of the trust corpus to be included in the grantor's gross estate under section 2036 or 2038); Rev. Rul. 2011-28 (stating that a substitution power, when exercised in a nonfiduciary capacity, to acquire an insurance policy does not by itself cause the value to be included in the grantor's gross estate under section 2042).

[45] Kuno S. Bell, *Use Defective Grantor Trusts for an Effective Triple Play*, PRACTICAL TAX STRATEGIES 12 (July 2005).

4. Cash and marketable securities are easy to value for gift and estate tax purposes and the audit risk on such a gift would presumably be lower than gifting hard-to-value illiquid assets in the first instance.
5. Exercising a swap power can also be useful for near death swaps to leverage the step up in basis at death, to preserve loss, to elude the three-year rule, and to control cash flow.[46]
6. Since exchanging assets of equal value with a trust isn't a gift, the transaction isn't required to be reported on a gift tax return. Instead, the ongoing reporting of income, gain, loss, deduction, and credit attributable to the recognized activities in the trust, or a portion of the trust, will be reported to the IRS each year.
7. In structuring a grantor trust, it's possible to structure the trust such that the grantor only retains control over a portion of the trust. For example, the power of substitution can extend over certain assets.[47] If this is the case, if the power identifies specific property for the substitution power, such as a private business interest, the trust may be a partial grantor trust as to that particular property. If that is the case, the income, gain, loss, deduction, and credit attributable to other trust assets are reported and taxed to the trust itself.[48]
8. That said, many attorneys do encourage clients to report swaps on gift tax returns to start the statute of limitations running and prevent the IRS from arguing the swap was a partial gift. Part 4 Question 13e of Form 706 asks whether the decedent ever transferred or sold an interest in a partnership, LLC, or closely held corporation to a trust the decedent created or benefited from. Arguably, this requires reporting any swap on an estate tax return.

C. Power to Borrow/Lend.

1. Either (i) permitting the grantor the power to borrow or take loans without adequate security or (ii) permitting the trustee the power to lend to the grantor with inadequate interest or security under IRC Section 675 is another common provision that results in a trust being classified as a grantor trust.[49]
2. The power to borrow against or take loans from trust assets increases flexibility, such as allowing the grantor access to trust assets to pay expenses if too much liquidity has been gifted.
3. A grantor's power to borrow from the trust without having to pay adequate interest or without having to give adequate security should not cause gross estate inclusion of the trust property. Such a power does not affect beneficial enjoyment of the trust property and does not constitute a power to alter or amend the terms of the trust. This power is thus a good candidate for defective grantor trust status.[50]
4. Of course, any borrowed amounts that remain unpaid are included in the grantor's estate, and ongoing borrowing for the grantor's ordinary life expenses could lead to an argument for estate tax inclusion under IRC Section 2036(a)(1). It's important that there is no prearranged agreement for the trustee to lend when holding such a power.

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[46] Five scenarios for utilizing the swap power are outlined in depth in Samuel A. Donaldson, Burning Questions (and Even Hotter Answers) About Grantor Trusts (2010).

[47] *See* Steven Siegel, *Understanding Grantor Trusts*, NAEPC Journal of Estate & Tax Planning.

[48] Recall the portion rule of Treasury Regulation Section 1.671-3.

[49] This rule won't apply where a trustee (other than the grantor) has a general power under the trust instrument to make loans to anyone without regard to the payment of adequate interest or the giving of adequate security. *See* IRC § 675(2) and Treas. Reg. § 1.675-1(b)(2).

[50] Samuel A. Donaldson, *Burning Questions (and Even Hotter Answers) About Grantor Trusts* (2010).

5. Although not mandated by the IRC, many estate planners prefer to limit these powers to independent trustees who aren't related or subordinate to the grantor under IRC Section 672(c).

6. To eliminate any debate about whether security was adequate (or to enable loans to the grantor without security), the trust should be clear that adequate security isn't required.

7. Regardless of the security, any promissory notes swapped into the trust by the grantor should be set at a minimum applicable federal rate ("AFR") at the time of the issuance of the note, and interest should be paid to the trust at least annually.[51] The note should also contain terms to make its value discernible by a valuation professional to ensure that the exchange is for equivalent value.

8. Regardless of how they are drafted, in practice, these grantor borrowing/lending powers are typically implemented (i) with some security; (ii) with annual interest set at least at the AFR; and (iii) only when an independent trustee is involved; and (iv) subject to the trustee's fiduciary discretion over the loan's other terms. While the power to borrow or lend without security can be permissible, it remains prudent to include security for such transactions to better protect the trust and its beneficiaries in case of default.

D. <u>Swap of Promissory Note</u>.

1. If the governing instrument permits both swaps and loans, a grantor could swap assets from the trust in exchange for a promissory note.[52] This could be preferable to the scenario described above where the grantor would otherwise be swapping in low basis illiquid assets that require a valuation.

2. For the same reasons described above, it's recommended that such swaps of promissory notes include security, even if not required.

3. In addition, any promissory notes swapped into the trust by the grantor in exchange for other assets should be set at least at the minimum AFR at the time of the issuance of the note, and interest should be paid to the trust at least annually. The note should also contain terms to make its value discernible by a valuation professional to ensure that the exchange is for equivalent value.

4. For example, the trust could transfer $10 million worth of assets to a client in exchange for a nine-year, interest-only, promissory note. So long as the principal amount is $10 million and the interest rate on the note equals the AFR, that is an exchange of assets with equivalent value.[53] The client could then use the $10 million received from the trust for additional gifting.

5. A relatively new issue to think about in this context is the applicability of the step transaction doctrine and the so-called anti-clawback regulations. When the decrease in transfer tax

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[51] Borrowing on a below-market interest basis, however, is fraught with income and gift tax consequences. *Id*., citing IRC § 7872.

[52] *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984) (holding that substitution using unsecured note is a loan, and the trust did not include the power to loan); *In re the Matter of the Mark Vance Condiotti Irrevocable GST Trust* (Colorado Court of Appeals No. 14CA0969, July 9, 2015) (ruling that attempt to substitute with an unsecured promissory note was not proper when trust permitted swaps, but did not also contain a provision permitting unsecured loans to the grantor); *Benson v. Rosenthal*, CIVIL ACTION NO: 15-782 SECTION: "H"(2) (E.D. La. Nov. 10, 2016) (involved the management of several trusts established by the owner of the New Orleans Saints and Pelicans, where the court found the owner, as grantor, could substitute with promissory notes, when notes were fully secured and trust contained both substitution and loan powers).

[53] *See Interesting Interest Questions: Interest Rates for Intra-Family Transactions*, Hesch, Gassman and Deniocolo, Tax Management Estates, Gifts and Trusts Journal, Vol. 36, No.2, Mar. 10, 2011; *see also Estate of Bolles v. Comm'r* T.C. Memo. 2020-71, *aff'd*, 133 AFTR 2d 2024-1235 (9th Cir., Apr. 1, 2024).

exemption was a concern, the IRS issued regulations slightly modifying how estate tax is calculated. If someone made $X of gifts when the gift tax exemption was $X, then dies when the estate tax exemption is less than $X, there would still be no tax on the first $X of the adjusted gross estate. Concerned about people making a legally binding promise to gift,[54] the IRS subsequently issued proposed regulations that, among other things, are intended to remove any benefit from someone who makes a promise to gift while the gift tax exemption is higher than the estate tax exemption when that person dies.[55] That proposed regulation is discussed more fully below.

6. There could be some risk of facing arguments that swapping a note into Trust #1 to make a gift to Trust #2 is no different than making a gift of a promissory note to Trust #2. That position, if upheld, could implicate the anti-clawback regulations.[56]

7. A more common issue with using a note to swap assets out of a grantor trust is the fiduciary duty of the trustee.[57] When exchanging assets using a swap power, the trustee has a fiduciary duty to ensure the assets received by the trust have the same value as the assets the trust is transferring. While a promissory note that bears adequate interest may be valued at its face amount for gift tax purposes, arguably an appraiser should take into account whether or not the note is secured, the credit worthiness of the debtor, the marketability of the debt, and other relevant factors.[58]

E. <u>Other Grantor Trust Powers</u>.

1. <u>Adding Charitable Beneficiaries</u>. Generally, any power exercisable by the grantor or a nonadverse party to control beneficial enjoyment of trust property without the consent of an adverse party will render the grantor the deemed owner of the trust.[59] The one exception is the power of a nonadverse party to add charitable beneficiaries. If exercised, it enables the trust to take charitable income tax deductions if distributions are made, the grantor is treated as the owner of the trust for federal income tax purposes and, assuming the grantor has no retained interest or power to alter or amend the terms of the trust, no portion can be included in the grantor's gross estate.[60]

2. <u>Grantor's Spouse</u>. Including the settlor's spouse as a permissible beneficiary under IRC Section 677 and/or as a fiduciary with the power to make discretionary distributions under IRC Section 674 is also permissible in a grantor trust.

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[54] *See e.g.*, Austin Bramwell, *The Gift-by-Promise Plan Works as Advertised*, Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2033, Dec. 3, 2012.

[55] 87 Fed. Reg. 24,918 (Apr. 27, 2022).

[56] For a detailed discussion of step transaction, *see* Carol Harrington, *Watch Your Steps—Don't Abuse Substance in Transfer Tax Transactions*, 57th Annual Heckerling Institute on Estate Planning, Chapter 13, Jan. 12, 2023.

[57] *See* L. Paul Hood, Jr, Snap, Crackle, Swap: *The Substitution Power Under the Microscope*, Estate Planning Journal, Apr. 2020.

[58] *See* Scott A. Harshamn, *Planning Opportunities for Notes Receivable in an Estate*, Estate Planning Journal Apr. 2003; *see also Estate of Harper v. Comm'r*, T.C. Memo. 2002-121 describing five factors used in discounting notes: (1) value of collateral; (2) environmental concerns with collateral; (3) state law treatment of personal guarantees; (4) market rate of interest; and (5) doubt as to whether the note would be paid; *see also Estate of Rosen v Comm'r*, T.C. Memo. 20060115.

[59] IRC § 674(a) states in relevant part that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, subject to the exceptions outlined in IRC § 674(b)-(d).

[60] *Madorin v. Commissioner*, 84 T.C. 667 (1985).

3. Sample Grantor Trust Language. Please refer to Addendum B7 for sample grantor trust power provisions.

F. For Grantor Trusts, Include a Tax Reimbursement Provision.[61]

1. While originally intended to punish taxpayers who tried to evade income taxes by transferring assets to trusts, grantor trusts have become an essential tool in estate planning. With grantor trust status, a trust can accelerate growth without the tax drag of a non-grantor trust and its severely compressed income tax brackets. Also, the trust can use the grantor's social security number as its taxpayer identification number and reduce tax preparation fees (any grantor trust with its own taxpayer identification number must file a Form 1041 with a grantor trust letter).[62] Grantor trusts can engage in desirable transactions, such as renting residential real estate, buying assets in an installment sale at low interest rates, and swapping out low-basis assets for higher basis assets with the grantor.

2. A well-drafted grantor trust should always include the ability to terminate grantor trust status in case the grantor tires of paying the trust's income taxes. For example, in a year when there is an unusually large capital gain or in which the grantor may be particularly cash-strapped, the grantor might be inclined to terminate the status rather than incur the tax liability. This would typically be accomplished by the grantor irrevocably surrendering the powers that make the trust a grantor trust.

3. Terminating grantor trust status, however, is harmful to the trust and is always contrary to the best interests of the beneficiaries. It may also have unintended consequences if the grantor is engaged in otherwise non-recognized transactions with the trust, such as a lease with a qualified personal residence trust ("QPRT"), or an installment sale to an irrevocable grantor trust. In such situations, it's preferable, in lieu of terminating grantor trust status, for the trust to give the trustee the power, exercisable in the trustee's sole discretion, to reimburse the grantor for some or all of the taxes paid individually by the grantor that are due on trust income.

4. Across the country, many practitioners are addressing this issue by inserting language in their trusts giving trustees the authority to reimburse grantors for taxes (or to pay the trust's share of the tax liability directly) as a disincentive for terminating grantor trust status altogether and to build in more flexibility. Please refer to Addendum B8 for some sample grantor trust reimbursement provisions.

5. The IRS permits reimbursement for taxes and won't include the amount of the trust in the settlor's taxable gross estate as long as the payment isn't: (i) forbidden by state law; (ii) subject to a pattern of abuse suggesting an agreement to reimburse; or (iii) mandatory. In Revenue Ruling 2004-64, the IRS addressed this issue and determined that there would be no inclusion in the gross estate for U.S. estate tax purposes if the trustee has discretionary authority, under the instrument or applicable local law, to reimburse the grantor for the income tax liability due on trust income. There must not be any facts indicating control by the grantor, such as preexisting arrangements, powers to remove trustee and name the grantor as trustee, or local law subjecting the trust assets to the claims of the grantor's creditors. On the other hand, if the applicable local law or the trust's governing instrument requires a mandatory payment for the

[61] This section of the outline on grantor trust reimbursements is drawn from Kim Kamin, *Where Are All the Grantor Trust Reimbursement Statutes?*, Wealth Management (Jan. 17, 2018), available at http://www.wealthmanagement.com/estate-planning/where-are-all-grantor-trust-reimbursement-statutes, as updated for these materials.

[62] Ivan Taback & Scott A. Bowman, *Frequently Asked Questions on Grantor Trust Tax Reporting*, Estate Planning Journal Aug. 2012.

income tax liability, this can trigger inclusion in the grantor's taxable gross estate under IRC Section 2036(a)(1) for any trust created after October 4, 2004.

6. Under the holding of the Revenue Ruling, no state statute expressly authorizing reimbursement for grantor taxes should be necessary, as long as such reimbursement is permitted by the instrument, and there is no local law subjecting the trust assets to the grantor's creditors' claims. Nonetheless, to provide comfort and clarity, many states have enacted statutes that address grantor trust reimbursement.

7. States have been heeding the call to make statutory revisions that facilitate grantor trust reimbursement. Currently, seven states (Colorado, Connecticut, Delaware, Florida, Indiana, New Hampshire, and New York) have enacted legislation authorizing income tax reimbursement even for trusts that are silent with respect to granting the trustees that power.[63] In addition thirteen states (Arizona, California, Idaho, Illinois, Iowa, Kentucky, Maryland, Massachusetts, Montana, North Carolina, Pennsylvania, Texas and Virginia) don't expressly authorize the trustee to reimburse the trustor, they have enacted statutes preventing creditors from reaching trust assets based solely on a trustee's power to reimburse.[64] Furthermore, a majority of states appear to have statutes clarifying that using an income tax reimbursement provision won't cause estate tax inclusion.[65]

G. The Burn of Grantor Trusts Over Time. In addition to the various ways of building flexibility into a plan, the grantor trust nature of the planning can effectively transfer more wealth than the initial gift or sale. This is true regardless of any valuation discount taken in the fair market determination of a closely held business or interest in real estate. This phenomenon is known as the income tax burn. The income tax burn can be incredibly powerful to reduce the value of the grantor's taxable estate over time.[66] But what happens if the income tax burden becomes too great, and the grantor no longer wishes to pay the tax?

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[63] *See e.g.*, Jennifer E. Smith & Kristen A. Curatolo, *Strategies for Mitigating the 'Burn' of Grantor Trust Status*, Bloomberg Tax (May 11, 2023). *See* EPTL §§ 7-1.11, 7-3.1(d) (New York); N.H. Rev. Stat. § 564-B:8-816 (New Hampshire); C.R.S. § 15-5-818 (Colorado); 12 Del. C. § 3334 (Delaware); C.G.S § 45a-499fff (Connecticut); Fla. Stat. § 736.08145 (Florida); Ind. Code § 30-4-3-38 (Indiana).

[64] *Id. See* CA Probate Code 15304(c) (California, which requires express authorization in trust for reimbursement); Ariz. Rev. Stat. § 14-10505 (Arizona); Idaho Code Ann. § 15-7-502 (Idaho); 760 ILCS 3/505 (Illinois); Iowa Code Ann. § 633A.2304 (Iowa); Ky. Rev. Stat. Ann. § 386B.5-020 (Kentucky); Md. Code Ann., Est. and Trusts § 14.5-1003 (Maryland); M.G.L.A 203E § 505 (Massachusetts); M.C.A. § 72-38-505 (Montana); N.C. Gen. Stat. Ann. § 36C-5-505 (North Carolina); 20 Pa. C.S.A. § 7745 (Pennsylvania); Tex. Prop. Code Ann. § 112.035 (Texas); and Va. Code Ann. § 64.2-747 (Virginia). *See also* Todd A. Flubacher & J. Zachary Haupt, *Delaware*, Wealth Management (Jul. 22, 2019), available at https://www.wealthmanagement.com/estate-planning/delaware.

[65] *See* Nate Patterson & Craig Benson, *Clarity on Income Tax Reimbursement for Grantor Trusts in Nebraska*, Nebraska Society of CPAs (2022), available at https://www.koleyjessen.com/media/publication/91_Clarity%20on%20Income%20Tax%20Reimbursement%20for%20Grantor%20Trusts%20in%20Nebraska%20.pdf.

[66] Keep in mind that grantor trusts must also pay state income taxes on a grantor trust's income and gains for states that have an income tax. *See* Andrey Yushkov, *State Individual Income Tax Rates and Brackets, 2024*, Tax Foundation (Feb. 20, 2024), https://taxfoundation.org/data/all/state/state-income-tax-rates-2024/. *But see* Steve Oshins, *10th Annual Non-Grantor Trust State Income Tax Chart* (2024), https://www.oshins.com/_files/ugd/b211fb_7febdbe7bdb54054855f7b8656b5d794.pdf (which provides a comprehensive overview under which each state taxes a non-grantor trust). *See also* David A. Handler and Tony Ray Meyer-Mangione, *Who Wins When? An Analysis of the Techniques that Use Grantor Trusts to the Techniques that*

1. Reimbursing the Grantor, Now or Later? As noted above, one possible solution is to include in each irrevocable grantor trust the ability to reimburse the grantor for the tax they paid that is attributable to the trust income. To stay within the safe harbor of Revenue Ruling 2004-64, the discretion to reimburse for income tax should be held by a trustee who isn't a related or subordinate person to the grantor (see IRC Section 672(c)). Another best practice is ensuring the provision is in the original trust document and not later added through the trust modification process. Chief Counsel Advice 202352018, issued towards the end of 2023, is a controversial piece of authority, but one that specifically speaks to modifying a trust to add a reimbursement power. There, the IRS ruled that trust beneficiaries have made a taxable gift by consenting to add to the terms of a grantor trust a discretionary power in the independent trustee to reimburse the grantor for income tax the grantor pays on the trust's income.

2. Too Good to be True? Then there is the risk and effect of regularly reimbursing the grantor for income taxes. First, the regular exercise of the reimbursement, perhaps annually or in a pattern, could cause estate tax inclusion under IRC Section 2036(a)(1) as a retained right to possession or enjoyment of the income from the trust. Clients may sometimes falsely believe that the reimbursement is a positive long-term approach. The attorney and the CPA can be valuable in modeling and discussing the grantor trust burn benefits.

3. Weigh the Benefits of Grantor Trust Status. But what if the burn of a grantor trust is too burdensome? One option is to sell appreciating value and discounted valuation assets to the grantor trust in exchange for a promissory note at AFR as the interest rate is set for the note's duration. This can limit trust income to only the paid interest at AFR which is disregarded while a grantor trust. Or, once the client has realized the benefit of this grantor trust feature it may be the appropriate time to discuss turning off grantor trust status and having the trust pay its own taxes.

4. Don't Forget the Income Tax. There are several considerations as this option is discussed with the client. Potential current income tax is one such issue. If, at the time of the termination of the grantor trust feature, the liabilities of the trust exceed the fair market value of the assets, the grantor may recognize short or long-term gain on the conversion of the trust. The existence of promissory notes and value of the trust assets must be considered.[67]

5. Should the Entire Grantor Trust be Affected? Another consideration is how to terminate grantor trust effectively and completely. This can be accomplished by releasing a power, by independent trustee or trust protector action. However, what if the grantor nature of the trust is incomplete? The issue is the portion rule of Treasury Regulation Section 1.671-3. In that regulation, six portions may be recognized in a grantor trust. These are (i) ordinary income, (ii) income allocable to the corpus, (iii) the entire trust, (iv) an undivided fraction of the trust, (v) a pecuniary amount, and (vi) specific trust property. A grantor likely wishes to turn off the grantor trust income tax recognition over the entire trust –all ordinary income, capital gain, and other tax amounts. But what about if there are circumstances in which the grantor who is the client is just one of the grantors? For example, when a married couple create an irrevocable grantor trust for the benefit of a child, then they get divorced. They are both still grantors, but has the portion rule come into play?

Use Non-Grantor Trusts, 50th Annual Notre Dame Tax and Estate Planning Institute (Sept. 27, 2024) (modeling demonstrated that under all state income tax rates now in effect, a grantor trust will always beat a non-grantor trust for overall value to the family. The state income tax rate would have to be assumed to be 25.7% for a non-grantor trust to win, but even then, it would only win for the first 20 years and then a grantor trust would win each year thereafter).

[67] For more on toggling off grantor trust status *see* Kristen A. Curatolo & Jennifer E. Smith, *Strategies for Mitigating the "Burn" of Grantor Trusts Status*, Tax Management Estates, Gifts and Trusts Journal, May 11, 2023.

6. The Difficulty of Toggling Off Grantor Trust Status. Recall that the grantor trust rules were originally passed as anti-abuse rules. As a result, it isn't always a simple matter to terminate a grantor trust. IRC Sections 671-679 must each be analyzed to ensure what was a grantor trust is now a non-grantor trust. For example, just releasing a IRC Section 675(4) swap power won't make a trust a non-grantor trust if the grantor's spouse is a discretionary beneficiary and the trust is annually paying insurance premiums.

7. Options for Helping the Grantor. Sometimes it's possible to avoid or delay the termination of grantor trust status by addressing a client's very real concerns about cash flow and liquidity that are affected by phantom income generated by a grantor trust. If the issue is temporary, the trust may be able to provide an AFR loan to the grantor. That could provide some short-term liquidity that the grantor needs. If the issue is recurring, the grantor could swap a valuable but illiquid asset, like a vacation home, into the trust in exchange for liquid assets. That would alleviate the grantor's need for liquidity while preserving the benefits of a grantor trust. It's important to understand the concerns a client has to present all potential options.

8. Are There Alternatives to Terminating the Grantor Trust? Perhaps the most straightforward grantor trust preserving tool is the loan that can be made to the grantor with interest, and with or without adequate security. To the extent that borrowed assets and interest aren't fully repaid by the close of the year, grantor trust status for at least a portion of the trust will be continued under IRC Section 675(3). This feature allows, in other cases, an otherwise non-grantor trust to become a grantor trust, at least over a portion, on a year-by-year basis. When dealing with loans from the trust, the planner should consider whether the trustee is related or subordinate to the grantor, the terms of the trust including existence and sufficiency of the security offered by the grantor, and the interest charged to the grantor. The repayment schedule, if considered for purposes of establishing, or retaining grantor trust status over all or a portion of the trust, should be considered.

9. Private Placement Life Insurance (PPLI) and Variable Annuities (PPVA). Another option to maintain the benefits of grantor trust status while reducing the impact of phantom income is to invest some of the trust's assets through PPLI or PPVA. Both of those insurance products allow assets to be invested for long term growth without incurring any immediate income or capital gains tax. As with all insurance products, it's important to understand the associated costs, investment limitations, and options for exiting if investments underperform.[68]

IX. Formula Gifts with Valuation Clauses.

A. Dealing with Uncertainty. Many of the techniques discussed in these materials involve transferring assets between related parties. It's often the case that some aspect of that transfer is uncertain. It may be the value of the property, the amount of gift tax exemption remaining, or even whether a particular transfer can be treated as a taxable gift. In those circumstances, incorporating a valuation clause into the relevant documents may be appropriate.

B. Agreement Between Parties. Broadly speaking, valuation clauses involve an agreement between two or more parties involved in an asset transfer. The clause acknowledges that one or more aspects of that transfer are unknown, and the parties agree that the transfer can adapt in some way if a mutual assumption proves to be incorrect or simply if the facts will not be determined until a later point in time.

C. Consider the Factors. There are a variety of valuation clauses, and which approach is best in a particular situation depends on a number of factors including (i) the relationship of the parties, (ii)

[68] For more on PPLI and PPVA, *see* Mary Ann Mancini & Ashley B. Sawyer, *Understanding Private Placement Life Insurance*, 162 Tr. & Est. (Apr. 2023).

client tolerance for complexity, (iii) whether the transferred asset will be income-producing, (iv) whether the transferred asset must be registered or is otherwise subject to regulatory oversight, (v) the charitable inclination of the client, and (vi) whether the counter party is a grantor trust.[69]

D. Types of Valuation Clauses. Valuation Clauses can be grouped into three basic categories:

1. Value Adjustment – Adjust What Was Transferred.

    a. This type of clause states that if the value of the transferred property is redetermined, then an adjustment is made to what was transferred.

    b. This would include cases such as *Wandry*,[70] where the taxpayer wanted to transfer $X worth of LLC units, but the value of a unit was uncertain. To account for that uncertainty, the assignment document stated the transfer was of $X worth of LLC units with the number of units to initially be determined by a valuation and that number to be adjusted if a different determination was ultimately made by the IRS or a court of law.[71] This style of valuation clause can be useful, but keep in mind the uncertainty could lead to complex adjustments at some future time. It may take six to ten years from the time a transfer is made to the time valuation is finally determined in court, after which it may be necessary to adjust for income distributions, taxes, and various other events that have occurred based on ownership.[72]

2. Value Adjustment – Adjust Consideration Given. This type of clause states if the value of the transferred property needs to be adjusted, there is an adjustment to the consideration given. In other words, one party will pay the other party any difference in value. As a result, if the value is later determined to be incorrect, then no adjustments need to be made with regard to ownership of transferred property. Instead, there will merely be a payment between the parties to account for the changed value.[73]

3. Reallocation – Adjust Who Received the Transfer. This type of clause provides certainty about what was transferred, but it leaves unclear exactly who received it. A reallocation clause can be drafted in several ways.

    a. In *McCord*,[74] the taxpayer transferred limited partnership interest to their sons, certain GST exempt trusts, and two charities. It was up to those transferees to negotiate the value of the interests, which would determine what portion of the partnership each owned.

    b. *Christiansen*[75] involved an estate in which a child disclaimed everything beyond $6.35 million. Per the terms of the estate plan, all disclaimed property passed to a charitable foundation or a charitable lead annuity trust (CLAT). Ultimately the taxpayer lost on valuation, but the disclaimer was successful. No charitable deduction was received for the

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[69] For a discussion of this topic, *see* the materials prepared by John W. Porter and presented by Keri D. Brown *Estate and Gift Audit & Litigation Issues*, AICPA & CIMA Engage Advanced Estate Planning, Las Vegas, NV (June 7, 2023). *See also* materials prepared by John W. Porter in *A View From The Trenches: Current Issues In Transfer Tax Audits and Litigation,* 50th Annual Notre Dame Tax & Estate Planning Institute (Sept. 27, 2024).

[70] *Estate of Wandry v. Comm'r*, T.C. Memo. 2012-88 (Mar. 26, 2012).

[71] For a more thorough description of *Wandry, see* Stephen Liss & Anthony Ruscigno, *Wandry Does Wonders for Formula Clause Gift Strategy*, Estate Planning Journal, Oct. 2012.

[72] For more on the adjustments that may be necessary if a *Wandry* style valuation clause is put into effect, *see* Stephen Liss, *Valuation Clauses: Panacea or Pandora's Box?,* Trusts & Estates Magazine, Apr. 2011.

[73] The most recent case specifically approving this approach is *King v. United States*, 545 F.2d 700 (10th Cir. 1976).

[74] *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006).

[75] *Estate of Christiansen v. Comm'r*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009).

interest passing to the CLAT because the disclaimant's contingent remainder interest meant this wasn't a qualified disclaimer under IRC Section 2518.

(1) Qualified disclaimers can be useful to create optionality when it's unclear whether Congress will extend the current exemption levels.

(2) A variation on this theme would be to gift property to a lifetime QTIP trust. If a QTIP election isn't made on a timely filed gift tax return, this transfer would use gift tax exemption. This approach can also be used to extend the time a client has to decide whether to complete a gift, which would hopefully allow enough time for Congress to decide what, if any, action it's going to take.[76]

c. In *Petter*[77] the taxpayer transferred certain LLC units to two grantor trusts by gift. To the extent the value of those units exceeded the taxpayer's remaining gift tax exemption, the excess would pass to charity. Additional LLC units were then sold to the trusts, and charity was to receive the sold units to the extent their value exceeded $4 million. It was clear what units were transferred, but it was unclear whether those units were held by the trusts or charity. That required a final determination of their value. Although the IRS ultimately contested the appraised value of those units, the Tax Court respected the allocation of units required by the transfer documents.

d. *Hendrix*[78] involved a similar allocation as *McCord*, with $15 million of stock in a closely held corporation passing to two trusts and the balance passing to the Greater Houston Community Foundation based on a negotiated value. The Tax Court again upheld this approach.

4. <u>Who Receives Excess Value</u>? With a defined value allocation clause design, an important decision is who or what will receive the excess value? To date, the reported cases have involved a charitable lead trust, a private foundation, and a public charity. In theory, other options would include a spouse, a marital deduction trust, a grantor retained annuity trust ("GRAT"), or an incomplete gift trust. The key feature of all such pour-over beneficiaries is that there is no gift tax for a transfer to such parties.

X. <u>Using Exemptions – Beyond the Basics</u>.

A. <u>Freeze and Reverse Freeze Partnerships</u>.

1. Another option for using gift exemption that can transfer significant wealth to younger generations is the preferred partnership.[79] Preferred partnerships come in two basic forms. The traditional freeze partnership involves the senior generation retaining a preferred interest that provides cash flow but doesn't participate in any future appreciation. The younger generation, or a trust for their benefit, receives the common interest. The common interest doesn't receive any current distributions until any required distributions are made to the preferred interest holder. Future appreciation, however, redounds to the benefit of the common interest holder. This is a highly effective way to ensure the cash flow needs of a senior generation while transferring future appreciation to younger generations.

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[76] For more on this strategy, *see* Jonathan Blattmachr & Carlyn S. McCaffery, *The Estate Planning Tsunami of 2020*, Estate Planning Journal Nov. 2020 at 10-11.

[77] *Petter v. Comm'r,* T.C. Memo. 2009-280 and 653 F.3d 1012 (9th Cir 2011).

[78] *Hendrix v. Comm'r,* T.C. Memo. 2011-133.

[79] For a detailed analysis of Preferred Partnerships, *see* N. Todd Angkatavanich, *Floating Cars- Moving Staircases: Understanding the Mystical Rules of Chapter 14 in the Muggle World*, 58th Annual Heckerling Institute on Estate Planning, Jan. 11, 2024.

2. With a reverse freeze partnership, the senior generation keeps the common interests, while the preferred interests are transferred to younger generations. One advantage of the reverse freeze is that a traditional freeze partnership must be carefully structured to ensure it does not violate IRC Section 2701. The reverse freeze isn't subject to IRC Section 2701, greatly reducing the potential gift tax consequences for this planning.

3. Regardless of the structure chosen, both types of preferred partnership create a valuable interest that can be gifted to younger generations while preserving some economic benefit for the senior generation.

B. Beware the Implied Agreement.[80]

1. Treasury Regulation Section 20.2036-1(c) provides, in pertinent part, that "[a]n interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred."[81]

2. While an implied agreement is a concern highlighted in the self-settled spendthrift trust context,[82] the issue exists even in connection with so-called third-party trusts. For example, if the donor transfers property to the trustee of a trust for the exclusive benefit of the donor's spouse and descendants, but the donor, at the time of the transfer, has an understanding, express, or implied, with the trustee as to how the trust property is later to be distributed to the beneficiaries, then Treas. Reg. Section 20.2036-1(c) is implicated in the same way it would be if the donor was themself the beneficiary of the trust.

C. Suggestions for How to Avoid the Finding of an Implied Agreement:

1. Have the transferor retain sufficient assets in the transferor's individual name to support the transferor's lifestyle for a period no less than the transferor's actuarial life expectancy, after accounting for the transferor's other sources of income. Consider engaging a financial planning professional to assist in this assessment.

2. Consider the use of a corporate trustee, in lieu of an individual trustee, as one would expect that an implied agreement with a corporate trustee is less likely to be found than might be the case with an individual trustee (and especially if the individual trustee is a friend or family member of the settlor).

3. Consider the substitution of the original trustee for a successor trustee prior to any distribution being made, since it would seem impossible for the requirement under Treas. Reg. Section 20.2036-1(c) that the understanding existed at the time of the transfer if the trustee itself wasn't the trustee at the time of the transfer.

4. Consider that an understanding can't be found where distributions haven't actually been made and, where distributions might actually need to be made to the transferor, the transferor is likely no longer concerned about the estate tax consequence of an implied agreement because the transferor wouldn't be seeking a distribution absent a need for funds for consumption.

5. In addition, always consider a partial decanting of the original trust to a new trust with a new independent trustee in an amount designed to support the transferor's lifestyle for the transferor's lifetime, with any excess trust assets retained in the original trust. In this situation,

[80] This discussion of implied agreement is based on and used with permission from Daniel S. Rubin, *Effective Gift and Estate Tax Planning with Maximum Permissible Retained Rights and Powers*, New York State Bar Association Trusts & Estates Law Section 2023 Fall Meeting (Sept. 29, 2023).

[81] *See Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005); ; *Turner v. Comm'r*, 49 T.C. 356 (1968).

[82] *See* PLR 9837007;PLR 200944002.

the finding of an implied agreement with regard to the original trust would be unlikely, if not impossible.

XI. Advanced Planning for Increased Structural Optionality.

A. Back-End SLATs.[83]

1. One benefit of granting broad enough powers of appointment in a lifetime gift trust (such as a SLAT) is that such powers can be used to create flexibility to exercise such powers in favor of a trust where the settlor can be a beneficiary. While there should, of course, never be a prior agreement to do so, under certain trust structures a beneficiary spouse can exercise their lifetime or testamentary power of appointment in favor of the original settlor spouse. This approach is referred to as a Back-End SLAT.

2. Several states, including Florida, tweaked their versions of UTC Section 505 and added a lifetime QTIP Trust exception. For state law purposes, the donee spouse is the settlor, which means that the interest for the donor spouse is now an interest in a third party trust and therefore not subject to UTC Section 505(a)(2)[84].

3. Back-End SLATs are currently sanctioned in ten states, namely: Arizona, Delaware, Florida, Kentucky, Mississippi, North Carolina, South Dakota, Tennessee, Texas, and Wisconsin,[85] thereby breaking the state law self-settled spendthrift trust link between the trust and the donor spouse.

4. However, in adopting these statutes, a matter that appears to have been overlooked is the transfer tax consequences of the donor's retained interest. While the lifetime QTIP Trust has a Treasury regulation supporting non-gross estate inclusion, the back-end SLAT interest has no such support. Accordingly, the issue of gross estate inclusion under Sections 2036 and/or 2038 continues to lurk.

5. One suggestion to mitigate arguments that the settlor has improperly retained an interest is to implement a back-end SLAT only in states that also have Domestic Asset Protection Trust ("DAPT") statutes in place.[86]

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[83] This section of the outline is paraphrased from language provided by and reproduced with the permission of George Karibjanian, Franklin Karibjanian & Law, PLLC. For more on this topic *see* George Karibjanian, *Exploring the "Back-End SLAT" – Mining Valuable Estate Planning Riches or Merely Mining Fool's Gold?* 47 TAX MGMT. ESTS., GIFTS & TRTS. J. NO. 6 (Nov. 10, 2022).

[84] *See* Fla. Stat . § 736.0505(3).

[85] This research and analysis was adopted from a presentation given by George Karibjanian, of Franklin Karibjanian & Law PLLC at the 2024 Delaware Trust Conference entitled, *Back-End SLATs, Estate Taxes and Asset Protection: The Perfect 2025 Planning Technique or Planning Fraught with Terror*, (Oct. 28, 2024). For more on this topic *see* George Karibjanian, Exploring the *Back-End SLAT" – Mining Valuable Estate Planning Riches or Merely Mining Fool's Gold?*, 47 TAX MGMT. ESTS., GIFTS & TRTS. J. NO. 6 (Nov. 10, 2022).

[86] *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S.C. Zeydel, *Supercharged Credit Shelter Trusts Versus Portability*, 29 Prob. & Prop. 10 (2014).

B. DAPTs and Springing DAPTs.

1. Currently, twenty-one states allow some version of self-settled DAPTs: Alabama, Alaska, Arkansas, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.[87] The state statutes and precedential case law do vary, so selection of the most desirable jurisdiction for a particular client will be important. The four states that are deemed to be hospitable to both Back-End SLATs and DAPTs are: Delaware, Mississippi, South Dakota, and Tennessee.

2. A DAPT is simply an irrevocable trust established by the settlor that also includes the settlor as a permissible beneficiary of the trust during their lifetime while including spendthrift protection for their creditors and designing the trust so that the trust assets would be excluded from the settlor's taxable estate. The trusts are designed to significantly limit any future distributions to the settlor by an independent trustee in their discretion, and typically only for health and support needs and after considering all available resources. At the time of establishing the DAPT in a jurisdiction that permits them, the settlor must sign an affidavit of solvency that they have sufficient assets outside the gift to the new trust to cover all anticipated future creditors and their anticipated support needs.

3. The DAPT option may be particularly appealing to a single client who doesn't yet have any descendants. The client might name parents, siblings, niblings, and any future spouse or descendants as beneficiaries. Accordingly, for a single client, a client with no children, and/or a client who isn't willing to bet on the future of their marriage, the client may want to set up a DAPT with the intention of locking in their exemption now, but to avoid permanently losing all access to the assets, could create a completed gift trust that is primarily for the benefit of descendants or other family members (including a spouse). This trust should be settled in one of the states that permits DAPTs. The client could be an initial beneficiary entitled to distributions pursuant to an ascertainable standard, such as health and support (as the goal would be for the client to get distributions in exceptional circumstances only). The settlor shouldn't be planning to actually need the trust assets at the trust inception and should complete an affidavit of solvency at the time the trust is created.

4. Additionally, when DAPTs are structured for estate planning purposes, rather than purely as asset protection vehicles, they are taxed as grantor trusts, conferring all of the same benefits as traditional grantor trusts discussed within this outline.[88]

5. As one alternative, rather than having the settlor named immediately as a permissible current beneficiary, it might be preferable to just empower an independent Trust Protector (serving in a non-fiduciary capacity) to later add the settlor to the class of beneficiaries subject to the ascertainable standard. This is referred to as a "springing DAPT." The springing DAPT is sometimes used when planning for couples with the goal of creating non-reciprocal trusts. So, if in the first instance, the trust is only for descendants, it could also permit a Trust Protector to later add in the settlor as a permissible beneficiary. It could also be a "springing SLAT" if it also permits the independent Trust Protector who is not a fiduciary to add the settlor's spouse as a beneficiary.

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[87] *See* Mark Merric & Daniel G. Worthington, *Best Situs for DAPTs in 2023*, Wealth Management (Dec. 19, 2022), available at https://www.wealthmanagement.com/estate-planning/best-situs-dapts-2023. *See also* Kim Kamin & Melisa Seyhun, *Introduction to Asset Protection and to Domestic Asset Protection Trusts*, Illinois Institute for Continuing Legal Education (Oct. 1, 2024).

[88] *See* Treas. Reg. § 25.2511-2;Rev. Rul. 2004-64. *See also* David G. Shaftel and David H. Bundy, *Domestic Asset Protection Trusts Created by Nonresident Settlors*, 1, 26-28 (2005).

6. Almost every client would like to gift property to a trust that isn't subject to estate tax and still retain the ability to benefit from that same trust. While DAPTs are intriguing because they offer this possibility, they haven't become a standard part of estate planning because the estate tax treatment remains unclear and highly fact-dependent. If there is an implied understanding that distributions would be made to the settlor/beneficiary as needed, the risk of estate tax inclusion under IRC Section 2036 is significant. Similarly, if a settlor/beneficiary's creditors can reach the trust assets, they would still be subject to estate tax in the grantor's estate. The effectiveness of a DAPT can vary greatly depending on the facts of a particular case.[89]

C. Special Power of Appointment Trust ("SPAT"). A SPAT is similar to the springing DAPT or springing SLAT in that it enables effective use of any remaining exemptions by allowing a settlor to gift assets to an irrevocable trust, with an appointer granted the power to distribute assets to a designated group of beneficiaries. SPATs offer flexibility by allowing the Appointer to appoint assets back to the grantor in the future, without making the grantor a direct beneficiary.[90] The SPAT also can permit addition of spouses, descendants or other family members who aren't designated in the original instrument as beneficiaries.

D. Use of Existing QTIPs for Gifting.[91]

1. When a spouse (or surviving spouse) has inadequate assets of their own to gift, assets in an existing lifetime or testamentary QTIP trust that will be included in that spouse's taxable estate may be highly desirable assets for the spouse to gift using their exemption.

2. That said, getting assets out of the marital trust could be challenging depending on the design of that trust because of IRC Section 2519. In the best-case scenario, there would be an independent trustee with authority to distribute or loan trust assets to the spouse to facilitate the gifting. Using sales from the trust or preferred partnerships is also possible to escape deemed gift tax liability for the beneficiary spouse.[92]

XII. Planning with Promissory Notes.

A. Gift By Promise.

1. If a client wishes to make a substantial gift but does not want to part with the assets immediately, they may wish to consider some variation of gifts by promise. This is an option for clients whose net worth is on an upward trajectory, but they're not yet at a point where they can afford to make such large gifts using their available assets. In other cases, clients have sufficient net worth, but a substantial portion of their balance sheet isn't transferable or is extremely difficult to value.

2. This technique was widely discussed in 2012 when it appeared the gift tax exemption would decrease from $5.12 million to $1 million, and again in 2020 in anticipation that the new

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[89] *See* Jonathan Blattmachr & Carlyn S. McCaffery, *The Estate Planning Tsunami of 2020*, Estate Planning Journal Nov. 2020 at 11.

[90] *See* Abigail O'Connor, Mitchell Gans and Jonathan Blattmachr, *SPATs: A Flexible Asset Protection Alternative to DAPTs*, 46 Estate Planning 3 (Feb. 1, 2019).

[91] For a discussion of this topic, s*ee* Christopher Siegle, *Time to Rethink the Typical Testamentary QTIP Trust*, Trusts & Estates Magazine, November 2023; James M. Kane, *Two Key 2022 Advantages for Inter-vivos QTIP Trusts vs. SLATs*, Steve Leimberg's Estate Planning Newsletter #2932, Jan. 12, 2022.

[92] *See* Christopher P. Siegle, *Time to Rethink the Typical Testamentary QTIP Trust?*, Trust and Estates, Nov. 2023, at 2.

administration would enact legislation that would decrease the gift tax exemption.[93] The fundamental idea is to make a legally binding promise to transfer wealth in the future. That creates an asset on the balance sheet of the trust (the gift receivable) and a debt on the balance sheet of the client (the obligation to make this transfer in the future).

3. For this planning to work, the debt must be legally binding. The mere promise to make a gift isn't a gift.[94] In contrast, a promissory note is a completed gift when it's legally binding and made for sufficient consideration.[95] As lawyers well know, consideration to make a contract legally binding can be as little as a mere peppercorn. To provide some level of substance, however, imagine a trust has $100,000. The trust and the settlor enter into a contract under which the settlor agrees to pay the trust $27 million within the next 9 years and further agrees to pay interest at the AFR each year on any unpaid amount. In exchange, the trust gives the settlor $100,000 today. Such an amount is far more than a peppercorn, and it seems likely a court would find this to be a legally binding contract, obligating the settlor to make the $27 million payment in due course. Under existing law, this should be a gift of $26,900,000.

4. Gifting a promise to gift isn't as attractive as it was in 2020. At that time so called anti-clawback regulations had been finalized that were intended to protect a taxpayer in case the gift tax exemption was to decrease after a gift was made.[96] In other words, the anti-clawback rules ensured if a taxpayer dies when the estate tax exemption is lower than the gift tax exemption was when the same taxpayer made a large gift, the taxpayer will receive the benefit of the larger exemption when calculating any estate tax liability. In April 2022, however, the IRS proposed an additional regulation to avoid what was perceived as an abuse.[97] Specifically, the proposed regulation is intended to deny anti-clawback treatment for "[t]ransfers made by enforceable promise to the extent they remain unsatisfied as of the date of death."[98]

5. Two important points to note on these proposed regulations. First, it has been several years since they were issued, and they have yet to be finalized. Second, even if they were finalized, the provision isn't relevant if the note is repaid at least eighteen months before the death of the taxpayer.[99]

6. In structuring this type of gift, consider the following best practices:

   a. An existing or new trust should be funded with some liquid assets, so its only asset isn't the note receivable.

   b. Further fund the trust by creating a promissory note from the grantor to the trust up to the balance of the grantor's exemption amount. Structure the promissory note as a term note

[93] For a more detailed discussion of the arguments in favor and against this idea, *see* Bramwell & Mullen, *Donative Promise Can Use Up Gift Tax Exemption*, Steve Leimberg's Estate Planning E-mail Newsletter #2001, Aug. 23, 2012; Bramwell, *The Gift-by-Promise Plan Works as Advertised*, Steve Leimberg's Estate Planning E-mail Newsletter # 2033, Dec. 3, 2012; Heyman, McCaffery & Schneider, *The Gift by Promise Plan SHOULD Work-At Least in Pennsylvania*, Steve Leimberg's Estate Planning E-mail Newsletter #2034, Dec. 4, 2012; 33 P.S. § 6 (a PA promissory note can be valid without consideration if the writing contains an express statement that the signer intends to be legally bound); Pennell and Baskies, *Final Words on Gift-by-Promise Technique*, Steve Leimberg's Estate Planning E-mail Newsletter #2036, Dec. 10, 2012.

[94] *See* Rev. Rul. 67-396.

[95] *See* Rev. Rul. 79-384; Rev. Rul. 84-25; *Comm'r v. Copley*, 41 AFTR 705 (7th Cir. 1952).

[96] *See* Treas. Reg. § 20.2010-1.

[97] *See* 87 Fed. Reg. 24,918 (4/27/2022).

[98] Prop. Treas. Reg. § 20.2010-1(c)(3)(i)(B).

[99] Prop. Treas. Reg. § 20.2010-1(c)(3)(i)(D).

or a demand note with a default due date (*e.g.*, 9-20 years). In all instances the date for repayment should be within client's life expectancy.

c. The note should bear interest at the AFR or higher.[100]

d. Have a security agreement to secure the note with the maker's assets.

e. Document that the note is binding because: (i) a relevant provision under applicable state law states as much; (ii) it's in exchange for non-financial consideration; and/or (iii) it's in exchange for financial consideration such as when the trustee of the trust pays for the promissory note. Consider having the payments be quarterly and having the trustee rely on and document their reliance on the note in some way (*e.g.*, in reliance on the note, I am making an investment in private equity and plan to use the note quarterly installment payments to pay capital calls).

f. Maker should have the right to prepay without penalty.

g. Maker should pay at least the interest each year and should pay down the principal of the note as soon as is practical.

B. Variations of Gifts by Promise.

1. Gift Followed by Swap. Gift an asset that is relatively easy to transfer (*e.g.*, cash, public securities moving between accounts at the same custodian, interests in an entity that isn't entitled to a discount and require a simple assignment form) to a grantor trust that has the power to substitute and to borrow. Then shortly thereafter (6 months, one year, three years), swap back the asset for a promissory note. Although it doesn't have to be, the Note should be at least at AFR and preferably secured. The goal is always to pay the note down as soon as possible. If there is a grantor trust power to substitute, but not to borrow without adequate security, then all notes must be adequately secured.

2. Swaps Followed by Gifts. If there is already a well-drafted grantor trust with assets in it, swap out those assets for a note. Although it doesn't have to be, the Note should be at AFR and secured, and the goal is always to pay the note down as soon as possible. Then the swapped-out assets are available to gift to a new grantor trust. (Or in some cases, settlors might even gift the same assets back into the same trust after some time has passed following the original swap.)

3. Gifts of Single Member LLC Interests Where Asset in LLC is a Note.

a. Client sets up Grantor Trust with seed gift of cash (*e.g.*, \$10k-\$100k). Trust can be a lifetime Family Trust (SLAT).

b. Client then sets up a single member LLC documenting all the non-tax reasons for doing so, and client contributes capital to the LLC, including a significant promissory note. Goal would be for the total value of the LLC to be the remaining exemption amount.

c. Neither client nor their spouse should be in control of that LLC, but the trustee could be the Manager.

d. Client gifts all their LLC interests to the trust (if gifting all of entity to trust, then may not need a qualified appraisal to determine the value of the LLC since the transfer won't be entitled to discounts).

[100] For further information on demand loans, *see* IRC § 7872(e)(2) and Table 6 published in July each year for the correct interest rate, available at https://resources.evans-legal.com/?p=516.

e. Pay down the note to the LLC as soon as is practicable.

4. Contribute an Existing Note from Spouse. For a trust that is just for descendants, Spouse A gives a promissory note to Spouse B, and then in the future Spouse B contributes the note to a grantor trust.

5. Promissory Notes in Multi-Member LLC. Form a new partnership/LLC that isn't a single member LLC where another person (*e.g.*, spouse) contributes property, and the grantor contributes the promissory note to the new entity in exchange for interests. Then the grantor gifts all their interests in the new entity to the grantor trust.

6. Commercial Loan with Swap. If client does have sufficient other assets like a home or art collection that can be used as security for a large commercial loan, borrow as much as possible from a third party, use that cash to fund the grantor trust. Then swap out the cash for a promissory note to the grantor trust and pay off the commercial loan.

7. Overpay for Purchase of Trust Assets. Grantor trust sells an asset to grantor in exchange for a promissory note, and grantor overpays for that asset by up to the exemption amount so that the excess of the payment over FMV is then reported as a gift, but the initial sale is consideration for the note. This would be the exact opposite of a sale to a grantor trust. Instead, it's a sale from a grantor trust and would follow all the usual formalities of such a sale.

C. Borrowing to Fund Gifts Also Creates Income Tax Benefits.

1. Successful people often understand the power of leverage and may be willing to take on debt to implement their chosen estate planning strategy.

2. Borrowing against the equity in a primary residence is a common strategy, and it can provide significant tax benefits. Specifically, interest paid on a mortgage for a primary or secondary residence may be deductible for those itemizing deductions on their annual income tax return. The deduction is available to the grantor of a grantor trust if the trust owns the residence. Current rules allow mortgage interest deductions on up to $750,000 ($375,000 if married filing separately) of loan debt secured by one primary and one secondary residence.[101] Mortgages taken out before December 16, 2017, have a higher mortgage interest deduction limit of $1 million ($500,000 if married filing separately), including refinancing of that debt, subject to specific requirements.[102] However, to qualify for the mortgage interest deduction, the loan proceeds must be used to purchase, build, or improve the residence. To claim the deduction, and offset some income tax, the taxpayers must be able to trace the loan proceeds to these qualifying uses. Moreover, assuming no other deductions are available to the taxpayer, the amount of the loan proceeds that can be traced to these qualifying uses must exceed the standard deduction ($29,200 for those married filing jointly and $14,600 for those married filing separately in tax year 2024) in order for the tax benefit to be significant.[103]

3. In addition to the mortgage interest deduction, another strategy involves using home equity for investments. If the proceeds from a home equity loan are used for investment purposes, such as purchasing marketable securities, the taxpayer has an unlimited investment interest

[101] *See generally Publication 936 Home Mortgage Interest Deduction*, IRS (2023), available at https://www.irs.gov/pub/irs-pdf/p936.pdf. TCJA lowered the threshold to $750,000, but it was scheduled to revert to $1 million after 2025. OBBBA extends the lower threshold—permanently.

[102] *Id.*

[103] *See* Kelly R. Taylor, *What's the 2024 Standard Deduction?*, Kiplinger (Oct. 1, 2024) (noting standard deduction limits).

deduction, which allows the interest to be deducted on the loan amount used for investments.[104] Furthermore, any unused portion of the investment interest deduction can be carried forward to future tax years. As a result, it's often possible to borrow money secured by a residence, gift those borrowed funds to a grantor trust, and deduct the interest associated with that loan as long as the trust invests those proceeds in marketable securities.[105]

D. Borrowing From Trusts.

1. Just because assets are in a trust doesn't mean they need to stay there. Borrowing assets from a trust may provide family members with the assets needed for additional gifting. It can also be a way to move future appreciation from a less tax advantaged trust to one that is more tax advantaged.

2. Trust assets can be loaned to a beneficiary, who could then use those borrowed assets to make their own gifts.

3. If the grantor is the income tax owner of two trusts, one completely GST exempt, and one that isn't completely GST exempt, perhaps a loan of the trust assets taken from the non-GST exempt trust in favor of the GST exempt trust could provide greater growth of the GST exempt trust. This would effectively freeze the value of the non-exempt trust.

4. In most situations both trusts are grantor trusts and have the same grantor, so there would be no income tax effect for this loan. If the trusts were non-grantor trusts there would be taxable income, but there could also be an offsetting deduction for the trust paying the interest.

E. Loan Suggestions. If the loan is trust to trust, the terms of the lending trust should provide that loans bear a reasonable interest and should be secured. A trustee will seek to ensure that the interest and security satisfies its fiduciary duty to invest the trust property and duties to the current and remainder beneficiaries. Interest must equal at least the AFR. With the AFR as the floor, perhaps a rate closer to a commercial rate used by banks would be more appropriate to ensure fiduciary duties are being respected. This could depend on whether the beneficiaries of the two trusts are identical. The security could be evidenced by a UCC-1 or other security agreement between the parties. The term of the loan should be limited to no longer than the life expectancy of the grantor.

XIII. Planning with Unused Gift Tax Exemption Only.

A. Overview. Some clients may have a mismatch resulting in more remaining gift exemption than remaining GST-exemption. This is particularly common when the client has made gifts to a GST-exempt pot trust that utilized Crummey withdrawal rights and annual exclusion for the gift tax, and then GST exemption was allocated to those gifts. For such clients, if the goal is utilizing their gift exemption now, they will have several options.

B. Loan Forgiveness or Gift for Loan Repayment. If the client is holding any mortgages or promissory notes from any non-skip persons, now would be an opportune time to simply forgive such loan(s) up to the available gift exemption. If the client has cash available, gifting cash to the individual(s) to pay off the loan might end up being simpler from a gift tax reporting perspective as gifting cash is always easier to report.

C. Outright Gifts to Children. For simplicity, this might be the time to just gift cash or other assets outright to children. Many clients worry that their children aren't getting adequate practice

[104] *See generally Form 4952 Investment Interest Expense Deduction*, IRS (2023), available at https://www.irs.gov/pub/irs-access/f4952_accessible.pdf.

[105] For more on this topic, *see* Benjamin A. Cohen-Kurzrock, Jeff Hopkins, Adam Ludman, & Tom McGraw, *Tax Aware Borrowing, Taking into Account Estate, Gift and Income Tax Considerations*, American Bar Association Real Property Trusts and Estates Section 35th Annual RPTE National CLE Conference.

managing their own assets. Making gifts outright and with no strings can be an ideal way for children to practice budgeting and investing. And for minor children, such gifts can be in UTMA accounts that they can access when they turn 21.

D. Gift to Non-Exempt Trust. If there is an existing non-exempt trust (such as the remainder from a GRAT or QPRT) assets could be added to that trust. Or a new non-exempt trust could be created to benefit one or more skip persons. These trusts can be particularly beneficial in order to plan for the assets to be available for the future support needs of parents, siblings, children or other non-skip persons.

E. New GRAT(s). There is no rule that a GRAT needs to be zeroed out. Using remaining exemption to fund a non-zeroed out GRAT with the remainder to be held in non-exempt trusts for children or other non-skip persons can potentially be a good way to leverage a client's remaining exemption.

F. New QPRT(s). Similarly, when clients look at their balance sheets for assets to gift, it's more common that a home or vacation home is the most likely asset. Gifting all or a portion of a personal residence into a QPRT can be an effective way to utilize only the client's remaining gift exemption to benefit non-skip beneficiaries.

XIV. Planning with Unused GST-Tax Exemption Only.

A. Overview. Some taxpayers will exhaust their lifetime gifting exemption, but still have unused GST exemption. This is a valuable tax attribute that should be fully used before the client's death.[106]

B. Allocate GST Exemption to Existing Non-Exempt Trust.

1. A client may create a GST non-exempt trust for many reasons. Perhaps the trust was created when the GST exemption was much smaller. Perhaps they engaged in GRAT planning that provides no leverage to the allocation of GST exemption. Whatever the reason, for clients with existing non-exempt trusts, consider allocating any remaining GST exemption to those trusts to take advantage of the increased exemption.

2. Pursuant to Treasury Regulation Section 26.2632-1(b)(4)(ii)(A)(1), while GST is normally allocated to a gift in trust on the gift tax return for the relevant year, a late allocation of GST exemption can be made after the due date. In other words, GST exemption can be allocated years after a trust was initially funded. The client must, however, allocate an amount of GST exemption equal to the value of the trust assets at the time the late gift tax return is filed.

3. For administrative convenience, the late allocation can use the value of trust assets as of the first day of the month. So, for example, if a gift tax return allocating GST to an existing trust is filed March 25th, the client can allocate GST based on the March 1st value of the trust.[107]

C. Modifying a Non-Exempt Trust.

1. A trust that wasn't originally designed to be GST exempt may be missing important provisions. For example, the trust as drafted may distribute all assets to non-skip persons as they reach certain ages instead of holding the assets in a continuing trust.

2. Alternatively, the trust may contain a testamentary general power of appointment which could be exercised over both exempt and non-exempt assets. Perhaps still, the trust may have a trustee successor system that is unsustainable for a dynastic trust. Regardless of the specific issues, if

[106] For a detailed review of the substantive rules associated with the Generation Skipping Transfer Tax, *see* M. Read Moore, *A Sequel Much Worse Than the Original: Planning for GST Tax on Nonexempt Trusts*, 54th Annual Heckerling Institute on Estate Planning. *See also* Julie Miraglia Kwon, *Beyond the Basics of GST Tax: Queries + Conundrums*, 55th Annual Heckerling Institute on Estate Planning.

[107] Treas. Reg. § 26.2642-2(a)(2).

a taxpayer makes a late allocation of GST exemption, it's common to modify the terms of the trust to better serve the family's long-term needs.

XV. Modifying an Irrevocable Trust.

A. Overview. There are several tools to modify an irrevocable trust, though some are viewed more favorably by the IRS than others. This outline has previously detailed the flexibility that can be achieved via Trust Protectors and Powers of Appointment. However, there are additional options available to modify an irrevocable trust. All options should be evaluated when deciding which approach is best suited to a client's particular situation.

B. Decanting. As the name implies, decanting refers to the act of distributing trust property from one irrevocable trust to another trust, under the trustee's discretionary authority to make distributions. An individual trustee with the power to distribute in trust for the benefit of beneficiaries in most (if not all) states should be authorized to engage in common law decanting by distributing the old trust into a new trust for the benefit of the same beneficiaries. Nonetheless, many trustees prefer to rely on statutory decanting. The state governing statute should indicate whether its provisions are mandatory or merely defaults for the decanting process.

1. Common Law Decanting.

a. Long before the term "trust decanting" went mainstream, trustees engaged in what is now described as decanting by simply exercising their discretion to distribute trust assets under a nonascertainable standard. Trustees would distribute the assets to a new trust for the benefit of all or a subset of the beneficiaries of the original trust.[108]

b. The earliest case law reference to a common law decanting power in the U.S. appears to have been in 1940 in *Phipps*, when the Florida Supreme Court determined that the terms of the trust that authorized the trustee to distribute trust property to one or more trust beneficiaries in their sole and absolute discretion also permitted the trustee to create a second trust for the benefit of the beneficiaries.[109]

c. Even as many states adopt decanting statutes, a trustee in a state without a decanting statute can still rely on common law trust decanting. For example, Massachusetts has adopted a version of the UTC but does not have a separate decanting statute. In *Morse*, the Supreme Judicial Court ruled that trustees may transfer trust assets to another trust without the approval of the beneficiaries where they have broad discretion to make distributions to the beneficiaries or for their benefit.[110] Importantly, the court also indicated that this may only work with older trusts, saying: "In light of the increased awareness, and indeed practice, of decanting, we expect that settlors in the future who wish to give trustees a decanting power will do so expressly. We will then consider whether failure to expressly grant this power suggests an intent to preclude decanting."

d. Also in Massachusetts, *Ferri* raised additional questions about decanting under the common law.[111] There, the court reiterated the *Morse* holding that a trustee of a Massachusetts irrevocable trust may be granted the power to decant through language in

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[108] Jeffrey D. Chadwick, A DECADE-PLUS OF TRUST DECANTING IN TEXAS, Estate Planning and Community Property Law Journal, Vol. 16:349 (2024).

[109] *See Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940); Lydia Lee Lockett and Peter Blumeyer, *Sour Grapes – When Decanting Gives Rise to Litigation*, American Bar Association, Real Property, Trust and Estate Law Section (September/October 2019).

[110] *Morse v. Kraft*, 466 Mass. 92 (2013).

[111] *Ferri v. Powell-Ferri*, 476 Mass. 651 (2017).

the governing instrument, even where there is no decanting statute. The decanting authority need not be granted expressly and may be inferred from the entirety of the powers given to the trustee by the settlor. Finally, *Ferri* held that the power to decant may be exercised to eliminate a presently exercisable right of withdrawal, which presents troubling tax consequences.[112]

e. *Ferri* took a step further and introduced the idea that a trustee who can decant under the trust has a duty to do so. The court stated that, in accordance with the dispositive provisions of the trust instrument, "the trustee could exercise [their] powers and obligations under the… Trust, including the duty to decant if the trustee deemed decanting to be in the beneficiary's best interest." *Ferri* highlights a critical distinction between common-law and statutory decanting. Many decanting statutes contain an express disclaimer that they don't create an affirmative duty to decant.[113] The same is true of the recently promulgated Uniform Trust Decanting Act. As some Massachusetts lawyers have flagged, *Ferri* appears to take a different approach and should be evaluated by advisors in Massachusetts and other common law decanting jurisdictions nationwide.[114]

f. The above suggests that drafting attorneys would be well-advised to both expressly permit an independent trustee to make distributions into a new trust for the benefit of some or all of the current trust beneficiaries, to enable them to add charitable beneficiaries (a common grantor trust power which can facilitate charitable giving from the trust when that is in the best interests of the beneficiaries), and to state that there is no fiduciary obligation to decant as was addressed in the Ferri case.

g. Please refer to Addendum B9 for sample language for decanting in the trust.

2. <u>Statutory Decanting</u>.

a. If the terms of a trust fail to provide for decanting in a state where there is statutory decanting, then to modify the trust, the trustee can utilize the statutory decanting.

b. There are now 36 states that have either adopted the Uniform Trust Decanting Act or enacted their own decanting statute. Thus, most jurisdictions will have statutory guidance.

c. The trust instrument can be explicit in permitting decanting, and it can potentially go further by waiving statutory requirements to notify contingent remaindermen or otherwise limit a beneficiary's right to object to the decanting to very specific causes.

d. Like actions taken by a Trust Protector, decanting should be used with caution if the goal is to remove trust beneficiaries. For example, in *Hodges*, the trustees were found to have breached a duty of impartiality when decanting a trust to eliminate certain beneficiaries.[115]

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[112] The tax consequences of *Ferri*, namely the gift, estate, income, and GST tax consequences, and the implications on Crummey rights were explored in depth by Kristin T. Abati and Renat V. Lumpau, *Common-Law Decanting of Trusts: Lessons From Massachusetts*, Estate Planning Journal, Oct 2017.

[113] *See, e.g.*, Del. Code Ann. tit. 12, § 3528(e) ("No trustee or adviser shall have a duty to exercise [the authority to decant] nor, absent willful misconduct, any liability to any person for failure to exercise such authority or failure to consider whether to exercise such authority."); N.H. Rev. Stat. Ann. § 564-B:4-418(o) ("A trustee does not have a duty to decant or an ongoing duty to consider whether to decant.").

[114] Kristin T. Abati and Renat V. Lumpau, *Common-Law Decanting of Trusts: Lessons From Massachusetts*, Estate Planning Journal, Oct 2017.

[115] *Hodges v. Johnson* 2017 WL 6347941 (N.H. 2017); For a more detailed discussion, *see* William P. LaPiana, *Balancing the Duty of Impartiality and Decanting to Eliminate an Interest*, Estate Planning Journal, March 2018.

e. Trust decanting can be used to remove a beneficiary's withdrawal right if it hasn't yet vested, and establish a supplemental needs trust.[116]

f. Modifying a trust that was irrevocable on September 25, 1985, can affect its status as a pre-enactment trust. There is no guidance on whether a modification could negatively impact the inclusion ratio of a trust that has had GST exemption allocated to it. Conservative planners tend to follow the guidance on pre-enactment trusts when deciding what modifications can be safely made to those trusts.

g. As touched on previously, a trust modification, including a decanting, can be considered a gift from the beneficiary. The scope of this issue isn't entirely clear. For example, if a trust is required to pay all income to the beneficiary, modifying the trust in a way that removes that mandatory income interest could be a gift of that interest.

h. At the drafting stage, including broad investment and administrative powers can minimize the need for decanting. This may involve a comprehensive list of investment and administrative powers, as well as incorporating all state statutory powers as they exist at the time of execution and at any time in the future during the trust's administration. For example, the introduction to the list of powers within the trust might say: "In addition to all powers now or hereafter granted by law regardless of the statutory effective date of the power, the trustee shall have the following powers with respect to each trust held under this instrument..." Since modern families often prefer to separate trustee functions, like assigning one trustee for trust administration and a second fiduciary as investment director, it's helpful to divide the administrative powers and investment powers into separate sections within the trust instrument.

C. <u>Trust Mergers</u>.

1. <u>Contemplating Merger in the Trust</u>.

a. Most well-drafted trust instruments will contain a provision granting the trustee authority to merge a trust created under the instrument with other trusts that are substantially similar or similar. Please refer to Addendum B10 for sample language enabling a trust merger.

b. Such provisions are beneficial when multiple trusts are created for the same family members with similar terms under the instrument and other governing instruments. (For example, the testamentary trusts under a married couple's revocable trusts and under their lifetime irrevocable gift trusts.) Maintaining multiple trusts for the same beneficiary can become inefficient, expensive, and confusing for the clients over time. By merging trusts, a trustee may achieve economies of scale in investments and administration.

c. Merger is also a valuable tool to address changed circumstances, advancements in the law, or improved drafting techniques. For example, an advisor may advise merging poorly drafted or outdated trusts into a more recent and better-drafted trust if the beneficial interests are not materially impacted and the trusts have substantially similar terms.[117]

d. When drafting a trust, it can be helpful to relax the standard for merger to similar instead of requiring trusts to be substantially similar. Alternatively, the trust might elaborate on

[116] *See, e.g.*, *Matter of Kroll*, 2016 N.Y. App. Div. LEXIS 6389 (2016), where New York Court held that a supplemental needs trust created through decanting before the beneficiary's right to trust assets vested was not required to have a payback provision.

[117] *See* Chad Baker, Merge Ahead: Combining Irrevocable Trusts, WealthManagement.com https://www.wealthmanagement.com/estate-planning/merge-ahead-combining-irrevocable-trusts?redirectToPayment=true.

what is needed for the trusts at issue to be eligible to merge. For example, the merger might require that the trust assets be held by the same trustee(s), for the same current and remainder beneficiaries, and be subject to the same distribution standards.

e. As with all provisions that contemplate future flexibility and modifications, it's best for the enabling provision to be in the instrument itself. However, if the instrument is silent, it's almost certain that the governing state statute would permit mergers. Historically, state merger statutes did not require any specific notice to beneficiaries or beneficiary approval, but this has started to change under the UTC.

2. UTC Rule and Comments about Merger.

a. States that have adopted some version of the UTC likely have a provision that authorizes a trustee: "after notice to the qualified beneficiaries, [to] combine two or more trusts into a single trust … if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust."

b. The official comment to UTC Section 417 states that the rule is subject to contrary provisions in the trust and clarifies that the two trusts need not have identical terms. However, the comment cautions that "the more the dispositive provisions of the trusts to be combined differ from each other, the more likely it's that a combination would impair some beneficiary's interest and be less likely to be approved."

c. The UTC does not require trust mergers to be approved by a court or the beneficiaries, though some states have modified their laws to require as much.[118] The comment to UTC Section 417 nonetheless suggests that a trustee should consider obtaining beneficiary consent or court approval if the terms of the two trusts are not substantially similar or if there may be discontent among the beneficiaries.

D. Nonjudicial Settlement Agreements ("NJSA").

1. Power of an NJSA.

a. The binding NJSA is a powerful tool for amending or repairing irrevocable trusts. An NJSA is an agreement among interested persons to make alterations to an irrevocable trust. Interested persons are generally defined as any person whose consent would be required to achieve a binding settlement were the settlement to be approved by the court.

b. Depending on state law provisions, the trust terms that an NJSA may modify are limited only by the restriction that the modification may not violate any material purpose of the trust and would be approved by a court if reviewed.

c. All NJSA statutes are not created equal. Not only do trust code provisions vary from state to state, but also so do courts' willingness to take an expansive view of the permissible subject matter and the intent of the agreement.

d. Because most trusts have or potentially will have minor, incapacitated, or unborn beneficiaries, state law must also have rules for allowing certain persons to represent such beneficiaries to make NJSAs a practical way to modify trusts. These are known as virtual representation statutes.

[118] Six states allow mergers only with some level of court intervention, namely: (1) California; (2) Colorado; (3) Georgia; (4) Maryland; (5) Montana; and (6) Rhode Island. *See* Todd A. Flubacher, Trust Merger: What's Good for the Goose is Good for the Gander, Delaware Banker (Spring 2013).

2. Virtual Representation.

   a. Virtual representation clauses should be included in a trust to allow a trustee or personal representative to act on behalf of certain beneficiaries who are not present or are unable to participate in the decision-making process. This clause enables the representative to represent the interests of beneficiaries who may be minors, incapacitated, or otherwise unable to be involved in the administration of the trust.

   b. The clause should provide that a trustee or an appointed representative (like the Primary Beneficiary) may make decisions for these beneficiaries based on the interests of those beneficiaries as if they were present. This can streamline the administration process and avoid complications that might arise if each beneficiary needed to be consulted individually.

   c. All states, except for California, Louisiana, and Oklahoma, have adopted some versions of a virtual representation statute. Of the states that do have virtual representation statutes, nearly all expressly permit NJSAs and/or have separate NJSA statutes—the outliers being Rhode Island, Indiana, Hawaii, Colorado, and Alaska.[119]

3. GST Tax Considerations.

   a. Some private letter rulings have sought confirmation of the GST tax consequences of an NJSA. In PLR 201025026, an NJSA modified four irrevocable trusts to add a trustee power to merge trusts. There, the IRS stated that at a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of distributions to the highest generation individual having an interest in a direct skip trust. In PLR 201032026, the NJSA divided a testamentary trust into separate continuing trusts for grandchildren and great-grandchildren and the IRS held that the division (i) did not result in a shift of any beneficial interest to any beneficiary who occupies a generation lower than the persons holding the beneficial interests prior to the division and (ii) did not extend the time for vesting of any beneficial interest in the new trusts beyond the period provided for under the original trust.

   b. GST tax is a risk from a "nonjudicial reformation [of a GST exempt trust] that is valid under applicable state law."[120] Taxation would occur when the modification shifts "a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in [IRC Section 2651]) than the person or persons who held the beneficial interest prior to the modification, and . . . extend[s] the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust."[121]

4. Gift Tax Considerations. Gift tax can be imposed on certain NJSA settlements. PLR 201530008 involved a settlement agreement between trustees and beneficiaries concerning income and principal distributions from a testamentary trust and the construction of the phrase "by right of representation." The IRS stated that an agreement settling a dispute "is effective for gift tax purposes [when] the settlement is based on a valid enforceable claim asserted by the parties

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[119] Susan T. Bart, Virtual Representation Statutes Chart, chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.afslaw.com/sites/default/files/2022-05/Virtual-Representation-Statues-Chart.pdf.

[120] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1).

[121] Linda Kotis, *Nonjudicial Settlement Agreements: Your Irrevocable Trust Is Not Set in Stone*, American Bar Association Real Property, Trust, and Estate Law Section (March 1, 2017) https://www.americanbar.org/groups/real_property_trust_estate/resources/probate-property/2016-2022/nonjudicial-settlement-agreements/?login.

and, to the extent feasible, produces an economically fair result." To determine the legitimacy of each party's claim, state law must be examined. The settlement must either reflect the result that would apply under state law or otherwise be justifiable because of the uncertainty of the outcome of potential litigation. In this case, the IRS ruled that the issues were bona fide and based on valid enforceable claims by the interested parties. The settlement agreement to terminate the trust and divide it into two subtrusts with a *per stirpes* distribution of trust assets among the descendants was reflective of the parties' rights under applicable state law. The IRS concluded that the terms of the settlement agreement would not cause a gift.[122]

5. Income Tax Considerations. Using an NJSA to define a method of determining trust income may cause a gain recognition event for purposes of IRC Section 1001[123] states that a switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding NJSA) may constitute a recognition event to the trust or its beneficiaries… and may result in taxable gifts from the trust's settlor and beneficiaries, based on the relevant facts and circumstances.

E. Trust and Estate Dispute Resolution Act ("TEDRA").

1. A couple of states have adopted a version of an NSJA statute that has been hailed for its flexibility in permitting future modifications beyond what is currently permitted by other mechanisms.

2. Currently, TEDRA in its full form has been adopted only by two states (Washington and Idaho), and some practitioners have accused TEDRA of going too far. In the menu of trust modification options, TEDRA is thought of as the nuclear option.

3. In the state of Washington, TEDRA was enacted in 1999 and sets out special accelerated procedures and rules to handle such disputes, with a focus on faster court processes, alternate dispute resolution, and modified rules for attorneys' fees. [124] TEDRA applies to essentially any matter involving a trust or estate and the parties thereof. This is intentionally broad to capture as many actions as possible. Though the court retains "full power and authority"[125] to step in on disputes, *Kordon*, held that TEDRA "shall not supersede, but shall supplement, [the court]."[126] TEDRA's NJSA procedures can be invoked at any time by fiduciaries, beneficiaries and/or other interested parties who agree to resolve an issue that could be (but isn't necessarily) contentious. TEDRA's NJSA provisions can be used, for example, to modify an obsolete trust provision, to terminate a trust early, to agree to a methodology for characterizing property in an estate as separate or community, to create a mechanism for resolving future disputes, or to change or add fiduciaries. Almost anything that could be the subject of a petition under TEDRA can be the subject of a TEDRA NJSA.

4. Idaho's version of TEDRA, enacted in 2005, was modeled after the Washington statute and contains almost all of the substantive provisions.[127] There are, however, some significant differences as well. Absent from Idaho's version are the procedural rules for jurisdiction, venue, statutes of limitation, and discovery. Instead, the Idaho TEDRA applies the Idaho rules of civil procedure to all proceedings, which means that the process for initiating a TEDRA proceeding in Idaho is akin to filing any other civil action and somewhat more complex than

[122] *Id*.

[123] *See* Treas. Reg. § 1.643(b)-1.

[124] RCW 11.96A.010-902.

[125] *In re Estate of Black*, 116 Wash. App. 476, 483, 66 P.3d 67 (2003).

[126] *In re Estate of Kordon*, 157 Wash. 2d 206, 212, 137 P.3d 16 (2006).

[127] See Trust and Estate Dispute Resolution Act, supra.

the simplified Washington rules.[128] Additionally, Idaho's statute does not have the express mediation and arbitration provisions found in the Washington statute.

5. As one practitioner has noted, TEDRA can grant a determined and aligned set of beneficiaries the power to make any change whatsoever to an irrevocable trust that they feel is desirable or necessary, which is a step beyond the flexibility to fix antiquated or obsolete terms of a trust.[129] Beneficiaries can relax rules or eliminate restrictions without regard for the material purpose of the trust or the settlor's original dispositive desires.[130]

F. Drafting to Prohibit Modifications. While the trend for several decades has been to develop new tools that permit the modification of trusts, that does not always fit with the goals of a particular client. There may be one or more aspects of a trust that a client wants to ensure remain sacrosanct, even if other provisions are modified to adapt to changing circumstances. To achieve this goal, there are two fundamental approaches a draftsperson can take to (i) focus on specific powers or (ii) identify material purposes. These approaches are not mutually exclusive.

1. With regard to specific powers, the drafting attorney should consider the existing tools and potential future tools that can be used to modify a trust. As noted above, these powers could be based on the trust instrument, common law, or governing statute (including statutes of other states). While a complete prohibition on future modifications is too ill-advised to take seriously, the power to modify could be limited in scope or exercisable only with the notice to and/or consent of the appropriate parties.

2. For example, a trust could specifically prohibit modification that would eliminate the requirement for an independent co-trustee. If that is also too restrictive, perhaps the trust instrument prohibits modification that would eliminate the requirement for a corporate or other independent trustee, unless such modification is approved by all trust beneficiaries and some percentage of the settlor's descendants who are not beneficiaries of the particular trust in question. As you can see each of these options limits the use of NJSAs to various degrees. The goal would be to identify the approach best suited to the concerns of the particular client.

3. The challenges of focusing on specific powers include (i) the need to carefully consider a wide range of powers and circumstances, and (ii) the fact that creative future lawyers will be tasked with finding ways to achieve their clients' goals even if those goals conflict with the clear spirit of the current work. These lawyers might argue that a new statute falls outside the scope of the drafted prohibitions, or they might interpret the trust language as ambiguous or sufficiently narrow that they can use option G even if options A-F are clearly forbidden. Identifying the material purposes of the trust within the trust instrument can be helpful in these situations.

4. Throughout the UTC, it's specifically stated that a power cannot be exercised to thwart a material purpose of a trust.[131] The concept of a material purpose, however, long predates the UTC, with many pointing to the 1889 Massachusetts case of *Claflin*. In *Claflin*, the court held the provisions of a will delaying a son's inheritance until he reached certain ages were valid because the purposes of the trust created under that Will had not yet been accomplished.[132]

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[128] Idaho Code § 15-8-203.

[129] Charles A. Redd, *Flexibility vs. Certainty—Has the Pendulum Swung Too Far?*, ACTEC 2019 Annual Meeting.

[130] *Id*.

[131] *See e.g.*, UTC §§ 111(c), 411(b), and 706(b)(4). Also see the comments to § 4 of the Uniform Trust Decanting Act, "An exercise of the decanting power must be in accordance with the purposes of the first trust. The purpose of decanting is not to disregard the settlor's intent but to modify the trust to better effectuate the settlor's broader purposes or the settlor's probable intent if the settlor had anticipated the circumstances in place at the time of the decanting."

[132] *Claflin v. Claflin*, 149 Mass. 19 (1889).

5. By identifying one or more material purposes in a trust, it will be harder for a future trustee or beneficiary to take any action that adversely impacts that material purpose, regardless of what specific action that might be.

6. For many clients, the material purpose might simply be to avoid unnecessary transfer taxes at each generation and to provide asset protection from beneficiaries' creditors. But the material purpose could be broader as well.

7. For example, suppose you have a client who wants to ensure trust assets are preserved for future generations by prohibiting annual distributions beyond 5% of trust assets. Consider a paragraph that says something like, "*Preserving assets to be available to provide for the health, education and support of future generations is a material purpose of the formation and funding of this trust. Limiting distributions of trust property to no more than 5% of trust assets each year is a critical aspect of achieving this material purpose. As a result, each trustee, trust advisor, trust protector, beneficiary, or other party associated with this trust in any way is strictly prohibited from taking any action that would, whether directly or indirectly, result in a distribution of trust property in excess of 5% of trust assets each year or would in any other way reduce the likelihood of achieving the material purpose of this trust while any descendant of mine is alive.*"

XVI. <u>Other Important Tax Updates Under OBBBA</u>.

A. <u>Overview</u>. OBBBA made many significant updates to the tax code beyond its impact on the transfer tax exemption levels. The following highlights some of the provisions of OBBBA that affect estate planning attorneys and our clients. This list isn't intended to be exhaustive.

1. <u>Tax Rates</u>. OBBBA permanently preserves the lower ordinary income tax rates and adjusted bracket widths from the TCJA and provides a minor inflation adjustment for income subject to the 10% and 12% brackets, which cuts taxes slightly for income in these brackets. The top tax rate will remain at 37% in 2026.

2. <u>Itemized Deductions</u>. OBBBA preserves the standard deduction, which was scheduled to be cut in half, and increases it slightly to $15,750 for single filers and $31,500 for joint filers in 2025, indexed to inflation annually moving forward.

3. <u>SALT Deduction</u>. OBBBA temporarily provides a more generous deduction cap for state and local taxes ("SALT"), increasing the cap from $10,000 to $40,000 from 2025 to 2029. The more generous SALT deduction cap is paired with an income limit starting at $500,000, which phases out the more generous deduction back down to $10,000 for taxpayers with incomes over $600,000. The deduction value and the income limit will increase by 1% each year through 2029. Starting in 2030, the SALT deduction cap will revert to its prior law value of $10,000 for all filers ($5,000 for those married filing separately) permanently.

4. <u>Charitable Donations of Cash</u>. OBBBA makes permanent part of the TCJA that limits cash donations to 60% of adjusted gross income (AGI) to public charities. A 0.5% floor on charitable deductions for individuals permits them to claim itemized deductions before the typical AGI limits of contributions to a public charity of 60% of AGI for cash, or 30% of AGI for appreciated assets. The OBBBA also includes a set of ordering rules that specify which type of contributions are reduced first by the 0.5% AGI floor.

5. <u>199A Qualified Business Income</u>. OBBBA extends and makes permanent the Section 199A pass-through deduction, which allows pass-through business owners to deduct 20% of qualified business income when calculating taxable income. The law also provides a $400 minimum deduction for taxpayers with $1,000 or more of active qualified business income.

6. <u>Qualified Opportunity Zones</u>. OBBBA made a series of changes to the rules governing qualified opportunity zones ("QOZ"). For investments made after December 31, 2026, gains

deferred through investment in the QOZ program will now be recognized on the fifth anniversary of the investment date (unless there is an earlier sale or exchange), rather than a fixed date. It also makes permanent a 10% basis step-up benefit, which takes effect immediately before the end of the five-year deferral period. The law tightens the rules under which census tracks can qualify as QOZs and creates the new, more beneficial fund category of Qualified Rural Opportunity Fund ("QROF"), providing investors in rural communities with additional tax benefits. The new law eliminates the sunset provision terminating Qualified Opportunity Funds ("QOF") investments liquidated after December 31, 2047, and establishes instead a 30-year rolling horizon on gain elimination with respect to post-10-year dispositions of QOF investments. For investments sold or exchanged before 30 years, the step-up will reflect the fair market value of that investment as of the date such investment is sold or exchanged. In contrast, for investments held 30 years or more, the basis step-up will be frozen at the fair market value on the 30th anniversary of the investment.

7. Use of 529 Accounts. OBBBA introduces several changes to 529 education savings plans, including increasing the annual limit for using 529 plan assets for K-12 expenses from $10,000 to $20,000 starting in 2026 and expanding the definition of qualified expenses to include expenses for postsecondary credentialing—such as tuition, fees, books, and supplies required for recognized postsecondary credential programs.

8. Trump Accounts. OBBBA created a new savings account for children, allowing parents and others to contribute up to a combined $5,000 yearly (adjusted for inflation starting in 2027) for the child to use after turning 18 years old. The accounts include a $1,000 deposit made by the federal government for children born in 2025 through 2028. Employers are also allowed to contribute up to $2,500 tax-free to employee accounts. The account grows tax-deferred until account owners make withdrawals, which can only start at age 18, and the account at that point essentially follows the rules in place for individual retirement accounts.

9. Changes to Controlled Foreign Corporations ("CFCs"). OBBBA largely restores the pre-TCJA prohibition on downward attribution but applies CFC-like inclusions to a newly defined class of US shareholders, referred to as foreign-controlled US shareholders. Foreign-controlled US shareholders are US shareholders that are deemed to own more than 50% of a foreign corporation other than a CFC (such foreign corporation is referred to as a "foreign-controlled foreign corporation"). Foreign-controlled US shareholders must include their pro rata share of such foreign-controlled foreign corporation's GILTI and subpart F income. This significantly narrows the scope of inclusion shareholders that must include their pro rata share of a CFC's GILTI and subpart F income due to downward attribution.[133]

10. The Global Intangible Low-Taxed Income Regime. The law restructures the tax on global intangible low-taxed income (GILTI) and the deduction for foreign-derived intangible income (FDII) by repealing the deduction for qualified business asset investment (QBAI). GILTI is now known as Net CFC Tested Income (NCTI). OBBBA reduced the Section 250 deduction to 40% (down from 50%), eliminated the 10% deemed return on Qualified Business Asset Investment, and improved foreign tax credit treatment. These shifts effectively raise taxes on physical capital deployed abroad by US firms, while lowering taxes on capital in the US used for exports.[134]

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[133] Julia Ushakova-Stein, *et. al.*, How the OBBBA's International Tax Rule Changes Impact MNEs, Tax Management International Journal, 7/21/2025.

[134] Matthew L. Roberts, *OBBBA Revises Existing GILTI Tax Rules For U.S. Shareholders Of CFCs*, Forbes (July 22, 2025) https://www.forbes.com/sites/matthewroberts/2025/07/22/obbba-revises-existing-gilti-tax-rules-for-us-shareholders-of-cfcs/.

XVII. Conclusion.

A. Estate Planning and Uncertainty. Estate planning is inherently uncertain, as family circumstances, asset values, and future tax laws are subject to change. The key is to acknowledge this and plan accordingly.

B. Legislative Changes and Strategic Planning. Though OBBBA has indefinitely increased exemption amounts and removed the urgency of year-end gifting, future legislative changes could still impact transfer tax rules, and strategic planning continues to be necessary.

C. Balancing Present and Future Needs. Thoughtful planning should balance current opportunities with long-term needs, considering each client's financial capacity, family structure, and goals for wealth transfer. Avoid rushed decisions that may limit future options.

D. Drafting Best Practices. Drafting trusts with flexible provisions can enable families to adapt to changing circumstances, including divorce, shifts in beneficiary needs, and updates to tax law.

E. Structural Optionality in Trusts. Advanced trust structures can offer increased optionality, allowing for continued access, tax benefits, and asset protection, but they must be carefully drafted to avoid unintended tax consequences.

F. Tools for Trust Modification. Modification tools like decanting, trust mergers, and NJSAs provide pathways to update irrevocable trusts, but planners must be mindful of IRS scrutiny and state law requirements.

G. Importance of Documentation. Ongoing documentation and record-keeping are critical for tracking exemption usage, prior gifts, and changes in trust instruments to avoid costly mistakes.

H. Embracing Flexibility in Estate Planning. Ultimately, the best estate plans are those that embrace flexibility, anticipate change, and empower clients and their fiduciaries to make informed decisions as circumstances evolve.

XVIII. Addenda.

A. Historical Federal Transfer Tax Facts

B. Sample Trust Language

1. Sample Distribution Standards
2. Sample Power of Appointment Provisions
3. Sample Power to Create Testamentary General Power of Appointment
4. Sample Fiduciary Appointment Provisions and Divided Trustee Structure
5. Sample Change of Situs and Governing Law
6. Sample Trust Protector Enabling Language
7. Sample Grantor Trust Powers
8. Sample Grantor Trust Reimbursement Provisions
9. Sample Decanting Permission with Limited Notice
10. Sample Trust Merger

Addendum A: Historical Federal Transfer Tax Facts

Year	Estate Tax Exemption	Top Estate Tax Rate	Gift Tax Exemption	Top Gift Tax Rate	GST Exemption	Top GST Rate	Annual Exclusion
1979	$147,000	70%	$147,000	70%	N/A	N/A	$3,000
1980	$161,000	70%	$161,000	70%	N/A	N/A	$3,000
1981	$175,000	70%	$175,000	70%	N/A	N/A	$3,000
1982	$225,000	65%	$225,000	65%	N/A	N/A	$10,000
1983	$275,000	60%	$275,000	60%	N/A	N/A	$10,000
1984	$325,000	55%	$325,000	55%	N/A	N/A	$10,000
1985	$400,000	55%	$400,000	55%	See Note[*]	N/A	$10,000
1986	$500,000	55%	$500,000	55%	$1,000,000	55%	$10,000
1987-1997	$600,000	55%	$600,000	55%	$1,000,000	55%	$10,000
1998	$625,000	55%	$625,000	55%	$1,000,000	55%	$10,000
1999	$650,000	55%	$650,000	55%	$1,010,000	55%	$10,000
2000	$675,000	55%	$675,000	55%	$1,030,000	55%	$10,000
2001	$675,000	55%	$675,000	55%	$1,060,000	55%	$10,000
2002	$1,000,000	50%	$1,000,000	50%	$1,100,000	50%	$11,000
2003	$1,000,000	49%	$1,000,000	49%	$1,120,000	49%	$11,000
2004	$1,500,000	48%	$1,000,000	48%	$1,500,000	48%	$11,000
2005	$1,500,000	47%	$1,000,000	47%	$1,500,000	47%	$11,000
2006	$2,000,000	46%	$1,000,000	46%	$2,000,000	46%	$12,000
2007	$2,000,000	45%	$1,000,000	45%	$2,000,000	45%	$12,000
2008	$2,000,000	45%	$1,000,000	45%	$2,000,000	45%	$12,000
2009	$3,500,000	45%	$1,000,000	45%	$3,500,000	45%	$13,000
2010[×]	$0 or $5,000,000	0% or 35%	$1,000,000	35%	No GST tax	0%	$13,000
2011	$5,000,000	35%	$5,000,000	35%	$5,000,000	35%	$13,000
2012[≡]	$5,120,000	35%	$5,120,000	35%	$5,120,000	35%	$13,000
2013	$5,250,000	40%	$5,250,000	40%	$5,250,000	40%	$14,000
2014	$5,340,000	40%	$5,340,000	40%	$5,340,000	40%	$14,000
2015	$5,430,000	40%	$5,430,000	40%	$5,430,000	40%	$14,000
2016	$5,450,000	40%	$5,450,000	40%	$5,450,000	40%	$14,000
2017	$5,490,000	40%	$5,490,000	40%	$5,490,000	40%	$14,000
2018[∨]	$11,180,000	40%	$11,180,000	40%	$11,180,000	40%	$15,000
2019	$11,400,000	40%	$11,400,000	40%	$11,400,000	40%	$15,000
2020	$11,580,000	40%	$11,580,000	40%	$11,580,000	40%	$15,000
2021	$11,700,000	40%	$11,700,000	40%	$11,700,000	40%	$15,000
2022	$12,060,000	40%	$12,060,000	40%	$12,060,000	40%	$16,000
2023	$12,920,000	40%	$12,920,000	40%	$12,920,000	40%	$17,000
2024	$13,610,000	40%	$13,610,000	40%	$13,610,000	40%	$18,000
2025	$13,990,000	40%	$13,990,000	40%	$13,990,000	40%	$19,000
2026**	$15,000,000	40%	$15,000,000	40%	$15,000,000	40%	TBD

[*] The GST tax became effective for transfers after September 25, 1985, with a $1,000,000 exemption.

[×] Estates of decedents who died in 2010 had the choice to use the $5,000,000 estate exemption/35% estate tax rate or $0 estate tax exemption/0% estate tax rate coupled with the use of the modified carryover basis rules.

[≡] The American Taxpayer Relief Act of 2012 (ATRA) provided that the estate tax exemption, lifetime gift tax exemption, and GST exemption would be indexed for inflation from 2011 starting in 2012 and future years.

[∨] The Tax Cuts and Jobs Act of 2017 doubled exemptions and changed inflation adjustments from the traditional Consumer Price Index (CPI) to the Chained Consumer Price Index (C-CPI).

** The One Big Beautiful Bill Act increased exemptions to $15,000,000 beginning in 2026 to be indexed for inflation in future years. The annual exclusion amount for 2026 has yet to be announced.

Addendum B1: Sample Distribution Standards

1. For Family Trust or Other Spousal Lifetime Access Trust

   The trustee shall distribute to any one or more of my spouse and my descendants living at the time of the distribution as much of the net income and principal of the trust, even to the extent of exhausting principal, as the trustee determines from time to time to be required for their respective health, support, and education, and as the independent trustee, if any, believes to be desirable from time to time for their respective best interests; provided, however, that: (1) the trustee shall add any undistributed net income to principal from time to time, as the trustee determines; (2) my primary concern during the life of my spouse is for the health and support of my spouse, and the trustee shall not make a distribution to any other beneficiary under this paragraph if the trustee believes it may jeopardize the trustee's ability to make such distributions to my spouse in the future; (3) to the extent that the trustee believes it advisable, the trustee shall not distribute principal of the Family Trust to my spouse as long as any principal remains in the Marital Trust; (4) no distribution made under this paragraph to a descendant of mine shall be charged as an advancement; and (5) the trustee may make unequal distributions to the beneficiaries or may at any time make a distribution to fewer than all of them, and shall have no duty to equalize those distributions. The term "trustee" and any pronoun referring to that term designate the trustee or trustees at any time acting hereunder, regardless of number or gender, and the term "independent trustee" means a trustee who is not a beneficiary of the trust or a related or subordinate party, as defined in Section 672(c) of the Code, with respect to any beneficiary of the trust. The term "trustee" includes the term "independent trustee."

2. For Child's Trust

   If the child for whom the trust is named is living on the division date, then commencing as of the division date and during the life of that child, the trustee shall distribute to the child as much of the net income and principal, even to the extent of exhausting principal, as the trustee in the trustee's sole and absolute discretion believes to be desirable for the best interests of the child, without regard to the interest of any other beneficiary; provided, however, that if the trustee is not an independent trustee, then the distributions shall be limited to those that the trustee determines to be required for the health, support and education of the child. The trustee shall add any undistributed net income to principal from time to time, as the trustee determines.

Addendum B2: Sample Powers of Appointment Provisions

1. Granting Broad Special Lifetime and Testamentary Powers of Appointment

   If the primary beneficiary is living on the creation of the trust, then at such time at or after the date of the creation of the trust as the primary beneficiary has reached the age of [30] years, the trustee shall also distribute to any one or more persons or organizations as much or all of the principal of the trust as the primary beneficiary may appoint either by will or from time to time by signed instruments delivered to the trustee during the primary beneficiary's life, which instruments shall specify whether such appointment is to be effective immediately, upon the primary beneficiary's death, or at some other time and shall be irrevocable unless made revocable by their terms. Notwithstanding the foregoing, the primary beneficiary shall not have the power (i) to appoint any principal under this paragraph to the primary beneficiary, the primary beneficiary's estate, or the creditors of either, or (ii) to satisfy any legal obligation of the primary beneficiary, including any obligation to support or educate any person.

2. Method of Exercise of Powers of Appointment

   The trustee shall distribute any trust principal or net income as to which a power of appointment is exercised to the designated appointee or appointees (whether living at the time of exercise or thereafter born) upon such conditions and estates, in such manner (in trust or otherwise), with such powers, in such amounts or proportions, and at such time or times (but not beyond the period permitted by any applicable rule of law relating to perpetuities) as the holder of the power may specify in the will, revocable trust or other instrument exercising the power. To be effective, the exercise of any power of appointment granted hereunder shall make specific reference to the provision creating the power. The donee of a power of appointment granted hereunder may provide that if no descendant of mine is living, then the property subject to that power may be distributed to one or more beneficiaries other than those set forth in the [Contingent Ultimate Disposition Provisions] of this instrument (excluding the donee, the donee's estate and the creditors of either) without violating the terms of that power. In determining whether a testamentary power of appointment has been exercised by will, the trustee, without liability (unless there is proof of bad faith), may rely on a will believed by the trustee to be the will of the holder of the power of appointment, or assume that the holder left no will in the absence of actual knowledge of one within three months after the holder's death. The trustee shall not require that any will purporting to exercise a power be admitted to probate.

Addendum B3: Power to Create Testamentary General Power of Appointment.

An independent trustee is authorized in its sole discretion with respect to all or any part of the principal of any trust created hereunder, by an instrument in writing, to: (i) create in a beneficiary a testamentary general power of appointment within the meaning of Section 2041 of the Code (including a power the exercise of which requires the consent of some other person other than any beneficiary or trustee); (ii) limit a testamentary general power of appointment created under this paragraph, as to all or part of such principal at any time prior to the death of such beneficiary by narrowing the class to whom such beneficiary may appoint the property subject to such appointment, so as to convert such power into a special power of appointment; (iii) eliminate such power for all or any part of such principal as to which such power was previously created at any time prior to the death of such beneficiary; (iv) irrevocably release the right to limit or eliminate such power with respect to such trust; and (v) divide such beneficiary's share of such trust principal into two fractional shares based upon the portion of such beneficiary's share of such trust that would be then includable in the gross estate of such beneficiary holding such power if they died immediately before such division (in which case the power shall be over the entire principal of one share which has an inclusion ratio of one and over no part of the other share which has an inclusion ratio of zero), including through effecting a qualified severance (as defined in Section 2642(a)(3) of the Code), and each such share shall be administered as a separate trust unless the trustee, in the trustee's sole discretion, thereafter directs the trustee of the trusts to combine such separate trusts into a single trust which the trustee is hereby authorized to do.

In granting such power to the independent trustee, it is my desire, which is not binding on the independent trustee, that a testamentary general power of appointment be created when the independent trustee believes the inclusion of the property subject thereto in the beneficiary's gross estate may achieve a significant savings in income taxes by subjecting such assets to an estate tax.

I hereby direct that the independent trustee's decisions under this Article shall be absolutely binding on all beneficiaries of the trust and of the estates of all such beneficiaries and that the independent trustee shall incur no liability by reason of any adverse consequences of such decisions to any beneficiary.

Addendum B4: Sample Fiduciary Appointment Provisions and Divided Trustee Structure

1. Fiduciary Appointer Provisions

   The Fiduciary Appointer may appoint any one or more Qualified Appointees as additional or successor trustees, Fiduciary Appointers, Fiduciary Removers, Investment Directors, Distribution Directors, and Designated Representatives. Any appointment of an additional or successor fiduciary hereunder shall be in writing, may be made to become effective at any time or upon any event, may be for a specified period or indefinitely, may be for limited or general purposes and responsibilities, and may be single, joint or successive, all as specified in the instrument of appointment. The Fiduciary Appointer acting from time to time may revoke any such appointment made by that Fiduciary Appointer before it is accepted by the appointee, may revoke or supersede an appointment by a previous Fiduciary Appointer that has not been accepted by the appointee unless the previous Fiduciary Appointer's instrument of appointment specifies otherwise, and may supersede the appointments otherwise made in this Article. If two or more instruments of appointment or revocation by the same Fiduciary Appointer exist and are inconsistent, the latest by date shall control. The Fiduciary Appointer shall act only in a fiduciary capacity in the best interests of all trust beneficiaries. For purposes of this instrument: (1) the Fiduciary Appointer means my spouse, if not disabled, otherwise the beneficiary for whom the trust is named (the "Named Beneficiary") if any, or if none, the beneficiaries to whom the current trust income may or must then be distributed by majority; and (2) a Qualified Appointee means any person who has attained the age of ____ years, or any bank or trust company, within or outside the State of ___________.

   A version for an irrevocable trust would modify the final sentence of the Fiduciary Appointer paragraph and add:

   For purposes of this instrument: (1) the Fiduciary Appointer means me, if not disabled, otherwise my spouse, if not disabled, otherwise the beneficiary for whom the trust is named (the "Primary Beneficiary") if any and if not disabled, or if none, the beneficiaries to whom the current trust income may or must then be distributed by majority; and (2) a Qualified Appointee means any person (other than me) who has attained the age of [30] years, or any bank or trust company, within or outside the State of [_____]. Notwithstanding anything herein to the contrary, if I am acting both as Fiduciary Appointer and Fiduciary Remover, then my removal of a trustee shall be ineffective unless I fill the vacancy by appointing a Qualified Appointee who is not a related or subordinate party with respect to me, as defined in Section 672(c) of the Internal Revenue Code, with respect to me.

2. Fiduciary Remover Provisions

   The Fiduciary Remover, if any, may remove an incumbent trustee, Fiduciary Appointer, Fiduciary Remover, Investment Director, Distribution Director, and Designated Representative by written notice delivered to that trustee or other individual, as the case may be, and to the Fiduciary Appointer. The Fiduciary Remover means me, if not disabled, otherwise my spouse, if not disabled, otherwise those of my children who are not disabled; provided, however, that each descendant of mine who has attained the age of twenty-five years and is not disabled shall act as Fiduciary Remover for each trust named for that descendant in advance of the other individuals identified in this paragraph or appointed under this Article. The Fiduciary Remover shall act only in a fiduciary capacity in the best interests of all trust beneficiaries. The Fiduciary Remover shall have no duty to keep informed as to the acts or omissions of others or to take action to prevent or minimize loss, and shall not be liable for the acts or omissions of any other fiduciary or any beneficiary hereunder, absent proof of bad faith.

3. Divided Trusteeship/Directed Trust

A. The Fiduciary Appointer acting from time to time may appoint one or more Qualified Appointees as Investment Director of the trust pursuant to paragraph of the Trustee Provisions of this instrument. Despite the general powers of the trustee, the following provisions shall apply, where the context admits, to each trust from time to time held hereunder, during any period in which an Investment Director shall be acting:

(1) The trustee shall follow the written directions of the Investment Director with respect to the purchase, sale, retention, or encumbrance of trust principal and the investment and reinvestment of funds held hereunder and shall have no duty to review or monitor trust investments.

(2) The trustee shall issue proxies to vote all securities held by the trustee to or on the written order of the Investment Director, and the trustee shall not thereafter be liable for the manner in which those securities are voted, for any direct or indirect result of that voting, or for any failure to vote those securities.

(3) No trustee shall be accountable for any loss or diminution in value sustained by reason of following a direction by the Investment Director or from failing to take an action with respect to trust principal in the absence of a direction from the Investment Director pursuant to the preceding provisions of this paragraph, and no person dealing with the trustee shall be required or privileged to inquire whether there has been compliance with those provisions.

(4) Any Investment Director acting hereunder may resign at any time, and from time to time may waive for limited periods of time or delegate to any other person (including the trustee with the trustee's consent) any or all of their rights under this paragraph, by written notice delivered to the trustee. In the case of any such delegation, the person to whom rights and powers are delegated may take any action or make any decision for the Investment Director making that delegation, within the scope of the delegated rights and powers, with the same effect as if the Investment Director making that delegation had participated in that action or decision.

(5) The rights and powers herein conferred on the Investment Director shall be exercisable only in a fiduciary capacity.

4. Direction Power of Individual Co-Trustee

An individual co-trustee shall have all the powers of an Investment Director and of a Distribution Advisor, subject to any limitations herein for a beneficiary, or a related or subordinate party, who is acting as co-trustee. Notwithstanding the foregoing, such individual co-trustee may have sole signatory authority to effectuate such investment and distribution directions.

Addendum B5: Sample Change of Situs and Governing Law

Option 1: The independent trustee may transfer the situs of administration of any trust created under this instrument, and, at the time of or following any change in situs, also may change the law governing the administration of the trust to the law of the new situs, in each case as the independent trustee may from time to time determine to be in the best interests of the trust and its beneficiaries, without regard to the notice requirements, duties and limitations on the independent trustee's authority contained in [Illinois Trust Code Section 108 – or any similar provision], all of which are expressly waived. Any such change in governing law shall only take effect to the extent that it does not result in any significant change in the interests of beneficiaries. The independent trustee shall have no duty to monitor the laws of other possible jurisdictions in order to determine whether and when to exercise this power.

Option 2: The independent trustee may, by written instrument filed with the trust records, change the situs and governing law of any trust to that of another state, except that any such change in governing law shall take effect only to the extent that it does not result in any significant change in the interests of beneficiaries.

Addendum B6: Sample Trust Protector Enabling Language

1. The party or parties who are acting as Fiduciary Appointer may appoint any one or more individuals who would qualify as independent trustees and who are not then disabled as Trust Protector. Any appointment of a Trust Protector hereunder shall be in writing, may be made to become effective at any time or upon any event, and may be single, joint or successive, all as specified in the instrument of appointment. The Fiduciary Appointer may revoke any such appointment before it is accepted by the appointee. An appointment that has not been accepted by the appointee may be revoked by a subsequent Fiduciary Appointer unless the instrument of appointment specifies otherwise. In the event that two or more instruments of appointment or revocation by the same Fiduciary Appointer exist and are inconsistent, the latest by date shall control.

2. The Trust Protector may resign from one or more trusts held hereunder by giving prior written notice of such resignation to the Fiduciary Appointer and any other Trust Protector then acting. No trust created under this instrument is required to have a Trust Protector, and all trusts created hereunder need not have or continue to have the same Trust Protector.

3. The Trust Protector, by written instrument delivered to the Trustee, may modify or amend the terms of the trust, as such terms apply to one or more of the trusts created hereunder, in order to achieve tax advantages or to preserve tax benefits otherwise available with respect to the trust, to convert a beneficiary's interest to a supplemental needs interest that would allow the trust (with respect to that beneficiary) to qualify as a trust for a disabled beneficiary under applicable law or to qualify as a "qualified disability trust" under Section 642 of the Code, or for any other reason that the Trust Protector believes to be necessary or desirable, and, if the instrument so provides, any such modification or amendment shall apply retroactively to the inception of the trust. The Trust Protector may convert a beneficiary's interest to a supplemental needs interest only if the Trust Protector believes that the conversion is necessary for the beneficiary to qualify for benefits from a federal, state or local government or agency thereof ("public benefits") and that the conversion is in the best interests of the beneficiary. The document implementing a conversion to a supplemental needs interest may provide for the possibility that the beneficiary's interest may be converted back to its original form hereunder if such a reconversion would be in the best interests of the beneficiary. Notwithstanding the foregoing, the Trust Protector may not make a modification or amendment that would (i) significantly change any beneficiary's beneficial interests under the trust, except if necessary and in a beneficiary's best interests to convert the beneficiary's interest to a supplemental needs interest to allow the beneficiary to qualify for public benefits, (ii) require any beneficiary to return to the trust amounts previously vested or distributed, (iii) modify the qualifications to act as Trust Protector, or (iv) change this sentence. For purposes of the preceding sentence, an amendment that changes the tax characteristics of the trust (including, but not limited to, an amendment that causes the trust to be or not to be a grantor trust or that grants or eliminates a general power of appointment) shall *not* be deemed a significant change in a beneficiary's beneficial interests. The term "supplemental needs interest" means the ability to receive distributions for the beneficiary's safety and welfare to the extent that such needs are not covered by public benefits that the beneficiary receives due to handicap, disability or financial need. Distributions made to a beneficiary with a supplemental needs interest may only be made to the extent that they supplement (and not supplant) the beneficiary's public benefits.

4. At any time when more than one person is acting as Trust Protector, the Trust Protectors must act unanimously.

5. The Trust Protector, in that capacity, shall have no duty to monitor any trust created hereunder in order to determine whether any of the powers and discretions conferred under this instrument

should be exercised. Further, the Trust Protector, in that capacity, shall have no duty to keep informed as to the acts or omissions of others or to take any action to prevent or minimize loss. Any exercise or non-exercise of the powers and discretions granted to the Trust Protector shall be in the sole and absolute discretion of the Trust Protector and shall be binding and conclusive on all persons. The Trust Protector is not required to exercise any power or discretion granted under this instrument. Absent proof of bad faith, the Trust Protector, in that capacity, is hereby exonerated from any and all liability for the acts or omissions of any fiduciary or any beneficiary hereunder or arising from any exercise or non-exercise by the Trust Protector of the powers and discretions conferred under this instrument.

6. The Trust Protector acting from time to time, if any, on their own behalf and on behalf of all successor Trust Protectors, may at any time irrevocably release, renounce, suspend, or modify to a lesser extent any or all powers and discretions conferred on the Trust Protector under this instrument by a written instrument delivered to the trustee and the Fiduciary Appointer.

Addendum B7: Sample Grantor Trust Powers

1. Grantor Trust Power to Substitute

During my life, I specifically retain the power to reacquire all or any portion of the trust corpus by substituting other property of equivalent value upon written notice to the trustee, which power shall be exercisable by me in a nonfiduciary capacity and without the approval or consent of any person acting in a fiduciary capacity, subject to the requirement that property of an equivalent value be substituted. I also may release this power at any time by written instrument delivered to the trustee. A guardian, conservator or personal representative may exercise my rights under this paragraph on my behalf during any period in which I am disabled.

2. Grantor Trust Power to Borrow

Option 1 - Grantor Ability to Borrow:

At any time during my life, I may borrow principal or income of the trust without security, but this shall not relieve the trustee of any fiduciary obligation with respect to the other terms of the loan, including the obligation to confirm that a promissory note or other evidence of indebtedness given to the trust is of sufficient value. I may irrevocably release the power granted to me in this paragraph at any time by written instrument delivered to the trustee. A guardian, conservator or personal representative may exercise my rights under this paragraph on my behalf during any period in which I am disabled.

Option 2 – Trustee Power to Lend to Grantor:

At any time during my life and upon my request, the independent trustee may from time to time lend to me principal or income of the trust without interest or without security. The trustee may irrevocably release this power by written instrument filed with the trust records and delivered to me and the current income beneficiaries. Any release made under this paragraph shall bind all successor trustees.

3. Grantor Trust Power to Add Charitable Beneficiaries

During my lifetime, the independent trustee may add or delete any one or more charitable organizations as additional beneficiaries under paragraph of this Article, and the trustee may distribute such amounts of income and principal to them, in such proportions, as the trustee believes to be desirable.

Addendum B8: Sample Grantor Trust Reimbursement Provisions

Option 1: [*] If the settlor is treated (under Subpart E, Part 1, Subchapter J, Chapter 1 of the Code) as the owner of all or part of any trust under this Agreement, the Trustees (other than a Trustee who is, with respect to the Settlor, a "related or subordinate party" within the meaning of Section 672(c) of the Code) may, in their absolute discretion, reimburse the Settlor for any amount of the Settlor's personal income tax liability that is attributable to the inclusion of such trust's income, capital gains, deductions and credits in the calculation of the Settlor's taxable income. The trustees may pay the Settlor directly or may pay the reimbursement amount to an appropriate taxing authority on the Settlor's behalf, as they see fit. No policy of insurance on the Settlor's life, if any is held in a trust from which the Settlor is reimbursed, nor its cash value nor the proceeds of any loan secured by an interest in the policy may be used to reimburse the Settlor or to pay an appropriate taxing authority on the Settlor's behalf.

Option 2: For each taxable year that the trust constitutes a so-called "grantor trust," the Trustees may reimburse the Grantor out of income or principal (apportioned among the trusts hereunder) for the Grantor's income tax (federal, state, local, or foreign) on the amount of the trust's income (if any) reportable on the Grantor's individual income tax return under Code Sec. 671.

Option 3: With respect to each taxable year of the trust (or portion of a taxable year), the trustee may distribute to me such amount of the net income and principal of the trust as the independent trustee, in the independent trustee's sole and unfettered discretion, determines is appropriate to provide for any income tax imposed upon me with respect to the taxable income of the trust for such taxable year; provided that the power to direct this distribution to me may only be exercised (by giving a binding written direction to the acting trustee) by an independent trustee, and at any time that no independent trustee is acting, by a Qualified Appointee who is an independent trustee, appointed by the Fiduciary Appointer as a special trustee, whose authority shall be limited to exercising this discretion.

Option 4: From time to time an Independent Trustee may pay out of income or principal of a trust such amount as the Independent Trustee determines will fully or partially compensate the Grantor for income tax incurred by the Grantor on the trust's taxable income. Such payment may be made by a direct payment to the taxing authority or by reimbursement to the Grantor, or both, as the Independent Trustee determines. This paragraph supersedes any otherwise applicable provision of law governing payment or reimbursement of the Grantor's taxes, including any right the Grantor would otherwise have to such payment or reimbursement. The Independent Trustee may, at any time, by a written instrument, signed and dated and filed with the records of the trust, irrevocably release wholly or in part the power given to them by this paragraph. Such release shall not restore any right, power or authority under any such otherwise applicable provision of law.

Option 5:[†]

a. The Trustor hereby waives any right of reimbursement under any applicable law for the Trustor's tax liability (whether federal, state or otherwise), if any, attributable to a trust being treated as a "grantor trust" as to the Trustor under Code Sections 671 through 679.

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[*] Sample language courtesy of David Pratt from Proskauer Rose LLP.

[†] Sample language from Jennifer E. Smith and Kristen A. Curatolo.

If (i) in any calendar year, a trust created hereunder is treated as a "grantor trust" as to the Trustor under Code Sections 671 through 679 and (ii) Revenue Ruling 2004-64 has not been modified, revoked or withdrawn and may be relied upon as precedent in the jurisdiction in which the trust is administered as it pertains to situation 3 described in Revenue Ruling 2004-64 (or if it has been modified, revoked or withdrawn if other binding precedent then exists that reaches the same holding as currently set forth in Revenue Ruling 2004-64 for situation 3), the trustee may, in the trustee's discretion, pay directly to the taxing authorities or reimburse the Trustor out of the trust property such amount equal to the amount by which the Trustor's Federal, state and local income taxes for the immediately preceding calendar year exceed the amount of such taxes that would have been imposed if the trust's income, gains, losses and deductions had not been included in the determination of the Trustor's income tax liability (the "Incremental Taxes"); provided, however, (i) the cash value of a life insurance policy on the Trustor's life, or proceeds from a loan made against such policy, may not be used or applied for the payment of the Incremental Taxes, and (ii) the trustee shall have no discretion to pay directly to the taxing authorities or reimburse the Trustor out of the trust property any amount pursuant to this Section if such discretion, combined with any applicable state law which would subject the trust property to the claims of the Trustor's creditors, or would cause inclusion of the trust property in the Trustor's gross estate for federal or state estate tax purposes. If it is finally determined for income tax purposes that the trustee reimbursed the Trustor an amount in excess of the Incremental Taxes, the Trustor shall repay such trust such excess amount within thirty (30) days of the final determination of the Incremental Taxes.

b. It is intended that the trustee's exercise of discretion to reimburse the Trustor for any such income taxes not be considered a gift from the trust beneficiaries to the Trustor and that the existence of such power shall not be considered a retained right or interest that will cause inclusion of any part of any trust created hereunder in the Trustor's estate for federal and state estate tax purposes; this Section and this Agreement shall be construed in accordance with this stated intent. Notwithstanding any other provision of this Agreement, only a trustee who is not related or subordinate to the Trustor within the meaning of Section 672(c) of the Code, may exercise the powers to reimburse the Trustor granted to the trustee pursuant to this Section. This provision supersedes any otherwise applicable provision of law governing payment or reimbursement of the Trustor's taxes, including any right the Trustor would otherwise have to such payment or reimbursement.

Addendum B9: Sample Decanting Permission with Limited Notice

An independent trustee shall have the power at any time and from time to time, in the sole and absolute discretion of the trustee, to distribute any portion or all of the principal of any trust held hereunder to the trustee of another trust under any other instrument, by whomever created, to the maximum extent permissible under applicable law. The trustee's exercise of the foregoing power need not comply with the applicable decanting statute under the laws of the state whose laws then govern the administration of this trust, including, but not limited to, that the trustee need not provide advance notice to any current beneficiary nor any notice at all to any [contingent] remainder beneficiary. Notwithstanding the foregoing, if a beneficiary of the trust is acting as a trustee hereunder, such beneficiary may participate in the exercise of the power under this paragraph only to the extent that the beneficiary's beneficial interests in, and fiduciary and non-fiduciary powers over, the successor trust are no broader than the interests and powers of the beneficiary under this instrument.

Addendum B10: Sample Trust Merger Language

In addition to all powers now or hereafter granted by law regardless of the statutory effective date of the power, a trustee shall have the power to merge at any time after the death of the last to die of my spouse and me all the trust property with the property of any other trust created by my spouse or me during life or by will, and held by the same trustee for the benefit of the same beneficiaries and upon similar terms and conditions as those set forth herein, and, at the trustee's discretion, either administer the merged assets as a single trust hereunder or transfer the trust property to that other trust, to be administered under the instrument governing that other trust, and thereafter terminate the trust hereunder as a separate entity; and in order to facilitate the merger of trusts, the trustee may shorten the perpetuities period. In addition, an independent trustee also has the power to merge and consolidate two or more trusts that have similar terms into a single trust, provided the terms of the second trust, in the aggregate, shall provide for (i) the same succession of interests of beneficiaries [(ii) the same scope of distribution standards, and (iii) the same acting trustee or trustees] as are provided in the original trust, and the trustee may not exercise any power under this subparagraph in a manner that would cause any trust created pursuant to this subparagraph not to be eligible for any federal tax deduction, exclusion, election, exemption or other special federal tax status for which the original trust was eligible.