Washington, DC
Estate Planning Council

# Estate Planning Without an Estate Tax

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5:30 pm to 6:20 pm

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**The McGuireWoods Private Wealth Services Group**

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The McGuireWoods LLP Private Wealth Services Group welcomes your questions or comments about these seminar materials. Please feel free to contact any member of the Group.

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## Estate Planning Without an Estate Tax

I. Introduction

A. Definition of Estate Planning

Estate Planning is the act of preparing for the transfer of a person's wealth and assets after his or her death. Assets, life insurance, pensions, real estate, cars, personal belongings, and debts are all part of one's estate.[1]

B. Impact of 2016 Federal Election

1. The most conspicuous development of 2016, affecting many areas of public policy including tax policy, is clearly the 2016 election, most notably the election of President Donald Trump and the retention of Republican control of the Senate. With the continued Republican control of the House, the Republicans have complete control of the executive and legislative branches of the federal government.

2. While tax reform is discussed almost every four years, and it is harder to do than it sometimes sounds, the talk this year is serious. With control of both Houses of Congress barely changed and the surprising capture of the White House, Republican leadership will be under enormous pressure to produce very significant tax legislation in 2017 by the August recess because now they can, and because, with no excuses left, they must. The June 2016 Blueprint summarized below, which Ways and Means Chairman Kevin Brady has described as 80 percent in sync with President Trump's campaign's plan and to which the President's transition team seems largely willing to defer, will be the likely vehicle.

C. History of Estate Tax

1. The Stamp Act of 1797 imposed a federal stamp on wills in probate to pay off debts incurred during the undeclared naval war with France in 1797. Congress repealed the Stamp Act in 1804.

2. The Tax Act of 1862 imposed a federal inheritance tax. Congress increased the rates and added a succession tax in 1864. The tax was repealed in 1870.

3. The War Revenue Act of 1898 to help pay for the costs of the Spanish-American War imposed a tax, but was repealed shortly after enactment.

4. The modern estate tax was enacted in 1916.

D. Current Estate Tax Laws and Impact on Individuals

1. The federal government and the state where an individual resides or owns real estate can impose taxes on the transfer of wealth during life or at death. The three federal taxes are:

   a. The estate tax (for transfers at death);

   b. The gift tax (for lifetime transfers); and

   c. The generation-skipping transfer ("GST") tax (for transfers, during life or at death, to individuals two or more generations below the transferor).

2. The two basic federal taxes are the estate and gift taxes. Generally, one of these taxes is imposed when one person transfers property to another without receiving equal value in return.

3. All property owned by a person at death is subject to the estate tax. The gift tax applies only to specific property items that a person gratuitously transfers during life.

4. The gift tax applies to any direct or indirect transfer of property. This includes outright gifts or gifts in trust, gifts of real property, and gifts of both tangible and intangible personal property. Types of transactions that may be considered gifts include:

   a. The transfer of cash or securities.

   b. The creation of a trust.

   c. The forgiveness of a debt.

   d. An interest-free or below-market interest rate loan.

   e. The assignment of a judgment.

   f. The assignment of the benefits of an insurance policy.

   g. The transfer of an automobile, boat, painting, jewelry, or other personal property.

   h. Permitting a child or friend to use a vacation home without paying rent.

5. The transfer must be made for donative, rather than business, purposes. Although an individual may make a taxable gift without being aware of it (such as selling stock in a closely-held business to a son for an amount of money that is later determined to be less than the fair market value of the

stock), generally a taxable gift must be accompanied by donative intent on the part of the donor.

6. For this reason, involuntary transfers and most bona fide business transactions fall outside the scope of the gift tax. Transfers made according to divorce decrees and arm's-length business sales that turn out to be windfalls for the purchaser are not taxable gifts.

7. The amount subject to gift tax is the difference between the fair market value of the property transferred and the value of any consideration received in return. The gift tax applies only if there has been a completed, irrevocable transfer of property from one person to another. If the transfer can be revoked by the donor, then no completed gift has occurred. If an individual makes a transfer that is not a taxable gift because at the time of transfer it was not complete and irrevocable, then a taxable gift will occur whenever the transfer does become irrevocable. Thus, if an individual establishes a trust for the benefit of his son and retains the right to revoke the trust, no taxable gift has been made.

8. There are a number of deductions and exclusions that may protect a gratuitous transfer from estate tax or gift tax:

    a. An individual can give up to $14,000 of property each year to a donee free of tax as a so-called "annual exclusion gift." A married couple can each give $14,000 separately to a donee, or one spouse of the couple can give $28,000 to that donee and the other can agree to be treated as having split the gift. There is no limit on the number of annual exclusion gifts that can be made.

    b. An individual may pay for tuition or medical expenses of a donee without incurring gift tax liability. These payments must be made directly to the educational institution or individual care provider.

    c. A person can transfer unlimited amounts of property to his or her spouse free of tax because of the unlimited "marital deduction." These transfers must be made outright to the spouse or into certain types of qualifying trusts for the exclusive benefit of the spouse during the spouse's life.

    d. Transfers to qualifying charities during life or at death are entirely transfer tax free. There are no limitations on the charitable deduction for estate tax or gift tax purposes.

9. The third federal transfer tax is the generation-skipping transfer tax, or "GST tax."

a. The GST tax was designed to fill a gap in the estate and gift tax systems which previously allowed certain transfers to avoid taxation. Before the enactment of the tax in 1986, an individual could avoid transfer taxes on property over many generations by placing the property in a long-term trust for the benefit of several generations of beneficiaries, or by skipping over one or more generations of beneficiaries entirely (for example, by leaving property directly to grandchildren and bypassing children). If the trust was properly structured, the trust property would escape taxation as it passed from generation to generation. Only when the trust terminated would the property be subject to taxation. A trust could last for several generations and insulate property from transfer tax during that time.

b. Now, if an individual makes a transfer of property in a manner which will escape the gift tax or estate tax at a lower generation level, the GST tax may be imposed at a flat rate equal to the highest transfer tax rate (45% in 2009; 35% in 2011 and 2012; and 40% in 2013 and thereafter). There are certain exemptions to the tax, the most important of which is the "GST exemption." The GST exemption in 2017 is $5,490,000.

## II. The Possibility of Changes in the Estate Tax

### A. Trump's Proposal

1. The Donald J. Trump for President Website has the following text on the website about the estate tax:

   "The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed."[2]

2. In September 2016, Candidate Trump said of his proposal, "It ends the death tax. It's a double taxation, a lot of families go through hell over the death tax."

3. It is unclear from the current Trump Proposal whether the gift tax and the generation-skipping transfer tax will be repealed and whether the proposal refers to a capital gains tax on appreciated assets at death or carryover basis in some modified form as was proposed in the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") was enacted for 2010 when the estate was repealed.

B. Republican Blueprint

1. The Republican leadership of the House of Representatives issued “A 21st Century Tax System Built for Growth” on June 23, 2016 as a “Blueprint” to outline how it wishes to reform the current income tax system. The Blueprint noted upfront that it does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system.

2. According to the Blueprint, the new tax system will simplify and lower tax rates. It also will provide for reduced but progressive tax rates on capital gains, dividends, and interest income. In addition, the changes will significantly reduce the complexity and compliance burdens of the current system.

3. One integral part of this Blueprint is a new IRS that will be aligned with the new tax code. Under the Blueprint, the new IRS will be built for customer service. The new IRS will have a unit that will serve families and individuals and a separate unit that will serve businesses.

4. The Blueprint notes that, at the beginning of the 114th Congress, House Republicans approved a rule requiring the Joint Committee on Taxation to estimate the macroeconomic effects of major tax legislation and to include changes in Federal revenues resulting from changes in the size of the economy to be included as part of the official revenue estimate. This means that dynamic scoring, as opposed to static scoring will be used.

5. The Blueprint assumes that the substantial tax increases enacted as part of the Obamacare law will be repealed.

6. Highlights:

    a. This Blueprint seeks to simplify, flatten, and lower tax rates for families and individuals and to provide reduced and progressive tax rates on capital gains, dividends and interest income, to encourage savings and investment. This Blueprint will eliminate the alternative minimum tax. The Blueprint also will eliminate the estate tax and the generation-skipping transfer tax “so that the death of a family member or loved one no longer will be a taxable event.”

b. Individual Income Tax Rates.

(1) The Blueprint consolidates the current seven tax brackets to three brackets and lowers the top individual income tax rate to 33 percent. Going forward, these income tax brackets will be indexed for inflation.

| INDIVIDUAL INCOME TAX BRACKETS UNDER THE BLUEPRINT | |
|---|---|
| Current Law | Blueprint |
| 10% | 0% / 12%* |
| 15% | |
| 25% | 25% |
| 28% | |
| 33% | 33% |
| 35% | |
| 39.6% | |

* The new standard deduction is larger than the current-law standard deduction and personal exemptions combined. This, in effect, creates a larger 0 percent bracket. As a result, taxpayers who are currently in the 10 percent bracket always will pay lower taxes than under current law.

(2) The Blueprint creates a new business tax rate for small businesses that are organized as sole proprietorships or pass-through entities, which means that small business income will be subject to a maximum tax rate of 25 percent.

(3) Individual Alternative Minimum Tax. This Blueprint repeals the individual AMT.

c. Income from Savings and Investment. The Blueprint provides for reduced tax on investment income. Families and individuals will be able to deduct 50 percent of their net capital gains, dividends, and interest income, leading to basic rates of 6 percent, 12.5 percent, and 16.5 percent on such investment income depending on the individual's tax bracket. The Blueprint also includes interest income within the reduced tax on investment income, as part of the move in the direction of a cash-flow tax.

d. Consolidation of Deductions. The Blueprint consolidates five basic family tax deductions and credits—the basic standard deduction, additional standard deduction, personal exemption for taxpayer and spouse, the personal exemptions for children and dependents, and the child tax credit into one deduction and one credit—a larger standard deduction and an enhanced child and dependent tax credit.

e. Earned Income Tax Credit. The Blueprint will continue the earned income tax credit ("EITC").

f. Simplification of Tax Benefits for Higher Education. This Blueprint will simplify the current array of tax benefits for families looking to make education more affordable for their children by simplifying and consolidating the current-law provisions to provide a package of higher education tax benefits that will cover both college and vocational training programs, including a savings incentive, such as 529 plans, and tax relief targeted at helping low- and middle-income families with the costs of higher education, such as the American Opportunity Tax Credit.

g. Individual Exclusions and Deductions. The Blueprint reflects the elimination of all itemized deductions except the mortgage interest deduction and the charitable contribution deduction.

h. Retirement Savings. The Blueprint appears to continue current incentives for savings such as Individual Retirement Accounts ("IRAs"). It also states that the Committee on Ways and Means will explore the creation of more general savings vehicles, using as a model the existing retirement accounts. It may look at Universal Savings Accounts. These are accounts to which individuals could contribute cash and over which they would have full control of investment decisions. Account holders could withdraw both contributions and earnings at any time, and for any reason, without penalty.

i. Estate and Generation-Skipping Transfer Taxes. This Blueprint repeals the estate and generation-skipping transfer taxes which "will eliminate the Death Tax, which can result in double, and potentially even triple, taxation on small businesses and family farms."

C. Impact on Estate Tax, GST Tax, and Gift Tax. As can be seen above, it is unclear as what form, if any, repeal or changes in the estate, gift, and generation-skipping transfer tax will take. Some questions are:

1. Will all three taxes be repealed?

2. Will the gift tax be retained as it was in the 2001 Tax Act? The reason for the retention of the gift tax in the 2001 Tax Act was to prevent United States citizens from making gifts of highly appreciated assets to family members or others in jurisdictions that have no income tax or gift tax. The recipients would then sell the highly appreciated assets and pay no capital gains or other taxes. Then the recipients would gift the proceeds back to the original United States donors.

3. Will there be a step up in basis for assets passing at a decedent's death?

4. Will a capital gains tax be imposed at death? If so, will there be exemptions or a threshold before the capital gains tax will be imposed?

5. Will there be carryover basis for appreciated assets at death? If so, will there be a modified carryover basis regime as there was in the 2001 Tax Act? Under the 2001 Tax Act, a decedent's executor could allocate a basis increase of up to $1.3 million, regardless of the recipient of the property. An additional $3 million of basis could be allocated to property owned by the decedent at death that was transferred to the decedent's surviving spouse either as an outright gift or as qualified terminable interest property ("QTIP").

D. Statements on Possible Repeal

1. "It will still be a heavy lift but not insurmountable as it has been with Obama in office. Trump made repeal of the death tax a key tenet of his tax reform proposal, and we look forward to working with him to see it through." Palmer Schoening, President of the Family Business Council.

2. "I look forward to working with President-elect Trump on legislation to permanently bury the death tax once and for all. For too long, this tax has threatened family owned businesses—including women and minority-owned businesses—from being passed down to their children and grandchildren. It's time to move forward with pro-growth reform that fully repeals it with a tax code built for growth." Kevin Brady, Chair of the House Ways and Means Committee, November 21, 2016.

3. "The death tax on family farms, small businesses, ranches and estates has crippled hard-working families for far too long. It ought to be repealed, plain and simple." Orrin Hatch, Chair of the Senate Finance Committee, November 21, 2016.

E. Legislative Framework

1. It might be assumed that the Republican leadership would want some Democratic votes. After all, they made such a big deal of the enactment of the Affordable Care Act without a single Republican vote. But memories are short. In any event, it is not clear that the Republican leadership would want Democratic votes so much that they would try to get 60 total votes in the Senate to "call the question" on regular legislation. A few bipartisan votes are fine, but not so desirable that the leadership would really want to "negotiate" or to concede much to get them. That leaves the process of "budget reconciliation" as the likely process, especially for a clearly fiscal agenda like tax legislation. But while "reconciliation" famously does not need 60 votes in the Senate, the 60-vote requirement cannot be avoided just be using the label "reconciliation." There must first be a "budget resolution," setting out broad guidelines for the inputs of multiple

committees that will be brought together and "reconciled." If that budget resolution is not passed by March, or perhaps April, tax reform will be behind schedule.

2. Budget reconciliation can be used only once a year. It is limited to fiscal matters. And it is limited further by constraints like the impropriety of affecting budget outcomes beyond an arbitrary budget window—most recently ten years. We all remember (or have heard about) the peculiar one-year "repeal" of the estate tax that was enacted in budget reconciliation in 2001. Sunsets are not inevitable. There are workarounds. The Taxpayer Relief Act of 1997 was also enacted through budget reconciliation, with substantial permanent estate tax cuts. But both 1997 and 2001 presented much different fiscal environments. In June 2001, when the 2001 Tax Act was enacted—before 9/11, Afghanistan, and Iraq—budget surpluses of trillions of dollars were forecast for the coming decade. The 2001 Tax Act included only a modest one and one-third trillion dollars of tax cuts! Today the forecasts are only more deficits.

F. Possibility of Repeal

1. Some commentators have said that the estate tax will be repealed by Congress and that it is already dead.

2. Others believe that the estate tax may survive and point out:

   a. The technical paths to permanent repeal of the estate tax are complicated and maybe risky to Republicans (especially to the extent they need Democratic support).

   b. The unexpected surge of disillusioned middle-class voters that propelled President Trump to victory may not be very excited about the estate tax.

   c. The attractiveness of repeal even to traditional supporters may be blunted by the prospect of having to keep the gift tax, or having to deal with a scary new capital gain or basis regime, and attempts to "have it all" will cost still more and look still more greedy.

   d. Repeal of the estate tax in 2017, permanently or temporarily, would require political capital that the Republican leadership will probably decide to spend elsewhere. A compromise reduction of rates by 5 or 10 percent is possible, and even with high exemptions there might actually be some justification in tax policy for bringing transfer tax and income tax rates closer together. But that too would look expensive and possibly too greedy.[3]

G. Issues to Be Addressed in 2017. BNA's Daily Tax Report of December 28, discussed six burning questions on the estate tax. These questions are:

1. Will Repeal Occur?

2. Will There Be a Gift Tax?

3. Capital Gains at Death?

4. Will Basis Step-Up Disappear?

5. Special Rules for Businesses or Farms?

6. Does the Charity "Abuse" Provision Stick?

III. Areas of Estate Planning that Will Continue Even if there is Repeal

A. Estate planning will still be necessary to permit an individual to pass assets to his or her beneficiaries in the form that he or she would like. This could include outright gifts or gifts in trust. One has only to look at the contest over the estate of Prince, who died in 2016 and left no will. Prince's heirs are coming out of the woodwork and crying and fighting over his estate.

1. Primary Objectives

a. An estate plan is a plan for transporting one's wealth. Like any transportation plan, it designates a destination—the persons who will receive the property. It also can provide instructions on how the property may be used. In transportation, minimizing breakage is a goal. Likewise, in an estate plan, minimizing loss of property, to taxes or to waste, is an important goal in establishing a plan to pass property as the client wishes.

b. In order to accomplish these goals, an individual will need to formulate his or her specific objectives and desires about the disposition of his or her property, the use of trusts, and the appointment of fiduciaries. The estate planning professional must assist the individual in this process by explaining the available alternatives, and the impact of tax planning and creditor protection considerations.

2. The Will

a. The starting point for addressing all of the client's testamentary planning objectives is a Will. Historically, it is the traditional means of disposing of one's property at death.

b. Wills tend to take one of the following three forms:

(1) A simple will that leaves the testator's property outright to one or more recipients.

(2) A complex will that uses trusts and involves tax planning.

(3) A pour-over will that disposes of the testator's tangible personal property and then directs the distribution of the balance of the testator's property to a revocable trust created by the testator during life.

c. The specific requirements for a Will are governed by state law. The common requirements are that the person signing the Will (often referred to as the testator or testatrix) must be at least 18 years of age, competent, and free of undue influence. A Will generally must be witnessed, and some states either require that the testator and witnesses appear before a notary public or make the process for admission of the Will easier if it is notarized.

3. The Revocable Living Trust

a. A revocable living trust is a trust created by an individual during life to hold the individual's assets and over which the individual retains complete control. It can provide several important benefits.

b. The creator, or "settlor", of the trust usually names himself as initial trustee and reserves the right to use the trust property for whatever purposes he wishes. The settlor reserves the power to change the terms of the trust at any time.

c. The trust designates one or more successor trustees and provides a mechanism for naming additional successor trustees if necessary. If the settlor becomes disabled, the designated successor trustee of the trust would manage the trust assets for the settlor's benefit. Without the trust, it would be necessary to have a court appoint a guardian to manage the individual's property if he became disabled. The trust, unlike a person, is immune to disability and provides continuity of management.

d. In addition, the trust typically contains testamentary provisions to provide for the disposition of the settlor's assets after his death. Using a trust for this purpose instead of a will has several advantages.

(1) The use of a revocable living trust protects the settlor's privacy. A will must be filed in the probate court after death and becomes a public document. In contrast, in most states, a trust does not have to be filed with the court, so that the details of the settlor's dispositive scheme remain private.

(2) Any assets that were held in the trust at the time of the settlor's death will be disposed of in accordance with the provisions of the trust and will not be subject to probate administration and public disclosure. The expenses of administering a trust after the settlor's death may be less than the expenses of probating the estate, and the process less time-consuming.

(3) In some states, a trust is harder to challenge than a will, so the settlor's estate plan would be more secure in the event that a beneficiary was dissatisfied with the plan and attempted to challenge it in court.

(4) In most states, a trust is easier to amend than a will. Except in a few states (Florida being one example), witnesses are not required.

(5) While revocable living trusts have all of these practical management advantages, they do not save federal income or estate tax. In addition, they are effective only as to property that the settlor actually transfers to the trust. Therefore, it is necessary to change the title to real estate, bank accounts, investment accounts, and other assets.

4. Durable Power of Attorney

a. A durable power of attorney enables an individual, called the "principal," to designate someone as his agent to handle his financial and personal affairs in the event of disability.

b. The power of attorney supplements the disability protection of a living trust by covering aspects of the principal's financial affairs that a trustee of a trust cannot handle, such as dealing with any assets that are not in the trust, signing tax returns, or taking legal action on behalf of the principal.

c. The power of attorney can permit the agent to transfer property into the principal's living trust where it can be managed by the trustee.

d. The laws of most states provide that a properly drafted and validly executed power of attorney will not terminate on the incapacity of the principal, but will remain in effect until the principal actually is adjudicated a disabled person by a court, or until the power is revoked or otherwise terminated by its terms.

e. Like the living trust, a durable power of attorney also may function as a substitute for a guardianship when the principal no longer can manage his affairs. Even where the principal has not established a living trust, use of a durable power of attorney thus can offer management protection in most events, with minimal cost.

f. There is now a Uniform Power of Attorney Act which, as of 2016, has been adopted in 12 states: Alabama, Arkansas, Colorado, Connecticut, Hawaii, Idaho, Iowa, Maine, Maryland, Montana, Nebraska, Nevada, New Mexico, Ohio, Pennsylvania, South Carolina, Utah, Virginia, Washington, West Virginia, Wisconsin. The hope is that the Uniform Act will increase the acceptance of powers of attorney by third parties, and provide a more consistent set of rules for the agents' duties and rights that will reduce abuses by agents.

g. If it is the principal's wish that the agent have the power to make gifts, that power should be explicitly granted in the instrument. The IRS has attempted to recapture in the decedent's gross estate gifts made by an agent pursuant to a durable power of attorney which did not expressly grant the power to make gifts. See Estate of Casey v. Comm'r, 948 F.2d 895 (10th Cir. 1991); Estate of Ridenour v. Comm'r, 94-2 U.S.T.C. ¶60,180 (4th Cir. 1994) (aff'g T.C. Memo. 1993-41, 65 T.C.M. (CCH) 1850 (1993)); Estate of Goldman v. Comm'r, T.C. Memo. 1996-29, 72 T.C.M. (CCH) 1896 (1996). Although the IRS has obtained mixed results from its challenges of such gifts, it continues to be best to include a specific gift giving power. In most jurisdictions, it remains necessary to include a specific provision in a power of attorney authorizing the agent to make gifts.

5. Health Care Power of Attorney

a. A health care power of attorney permits an individual to designate an agent to make health care decisions in the event of the individual's incapacity. This can include the authority to terminate life-sustaining procedures where the individual has a terminal illness. In some states, the health care power is referred to as a health care directive or health care proxy.

b. Health care powers of attorney often permit an individual to give broad instructions on the use or discontinuance of life support measures. For example, a health care power of attorney often allows the withdrawal of food and water. This can be very important if an individual is permanently comatose, but can be kept alive through the administration of food and water.

c. The agent under a health care power of attorney also can be empowered to make decisions about anatomical gifts.

d. A living will is a legal document in which an individual can set forth his wishes regarding the withdrawal of life-sustaining procedures in the event that he becomes terminally ill.

(1) Before health care powers of attorney, most states permitted individuals to sign a living will as a way of expressing their wishes. Living Wills originally did not allow the designation of a decision-maker.

(2) A health care power is generally considered superior to a living will because it designates someone to make those decisions. In addition, in many states, medical procedures that could not be withheld or withdrawn on the basis of a living will alone, such as the artificial provision of food and water, could be withdrawn by an agent under a health care power. In some states, the healthcare power is combined with or works in conjunction with a living will directive. In other states, the two can be construed as inconsistent and should not be used together.

6. Codicils and Trust Amendments

a. Even a simple estate plan will need to be changed over time. There will be additions to the individual's family, the individual may acquire new assets to be specially disposed of, or relationships will change that cause the individual to want to remove or add someone in the individual's estate plan. While these changes can be addressed in a new will or restated trust agreement, it is often simpler to amend the existing will with a codicil or prepare an amendment to the trust instrument.

b. A codicil may only change a portion of the will, but it is considered to "republish" the entire will. The will and codicil are treated as expressing the testator's intent as of the date of the codicil.

(1) If there are inaccuracies in the original will, either due to drafting errors or because of changed circumstances since the will was signed, these inaccuracies are in effect ratified by the codicil. Therefore, it is important to reexamine the entire will when preparing a codicil. The will also should be reviewed to ensure that nothing in the codicil is inconsistent with it, an ambiguity that could require a will construction suit.

(2) Because the proper execution of a codicil is a republication of the will, any question of the validity of the original will is eliminated by the proper execution of the codicil. A codicil

must be executed with the same formalities necessary for proper execution of a will.

c. A trust grantor cannot unilaterally amend a trust unless he reserved the right to do so in the trust instrument, although the laws of some states provide that a trust is revocable by the grantor unless the trust instrument specifically states that it is irrevocable. Although the legal concept of republishing does not apply to trust amendments, the same approach should be taken of reviewing the entire document when preparing a trust amendment. In addition, a trust amendment should include a clause reaffirming the right of the grantor to amend or revoke the trust instrument, including the provisions added by the amendment. This eliminates any possibility of a dispute over the validity of later amendments.

B. Benefits of Placing Property in Trust

1. Individuals often believe that they need nothing more than a simple will if their estates are below the applicable exclusion amount and they do not anticipate that federal estate tax will be due at either their death or the death of their spouse. A will that leaves all the assets to the spouse and, upon the spouse's death, divides the assets equally among the children is considered sufficient to protect the family adequately. A closer look points out the risks inherent in such a plan.

2. If an individual leaves even modest amounts of money to a spouse who has never had any experience with financial management and investment decisions, he or she may be placing an unfair burden upon the spouse. This type of burden translates into anxiety instead of security.

a. The surviving spouse may remarry, and all or a portion of the assets originally intended to go to children may end up in the hands of the new spouse, or children of the second marriage.

b. Even if the surviving spouse does not remarry, he or she may be put in the position of saying "no" to a child who wishes to use the inherited wealth for a risky new business venture or some speculative investment. Depending upon the relative strengths of the child and surviving spouse, imprudent decisions may be made which could rapidly dissipate the property left for the family.

c. A surviving spouse who has been insulated from financial matters may, upon receiving an inheritance, simply become overwhelmed by the immediate feeling of wealth and independence and live in a manner that could quickly exhaust the remaining estate.

3. By using trusts to transfer property, either during life or at death, the donor is able to maintain an element of control over the property. The donor can

designate under what circumstances and for what purposes a beneficiary will receive that property or its income. Trusts also permit the donor to determine who will manage the property as trustee. Other advantages of trusts include the following:

a. Retention of property in trust preserves the benefits of the investment and management skills of the trustee.

b. A trust can protect assets from the claims of third-party creditors of the beneficiary, such as the plaintiff in a lawsuit or a spouse in a failed marriage. Generally, a creditor or litigant cannot gain access to assets set aside in a properly drafted trust by someone other than the beneficiary. The same is generally true with respect to a divorcing spouse, although state law varies on the degree to which courts can consider the existence of trust assets in determining the division of assets upon divorce.

c. Children who have not fully matured may rapidly dissipate an outright inheritance, whereas a trust can provide for incremental distribution of inheritances.

d. Large outright distributions may spoil children and destroy their incentive to provide for self-support.

4. On the other hand, an overly restrictive trust may prevent an entrepreneurial child from reaching the property and exploit a business opportunity. A well-drafted trust can be flexible enough to allow a capable beneficiary to take advantage of such opportunities.

5. Placing property in trust may grandfather trust assets from future estate tax.

C. Advising on Creditor Protection

1. Basic Creditor Protection

a. Outright Gifts of Property. Outright gifts are a simple way for a client to protect his or her assets from the claims of creditors. Assets that the client gives away are no longer subject to seizure by the client's creditors. However, if the client is insolvent, or would become insolvent by making the gift, there may be consequences under the Fraudulent Conveyance statutes

b. Trusts. Trusts may be the most important regularly used and accepted asset protection tool available. For transfer of property by gift, a trust can be used to alleviate the client's concerns about the beneficiary's imprudent use of the property.

c. Co-Ownership. Different forms of co-ownership, such tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, may provide some protection against creditors.

d. Trusts for Disabled Beneficiaries.

(1) The most likely potential creditor of a disabled beneficiary is the federal, state or local agency that provides public assistance to that beneficiary. Over the past 10 to 15 years, public agencies have become more aggressive in seeking reimbursement for the cost of caring for disabled persons. Many states have passed laws that permit agencies to seek reimbursement and that define the assets which are available to the government agency. These statutes must be considered carefully when drafting a trust that is designed to provide supplemental benefits to a disabled person in order to improve the quality of the person's life without having the entire trust subject to confiscation by a government agency.

(2) State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. In many states, a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary will be treated as an asset of the beneficiary for the purpose of determining eligibility for public aid. However, in other cases, a state has been unable to obtain reimbursement for public aid where the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance (especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources). Many state legislatures are now attempting to provide statutory guidelines for when trust assets will be considered available to the beneficiary for the purpose of qualifying the beneficiary for public assistance or allowing the state to seek reimbursement from trust assets.

e. Exempt Assets. Separate and apart from the protection of a tenancy by the entirety arrangement, most states have a homestead exemption that allows an individual to always retain a certain amount of equity in their residence. In many states, the exemption is limited; for example, in Illinois, it is $7,500. Florida and Texas, however, have homestead exemptions that allow residents to retain all the equity in their home and adjacent land, subject to certain size (but not value) limitations.

(1) Florida allows a homestead exemption for properties of up to 160 acres outside a municipality, and up to one-half acre inside a municipality.

(2) Texas has a rural homestead exemption for up to 200 acres for a family, 100 acres for a single person; and an urban homestead exemption for up to one acre.

f. Life Insurance. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent. Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

g. Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of some states, like Texas. One simple asset protection step for a person in a high-risk profession is to take maximum advantage of opportunities to contribute to qualified retirement plans.

2. Premarital Agreements

a. Work will be needed to provide for the distribution and ownership of assets for couples about to marry.

3. Limited Partnerships

a. The family-owned partnership has become a popular vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and non-tax, including valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests.

b. With respect to asset protection planning, a limited partner's personal exposure for the debts of the partnership is generally limited to his investment in the partnership. This prevents a creditor of the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

c. A limited partnership also can provide a modest level of creditor protection against creditors of a partner who are seeking assets to satisfy a debt or judgment. Almost every state has enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"). RULPA helps protect a limited partnership interest from the claims of creditors of the partner by mandating an unattractive remedy for a creditor seeking that partner's interest.

d. Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides that a court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. The effect of the charging order is that a partner's creditor will only receive those partnership distributions which, absent the charging order, would have been distributed to the debtor partner.

4. Limited Liability Companies

a. The limited liability company ("LLC") is a viable alternative to the use of a limited partnership. The LLC first became available in Wyoming in 1977 and is now available in almost every state. The LLC has the limited liability of a corporation, but preserves the flow through treatment of taxable income (or loss) of a partnership. The LLC can provide an attractive alternative to the use of a general or limited partnership, especially where there is a desire to limit the personal liability of the family members in relation to the activities of the entity.

b. With respect to asset protection issues, many state LLC statutes contain charging order sections similar to that found in the RULPA. Also, LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

(1) A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;

(2) An assignee will not become a member of the LLC without the unanimous consent of the other members; and

(3) An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.

5. Domestic Asset Protection Trusts

a. Certain states permit the settlor of an irrevocable trust to obtain spendthrift protection from an irrevocable trust if certain require are met.

b. While Missouri was the first state to enact Domestic Asset Protection Trust legislation in 1986, few attorneys outside of Missouri paid attention to it or were even aware of it. However Domestic Protection Trusts gained public awareness when, in 1997, both Alaska and Delaware enacted legislation permitting Domestic Protection Trusts.

c. As of 2016, the following 18 states allow such self-settled asset protection trusts: Alaska, Colorado, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

d. The basic requirements in each of these Domestic Asset Protection States are:

(1) There must be a resident trustee in the state.

(2) Some of the assets of the trust must be held in the state.

(3) Some of the administration of the trust must take place in the state.

(4) The transfer of assets to the domestic asset protection trust cannot be a transfer in fraud of creditors.

(5) The trust must be irrevocable.

(6) The settlor is a discretionary beneficiary of the income and principal of the trust.

6. Offshore Protection Trusts

a. Offshore Protection Trusts have become one of the most talked about estate planning techniques for many years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions, usually former British colonies or current British dependencies permit a settlor to create a spendthrift trust for his or her own benefit. These barriers often insulate the property entirely from creditors, or produce early and inexpensive settlements.

b. Creditor Protection Benefits

(1) An Offshore Protection Trust can create geographic, legal, procedural, and financial hurdles to reaching its assets.

(2) The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially since foreign jurisdictions may prohibit contingent fee litigation or require significant deposits to commence a proceeding.

(3) Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments. Thus, an action first brought in a United States court may have to be tried all over in a foreign jurisdiction.

(4) As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions which protect the interests of a settlor-beneficiary. Such provisions are in contrast to dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

7. If the estate, gift, and generation-skipping transfer tax are repealed, individuals may still want to establish long-lasting trusts that could last several generations to protect assets from creditors and also protect the assets in the trust from the imposition of a future estate, gift, or generation-skipping transfer tax. The United States is, as noted above, currently on its fourth estate tax. There is no guarantee that a future Congress will not enact new estate, gift, or generation-skipping transfer taxes.

a. The ability to established long-term irrevocable trusts for several generations has been greatly aided by the enactments of laws in many states that have either eliminated or greatly extended the common law rule against perpetuities. In fact, without a gift tax, unlimited amounts could be placed in such a trust.

b. The common law Rule Against Perpetuities (the "Rule") provides that no interest is good unless it vests or fails within a life in being plus twenty-one years.[4] Currently, twenty states effectively have abolished the Rule. Nine states have repealed the Rule outright. A tenth (Delaware) has repealed the Rule with respect to interests in personal property. An additional nine states and the District of Columbia have preserved the Rule, but have granted trust settlors the authority to opt out of it by including specified provisions in their trust instruments. In 2000 Florida extended the perpetuities period to 360 years,[5] and in 2001 Washington extended it to 150 years.[6] In 2003, Utah extended its perpetuities period to 1,000 years.[7] Also, in 2003, Wyoming adopted an opt-out provision for personal property and extended the perpetuities period to 1,000 years.[8] In 2005, Nevada extended the perpetuities period to 365 years.[9] In 2006, Colorado extended the perpetuities period to 1000 years.[10] In 2007, Tennessee extended the perpetuities period to 360 years.[11]

c. Repeal Legislation. Statutory provisions in Alaska, Idaho, Kentucky, New Jersey, Rhode Island, South Dakota, and Wisconsin each provide that the Rule is not in force in the respective states, while Pennsylvania provides for this for interests created after December 31, 2006.[12] Statutes in effect in Idaho, South Dakota, and Wisconsin provide that the repeal of the Rule applies retroactively.[13] By contrast, New Jersey's statute provides that it shall not be applied retroactively.[14] It is unclear whether the repeal of the Rule in Alaska or Rhode Island applies retroactively[15]. North Carolina repealed the Rule Against Perpetuities effective August 9, 2007.[16] A state constitutional problem arose because of the provision of Section 34 of Article I of the North Carolina Constitution that provides "Perpetuities and monopolies are against the genius of a free state and shall not be allowed." On February 2, 2010, the North Carolina Appellate Court upheld the constitutionality of the North Carolina repeal.[17] Hawaii repealed the Rule with respect to its form of domestic asset protection trust that became effective July 1, 2010.[18]

d. Delaware and Michigan Partial Repeal Legislation. Delaware has repealed the Rule only with respect to interests in personal property,[19] but replaced the common law Rule with a perpetuities period of 110 years for real property held in trust.[20] It is unclear whether either of these provisions apply retroactively to existing trusts. Michigan has repealed the Rule with respect to personal property effective May 28, 2008.[21]

e. Opt-Out Legislation. The remaining twelve states (plus the District of Columbia) that have effectively abolished the Rule have done so by providing settlors with the power to opt out of the Rule's application to their trusts. These states include Illinois, Maine, Maryland, Ohio, Arizona, Colorado, Missouri, New Hampshire, Virginia, and Wyoming.

D. Lifetime Planning if the Gift Tax is not Repealed

1. If the estate and generation-skipping transfer taxes are repealed, but the gift tax is retained, then planners will still continue to use various techniques to avoid gift tax for clients and customers who wish to transfer assets to family members and others without gift tax consequences. This will admittedly apply primarily to high net worth taxpayers.

2. Irrevocable Life Insurance Trusts

   a. Clients may still create irrevocable life insurance trusts as a way to transfer the death benefits of life insurance policies to family members without adverse gift tax consequences even if there are no estate tax consequences. They may do so to provide creditor protection to the beneficiaries, to retain control over the ultimate disposition of the assets in the irrevocable life insurance trusts, and to protect those assets against a possible future reimposition of the estate tax.

   b. This will require planning in many instances to qualify transfers to the trusts for the gift tax annual exclusion through the use of Crummey powers and to minimize the exposure of the holders of the Crummey powers to potential gift tax exposure through the use of vested interests or hanging powers of withdrawal for example.

3. Family Limited Partnerships and Limited Liability Companies

   a. Family limited partnerships and limited liability companies will continue, if there is a gift tax, to be used for managing assets and obtaining discounts for gift tax purposes. In addition, as discussed above, family limited partnerships and limited liability companies provide a certain degree of protection from creditors.

   b. The lack of marketability and minority interest discounts will likely be available to allow individuals to gift interests in a family limited partnership or limited liability company at a value below that of the value of the underlying assets of the family limited partnership or limited liability company.

   c. Although the IRS has been hostile toward the valuation discounts that have been obtained in many instances for testamentary and lifetime transfers of family limited partnership or limited liability company interests, efforts to restrict those discounts, such as the proposed regulations under Section 2704 may come to naught in light of the unfavorable reaction of Republican Senators and Representatives to the proposed regulations and the advent of a Republican administration in 2017.

4. Split Interest Techniques. If there is still a gift tax while the estate tax is repealed, individuals will use split interest gifts such as Grantor Retained Annuity and Unitrusts and Grantor Retained Income Trusts (especially Qualified Personal Residence Trusts) as a way to leverage a donor's applicable exclusion amount. Sales to Defective Grantor Trusts will likely be used as an alternative to Grantor Retained Annuity Trusts since they involve no use of a donor's applicable exclusion amount.

E. Planning for Carryover Basis or a Capital Gains Tax at Death

1. Planning for carryover basis when a person dies may become complicated, especially if there is some form of modified carryover basis regime similar to that enacted as part of the 2001 Tax Act.

   a. In the 2001 Tax Act, there was a basis increase of $1.3 million provided for each taxpayer and an additional basis increase of $3 million for property passing to a surviving spouse.

   b. Some commentators have discussed a basis increase of as much as $5 million indexed for inflation for each decedent if any repeal of the estate tax includes carryover basis. Planning will be required for this.

   c. This may make insurance more popular as an asset since the proceeds are received as cash when the insured dies and there are no capital gains tax consequences.

2. Likewise, if there is a capital gains tax at death, planning will have to be done for the payment of that tax. Many issues would arise in drafting such a tax. These issues include:

   a. How would the tax be reported and when would the tax be due?

   b. Would there be some form of modified basis step-up?

   c. Would there be a marital deduction or special basis step-up for property passing to a surviving spouse?

   d. Would there be special provisions for the payment of the capital gains tax owed at an individual's death such as special use valuation of deferral of the payment of the tax?

F. Income Tax Planning

1. No matter what happens with respect to taxes, clients will still need advice on both federal and state taxes.

2. Any changes in the federal income tax enacted in 2017 and effective in 2017 or later may affect individuals and entities including corporations, partnerships, and limited liability companies. This will depend upon the parts of the Internal Revenue Code, if any, that Congress revises.

   a. A reduction in the income rates for individual income or corporate tax rates will affect many clients.

   b. The elimination of the Alternative Minimum Tax will also have a positive impact.

   c. The repeal of the Affordable Care Act, which is part of the Republican platform, should lead to the repeal of the 3.8% tax on net investment income which was enacted to help fund the Affordable Care Act.

   d. The elimination of all deductions for individuals, except the home mortgage interest deduction and the charitable deduction, will also affect clients. It also appears that Congress may consider capping the total amount of deductions for high-net-worth taxpayers.

3. Federal Fiduciary Income Tax

   a. The fiduciary income tax found in Subchapter J of the Internal Revenue Code is one of the more complex and confusing tax provisions. One wonders if Congress will take any action with respect to Subchapter J when it addresses reform of the Internal Revenue Code in 2017 and later.

   b. Among the complex areas of Subchapter J are:

      (1) What makes a trust a grantor trust for income tax purposes?

      (2) DNI and what it really means.

      (3) The lack of simplicity of simple trusts and the complexity of complex trusts.

      (4) The limitations on deductibility of trust expenses.

      (5) Timing distributions to the advantage of beneficiaries.

      (6) Making the Section 645 election work for clients.

      (7) The ins and outs of equitable adjustments and private Unitrusts.

4. State Income Taxation of Irrevocable Non-grantor Trusts

a. Currently seven states, Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming, do not tax the income of trusts. The other states and the District of Columbia do tax the income of trusts to a greater or lesser extent.

b. If a trust is treated as a grantor trust for federal income tax purposes, all income (ordinary and capital gains) will be taxed to the grantor of the trust. Most states follow the federal grantor trust rules. If a trust is a grantor trust for federal income tax purposes, the trust will be treated as a grantor trust for state income tax purposes. Pennsylvania and Tennessee do not follow the federal grantor trust rules for irrevocable trusts and the District of Columbia and Louisiana tax grantors only in limited circumstances.

c. Every state follows the rule that to the extent that income is distributed from an irrevocable non-grantor trust to a beneficiary, the beneficiary pays the tax and not the trust. Consequently, in examining the income taxation of a trust or estate from a state law perspective, one is primarily looking at the taxation of income accumulated in a trust as well as capital gains.

d. In the remainder of this section, the focus will be on the state income taxation of irrevocable non-grantor trusts. Non-grantor irrevocable trusts are generally taxed for state income tax purposes on one or more of the following bases:

(1) The trust was created pursuant to the will of a testator who lived in the state at the time of his or her death.

(2) The creator of an inter vivos trust lived in the state at the time the trust became irrevocable.

(3) The trust is administered in the state.

(4) One or more trustees live or do business in the state.

(5) One or more beneficiaries live in the state.[22]

e. The trust that meets one or more of the bases for taxation in a state is generally referred to as a "Resident Trust."

f. The bases for the state income taxation of non-grantor trusts vary from state to state:

(1) <u>Trust created by will of resident</u>. Connecticut, District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax a trust

that is created by the will of a decedent who was a resident of the state at the time of his or her death. Other states, such as New Jersey and New York, require that such a trust have Resident Trustees, assets, source income, or a resident beneficiary before they will tax such a trust.[23]

(2) Inter vivos trust created by resident. The District of Columbia, Illinois, Maine, Maryland, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, West Virginia, and Wisconsin tax an inter vivos trust if it becomes irrevocable when the creator lived in the state.[24]

(3) Trust administered in the state. Colorado, Georgia, Indiana, Kansas, Louisiana, Maryland, Minnesota, Mississippi, Montana, New Mexico, North Dakota, Oregon, South Carolina, Virginia, and Wisconsin tax the trust if a trust is administered in that state. Idaho and Iowa tax a trust if it is administered in the state if this basis is combined with other factors. Hawaii requires that a trust administered in Hawaii have at least one resident beneficiary for the trust to be taxed in Hawaii. Utah since 2003 has permitted a Utah corporate trustee to deduct all nonsource income of a trust administered in Utah.[25]

(4) Resident Trustee. Arizona, California, Georgia, Kentucky, Montana, New Mexico, North Dakota, Oregon and Virginia tax an irrevocable trust if one or more trustees reside in the state.[26]

(5) Resident beneficiary. California, Georgia, North Carolina, North Dakota and Tennessee tax a trust if it has one or more resident beneficiaries.[27]

g. There are many variations to the bases rules above depending upon the laws of a particular state. One must look at the law of each state in determining whether that state's income tax will apply to a particular trust.

h. As can be seen above, some states apply more than one basis in determining whether a trust is subject to income taxation of that trust. For example, Virginia taxes the income of a non-grantor trust if (i) the trust is created by the will of a Virginia decedent; (ii) the trust is created by a Virginia resident; (iii) the trust is administered in Virginia; or (iv) there is at least one trustee who is a Virginia resident.

i. Examples of different states:

(1) The opportunity for reducing taxes can be important. State fiduciary income tax rates range from 3.07% in Pennsylvania to as high as 12.846% in New York City.

(2) New York. New York defines a Resident Trust as a trust created by a New York resident or grantor. New York does not tax a trust if a trust has no New York trustees, assets, or source income.

(3) Connecticut. Connecticut basically taxes irrevocable trusts that are created by a Connecticut testator or a person who is a resident of Connecticut at the time the trust became irrevocable.

(4) Delaware. Delaware generally does not impose any income tax upon Resident Trusts except in cases where one or more trust beneficiaries live in Delaware and then only upon the portion of the trust income attributable to the beneficiaries who reside in Delaware.

(5) Maryland. Maryland taxes an irrevocable trust created by a Maryland testator or grantor if the trust was created under the will of a decedent domiciled in Maryland on the date of decedent's death, the creator or grantor of the trust is a current resident of Maryland, or the trust is principally administered in Maryland.

(6) Virginia.

(a) Virginia, as noted above, has a broad definition of a Resident Trust subject to Virginia taxation. The definition is:

> A trust created by the will of a decedent who at his death was domiciled in the Commonwealth; a trust created by or consisting of property of a person domiciled in the Commonwealth; or a trust which is being administered in the Commonwealth.[28]

(b) The Virginia Administrative Code expands on this definition by adding that a trust is considered to be administered in Virginia if "its assets are located in Virginia, its fiduciary is a resident of Virginia or it is under the supervision of a Virginia court."[29]

(7) Missouri. A trust will be subject to Missouri income tax if it was created by the will of a Missouri decedent or it is an

inter vivos trust created by a Missouri resident. In addition, the trust must have a resident income beneficiary on the last day of the taxable year if the trust is to be subject to tax in Missouri.

(8) California. A trust is a California resident for income tax purposes if a trustee or non-contingent beneficiary is a resident of California, regardless of the residence of the settlor. With respect to corporate fiduciaries, the residence of the corporate fiduciary is the place in which the corporation conducts the major portion of the administration of the trust.[30]

j. Given the complexity of and the differences between the rules governing the income taxation of trusts and estates by different states, an irrevocable non-grantor trust may be subject to income taxation in more than one state.

k. Responses to DING trusts, NING trusts, and Attempts to Minimize State Income Tax

(1) A "DING" trust, or "Delaware Incomplete Non Grantor" Trust, is an irrevocable trust established under the laws of Delaware. When established in Nevada, such a trust is referred to as a "NING" trust.

(2) Such a trust has the following features:

a. The trust is irrevocably established in a jurisdiction without state income tax on trusts (in the case of a DING, Delaware; and in the case of a NING, Nevada) by a settlor from another jurisdiction;

b. The settlor retains sufficient control such that the trust is treated as an incomplete gift for federal gift tax purposes and does not trigger gift tax upon its creation; and

c. The settlor does not retain any power that would cause the trust to be treated as a "grantor" trust for income tax purposes, such that the trust, and not the settlor, is taxed on the income of the trust.

(3) In a series of private letter rulings, the IRS has confirmed that a trust may be established where the grantor parts with sufficient control such that the settlor is not treated as the grantor for federal income tax purposes, but where the settlor retains sufficient control so that the gift is deemed to be incomplete for federal gift tax purposes.[31]

(4) The DING or NING trust has no savings from federal income tax, because the trust still must pay federal income tax on any income.

(5) However, the trust can offer savings from <u>state</u> income tax, because the trust is designed to be treated as a resident only of the forum state, and the trust would pay no income tax in that state.

(6) Generally, New York taxes "Resident Trusts" on income, regardless of whether that income comes from sources located in New York.

(7) New York's Response to DING/NING Trusts

a. New York law generally defines a "Resident Trust" as:

b. a trust, or a portion of a trust, consisting of property transferred by will of a decedent who at his death was domiciled in this state, or

c. a trust, or portion of a trust, consisting of the property of:

(i) a person domiciled in this state at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable; or

(ii) a person domiciled in this state at the time such trust, or portion of a trust, became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable."[32]

d. New York law provides, however, that even if a trust is created by a New York resident as provided above, a Resident Trust is not subject to tax if all of the following are satisfied:

"(i) all the trustees are domiciled in a state other than New York;

(ii) the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and

(ii) all income and gains of the trust are derived from or connected with sources outside of the state of New York."[33]

e. <u>Prior Law and DING/NING Trusts by New York Resident</u>. Under prior law, if a trust was created by a New York resident, but has no New York resident trustee, no assets located in New York, and no New York source income, then the trust pays no New York income tax. This tax savings can be considerable. Currently, New York has a state capital gains rate of 8.8%.

f. <u>Current Law and DING/NING Trusts by New York Residents</u>. However, in 2014 New York adopted a statute to expressly address such DING/NING trusts. This law classifies such DING/NING trusts as grantor trusts for purposes of New York state law. This law provides that a trust is treated as a Resident Trust if the grantor is a New York resident, if the transferor is not treated as grantor for federal tax purposes, and if the transfer to the trust is an incomplete gift for federal gift tax purposes. The statute taxes in New York the assets of an "incomplete gift non-grantor trust," which is defined as follows:

> an "incomplete gift non-grantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under … the Internal Revenue Code, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under … the Internal Revenue Code, and the regulations thereunder.[34]

That is, the statute expressly reaches trusts which (1) are non-grantor trust for federal income tax purposes, and (2) result from an incomplete gift for federal income tax purposes.

G. Charitable Planning

1. Many opportunities exist for enhanced charitable giving by trust and private banking customers. This is especially true when one examines the history of charitable giving by Americans.

a. Americans are among the most generous people, ranking second only to Canadians in terms of average donations to charity.

b. In 2015, Americans gave $373.25 billion to charities. This was a $14.2 billion increase over charitable giving in 2014 (Giving USA 2016: The Annual Report on Philanthropy for the Year 2015, published by Giving USA Foundation, and researched and written by the Center on Philanthropy at Indiana University).

c. Individuals gave $264.58 billion and contributed 71¢ of each dollar given to charity in 2015.

d. Bequests totaled $31.76 billion in 2015.

e. Corporate giving was $18.45 billion in 2015.

f. Far more than one million charities are presently recognized by the IRS.

2. Given the generosity of individuals, coupled with the overwhelming value of the future transfer of wealth between generations, Many opportunities will exist for charitable planning no matter what happens in the future,

3. Income Tax Deduction for Charitable Contributions. The deductibility of charitable contributions for income tax purposes is subject to two types of limitations. These two limitations often make charitable planning challenging.

a. Percentage Limitations. There are "percentage limitations" on the amount that an individual may claim as a charitable deduction against his gross income in any tax year.

b. Valuation Limitations. With respect to certain appreciated property contributed to charity, the individual may be required to use the property's tax basis, rather than its fair market value at the time of the contribution, for the purpose of determining the deductible amount of the contribution.

4. Substantiation Requirements. The IRS may disallow an individual's income tax charitable deduction if it is not properly substantiated. Recordkeeping requirements apply to all charitable contributions. Additional appraisal requirements apply to certain large contributions of property, other than cash or publicly traded securities.

5. Split interest charitable gifts, especially lifetime charitable remainder trusts (which provide an income tax charitable deduction for the remainder interest), will continue to be used if there is no estate tax. If the estate tax

is repealed, but the gift tax is not, charitable lead trusts, especially charitable lead annuity trusts which can be "zeroed out," will be popular.

6. High worth clients will need advice on setting up private foundations with all of their restrictions and limitations and donor advised funds.

H. Retirement Benefits

1. For all estate planning professionals who represent and work with executives, business owners, and self-employed professionals, planning for retirement benefits is critical.

2. Retirement benefits will be the single largest asset of many individuals. It is common for retirement benefits to have a value in the hundreds of thousands of dollars, and benefits exceeding one million dollars are by no means rare. Ownership and receipt of retirement benefits will entail significant income tax consequences even if there is no estate tax.

3. Given the complexity of retirement plans, clients need advice in navigating the distinctions between qualified and non-qualified benefits and understanding the differences between, for example, defined benefit and defined contribution plans and regular IRA's and Roth IRAs.

I. Elder Law

1. Estate planning for the elderly and incapacitated presents unique challenges. On the non-tax front, there may be questions of the individual's competence, or ability to understand the estate planning alternatives being considered. Communication may be a challenge due to physical disability. There may be questions of influence by other family members.

2. Elderly clients often have special concerns related to health care and extended care arrangements for themselves.

3. If the person is mentally incapacitated, and needs estate planning, there are both special procedures and special challenges in determining the person's presumed intent.

4. As the American population ages, more and more people will need advice on issues such as financial planning, housing, long-term care insurance, Medicare, and Medicaid.

J. Business Planning

1. Advising closely held businesses on non-tax and tax issues will continue to be important even if there is no estate tax.

2. Non-Tax Issues:

a. Experts estimate that 85% of the crises faced by family businesses focus around the issue of succession.[35] Therefore, in addition to addressing the legal aspects of passing a family business from one generation to the next, attorneys, accountants, family business consultants, trust officers, and other professionals must help families meet and overcome the conflict that will inevitably occur when a family plans for the succession of the control and/or ownership. In fact, such conflict is, in most situations, inescapable. Experts tell us that conflict is a necessary part of human relationships. Human beings are incapable of spending any significant time together without having differences.[36]

b. Surmounting the challenges of this conflict requires both sensitivity to family dynamics and an extensive knowledge of the wide range of legal disciplines that impact succession issues.

c. Lack of Succession Planning. Despite the importance of succession planning, a 2007 survey of family businesses found that 40.3% of business owners expected to retire within 10 years. But of those business owners expecting to retire in 5 years, only about half (45.5%) had selected a successor, and of those expecting to retire in 6–11 years, only 29% had selected a successor.37 But 30.5% had no plans to retire, ever; and since the median age of the business owner was 51, many planned to die in office.38

d. Human Planning Requirements. A business owner who fails to prepare and execute a succession plan—and especially one who dies in office—leaves his or her family, business, and wealth in a uncertain state subject to questions about what should be done with the business and attacks by those who wish to take control or have ownership or those who think that they are entitled to ownership and control.

3. Planners will have to advise closely held and family owned businesses on a variety of tax issues as well:

a. Buy-Sell Agreements

(1) The buy-sell agreement is a contract among the owners of a business, or between the owners and the company, which sets out what will happen to their various ownership interests upon the occurrence of certain specified future events (such as death or withdrawal). Buy-sell agreements are used primarily to achieve non-tax goals. They can serve a number of useful purposes in a family business, before, during and after a period of succession.

(2) Control. A typical agreement will give the entity, the owner, or both a right of first refusal on certain proposed transfers by a shareholder. This protects the existing owners from unwillingly becoming business partners with an undesirable owner. It may permit a senior family member who controls the business to become comfortable with making gifts of stock, since the agreement will give him or her some control over what his children do with the stock.

(3) Liquidity. A buy-sell agreement can provide a withdrawing family member with a market for his or her interest by providing a put right in certain circumstances. The most common point in time to grant a put right is at the death of a shareholder. It allows a surviving spouse or children who are not interested in continuing in the business to liquidate their interest. Put rights also can be granted at retirement or when the shareholder ceases to be employed with the business for other reasons.

(4) Planning. A buy-sell agreement helps push a family toward further succession planning by focusing them on what options should be given to the family of a deceased shareholder and how to fund the repurchase of stock under the agreement.

(5) Preservation of Tax Benefits. It is also possible to include in a buy-sell agreement prohibitions against certain actions by the shareholder that would threaten tax elections. A buy-sell agreement for an S corporation typically prohibits a shareholder from transferring stock to an entity or person that is not a permissible shareholder of an S corporation, or from taking any other action that would threaten the S election.

b. Once it is determined that a buy-sell agreement is desirable, the next determination must be who the operative parties to the agreement will be. Obviously, the withdrawing party will be the seller, but the purchaser may be the other owners (a cross purchase), the business itself (an entity purchase), or a combination of the two. Except to the extent that tax consequences may vary, the seller is generally not concerned with the question of who acts as the purchaser (assuming that the purchase price is paid in full at closing). He is concerned only with getting the appropriate amount of money for his interest. However, it is important that the purchaser be identified and that steps be taken to ensure that the purchaser has the funds necessary to make the required purchase.

(1) Cross-Purchase Agreement. A buyer will often prefer a cross-purchase agreement since this will result in an increase in the buyer's basis in his stock. If the other shareholders are to make the purchase, it is often desirable for them to take out insurance on one another's lives so that funds will be available to make the purchase. Obviously, with a large number of shareholders, this can be very expensive as well as administratively cumbersome. If this type of cross-purchase arrangement is structured, at the death or withdrawal of one shareholder, the policies he holds on the lives of the other shareholders must be assigned to the remaining shareholders. Younger shareholders may bear a disproportionate burden of the cost of such agreements because the policies on the lives of the older stockholders, which they must purchase, will have higher premiums than the policies on their lives, which the older stockholders must purchase.

Generally, the cross purchase of insurance by the shareholders is not associated with any adverse income tax consequences. When the surviving shareholders receive the insurance proceeds on the deceased shareholder's life at his death, those proceeds will not normally constitute taxable income to them. When they purchase the stock from the decedent's estate, no significant taxable gains should occur because, by reason of the decedent's death, the estate has received a step-up in the income tax basis of the stock being sold. Moreover, the full amount paid for the stock so acquired is included in the surviving stockholders' income tax basis for that stock, so any subsequent sale of the business by them would result in their realizing less capital gain.

Although no income tax problems generally result from cross-purchase agreements, if the insurance policies are transferred among the remaining owners, problems can arise as a result of changes in stock ownership. In these cases, assignments of the policies may run afoul of the "transfer for value" rules of the tax law (Section 101(a)(2)) and may cause the proceeds of the insurance to be fully income taxable when the transferee shareholder collects them.

If corporate earnings are to be the principal source of premium payments, additional problems are created. When the shareholders own the policies, any premium payments by the corporation will be income to the shareholders. If the company owns the policies but distributes the proceeds to the surviving shareholders to allow them to make the purchase, the proceeds may be a taxable dividend.

(2) Entity Purchase Agreement. Alternatively, the buy-sell agreement can be structured to have the business itself (rather than the other owners) be the ultimate purchaser at the time of the withdrawal or death of any of the owners.

This alternative may seem attractive if the corporation has sufficient funds to affect the purchase; however, accumulating such funds could cause the corporation to run afoul of the "unreasonable accumulation of earnings" provisions in the income tax law. Sections §§ 531–537.

If the corporation does not have sufficient funds to affect purchases at the death of an owner, it could acquire insurance for such purchases. Only one policy on the life of each shareholder would be necessary, and there would be no need for transfers of policies, eliminating concern over the "transfer for value" rules. Further, the cost differences of policies between shareholders of various ages are equalized (because the corporation pays for all policies).

The receipt of insurance proceeds by a C Corporation could have income tax consequences. While insurance proceeds received by the corporation are not subject to regular income tax liability, they may now be subject to the corporate alternative minimum tax. Under the alternative minimum tax, the corporation must add to its tax base one-half of the amount of the proceeds received for the taxable year. This may result in additional tax owed by the corporation, which will either reduce the amount of after-tax proceeds available to be used for the stock purchase, or reduce the corporation's surplus (and thus, its value to the remaining shareholders). While this potential tax cost itself can be insured for by increasing the amount of insurance coverage carried on the shareholders, this could be expensive.

Although having the corporation serve as the purchaser in the buy-sell agreement may appear desirable, there are certain disadvantages. First, such purchases constitute redemptions for income tax purposes. As is discussed in detail later in this chapter, unless certain very specific requirements are met, the amounts distributed from the corporation for the stock interest constitute dividend income to the recipient. The tax consequences of this to the recipient would be undesirable in that the proceeds, instead of being nearly tax free, would be taxable as ordinary income. Accordingly, in structuring a corporate redemption, one must ensure that the redemption will qualify as (a) substantially disproportionate, (b) a complete termination of interest, or (c) a redemption to pay death taxes.

Moreover, the remaining shareholders may face potential capital gains problems. When the corporation purchases the selling shareholder's shares, the value of the remaining owners' shares may increase, although their income tax basis in the shares will not. The value of the corporation, and accordingly the outstanding stock, may also be increased by the receipt of insurance proceeds by the corporation. A subsequent sale of a remaining shareholder's interest may thus result in a large capital gain.

One final potential tax trap with regard to buy-sell agreements should be recognized. Sometimes such agreements are structured to require the surviving shareholders to purchase the stock at the death of one of them, but then, at the time of sale and purchase, it is determined that the corporation has adequate funds to make the purchase. Even if it is possible to structure a purchase by the corporation that will not be taxable as a dividend to the recipient, an unintended dividend to the surviving shareholders may be imputed for income tax purposes. This would be the case if a primary, unconditional obligation of such shareholders (the requirement to purchase the stock) were satisfied by the corporation. To avoid this result, the buy-sell agreement should generally not impose a primary unconditional obligation on the surviving shareholders but should give the corporation the first right to purchase and should make the shareholders obligated to purchase only if the right is not exercised.

4. Redemptions of Stock under Section 302 of the Internal Revenue Code

a. A redemption of a shareholder's stock by the business is a very effective way to terminate or reduce the shareholder's interest in the business and provide him or her with liquidity. The business itself is often in the best position to fund a buy-out of a shareholder. Provisions for redemption of stock are often found in buy-sell agreements, and are frequently privately negotiated when a shareholder wishes to liquidate his or her investment.

b. A major problem in planning for redemptions (at least with respect to C corporations) is that if the corporation purchases the stock of a shareholder, pursuant to a buy-sell agreement or otherwise, the proceeds paid to the shareholder will be treated as dividend income, rather than proceeds from a sale, unless the redemption qualifies as an exchange under Section 302 or 303 of the Code.

c. A redemption will only qualify for exchange treatment only if the redemption: (a) is "substantially disproportionate," (b) results in a "complete termination of the shareholder's interest, (c) is not "essentially equivalent to a dividend" in light of all relevant facts and circumstances, or (d) is necessary to pay estate taxes resulting from inclusion of the closely held stock in the shareholder's estate. Of course, this last type of redemption qualifying for exchange treatment will no longer be applicable if the estate tax is repealed.

5. S Corporations. Much planning will have to be done for S Corporations. There are over 3.5 million S Corporations.

a. Definition of S Corporation. Subchapter S of Chapter 1 of the Internal Revenue Code permits an electing corporation to be taxed in a manner similar to a partnership and thereby avoid double taxation on corporate earnings. Generally speaking, an S corporation is not taxable as a separate entity. Instead, the corporation's income, loss, deductions, and credits are passed through pro rata to its shareholders, who must include these items in the computation of their separate income taxes (Section 1366). Section 1361(b)(1) sets out the requirements that must be satisfied in order for a corporation to elect and maintain S corporation status.

b. Requirements for S Corporation Status

(1) No more than 100 shareholders;

(2) No shareholders other than individuals, estates, certain trusts, and, as of January 1, 1998, certain tax-exempt organizations. The only tax-exempt organizations that qualify are charitable organizations described in Section 501(c)(3) and qualified retirement plans described in Section 401(a);

(3) No nonresident alien shareholders;

(4) No more than one class of stock (for these purposes, differences in voting rights among the shares of common stock are disregarded); and

(5) No membership in an affiliated group determined under Section 1504.

c. Shareholder Consent to S Election. If the foregoing requirements are met, all shareholders must consent to making the S election before the election can be validly made (Section 1362(a)). Once the election has been made, it applies for all succeeding taxable years, so long as the corporation continues to meet the qualifying requirements. The election can also be voluntarily revoked in certain cases.

d. Trusts That Can Hold S Corporation Stock. Section 1361(c)(2) specifies six types of trusts that will qualify as S corporation shareholders:

(1) A voting trust;

(2) A trust, all of which is treated as owned by an individual who is a citizen or resident of the United States under the grantor trust rules of Sections 671–678;

(3) A trust that was a grantor-type trust (including a Qualified Subchapter S Trust ("QSST") for which a qualified election was made) immediately before the death of the deemed owner and that continues in existence after that person's death, but only for a period of two years;

(4) An otherwise nonqualifying trust to which stock was transferred pursuant to a shareholder's will, but only for a period of two years beginning on the date of transfer;

(5) An Electing Small Business Trust ("ESBT"), defined under Section 1361(e), for which a qualifying election is made; and

(6) A QSST, defined under Section 1361(d)(3), for which a qualifying election is made.

6. Employee Stock Ownership Plans ("ESOP"). An ESOP is a defined contribution retirement plan designed to invest primarily in employer securities. Section 4975(e)(7). An ESOP is separate from the family business so a sale to the ESOP is not a redemption, and the rules for qualification of a redemption as an exchange (rather than a dividend) do not apply.

K. Trust Administration and Fiduciary Litigation

1. A repeal of the estate tax may mean that individuals will place more assets and funds in trust than currently, because assets will no longer be depleted to pay estate, gift, and generation-skipping transfer taxes. The more assets that are in trust, the more likely that beneficiaries will fight with themselves

or contest the actions of trustees. Thus, a repeal of the estate tax will likely lead to more fiduciary litigation than currently.

a. With the rise of the use of irrevocable trusts for tax and non-tax reasons, draftspersons and settlors are looking ways to provide for flexibility in these irrevocable trusts. There will be a growing need for advice on this. Methods that are used include:

   (1) Lifetime and testamentary powers of appointment.

   (2) The use of trust directors or protectors who have powers to amend the provisions of irrevocable trusts.

   (3) Reformations.

   (4) Non-Judicial Settlement Agreements under the Uniform Trust Code.

b. An increase in fiduciary litigation or fiduciary disputes could lead to more work for estate planning professionals as expert witnesses, mediators, or arbitrators.

c. In addition, an increase in the amount of assets held in trust because of a repeal of the estate tax could result in the need for more investment advice with respect to the appropriate assets to be held in particular trusts.

L. Mediation or Arbitration

1. Mediation of disputes which is non-binding or arbitration of disputes which is binding may be a way of resolving disputes involving trusts.

2. The trust instrument might simply provide that in the event of disagreement between two individuals—such as a disagreement between two trustees, or a disagreement in a valuation of trust property that might affect two beneficiaries—those individuals must submit the dispute to a third party, whose determination is binding.

3. Of course, such a submission to a third party might be easier envisioned than executed. The two individuals frequently disagree on which third party should resolve the issue.

4. A common alternative is to provide that each party may select a representative, and then those two representatives select the third, neutral party. This is a common approach in disputes over real estate, in which the two appraisers select a third appraiser, whose determination is binding.

**SAMPLE TRUST PROVISION:** In the event that two or more Trustees are then serving, and in the event the Co-Trustees cannot reach a unanimous agreement on a course of action, the Co-Trustees shall unanimously select any individual, bank, trust company, or other entity having trust powers (the "Neutral Party"), who shall decide the issue submitted, and whose decision on said issue shall be binding on all parties. In the event that the Co-Trustees cannot agree on the selection of a Neutral Party, then each Co-Trustee shall have the right to select a Neutral Party, and those Neutral Parties shall unanimously select a further Neutral Party, which further Neutral Party shall decide the issue submitted, and whose decision shall be binding on all parties.

5. There is one important limitation to this submission to a third party: case law suggests that even in this case, the decision of the third party may not be absolutely binding. Instead, the decision may still be reviewed by a court to ensure that the third party acted in good faith, consistent with his or her fiduciary duties.

6. Because of this uncertainty about the ultimate enforceability of such a provision for resolution within the instrument, a grantor may be better served to insert a specific clause requiring submission of the dispute to a formal arbitration. But as discussed in the following section, those arbitration clauses, too, raise doubts about enforceability.

M. Enforceable Arbitration or Mediation Clauses

1. Introduction

a. An arbitration or mediation clause in a trust would require trustees, beneficiaries, and other individuals involved in a dispute over a trust to submit that dispute to an alternative forum of conflict resolution.

b. In mediation, a third party brings the sides together and works with them to develop a voluntary resolution that all parties can voluntarily enter. But the parties must voluntarily agree on such a resolution; if the mediator is unsuccessful in leading the sides to reach such an agreement, then the sides proceed with other means of resolving their disputes.

c. In arbitration, by contrast, the parties submit their dispute to a third party, who resolves that dispute in a binding fashion.

d. Benefits of Arbitration and Mediation

(1) Mediation and arbitration have certain benefits, particularly in the case of disputes over trust matters. This process can take a much shorter time period, thereby heading off a long and bitter family disputes, and lessening the chance that the dispute will embitter family members over years of litigation. Reducing the length of the dispute also reduces costs for both the trust and beneficiaries.

(2) Because of these benefits, grantors in particular might favor the inclusion of a clause in the trust that requires parties to submit the dispute to mediation or arbitration. The grantor might understandably feel that the trust should not exist as a setting for family members to fight over the trust assets, and the grantor might also be concerned that such disputes will burn up the trust assets in litigation.

2. Background Principles of Law

a. Despite the potential advantages of arbitration and mediation clauses, and despite the apparent support that such clauses would have from grantors, current case law probably would not enforce such a clause.

b. An arbitration clause is not favored under the common law, because it is seen to rob parties of their right to have their dispute resolved in court.

c. Instead, an arbitration clause is only enforceable if authorized by statute. Only two states have specifically authorized arbitration clauses in trust by statute.

(1) Florida law also would enforce "[a] provision in a will or trust requiring the arbitration of disputes, other than disputes of the validity of all or a part of a will or trust." <u>See</u> Fla. Stat. Ann. § 731.401.

(2) Arizona law generally makes enforceable any provision in a trust for "mandatory, exclusive and reasonable procedures to resolve issues … with regard to the administration or distribution of the trust." <u>See</u> Ariz. Rev. Stat. Ann. § 14-10205.

d. Absent such a specific statutory authorization, an arbitration clause in a trust would be evaluated under the state's general arbitration statute. Most states' arbitration statutes provide that an arbitration clause is enforceable if it is contained within a "written agreement" or "written contract."

e. Until recently, the few cases that had addressed this issue had held that an arbitration provision in a trust is not enforceable against the trustees or beneficiaries.

(1) In Schoneberger v. Oelze, 96 P.3d 1078 (Ariz. Ct. App. 2004), the Arizona Court of Appeals reasoned that because Arizona would only enforce an arbitration provision in a "written contract," and because a trust is not a "contract," an arbitration provision is not enforceable in a trust.

(2) Similarly, in In re Calomiris, 894 A.2d 408 (D.C. Ct. App. 2006), the D.C. Court of Appeals held that such a provision in a will is not enforceable, because a will is not a contract, either.

3. Recent Case Law. In two recent cases, courts have suggested that under certain circumstances, an arbitration provision in a trust might be enforceable against a beneficiary.

a. Rachal v. Reitz, 403 S.W.3d 840 (Tex. 2013). In Rachal, the Texas Supreme Court held that a beneficiary was bound by an arbitration provision in a trust. Because the beneficiary attempted to enforce his rights to the other provisions of the trust, he was deemed to have consented to the other terms of the trust, including its arbitration provision.

(1) In 2000, Andrew Francis Reitz created a revocable trust, naming himself as initial trustee. As successor trustee he named Hal Rachal, Jr., the attorney who drafted the trust. The trust provided that upon Andrew's death, the trust assets would be held for the benefit of Andrew's sons, James and John. The trust contained an arbitration clause, which required all disputes to be submitted to arbitration.

(2) After Andrew's death, Hal became trustee. John sued Hal, alleging what the Texas court called "systematic looting" of the trust. Hal invoked the arbitration clause and moved the court to compel arbitration.

(3) The Texas Supreme Court reasoned that Texas law would enforce a "written agreement" to arbitrate disputes. It further noted that a party can be deemed to "agree" to an instrument if he sues to enforce his rights under that instrument. Because John was suing to enforce his rights under the instrument, he was deemed to have consented to the other provisions of the trust, including the arbitration clause. The court reasoned that it would be "incongruous" to let John sue

to enforce his rights as beneficiary of the trust, but to allow John to ignore the arbitration clause in the same trust.

b. McArthur v. MacArthur, 224 Cal.App.4th 651 (2014). In McArthur, a California appellate court confirmed the reasoning of Rachal that a beneficiary who challenges the entire instrument which contains the arbitration provision, and who does not seek any benefit under the instrument can avoid being deemed to consent to the terms of the arbitration provision.

(1) In 2001, Frances McArthur created an inter vivos trust, which upon her death would divide Frances' assets into equal shares for her three daughters. In January 2011, Frances executed an amendment to the trust, by which she allocated a larger portion to her daughter Kristi, designated Kristi as a co-trustee, and required that any disputes related to the trust be submitted to mediation and arbitration. Frances died in August 2011.

(2) Following Frances' death, her daughter Pamela contested the 2011 amendment to the trust. She claimed that the amendment was the result of undue influence and that Frances lacked testamentary capacity when it was executed. Kristi moved to compel arbitration to resolve Paula's claims.

(3) Under California law (as in Texas law at issue in Rachal), a "written agreement" to arbitrate future disputes is enforceable against the parties.

(4) The court reasoned that because Pamela contested the 2011 amendment itself, which contained the arbitration provision, she was not deemed to have consented to the terms of the 2011 amendment. The court held that Pamela was therefore not bound by the arbitration provision, and she could proceed in court.

N. Decanting. This is a technique under which a trustee of a current trust may create a new trust and transfer assets to the new trust. Given the differences between the law of the different states that permit decanting either by case law or statute, advice will be needed on decanting.

1. Exercise of discretionary distribution power to create trust. In Florida, before the enactment of its decanting statute, in certain circumstances, a trustee may have been able to create a new trust for a beneficiary through the exercise of a discretionary distribution power. In Phipps v. Palm Beach Trust Co.,[39] the Florida Supreme Court held that a trust authorizing the trustee to pay all or any part of the principal or income of the trust in such

proportions as the trustee determined gave the trustee a "special power of appointment" under which the trustee could create a new trust for any one or more of the beneficiaries of the current trust. The Phipps court believed that the power vested in a trustee to create a fee interest through an outright distribution included the power to create or appoint an estate less than a fee unless the donor indicated a contrary intent. Under the Phipps holding, if a trustee has the discretionary authority to distribute income and principal to a beneficiary, the trustee could create a trust for a problem beneficiary and distribute property to the trust rather than distributing the property outright to the beneficiary. Whether courts in other states without a decanting statute would be as expansive in their reading of an outright distribution power is unclear. However, for a trustee willing to exercise the power to create a new trust, this might provide a solution. Massachusetts has also permitted decanting by case law in Morse v. Kraft in 2013.[40]

2. Uniform Trust Decanting Act

a. The Uniform Trust Decanting Act ("UTDA") was promulgated by the Uniform Law Commission in 2015. The purpose was to provide a more complete set of rules for decanting than currently exist in any state.

b. The UTDA has a stricter set of rules that apply when the settlor gave the trustee limited discretion over distributions and a more liberal set of rules when the trustee has expanded discretion. The person exercising the decanting powers is subject to all applicable fiduciary duties. This includes the duty to act in accordance with the purposes of the first trust.

c. A trustee with limited discretion over distributions may distribute for administrative or tax purposes, but the beneficial interests under the new trust must be substantially similar to the interests under the first trust. This prevents a trustee with limited discretion from reducing or eliminating the interest of any beneficiary.

d. A trustee with "expanded" discretion has the ability to reduce or eliminate the interests of beneficiaries under the first trust.

e. The UTDA limits decanting when it would defeat the charitable or tax-related purpose of the settlor.

f. The UTDA prohibits decanting for the purpose of adjusting trustee compensation without the unanimous consent of the beneficiaries or court approval.

g. The trustee is supposed to give sixty days' notice of the intention to decant to interested parties including the settlor, the beneficiaries, holders of presently exercisable powers of appointment, and holders of the power to remove the current trustee.

h. The UTDA has, as of December 20, 2016, been enacted in two states, Colorado and New Mexico.

3. Decanting Statutes. Twenty-five states now have statutes under which a trustee, pursuant to a power to distribute trust assets outright, may appoint trust assets in favor of another trust. These states are:

1. Alaska[41]
2. Arizona[42]
3. Colorado[43]
4. Delaware[44]
5. Florida[45]
6. Illinois[46]
7. Indiana[47]
8. Kentucky[48]
9. Michigan[49]
10. Minnesota[50]
11. Missouri[51]
12. Nevada[52]
13. New Hampshire[53]
14. New Mexico[54]
15. New York[55]
16. North Carolina[56]
17. Ohio[57]
18. Rhode Island[58]
19. South Carolina[59]
20. South Dakota[60]

21. Tennessee[61]

22. Texas[62]

23. Virginia[63]

24. Wisconsin[64]

25. Wyoming[65]

O. State Death Taxes. Even if the federal estate tax is repealed, many states will have a state death tax. In addition, Connecticut has a state gift tax. Planning will have to be done for residents of states with a state death tax and non-residents with property subject to tax in a state with a state death tax.

1. Planning for individuals who reside in one of these states or who have property subject to a state tax is more complicated than planning for individuals who are not subject to separate state death taxes. The states that currently have a separate state death tax (and their thresholds for tax) are:

| **State** | **Type of Tax** | **2017 Estate Tax Filing Threshold** |
|---|---|---|
| | | |
| Connecticut | Stand-Alone Estate | $2,000,000 |
| Delaware | Estate | $5,490,000 |
| District of Columbia | Estate | $2,000,000 |
| Hawaii | Stand-Alone Estate | $5,790,000 |
| Illinois | Estate | $4,000,000 |
| Iowa | Inheritance | |
| Kentucky | Inheritance | |
| Maine | Estate | $5,490,000 |
| Maryland | Estate and Inheritance | $3,000,000 |
| Massachusetts | Estate | $1,000,000 |
| Minnesota | Estate | $1,800,000 |
| Nebraska | County Inheritance | |
| New Jersey | Estate and Inheritance | $2,000,000 |
| New York | Estate | $4,187,500* |
| Oregon | Estate | $1,000,000 |
| Pennsylvania | Inheritance | |
| Rhode Island | Estate | $1,500,000 |
| Vermont | Estate | $2,750,000 |
| Washington | Stand-Alone Estate | $2,129,000 |

* As of April 1, 2016 and through March 31, 2017. From April 1, 2017 through December 31, 2018 the New York Exemption is $5,250,000.

2. The effective combined federal and state tax rate for those states that are decoupled from the current federal state death tax varies depending upon whether the state permits the taxpayer to take into account the federal deduction in calculating the state tax. Internal Revenue Code Section 2058

allows a deduction for the state tax in calculating the taxable estate, which generally resulted in an iterative (or algebraic) calculation. In some of those states, however, the state law does not allow a deduction for the state tax in calculating the state tax itself. This avoids the iterative calculation, but it changes the effective state and federal tax rates. The federal estate tax return (Form 706) was redesigned to accommodate the calculation of tax in such a state by providing a separate line 3a on page 1 for calculating a "tentative taxable estate" net of all deductions except state death taxes, a line 3b for separately deducting state death taxes, and a line 3c for the federal taxable estate (old line 3). The "tentative taxable estate" in effect was the taxable estate for calculating the state tax (but not the federal tax) in such a state.

3. As the following table shows, the marginal federal rate in 2017 is 33.6% or 34.5% depending on whether the state allows a deduction for the state tax itself.

| **Top Marginal Estate Tax Rates** | | | |
|---|---|---|---|
| | **Federal** | **State** | **Total** |
| **2017** | | | |
| "Coupled" State | 40% | 0 | 40% |
| Ordinary "Decoupled" State | 34.5% | 13.8% | 48.3% |
| "Decoupled" State/No Deduction | 33.6% | 16% | 49.6% |

4. The resulting loss of state revenue and state budgetary shortfalls may lead states that lack a state death tax to enact new state death tax legislation. Two states have already done this. In 2009, Delaware, which had lacked a state death tax since 2005, reinstated its state death tax. Hawaii did so in 2010. Vermont lowered the threshold for its state death tax in 2009. However, it should be noted that some states actually phased out or eliminated their state death taxes at different points. New Jersey has repealed its state estate tax, but not its inheritance tax as of January 1, 2018. These states included Virginia, Wisconsin, Kansas, Indiana and Oklahoma. Other states have increased their thresholds for state death taxes. These states include Maine, Maryland, Minnesota, New York and Rhode Island.

5. Not all states that have a state death tax, as noted above, set the same threshold for the imposition of the tax or enacted consistent provisions concerning whether it would be possible to make an election to qualify a QTIP trust for a state marital deduction distinct from the federal election. The variation in state laws since the enactment of the 2001 Tax Act resulted in a dramatic increase in estate planning complexity for individuals domiciled or owning real or tangible personal property in states with a state death tax. Individuals have explored numerous techniques for dealing with state death taxes, such as change of domicile, creation of legal entities to hold real property and movables, and use of lifetime gifts.

6. The states with a separate state estate or inheritance tax that specifically permit a QTIP election are Illinois, Kentucky (for separate inheritance tax), Maine, Maryland, Massachusetts, Minnesota, New Jersey (only to the extent permitted to reduce federal death tax), Oregon, Pennsylvania (for separate inheritance tax), Rhode Island, and Tennessee (for separate inheritance tax).

7. Portability of the federal exclusion provides further planning options. A couple can avoid all estate tax at the first death by passing property to the survivor in a form that qualifies for the marital deduction. The estate of the first spouse to die can elect portability, giving the survivor $10,980,000 of exclusion in 2017.

   a. The failure to shelter property from state estate tax at the first death can increase overall state estate taxes. Currently, only Hawaii and Delaware follow portability at the state level.

   b. A common solution is to use a credit shelter trust for the state threshold amount and then elect portability for the unused exclusion of the first spouse to die.

8. In an era of a greater federal estate tax exemption, individuals in states with a state death tax still have plenty of opportunities to implement strategies that minimize the impact of state death taxes, through a combination of lifetime transfers, change in domicile, and deferral of payment of state taxes by use of state QTIP elections. But the planning is more difficult because of the separate rules often affecting state and federal taxation.

IV. The Future

A. No matter what happens with respect to the possible repeal of the estate tax, gift tax, and generation-skipping transfer tax in 2017 or later, much work will remain for all estate planners.

B. If Congress fails in any attempt to repeal the estate tax, the gift tax, or the generation-skipping transfer tax, then the work of estate planners will continue as now. Of course, Congress may amend one or more of the three taxes by, for example, increasing the exemption or lowering the rates.

C. If the estate tax is repealed (and presumably if the estate tax is repealed the generation-skipping transfer tax will be repealed), there will still be much work for all estate planners.

   1. For several years after repeal, lawyers will have work to revise estate plans in light of the lack of an estate tax. This may mean changing beneficiaries, the amounts going to specific beneficiaries, or formulas for allocating property. It may also mean seeking to terminate or change the terms of

various irrevocable techniques that were created for estate and gift tax avoidance reasons.

2. If the estate is replaced with a capital gains tax at death, planning will have to account for the imposition of that tax.

3. If there is a carryover basis regime, work will be necessary to account for this.

4. If the gift tax is retained in any repeal of the estate and generation-skipping transfer taxes, planning will have to be done to avoid the gift tax.

5. Planning for estate taxes will still continue in those states with a state death tax.

6. The number of trusts and the value of the assets in trust will likely increase since estate taxes do not have to be paid at death and possibly gift taxes will not have to be paid on lifetime transfers.

7. Insurance will still be used for income replacement, the payment of capital gains tax at death, insuring that beneficiaries receive a minimum amount at the death of one or more insureds, funding business strategies such as buy-sell agreements, or for investment. Private placement insurance may become more popular as a form of investment if there is carryover basis or a capital gains tax at death.

8. The advice and counsel of estate planning professionals, no matter what the discipline will still be needed in areas such as:

    a. Creditor Protection

    b. Assert Protection

    c. Business Planning

    d. Income Tax Planning

    e. Elder Law Issues

    f. Retirement Benefits

    g. Charitable Planning

    h. Insurance Planning

D. While change can be disruptive, even if the estate tax is repealed, the future is bright for those estate planners who are willing to adapt and go after the immense amounts of work that will still be there.

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[1] www.investinganswers.com
[2] www.donaldjtrump.com
[3] Ronald D. Aucutt. "Top Ten" Estate Planning and Estate Tax Developments of 2016.
[4] See Angela M. Vallario, Death by a Thousand Cuts: The Rule Against Perpetuities, 25 J. Legis. 141 & n.1 (1999) (citing John Chipman Gray, The Rule Against Perpetuities 191 (4th ed. 1942)).
[5] Florida Stat. Ann. § 689.225(2)(f). This provision is valid for all trusts created after December 31, 2000. For older trusts, the previous perpetuities period of 90 years remains effective.
[6] Wash. Rev. Code § 11.98.130. This provision is applicable to any irrevocable trust with an effective date on or after January 1, 2002. Unless the trust instrument otherwise provides, this provision does not apply to any irrevocable trust with an earlier effective date or any revocable or testamentary trust with an effective date on or after January 1, 2002 if at all times after the date of enactment the creator of the trust was not competent to revoke, amend or modify the will or trust instrument.
[7] Utah Statutes § 75.2-1203.
[8] Wy. ST. § 34-1-3-139(b).
[9] Nev. Rev. Statutes § 111.031.
[10] Col. Rev. Statutes § 15-11-1102.5 (1).
[11] Tenn. Code § 66-1-202 (f).
[12] See Alaska Stat. §34.27.075 (West 2000) ("The common law rule against perpetuities does not apply in this state"); Idaho Code §55-111 (West 2000) ("there shall be no rule against perpetuities applicable to real or personal property"); Kentucky Rev. Stat, ch. 381, § 224 ("An interest created in real or personal property shall not be void by reason of any rule against perpetuities, whether the common law rule or otherwise. The common law rule against perpetuities shall not be in force in this Commonwealth); N.J. Stat. Ann. § 46:2F-9 (West 2000) ("No interest created in real or personal property shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise. The common law rule against perpetuities shall not be in force in this State"); R.I. Gen. Laws § 34-11-38 (West 2000) ("The common law rule against perpetuities shall no longer be deemed in force and/or of any effect in this state"); S.D. Codified Laws § 43-5-8 (West 2000) ("The common-law rule against perpetuities is not in force in this state"); Wis. Stat. Ann. §700.16(5) (West 2000) ("The common-law rule against perpetuities is not in force in this state"). Pennsylvania Senate Bill 660 (signed on July 7, 2006), amending Pennsylvania Consolidated Statutes Title 20, § 6104.
[13] Idaho's statute provides that "no trust heretofore or hereafter created, either testamentary or inter vivos, shall be declared void [under the Rule]. . ." Idaho Code §55-111. South Dakota's statute provides: "If no action or proceeding has been instituted by July 1, 1984, to declare void any instrument which existed prior to July 1, 1983 under the provisions of this chapter as it existed prior to July 1, 1983, then all such instruments shall be interpreted under this chapter 43-5." S.D. Codified Laws §43-5-9. Wisconsin's statute provides that it "applies to interests in property in existence on July 1, 1971, and to interests in property created after such date." Wis. Stat. Ann. §700.25.
[14] New Jersey's statute provides that the abolishment legislation applies to future property interests or powers of appointment created on or after 7/9/99 or created before 7/9/99 pursuant to the laws of a state that does not enforce the Rule and to which, after 7/9/99, New Jersey law is made applicable by such means as a transfer of the trust situs to New Jersey or a change in the law governing a trust instrument to New Jersey law. See N.J. Stat. Ann. §46:2F-11(a).
[15] Alaska's statute provides that the statutory rule against perpetuities contained in Alaska Statutes §34.27.051 applies to trust instruments executed on or after April 2, 1997 if the trust instrument creates a nonvested property interest subject to the exercise of a power of appointment that creates a new or successive power of appointment. See Alaska Stat. §34.27.070. Neither §34.27.051 nor §37.27.070 discusses nonvested property interests that are not subject to such powers of appointment. Therefore, it appears to be unclear whether the repeal of the Rule applies

retroactively to all nonvested property interests. Rhode Island's statute provides that the Rule is no longer in force provided that "the provisions of this section shall not be construed to invalidate or modify the terms of any interest which would have been valid prior to the effective date of this act [1999]. . ." R.I. Gen. Laws §34-11-38.

[16] N.C. Gen. Stat. §41-23.

[17] Brown Brothers Harriman Trust v. Benson, 202 N.C. App. 283 (2010), appeals denied by North Carolina Supreme Court, 703 S.E. 2d 157 (2010).

[18] Hawaii Rev. Stat. §525-4(6).

[19] See Del. Code Ann. tit. 25, §503(a) (West 2000) ("No interest created in real property held in trust shall be void by reason of the common law rule against perpetuities and no interest created in personal property held in trust shall be void by reason of any rule against perpetuities, whether the common law rule or otherwise").

[20] See id. at §503(b).

[21] Mich. Comp. Laws §§ 554.91-94.

[22] Richard W. Nenno. "Let My Trustees Go! Planning to Minimize or Avoid State Income Taxes on Trusts." Proceedings of the 2012 Heckerling Institute on Estate Planning. p. 15-7. (Hereafter "Nenno"). This paper is the best single source on the income taxation of trusts and estates from a state perspective.

[23] Nenno, p. 15-8.

[24] Nenno, p. 15-8.

[25] Nenno, p. 15-9.

[26] Nenno, p. 15-9.

[27] Nenno, p. 15-9.

[28] Va Code Ann. § 58.1-302.

[29] 23 VAC 10-115-10.

[30] Cal Rev and Tax Code § 17742.

[31] See, e.g., Private Letter Rulings 201510001–201510008 (issued October 10, 2014; released March 6, 2015).

[32] N.Y. Tax Law § 605(b)(3)(A)–(C).

[33] N.Y. Tax Law § 605(b)(3)(D).

[34] N.Y. Tax Law § 612(b)(41) (McKinney).

[35] Bernard Kliska, *Planning for Business Succession*, CHI. BAR ASS'N, Apr. 16, 1996, at 1.

[36] *Id.* at 1.

[37] MASSMUTUAL, AMERICAN FAMILY BUSINESS SURVEY 7 (2007).

[38] MASSMUTUAL, AMERICAN FAMILY BUSINESS SURVEY 7 (2007).

[39] Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940).

[40] 466 Mass. 92 (2013)

[41] Alaska Stat. § 13.36.157

[42] Ariz. Rev. Stat. §14-10819

[43] Col. Rev. Stat. §15-16-901 et. seq.

[44] Del. Code tit 12 § 3528

[45] Fla. Stat. § 736.04117

[46] 760 ILCS 5/16.4

[47] Ind. Code § 30-4-3-6

[48] KRS § 286.175

[49] MCL § 556.115a

[50] Minn. Stat § 502.85

[51] Mo. Rev. Stat. § 456.4-419

[52] Nev. Stat. § 136.037

[53] N.H. Rev. Stat. § 564-B:4-418

[54] Uniform Decanting Act, passed March 8, 2016 and effective January 1, 2017

[55] N.Y. EPTL § 10-6.6(b).

[56] N.C. Gen. Stat. § 36C-8-816.1

[57] Ohio Rev. Code § 5808.18

[58] HB7664

[59] S. Car. Stat § 62-7-816A

[60] S.D. Codified Laws § 55-2-15

[61] Tenn. Code § 35-15-816(b)(27)

[62] Texas Property Code §§ 112.071-112.087

[63] VA Code § 64.2-778.1

[64] Wis. Trust Code § 701.0418
[65] Wy. Stat. § 4-10-816(a) (xxviii)