GOOD N' PLENTY:
WEALTH TRANSFER AND INCOME TAX PLANNING OPPORTUNITIES UNDER THE 2017 TAX ACT

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I. Introduction

The very high (by historical terms) GST tax and estate tax exemptions afforded by the Tax Cuts and Jobs Act of 2017 should increase the popularity and usefulness of flexibly-drafted dynasty trusts as a transfer tax planning tool. Assets transferred to a GST exempt dynasty trust can remain available for the use and enjoyment of generations of beneficiaries in perpetuity while remaining outside the transfer tax system forever. Dynasty trusts have many benefits for families with substantial or even a modest level of wealth because they can protect assets from creditors, avoid or minimize state income taxes, avoid or minimize gift taxes and handle any future Congressional change of heart regarding the estate and GST tax law while serving as a powerful tool for making intergenerational transfers of wealth. Trusts that are irrevocable and perpetual require careful drafting so that they include the utmost flexibility because the law, the financial circumstances of the trust, and the circumstances of the trust beneficiaries, will likely change during continuation of the trust in ways that were not foreseen or considered when the governing instrument was drafted.

A dynasty trust agreement can be designed to provide beneficiaries with enormous benefits beyond the traditional right of a beneficiary to receive outright distributions. For example, a trust agreement could allow the trustee to purchase residential real estate as an asset of the trust and allow a beneficiary to live in the residence rent-free. Instead of making a large distribution to a beneficiary to purchase a home, if the trustee purchased the home within the trust and allowed the beneficiary to live in it, the value of that home could remain outside of the transfer tax system and it would be protected from the claims of the beneficiary's creditors. The trust agreement also can allow a trustee to guarantee bank loans made to the beneficiaries, invest in business ventures owned or managed by beneficiaries or even make loans to the beneficiary to start up a business or make loans to the business. The trust agreement could also contain provisions to create a supplemental needs trust for a beneficiary (either automatically or in the discretion of the trustee if the need arises) so that it is possible to maximize that beneficiary's eligibility for governmental benefits while having supplemental needs met through the trust's assets. A dynasty trust also can be drafted to provide the trustee with precatory language or directives that give the trustee guidelines concerning distributions. For example, the settlor could express his or her intent that distributions not be made to or for the benefit of beneficiaries if the trustee believes the money could be used for any illegal purposes, or for drugs, alcohol or gambling, if the beneficiary is incarcerated, or is living an unproductive lifestyle. The dispositive provisions could state that distributions should not be made for the expenses and costs of basic support and maintenance of a healthy, competent beneficiary who is of working age and not a full-time student. This would encourage such beneficiaries to pursue a career and become financially independent. The settlor could express an intent that distributions be made for the benefit of a beneficiary who does not have sufficient assets for health insurance, disability or long-term care

insurance coverage. And of course, the trust can contain silent trust provisions so that beneficiaries are unable to obtain information about the trust for a period of time.

Suppose that a wealthy client simply bequeaths all of his or her assets outright to children or grandchildren because the estate tax exemption is so high. Now those assets are in the children or grandchildren's hands. An outright bequest does not address the risk that wealth would be dissipated in a single generation due to unprepared spendthrift descendants, untimely deaths, a possible return of the estate tax, creditors' claims and divorce settlements. If a lower estate or GST tax exemption is ever reinstituted, any assets remaining in the hands of the beneficiaries would be subject to those taxes. If the beneficiaries had instead received the inheritance in a flexible dynasty trust, all future generations could benefit from the wealth without the application of any gift tax through discretionary distributions by the trustee, and provide for future generations by means of the exercise of powers of appointment. A dynasty trust could sprinkle distributions among generations of the client's descendants, enable the use and enjoyment of trust property and adapt to future changes to the family situation and tax laws, while providing creditor protection and allowing the beneficiaries to enjoy substantial control over the trust.

II. Dynasty Trusts.

A dynasty trust is siumply a trust that has no termination event within its terms and, thus continues perpetually. Some jurisdictions permit so-called perpetual trusts, but frequently have a maximum duration such as 360 years or 1,000 years. Over 20 years ago, Delaware repealed its rule against perpetuities, thus permitting perpetual dynasty trusts.[1] Real estate held directly in a trust is subject to a 110 year rule against perpetuities, however, that can be easily remedied at any time by transferring the real estate into a limited liability company or other entity.[2]

Often, a dynasty trust is structured as a so-called grantor trust for federal income tax purposes, which means that the grantor is required to personally pay all of the federal (and typically state) income taxes on the income of the trust, thereby effectively allowing the value of those assets to compound within the trust income tax-free.[3] This is generally viewed as a positive estate planning technique because the payment of the income taxes of the trust are not treated as additional taxable gifts. At the settlor's death, or the death of a surviving spouse, the dynasty trust is frequently divided into per stirpital shares for the settlor's issue, although some settlors prefer to continue the trust as a single "pot" trust. The trust assets are available to be distributed to or for the benefit of the trust beneficiaries at all times, but if the beneficiaries have sufficient assets outside the dynasty trust to meet their needs, the assets in the trust will continue to grow for the benefit of future generations of the settlor's issue free from transfer taxes in perpetuity. Typically, ultimate charitable beneficiaries or intestate heirs are named in the event none of the settlor's issue is living before the dynasty trust is exhausted.

1 25 Del. C. § 503(a).
2 25 Del. C. § 503(b).
3 *See* I.R.C. §§ 671-679 and Rev. Rul. 2004-64 2004-2 CB 7.

Dynasty trusts provide numerous benefits that would simply not be available if the assets were simply transferred outright to the beneficiaries, including potential state income tax savings, transfer tax savings, and creditor protection.[4] Under the generation-skipping transfer ("GST") tax as in effect in 2018, each person has approximately a $11,180,000 exemption available for use during lifetime or at death which matches the exemption from the federal gift tax.[5] If GST exemption is allocated to a transfer to a dynasty trust, the trust and all transfers from the trust are exempt from GST tax. If a trust's settlor and the settlor's spouse agree to "split" the gift to the dynasty trust, pursuant to section 2513, both spouses may allocate their GST tax exemptions to a single trust.[6] Thus, a married couple can fund an approximately $22.4 million dynasty trust that is entirely exempt from gift tax, estate tax and GST tax for so long as the assets are held in trust. Such a trust remains exempt no matter how large the corpus grows.

As stated above, usually, a dynasty trust will be structured as a so-called grantor trust for federal income tax purposes, meaning that the grantor will pay the income tax on the trust's income and the trust will grow tax free for the rest of the grantor's life.[7] This is generally viewed as an estate planning advantage because the grantor's payment of the trust's income taxes is not treated as an additional taxable gift to the trust; accordingly, the trust receives the benefit of growing free from income taxes for future generations. In Revenue Ruling 2004-64, the IRS made it clear that a settlor's payment of income tax on the income of a grantor trust, the contributions to which were the subject of completed gifts, is not treated as an additional gift to the trust.[8] Typically, the trust is treated as a grantor trust because of the inclusion of a provision that allows the grantor to substitute property for property of an equivalent value.[9] The grantor's non-fiduciary power to acquire trust property by substituting property of equivalent value should not, by itself, cause the value of the trust principal to be included in the grantor's taxable estate under section 2036 or 2038, so long as the trustee has a fiduciary duty, under either the trust instrument or applicable local law, to insure that the substituted properties are in fact of equivalent value, and the exercise of the power does not shift benefits among trust beneficiaries.[10] Delaware has a statute, 12 Del. C. § 3316, which compels this treatment

[4] *See* T. Pulsifer & T. Flubacher, *Dynasty Trusts May Be Even More Powerful If Transfer Tax Laws Change*, Estate Planning Vol. 34 No. 11 (November 2007).

[5] *See* I.R.C. §§ 2631; 2505. All references to a "section" or "§" of the Code or the Treasury Regulations refer to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

[6] I.R.C. § 2652(a)(2). Note, however, that under section 2513, gift-splitting is unavailable if the settlor's spouse is also a discretionary beneficiary of the trust such that the interest of the spouse cannot be quantified.

[7] I.R.C. §§ 671-679.

[8] Rev. Rul. 2004-64, 2004-2 CB 7.

[9] *See* I.R.C. 675(4)(C).

[10] *See* Rev. Rul. 2008-22, 2008-1 C.B. 796 (A grantor's non-fiduciary power to acquire trust property by substituting property of equivalent value will not, by itself, cause the value of the trust principal to be included in the grantor's taxable estate under I.R.C. Section 2036 or 2038, so long as the trustee has a fiduciary duty, under either the trust instrument or applicable local law, to insure that the substituted properties are in fact of equivalent

so that it complies with Revenue Ruling 2008-22. It provides that the fiduciary responsible for investment decisions has the responsibility to ensure equivalent value, and this could be the trustee or in the case of a directed trust could be the investment adviser. Making the spouse a discretionary beneficiary of both trust income and principal or giving an independent person the power to add beneficiaries will also cause a trust to be treated as a grantor trust.[11] A flexibly drafted grantor trust should also confer the ability to "turn off" grantor trust treatment by releasing or disclaiming the powers causing grantor trust treatment.

The IRS has ruled that if, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under section 2036(a)(1).[12] If, however, the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate so long as that does not cause the grantor's creditors to have access to the trust. Delaware's spendthrift statute provides that a trustee's discretionary authority to pay directly or to reimburse the settlor for any tax on trust income or principal that is payable by the grantor shall not cause the trust assets to be subject to the claims of the grantor's creditors solely by reason of this discretionary authority.[13] Thus, the grantor can retain the right to be reimbursed from the trust for income tax liabilities and, so long as this does not cause the trust assets to become subject to the claims of the grantor's creditors, this should not produce adverse estate tax consequences.

If a dynasty trust is taxed as a grantor trust, the grantor can sell an asset, such as a closely held business, start-up company, or some other type of growth asset, to the trust in exchange for an installment note. The trust must be a grantor trust so that the sale does not trigger a taxable event that will cause capital gains (a grantor trust is treated as the same as the grantor for these purposes). The conventional wisdom with such transactions is that the trust must have assets independent of the assets purchased in order for the transaction to be respected as a sale for debt, rather than a transfer with a retained interest.[14] If a settlor of a trust is able to fund a trust with $22,400,000, the settlor could sell a growth asset valued in excess of over $200,000,000 to the trust, and all of the growth on that asset, after repayment of the debt, would be outside of the transfer tax system. This could be a very powerful estate "freeze" technique. An estate freeze technique such as this will provide the opportunity to shift massive amounts of future

value, and the exercise of the power does not shift benefits among trust beneficiaries); *see also* Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (applying the same reasoning to the substitution of a life insurance policy).

11 See the spousal attribution rules under I.R.C. § 672(e).

12 Rev. Rul. 2004-64, 2004-2 CB 7.

13 12 Del. C. § 3536(c).

14 *See* M. Gans & J. Blattmachr, *Private Annuities and Installment Sales: Trombetta and Section 2036*, 120 J. TAX'N 227 (May 2014).

growth on assets outside of the transfer tax system without the current payment of gift tax. Moreover, it should protect the assets from estate and GST taxes in the future, even if the exemptions are lowered again at a later time.

A. What if an Estate Is Not Subject To Estate Tax?

Notwithstanding with unprecedented $11.2 million exemption, dynasty trusts drafted to maximize flexibility should continue to be a most desirable estate planning tool, providing adaptability, appropriate governance, creditor protection and state income tax avoidance, all in a transfer-tax free safe-haven. In other words, every client, big and small, should be packing as many assets as possible into flexible perpetual irrevocable trusts.[15] A big motivation for transferring assets to a dynasty trust is that that a future Congress can be expected to someday reenact a lower exemption. Dynasty trusts help families with any level of wealth protect their assets from creditors, avoid or minimize state income taxes, avoid or minimize gift taxes and handle any future Congressional change of heart regarding the estate and GST tax law while serving as a powerful tool for making intergenerational transfers of wealth. A dynasty trust agreement can be designed to provide beneficiaries with enormous benefits beyond the traditional right to receive outright distributions.

Many descendants' initial reaction may be to prefer an outright distribution of wealth rather than a beneficial interest in a trust because of a perception that trusts are a costly and burdensome tool of the lawyers and bankers that removes control of the family wealth to third parties who then determine rights to the use and enjoyment of the assets. However, heirs should prefer receiving an inheritance in the form of a well-designed dynasty trust rather than an outright bequest, if their goal is continued enjoyment of the assets with a substantially reduced risk of diversion or loss. A dynasty trust drafted with sufficient built-in flexibility and control can actually provide descendants with all of the advantages of a trust, while offering a level of indirect control and enjoyment that may closely mirror outright ownership. Nonetheless it may be challenging for wealth planners to convince clients who assume that using trusts is tax motivated or only needed to protect the very young that a bequest in trust can provide beneficiaries with superior enjoyment of the family wealth and many important additional protections that cannot be achieved otherwise.

Beneficiaries may possess many rights and powers over assets held in trust without incurring adverse gift (and if applicable, estate and GST tax) consequences or exposing the assets to creditor claims. There are many important non-tax motivations for creating trusts irrespective of estate tax planning. These motivations should be important to both the settlor and the beneficiaries.

[15] *See* T. Flubacher, How to Deal With Repeal - Dynasty Trust Planning Will Be an Essential Tool, Trusts & Estates Magazine (March 2017).

B. GST Planning

With an $11.2 million GST tax exemption, modifications to GST non-exempt trusts and GST transfers might be able to occur without adverse GST tax consequences. Under current law, modifications to GST exempt trusts such as divisions, settlement agreements, decanting, judicial and non-judicial modifications, and certain constructions cannot be made without losing GST exempt status unless the modifications fall within the safe harbors found in the Treasury Regulations.[16] If beneficiaries have available exemption, it may be advisable to trigger inclusion in a beneficiary's estate to identify a new transferor for GST tax purposes, to extend the duration of a trust, or to possibly get a step-up in basis using the techniques discussed below.[17] With an $11.2 million exemption and the ability to trigger a new transferor without incurring estate tax, GST exempt trust may be modified without fear of loss of tax benefits. So long as the modification would not implicate gift or income taxes, it could be made, even to extend the duration of a trust to enhance its exemption from taxation.

C. Turning Revocable Trusts Into Dynasty Trusts.

Certainly many clients will not be able to make a gift during lifetime that uses up their entire $11.2 million exemption. Those clients would be well advised to create a GST exempt perpetual dynasty trust at death to avoid future estate taxes. However, if the client does not live in a dynasty trust jurisdiction, thoughtful planning will be necessary to ensure that the assets passing by testamentary disposition are able to pass into a dynasty trust that does not violate the rule against perpetuities in their domicile jurisdiction. In most jurisdictions, if the client passes assets by will or through their revocable trust of which they are the trustee, it will likely violate their home-state's rule against perpetuities.

The determination of whether a trust violates the rule against perpetuities is a matter of trust validity. Under conflicts of laws rules, the validity of a trust is determined at the time of its creation. The perpetuities rules in the states vary considerably. Currently, 20 states permit perpetual trusts, 8 states permit very long trusts, 14 states follow the USRAP (including California, Connecticut, Georgia, Indiana, Massachusetts, South Carolina), 8 states follow the common law rule against perpetuities (including New York and Texas), and one state (Louisiana) usually requires trusts to terminate at the later of the death of the last income beneficiary or 20 years after the trustor's death.

For all of the reasons described in this outline, clients would be well-advised to pass all of their wealth into a flexible dynasty trust that provides tremendous flexibility and utility, while offering all of the benefits of a trust while keeping the assets outside of the transfer tax system forever. Those clients should consider funding a dynasty trust at death through a testamentary transfer, such as a will or

16 Reg. § 26.2601-1(b)(4).

17 *See* 25 Del. C. § 504; *see also* I.R.C. § 2041(a)(3); Reg. § 20.2041-3(e)(1)(ii).

revocable trust, so the assets can pass to future generations in a dynasty trust. Advisers and clients who reside in a rule against perpetuities jurisdiction should be cautioned about creating a traditional revocable trust in their jurisdiction, or even funding it from a pour over from the will because that will likely violate the rule against perpetuities.

Suppose that a testator or trustor wants to create a Delaware dynasty trust that will last longer than the period permitted by the common-law rule against perpetuities or the USRAP that is in effect in their home state. If the home state is one of the 8 states that still have the common law rule or is one of the 14 states that follow the USRAP, then a beneficiary might successfully challenge the trust in a home state court, arguing that the trust violated the rule against perpetuities. For example, if a client in New York creates an inter vivos revocable trust and names himself or herself as trustee, and then after death, a Delaware trustee is appointed as successor trustee, or the assets pour over to a Delaware perpetual trust, that would appear to violate the rule against perpetuities. The rule against perpetuities says that all interests in a trust must vest or fail within lives in being plus 21 years. If a New York revocable trust pours over to a perpetual Delaware trust, those terms in the New York revocable trust would also violate the New York rule against perpetuities and the New York revocable trust will be void ab initio. That is because the revocable trust is a trust, and all interests in that revocable trust would not vest or fail within lives in being plus 21 years. Also, this same prohibition is generally applicable to other testamentary transfers like a pour over from a will. If the client sets up a Delaware dynasty trust during lifetime and funds it at that time, then clearly Delaware law would govern the validity of that trust and the Delaware perpetuities law would apply to the trust (just as it does with all of the completed gift dynasty trusts that we create all the time). That is the only way the assets can stay in trust in perpetuity without risk that you are violating the home state's rule against perpetuities.

D. Drafting Flexibility.

To address changes in circumstances regarding the tax, economic, and political environment and the specific factual circumstances of the beneficiaries over generations, it is imperative that a dynasty trust be drafted with maximum flexibility in mind. A super-flexible dynasty trust could be drafted with many additional features to ensure that it can adapt and withstand the test of time. It should be drafted so that if the trust divides into per stirpital shares at the death of each generation, it is held for the primary beneficiary as well as his or her descendants as an open class that has purely discretionary sprinkle interests, to maximize flexibility. It is also recommended that the trustee or a direction adviser or trust protector be given express powers to decant, divide trust, merge with another trust, make administrative amendments and grant powers of appointment, which could be drafted to go beyond the scope of what is permissible under applicable state statutes. This will enable changes to occur in the trust terms in the future. Additionally, the trust could include the role of a non-fiduciary "selector," who can add or remove beneficiaries, and a "trust

protector," who can hold a variety of powers defined in the document, such as changing the trust situs and governing law, appointing and removing trustees, receiving accounts and binding beneficiaries, and making other decisions. When drafting a dynasty trust, it is very important to ensure that the mechanisms for appointing trustees, direction advisers, selectors and trust protectors will continue to operate appropriately even when all persons named are no longer serving or able to serve.

E. Enjoy protection from creditors and divorce claims.

A properly designed dynasty trust will protect trust assets from the claims of beneficiaries' creditors and reduce assets available to address spousal divorce claims if it includes a spendthrift clause and is governed by the laws of a state that protects trust assets from such claims. Trusts are one of the few estate planning tools that can provide liberal use, enjoyment and disposition of assets while avoiding taxes, creditors, divorce settlements and spendthrift heirs that may cause dissipation of family wealth.

F. Control investments.

A directed trust is a trust that includes a power of direction whereby an adviser or another trustee, who could be a beneficiary, directs the trustee in the exercise or non-exercise of certain powers relating to the administration of the trust.[18] One use of a trust director would be to direct the trustee's exercise of investment decisions pertaining to all or a portion of the assets. Descendants can control all investment decisions or certain special holdings like closely held entities, real estate and concentrated positions, by serving as the investment advisor or investment trustee of a directed trust. Alternatively, the beneficiaries may have a special relationship with a local investment manager other than the corporate fiduciary that has an office close to their residence and is better equipped to manage the family's investment needs in the trust. An individual with specialized expertise in running the family business that is held in a trust may possess the special skills required to make business decisions for that investment. The settlor may want to pass wealth down to successive generations through the use of a trust, but is not yet ready to turn over the investment management. Here, the settlor can retain the power to manage the trust investments by serving as the investment adviser and directing the trustee. In any of these situations, a directed trust can help facilitate the objectives of the settlor or beneficiaries where the trustee is unable or unwilling to do so. The investment responsibilities and liabilities can be assigned to an investment adviser, named in the trust instrument,

[18] For further discussion of directed trusts, see Todd A. Flubacher, Directed Trusts: Panacea or Plague?, Trusts & Estates Magazine (Feb. 2015); Todd A. Flubacher and David A. Diamond, The Trustee's Role in Directed Trusts, Trusts & Estates Magazine (Dec. 2010); Richard W. Nenno, Good Directions Needed When Using Directed Trusts, Estate Planning Journal (Dec. 2015); Mary Clarke and Diana S.C. Zeydel, Directed Trusts: The Statutory Approaches to Authority and Liability, Estate Planning Journal, (Sep. 2008).

and the trust instrument can require the trustee to act solely upon that investment adviser's direction.

An investment adviser could have responsibility for directing the trustee with respect to all of the trust assets, some portion of the trust assets, or specific assets (sometimes referred to as "Special Holdings" or "Special Assets"). In that case, liability for a concentration would be shifted to the investment advisor, who may be held to a lesser standard of care than a trustee would be. Often, the investment adviser will be responsible for directing the valuation of assets subject to direction, particularly when values are not readily available on a public exchange. There are many reasons why a settlor may wish to allocate responsibility for investment decisions to an investment adviser. One common reason is to enable the trust to hold specialized assets. An individual serving as investment adviser who knows the settlor (or may even be the settlor) may be more willing to hold an interest in a single limited liability company, or a closely held business or other special asset, and may be more in tune with the settlor's plans for future transactions involving a family-owned company or start-up. An individual with specialized expertise in running the family business may possess the special skills required to make business decisions for the company. A settlor may also want more than one investment manager for the trust assets. In that case, the trustee could be directed to allocate assets among multiple investment managers.

G. Control distributions.

Another common use for directed trusts is where a distribution adviser directs the trustee with respect to distribution powers. Settlors often want the responsibility for making trust distributions to belong to individuals who are close to the family and have personal knowledge of the beneficiaries' needs. This may be particularly desirable where a beneficiary has special needs or where the trust instrument includes lifestyle incentives or prohibitions that require personal knowledge and impose commitments of time and attention. Within limits, descendants can have control over distribution decisions by serving as the distribution advisor of a directed trust. Such powers should exclude the descendant as a beneficiary or be limited to an appropriate ascertainable standard described in section 2041(b).

H. Remove and replace trustees and advisors and appoint a special purpose trustee.

Descendants can remove and appoint the trustee and any investment advisors, distribution advisors, trust protectors or any other power holder. Descendants can also have the power to appoint a special purpose trustee from time to time with exclusive power to exercise specific, limited or restricted powers, duties or responsibilities. The power to remove and appoint persons possessing powers that, if held by the beneficiary, would trigger a transfer tax, should be limited to

successors who are not related or subordinate to the beneficiary within the meaning of section 672(c).[19]

I. Serve as a co-trustee.

Descendants could serve as a co-trustee of their trust, although that role should be carefully limited to avoid adverse transfer tax concerns that could arise if the gift and estate tax are in effect. For example, beneficiaries should not possess the power to make distributions to themselves, unless the distribution power is limited to an ascertainable standard.[20]

J. Use and enjoy assets.

The trustee can have discretion to permit beneficiaries to use and enjoy trust assets, with all of the advantages of assets held in trust, including continued immunity from transfer taxes and creditor protection. The trustee could also make and guarantee loans to beneficiaries or invest in a beneficiary's start-up business ventures. For example, a trust agreement could allow the trustee to purchase residential real estate and allow a beneficiary to live in the residence rent-free. In fact, the agreement can allow beneficiaries to use any property owned by the trust, including things like boats, works of art or airplanes. The trust agreement also can allow a trustee to guarantee bank loans made to the beneficiaries, invest in business ventures owned or managed by beneficiaries or even make loans to the beneficiary to start up a business (or make loans to the business). Instead of making a large distribution to a beneficiary to purchase a home, if the trustee purchased the home within the trust and allowed the beneficiary to live in it, the value of that home could receive all of the tax and creditor benefits of other property held in trust.

K. Appoint assets at death or during life.

Beneficiaries can have a testamentary (or lifetime) limited power of appointment over a fully discretionary trust, thus giving the beneficiaries substantial control over the disposition of assets, effectively allowing them to make tax-free transfers among descendants, facilitate gifts to charities and change the dispositive plan. Note that is current beneficiary exercises a lifetime power of appointment, it could result in a taxable gift to the extent that it reduces that beneficiaries interest

[19] There may be adverse transfer tax consequences if a beneficiary possesses the power to remove and appoint trustees or other fiduciaries if the fiduciary has a power of distribution not limited by ascertainable standards or other power that might trigger a transfer tax if possessed by the beneficiary, unless the appointed trustee is not a related or subordinate party to the grantor under Section 672(c). *See, e.g.,* Rev. Rul. 95-58, 1995-2 C.B. 191 (relating to removal and replacement powers held by a settlor which has been extended by private letter rulings (not precedent) to similar powers held by a beneficiary).

[20] *See* Reg. §20.2041-1(c)(2).

in favor of another beneficiary. ,It is the IRS's view that the exercise is a taxable gift, the value of which is a question of fact.[21]

L. Save state income taxes.

Depending on the state in which the grantor and beneficiaries are domiciled, it may be possible to avoid all state income taxes on trust income and capital gains. If the dynasty trust is created in a jurisdiction that imposes no state income tax, the trust will avoid taxation in those taxing jurisdictions that base their income tax regime on the location of the trustee.[22]

M. Limit information.

In some jurisdictions, it is possible to limit or eliminate the information that some or all beneficiaries are entitled to receive for a period of time with a so-called "silent trust." A silent trust can be used by settlors who wish to restrict beneficiaries' rights to notice and information or accountings for a period of time. For example, the settlor of a very large trust may not wish for the beneficiaries to become aware of the trust until they reach a suitable age, in order to foster productive lives, careers and education and prevent the beneficiaries from becoming dependent upon the trust. This could facilitate goals such as avoiding the wealth becoming a disincentive for a productive life or preventing beneficiaries who reside in high risk locations or who have personal problems from being harmed by the source of wealth. A designated representative could receive informal accounts on behalf of beneficiaries, and is frequently insisted upon in order to permit the trustee to account. Silent trusts are also useful to validate so-called "blind trusts" for politicians and public officials.[23]

N. Promote productive lifestyles.

Trusts can include precatory language setting forth settlor values and wishes, creating incentives or precluding distributions in the case of drug or alcohol abuse, incarceration or other harmful behavior. Holding assets in trust, as opposed to outright ownership, can also prevent disincentivized heirs. Clients with special assets, such as privately held businesses and real estate, often prefer such assets to be held in a trust, instead of passing outright to descendants. A dynasty trust can be drafted to provide the trustee with certain guidelines concerning distributions. For example, the settlor could express an intent that distributions not be made to or for the benefit of beneficiaries if the trustee believes the money could be used for any illegal purposes, or for drugs, alcohol or gambling, or in the case of a beneficiary who leads a life of unrepentant crime or self-destruction. Any such provision should give the trustee broad discretion to

[21] *See* Rev. Rul. 75-550, 1975 C.B. 357; Priv. Ltr. Rul. 200243026 (July 24, 2002) (not precedent); Priv. Ltr. Rul. 8608002 (Oct. 7 1985) (not precedent).

[22] *See* 30 Del. C. § 1635-1636.

[23] *See,* 12 Del. Cl. §§ 3303, 3339.

make a determination, including by relying on the judgment of other family members. A precatory provision authorizing a trustee to withhold distributions in that even, but not requiring it, will provide the greatest protection for a trustee. A provision authorizing a trustee to limit distributions to medical expenses in such a case can be beneficial. The dispositive provisions could state that distributions should not be made for the expenses and costs of basic support and maintenance of a healthy, competent beneficiary who is of working age and not a full-time student. This would encourage such beneficiaries to pursue a career and become financially independent. The trust might also require achieving certain educational goals, although the instrument should permit deviation in the case of a beneficiary who achieve financial independence without attaining those goals. The settlor could express an intent that distributions be made for the benefit of a beneficiary who does not have sufficient assets for health insurance, disability or long-term care insurance coverage, regardless of any other guidance that might limit distributions. The trust could also encourage beneficiaries to develop productive business skills by making loans to a beneficiary for a business enterprise in which a beneficiary is involved if such beneficiary possesses good judgment and financial acumen and if the beneficiary presents the trustee with a professional business plan that passes muster.

O. <u>Protect special needs descendants.</u>

Trusts can be designed to protect beneficiaries from losing governmental benefits such as, for example, Social Security Administration benefits, Medicaid and Supplemental Security Income benefits or any other benefits from any private or public profit or non-profit organization. The trust agreement could contain provisions to create a supplemental needs trust for a beneficiary so that it is possible to maximize that beneficiary's eligibility for governmental benefits while having supplemental needs met through the trust's assets.

P. <u>Protect assets from the return of the estate tax.</u>

A dynasty trust that is designed to prevent federal estate tax inclusion or a GST tax under current law, and has enough flexibility within the document to adapt to changing circumstances in the future, should protect the assets held in the trust from any future gift, estate or GST tax, should those taxes ever return. If a dynasty trust is designed to avoid estate inclusion in the estates of the beneficiaries and the settlor, and to avoid taxable gifts by the beneficiaries, then the assets should be protected from future transfer taxes for so long as the assets remain in trust.

III. <u>Addressing Future Tax Issues With Drafting Flexibility.</u>

Including the assets of a trust could be advantageous under certain circumstances. For example, depending upon the specific circumstances it could be advantageous to cause some of the assets of a dynasty trust to be included in the taxable estate of a beneficiary, if the estate tax exemption is very high, the beneficiary has all of his estate tax exemption

available, and the trust has low-basis assets. In this situation, estate inclusion could provide a step-up in basis, without incurring any negative transfer tax consequences. Another example of a situation where it could be advantageous to cause the assets of a dynasty trust to be included in the taxable estate of a beneficiary is where trust assets are not GST tax exempt. By including the assets in the taxable estate, the trust could avoid the GST tax and use the beneficiary's estate tax shelter instead.

A. Springing General Power of Appointment.

One way to cause the assets of a dynasty trust to become includible in a beneficiary's estate is a so-called springing general power of appointment. This is accomplished by drafting language in the trust instrument that grants the trustee the discretion to give a beneficiary a general power of appointment, thus triggering estate tax under section 2041.

B. Delaware Tax Trap.

Another way to cause the assets of a dynasty trust to become includible in a beneficiary's estate is to use a testamentary limited power of appointment to intentionally trigger the so-called Delaware tax trap.[24] Section 2041(a)(3) relating to the estate taxation of powers of appointment, and section 2514(d) of the Code relating to lifetime transfers, are colloquially known as the "Delaware tax trap" because they were enacted in order to prevent estate and gift tax avoidance through the use of Delaware trusts. When the provisions were enacted in 1942, most states, including Delaware, applied the common law rule against perpetuities, which limited a trust's duration to lives in being when the trust was created plus 21 years. Where a trust instrument included a power of appointment, and the power holder exercised the power, most state laws required that the perpetuities measuring period relate back to the time the trust was originally created. Delaware, however, had a rule that when a power of appointment (whether general or special) was exercised, a new period for measuring the rule against perpetuities commenced upon the exercise of the power. Thus, for example, suppose that under Delaware law, a grantor created a trust with income to his son for life, and thereafter as the son might appoint. The son could appoint by granting his daughter income for life and granting her a power to appoint the remaining trust property upon her death, she could do the same for her child, and so on. Each exercise would start a new perpetuities period running, so that (absent section 2041(a)(3) and before the present Delaware rule against perpetuities), a Delaware trust could have lasted forever and not be subject to federal estate taxation. To deal with this Delaware problem, Congress enacted a rule embodied in sections 2041(a)(3) and 2514(d) which stated that if a power holder exercises a power of appointment created after October 21, 1942 by creating another power of appointment which under the applicable local law (i.e., Delaware) can be validly exercised so as to postpone the vesting of any estate or

[24] J. Blattmachr and J. Pennell, *Using "Delaware Tax Trap" to Avoid Generation Skipping Taxes*, 68 J. TAX'N 242 (Apr. 1988).

interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the creation of the first power, then the property subject to the power is includible in the gross estate of the person who creates the second power. Thus, looking at the law in Delaware at the time when the Delaware tax trap legislation was enacted, if a holder of a testamentary special power of appointment exercises that power to create another power of appointment, then upon the holder's death the entire trust corpus would be includible in the holder's gross estate for federal estate tax purposes.

Under current Delaware law, it is generally possible to exercise a limited power of appointment in a manner that will cause the property subject to the power to be included in the power holder's federal gross estate under the Delaware tax trap. Under Delaware law, a person can exercise a limited power of appointment in favor of a further trust which contains a limited power of appointment that can be exercised so as to postpone the vesting of the trust property for a period determined without regard to the date of the creation of the first power. Under section 2041(a)(3), if someone exercises a power of appointment in this fashion, the exercise will cause all of the assets subject to the exercised power of appointment to be included in the estate of the power holder. The beneficiary would exercise his or her power of appointment in favor of a further trust which contains a second power of appointment. This second trust could be written to last only a short period of time, such as six months, in order to trigger the Delaware tax trap and then distribute the assets to the beneficiaries' issue. In some instances, it may be an advantageous tax planning strategy to cause some or all of those assets to be included in the beneficiary's taxable estate. If such trusts are settled in Delaware, the power holders may, for example, elect to cause trust property to be included in their gross estates in order to avoid the imposition of the generation-skipping tax in cases where the power holder's estate tax rate is below the generation-skipping tax rate. It is also always possible to exercise the limited power of appointment in a fashion that does not cause the property subject to the power to be included in the power holder's federal gross estate. The assets subject to a power will not be includible in the power holder's taxable estate if the power holder either (1) does not exercise the power, (2) exercises the power but does not create another power of appointment, or (3) exercises the power so as to create another power of appointment, where the second power of appointment relates to the date of creation of the first power. Thus, for example, a power holder can obviously avoid estate taxation by not exercising his or her power over the assets that he or she does not want included in his or her estate. The power holder could also avoid estate taxation while exercising his or her power by exercising the power to create a further trust which does not contain a power of appointment. If desired, the power holder could design the new trust so that the trustee or trust protector of the new trust holds the powers that otherwise would have been given to a beneficiary power holder. Finally, the power holder could exercise the power in a fashion that creates a second power, however, he or she could provide in the instrument effecting the exercise that every estate or interest in property created through the exercise of the second power shall vest within a

specified time period measured from the date of creation of the first power (for example, within 100 years following the creation of the first power). The Treasury Regulations expressly provide that property subject to a special power is includible in the power holder's gross estate under section 2401(c)(3) only if the second power created by the exercise of the first power can, under the terms of the instrument exercising the first power and applicable local law, be validly exercised so as to postpone vesting of the property for a period ascertainable without regard to the date of creation of the first power.[25] Therefore, in any case where the instrument exercising the first power expressly provides that all property subject to the second power must vest within a specified time period measured from the date of creation of the first power, it is clear that the property subject to the first power is not includible in the power holder's gross estate under section 2041(c)(3). The ability to utilize a limited power of appointment to either cause or avoid estate taxation can be a very useful tax planning opportunity because it provides a beneficiary with maximum flexibility in deciding exactly what amount of the assets in a trust shall be includible in his or her estate by purposely "triggering the trap" over the portion of assets that the beneficiary wants to have included in his or her estate for tax planning purposes. This flexibility in Delaware's law does not exist under the laws of any other state.

IV. SLAT With Maximum Flexibility.

Clients can be understandably concerned about giving away a large portion of their wealth, and may want to retain the potential to someday access those assets again in the future. This is particularly true in the present situation where we see such large gift tax exemptions. There are several options that planners can consider. Sometimes planners will consider completed gift asset protection trusts or a trust in which the grantor could be added as a beneficiary in the future, or the grantor could be the potential object of an exercise of a limited power of appointment that is exercisable by another person. Some states have enacted so-called asset protection trusts, and spendthrift statutes that provide adequate creditor protection for such structures which can help ensure that transfers can be treated as completed gifts.[26] Perhaps a bigger concern grantors frequently have is that while they want to make an irrevocable gift to a trust for beneficiaries, they recognize that the need to change the way the assets are ultimately disbursed from the trust, in the event of changed circumstances in the future. In other words, grantors often get cold feet about being permanently committed to an irrevocable structure.

A so-called "Spousal Lifetime Access Trust" ("SLAT") can be drafted with so much flexibility that it can satisfy all of these concerns. A SLAT is a trust that includes the grantor's spouse as a discretionary beneficiary, yet contributions to the trust are completed gifts for gift tax purposes because the trust does not satisfy the requirements of qualified terminable interest property under Code Section 2523(f)(2). With this structure, the grantor's spouse could receive distributions from the trust. Consequently, a grantor who is happily married could make a completed gift to a SLAT, but also potentially

25 Reg. § 20.2041-3(e)(1)(ii).

26 *See* 12 Del. C. §§ 3570 et seq.; 12 Del. C. §§ 3536.

benefit from the trust assets in the future if distributions are ever made to his or her spouse.

The plan begins with an inter vivos dynasty trust, drafted to incorporate all of the flexibility tools described above. The trust instrument will include express decanting and amendment powers, and the trustee will have very broad trustee powers and discretion over distributions to classes of beneficiaries. Such a structure will maximize flexibility. The trust would be structured as a SLAT and the beneficiaries (including the spouse) will be giving maximum flexibility, such as limited powers of appointment, and the power to remove and appoint all fiduciaries, transfer situs and choice of law, and they will even have the option to serve as investment direction advisers and possibly co-trustees. Lastly, the trustees will be given tools such as springing general power of appointment to address future tax problems. The flexible dynasty trust can include as many of the tools described above as the settlor wishes.

Another powerful feature of the SLAT is the fact that although the grantor cannot possess the power to alter who receives the assets because that would cause estate inclusion under section 2036, the grantor's spouse can possess that right in the form of a limited power of appointment. The spouse could possess a lifetime or testamentary limited power of appointment that could be exercised to change the disposition of the trust assets without adverse transfer tax consequences. This flexibility is available as long as the spouse is alive and is a beneficiary of the SLAT, possessing that power. The trust could also provide that the spouse has a beneficial interest and a power of appointment only for so long as she is a qualified spouse, meaning married to and living with the settlor, and has not commenced any action for separate maintenance or divorce. The opportunity to change the disposition of the trust's assets will be lost once the spouse dies and the spouse could pre-decease the grantor, or ceases to be a qualified spouse. However, there is another tool that can be used to provide this flexibility, even following the death of the grantor and beyond.

The trust could include the role of a "selector" who possesses the non-fiduciary power to add and remove beneficiaries. Selector provisions are commonly used by planners to trigger grantor trust treatment, and have been used frequently in offshore trusts.[27] So long as the grantor's spouse is a beneficiary with the ability to receive discretionary distributions of both income and principal, the trust will be treated as a grantor trust for federal income tax purposes anyway, due to spousal attribution under section 672(e), and grantor trust treatment could not be turned off during the spouse's lifetime without removing the spouse as a beneficiary. While such provisions are often included as pro forma merely to trigger grantor trust treatment, it can be used to make the trust tremendously flexible and adaptable. The selector could even be used to remove the interest of the spouse. The selector can provide additional flexibility to alter the beneficiaries and remaindermen of irrevocable trust if the spouse dies before the grantor, which would have negated the flexibility afforded by the spouse's lifetime and

[27] I.R.C. § 674(b)(5) (If the trustee is not an adverse party and any person has the power to add beneficiaries to the trust (other than to account for after-born or after-adopted children), the trust will be a grantor trust.)

testamentary powers of appointment. A selector could add charities, nieces and nephews or siblings of the grantor as beneficiaries of the trust.

Good N' Plenty:

The Delaware Tax Opportunity

Springing the Delaware Tax Trap to Increase Cost Basis Using a Trust Beneficiary's Unused Exemption

2018 Delaware Trust Conference

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Wilmington Trust, N.A.

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The Opportunity – The Delaware Tax Trap is a preferred method for utilizing a beneficiary's unused estate tax exemption to increase the tax cost basis of a trust's assets.

A trust beneficiary whose own gross estate will fall well below the federal estate tax exemption has certain planning opportunities for increasing the tax cost basis of assets held in trust for their benefit. By using their otherwise unused estate tax exemption, the beneficiary may include trust assets in their taxable estate to obtain a step-up in the income tax cost basis of the assets upon their death under § 1014 of the Internal Revenue Code (IRC or the Code). The preferred method to trigger the Tax Trap for obtaining a basis step-up requires that the beneficiary must possess a limited testamentary power of appointment and the trust must be administered in a state, like Delaware, that permits a limited power to be exercised to trigger the Tax Trap using a second limited power of appointment. Most trust-friendly states do not permit the Tax Trap to be sprung in this manner so it is truly the Delaware Tax Opportunity.

Common Methods for Achieving a Step-up in the Cost Basis of Trust Assets

A. Using Distributions from a Trust to "Top Up" a Beneficiary's Estate

One strategy used to achieve a basis step-up is to have the beneficiary request a significant distribution from the trust to "top up" their estate and obtain a step-up in cost basis of the assets upon their death. They can place these assets back into a trust upon their death for the same beneficiaries of the original trust in order to continue the estate plan created by their ancestor who settled the original trust. However, this strategy carries with it certain risks and limitations.

1. A distribution from the trust out to the beneficiary would generally carry out current-year taxable income as part of the distributable net income of the trust if the trust is not a grantor-type trust at the time of the distribution.
2. These assets would be exposed to the beneficiary's creditors before they are placed back in trust upon the beneficiary's death.
3. The beneficiary may also misuse or dissipate the assets instead of following their original plan to resettle a new trust for the same beneficiaries.
4. The beneficiary must generally wait to fund the new trust until their death in order to obtain the step-up in cost basis. This delay in funding the trust is required so the assets are included in the beneficiary's estate to obtain a basis step-up. This delay makes it nearly impossible to precisely match the required distributions from the original trust with the exemption that will be available upon the beneficiary's death. It is even possible that trust assets could be over-distributed, appreciate in value, or the available exemption reduced, to cause

the beneficiary's gross estate to exceed the exemption amount available to the beneficiary upon death and owe federal estate tax.

B. Grant the Beneficiary a General Power of Appointment Over Trust Assets

Most "modern" trusts give a power to the trustee or a trust protector to grant to beneficiaries a general power of appointment ("GPA")[1] over trust assets. This power to grant GPAs is a common tool used to eliminate potential generation skipping transfer tax ("GSTT") – a beneficiary would receive a general power of appointment over trust assets to the extent such power would reduce the GSTT to zero. However, the ability to grant a GPA is often a broad power that is for more purposes than to minimize only GSTT so this power may allow for the grant of a GPA for other tax savings opportunities such as increasing the cost basis of trust assets. Consequently, it may be possible under the terms of the trust agreement to grant GPAs as a method for including assets in a beneficiary's estate to increase the cost basis of those assets.

Some of the drawbacks of this tool include:

1. Most older trust instruments don't contain the power to grant a GPA so this tool may not be available. However, most trusts provide current beneficiaries with special (or limited) powers of appointment ("SPA")[2] to provide estate planning flexibility without generally causing inclusion in the beneficiary's gross estate of the trust assets subject to the SPA. A beneficiary's exercise of an SPA is the tool needed for use of the Delaware Tax Trap.
2. A GPA is a blunt instrument for purposes of gaining a step-up in cost basis for trust assets.
    a. Even if the amount subject to the GPA is tailored to the beneficiary's available exemption so that the inclusion of the assets does not increase the beneficiary's estate tax liability, the identity of the assets subject to the power and, therefore, includible in the beneficiary's estate, may be uncertain. Without ensuring that the lowest-basis assets are included within the power of appointment, the value of the step-up may not be maximized.
    b. The grant (or failure to grant) the GPA is not within the beneficiary's control. A third party (typically, a trustee or trust protector) is the one with the ability to grant the GPA. If they fail to act, the beneficiary's exemption may be wasted. The fiduciary with the power to grant a GPA

[1] A general power of appointment (GPA) is defined under IRC Sections 2041(b)(1) and 2514 (c). The definition under Section 2041 states that a GPA is "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate…". The definition is similar for gift tax purposes under Section 2514.

[2] A special power of appointment (SPA) is a power of appointment that is not a general power of appointment. Trust assets subject to an SPA are not generally included in the beneficiary's gross estate unless deemed to be included due to application of the Delaware Tax Trap.

may be focused upon only minimizing GSTT and not be aware of basis step-up opportunities. If they grant too much power, the beneficiary may be forced into paying estate tax.

c. General powers of appointment may expose the property subject to the power to the beneficiary's creditors.
d. Finally, the specific assets included in the beneficiary's estate may be an inefficient use of their exemption if the powers granted to them are not properly customized.

C. THE OPPORTUNITY: The Delaware Tax Trap Sprung in Delaware Using SPAs

The Delaware Tax Trap is an opportunity for a trust beneficiary to control the use of their available exemption amount, customizing its use to the precise amount of their remaining exemption, while targeting the lowest-basis assets held in trust to maximize the basis step-up upon their death. The Tax Trap does not expose trust assets to the beneficiary's creditors[3] and avoids the potential misuse of trust assets by the beneficiary prior to their death.

1. The Delaware Tax Trap is a fairly precise tool that can ensure the beneficiary is not exposed to an increased estate tax liability while at the same time targeting for increase the trust assets with the lowest relative cost basis thereby maximizing the basis step-up offered by the use of the beneficiary's exemption.
2. Although the "Delaware" tax trap (IRC Section 2041(a)(3)) applies to trusts administered in any state, only Delaware and a handful of other states provide a trust beneficiary with the opportunity to exercise a limited power of appointment to maintain the assets in an ongoing discretionary trust while including the assets in the beneficiary's estate for basis step-up purposes. The other states, including all of the other trust-friendly states (e.g, NV, SD, AK, NH, WY), have either (i) prevented by statute the springing of the Delaware Tax Trap or (iii) allow the Trap to be sprung using only presently exercisable general (PEG) powers of appointment (which carry significant disadvantages), or both.[4]

Definitions

<u>First Power</u> – a special (nongeneral) lifetime or testamentary power of appointment granted by an inter vivos trust instrument or by a Will.

<u>Second Power</u> – a second or further special (nongeneral) lifetime or testamentary power of appointment conferred by the exercise of a First Power.

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[3] *See* Title 12 Del. Code §§3536(d)(1), 3536(d)(2).
[4] Raatz, *USRAP Surprise Trigger of Delaware Tax Trap*, Estate Planning Journal, May 2016.

HISTORY

Delaware Pioneers "Perpetual" Trusts Despite the Rule Against Perpetuities

In 1933, every state in the country had a rule against perpetuities ("RAP") that limited the duration of a trust. The common law RAP provides that "no interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest."[5] The common law RAP and, later, the Uniform Statutory Rule Against Perpetuities ("USRAP") provide that the validity of an interest in trust (Second Power) created by the exercise of an SPA (First Power) is measured from the date of creation of the original trust that granted the SPA (First Power). The result is that the period used to measure the validity of unvested interests created through the exercise of an SPA "relates back" to the date when the original SPA (First Power) was created.[6] Due to this relation-back doctrine, the common law RAP and the USRAP require that the time period within which a Second Power, created through the exercise of a First Power, may be exercised, and during which any interest created by an exercise of the Second Power must vest, is measured by calculation of the perpetuities period starting on the date of the creation of the First Power.[7] The original date of creation remains the relevant starting point for measuring the perpetuities period so the perpetuities clock may not be re-set through the exercise of successive powers of appointment.

To circumvent the Rule Against Perpetuities, Delaware enacted legislation in 1933[8] that allowed the option, through the exercise of SPAs in successive generations, for assets to remain in trust without being required to vest in possession within the original RAP period. As noted above, the common law RAP required that the validity of an exercise of a Second Power granted by the exercise of a First Power relates back to the creation of the First Power. The new Delaware law provided that the date of <u>exercise</u> of the First Power, <u>not the date of creation</u> of the First Power, was the applicable starting point for

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[5] Gray, John Chapman, The Rule Against Perpetuities, Little, Brown, and Company (1886), § 201.
[6] Restatement, Second, Property (Donative Transfers) §1.2 h.
[7] See, e.g., USRAP at §2.
[8] 38 Del. Laws 198, Section 1 (1933). The Delaware statute read: "Every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of a power of appointment, irrespective of whether the power is limited or unlimited as to appointees, irrespective of the manner in which such power was created or may be exercised, and irrespective of whether such power was created before or after the passage of this Act, shall for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted be deemed to have been created at the time of the exercise and not at the time of the creation of such power of appointment; and no such estate or interest shall be void on account of any such rule unless such estate or interest would have been void had it been created at the date of the exercise of such power of appointment otherwise than through the exercise of a power of appointment."

measuring the perpetuities period applied to the valid exercise of the Second Power. Essentially, the new Delaware legislation was a clever method to void the relation-back theory for testing the validity of a Second Power. Untethered from application of the relation-back doctrine, assets could remain in trust through the exercise of successive powers without imposition of an estate tax.[9]

This new Delaware statute removed the relation-back rule and provided that the perpetuity period for the Second Power is fixed upon the date of exercise of the Second Power without regard to the date of creation of the First Power. The statute may be condensed as follows: Every interest in property (Second Power) created through the exercise of a power of appointment (exercise of First Power) shall for RAP purposes be deemed to have been created at the time of the exercise of the First Power and not at the time of the creation of such First Power. Because the exercise of an SPA does not generally cause inclusion in the powerholder's gross estate, the trust assets roll forward in trust without being subject to an estate tax. Current Delaware law[10] retains the basic rule originally enacted in 1933 and provides that violations of the RAP are measured from the date of exercise of a power of appointment instead of from the date of creation of the power. Another section of the law clarifies that "trusts created by the exercise of a power of appointment, whether nongeneral or general, and whether by will, deed or other instrument, shall be deemed to have become irrevocable by the trustor or testator on the date on which such exercise became irrevocable."[11]

As an example, G creates a trust in 2018 and grants his daughter, D, a testamentary SPA (First Power). D exercises her SPA upon her death in 2025 to appoint the property for the benefit of her son, S, and grants to S a testamentary SPA (Second Power). The RAP applicable to S's Second Power is calculated from 2025, not from 2018. The perpetuities "clock" is re-set upon the exercise by D of her SPA (First Power) to create S's SPA (Second Power).

Enter the Delaware Tax Trap (the "Tax Trap")

The Tax Trap enacted in 1951 was Congress's response to the new "perpetual" Delaware trusts that would avoid estate tax forever. The Tax Trap attacked the Delaware statute by imposing the relation-back doctrine through the tax code. If the exercise of a Second Power could violate the relation-back doctrine, the assets appointed through the exercise of the First Power were includible in the gross estate of the beneficiary who exercised the First Power in this manner.

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[9] Barton Leach, "Perpetuities in a Nutshell," 51 Harv. L. Rev. 638, 653.
[10] 25 Del. Code Section 501.
[11] Title 25 Del. Code. Section 503(c).

Internal Revenue Code Section 2041(a)(3)[12] (the "Delaware Tax Trap") includes in the gross estate all property "[t]o the extent of any property with respect to which the decedent – (A) by will, or (B) by a disposition which is of such nature that if it were a transfer of property owned by the decedent such property would be includible in the decedent's gross estate under section 2035, 2036, or 2037, exercises a power of appointment created after October 21, 1942, by creating another power of appointment [a Second Power] which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the [F]irst [P]ower." The Delaware Tax Trap imposed the relation-back doctrine to the successive exercises of SPAs with the penalty for violation of the doctrine being inclusion in the gross estate of the beneficiary exercising the First Power. The beneficiary was "trapped" for estate tax purposes if they attempted to create a perpetual trust in Delaware to circumvent the estate tax.

The legislative history of this new provision added in 1951 clearly indicated that the law was intended to trap for taxation within the RAP all trust assets that would otherwise escape taxation through the successive exercise of nongeneral powers of appointment. The Senate Finance Committee's report stated that "[i]n at least one State a succession of powers of appointment, general or limited, may be exercised over an indefinite period without violating the rule against perpetuities. In the absence of some special provision in the statute, property could be handed down from generation to generation without ever being subject to estate tax."[13]

Treasury regulations further clarify when a beneficiary exercising a nongeneral power of appointment springs the Tax Trap. The determination is based upon the terms of the instruments creating and exercising the First Power and applicable local law.[14] If the First Power is exercised to create another power of appointment (the Second Power) but local law provides that the exercise of a First Power to create a Second Power does not commence a new perpetuities period, the Tax Trap may not be sprung. Applicable local law imposes the relation-back doctrine so these assets do not need to be trapped for taxation upon the expiration of the original RAP.

Case Law

The only reported case that has addressed §2041(a)(3) is *Estate of Murphy v. Commissioner.*[15] The Tax Court held that the exercise of a First Power to create a

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[12] IRC Section 2514(d) is the corresponding federal gift tax provision that defines as a taxable transfer the exercise of a First Power to create a Second Power not subject to the relation-back doctrine, i.e. the Tax Trap under the gift tax provisions of the Code.
[13] S. Rep. No. 82-382 (1951).
[14] Reg. Section 20.2041-3€(1)(ii).
[15] 71 T.C. 671 (1979).

Second Power did not spring the Tax Trap because under applicable state law (Wisconsin), the exercise of the SPA did not suspend the power of alienation beyond the period measured from the date of creation of the First Power. The government had argued that § 2041(a)(3) applied whenever a First Power was exercised to create a Second Power if only one of the three prohibited conditions of title existed – (i) a postponement of vesting, (ii) the suspension of absolute ownership, or (iii) suspension of the power of alienation of property. However, the Tax Court held that Congress did not intend for the Tax Trap to apply in a state, such as Wisconsin, that has only a rule against the suspension of the power of alienation. If this applicable local law provides a limitation period ascertainable with regard to the date of creation of the First Power, the Tax Trap is avoided. The IRS acquiesced in the result of the case.[16]

Administration of Trust in Delaware Permits Springing the Tax Trap Even if the Beneficiary Holding the First Power Does not Reside in Delaware.

A common question is which state's law applies to determine the effect of a beneficiary's exercise of an SPA. If the beneficiary holding the First Power resides in a state that does not allow for the exercise of the power in a manner that springs the Tax Trap, the cost basis management opportunities for that beneficiary are limited. However, the law governing the administration of the trust determines how the power of appointment may be exercised and the ramifications of such exercise.[17] Consequently, increasing the cost basis of trust assets through the exercise of a First Power to create a Second Power should be possible by having the trust administered in Delaware with a Delaware trustee regardless of where the beneficiary exercising the SPA resides.

Availability of the Tax Trap in a State that Allows Perpetual Trusts

In the absence of case law interpreting §2041(a)(3), there has been a lot of debate regarding the application of the Tax Trap in a state that has eliminated its rule against perpetuities. Is the Delaware Tax Trap sprung in every case or is it impossible to spring the Tax Trap? Neither of these conflicting viewpoints should prevent the targeted use of the Tax Trap to increase cost basis using a beneficiary's unused exemption.

There are two "requirements" of the Tax Trap that are discussed when determining its application in a given situation. The first is the "matching rule" which provides that the Tax Trap is sprung if the perpetuity period for the Second Power does not match the

[16] 1979-2 C.B. 2.
[17] Wilmington Trust Co. v. Wilmington Trust Co., 24 A.2d 309 (Del. 1942). *See also*, Wilmington Trust Co. v. Sloane, 54 A.2d 544 (Del. Ch. 1947).

perpetuity period of the First Power. The second is a requirement that the Second Power postpones the vesting or the suspension of the power of alienation beyond the limits imposed upon the First Power. However, neither of these "requirements" is explicitly stated in the Tax Trap IRC sections, Treasury Regulations, nor case law. Both requirements are inferred from Congress' motives when enacting the Tax Trap and property law theories supporting enforcement of a rule against perpetuities. Neither should limit the availability of the Tax Trap as a tool available in Delaware for increasing cost basis through the use of a beneficiary's unused exemption amount.

The Tax Trap is not sprung whenever a First Power is exercised to create a Second Power under a state's law that allows for a perpetual trust.

Some commentators argue that to avoid springing the Tax Trap, the applicable state law must provide a definable period against which the vesting of an interest may be measured.[18] A period must be specified during which vesting may be postponed. Such period begins on the date of the Second Power's exercise and ends on a date that cannot be ascertained without regard to the date of creation of the First Power. Hence, avoidance of springing the Tax Trap requires a finite perpetuities period. In a state that allows for a perpetual trust, the argument goes, there is no finite vesting period so any exercise of a First Power to create a Second Power springs the Tax Trap.[19]

However, the Tax Trap by its statutory terms does not require a fixed or finite period to avoid springing the trap, only that the applicable period is ascertainable without regard to the date of the creation of the First Power. A fixed-period requirement does not appear anywhere in the IRC Tax Trap sections, Treasury Regulations, nor cases considering §2041(a)(3). §2041(a)(3) causes estate inclusion upon the creation of a Second Power that can be exercised to suspend vesting of trust property for a "period ascertainable without regard to the date of creation of the first power". Following the logic of the argument that a perpetual trust does not provide for a finite "period", §2041(a)(3) literally cannot apply to cause estate inclusion because no ascertainable period is created. The Second Power may vest without regard to the date of creation of the First Power. Moreover, an indefinite period is still a period of time and may be measured with regard to the date of creation of the First Power. An indefinite period measured from today will be longer than the same indefinite period measured beginning tomorrow. For the cautious practitioner, an explicit solution to address this

[18] Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, Estate Planning Journal, Vol. 28, No. 02 (Feb 2001).
[19] Spica, *A Trap for the Wary: Delaware's Anti-Delaware-Tax-Trap Statute Is Too Clever by Half (or Infinity), 43 Real Prop., Tr. & Est. J. 673 (Winter 2009).*

concern is for the instrument exercising the First Power to place a maximum fixed period (even 1,000+ years) which relates back to the creation of the First Power.[20]

<u>The Tax Trap May Be Sprung in a State That Allows for Perpetual Trusts</u>

On the other side are commentators who suggest that the Tax Trap may not be sprung in a perpetual trust state because the indefinite duration of a perpetual trust may not be "re-set" upon the exercise of a First Power to create a Second Power.[21] A perpetual trust "is forever and that's a mighty long time".[22]

Although the stated intent of the Tax Trap was to attack the postponement of vesting offered by the Delaware law, the mechanism used to implement the rule was whether the relation-back doctrine applied to the vesting period of the Second Power. Springing the Tax Trap (causing inclusion in the gross estate of the beneficiary/decedent who exercised the Frist Power) requires that the applicable perpetuities period (period for which vesting may be postponed or the power of alienation suspended) for the exercise of the Second Power, if any, is determined (ascertainable) without regard to the date of creation of the First Power.

It is important to note that the Tax Trap does not require that the applicable period for measuring the validity of the Second Power is a longer period than the original perpetuities period. Delaware law provides that the Second Power is "deemed to have been created at the time of the exercise and not at the time of creation of such [First P]ower of appointment."[23] By definition, the period for the Second Power is ascertainable without regard to the date of the creation of the First Power. The applicable perpetuities period for the Second Power is determined at the time of the exercise of the First Power, not with regard to the date of creation of the First Power. The relation-back doctrine does not apply so the Tax Trap would be sprung. Delaware law has an opt-out provision to avoid the Tax Trap, if that is desired.[24]

Anti-Tax Trap Laws

In response to the perceived threat of inadvertently springing the Tax Trap to cause unnecessary estate tax, many states enacted laws which prevented the exercise of an SPA to reset the RAP other than by granting a presently exercisable general power of

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[20] Nenno, *Getting a Stepped-Up Income-Tax Basis and More by Springing-or Not Springing-The Delaware Tax Trap the Old-Fashioned Way,*" 40 Tax Management Estates, Gifts and Tr. J., No. 5, 215 (Sept. 10, 2015).
[21] Kolasa, *Problems in Springing the Delaware Tax Trap*, Trusts & Estates Magazine, April 2018. *See, also*, Horn, *Flexible Trusts and Estates for Uncertain Times*, at 559 (ABA, 6th ed. 2017).
[22] Prince and the Revolution, *Let's Go Crazy*, Purple Rain, Warner Brothers (1984).
[23] Title 25 Del. Code §501(a).
[24] Title 25 Del. Code §501(b).

appointment. These laws took away the flexibility to trigger the Tax Trap using successive SPAs when doing so would be advantageous. As mentioned previously, GPAs carry significant drawbacks as a mechanism for gaining basis step-up for trust assets. Consequently, administering a trust in a state that enforces an anti-Tax Trap law should be avoided to retain the flexibility of using a beneficiary's unused estate tax exemption to obtain a step-up in cost basis using successive SPAs.

Some Trust-Friendly States With Anti-Tax Trap Statutes

Alaska[25] – "If a nongeneral power of appointment is exercised to create a new or successive nongeneral power of appointment . . . , all property interests subject to the exercise of that new or successive nongeneral . . . power of appointment are invalid unless, within 1,000 years from the time of the creation of the original instrument or conveyance creating the original nongeneral power of appointment that is exercised to create a new or successive nongeneral. . . power of appointment, the property interests that are subject to the new or successive nongeneral . . . power of appointment either vest or terminate."[Emphasis added]

Nevada[26] – "For purposes of NRS 111.103 to 111.1039, inclusive, a nonvested property interest or a power of appointment arising from a transfer of property to a previously funded trust or other existing property arrangement is created when the nonvested property interest or power of appointment in the original contribution was created."[Emphasis added]

South Dakota[27] – "If a future interest or trust is created by exercise of a power of appointment, the permissible period is computed from the time the power . . . is created if the power is not a general power."[Emphasis added]

Statutes to Protect Grandfathered Trusts From an Inadvertent Tripping of the Trap

Delaware's law[28] protects from the inadvertent trigger of the Tax Trap over grandfathered or GSTT-exempt assets. However, an exception exists to allow the Tax

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[25] Alaska Stat. §34.27.051(c)
[26] Nev. Rev. Stat. §111.1033(3).
[27] S.D. Codified Laws §43-5-5.
[28] Title 25 Del. Code §504(a). "Notwithstanding any other provision of this chapter and except as otherwise provided in subsection (b) of this section, in the case of a power of appointment over property held in trust (the "first power"), if the trust is not subject to, or has an inclusion ratio of zero for purposes of, the tax on generation-skipping transfers imposed pursuant to Chapter 13 of the Internal Revenue Code or any successor provision thereto and the first power may not be exercised in favor of the donee, the donee's creditors, the donee's estate or the creditors of the donee's estate, then every estate or interest in property, real or personal, created through the exercise, by will, deed or other instrument, of the first power,

Trap to be sprung over grandfathered or GSTT-exempt assets under circumstances where it may be desirable to do so (e.g., a beneficiary intends to step-up the tax cost basis utilizing the beneficiary's unused estate and GSTT exemptions).[29]

Does a decanting process trigger the Tax Trap? The answer is "No".

The Second Restatement of Property characterizes a trustee's discretionary power to invade principal as a power of appointment. Moreover, a trustee's "decanting" power (ability to distribute trust property in further trust) is generally interpreted as an exercise of a power of appointment.[30] Consequently, the exercise of the trustee's distribution powers in further trust may be viewed as the exercise of a First Power that could potentially trigger the Tax Trap if this exercise grants a Second Power in a manner that provides a perpetuities period that is ascertainable without regard to the date of creation of the First Power.

However, this question was answered directly in the legislative history of the Tax Trap. The Tax Trap sections of the Code exclude a trustee's discretionary power to invade principal which is not coupled with an interest in the property. Only beneficially held powers of appointment are the subject of the Tax Trap.[31] Consequently, a decanting process undertaken to extend the duration of a trust should not trigger the Tax Trap.[32]

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irrespective of: (1) The manner in which the first power was created or may be exercised, or (2) Whether the first power was created before or after the passage of this section, shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted, be deemed to have been created at the time of the creation of, and not at the time of the exercise of, the first power. For purposes of applying the foregoing rule, if any part of an estate or interest in property crated through the exercise of the first power includes another power of appointment (the "second power"), then the second power of appointment and any estate or interest in property (including additional powers of appointment) created through the exercise of the second power shall be deemed to have been created at the time of the creation of the first power."

[29] Title 25 Section 504(b). "Subsection (a) of this section shall not apply to the exercise of a first power or second power over property held in trust that is not subject to, or has an inclusion ratio of zero for purposes of, the tax on generation-skipping transfers imposed pursuant to Chapter 13 of the Internal Revenue Code or any successor provision thereto if the instrument of exercise of any such power makes express reference to subsection (a) of this section and expressly states that subsection (a) of this section shall not apply to the exercise of the power or makes express reference to Section 501 of this title and expressly states that Section 501 of this title shall apply to the exercise of the power."

[30] Restatement, Second, Property (Donative Transfers) §11.1 d.
[31] S. Rep. No. 82-382, at 1535 (1951).
[32] *See* PLR 200744020 (decanting of a grandfathered trust did not fall within §2041(a)(3)).

Conclusion:

The Delaware Tax Trap is a powerful tool used to increase the tax cost basis of trust assets by including those assets in the gross estate of a trust beneficiary without exposing those assets to the beneficiary's creditors or increasing the beneficiary's estate tax burden. Moreover, the Tax Trap is customizable to soak up only a beneficiary's unused estate tax exemption while stepping up the cost basis for the lowest basis assets held in trust. While the Tax Trap may be available in many states through the use of PEG powers, the drawbacks of granting general powers of appointment make it important to spring the trap using successive SPAs. The Tax Trap tool should be available to beneficiaries residing in any state as long as the trust granting the First Power is being administered in Delaware with a Delaware trustee. With the increased federal estate tax exemption and the likelihood that many trust beneficiaries may die with unused federal estate tax exemption, administering a trust in Delaware retains the flexibility for the beneficiary to spring the Tax Trap using SPAs when appropriate.

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WILMINGTON TRUST

The Delaware Income Tax Advantage for Trusts

Establish your trust in the right state, the First State

By: Jeffrey C. Wolken
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KEY POINTS

- Recent changes in the federal tax laws have provided a renewed focus on state income taxes and strategies available to minimize these taxes
- While personal trusts have been used most commonly as estate and gift tax planning tools, they now have increased importance as vehicles for minimizing a family's federal and state income tax liability
- If you live in a high-tax state there may be opportunities to reduce or eliminate state taxes on some of your income by establishing a new trust in Delaware or moving an existing trust to the First State

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The Tax Cuts and Jobs Act passed in late 2017 made significant changes to many areas of federal tax law and highlighted the importance of income tax planning. Personal trusts, where individuals establish trusts for their own benefit or the benefit of other individuals, have been used most commonly as estate and gift tax planning vehicles. However, some of the changes under the new federal law have increased the importance of these trusts as tools for minimizing a family's federal and state income tax liability. Holding family wealth inside a trust may limit the ability of your home state to tax the trust's income, and provides flexibility in customizing the income tax cost basis step-up upon death. Your family's asset "location" (where your assets are held in trust) instead of asset "allocation" (how your assets are invested) is now a primary driver of wealth by reducing or eliminating the drag of income taxes. The following strategies may provide opportunities for your family to minimize income taxes by making the First State the home state for your assets.

State income tax minimization using personal trusts

Delaware has a state fiduciary income tax on income accumulated in a "non-grantor" trust where the trust itself, and not the grantor, is taxed on income earned by the trust. However, there is a full exemption from this tax if the income is accumulated for beneficiaries who are not current Delaware residents. Due to the state's low population and the fact that many trusts coming into Delaware have no other ties to the state, most trusts administered in Delaware are not subject to Delaware state income tax. Consequently, using Delaware as a trust planning jurisdiction is similar to using states that don't have any income tax.

As state income taxes become a more significant percentage of your overall tax burden, if you live in a high-tax state there may be opportunities to reduce or eliminate state taxes on some of your income. Regardless of your state of residence, you may create a new trust in Delaware and most existing irrevocable trusts may be moved into Delaware for ongoing administration. Trusts offer many tools to shield certain assets from income taxation in your home state. A few of these tools are:

Changing your trustee to escape state taxes. If you live in a high-tax state and created a trust, or you are the beneficiary of a trust, it may be as simple as changing from a trustee located in your home state to one in a low or zero-tax state in order to reduce the trust's state income tax burden. Each state has unique laws regarding how the state taxes (i) a trust established by its residents, (ii) a trust with resident beneficiaries, or (iii) a trust administered in the state. For convenience or cost savings, most trusts use an individual family member, trusted advisor, or local financial institution as the initial trustee to get the structure up and running. Consequently, you may not have considered the state tax burden that the trustee's location has on the trust's ongoing administration. In many cases, changing the location of the trustee to Delaware may be sufficient for the trust to eliminate or defer paying state taxes on income accumulated in the trust.

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Appoint a successor trustee in a tax-friendly jurisdiction. During your lifetime, some trusts are best administered by you or other family members. Common examples are an irrevocable life insurance trust (ILIT) used to remove a life insurance policy's death benefit from the taxable estate, or a revocable lifetime trust used to avoid the probate process at death. These are generally "grantor" trusts where the trust's income is taxed to the person who created the trust, so the location of the trustee has no impact on the tax burden. However, these trusts generally become their own taxpayer (or a non-grantor trust) following the grantor's death. At this same time, the trust may receive significant value from the death benefit of a life insurance policy or significant, complex assets requiring ongoing administration following settlement of the estate. Appointing a successor corporate trustee in a tax-friendly state like Delaware will offer professional management of these assets at the same time state taxes may be eliminated or deferred on income accumulated in the trust.

Turn off grantor trust status. When making a gift into an irrevocable trust, it is common for the trust to be structured as a grantor trust so you continue to make tax-free gifts by paying the income tax burden on the trust for the benefit of your heirs. Although the gift into trust is complete for gift tax purposes so the assets are outside of your estate, the trust is structured so you are still the owner for income tax purposes. This allows the trust's assets to grow income tax-free since you, as the grantor, are picking up the tax bill. However, the grantor trust feature can generally be turned off so the trust becomes its own taxpayer. If the trust is administered in a tax-friendly state such as Delaware, it may be possible to turn off payment of state taxes on the trust's income by simply making the trust responsible for the taxes instead of you, as the grantor, who resides in a high-tax state. When the estate tax exemption was lower, paying your trust's tax bill helped reduce the amount of your family's wealth ultimately subject to death taxes. However, with some of the pressure on estate minimization relieved under the new federal tax law (the exemption more than doubled to $11,180,000 per person in 2018), turning off grantor trust status to avoid state taxes may be appealing in many situations.

Due to the state's low population and the fact that many trusts coming into Delaware have no other ties to the state, most trusts administered in Delaware are not subject to Delaware state income tax.

Delaware incomplete gift non-grantor (DING) trusts. A trust structure offered in Delaware is the DING trust, where you retain ownership of the trust's assets for gift tax purposes while the trust owns the assets for income tax purposes. The trust is its own taxpayer for income tax purposes, so this allows you to shift income out of your home state into a state where the trust will not pay a state income tax. A DING trust helps minimize state income taxes without incurring a federal gift tax. The structure of a DING trust must be tailored to the specific trust tax nexus rules of your home state, but can often result in a substantial income tax savings to you and your heirs. This tax savings is not available for earned income, income from real estate, or some other types of income treated as "source" income in your home state. However, a DING trust is a very effective tool to consider prior to the sale of a business or concentrated stock position that will incur a large capital gain. In addition, it is a nice way to minimize the tax burden on an invested portfolio that generates significant income.

Maximizing the step-up of income tax cost basis upon death using the Delaware tax trap (opportunity). With estate tax exemptions more than doubling under the new federal law, many trust beneficiaries may die with unused estate tax exemption while significant low-basis trust assets are held for their benefit. If the trust grants you a limited power of appointment (common in most irrevocable trusts), you can exercise the power in a way to select which trust assets

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should be included in your estate for tax purposes while the same assets continue in trust for asset protection and estate tax purposes. The assets that are deemed to be included in your estate should receive a step-up in their income tax cost basis, which will reduce the future capital gain incurred when they are eventually sold. This basis step-up would help reduce both federal and, in most cases, state income taxes. Your ability to exercise a limited power of appointment in this manner is unique to trusts administered in Delaware and not available in other trust-friendly states such as Nevada, South Dakota, or Alaska. Moreover, virtually any trust may be administered in Delaware regardless of where it was created or administered previously. If you are the beneficiary of a trust holding low-basis assets and will not be able to use all of your estate tax exemption, you may want to work with the trustee to add a Delaware trustee to make this basis step-up tool available to you.

Managing your trust and its assets

With the increased use of Delaware trusts to meet income tax planning goals, it is important to understand the additional estate planning benefits and flexible administrative tools that can be incorporated into your trust structure. Some of the trust features available to you under Delaware law are the ability to: (i) create a perpetual trust that serves as a family endowment through multiple generations, (ii) protect trust assets from your creditors and your beneficiaries' creditors, (iii) determine when or how beneficiaries receive information regarding their interests in the trust by making your trust a "quiet trust," and (iv) retain control over investment or distribution decisions through a directed trustee structure.

The directed trustee feature is one of the most flexible tools available under Delaware law. Delaware law provides the ability for you to name trust advisors who may direct the trust's investments, distributions from the trust, or other discretionary actions of the trust so you and your family remain in control. Delaware has recognized a "directed trust" structure for over a century.

A "quiet trust" is the common description for a trust that puts restrictions on a trustee's duty and ability to inform trust beneficiaries regarding their interests in the trust. Every state, including Delaware, imposes a default duty upon trustees to inform beneficiaries of their interests in the trust. This may be problematic as beneficiaries of large trusts become adults, or during the planning phase when you don't believe the timing is right to disclose the trust's asset information to your descendants. Delaware law allows you to place limits on when or how the beneficiaries receive this information and allows for a "designated representative" who represents their interests while the trust remains quiet. The trust's resources remain available to your descendants even if they are not actively receiving information regarding the trust.

Delaware personal trusts have historically been powerful tools for gift and estate planning, asset protection planning, and for flexible administration. However, the recent changes in the federal tax laws have provided a renewed focus on state income taxes and strategies available to minimize these taxes. Delaware trusts offer a number of solutions ranging from simply moving a trust into Delaware by changing trustees to more sophisticated options allowing family wealth to be "exported" to Delaware via a DING trust so state tax on accumulated income may be deferred or eliminated.

The Tax Cuts and Jobs Act of 2017 revitalized the discussion around tools and strategies to minimize your income taxes. Asset location is now a more compelling aspect of wealth preservation than asset allocation. Wilmington Trust has advised affluent families for generations regarding the techniques available to meet your estate, tax, and wealth transfer planning needs. Working with your comprehensive Wealth Advisory team can help you implement an effective tax-minimization plan.

Virtually any trust may be administered in Delaware regardless of where it was created or administered previously.

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Jeff is responsible for developing trust planning strategies for wealthy individuals and families throughout the United States and abroad. He works closely with his clients' legal, tax, and investment advisors to construct and implement appropriate trust structures that take advantage of the state of Delaware's unique trust and tax laws.

Jeff earned his JD (summa cum laude) and MBA (with honors) from Syracuse University and holds a bachelor's degree in economics from Northwestern University, where he was a member of Phi Beta Kappa. Jeff is a frequent lecturer on topics involving the use of Delaware trusts for asset protection, state income tax minimization, and investment management for unique trust assets.

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Minimizing or Eliminating State Income Taxes on Trusts

By Richard W. Nenno

Part Three

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Minimizing or Eliminating State Income Taxes on Trusts

By Richard W. Nenno*

PART THREE

Editor's Note: One of the effects of the increasing amount of the applicable exclusion over the years, which was accelerated as a result of its doubling with the Tax Act of 2017, is the enhanced importance of income-tax planning. This applies not only to the federal income tax, but also to the vast majority of states that impose their own income tax.

The approaches taken by the various states differ significantly, so we are fortunate to have Dick Nenno, one of the foremost experts on state income taxes on trusts, provide an updated version of his materials from recent ABA and ACTEC meetings. In Part One,

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Dick provided an overview and discussed the various approaches to taxation of trust income, then reviewed the various constitutional restrictions, as reflected in numerous federal and state cases. Last month, he further examined these aspects, beginning with a discussion of the seminal U.S. Supreme Court case of Quill v. North Dakota and its progeny in state courts, then provided a constitutional analysis of taxation based on the residence of the testator or trustor. This month, he examines taxation of trusts administered in the taxing state and moves to a discussion of planning considerations for both new and existing trusts. He will conclude in Part Four with an analysis of home state court concerns and a host of other issues involving state income taxes to be considered by both the planner and the trustee.

Taxation of Trust Administered In State

The United States Supreme Court never has addressed whether a state can tax a trustee on income of a trust administered in the state, but there is no doubt that a state can do so. Practitioners should be on the lookout for guidelines that states use in assessing "administration" for purposes of their tax system.

The following Wisconsin cases have considered this issue:

In *Wisconsin Department of Taxation v. Pabst*,[1] the Supreme Court of Wisconsin held that Wisconsin could not tax a Pabst family trust because the administration did not occur in the state. The court justified its conclusion as follows:[2]

> To administer the trusts involved would be to manage, direct, or superintend the affairs of these trusts. Weber [a Wisconsin resident] did not perform these functions. The policy decisions were made by the nonresident trustees. Weber implemented those policy determinations. The trustees decided whether to distribute the income, whether to seek investment advice, and whether ministerial duties should be delegated to someone other than themselves. Ministerial acts performed in Wisconsin included an annual audit made by a Milwaukee certified public accountant and the filing of Federal tax returns in the Milwaukee office of the Internal Revenue Department. The activities carried on in Wisconsin were only incidental to the duties of the trustees.

In *Pabst v. Wisconsin Department of Taxation*,[3] the same court later held that Wisconsin could tax a different, but similar, Pabst family trust because administration did occur in the state. At the outset, the court announced a change of approach regarding income taxation in Wisconsin:[4]

> The key word of the statute, insofar as this appeal is concerned, is 'administered.' In *Wisconsin Department of Taxation v. Pabst*, we had before us the application of this same statute to two

> other trusts created by the settlor Ida C. Pabst. The decision cited the definition of 'administer' in Webster's Third New International Dictionary (1961, unabridged) which stressed the element of managing, directing, or superintending affairs.
>
> Nevertheless, upon further consideration we now conclude that the statutory word 'administered' as applied to an inter vivos trust of intangibles means simply conducting the business of the trust. The problem of determining whether such a trust is administered in Wisconsin may be made more difficult when the business of the trust is partly conducted in other states as well as in Wisconsin. In such a situation, a proper application of the statute would appear to require the conclusion that the trust is being administered in Wisconsin within the meaning of the statute if the major portion of the trust business is conducted in Wisconsin.

The court concluded:[5]

> In the instant case Wisconsin has extended the protection of its laws to the activities of Weber in carrying on the business of the trust at the office of Pabst Farms, Inc. Although no rent was paid by the trust for the use of such office, we deem this an entirely fortuitous circumstance. The only office that the trust had was maintained in Wisconsin and the major portion of the trust's business was transacted here during the period in question. We are satisfied there was a sufficient nexus with Wisconsin to permit it to impose the income taxes which it did, and we so hold.

Taxation of Resident Trustee

It is clear that a state can tax a resident trustee. Thus, in Greenough v. Tax Assessor of Newport,[6] the United States Supreme Court held that Rhode Island could impose an ad valorem tax on a resident trustee of an otherwise Nonresident Trust without violating the Due Process Clause.

Similarly, in *McCulloch v. Franchise Tax Board*,[7] the Supreme Court of California held that California could tax the co-trustee/beneficiary on accumulated income distributed to him from a Missouri trust because the co-trustee/beneficiary was a California resident. The court said:[8]

> We conclude that California could constitutionally tax plaintiff as the resident beneficiary upon the accumulated income when it was distributed to him. But plaintiff in the instant case was simultaneously beneficiary and a trustee. No possible doubt attaches to California's constitutional power to tax plaintiff as a trustee. His secondary role as a trustee reinforces the independent basis of taxing plaintiff as beneficiary.

Taxation of Trustee of Trust Having Resident Beneficiary

United States Supreme Court Cases. In *Brooke v. City of*

Norfolk[9] and *Safe Deposit and Trust Company v. Virginia*,[10] the United States Supreme Court held that a state cannot tax a nonresident trustee of a trust that had resident beneficiaries. But, in *Guaranty Trust Company v. Virginia*,[11] the Court confirmed that a state can tax resident beneficiaries on income that they received from a Nonresident Trust.

State Court Cases. The following state cases considered this issue. The precedential effect of the California decisions is unclear given that they dealt with tax years before statutory changes that took effect in 1963.[12] As noted above, in *McCulloch v. Franchise Tax Board*,[13] the Supreme Court of California held that California could tax a California resident beneficiary on accumulated income distributed to him from a Missouri trust for the reason just quoted.[14] And in *In the Matter of the Appeal of The First National Bank of Chicago*,[15] the California State Board of Equalization ruled that California could tax six trusts being administered in Illinois, because all beneficiaries were California residents. It said:[16]

> Appellant also urges that section 17742 (formerly 18102) is unconstitutional if it purports to tax the non-California income of a foreign trust which is administered by a nonresident trustee. This argument has been fully answered by the California Supreme Court in *McCulloch v. Franchise Tax Board*, wherein the court held that California could constitutionally tax a Missouri trust on income which was payable in the future to a beneficiary residing in this state, although such income was actually retained by the trust. The fact that the resident beneficiary was also one of the trust's three trustees was not relied upon by the court in holding that the residence of the beneficiary afforded a constitutionally sufficient connection to bring the trust's income within California's tax jurisdiction.

In *In the Matter of the Appeal of C. Pardee Erdman*,[17] the California State Board of Equalization, following *McCulloch* and *First National Bank of Chicago*, ruled that California could require California resident remainder beneficiaries to pay California tax on accumulated ordinary income and capital gains that had not previously been paid by the trustee of two trusts being administered in Illinois.

Recently, in *Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue* (2018),[18] the Supreme Court of North Carolina, considered whether North Carolina could tax the accumulated income of a trust having a nonresident trustee but resident discretionary beneficiaries under the state's statute taxing trusts for the benefit of North Carolina residents.[19] The trust was created by a New Yorker, was governed by New

York law, and had only New York trustees.[20] In the tax years in question, the discretionary beneficiaries were a child of the trustor and her children, all North Carolina residents.[21] Over $1.3 million was at stake.[22] The court held that imposition of the tax in the circumstances would violate the Due Process Clause of the federal constitution and a provision of the North Carolina constitution:[23]

> For taxation of a foreign trust to satisfy the due process guarantee of the Fourteenth Amendment and the similar pledge in Article I, Section 19 of our state constitution, the trust must have some minimum contacts with the State of North Carolina such that the trust enjoys the benefits and protections of the State. When, as here, the income of a foreign trust is subject to taxation solely based on its beneficiaries' availing themselves of the benefits of our economy and the protections afforded by our laws, those guarantees are violated. Therefore, we hold that N.C.G.S. § 105-160.2 is unconstitutional as applied to collect income taxes from plaintiff for tax years 2005 through 2008. Accordingly, we affirm the decision of the Court of Appeals that affirmed the Business Court's order granting summary judgment for plaintiff and directed that defendant refund to plaintiff any taxes paid by plaintiff pursuant to section 105-160.2 for tax years 2005 through 2008.

Similarly, in *Fielding for MacDonald v. Commissioner of Revenue*,[24] Judge Delapena of the Minnesota Tax Court opined that the presence of resident beneficiaries is an invalid basis for taxing a nonresident trustee. Thus, in criticizing the *Gavin* case,[25] he wrote:[26]

Gavin was incorrectly decided insofar as it relies on the domicile of trust beneficiaries as a basis for jurisdiction to tax a trust.

PLANNING CONSIDERATIONS FOR NEW TRUSTS

The state fiduciary income tax implications of a trust should be considered in the planning stage, because it is much easier not to pay a tax in the first place than to obtain a refund.[27] In planning to eliminate one state's tax, the attorney must make sure that the trust will not be taxed in one or more other states.

Testamentary Trust Created by Resident

The most legally uncomplicated way for an individual to escape a tax based on the residence of the testator is to move to a state that does not tax according to that basis. One must assume, however, that many clients will not be willing to change their actual physical homes for this reason alone.

The foregoing discussion strongly suggests that taxation based on the testator's residence alone is unconstitutional. Neverthe-

less, a constitutional battle in the courts should be avoided at all costs because it will be expensive at best and unsuccessful and expensive at worst. With states scrambling for revenue, courts will be hard pressed not to sustain a state's tax system.

Accordingly, as a general rule, a client should not create testamentary trusts if he or she wants to minimize state income taxes. Instead, he or she should fund a revocable trust created and maintained in another state during his or her lifetime because courts are less likely to sustain a tax on the income of an inter vivos trust than on that of a testamentary trust.[28] The inter vivos trust also might escape the income tax that otherwise would be payable by the probate estate.

Of course, some clients will create testamentary trusts. In Part One, 16 states were listed that tax a trust solely because the testator lived in the state at death. The highest courts in two of these jurisdictions-the District of Columbia and Connecticut-have upheld the state's ability to tax a testamentary trust on this basis. But, as shown in a 2015 New Jersey case,[29] imposition of tax might be subject to attack in one of the other states.

In New York and New Jersey, the rules for eliminating tax are clear and should be followed strictly. In Idaho and Iowa, where the testator's residence is one of several factors that determine taxability, the attorney should arrange other factors to save tax. Delaware, Massachusetts, Missouri, Montana, and Rhode Island tax a testamentary trust that has at least one resident beneficiary, which, as noted above, is a constitutionally suspect basis for taxation. If the applicable tax law does not apportion tax based on the number of resident and nonresident beneficiaries, the client might create multiple trusts to free the income attributable to assets held for nonresident beneficiaries from tax.

Because Alabama and Arkansas tax a testamentary trust that has a resident fiduciary, tax easily can be eliminated by appointing a nonresident fiduciary. Utah tax usually can be eliminated by appointing a Utah corporate trustee.

The courts that sustained a state's right to tax a testamentary trust solely because of the testator's residence did so because of ongoing benefits available to the trust through that state's judicial system. As will be discussed in Part Four, their reliance on that factor is misplaced. In any event, in the District of Columbia, Connecticut, and other states, a trust might escape taxation if the Will designates the law of another state to govern the trust and gives the courts of that other state exclusive jurisdiction over the trust. The Will also might direct the trustee to initiate a

proceeding to have the court of the other state accept jurisdiction. A state that taxes on this basis is a good place for a resident of another state to create a trust.

Inter Vivos Trust Created by Resident

The easiest way for a trustor to eliminate taxation on this basis is to move to a state that does not impose an income tax or that taxes in another way. But, as noted, a trustor might not be willing and able to relocate for this purpose.

In Part One, 12 states were listed that tax a trust solely because the trustor lived in the state. No case has held that a state may tax solely on this basis. Although *Chase Manhattan Bank v. Gavin*[30] held that Connecticut income taxation was constitutional if a trust had a resident noncontingent beneficiary, *Mercantile-Safe Deposit and Trust Company v. Murphy*[31] held that Nen York could not tax a trust that had a resident current discretionary beneficiary, and *Blue v. Department of Treasury*[32] held that Michigan could not tax a trust that held unproductive Michigan real estate. Moreover, in 2013, *McNeil v. Commonwealth* held that Pennsylvania could not tax resident inter vivos trusts that had resident discretionary beneficiaries[33] and *Linn v. Department of Revenue* held that Illinois could not tax a resident inter vivos trust that had no Illinois connections for the year in question.[34] Furthermore, *Fielding for MacDonald v. Commissioner of Revenue* held in 2017 that Minnesota could not tax four resident inter vivos trusts in comparable circumstances.[35]

In Idaho and Iowa, the attorney often can arrange other factors to eliminate taxation. In Alabama, Connecticut, Delaware, Massachusetts, Michigan, Missouri, Montana, Ohio, and Rhode Island, the attorney should make sure that portions of trusts attributable to nonresident beneficiaries are not taxed needlessly. The attorney should avoid appointing resident fiduciaries in Alabama, Arkansas, and Massachusetts. In this connection, it is common practice for attorneys in Boston law firms to serve as trustees of trusts created by Massachusetts residents. In such a case, the attorney should discuss the appointment and its implications with the client because such an appointment often will cause the trust's accumulated income and capital gains to be subject to Massachusetts income tax (usually at 5.10%)[36] that could be eliminated by appointing a non-Massachusetts trustee.[37]

As with a testamentary trust, the attorney might increase a trust's ability to escape tax by designating in the trust instrument that the law of another state will govern the trust and that the courts of that state will have exclusive jurisdiction over it.

Many states tax if the trustor was a resident when a trust became irrevocable. To prevent unnecessary taxation, a trustor of such a trust who moves to a state that does not tax on this basis should consider establishing a new trust rather than making additions to the existing trust.

Trust Administered in State

An attorney should think long and hard before having a client create a trust in one of the 14 states listed in Part Two, which tax a trust solely because it is administered in the state. This is a factor that can be managed to eliminate taxation by Idaho and Iowa, whose tax is based on several factors. Taxation can be eliminated in Hawaii even if the trust has a resident beneficiary. Utah tax generally can be escaped by involving a Utah corporate trustee. In any event, the attorney should ensure that all administration occurs outside the state in question.

Resident Trustee

A trust can prevent taxation by the eight states listed in Part One, if it does not have a resident fiduciary. This factor may be managed to eliminate taxation by Idaho and Iowa. The attorney must be mindful of this factor if a trust has resident beneficiaries in Delaware and Hawaii. Resident Beneficiary

The six states listed in Part One tax a trust solely because it has resident beneficiaries, which, as noted above, is a questionable basis for taxation. The attorney should ensure that income on assets attributable to nonresident beneficiaries won't be taxed unnecessarily. He or she also should make sure that tax on accumulated income and capital gains that might ultimately be distributed to nonresident beneficiaries won't be taxed prematurely.

PLANNING CONSIDERATIONS FOR EXISTING TRUSTS

With the assistance of counsel, every trustee should review the trusts that the trustee administers to identify all trusts that are paying state income tax to determine whether that tax can be reduced or eliminated. If tax has been paid erroneously, the trustee should request refunds for open years.[38] If the trustee discovers that tax can be escaped, the trustee should consider filing a "final" return in the year before the occurrence of a major transaction (e.g., the sale of a large block of low-basis stock). At the same time, the trustee and the advising attorney must make sure that steps taken to eliminate one state's tax won't subject the trust to tax elsewhere.

Planning Actions Based Upon Reason for Taxation

Testamentary Trust Created by Resident. If a state imposes its tax on a testamentary trust if the testator lived there at death, whether or not tax will continue to apply raises complex constitutional issues that were discussed in Parts One and Two. The constitutional issues involve the question of whether the state statute creating the basis on which the income tax is imposed violates various federal and state constitutional mandates, including the Commerce Clause and the Due Process Clause of the United States Constitution, and therefore can be safely ignored in the absence of any continuing nexus between the trust and the original state.

As discussed above, some states recognize the constitutional limits on their ability to tax and therefore identify the Exempt Resident Trust. Thus, they offer clear guidance on how to prevent tax. To escape tax in these states or to improve prospects for eliminating tax in states where the rules are not as clear, the trustee might explore transferring the trust's situs to another state, which might be accomplished by a provision in the governing instrument or by a state statute or court proceeding. Wisconsin recognizes that a change of situs will end a testamentary trust's liability for tax.[39]

Inter Vivos Trust Created by Resident. To determine whether a state's income tax on an inter vivos trust created by a resident can be eliminated, the trustee and attorney should go through a process comparable to that described above for testamentary trusts.

Trust Administered in State. Here, it might be possible to escape tax simply by changing the place where the trust is administered, with or without court involvement.

Resident Trustee. In states that tax on this basis, it should be possible to escape tax simply by replacing the resident fiduciaries with nonresident fiduciaries.

Resident Beneficiary. Short of having the beneficiary move, it is difficult if not impossible to prevent a resident beneficiary from being taxed on current distributions. Nonetheless, the attorney and trustee should make sure that tax is not paid prematurely on accumulated ordinary income and capital gains.

Effecting the Move

As discussed throughout this series of articles, the states tax the income of trusts based on one or more of five criteria-(1) the residence of the testator, (2) the residence of the trustor, (3) the place of administration, (4) the residence of the trustee, and (5) the residence of the beneficiary. Only the testator, trustor, or ben-

eficiary can change residence for criteria (1), (2), and (5). But, it is possible to control the place of administration (criterion (3)) and the residence of the trustee (criterion (4)).

Before doing anything else, the practitioner must examine the tax rules for the state in question to ensure that whatever steps are taken will further the objective of minimizing tax. This is because "administration" and "residence" might have very different meanings for tax and for other purposes. For example, some states provide guidance on when a trust is being administered within the state;[40] other states specify how to establish the residence of a corporate trustee.[41]

Changing Place of Administration

As described in Part One, 14 states tax trust income solely because the trust is administered in that state, and four more states tax such income based on the place of administration and other factors. If needed, the transfer of a trust's situs or place of administration from one state to another might be accomplished through an express provision in the trust instrument, a pertinent statute, or a court petition. A corporate trustee might change the place of administration simply by transferring duties to an office in another state. When examining a governing instrument, the practitioner should look for a clause that allows the trustee, adviser, or protector to change the place of administration.

Many states have statutes that permit a trust's place of administration to be changed without court participation. Hence, § 108(c) of the Uniform Trust Code ("UTC"),[42] a form of which is in effect in 32 states, authorizes a trustee to initiate a change in a trust's principal place of administration as follows:

> (c) Without precluding the right of the court to order, approve, or disapprove a transfer, the trustee, in furtherance of the duty prescribed by subsection (b), may transfer the trust's principal place of administration to another State or to a jurisdiction outside of the United States.

Rules are provided for notice to beneficiaries,[43] objections by beneficiaries,[44] and transfers of assets to successor trustees.[45]

Also, UTC § 111, a version of which is in effect in 32 states, allows the "interested persons" to enter into a nonjudicial settlement agreement as follows:[46]

> (b) Except as otherwise provided in subsection (c), interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust.

The provision defines "interested persons,"[47] prohibits them from violating a material purpose of the trust and permits them

to include only terms and conditions that could be approved by a court,[48] and authorizes an interested person to request court involvement.[49] The matters that may be resolved via nonjudicial settlement agreement include:[50]

(5) Transfer of a trust's principal place of administration

The place of administration of a trust also might be changed under the nonjudicial settlement agreement statutes of at least nine additional states that have not enacted the UTC.[51]

In some situations, it will be possible to change the place of administration only with court involvement. In this connection, California has had a court procedure for transferring a trust to another jurisdiction since 1991.[52] At least two other states have statutes that address the same subject.[53]

To move a trust, the beneficiaries or the trustee customarily must file a petition (often accompanied by an accounting) in the local probate court. In many instances, it also is necessary to file a petition in a court in the new state seeking the court's approval of the transfer of situs and acceptance of jurisdiction over the trust prior to the proceeding in the local probate court. That way, the local court knows of the new court's acceptance of jurisdiction upon the local court's approval of transfer.

For trusts of movables created by Will, a comment under § 271 of the Second Restatement of Conflict of Laws provides that:[54]

> [A] testamentary trustee may be required by statute to qualify as trustee in the court of the testator's domicil having jurisdiction over the testator's estate, when the trust is to be administered in that state. The trustee is then accountable to that court. Thereafter, however, the question may arise whether the administration of the trust may be changed to another state. In such a case, in contrast to the usual situation that prevails in the case of an inter vivos trust, it is necessary to obtain the permission of the court for a change in the place of administration. Since the trustee is accountable to the court, it is necessary to obtain the permission of the court to terminate the accountability of the trustee to it.
>
> The court should permit a change in the place of administration and a termination of the trustee's accountability to it if this would be in accordance with the testator's intention, either express or implied. Such a change may be expressly authorized in the will. It may be authorized by implication, such as when the will contains a power to appoint a new trustee in another state, or simply a power to appoint a new trustee if this is construed to include the power to appoint a trustee in another state.
>
> The court may permit a change in the place of administration and a termination of the trustee's accountability to it even

> though such change was not expressly or impliedly authorized by the testator. The court may authorize such a change when this would be in the best interests of the beneficiaries, as, for example, when the beneficiaries have become domiciled in another state or when the trustee has become domiciled in another state.
>
> [The court may refuse to permit a change in the place of administration and termination of the trustee's accountability to it, unless the trustee qualifies as trustee in a court of the state in which the trust is to be thereafter administered.

For trusts of movables created inter vivos, a comment under Restatement § 272 provides that:[55]

> When an inter vivos trust has become subject to the continuing jurisdiction of a court to which it is thereafter accountable, it becomes necessary to obtain the permission of that court to terminate such accountability. The question arises when the court is thereafter asked to appoint a successor trustee, or when the trustee acquires a place of business or domicil in another state, or when by the exercise of a power of appointment a trustee is appointed whose place of business or domicil is in another state. The same rules are applicable as are applicable in the case of a testamentary trustee.

Generally, courts will permit a trust to be moved if the trust instrument does not express a contrary intent, the administration of the trust will be facilitated, and the interests of the beneficiaries will be promoted.[56] Trustees and beneficiaries should not assume, though, that courts automatically will grant petitions to transfer situs. For example, courts have denied such petitions when the accomplishment of the stated objective-the elimination of New York fiduciary income tax-did not require the change.[57]

Changing a Resident Trustee to a Nonresident Trustee

If the governing instrument provides for the removal and replacement of the trustee without the necessity for court proceedings, the nomination of a trustee in another state might be sufficient in itself to escape the original state's income tax. Frequently, however, the governing instrument is silent on the issues of removal, resignation, and replacement. In such a case, the practitioner should next try to identify a way to change the trustee by nonjudicial means.

This might be accomplished under a state's version of UTC § 111, discussed above, because the matters that may be resolved under it include:[58]

> (1) the resignation or appointment of a trustee . . . .

A change of trustee also might be accomplished via the stand-alone nonjudicial settlement agreement statutes that are in effect in at least nine states.[59]

Otherwise, the beneficiaries must either obtain the trustee's agreement to resign, or convince the local probate court to remove the trustee. Courts are beginning to include state income-tax minimization as a pertinent factor when considering petitions, including under the state's versions of UTC § 706,[60] to replace trustees.[61] Many of the considerations in a court proceeding that were described above, will apply here as well.

Duty to Minimize Tax

Discomforting though it may be, trustees have a duty to minimize state income taxes on trusts. For example, under the duty to administer the trust in accordance with its terms and applicable law, § 76 of the Third Restatement of Trusts[62] offers the following comment:[63]

> A trustee's duty to administer a trust includes an initial and continuing duty to administer it at a location that is reasonably suitable to the purposes of the trust, its sound and efficient administration, and the interests of its beneficiaries. . . .
>
> Under some circumstances the trustee may have a duty to change or to permit (e.g., by resignation) a change in the place of administration. Changes in the place of administration by a trustee, or even the relocation of beneficiaries or other developments, may result in costs or geographic inconvenience serious enough to justify removal of the trustee.

This is a statutory duty in over half the states. Thus, § 7-305 of the Uniform Probate Code ("UPC"),[64] which is in effect in at least four states,[65] provides as follows:

> A trustee is under a continuing duty to administer the trust at a place appropriate to the purposes of the trust and to its sound, efficient management. If the principal place of administration becomes inappropriate for any reason, the Court may enter any order furthering efficient administration and the interests of beneficiaries, including, if appropriate, release of registration, removal of the trustee and appointment of a trustee in another state. Trust provisions relating to the place of administration and to changes in the place of administration or of trustee control unless compliance would be contrary to efficient administration or the purposes of the trust. Views of adult beneficiaries shall be given weight in determining the suitability of the trustee and the place of administration.

Whereas the Supreme Court of Nebraska refused to replace a corporate trustee pursuant to the Nebraska version of § 7-305 in a 1982 case,[66] the Supreme Court of Alaska replaced the corporate trustee and transferred the situs of the trust out of Alaska in a 2004 case,[67] and a Michigan intermediate appellate court replaced the corporate trustee and transferred the trust's situs from Michigan to Georgia in an unpublished 2008 case.[68]

Similarly, § 108(b) of the UTC,[69] a version of which is the law in 25 states, specifies that:

> A trustee is under a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries.

Even in the seven states that have enacted § 108 without adopting subsection (b) in the above form, the provision might be helpful in replacing trustees and transferring trusts. For example, Pennsylvania practitioners have told the author that they have used Pennsylvania's version of § 108

[70] to transfer trusts to Delaware to save Pennsylvania income tax.

Federal Transfer-Tax Consequences

Taking action (e.g., changing the trustee or place of administration) to eliminate state income tax should not cause a trust that is protected from the federal generation-skipping transfer tax because it was irrevocable on September 25, 1985, to lose that effective date protection.[71] The IRS has issued private letter rulings approving modifications of trusts to which GST exemption has been allocated if the changes would have been acceptable for effective-date-protected trusts.[72] Hence, trustees and attorneys may take steps to prevent state income tax in exempt trusts without adverse tax consequences.

* * * * * *

FOOTNOTES

[1] Wis. Dep't of Taxation v. Pabst, 112 N.W.2d 161 (Wis. 1961).

[2] Wis. Dep't of Taxation, 112 N.W.2d at 165.

[3] Pabst v. Wis. Dep't of Taxation, 120 N.W.2d 77 (Wis. 1963).

[4] Pabst, 120 N.W.2d at 81 (citation omitted).

[5] Pabst, 120 N.W.2d at 85.

[6] Greenough v. Tax Assessors of Newport, 331 U.S. 486 (1947). See the discussion of Greenough in Part One.

[7] McCulloch v. Franchise Tax Board, 390 P.2d 412 (Cal. 1964).

[8] McCulloch, 390 P.2d at 421.

[9] Brooke v, City of Norfolk, 277 U.S. 27 (1928). See the discussion of Brooke in Part One.

[10] Safe Deposit & Trust Co. v. Virginia, 280 U.S. 83 (1929). See the discussion of Safe Deposit in Part One.

[11] Guaranty Trust Co. v. Virginia, 305 U.S. 19 (1938). See the discussion of Guaranty Trust Co. in Part One.

[12] See Cal. Rev. & Tax Code § 17745.1.

[13] McCulloch, 390 P.2d 412.

[14] McCulloch, 390 P.2d at 421.

[15] In the Matter of the Appeal of The First Nat'l Bank of Chi., 1964 WL 1459 (Cal. State Bd. Eq. June 23, 1964), www.boe.ca.gov/legal/pdf/64-sbe-054.pdf.

[16] First Nat'l Bank of Chi., 1964 WL 1459, at *3 (citation omitted).

[17] In the Matter of the Appeal of C. Pardee Erdman, 1970 WL 2442 (Cal. State Bd. Eq. Feb. 18, 1970), www.boe.ca.gov/legal/pdf/70-sbe-0007.pdf.

[18] Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dep't of Revenue, 2018 WL 2937823 (N.C. 2018), aff'g 789 S.E.2d 645 (N.C. Ct. App. 2016), aff'g, 2015 WL 1880607 (Super. Ct. N.C. Apr. 23, 2015).

[19] N.C. Gen. Stat. § 105-160.2.

[20] Kaestner, 2018 WL 2937823, at *1.

[21] Kaestner, 2018 WL 2937823, at *1.

[22] Kaestner, 2018 WL 2937823, at *2.

[23] Kaestner, 2018 WL 2937823, at *7.

[24] Fielding for MacDonald v. Commissioner of Revenue, 2017

WL 2484593 (Minn. Tax Ct. May 31, 2017). See the discussion of Fielding in Part Two.

[25] Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999). See the discussion of Gavin in Part Two.

[26] Fielding, 2017 WL 2484593, at *17 n.85 (emphasis in original).

[27] See Matter of Michael A. Goldstein No. 1 Trust v. Tax Appeals Trib. of N.Y., 957 N.Y.S.2d at 433, 436 (N.Y. App. Div. 2012) (for years in question, interest on refund ran from date of filing of amended not original return).

[28] Joseph W. Blackburn, Constitutional Limits on State Taxation of a Nonresident Trustee: Gavin Misinterprets and Misapplies Both Quill and McCulloch, 76 Miss. L.J. 1, 5-9 (Fall 2006); Bradley E. S. Fogel, What Have You Done For Me Lately? Constitutional Limitations on State Taxation of Trusts, 32 U. Rich. L. Rev. 165, 210-13 (Jan. 1998).

[29] Residiary Trust A U/W/O Kassner v. Dir. Div. of Taxation, 28 N.J. Tax 541 (Super. Ct. App. Div. 2015), aff'g 27 N.J. Tax 68 (N.J. Tax Ct. 2013). See the discussion of Kassner in Part Two.

[30] Gavin, 733 A.2d 782.

[31] Mercantile-Safe Deposit & Trust Co. v. Murphy, 203 N.E.2d 490 (N.Y. 1964), aff'g, 242 N.Y.S.2d 26 (N.Y. App. Div. 1963). See the discussion of Mercantile in Part One.

[32] Blue v. Dep't of Treasury, 462 N.W.2d 762 (Mich. Ct. App. 1990). See the discussion of Blue in Part One.

[33] McNeil v. Commw., 67 A.3d 185 (Pa. Commw. Ct. 2013). See the discussion of McNeil in Part Two.

[34] Linn v. Dep't of Revenue, 2 N.E.3d 1203, 1211 (Ill. App. Ct. 2013). See the discussion of Linn in Part Two.

[35] Fielding v. Commissioner of Revenue, 2017 WL 2484593 (Minn. Tax Ct. Regular Div. 2017).

[36] Mass. Gen. Laws ch. 62, § 4; 2017 Mass. Form 2 at 2.

[37] Mass. Gen. Laws ch. 62, § 10(c).

[38] See Goldstein , 957 N.Y.S 2d at 436 (for years in question, interest on refund ran from date of filing of amended not original return).

[39] See instructions to 2017 Wis. Form 2 at 1.

[40] These will be discussed in Part Four.

[41] Massachusetts was discussed in Part One.

[42] UTC § 108(c) (amended 2010). The text of the UTC may be

viewed at www.uniformlaws.org/shared/docs/trust_code/UTC_Final_2017sep5.pdf (last visited June 15, 2018). A list of the states that have enacted the UTC is available at www.uniformlaws.org/LegislativeFactSheet.aspx?title=Trust Code (last visited June 15, 2018).

[43] UTC § 108(d) (amended 2010). In 2015, a Michigan intermediate appellate court held that a trustee's attempted transfer of situs from Florida to Michigan under Florida's version of § 108(c) was ineffective because the trustee did not comply with the statute's notice requirements even though language in the governing instrument arguably overrode them (In re Seneker Trust, 2015 WL 847129, at *2 (Mich. Ct. App. Feb. 26, 2015)).

[44] UTC § 108(e) (amended 2010).

[45] UTC § 108(f) (amended 2010).

[46] UTC § 111(b) (amended 2010). See Linda Kotis, Nonjudicial Settlement Agreements: Your Irrevocable Trust Is Not Set in Stone, 31 Prob. & Prop. 32 (Mar./Apr. 2017).

[47] UTC § 111(a) (amended 2010).

[48] UTC § 111(c) (amended 2010).

[49] UTC § 111(e) (amended 2010).

[50] UTC § 111(d)(5) (amended 2010).

[51] Cal. Prob. Code § 15404(a); 12 Del. C. § 3338(d)(5); Idaho Code §§ 15-8-103(1)(c)(iii), 15-8-301-15-8-305; 760 ILCS 5/16.1(d)(4)(H); Iowa Code § 633A.2202; Nev. Rev. Stat. §§ 164.940, 164.942; N.Y. Est. Powers & Trusts Law § 7-1.9; S.D. Codified Laws § 55-3-24; Wash. Rev. Code § 11.98.051.

[52] Cal. Prob. Code §§ 17400-17405. See 7 Austin W. Scott, William F. Fratcher & Mark L. Ascher, Scott and Ascher on Trusts § 45.5.3.1 at 3301-02 n.28 (5th ed. 2007) (hereinafter "7 Scott and Ascher on Trusts").

[53] Nev. Rev. Stat. § 164.130; Wash. Rev. Code § 11.98.055.

[54] Restatement (Second) of Conflict of Laws § 271 cmt. g (1971) (cross reference omitted).

[55] Restatement (Second) of Conflict of Laws § 272 cmt. e (1971).

[56] See Est. of Gladys Perkin, N.Y.L.J., June 9, 2010, at 33, col. 2 (Surr. Ct. N.Y. Cty. 2010); In re Estate of McComas, 630 N.Y.S.2d 895, 896 (Surr. Ct. N.Y. Cty. 1995); In re Second Intermediate Accounting of Henry Weinberger, 250 N.Y.S.2d 887 (App. Div. 1964); Application of New York Trust Co., 87 N.Y.S.2d 787, 794-95 (Sup. Ct. N.Y. Cty. 1949).

[57] See In re Bush, 774 N.Y.S.2d 298 (Surr. Ct. N.Y. Cty. 2003);

In re Estate of Rockefeller, 773 N.Y.S.2d 529 (Surr. Ct. N.Y. Cty. 2003). See also In re Hudson's Trust, 286 N.Y.S.2d 327, 330 (App. Div. 1968), aff'd, 245 N.E.2d 405 (N.Y. 1969).

[58] UTC § 111(d)(4) (amended 2010).

[59] Cal. Prob. Code § 15404(a); 12 Del. C. § 3338(d)(4); Idaho Code § 15-8-103(1)(c)(ii); 760 ILCS 5/16.1(d)(4)(F); Iowa Code § 633A.2202; Nev. Rev. Stat. §§ 164.940, 164.942; N.Y. Est. Powers & Trusts Law § 7-1.9, S.D. Codified Laws § 55-3-24; Wash. Rev. Code § 11.98.051.

[60] UTC § 706 (amended 2010).

[61] See Beardmore v. JPMorgan Chase Bank, 2017 WL 1193190, at *6 (Ky. Ct. App. Mar. 31, 2017) ("The move to Delaware would provide a significant aggregate tax savings over those years"); In re McKinney, 67 A.3d 825, 833 (Pa. Super. Ct. 2013) (factors include "location of trustee as it affects trust income tax"); Davis v. U.S. Bank Nat'l Ass'n, 243 S.W.3d 425, 430 (Mo. Ct. App. 2007) ("changing the domicile of the Trust to Delaware would avoid out of state income tax being paid on Trust income").

[62] Restatement (Third) of Trusts § 76 (2003).

[63] Restatement (Third) of Trusts § 76 cmt. b(2) (2003) (cross references omitted).

[64] UPC § 7-305 (amended 2008).

[65] See, e.g., Alaska Stat. § 13.36.090; Colo. Rev. Stat. § 15-16-305; Haw. Rev. Stat. § 560:7-305; Idaho Code § 15-7-305.

[66] In re Zoellner Trust, 325 N.W.2d 138 (Neb. 1982).

[67] Marshall v. First Nat'l Bank Alaska, 97 P.3d 830 (Alaska 2004).

[68] In re Wege Trust, 2008 WL 2439904 (Mich. Ct. App. June 17, 2008).

[69] UTC § 108(b) (amended 2010).

[70] 20 Pa. C.S. § 7708.

[71] See Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2).

[72] See, e.g., PLR 201820007, 2018 WL 2293662 (I.R.S. PLR 2018), PLR 201820008, 2018 WL 2293663 (I.R.S. PLR 2018), and PLR 201814005, 2018 WL 1702419 (I.R.S. PLR 2018).

Minimizing or Eliminating State Income Taxes on Trusts

By Richard W. Nenno

Part Four

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PART FOUR

Editor's Note: One of the effects of the increasing amount of the applicable exclusion over the years, which was accelerated as a result of its doubling with the Tax Act of 2017, is the enhanced importance of income-tax planning. This applies not only to the federal income tax, but also to the vast majority of states that impose their own income tax.

The approaches taken by the various states differ significantly, so we have been fortunate to have Dick Nenno, one of the foremost experts on state income taxes on trusts, provide an updated version of his materials from recent ABA and ACTEC meetings. In

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* ABOUT THE AUTHOR

Senior Trust Counsel and Managing Director, Wealth Advisory Services, Wilmington Trust Company, Wilmington, Delaware. Dick is a Fellow of the American Bar Foundation and of ACTEC and is a Distinguished Accredited Estate Planner. This article, with commentary, is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service. It is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. If professional advice is needed, the services of a professional advisor should be sought. Wilmington Trust is a registered service mark. Wilmington Trust Corporation is a wholly owned subsidiary of M&T Bank Corporation. Wilmington Trust Company, operating in Delaware only, Wilmington Trust, N.A., M&T Bank, and certain other affiliates, provide various fiduciary and non-fiduciary services, including trustee, custodial, agency, investment management, and other services. International corporate and institutional services are offered through Wilmington Trust Corporation's international affiliates. Loans, credit cards, retail and business deposits, and other business and personal banking services and products are offered by M&T Bank, member FDIC. Wilmington Trust Company operates offices in Delaware only. Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts. **IRS CIRCULAR 230: To ensure compliance with requirements imposed by the IRS, we inform you that, while this article is not intended to provide tax advice, in the event that any information contained in this article is construed to be tax advice, the information was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax related penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any matters addressed herein.** Copyright (c) 2018 Wilmington Trust Company. All right reserved.

Part One, Dick provided an overview and discussed the various approaches to taxation of trust income, and then reviewed the various constitutional restrictions, as reflected in numerous federal and state cases. He further examined these aspects in Part Two, beginning with a discussion of the seminal U.S. Supreme Court case of Quill Corp. v. North Dakota and its progeny in state courts, and provided a constitutional analysis of taxation based on the residence of the testator or trustor. Last month, he examined taxation based on administration in the taxing state, the residence of the fiduciary, and the residences of the beneficiaries and moved to a discussion of planning considerations for both new and existing trusts. This month, he concludes this discussion in Part Four with an analysis of home state court concerns and a host of other issues involving state income taxes to be considered by both the planner and the trustee. In addition, he also provides a brief summary of the impact of the Supreme Court's recent overruling of Quill in South Dakota v. Wayfair, Inc., and provides an appendix of various bases of state income taxation of nongrantor trusts.

RELIANCE ON AVAILABILITY OF HOME STATE COURTS IS MISPLACED

Exercise of Jurisdiction

In sustaining the ability to tax, the courts in *District of Columbia v. Chase Manhattan Bank*[1] and *Chase Manhattan Bank v. Gavin*[2] made much of the protections afforded to trusts by the states' courts. This reliance was mistaken.

Restatement Approach. For trusts of intangible personal property (such as those involved in *District of Columbia* and *Gavin*- whether created by Will or inter vivos, § 267 of the Second Restatement of Conflict of Laws provides that:[3]

> The administration of a trust of interests in movables is usually supervised . . . by the courts of the state in which the trust is to be administered.

A comment to § 267 indicates that the Will or trust instrument may designate the state of administration,[4] and a later comment describes the implications of such a designation as follows:[5]

> If the trust is to be administered in a particular state, that state has jurisdiction to determine through its courts not only the interests of the beneficiaries in the trust property but also the liabilities of the trustee to the beneficiaries, even though it does not have jurisdiction over the beneficiaries, or some of them. . . .
>
> So also a court of the state in which the trust is administered may give instructions as to the powers and duties of the trustee, although the beneficiaries or some of them are not subject to

> the jurisdiction of the court, provided they are given opportunity to appear and be heard.

Comment e to § 267 discusses the role of the court of primary supervision as follows:[6]

> Where the trustee has not qualified as trustee in any court and the trust is to be administered in a particular state, the courts of that state have primary supervision over the administration of the trust. They have and will exercise jurisdiction as to all questions which may arise in the administration of the trust. Thus, if an inter vivos trust is created with a trust company as trustee, the courts of the state in which the trust company was organized and does business will exercise jurisdiction over the administration of the trust.

If the home state court has jurisdiction over the trustee or the trust, this comment suggests that it should defer to the trust state's courts.[7]

The Scott treatise summarizes the applicable principles as follows:[8]

> Trust administration is ordinarily governed by the law of the state of primary supervision, and the rights of the parties ought not depend on the fact that a court of some other state happens to have acquired jurisdiction. Such a court may give a judgment based on its own local law, or it may attempt to apply the law of the state of primary supervision but apply it incorrectly.

UTC Approach. Under the UTC, establishing the "principal place of administration" of a trust is critical in determining which state's courts should handle trust questions because UTC § 202 provides in pertinent part:[9]

> (a) By accepting the trusteeship of a trust having its principal place of administration in this State . . . the trustee submits personally to the jurisdiction of the courts of this State regarding any matter involving the trust.
>
> (b) With respect to their interests in the trust, the beneficiaries of a trust having its principal place of administration in this State are subject to the jurisdiction of the courts of this State regarding any matter involving the trust. By accepting a distribution from such a trust, the recipient submits personally to the jurisdiction of the courts of this State regarding any matter involving the trust.

Thirty-two states have enacted a version of UTC § 202. Section 202's comment explains that "[t]his section clarifies that the courts of the principal place of administration have jurisdiction to enter orders relating to the trust that will be binding on both the trustee and beneficiaries."[10]

To determine a trust's "principal place of administration," UTC § 108(a) stipulates:[11]

> Without precluding other means for establishing a sufficient connection with the designated jurisdiction, terms of a trust designating the principal place of administration are valid and controlling if:
>
> (1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction; or
>
> (2) all or part of the administration occurs in the designated jurisdiction.

Thirty-three states have adopted a form of § 108.

UPC Approach. The UPC's approach is a bit different. UPC § 7-203 provides:[12]

> The Court will not, over the objection of a party, entertain proceedings under Section 7-201 involving a trust registered or having its principal place of administration in another state, unless (1) when all appropriate parties could not be bound by litigation in the courts of the state where the trust is registered or has its principal place of administration or (2) when the interests of justice otherwise would seriously be impaired. The Court may condition a stay or dismissal of a proceeding under this section on the consent of any party to jurisdiction of the state in which the trust is registered or has its principal place of business, or the Court may grant a continuance or enter any other appropriate order.

Although § 7-203 and the rest of Article 7 do not appear in the 2008 version of the UPC, at least seven states have statutes based on § 7-203.[13] In an unreported 2015 case, a Michigan intermediate appellate court applied Michigan's version of § 7-203 and held that Michigan courts lacked subject-matter jurisdiction because a trust's principal place of administration was in Florida.[14]

Section 7-101 of the UPC defines "principal place of administration" as follows:[15]

> Unless otherwise designated in the trust instrument, the principal place of administration of a trust is the trustee's usual place of business where the records pertaining to the trust are kept, or at the trustee's residence if he has no such place of business. In the case of co-trustees, the principal place of administration, if not otherwise designated in the trust instrument, is (1) the usual place of business of the corporate trustee if there is but one corporate co-trustee, or (2) the usual place of business or residence of the individual trustee who is a professional fiduciary if there is but one such person and no corporate co-trustee, and otherwise (3) the usual place of business or residence of any of the co-trustees as agreed upon by them.

Caselaw confirms that courts are cautious about construing trust questions governed by the laws of other states and that

consequently they often abstain from exercising jurisdiction.[16] To confirm jurisdiction outside a testator's or trustor's state of residence, the trustee and beneficiaries might commence a proceeding (e.g., to appoint a successor trustee, to make a unitrust conversion) early in the trust's existence.

Full Faith and Credit

A court in the state where a trust is being administered might not have to give full faith and credit to a judgment rendered by a court in the testator's or trustor's state of residence. Section 103 of the Second Restatement of Conflict of Laws states:[17]

> A judgment rendered in one State of the United States need not be recognized or enforced in a sister State if such recognition or enforcement is not required by the national policy of full faith and credit because it would involve an improper interference with important interests of the sister State.

Section 103's comments emphasize that it has an extremely narrow scope of application,[18] but authorities indicate that this section might apply if a state court is asked to give full faith and credit to a judgment rendered by a home state court. The Scott treatise frames the issue as follows:[19]

> In some situations, however, the court that has primary supervision over the administration of the trust may regard the judgment as an undue interference with its power to control trust administration. It may take the position that the court rendering the judgment applied its own local law, though it should have applied the law of the state of primary supervision, or that it incorrectly applied the law of the state of primary supervision. The question then is whether the court of primary supervision is bound to give full faith and credit to the judgment. The final determination of this question rests, of course, with the Supreme Court of the United States.

In 1958, the United States Supreme Court held in *Hanson v. Denckla*[20] that Delaware courts were not required to give full faith and credit to a judgment of a Florida court that lacked jurisdiction over the trustee and the trust property. The Scott treatise states that:[21]

> It seems clear that the Florida court, in applying its own local law and holding that the Delaware trust and the exercise of the power of appointment were invalid, unduly interfered with the administration of the trust by the Delaware courts . . . .
>
> Since the Delaware court could properly regard the judgment of the Florida court as unduly interfering with the administration of a trust that was fixed in Delaware, it was not bound by that judgment, notwithstanding the fact that the Florida court had jurisdiction over some or all of the beneficiaries. Indeed, it may well be argued that the Delaware court would not be bound

> by the Florida judgment even if the Florida court had jurisdiction over the trustee as well. A court may acquire jurisdiction over an individual trustee who happens to be in the state or over a corporate trustee that happens to have such a connection with the state as to give the state jurisdiction over it, or the trustee may appear in the action. We submit, however, that such a judgment would unduly interfere with the Delaware courts' supervision of the administration of the trust. It might, indeed, be held that not only would the Delaware courts not be bound to give full faith and credit to the Florida judgment, but that the Florida judgment would so interfere with the administration of the trust that it would be invalid as a denial of due process of law.

The Scott treatise suggests that the same principle should apply in other contexts.[22]

In the related case of *Lewis v. Hanson*, the Delaware Supreme Court unequivocally stated that Delaware courts would not have given full faith and credit to the Florida judgment even if the Florida courts had jurisdiction over the trustee and/or the trust property. It declared:[23]

> [W]e think the public policy of Delaware precludes its courts from giving any effect at all to the Florida judgment of invalidity of the 1935 trust. We are dealing with a Delaware trust. The trust *res* and trustee are located in Delaware. The entire administration of the trust has been in Delaware. The attack on the validity of this trust raises a question of first impression in Delaware and one of great importance in our law of trusts. To give effect to the Florida judgment would be to permit a sister state to subject a Delaware trust and a Delaware trustee to a rule of law diametrically opposed to the Delaware law. It is our duty to apply Delaware law to controversies involving property located in Delaware, and not to relinquish that duty to the courts of a state having at best only a shadowy pretense of jurisdiction.

The Supreme Court of New Hampshire applied the above principles in a 1986 case—*Bartlett v. Dumaine*.[24]

OTHER ISSUES

Simply Paying Tax is Risky

For attorneys and trustees, the easiest course is simply to pay state income taxes on trusts. But, this strategy is fraught with peril. Section 76 of the Third Restatement of Trusts imposes the following duty on a trustee:[25]

> A trustee's duty to administer a trust includes an initial and continuing duty to administer it at a location that is reasonably suitable to the purposes of the trust, its sound and efficient administration, and the interests of its beneficiaries.

As covered in Part Three, trustees in more than half the states have a statutory duty to locate trusts in appropriate jurisdictions.

The author is not aware of any case in which the taxation department of one state has sued a trustee in a court in another state to collect tax allegedly due the first state, nor of a reported case in which a trustee has been surcharged for failing to minimize income tax. It is understood that such cases are pending in New York State, and it seems likely that a successful surcharge case is inevitable. Therefore, attorneys and trustees who ignore the issue of minimizing state income taxes on trusts are inviting malpractice or surcharge claims.

Filing Position

In some cases, it will be clear whether a trust must pay a state's fiduciary income tax, while, in others, taxability will not be so evident. In uncertain cases, the attorney might request a ruling from the state's taxation department if it has a procedure for issuing rulings.[26] To minimize penalties and interest in unclear situations, the attorney might advise the trustee to file a timely return each year reporting that no tax is due and citing comparable cases from the same or other jurisdictions. The attorney also might counsel the trustee to segregate funds to pay taxes, penalties, and interest in case the filing position is unsuccessful.[27] In any event, the attorney and trustee should take a no-tax position in an uncertain case only after advising the trustor and beneficiaries in writing of the proposed action.

In clear cases, the author's firm—Wilmington Trust Company—will take the position that state fiduciary income tax is not due. If the issue is uncertain, it will file a return and pay tax unless counsel in the relevant state provides a reasoned opinion advising it not to do so.

Establishing Residence of Future Beneficiaries

Given that the most significant tax-saving opportunities relate to capital gains incurred by trustees and that those gains often are attributable to principal being held for later distribution, determining whether a state will treat unborn, unknown, and unascertained beneficiaries as residents or nonresidents is crucial in many states. Whereas Massachusetts[28] deems all such beneficiaries to be residents, Delaware and Rhode Island determine their residences based on the residences of currently identifiable beneficiaries.[29] The issue also is relevant in Connecticut, Hawaii, Michigan, and North Carolina where no pertinent guidance exists. As described in Part Three, basing taxation in whole or in part on the presence of resident beneficiaries is problematic.

Establishing Place of Administration

Numerous states tax a trustee in whole or in part based on whether it "administers" a trust within the state.[30] Of these states, Oregon, Utah, and Virginia provide rules as to when a trust is being administered within the state, which the attorney or trustee should follow in planning to eliminate tax. Colorado, Hawaii, Iowa, Kansas, Louisiana, Maryland, Mississippi, Montana, New Mexico, North Dakota, and South Carolina offer no such guidance.

Choosing a Jurisdiction for a Long-Term Trust

Part One noted that Professors Sitkoff and Schanzenbach found that trust funds move to states that allow very long or perpetual trusts and that do not levy an income tax on trustees of trusts created by nonresidents. Practitioners should avoid directing clients to Arizona (500-year trusts), Nevada (365-year trusts), North Carolina (perpetual trusts), Oklahoma (perpetual trusts), Tennessee (360-year trusts), and Wyoming (1,000-year trusts) because, even though they enacted statutes that abolished the common-law rule against perpetuities for trusts, they still have constitutional prohibitions on perpetuities.[31] This concern is particularly acute in Nevada where voters disapproved a ballot initiative to repeal the constitutional prohibition in 2002. Regarding this issue, Professor Sitkoff and a co-author wrote in 2014 that:[32]

> [L]egislation authorizing perpetual or long-enduring dynasty trusts is constitutionally suspect in a state with a constitutional prohibition of perpetuities.

A Nevada practitioner contends that a 1941 decision of the Supreme Court of Nevada—*Sarrazin v. First National Bank*[33]—and a 2015 decision of the same court—*Bullion Monarch Mining, Inc. v. Barrick Gold Strike Mines, Inc.*[34]—mean that the constitutional limitation no longer is relevant. The Sarrazin case was decided long before Nevada adopted a 365-year period for trust interests. Its entire description of the law of perpetuities in Nevada is as follows:[35]

> Section 4 of article XV of the constitution of Nevada reads: "No perpetuities shall be allowed except for eleemosynary purposes." There is no Nevada statute defining the rule against perpetuities. The common-law rule is usually stated thus: "No interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest." Other than the constitutional provision above quoted, there have not been called to our attention any other provisions, either constitutional or statutory, invalidating interests which vest too remotely, or forbidding restraints on alienation.

The emphasized sentence is dictum at best, because the court concluded that all interests in the trust in question would vest within the common-law rule against perpetuities period.[36]

The *Bullion Monarch Mining* case involved the applicability of Nevada's rule against perpetuities to "commercial mining agreements for the payment of area-of-interest royalties."[37] Not surprisingly, given the nature of the interest, the court held that it did not.[38] In the course of the opinion, the court discussed a 1974 case—*Rupert v. Stienne*[39]—as endorsing statutes that depart from the common law. Nevertheless, *Rupert*, which dealt with the "old common-law rule of interspousal immunity,"[40] did not involve a common-law rule that had been codified in Nevada's constitution. A decision of the Supreme Court of Nevada validating 365-year trusts might be helpful. The best way to resolve the issue, of course, would be for the voters to repeal the constitutional prohibition.

Source Income

The trust attorney should make sure that a small amount of source income will not cause an Exempt Resident Trust to be taxed as a Resident Trust.[41] For example, it appears that this is the case in New York.[42]

New Jersey is less aggressive than New York regarding the taxation of source income. Hence, in 1994, a New Jersey court granted New Jersey income tax refunds to twelve Florida trusts on gain recognized upon the liquidation of a corporation whose stock was owned by a partnership held by the trusts, even though the corporation owned several parcels of New Jersey real estate connected with business activity conducted in the state.[43] The court concluded that:[44]

The disposition of the corporat e stock here constitutes the nontaxable sale of the intangible asset.

Similarly, in 2015, the appellate division of the New Jersey superior court ruled that a testamentary trust created by a New Jersey decedent having a New York trustee and administration outside New Jersey was not taxable on interest income and S corporation income allocated outside New Jersey.[45]

In Minnesota, gain on the sale of a partnership interest is allocable to Minnesota in the ratio of the original cost of partnership tangible property in Minnesota to the original cost of partnership tangible property everywhere, determined at the time of the sale.[46] The Supreme Court of Ohio held in 2016 that the gain from the sale of a nonresidents' interest in an LLC was not Ohio-source income.[47]

Combining Nonresident Trustee With Resident Advisor, Protector, or Committee

Practitioners often ask whether New York tax or the tax of another state can be prevented by appointing resident advisors, protectors, or committee members to work with a nonresident trustee. This approach is risky—and should be avoided if at all possible—if the advisor is a fiduciary and/or exercises investment, distribution, or other management duties.[48] There is authority though, that the strategy will work if the advisor is only a custodian or agent[49] or if he or she delegates the fiduciary/management responsibilities.[50]

Changing Testator or Trustor by Exercise of Power

Another frequent inquiry is whether the identity of the testator or trustor in a state that taxes based on the residence of such an individual may be changed by:

- The exercise of a power of appointment
- The exercise of a decanting power

Resolution of the first issue necessarily depends on the law of the state in question. The exercise of a general power of appointment in New York or Connecticut will achieve this result, but the exercise of a nongeneral power will not.[51] In Virginia, though, the exercise of a nongeneral power of appointment by a Virginia resident over a nonresident's trust does create a Virginia Resident Trust.[52] This could produce the undesired result of having a trust established by the exercise of a nongeneral power being taxed as a Resident Trust in two states.

The authorities for decanting are not encouraging. For example, Regulations under IRC § 671[53] say that the identity of the grantor would not change in these circumstances. In addition, several of the state decanting statutes specify that a decanting power is a nongeneral power of appointment[54] and the available state tax rulings, other than in Virginia, indicate that the identity of the trust creator would not change.[55] In the 2013 *Linn v. Department of Revenue* case,[56] a trust created through the exercise of a trustee decanting power escaped Illinois income tax because:[57]

> The parties agree the Autonomy Trust 3 is an irrevocable trust, and A.N. Pritzker, who was an Illinois resident, is considered to be the grantor of the Autonomy Trust 3. Thus, under the Tax Act, the Autonomy Trust 3 is an Illinois resident and subject to Illinois income tax.

The Illinois statute,[58] which took effect in 2013, addresses the issue directly. It specifies, "[t]he settlor of a first trust is considered for all purposes to be the settlor of any second trust established

in accordance with this Section."[59] The Texas statute,[60]which took effect later that year has a comparable provision.[61]

State Income Taxation of CRTs

Determining the taxability of and the reporting requirements for a charitable-remainder trust ("CRT") for state income-tax purposes is quite challenging in several states. Many practitioners will be surprised to learn that two states—New Jersey and Pennsylvania—tax CRTs at the trust level. Accordingly, in 2009, the New Jersey Division of Taxation announced that:[62]

> Only exclusively charitable trusts qualify for income tax exemption under the New Jersey Gross Income Tax Act. A Charitable Remainder Trust, in contrast to a charitable trust, has "non-charitable" beneficiaries and does not operate exclusively for charitable purposes. Accordingly, a Charitable Remainder Trust is not an exclusively "charitable trust" exempt from New Jersey income tax under N.J.S.A. 54A:2-1 and income that is not distributed and which is not deemed to be permanently and irrevocably set aside or credited to a charitable beneficiary is taxable income to the trust. Similarly, the instructions to the Pennsylvania fiduciary income tax return provide in relevant part:[63]
>
> Charitable Remainder Annuity Trusts (CRATs) and Charitable Remainder Unitrusts (CRUTs) are trusts consisting of assets that are designated for a charitable purpose and are paid over to the trusts after the expiration of a life estate or intermediate estate.

Federally qualified CRATs and CRUTs are not charitable trusts if during the current taxable year:

- Any part of the trust's retained earnings may benefit any private individual in subsequent years; or
- Any part of the trust's current income is required under the governing instrument or any applicable state law to be distributed currently or is actually distributed or credited to a beneficiary that is not a charitable organization for which a donor may receive a charitable contribution deduction for federal income tax purposes.

> Important: CRATs, charitable remainder trusts, CRUTs and pooled income fund trusts of public charities are ordinary trusts that are not exempt from PA-41, Fiduciary Income Tax Return, filing requirements or taxation. These types of charitable trusts must file a Pennsylvania trust tax return, pay tax on any undistributed income, and report the income to the beneficiary on the same basis as any other ordinary trust.

Clients often create CRTs to diversify portfolios of low-basis securities without incurring immediate income tax on the gain. Such clients might be dismayed to learn that state tax is due on

the entire gain right away. That tax easily can be eliminated in New Jersey, and it might be escaped in Pennsylvania as well. Every other state that imposes an income tax appears to generally exempt CRTs from taxation.

Self-Settled Trust Option—The "DING Trust"

Most domestic asset-protection trusts ("APTs") are grantor trusts for federal income-tax purposes under IRC § 677(a) because the trustee may distribute income to—or accumulate it for—the trustor without the approval of an adverse party. But, a client might use a type of domestic APT known as the Delaware Incomplete Nongrantor Trust ("DING Trust"), to save income tax on undistributed ordinary income and capital gains imposed by Pennsylvania that has not adopted the federal grantor-trust rules for irrevocable trusts or, if the client is willing to subject distributions to himself or herself to the control of adverse parties, to eliminate income tax on such income imposed by one of the 43 states that have adopted the federal grantor-trust rules. In dozens of private letter rulings issued since 2013,[64] the IRS ruled that domestic APTs that followed the DING-Trust approach qualified as nongrantor trusts. Most—if not all—of the early rulings involved Nevada law in large part because, at the time, Nevada was the only domestic APT state that allowed a trustor to keep a lifetime nongeneral power of appointment. In the meantime, other domestic APT states have added that option.[65]

The trustor of a DING Trust might be able to receive tax-free distributions of the untaxed income in later years.[66] DING Trusts might no longer work in New York,[67] but the technique still is viable for residents of other states. In 2015, Wilmington Trust Company successfully resisted the California Franchise Tax Board's efforts to tax a DING Trust, saving the trustor millions of dollars of California income tax.

The author of a 2015 article concludes:[68]

> Few advisers are likely to say that the NING or DING trust is guaranteed to provide the desired results. A better question is: Are they worth the effort? This can be debated, but in some cases they will be.
>
> With every i dotted and t crossed, the informed and non-risk-averse client may go from the certainty of paying significant state income tax to the reporting position of paying little. Of course, the facts, documents, and details matter.
>
> The entire exercise can also be a helpful push into the related and often uncomfortable topic of estate planning.

Ethical Concerns

In some instances, it will be clear to the attorney that a trust

will not be subject to state fiduciary income tax. In other situations, however, it will not be clear whether the tax of a given state applies to the trust or, if it does, whether imposition of the tax is constitutional in the circumstances. The ABA Committee on Ethics and Professional Responsibility has advised that:[69]

> [A] lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no "substantial authority" in support of the position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law. This requires that there is some realistic possibility of success if the matter is litigated. In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.

Practical Concerns

Attorneys, accountants, trust officers, and other advisors understandably are concerned that they may lose business if they take steps to enable a trust to save state income tax, because doing so will put the beneficiaries in touch with new and possibly distant advisors. Nevertheless, they have a duty to put the interests of clients before their own and risk liability for not doing so. In the author's experience, attorneys' and accountants' fears in this regard are unwarranted. As an attorney for a Delaware trust company, he frequently works with attorneys from throughout the country and never has seen a non-Delaware attorney lose a client to a Delaware attorney because the latter always appreciates his or her limited role. Trust officers may be able to achieve the desired tax result within their own organizations.

What Can States Do?

States have limited choices for structuring constitutionally valid systems to tax the income of trusts that cannot easily be escaped. Hence, as discussed in Parts Two and Three, a state may tax based on the residence of the fiduciary and the place of administration, but practitioners can plan around these options. Taxing nonresident trustees based on the residences of testators, trustors, and beneficiaries is problematic. The best choice might be to tax resident beneficiaries on current and past distributions as is done in California and New York with the recognition that beneficiaries might move to eliminate tax.

NOTE ON SOUTH DAKOTA v. WAYFAIR, INC.

On June 21, 2018, in a 5-4 decision, the United States Supreme

Court eliminated the physical-presence requirement for substantial nexus to justify sales taxation under the Commerce Clause, declaring:[70]

> [T]he Court concludes that the physical presence rule of *Quill* is unsound and incorrect. The Court's decisions in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904, 119 L.Ed.2d 91 (1992); and *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), should be, and now are, overruled.

In the author's view, the *Wayfair* decision will have minimal impact on the state income taxation of trusts.[71]A taxing state still must establish the yet-to-be-developed new substantial-nexus test and, as demonstrated by *McNeil v. Commw.*,[72] satisfy the other three prongs of *Complete Auto Transit, Inc. v. Brady*.[73] Furthermore, *Linn v. Department of Revenue*[74] *and Fielding for MacDonald v. Commissioner of Revenue*[75] show that a nonresident trustee may win under the Due Process Clause, which has not required physical presence since the *Quill Corp. v. North Dakota* decision in 1992.[76] In fact, less than a month after the Court decided *Wayfair*, the Supreme Court of Minnesota affirmed the Minnesota Tax Court's decision and held 4-2 in *Fielding v. Commissioner of Revenue* that:[77]

> [E]ven when the additional contacts the Commissioner cites are considered in combination, the State lacks sufficient contacts with the Trusts to support taxation of the Trusts' entire income as residents consistent with due process. The State cannot fairly ask the Trusts to pay taxes as residents in return for the existence of Minnesota law and the physical storage of trust documents in Minnesota. Attributing all income, regardless of source, to Minnesota for tax purposes would not bear a rational relationship with the limited benefits received by the Trusts from Minnesota during the tax year at issue. We therefore hold that Minn. Stat. § 290.01, subd.7b(a)(2), is unconstitutional as applied to the Trusts.

* * * * * *

FOOTNOTES

[1] District of Columbia v. Chase Manhattan Bank, 689 A.2d 539 (D.C. 1997). See Discussion in Part Two.

[2] Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999). See Discussion in Part Two.

[3] Restatement (Second) of Conflict of Laws § 267 (1971). See Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, 7 Scott and Ascher on Trusts §§ 45.2.2.4.1, at 3102-14, 45.2.2.4.2, at 3114-22, 45.2.2.5, at 3122-25 (4th ed. 2010) (hereinafter "Scott"); Norman M. Abramson, Susan Gary, George G. Bogert & George T. Bogert, The Law of Trusts and Trustees, § 292, at 22-33 (3d ed. 2014) (hereinafter "Bogert").

[4] Restatement (Second) of Conflict of Laws § 267. cmt. c (1971).

[5] Restatement (Second) of Conflict of Laws § 267. cmt. d (1971).

[6] Restatement (Second) of Conflict of Laws § 267. cmt. e (1971).

[7] Restatement (Second) of Conflict of Laws § 267, cmt. e (1971).

[8] Scott § 45.2.2.6, at 3125.

[9] UTC § 202 (amended 2010).

[10] UTC § 202 cmt. (amended 2010).

[11] UTC § 108(a) (amended 2010). *See In re Seneker Trust*, 2015 WL 847129, at *2 (Mich. Ct. App. Feb. 26, 2015) ("[A]t the time of Stanley's death, the principal place of administration of the Trust was in Florida [not Michigan] . . .").

[12] UPC § 7-203 (amended 2008).

[13] See Alaska Stat. § 13.36.045; Haw. Rev. Stat. § 560:7-203; Idaho Code § 15-7-203; Mass. Gen. Laws ch. 203E, § 203; Mich. Comp. Laws § 700.7205; N.C. Gen. Stat. § 36C-2-203; Utah Code Ann. § 75-7-204.

[14] In re Seneker Trust, 2015 WL 847129, at *1.

[15] UPC § 7-101 (amended 2008). See Alaska Stat. § 13.36.005; Haw. Rev. Stat. § 560:7-101; Idaho Code § 15-7-101; Mich. Comp. Laws § 700.7209; RSMo § 456.027(3); Neb. Rev. Stat. § 30-3816.

[16] See, e.g., Bartlett v. Dumaine, 523 A.2d 1, 14-15 (N.H. 1986); Baltimore Nat'l Bank v. Cent. Pub. Util. Corp., 28 A.2d 244 (Del. Ch. 1942). See also Scott § 45.2.2.4.1, at 3112 n.36.

[17] Restatement (Second) of Conflict of Laws § 103 (1971).

[18] Restatement (Second) of Conflict of Laws § 103, cmts. a-b (1971).

[19] Scott § 45.2.2.6, at 3126.

[20] Hanson v. Denckla, 357 U.S. 235 (1958).

[21] Scott § 45.2.2.6, at 3128-29 (footnotes omitted).

[22] Scott § 45.2.2.6, at 3129.

[23] Lewis v. Hanson, 128 A.2d 819, 835 (Del. 1957) (citation omitted).

[24] Bartlett v. Dumaine, 523 A.2d 1 (N.H. 1986).

[25] Restatement (Third) of Trusts § 76 cmt. b(2) (2003).

[26] See, e.g., All Prior Revenue Bulletins Rescinded, Colo. Rev. Bull. 18-01 (Feb. 28, 2018), www.colorado.gov/pacific/sites/default/files/Revenue_Bulletin_18.01.pdf; Ky. Rev. Proc. KY-RP-17-01 (Nov. 22, 2017), https:/revenue.ky.gov; Rev. Admin. Bull. 2016-20 (Oct. 5, 2016), www.michigan.gov/documents/treasury/RAB_2012-20_-_Issuance_of_Bulletins_Letter_Rulings_and_Other_Guidance_536827_7.pdf; Cal. Franchise Tax Bd. Notice 2009-08 (Cal. Franchise Tax Bd. Oct. 12, 2009), www.ftb.ca.gov/law/notices/2009/2009_08.pdf. See also Cal. Franchise Tax Bd. Info. Ltr. 2012-01, 2012 Cal. FTB I.L. Lexis 1 (Franchise Tax Bd. Nov. 28, 2012), www.ftb.ca.gov/law/infoletter/Info2012_01.pdf.

[27] *See* Bradley E. S. Fogel, What Have You Done For Me Lately? Constitutional Limitations on State Taxation of Trusts, 32 U. Rich. L. Rev. 165, 228-29 (Jan. 1998).

[28] Mass. Gen. Laws ch. 62, § 10(a). *See* Mass. Regs. Code tit. 830, § 62.10.1(2)(b); instructions to 2017 Mass. Form 2 at 4.

[29] 30 Del. C. § 1636(b); R.I. Code R. 46-050-010, PIT 90-13(II)(B).

[30] See Discussion in Part One.

[31] See Ariz. Const. art. 2, § 29; Nev. Const. art. 15, § 4; N.C. Const. art. 1, § 34; Okla. Const. art. 2, § 32; Tenn. Const. art. 1, § 22; Wyo. Const. art. 1, § 30. An intermediate appellate court upheld North Carolina's statute in Brown Bros. Harriman Trust Co. v. Benson, 688 S.E.2d 752 (N.C. App. 2010). But, commentators advise the Supreme Court of North Carolina and other courts not to rely on the case because it is "deeply flawed" (Steven J. Horowitz & Robert H. Sitkoff, Unconstitutional Perpetual Trusts, 67 Vand. L. Rev. 1769, 1811 (Nov. 2014)). Another commentator points out that, "The inclusion of a separate clause, copied from the Pennsylvania Constitution, providing that the legislature 'shall regulate entails, in such a manner as to prevent perpetuities' shows that the framers of the North Carolina Constitution of 1776 were hostile to perpetuities as conventionally defined" (Joshua C. Tate, Perpetuities and the Genius of a Free State, 67 Vand. L. Rev. 1823, 1833 (Nov. 2014)). For an analysis of these

constitutional prohibitions, see Les Raatz, State Constitutional Perpetuities Provisions: Derivation, Meaning, and Application, 48 Ariz. St. L.J. 803 (Fall 2016).

[32] Horowitz & Sitkoff, 67 Vand. L. Rev., at 1803. Accord Jonathan G. Blattmachr, Mitchell M. Gans & William D. Lipkin, What if Perpetual Trusts are Unconstitutional?, LISI Est. Plan. Newsl. # 2263 (Dec. 18, 2014), www.leimbergservices.com.

[33] Sarrazin v. First Nat'l Bank, 111 P.2d 49 (Nev. 1941). See Steven J. Oshins, The Rebuttal to Unconstitutional Perpetual Trusts, LISI Est. Plan. Newsl. #2265 (Dec. 22, 2014), www.leimbergservices.com.

[34] Bullion Monarch Mining, Inc. v. Barrick Gold Strike Mines, Inc., 345 P.3d 1040 (Nev. 2015). See Steven J. Oshins, Unconstitutional Perpetual Trusts—Not So Fast Says the Nevada Supreme Court, LISI Est. Plan. Newsl. #2297 (Apr. 6, 2015), www.leimbergservices.com.

[35] Sarrazin, 111 P.2d at 51 (citation omitted; emphasis added).

[36] Sarrazin, 111 P.2d at 53.

[37] Bullion Monarch Mining, 345 P.3d at 1041.

[38] Bullion Monarch Mining, 345 P.3d at 1044.

[39] Rupert v. Stienne, 528 P.2d 1013 (Nev. 1974).

[40] Bullion Monarch Mining, 345 P.3d at 1042.

[41] Phillip J. Michaels & Laura M. Twomey, How, Why, and When to Transfer the Situs of a Trust, 31 Est. Plan. 28, 29 (Jan. 2004).

[42] See N.Y. Tax Law § 605(b)(3)(D).

[43] Tina Schiller Trust for Benefit Siegelbaum v. Dir. Div. of Taxation,14 N.J. Tax 173 (Super. Ct. App.Div. 1994).

[44] Tina Schiller Trust, 14 N.J. Tax at 181.

[45] Residuary Trust A U/W/O Kassner v. Dir. Div. of Taxation, 28 N.J. Tax 541, 548 (Super. Ct. App.Div. 2015). See Discussion in Part Two. Accord Hill v. Director, State Div. of Taxation, 2016 WL 3351959 (Super. Ct. App. Div. June 2, 2016).

[46] See Minn. Stat. § 290.17 subd. 2(c).

[47] Corrigan v. Testa, 73 N.E.3d 381 (Ohio 2016). See Roxanne Bland, Passthrough Entities: The Constitutional Dimension, 86 State Tax Notes 569 (Nov. 6, 2017); William T. Thistle, II, Bruce P. Ely & Christopher R. Grissom, Blurred Lines: State Taxation of Nonresident Partners, 81 State Tax Notes 689 (Aug. 29, 2016); Timothy Noonan & Joshua K. Lawrence, Could Ohio's Latest Due Process Case Spell Trouble for New York, 81 State Tax Notes

117 (July 11, 2016); Walter Hellerstein, Substance and Form in Jurisdictional Analysis: Corrigan v. Testa, 80 State Tax Notes 849 (June 13, 2016).

[48] See N.Y. TSB-A-04(7)I, 2004 N.Y. Tax Lexis 259 (N.Y. Dep't Tax. Fin. Nov. 12, 2004), www.tax.ny.gov/pdf/advisory_opinions/income/a04_7i.pdf.

[49] See, e.g., Taylor v. State Tax Comm'n, 445 N.Y.S.2d 648 (App. Div. 1981).

[50] See Yolanda King Family Trust, 2007 WL 3275357, at *1 (Cal. St. Bd. Eq. Oct. 4, 2007).

[51] See N.Y. TSB-A-03(6)I, 2003 WL 22970581 (N.Y. Dep't Tax. Fin. Nov. 21, 2003), www.tax.ny.gov/pdf/advisory_opinions/income/a03_6i.pdf; Ct. Ruling 2005-2, 2005 WL 578844 (Conn. Dep't Rev. Serv. Jan. 14, 2005), www.ct.gov/drs/cwp/view.asp?A=1513&Q=289024.

[52] See P.D. 16-62, 2016 WL 2940441 (Va. Dep't Tax. Apr. 20, 2016), www.tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/16-62.

[53] See Treas. Reg. § 1.671-2(e)(5). See also P.L.R. 200736002, 2007 WL 2570463 (I.R.S. PLR 2007) (["B]ecause the creation of the successor trusts is a modification of Trust for Federal income tax purposes, the successor trusts are treated as a continuation of Trust").

[54] See, e.g., Alaska Stat. § 13.36.158(a); Ariz. Rev. Stat. § 14-10819(C); Conn. Gen. Stat. § 45a-572; 12 Del. C. § 3528(c); Fla. Stat. § 736.04117(7)(a); 760 ILCS 5/16.4(t); Ind. Code § 30-4-3-36(c); Ky. Rev. Stat. Ann. § 386.175(6)(a); Mich. Comp. Laws § 556.115a(6); Minn. Stat. § 502.851, subd. 5; Nev. Rev. Stat. § 163.556(10); N.Y. Est. Powers & Trusts Law § 10-6.6(d); N.D. Cent. Code § 59-16.1-06; Ohio Rev. Code Ann. § 5808.18(E); R.I. Gen. Laws § 18-4-31(c); S.C. Code Ann. § 62-7-816A(f)(1); S.D. Codified Laws § 55-2-19; Tenn. Code Ann. § 35-15-816(b)(27)(E); Tex. Prop. Code § 112.077; Wis. Stat. § 701.0418(8)(a); Wyo. Stat. § 4-10-816(a)(xxviii).

[55] See N.Y. TSB-A-03(6)I, 2003 WL 22970581 (N.Y. Dep't Tax. Fin. Nov. 21, 2003), www.tax.ny.gov/pdf/advisory_opinions/income/a03_6i.pdf.

[56] Linn v. Dep't of Revenue, 2 N.E.3d 1203 (Ill. App. Ct. 2013).

[57] Linn, 2 N.E.3d at 1208.

[58] 760 ILCS 5/16.4.

[59] 760 ILCS 5/16.4(t).

[60] Tex. Prop. Code §§ 112.071?112.087.

[61] Tex. Prop. Code § 112.077.

[62] N.J. Div. of Tax'n Tech. Bull. 64, 2009 N.J. Tax Tech. Bull. Lexis 34 (Div. of Tax'n June 29, 2009), www.state.nj.us/treasury/taxation/pdf/pubs/tb/tb64.pdf.

[63] Instructions to 2017 Form PA-41 at 2?3. See 72 P.S. § 7301(c.1).

[64] See, e.g., PLRs 201751001-003 (Sept. 18, 2017); 201744006-008 (July 26, 2017); 201742006 (July 10, 2017); 201738008-009 (May 5, 2017); 201729009 (Mar. 27, 2017); 201718003?010, 012 (Dec. 20, 2016); 201653001?006 (Aug. 16, 2016); 201650005 (Aug. 26, 2016); 201636027?032 (May 23, 2016); 201628010 (Apr. 11, 2016); 201614006?008 (Dec. 4, 2015); 201613007 (Dec. 4, 2015).

[65] See, e.g. 12 Del. C. § 3570(11)(b)(2).

[66] See Gordon P. Stone, III, Tax Planning Techniques for Client Selling a Business, 43 Est. Plan. 3 (Oct. 2016); Robert W. Wood, Sellers and Settling Litigants Lured by Tax Savings of NING and DING Trusts, 77 State Tax Notes 565 (Aug. 10, 2015).

[67] See N.Y. Tax Law § 612(b)(41).

[68] Wood, 77 State Tax Not4es at 568.568.

[69] ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 352 at 3 (1985). See Dennis J. Ventry, Jr., Lowering The Bar: ABA Formal Opinion 85-352, 112 Tax Notes 69 (July 3, 2006).

[70] South Dakota v. Wayfair, Inc., 138 S.Ct. 2080, 2099 (2018).

[71] Accord Larry Katzenstein & Jeff Pennell, How Does South Dakota v. Wayfair Impact a State's Ability to Tax Undistributed Trust Income?, LISI Inc. Tax Plan. Newsl. #148 (July 12, 2018), www.leimbergservices.com ("there does not appear to be a change in the standards that will apply in the future").

[72] McNeil v. Commw., 67 A.3d 185 (Pa. Commw. Ct. 2013). See Discussion in Part Two.

[73] Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). See Discussion in Part Two.

[74] Linn v. Dep't of Revenue, 2 N.E.3d 1203 (Ill. App. Ct. 2013). See Discussion in Part Two.

[75] Fielding for MacDonald v. Commissioner of Revenue, 2017 WL 2484593 (Minn. Tax Ct. May 31, 2017). See Discussion in Part Two.

[76] Quill Corp. v. North Dakota, 504 U.S. 298 (1992). See Discussion in Part Two.

[77] Fielding v. Commissioner of Revenue, 2018 WL 3447690, at *8 (Minn. July 18, 2018) (footnote omitted).

Using Powers of Appointment to Obtain a Step Up in Basis

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Income Tax Planning More Important Than Estate Tax Planning

- Income tax planning is more important than estate tax planning for most people due to the current size of the estate, gift and GST exemption - $11.18 million (2018) per person.

- A key issue for most clients is preserving a step-up in basis at death

- The potential 20% federal capital gains tax, the 3.8% surtax on net investment income and state income tax could result in a capital gain tax of 30% or more

- Lifetime gifts of low basis assets won't make sense for most people as the donee will take the donor's low cost basis, Section 1015(a).

Income Tax Planning More Important Than Estate Tax Planning

- Avoidance of both capital gain tax and the net investment income tax and passing assets with a stepped-up basis is now the focus for most clients.

- Traditional estate planning techniques used to reduce the value of the assets at death may be counter-productive

- With most clients are no longer subject to the federal estate tax, claiming valuation discounts will not produce an estate tax benefit but instead will result in a reduction in the income tax basis and increase future capital gain taxes for the client's heirs

Basis - Death

- General rule: FMV at date of death for property acquired from a decedent. §1014(a)(1).
  - Can result in a step-up or a step-down in basis
  - Result: gains and losses on assets in decedent's gross estate are wiped out at death.
  - Exceptions:
    - Income in respect of a decedent (IRD). §1014(c).
    - Partnerships or LLCs – "hot assets" held in a partnership or LLC. §751(a)
    - S corporation IRD. §1367(b)(4) – basis of S corporation stock is reduced by items of IRD held by the S corporation
    - Employer stock – "net unrealized appreciation" (NUA) of employer stock distributed from a qualified retirement plan. Rev. Rul. 75-125.
    - Alternate valuation – basis is value as of earlier of six months from date of death or the date of distribution. §1014(a)(2).

Basis - Death

- General rule: FMV at date of death. §1014.
  - Exceptions (Cont.):
    - Section 2032A special use valuation – basis is special use value. §1014(a)(3). If estate tax is recaptured, basis of asset is adjusted. §1016(c)(1).
    - Conservation easements – To extent of qualified conservation easement election is made pursuant to §2031(c), the basis is the decedent’s basis in the asset. §1014(a)(4). The basis is reduced by the value excluded from the gross estate.
    - Jointly held assets – if spouse is joint owner, 50% of asset gets a step-up (or step-down). If joint owner is other than spouse, contribution test applies.
    - Gift of appreciated asset within one year of death - If appreciated assets is gifted to decedent within one year of death and asset is acquired by donor or the donor’s spouse as a result of donee’s death, step-up not permitted. §1014(e).

Basis - Death

- General rule: Basis of property included in a generation-skipping transfer (GST) is adjusted (but not above FMV) for GST tax paid. § 2654(a).
  - Basis of transferred property is increased by an amount equal to the GST tax attributable to the value of the property in excess of the adjusted basis of the property i.e. GST tax attributable to the appreciation. § 2654(a)(1).
  - Example: property with an adjusted basis of $50,000 is distributed from a trust in a taxable distribution when the FMV is $75,000 and a $30,000 GST tax is paid. The basis of the property would be adjusted to $60,000 ([$25,000/$75,000 x $30,000 GST tax] + $50,000 original basis)
  - Exception: for taxable terminations that occur as a result of the death of an individual, the basis of the property is adjusted similarly to the adjustment under § 1014(a)
    - If the inclusion ratio is less than one, any increase or decrease in basis is limited to the amount determined by multiplying the adjustment by the exclusion ratio.

Basis - Consistency

- New Law – Income tax basis must be consistent with estate tax value.
  - Beneficiaries required to use estate tax value as income tax basis. §1014(f).
  - Executors required to furnish information statements to IRS and beneficiaries about the value of estate assets. §6035.
  - Information statements must be furnished by earlier of 30 days after estate tax return is required to be filed (plus extensions) or 30 days after return is actually filed.
  - Penalties imposed for non-compliance.

Types of Powers of Appointment

- General – power exercisable in favor of *the decedent, his estate, his creditors or the creditors of his estate*. Section 2041(b)(1).
  - Causes inclusion in decedent's gross estate
- Special – power exercisable in favor of someone OTHER THAN the decedent, his estate, his creditors or the creditors of his estate
  - Not included in decedent's gross estate
  - Ascertainable standard – "health, education maintenance and support" – is not a general power of appointment and does not cause inclusion in the decedent's gross estate

Basis

- Property ***acquired from a decedent*** receives an income tax basis equal to the fair market value of the asset on the date of the decedent's death or, if the alternate valuation date is elected, the value on the alternate valuation date. Section 1014(a).

  - Property acquired pursuant to the exercise of a power of appointment is considered to be "acquired from the decedent." Section 1014(b)(5), (9).

  - It is the *existence*, not the exercise, of the general power of appointment that gives rise to the basis adjustment.

Upstream Planning

- General rule: Basis is FMV at date of death. §1014.
  - Basis of assets gets stepped up at death
  - Avoid gifting during life to get basis step-up at death
  - Transfer low basis assets to senior family members with nontaxable estates to cause estate tax inclusion and increase tax basis
    - Alternative: give or sell assets to a grantor trust fbo 3rd party (parents with no taxable estate) who have a general testamentary power of appointment over the trust.

Income Tax Planning More Important Than Estate Tax Planning

- One alternative – "upstream planning" – gift low basis assets to older generation who then leave them at death to the donor. That will give the donor a cost basis equal to the fair market value when the donee dies.

- Caution: if the donee dies within one year of the gift, the donor is not entitled to a cost basis equal to the fair market value at the date of the donee's death if the gifted asset is left to the donor or the donor's spouse. Section 1014(e).

- Alternative: have the donee leave the gifted asset to someone other than the donor e.g., the donor's child

Section 1014(e)

- Give asset to donee with short life expectancy.
  - Donee's estate plan leaves asset to donor
  - Donee dies, asset gets basis step-up
  - Caution: Gift of appreciated asset within one year of death - If appreciated assets is gifted to decedent within one year of death and asset is acquired by donor (or donor's spouse) as a result of donee's death, step-up not permitted. §1014(e).
    - Possible solution: Wife gives short life expectancy husband asset. Husband dies within one year. Husband leaves asset to trust fbo wife. Technically, asset isn't re-acquired by wife. However, according to the legislative history, § 1014(e) operates if transfer to donor spouse occurs "directly or indirectly."
    - Another possible solution: Wife give short life expectancy husband asset. Husband dies within one year. Husband leaves assets to non-spouse beneficiary e.g. kids. Basis is FMV at date of death.

Section 1014(e)

- Give asset to donee with short life expectancy.
  - Another possible solution: If donee dies within one year, donor can disclaim and assets will get step-up in basis equal to FMV at date of death.
  - Another possible solution: Donor could gift to a trust over which the donee has a general power of appointment. Arguably, GPOA is not a gift and Section 1014(e) doesn't apply. However, IRS may treat this as an indirect violation of Section 1014(e).
  - Another possible solution: Donor gifts to a trust fbo of non-spouse beneficiaries. Trust protector has power to add Husband as a beneficiary sometime more than one year after the gift to the trust.

Section 1014(e)

- General power of appointment trust funded with cash followed by sale
  - Donor funds a grantor trust with cash fbo donee spouse
  - Trust gives donee spouse GTPOA
  - Donor subsequently sells appreciated property to grantor trust. Rev. Rul. 85-13 prevents gain recognition
  - Trust assets included in donee-spouse's estate due to GTPOA
  - Basis step-up under § 1014(b)(9)
  - § 1014(e) shouldn't apply if donee dies within a year of the gift
  - § 1014(e) only applies if "appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent's death. § 1014(e)(1)(A).
  - Here, cash, not appreciated property was gifted to the trust.

Flexible Drafting

- Irrevocable trusts should be drafted to allow flexibility for trust distributions
  - Use independent trustee or trust protector with discretionary powers to distribute assets to beneficiary to get step-up in basis at beneficiary's death.
    - May raise fiduciary issues for trustee

Flexible Drafting

- Irrevocable trusts should be drafted to allow flexibility for trust distributions

  – Alternative: give someone such as a trust protector a non-fiduciary power of appointment to appoint trust assets to a beneficiary. This avoids the fiduciary issues for the trustee.

  - Alternative: Give trust protector the right to convert a special power of appointment to a general power of appointment or grant a GPOA to trust beneficiary e.g. spouse or others

  - Strategy: if no estate tax will be due upon the beneficiary's death, the beneficiary having a GPOA will result in a basis adjustment

  - Issue: the holder of the GPOA is deemed to have a power over all the assets subject to the power and that may cause inclusion in the power holder's estate of too much

Flexible Drafting

- Irrevocable trusts should be drafted to allow flexibility for trust distributions
  - Solution: give an independent party (e.g., child, another family member, non-family member), a non-fiduciary limited power to appoint property to the surviving spouse.
  - A power of appointment granted in a non-fiduciary capacity may be exercised arbitrarily. Restatement (Third) of Prop.: Wills & Other Donative Transfers § 17.1 (2011).

General Power of Appointment

- General power of appointment (GPOA) causes inclusion in the gross estate. Section 2041.
  - Consider formula GPOA i.e., a GPOA up to the amount that would not generate Federal estate taxes in the beneficiary's estate
    - Contingent on surviving beneficiary having unused applicable exclusion amount
    - Structured to be applicable to assets in trust that have appreciated
  - Further refinement:
    - Applies to assets with most appreciation
    - Applies to assets subject to tax at highest income tax rate e.g. collectibles
    - Applies to assets that will be sold earliest

Flexible Drafting

- The ideal trust
  - Assets get a step-up, but never a step down, in basis
  - Doesn't generate any federal estate tax

Flexible Drafting

- The ideal trust – solution:
  - Creative use of testamentary general and limited powers of appointment
  - Structure so that the assets in the trust receive a step-up, but not a step down, in basis
    - For example, (1) grant the beneficiary a special testamentary power of appointment (STPOA), or no power at all, over assets that constitute income in respect of a decedent (IRD) or assets that have a basis greater than fair market value and (2) grant a GPOA over assets that have a fair market value greater than their cost basis
  - Structure the powers of appointment to avoid additional estate tax
    - Caution: What if the asset subject to the GPOA when added to the assets in the beneficiary's estate exceeds the beneficiary's applicable exclusion amount?

Flexible Drafting

- Using a formula GPOA to avoid estate tax exposure:
  - Formula would provide that the GPOA is only applicable to appreciated assets to the extent it does not cause increased federal estate tax
  - Reg. 20.2041-1(b)(3) allows appointment of only a portion of property.
  - Further refinement of the formula – limit the GPOA to those assets with the greatest appreciation or would result in the greatest federal income tax considering both the *amount* and *character* of the income (e.g., collectibles, ordinary income v. long-term capital gain, qualifying small business stock, depreciable assets)

Flexible Drafting

- Structuring a formula GPOA to avoid estate tax exposure:
  - Simple formula – GPOA applies to a pecuniary amount e.g., power over assets with a value equal to the beneficiary's remaining applicable exclusion amount.
  - Problem: if the assets appreciate between the date of death and date of distribution, gain would be required to be recognized. Reg. 1.661(a)-2(f); Reg. 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 C.B. 286.
  - Possible solution: structure the beneficiary's power over the applicable property as a fraction of the assets, resulting in a fractional, or pro-rata, adjustment to basis. Each asset would get a fractional, adjustment to basis.

Flexible Drafting

- Structuring a formula GPOA to avoid estate tax exposure:
  - – Another possible solution: give an independent trustee a fiduciary limited power of appointment to choose the appointive assets subject to the surviving spouse's GPOA.
  - – Best possible solution: specify that the GPOA applies on a asset by asset basis, first to the asset with the greatest appreciation, then cascading to each next greatest appreciated individual asset until the amount available to avoid Federal estate tax is used up.
    - – IRS can't argue for an application of a "fairly representative" allocation as in the case of a fractional formula as the GPOA would apply to specific property, not to a pecuniary or fractional formula
    - – Practical issue: may have to create an extensive spreadsheet showing the fair market value and cost basis of the assets to apply the formula

General Power of Appointment

- General power of appointment (GPOA) causes inclusion in the gross estate. Section 2041.
  - Consider granting "upstream" GPOA to less wealthy parents. Assets included in their gross estate, no Federal estate tax, get basis step-up.
    - Give/sell assets to grantor trust fbo modest wealth parent which gives parent a general testamentary power of appointment
    - Included in parent's gross estate but no Federal estate tax
    - Basis step-up
    - Donor could allocate his generation skipping tax exemption to trust (assuming parent won't exercise the GTPOA)
    - Parent could allocate his generation skipping tax exemption to trust if parent exercises the GTPOA (parent becomes transferor upon exercise of GTPOA)
    - Parent could exercise GTPOA to dynasty trust fbo donor or trust could continue as dynasty trust if GTPOA not exercised.
    - Possible § 1014(e) issue if parent dies within a year of gift

Delaware Tax Trap

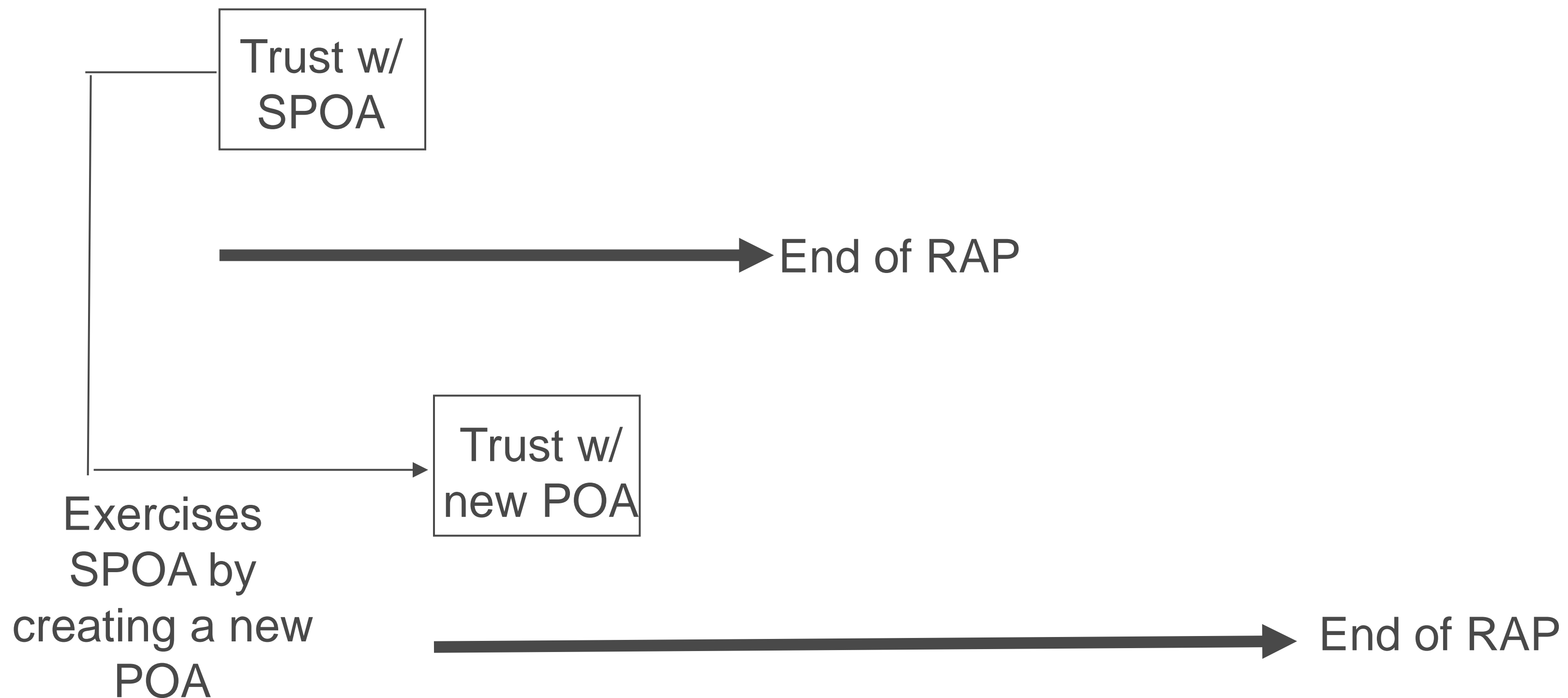
- Causes inclusion in gross estate and a step-up in basis - complicated

  - Property subject to a special power of appointment (SPOA) will cause inclusion in the power holder's gross estate if the power is exercised (the limited power must *actually be exercised*) to create another power of appointment which, under the applicable state law, can be validly exercised so as to postpone the vesting of an interest in the property subject to the power, or suspend the absolute ownership, for a person ascertainable without regard to the date of the creation of the first power. § § 2041(a)(3); 2514(d).

  - Result: triggering the Delaware Tax Trap results in a basis step-up

  - However, many states require SPOA to refer back to the creation date of the first power i.e. won't trigger the Delaware Tax Trap.

Delaware Tax Trap



Delaware Tax Trap

- Delaware tax trap may not work in all states as states have enacted "saving clauses" that require SPOA to refer back to the creation date of the first power i.e. won't trigger the Delaware Tax Trap.

  – Conn. Gen. State. § 45a-492; N.J. Rev. Stat. § 46.2F-10(a)(3); N.Y. Est. Powers & Trust Law § 10-8.1(a)

- Also, some trusts are drafted to limit the duration of the trust or the exercise of an SPOA from being exercised in a way to trigger the Delaware tax trap

Thank you!

Questions?

Disclosure

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Transfer Planning with Preferred Partnerships, Carried Interests and Profits Interests

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[1] The views expressed in this outline are solely of the author and do not necessarily represent the view of Ernst & Young LLP or any other firm of the global Ernst & Young organization.

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I. INTRODUCTION

There are a number of transfer tax issues that can arise under Chapter 14 of the Internal Revenue Code[2] in connection with transfers of business interests or transfers in trust when family members are involved. Contained within Chapter 14 generally are numerous gift and estate tax provisions that are designed to discourage certain types of transactions or arrangements entered into between members of the same extended family. The violation of one or more of these provisions can inadvertently cause a deemed gift or an increase in the value of one's estate, which can potentially result in the imposition of an unanticipated gift or estate tax, or an increase in such taxes. Many of these sections of the Code are written very broadly and can unexpectedly apply, even in circumstances where a transaction has not been structured with the intention of achieving estate or gift tax savings or where wealth transfer may not even be the objective.[3]

Generally, Chapter 14 of the Code, which is comprised of Sections 2701 through 2704, attempts to prevent perceived transfer tax abuses in the context of business or other interests held within a family. In very broad terms, the assumption underlying Chapter 14 appears to be that a senior family member will make decisions relating to the ownership and disposition of a family business and other interests so as to shift value to younger family members with reduced or minimal transfer tax consequences. Chapter 14 discourages certain transactions by treating them as deemed gifts, and others by disregarding certain agreements or restrictions that would otherwise affect value for transfer tax purposes.

The "Deemed Gift Provisions" are found in three sections of the Code: Section 2701, relating to recapitalizations and other types of "transfers" of business interests where different economic classes of equity are involved;[4] Section 2702, relating to transfers (and deemed transfers) to trusts with retained interests and joint purchases of property;[5] and Section 2704(a), relating to lapses of liquidation or voting rights.[6] Generally, the deemed gifts determined under these provisions are created by applying a "zero valuation" concept (except for Section 2704(a),

[2] The Internal Revenue Code of 1986, as amended, is hereafter referred to as the "Code." Unless otherwise indicated, each reference to a "section" is a reference to a section of the Internal Revenue Code of 1986; and each reference to "Treas. Reg. §" is a reference to a regulations section. The "IRS" or the "Service" means either or both the US Department of the Treasury and Internal Revenue Service, as the context may require.

[3] For excellent general commentaries and discussions regarding Chapter 14, *see generally*; Louis A. Mezzullo, "Transfers of Interests in Family Entities Under Chapter 14: Sections 2701, 2702, 2703 and 2704," 835-4th Tax Mgmt. (BNA) Estates, Gifts, and Trusts (2011); HOWARD M. ZARITSKY & RONALD D. AUCUTT, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS (2d ed. 1997); *Blattmachr on Anti-Freeze Provisions of the IRC New Chapter 14* (91-08.18) (Mass. C.L.E. 1991); DOUGLAS K. FREEMAN & STEPHANIE G. RAPKIN, PLANNING FOR LARGE ESTATES (LexisNexis 2012); CHERYL E. HADER, ESTATE PLANNING & CHAPTER 14: UNDERSTANDING THE SPECIAL VALUATION RULES (Practicing Law Institute, 2d ed. 2011).

[4] *See* Code Section 2701.

[5] *See* Code Section 2702.

[6] *See* Code Section 2704(a).

which determines the value of a deemed gift, or increases the value of an asset for estate tax purposes by measuring the difference in the value of the interest immediately prior to the lapse of a right versus its value immediately after the lapse), which assigns a value of zero to an interest in a business or trust that is held or retained by senior family members. These provisions have the potential to result in a deemed gift of some or perhaps even all of the value of the business or other interests in connection with transfers of certain interests in which another interest is retained.

The "Disregard Provisions" refer to the Chapter 14 provisions that have the effect of ignoring or disregarding, for transfer tax purposes, certain agreements or restrictions that would otherwise artificially assign a lower value to a business interest or would artificially reduce its value for estate or gift tax purposes. These provisions are included in Code Sections 2703 and 2704(b).

II. SECTION 2701—RECAPITALIZATIONS AND OTHER "TRANSFERS" OF BUSINESS INTERESTS.

Section 2701 can cause a deemed gift to occur typically in connection with a "transfer" of subordinate equity interest (i.e., common interests) in a corporation, partnership or Limited Liability Company (LLC) to a junior family member when certain discretionary rights (typically, but not necessarily, associated with preferred interests) are retained by a senior family member. The classic type of transaction to which Section 2701 can potentially apply is when a parent, who initially owns both common and preferred stock in a corporation (or in a partnership or LLC), transfers the common stock (or the common interest) to his children while retaining the preferred stock (or preferred interest).

For gift tax valuation purposes of the transferred common interest, the parent would want the retained preferred interest to have as high a value as possible so as to take the position that the value of the transferred common interest had a minimal value for gift tax purposes; determined under the assumption that the value of the preferred and common interests together make up 100% of the value of the entity so that the value of the transferred common is determined by subtracting the value of the retained preferred (the "Subtraction Method") from the entire value of the entity.

A. The Perceived Abuse.

Congress enacted the special valuation rules under Chapter 14 of the Code (Sections 2701 through 2704), effective for transfers after October 8, 1990, in an attempt to prevent perceived abuses with respect to family transactions involving the transfer wealth between family members (typically from senior to junior generations) with minimal or reduced gift and estate tax consequences through the perceived manipulation of value.

1. Discretionary Rights.

Prior to the enactment of Section 2701, in determining the value of gifted common interests, in order to artificially increase the value of the parent's retained preferred interests, the preferred interests might have been given certain *discretionary* rights, such as rights to non-cumulative dividends and redemption or conversion rights. It was often expected that these discretionary rights would never actually be exercised, but, nonetheless, would be able to boost the value of the parent's retained preferred interest, thereby reducing the value of the gift of the common interest under a Subtraction Method of valuation. If, however, parent was ascribed "credit" for gift tax purposes for those discretionary rights, but subsequently those rights were never actually exercised by parent, this would

result in a shifting of value to the common interest (then owned by the children) without a corresponding imposition of gift tax.

Section 2701 aims to discourage this perceived abuse by essentially ignoring the existence of such discretionary rights and, instead assigning a zero value to these retained rights in determining how much value or "credit" the senior family member should get for gift tax purposes under the Subtraction Method of valuation. Thus, under Section 2701, only specific types of *non-discretionary* rights (essentially rights that are mandatory and quantifiable) that fit within specific and narrow exceptions to the broader zero-valuation rule will be given any consideration or "credit" when determining the value of the senior family member's retained preferred interest.

2. Example.

The classic transaction that Section 2701 was designed to prevent involved parent forming a Preferred Partnership, or perhaps recapitalizing an existing single class partnership into a multi-class Preferred Partnership. Prior to Section 2701, the new or recapitalized partnership would have preferred "frozen" interests that provided for a fixed coupon, as well as common "growth" interests entitled to all the economic upside beyond the preferred coupon and liquidation preference. After forming the Preferred Partnership (or recapitalizing an existing single class partnership into a Preferred Partnership), parent would transfer by gift, sale, or perhaps a combination thereof, the common "growth" interest to the younger generation (or a trust for their benefit), and would retain the preferred "frozen" interests. The preferred interest would be structured so as to include various *discretionary* rights, such as non-cumulative preferred payment rights, rights to compel liquidation, puts and calls. When computing the value of the transferred common interests, these discretionary "bells and whistles" would artificially increase the value of the parent's retained preferred interest, and consequently, artificially depress the value of the transferred common interest; thus resulting in a "low ball" gift tax value of the gifted common interest. However, if the discretionary rights associated with parent's retained preferred interest were never actually exercised following the transfer of the common interest (or if preferred payments were never actually made), this would result in a shifting of value in the entity to the common interests then owned by the younger generation, thus achieving a gift tax-free shift of value.

Jerome Manning colorfully and succinctly described the perceived abuse associated with this type of arrangement as follows:

> *In the old days when restructurings were built with creative maneuvers ... to give the preferred [retained by the parent] a respectable facade for gift tax purposes [the preferred stock] was hung like a Christmas tree with voting rights, conversion rights, options to put and call, and liquidation opportunities.*[7]

Section 2701 was enacted in order to curtail this perceived abuse by manipulation of entity value by imposing a draconian "zero value" rule, which essentially ascribes a value of "zero" to certain components (known as "Distribution Rights" and "Extraordinary Payment Rights") of the preferred interest retained by the senior family member. The consequence is to attribute more or perhaps even all of the entity value to the common interest when determining the gift tax value of transferred common under a Subtraction Method of valuation, even though only one class of interest (the common interest) is actually transferred.

Certain relatively narrow exceptions were worked into the statute that do allow value to be ascribed to certain components of the parent's retained preferred interest under limited circumstances when the parent's preferred interest is structured within strict parameters designed to provide that the parent has retained rights that are essentially mandatory and quantifiable in nature. In other words, there is an implicit acknowledgement that if it can be determined that the parent must receive certain value (as opposed to discretionary rights that can be taken or not taken) and such can be quantified then it makes sense that the parent should get proper "credit" for such mandatory and quantifiable rights (and thus, should not be valued at zero) under the Subtraction Method of gift tax valuation.

B. Overview of Application.

1. Deemed Gifts.

Broadly, Section 2701 applies and can cause a deemed gift to occur when a senior generation family member, typically a parent (the "Transferor") or other senior family member (an "Applicable Family Member") holds an "Applicable Retained Interest" after a "transfer" to a "Member of the Family" of the Transferor has

[7] MANNING ON ESTATE PLANNING, 10-67 (Practicing Law Institute, 5th ed. 1995).

occurred. For these purposes, a "transfer" is very broadly defined to include, not only a traditional gift transfer (e.g., I give my child ten shares of common stock), but also a contribution to the capital of a new or existing entity, a redemption, recapitalization, or other change in the capital structure of an entity.[8] Thus, it is quite possible for a potential Section 2701 transfer to occur without intending to make a gift or even being aware that a potential gift has been triggered, for instance in the context of a recapitalization or initial capitalization of an entity. Additionally, there is no intent requirement to the statute and ignorance of law is not a basis to determine the statute inapplicable. Thus, it is quite possible for a deemed gift to arise under the statute in the context of a transaction, such as the initial capitalization of an entity, when one might otherwise think that no gift tax component or implication existed at all. Indeed, the provisions of Chapter 14 in general, and certainly the provisions of Section 2701 are not intuitive and, consequently, present a number of thorny traps for the unwary.

2. Zero Valuation Rule.

There are two types of rights, the retention of which by the senior generation can trigger Applicable Retained Interest status, and thus the Section 2701 zero valuation rule with respect to those retained rights: "Extraordinary Payment Rights" and "Distribution Rights" (both of which are discussed further, below).

If Section 2701 is applicable and the interest retained by the senior family member is not a "Qualified Payment Right" or other type of right to which the statute does not apply (discussed below) certain rights associated with the retained interest are valued at zero in applying the Subtraction Method.[9] This essentially results in some or perhaps even all of the family held interests in the entity being attributed to the transferred interest (typically a common or subordinate interest), thereby causing a Deemed Gift of some or potentially all of the interests retained by the senior family member.

[8] Treas. Reg. § 25.2701-1(b)(2)(i).

[9] Treas. Reg. § 25.2701-2(a)(1) & (2).

C. General Definitions.

1. Transfer.

The term “transfer” is broadly defined, and includes, in addition to a traditional transfer, a capital contribution to a new or existing entity, as well as a redemption, recapitalization or other change in the capital structure of an entity.[10]

2. Applicable Family Member.

The term “Applicable Family Member” includes the Transferor’s spouse, any ancestor of the Transferor or his or her spouse, and the spouse of any such ancestor.[11] (While this term is somewhat broader than just “senior family members,” sometimes in this outline that term will be used as a shorthand for “Applicable Family Member,” as that is the most typical situation in which the definition would apply.)

3. Member of the Family of the Transferor.

The term “Member of the Transferor’s Family” includes the Transferor’s spouse, any lineal descendant of the Transferor or his or her spouse, and the spouse of such descendant.[12] (While this term is somewhat broader than just “junior family members,” sometimes in this outline that term will be used as a shorthand for “Member of the Family of the Transferor,” as that is the most typical situation in which the definition would apply.)

4. Subtraction Method.

If Section 2701 applies to a transfer, the value of an interest transferred to a junior family member will be determined by subtracting from the value of the entire family-held interests the value of the interest retained by the senior family member, a deemed gift will have occurred from the senior family member to the junior family member of the value of all family held interests

[10] Treas. Reg. § 25.2701-1(b)(2)(i).

[11] Code Section 2701(e)(2); Treas. Reg. § 25.2701-1(d)(2). For purposes of this discussion, the Transferor and Applicable Family Members are referred to as the “senior family members,” although this is not technically always the case.

[12] Code Section 2701(e)(1); Treas. Reg. § 25.2701-1(d)(1) (*persons in any generation higher than the Transferor are NOT included in this group*). For purposes of this discussion, the Transferor and Members of the Family of the Transferor are referred to as the “junior family members,” although this is not technically always the case since the “spouse” of the Transferor is also included in this definition.

less the value of the senior interests retained by the senior family member determined under the Subtraction Method.[13]

D. Applicable Retained Interests.

Section 2701 applies to a transfer to a Member of the Family of the Transferor if the Transferor or an Applicable Family Member, holds an "Applicable Retained Interest" immediately after the transfer. There are two types of rights the retention of which will cause an Applicable Retained Interest to exist; the existence of either of which will cause the zero-valuation rule of Section 2701 to apply in valuing those retained rights: (1) Extraordinary Payment Rights; and (2) Distribution Rights.

1. Extraordinary Payment Rights.

Generally, these include liquidation, put, call and conversion rights *the exercise or non-exercise of which would affect the value* of the transferred common interest when the holder of such rights has discretion as to whether (or when) to exercise them. A call right includes any warrant, option, or other right to acquire one or more equity interest(s).[14]

Because it is assumed that such discretionary Extraordinary Payment Rights would never be exercised by the senior family member, so that greater value will pass to the younger generation family members holding common interests, they are given a value of zero in determining the value of the retained preferred interest for gift tax purposes under the Subtraction Method.

2. Distribution Rights.

The second type of right that will result in an Applicable Retained Interest is a "Distribution Right," which is the right to receive distributions with respect to an equity interest. However, a Distribution Right does not include: (i) a right to receive distributions with respect to an interest that is of the "same class" as, or a class that is "subordinate to," the transferred interest, (ii) an Extraordinary Payment Right, or (iii) one of the other rights discussed below.[15]

a. *Control Requirement.*

[13] Treas. Reg. § 25.2701-1(a)(2).

[14] Treas. Reg. § 25.2701-2(b)(2).

[15] Treas. Reg. § 25.2701-2(b)(3).

Unlike Extraordinary Payment Rights, with respect to which the interest holder individually has the discretion to participate or not participate in the growth of the entity, any discretion associated with a Distribution Right is *not held by the interest holder.* Rather, such discretion to make or not make distributions is held by the entity itself. As such, a Distribution Right will only be considered to exist with respect to an Applicable Retained Interest if "control" of the entity exists in the family. Control exists for these purposes if the Transferor and family members (including both junior and senior and more remote family members) "control" the entity immediately before the transfer.

(1) "Control" means:

(a) In the case of any partnership, at least 50% of the capital or profit interest in a partnership, or, *any equity interest as a general partner* of a limited partnership;[16] or

Comment: one issue that is not clear to practitioners is whether for these purposes an interest <u>in</u> a general partner constitutes an interest "<u>as</u> a general partner"?

(b) In the case of a corporation, at least 50% (by vote or value) of the stock of the corporation.[17]

(2) The presumption here appears to be that a family-controlled entity that holds such discretion would not make discretionary distributions to senior family members, so that greater value will remain in the entity, thereby benefiting the junior family members holding the common interests. Presumably such would not be the case with an entity that is not family-controlled.

3. <u>Section 2701 Applied to LLC Recapitalization.</u>

a. *Facts.*

[16] Code Section 2701(b)(2)(B).

[17] Code Section 2701(b)(2)(A).

In CCA 201442053,[18] the Internal Revenue Service (IRS) determined that Section 2701 was triggered in connection with the recapitalization of an LLC. In the CCA, an LLC was initially created by mother as a single class LLC, followed by gifts of LLC interests to her two sons and her grandchildren all of whom shared capital, profits and losses in proportion to their percentages interests. The LLC was later recapitalized, as a result of which all future profits or gains would be allocated to the sons only, as consideration for the sons agreeing to manage the LLC. Following the recapitalization, the mother's only interest was the right to the return of her capital account upon liquidation based on her membership interest as it existed immediately prior to the recapitalization.

b. *Conclusion*.

The IRS determined that the recapitalization was a Section 2701 "transfer" under Treas. Reg. § 25.2701-1(b)(2)(B)(2). It reasoned that the mother held an Applicable Retained Interest (her "Distribution Right") both before and after the recapitalization, and that her sons' right to receive future profits was a subordinate interest.[19]

c. *Criticism*.

In his article, Richard L. Dees argues that the IRS should withdraw the CCA and criticizes it as containing a rather muddled analysis in determining that the mother's retained interest was an "Applicable Retained Interest" due to the fact that "[b]oth before and after the recapitalization, Donor held an Applicable Retained Interest, an equity interest in Company coupled with a Distribution Right." Dees argues that the mother's right to receive her capital account upon termination of the LLC was not an "Applicable Retained Interest;" rather, such would have been either a "Mandatory Payment Right" or a "Liquidation Participation Right," neither of which is subject to valuation under Section 2701. Additionally, he points out that mother did not retain an "Extraordinary Payment Right" since she did not have the

[18] I.R.S. CCA 201442053 (Oct. 17, 2014).

[19] For a comprehensive and critical commentary on this CCA, *see* Richard L. Dees, *Is Chief Counsel Resurrecting The Chapter 14 "Monster?"* TAX NOTES (December 15, 2014).

discretionary right to withdraw her capital interest from the LLC which was subject to a stated term. (Since the publication of Dees' article, it has been determined that mother had a large enough percentage interest to unilaterally liquidate the LLC, which would have constituted an Extraordinary Payment Right.[20]) After the recapitalization, mother retained no rights to receive distributions with respect to her equity interests, but only the right to a return of her capital account.[21]

E. Exception to Distribution Right: "Qualified Payment Right."

The Code and Regulations contain an exception to the application of the zero valuation rule to a Distribution Right when the Distribution Right fits the definition of a "Qualified Payment Right."

1. "Qualified Payment Right" defined, Section 2701(c)(3):

a. Any dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent that such dividend is determined at a fixed rate;

b. Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount; or

c. Any Distribution Right for which an election has been made to be treated as a Qualified Payment.[22]

Because Qualified Payment Rights are mandatory, and no discretion of the family controlled entity to make or not make distributions exists with respect to a Qualified Payment Right, the perceived opportunity to manipulate value that Section 2701 was designed to prevent is not present with a Qualified Payment Right, and, therefore, the zero valuation rule will not apply.

A "Qualified Payment Right" is NOT an exception to an Extraordinary Payment Right; it is only an exception to a Distribution Right.

[20] Richard L. Dees, *The Preferred Partnership Freeze And The Reverse Freeze (Part II) - IRC Section 2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute*, at 6-39 (September 17-18, 2015).

[21] For an excellent in-depth discussion of CCA 201442053 and further analysis of Section 2701 generally, *see generally*, Richard L. Dees, *The Preferred Partnership Freeze And The Reverse Freeze (Part II) - IRC Section 2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute* (September 17-18, 2015).

[22] Treas. Reg. § 25.2701-2(b)(6)(i).

2. <u>"Lower Of" Rule - For Valuing a Qualified Payment Right Held in Conjunction with an Extraordinary Payment Right.</u>

a. If an Applicable Retained Interest provides the holder with a Qualified Payment Right and one or more Extraordinary Payment Rights, the value of all of these rights is determined by assuming that each Extraordinary Payment Right is exercised in a manner resulting in the lowest total value being determined for all the rights.[23]

b. An example of the "Lower Of" rule is as follows, based upon Treas. Reg. § 25.2701-2(a)(5):

Example: Dad, the 100% stockholder of a corporation, transfers common stock to Child and retains preferred stock which provides (1) a Qualified Payment Right having a value of $1,000,000; and (2) a right to put all the preferred stock to the corporation at any time for $900,000 (an Extraordinary Payment Right). At the time of the transfer, the corporation's value is $1,500,000. Under the "Lower Of" rule, the value of Dad's retained interest is $900,000, even though he retains a Qualified Payment Right worth $1,000,000. This is because his retained interests are valued under the assumption that Dad exercises his Extraordinary Payment Right (the put right) in a manner resulting in the lowest value being determined for all of his retained rights (i.e., in a manner that would yield him $900,000). As a result, Dad has made a gift of $600,000 ($1,500,000 - $900,000), rather than $500,000 if the value of his preferred interest was based upon the $1,000,000 value of the Qualified Payment Right.

F. <u>Minimum Value of Junior Equity Interest.</u>

If Section 2701 applies, in the case of a transfer of a junior equity interest, such interest shall not be valued at an amount less than 10% of the total value of all of the equity interests, plus the total indebtedness of the entity to the Transferor or an Applicable Family Member.[24]

G. <u>Rights that are Not Extraordinary Payment Rights or Distribution Rights.</u>

Certain rights may be retained in connection with preferred interests that are neither Extraordinary Payment Rights nor Distribution Rights, and,

[23] Treas. Reg. § 25.2701-2(a)(3).

[24] Code Section 2701(a)(4)(A).

therefore, are not valued at zero under Section 2701. These kinds of rights may take any of the following forms:

1. Mandatory Payment Rights.

A "Mandatory Payment Right," which is a right to receive a required payment of a specified amount payable at a specific time (e.g., mandatory redemption required at certain date at certain value);[25]

2. Liquidation Participation Rights.

A "Liquidation Participation Right," which is a right to participate in a liquidating distribution[26] (this is in contrast to a *right to compel* liquidation);

3. Guaranteed Payment Rights.

A "Guaranteed Payment Right," which is a right to a guaranteed payment of a fixed amount without any contingency, under Section 707(c);[27] or

4. Non-Lapsing Conversion Rights.

A "Non-Lapsing Conversion Right," which is a right to convert an equity interest into a specific number or percentage of shares (if the entity is a corporation), or into a specified interest (if the entity is a partnership or other non-stock entity).[28]

H. Section 2701 Subtraction Method.

The methodology used to determine the amount of a gift resulting from any transfer to which Section 2701 applies is as follows:

1. Step 1: Valuation of family-held interests.

Determine fair market value of all family-held equity interests in the entity immediately after the transfer.

[25] Treas. Reg. § 25.2701-2(b)(4)(i).

[26] Treas. Reg. § 25.2701-2(b)(4)(ii).

[27] Treas. Reg. § 25.2701-2(b)(4)(iii).

[28] Treas. Reg. § 25.2701-2(b)(4)(iv).

Special rules for contributions to capital apply which direct that the "fair market value of the contribution" be determined.

2. Step 2: Subtract value of senior equity interest.

The value determined in Step 1 is reduced by:

a. an amount equal to the sum of the fair market value of all family-held senior equity interests (other than Applicable Retained Interests held by the Transferor or Applicable Family Members) and the fair market value of any family-held equity interests of the same class or a subordinate class to the transferred interests held by persons other than the Transferor, members of the Transferor's family, and Applicable Family Members of the Transferor; and/or

b. the value of all Applicable Retained Interests held by the Transferor or Applicable Family Members.

Special rules for contributions to capital apply which instruct one to "subtract the value of any applicable retained interest received in exchange for the contribution to capital" determined under the zero valuation rule.

3. Step 3: Allocate.

Allocate the remaining value among the transferred interests and other family-held subordinate equity interests

4. Step 4: Determine the amount of the gift.

The amount allocated in Step 3 is reduced by any adjustments for:

a. minority discounts;

b. transfers with a retained interest; and/or

c. consideration received by Transferor (in case of contribution to capital, any consideration received in the form of an Applicable Retained Interest is zero)

5. Adjustment to Step 2.

If the percentage of any class of Applicable Retained Interest held by Transferor and Applicable Family Members (i.e., spouse and ancestors, but not junior family members) exceeds the highest percentage family held interests in the subordinate interests, the

excess percentage is treated as not held by Transferor or applicable family members.

6. Subtraction Method with "Lower of" Rule.

Example:[29] Corporation X has outstanding 1,000 shares of $1,000 par value voting preferred stock, each share of which carries a cumulative annual dividend of 8% and a right to put the stock to X for its par value at any time. In addition, there are outstanding 1,000 shares of non-voting common stock. A holds 600 shares of the preferred stock and 750 shares of the common stock. The balance of the preferred and common stock is held by B, a person unrelated to A. Because the preferred stock confers both a qualified payment right and an extraordinary payment right, A's rights are valued under the "lower of" rule of Treas. Reg. § 25.2701-2(a)(3). Assume that A's rights in the preferred stock are valued at $800 per share under the "lower of" rule (taking account of A's voting rights). A transfers all of A's common stock to A's child. The method of determining the amount of A's gift is as follows:

Step 1: Assume the fair market value of all the family-held interests in X, taking account of A's control of the corporation, is determined to be $1,000,000;

Step 2: From the amount determined under Step 1, subtract $480,000 (600 shares x $800)

Step 3: The result of Step 2 is a balance of $520,000. This amount is fully allocated to the 750 shares of family-held common stock.

Step 4: Because no consideration was furnished for the transfer, the adjustment under Step 4 is limited to the amount of any appropriate minority or similar discount. Before the application of Step 4, the amount of A's gift is $520,000.

I. Circumstances in Which Section 2701 is Inapplicable.

Section 2701 does not apply in the following circumstances:

[29] Treas. Reg. §25.2701-3(d), Ex. 1.

1. Same Class.

Section 2701 does not apply in circumstances where the retained interest and the transferred interest are of the "same class," meaning the rights associated with the retained interests are identical (or proportional) to the rights associated with the transferred interests, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (*e.g.,* Section 704(b)) are non-lapsing differences with respect to limitations on liability.[30]

2. Market Quotations.

Section 2701 does not apply if there are readily available market quotations on an established securities market for either the transferred interest or the retained interest;[31] and

3. Proportionate Transfers.

Also known as the "Vertical Slice" approach, this occurs where the transfer results in a proportionate reduction of each class of equity interest held by the senior and junior family members[32] (e.g., dad transfers 5% of both of his common and preferred stock to child, so that dad's interest in both his ownership of common and preferred is reduced by 5% for each class).

J. Limited Relief for Distribution Right Only: Election into Qualified Payment Right Treatment.

In the case of a Distribution Right, relief from the application of the zero valuation rule may be obtained by making an irrevocable election to treat such right *as if* it were a Qualified Payment Right.[33] However, no such relief is provided for Extraordinary Payment Rights.

a. If an election is made, then under the Subtraction Method, the Distribution Right would *not* be valued at zero. Rather, the fair

[30] Code Section 2701(a)(2)(B); Treas. Reg. § 25.2701-1(c)(3).

[31] Code Section 2701(a)(2)(A); Treas. Reg. § 25.2701-1(c)(1) & (2).

[32] Code Section 2701(a)(2)(C); Treas. Reg. § 25.2701-1(c)(4).

[33] Treas. Reg. § 25.2701-2(c)(2).

market value of such interests will be determined based upon traditional valuation principals, based upon facts assumed and agreed to in the election filed with the Transferor's gift tax return.

b. An election is made by attaching a statement to the Transferor's timely filed Gift Tax Return on which the transfer is reported. Detailed information must be included in the statement describing the transaction and providing additional information as set forth in the Treasury Regulations.[34]

c. An election assumes for Section 2701 purposes that a fixed annual payment will be made to the holder of the interest regardless of whether the entity has adequate cash-flow. In the case of such an election, the Distribution Right will be treated as a Qualified Payment Right and, as such, some flexibility is therefore provided to extend the period for actually making these payments:

(1) A four-year grace period to actually make a payment is permitted;[35]

(2) Deferral is permitted by satisfying payment of a Qualified Payment with a debt obligation bearing compound interest from the due date at an appropriate discount rate, provided that the term of the debt obligation does not exceed four years; and[36]

(3) If a Qualified Payment is not made within the four-year grace period, certain increases are made under the "compounding rule" upon the subsequent transfer of the interest by gift or death to account for such arrearages.[37]

K. Section 2701 Hypothetical.

Mom and child form a partnership into which Mom contributes $8,000,000 and child contributes $2,000,000 in exchange for their respective partnership interests. Child receives common interests and Mom receives preferred interests. The preferred interests provide Mom with the ability to require the partnership at any time to redeem her interest and return her contribution, as well as a non-cumulative priority

[34] Treas. Reg. § 25.2701-2(c)(5).

[35] Treas. Reg. § 25.2701-4(c)(5).

[36] *Id.*

[37] *See* Treas. Reg. § 25-2701-4(c).

preferred return equal to 5% annually provided that the partnership has adequate cash flow to satisfy the preferred return.

Section 2701 will apply to the hypothetical transaction outlined above for the following reasons:

a. The transaction would constitute a "transfer" within the meaning of the regulations which specifically includes "a capital contribution to a new or existing entity";

b. Mom has retained the following two types of "Applicable Retained Interests":

(1) *Extraordinary Payment Right*. The preferred interest retained by Mom gives her the ability to require the partnership to redeem her interest at any time, and return her investment contribution, which is considered an Extraordinary Payment Right.

(2) *Distribution Right*. In this case, Mom and Child are the only partners in the partnership and, therefore, they have the requisite "control" of the entity. In addition, Mom's preferred interest includes a Distribution Right which does not satisfy the definition of a Qualified Payment Right. A Qualified Payment Right requires, by its terms, cumulative, mandatory fixed rate payments on a periodic basis payable at least annually. In this case, the preferred return to mom is non-cumulative and is a fixed rate payment, but it is not required to be distributed at least annually.

(3) *Application*. Consequently, in determining the value of Mom's retained interest under the Subtraction Method, the Extraordinary Payment Right and the Distribution Right will each be valued at zero. However, Mom may elect to treat the Distribution Right as if it is a Qualified Payment Right via a timely-filed gift tax return. In such case, any gift would be determined by application of the "lower of" rule because Mom would then have both a Qualified Payment Right and an Extraordinary Payment Right. The gift will be determined based upon the lower value of the Qualified Payment Right and the Extraordinary Payment Right being ascribed to Mom's preferred interest in applying the Subtraction Method of valuation.

III. THE 2701 ATTRIBUTION RULES.

Various attribution rules apply under Section 2701 with respect to equity interests indirectly owned by way of entities such as partnerships, corporations and LLCs, as well as through trusts.[38] In addition, these rules are further complicated by the fact that it is possible to have "multiple attribution" in which the rules determine an equity interest to be owned by different people for purposes of Section 2701. In such case, certain "tie-breaker" rules apply, which set forth ordering rules as to whom will be attributed ownership of a particular interest depending upon the particular generational assignment of certain individuals as well as whether the equity interest in question is a senior interest or a subordinate interest. Given the complexity of these rules and how seemingly insignificant variations in the facts can lead to different conclusions, it is critical that a Section 2701 analysis include proper consideration of the attribution rules.

A. Entity Attribution Rules.

The attribution rules under Section 2701 applicable to entities such as corporations, partnerships and LLCs are relatively straightforward. The rules apply a proportionate ownership in the entity type of approach, which generally attributes ownership of an equity interest owned by an entity as owned by the owner of the entity to the extent of his or her percentage ownership in the entity.[39] In the case of entities that hold interests in other entities, the attribution rules have provisions to apply a "tiered" attribution approach.[40] An example is provided in the Treasury Regulations as follows:

> *A, an individual, holds 25% by value of each class of stock of Y Corporation. Persons unrelated to A hold the remaining stock. Y holds 50% of the stock of Corporation X .... Y's interests in X are attributable proportionately to the shareholders of Y. Accordingly, A is considered to hold a 12.5% (25% x 50%) interest in X.*[41]

B. Corporations and Partnerships.

In the case of interests in corporations, the attribution rules refer to the fair market value of the stock as a percentage of the total fair market value of all stock in the corporation.[42] In the case of partnerships and other entities

[38] Treas. Reg. § 25.2701-6.

[39] Treas. Reg. § 25.2701-6(a)(1). If the individual holds directly and indirectly in multiple capacities, the rules are applied in a manner that results in the individual being treated as having the largest possible total ownership. *Id.*

[40] *Id.*

[41] Treas. Reg. § 25.2701-6(b), Ex. 1.

[42] Treas. Reg. § 25.2701(a)(2).

treated as partnerships for federal tax purposes, the rules attribute to a partner interests based upon the greater of a partner's profit percentage or capital percentage.[43] For example, if a partner X makes a capital contribution of 10% of the partnership's assets and receives a 25% profits interest, and partner Y contributes 90% of the capital and receives a 75% profits interest, the attribution rules will treat X as having a 25% interest and Y as having a 90% interest in the Partnership (in the aggregate more than 100%); in each case the greater of the profit or capital percentage for each partner.

C. Trust Attribution Rules.

The attribution rules under Section 2701 with respect to trusts are not as straightforward as the entity attributions rules. This is because there are different sets of attribution rules that can apply and can result in multiple attribution of an equity interest to more than one person, as well as a set of "tie-breaker" rules that can also apply to resolve such cases of multiple attribution.

A proper analysis of the trust attribution rules often involves a multi-step process. First, one must apply the "basic" trust attribution rules. Then, if the trust at issue is treated as a grantor trust under Code Section 671 *et seq.*, one must also consider the "grantor trust" attribution rules, followed by further analysis under the "tie-breaker" or "multiple attribution" ordering rules, which calls for an examination of both the grantor's and the beneficiaries' generational assignments and a determination regarding whether the trust's equity interest is subordinate or senior. When parsing through these rules it becomes apparent that seemingly negligible changes in any of the foregoing factors can produce quite different results under the trust attribution rules and, in turn, the Section 2701 analysis.

1. The "Basic" Trust Rules.

It is often difficult to express a trust beneficiary's interest in a trust with any degree certainty; especially if there are multiple beneficiaries or if its trustees have been given substantial discretion with respect to distributions or other decisions affecting the beneficiaries' interests in the trust. In this sense (and many others), trusts are unlike entities where ownership percentages are more often readily determinable. This distinction appears to be one of the underlying policy rationales for the above-referenced "basic" trust attribution rules, which generally provide that a

[43] Treas. Reg. § 25.2701-6(a)(3).

person is treated as having a beneficial interest in a trust whenever they may receive distributions from the trust in exchange for less than full and adequate consideration.[44] The basic rules also attribute the trusts equity interests among its beneficial owners to the extent that they may each receive distributions from the trust, and based on a presumption that a trustee's discretion will be exercised in the beneficiary's favor to the maximum extent permitted.[45]

a. There is one exception to this rule: the equity interest held by the trust will not be attributed to a beneficiary who cannot receive distributions with respect to such equity interest, including income therefrom or the proceeds from the disposition thereof, as would be the case, for example, if equity interests in the entity are earmarked for one or more beneficiaries to the exclusion of the other beneficiaries.[46]

b. Ownership of an equity interest may be attributed to a beneficiary, even where the trust instrument states that he or she cannot own it or receive dividends or other current distributions from it, if he or she may receive a share of the proceeds received from its future disposition. Indeed, the Treasury Regulations provide that a trust's equity interest may be fully-attributed to its remainder beneficiaries.[47] A single equity interest owned by a discretionary trust could, therefore, be 100% attributable to *each* of its beneficiaries if only the "basic" trust attribution rule was considered. However, the above-mentioned grantor trust attribution and multiple-attribution ordering rules may very well modify this result in some cases, as is further discussed below.

2. <u>The Grantor Trust Attribution Rules.</u>

The grantor trust attribution rules attribute the ownership of an equity interest held by or for a "grantor trust" (i.e., a trust described under subpart E, part 1, subchapter J of the Code, regarding grantors and others treated as substantial owners of a trust) to the substantial owner(s) (or "grantor(s)") of such grantor trust.[48] Thus, a grantor of a grantor trust will also be considered

[44] Treas. Reg. § 25.2701-6(a)(4)(ii)(B).

[45] Treas. Reg. § 25.2701-6(a)(4)(i). These rules generally apply to estates as well, but for ease of discussion, the analysis herein will refer only to trusts.

[46] *Id.*

[47] *Id.*

[48] Treas. Reg. § 25.2701-6(a)(4)(ii)(C).

the owner of any equity interest held by such trust for purposes of the Section 2701 analysis.

However, if a transfer occurs which results in such transferred interest no longer being treated as held by the grantor for purposes of the grantor trust rules, then such shall be considered a transfer of such interest for purposes of Section 2701.[49]

3. <u>The Multiple Attribution Rules.</u>

If the "basic" and "grantor trust" attribution rules are both applied, ownership of an equity interest in an entity owned by a trust may often be attributable to the grantor *and* one or more beneficiaries of the same trust. To resolve such situations, one must look to the so-called "tie-breaker" or "multiple attribution" rules. These rules resolve such situations by application of a rule that orders the interests held and thereby determines how ownership should be attributed between the grantor, other persons and/or different beneficiaries. However, the way in which this ordering rule is applied will vary depending on: (1) whether the equity interest at issue is senior or subordinate; and (2) the generational status of particular persons in relation to the Transferor.

a. More specifically, if the above rules would otherwise attribute an "Applicable Retained Interest"[50] to more than one person in a group consisting of the Transferor and all "Applicable Family Members,"[51] then the multiple-attribution ordering rules re-attribute such Applicable Retained Interest in the following order:

(1) to the person whom the grantor trust attribution rules treat as the holder of the Applicable Retained Interest (if the trust is a grantor trust);

(2) to the Transferor of the Applicable Retained Interest;

(3) to the spouse of the Transferor of the Applicable Retained Interest; or

(4) pro rata among the Applicable Family Members.

[49] Treas. Reg. § 25.2701-1(b)(2)(C)(1).

[50] See discussion in Part II, Section D, above.

[51] See discussion in Part II, Section C, above.

b. By contrast, if the above rules would otherwise attribute a "subordinate equity interest" to more than one person in a group consisting of the Transferor, all Applicable Family Members and "members of the Transferor's family,"[52] then the multiple-attribution ordering rules attribute such subordinate equity interest in the following order:

(1) to the transferee of the subordinate equity interest;

(2) pro rata among members of the Transferor's family;

(3) to the person whom the grantor trust attribution rules treat as the holder of the subordinate equity interest (if the trust is a grantor trust);

(4) to the Transferor of the subordinate equity interest;

(5) to the spouse of the Transferor of the subordinate equity interest; or

(6) pro rata among the "Applicable Family Members" of the Transferor of the subordinate equity interest.

c. The distinction between the two sets of ordering rules appears to be motivated by two goals: (1) maximizing the chance that ownership of an Applicable Retained Interest will be attributed to a Transferor (or related parties grouped with the Transferor for Section 2701 purposes); and (2) maximizing the chance that ownership of a subordinate equity interest will be attributed to a transferee (or younger generations of the Transferor's family). The net result in both cases is an increase in the likely applicability of Section 2701.

[52] See discussion in Part II, Section C, above (and note that "Applicable Family Member" and "member of the Transferor's family" have different meanings).

IV. CARRIED INTEREST TRANSFER PLANNING AND SECTION 2701

Wealth transfer planning generally involves making a transfer of an asset (typically via gift, sale or a combination) that has appreciation potential in a manner so as to remove it from the grantor/parent's gross estate and hopefully allow post-transfer appreciation to occur outside of the estate in the hands of the next generation(s) or trusts for their benefit. Ideally, when selecting assets to transfer, the estate planner will want to identify assets that have the greatest potential for appreciation in the future and at the same time have characteristics that would support a current lower valuation, perhaps due to the uncertain or speculative nature of the asset and/or due to the fact that the target interest may be of a non-controlling nature. The gift tax is imposed based upon the fair market value of the assets on the date of transfer, and not on the subsequent appreciation. Therefore, if a taxpayer transfers an asset when it has a relatively low (or lower) value, for gift tax purposes the transfer will be considered to have been made at that lower value, regardless of the magnitude of post-gift appreciation. However, the potential for future growth of the asset will be a relevant factor that is taken into consideration by a valuation appraiser, as well as the IRS, in determining the current fair market value of that asset.

Estate planners often implement a variety of different techniques to "freeze" the value of the taxpayer's estate by locking in, or "freezing" the value of an asset at its current value, while shifting the future appreciation potential into the hands of the recipients. These estate freeze techniques are generally effective from a transfer tax (i.e., estate, gift and generation-skipping taxes) standpoint when the actual rate of return on the assets transferred will exceed a "hurdle" rate – generally, the Section 7520 Rate or the Applicable Federal Rate, depending upon the type of vehicle used.

Because of the significant potential for future appreciation associated with carried interest in a private investment vehicle, an interests in the general partner of a fund are often considered good candidates for wealth transfer planning. Specifically, in a typical fund where, for instance, a 1% capital contribution by the fund general partner may be entitled to an allocation of 20% of the profits, (the "carried interest") there is great potential for the value of the general partner interest to grow, perhaps exponentially (throughout this outline, the entity that is the general partner of a fund, which receives the special profit allocation or carried interest is sometimes referred to as the "GP" and the donor/parent who decides to transfer that interest is sometimes referred to as the "Fund Principal"). If that growth occurs in an estate planning vehicle that is excluded from the Fund Principal's estate, then this will result in a very transfer-tax efficient shift of future appreciation to or for the benefit of the next generation(s). If leverage is applied to the transaction, the planning becomes even more powerful potentially resulting in a much greater shift of appreciation particularly when interest rates are lower.

While there is nothing particularly unique about an interest in a private investment vehicle as an asset from a wealth transfer standpoint, for those practitioners who represent hedge or private equity fund clients in connection with gift planning with their carried interests, there are nonetheless a number of unique planning issues and pitfalls that must be carefully considered and navigated. These issues include the following:

1. Gift tax valuation uncertainty issues and how to best address that uncertainty;

2. Chapter 14 deemed gift issues under Section 2701 of the Internal Revenue Code (the "Code") and the so-called "Vertical Slice," as well as "Non-Vertical Slice" planning alternatives;

3. Incomplete gift issues associated with vested and unvested interests and retained interests;

4. Estate tax inclusion risks;

5. Trust and Entity Attribution Rules under Section 2701; and

6. Coordination issues with planning techniques and related pressure points.

A. <u>The Section 2701 Issue</u>[53]

Based on the legislative history surrounding Section 2701, it is clear that Congress did not intend for transfers of carried interests in funds to be targeted by the statute. Instead the aim was to prevent certain types of Preferred Partnership transactions that ended in overly generous wealth transfers without the attendant gift tax liability through the manipulation of rights within a family held entity.[54]

The problem for estate planners, however, is that the language of the statute is overly broad. Coupled with the draconian consequences in the event of its possible application, Section 2701 has thus become a major concern for estate planners representing hedge and private equity Fund Principals in connection with the transfer of carried interests.

[53] For a more detailed discussion of the possible application of Section 2701 in the context of estate planning with carried interests, *see generally* N. Todd Angkatavanich & David A. Stein, *Going Non-Vertical With Fund Interests - Creative Carried Interest Transfer Planning: When The "Vertical Slice" Won't Cut It*, TR. & EST. (Nov. 2010) [hereinafter "Angkatavanich & Stein, *Going Non-Vertical*"].

[54] 136 Cong. Rec. S15629, S15681 (Oct. 18, 1990).

1. Deemed Gift Problem.

If Section 2701 were to apply to the transfer of a general partner interest (that receives a carried interest) in a fund, the Transferor may be deemed to have made a gift for gift tax purposes of not just the carried interest actually transferred, but, perhaps significantly more, of his or her interests in the fund (e.g., general partner interest and limited partner interest). Because a fund principal often invests a sizeable amount of capital into a fund as a limited partner (either directly or perhaps via his or her interest in the general partner) such a deemed gift could be problematic from a gift tax perspective – if the amount of the principal's investment as a limited partner in the fund is large enough, the amount of the deemed gift could be dramatic and could cause a significant deemed gift tax liability; despite the fact that the principal had not actually transferred his or her limited partner interest nor intended to do so.

2. The "Vertical Slice" Approach.

To date, the most elegant and straightforward solution adopted by the estate planning community in this area is to structure the transfer of the carried interest within the proportionality exception to the statute (colloquially referred to as making a so-called "Vertical Slice" transfer of all of the Transferor's interests in the fund). Indeed, in the wealth transfer planning context, the term "carried interest" is rarely uttered without being followed by the words "Vertical Slice."

Simply put, making a Vertical Slice transfer requires the Fund Principal who wishes to transfer a portion of his or her carried interest to his or her family members to proportionately transfer all of his or her other equity interests in the fund in order to avoid triggering a deemed gift.

a. The Vertical Slice exception to Section 2701 is provided for in Treas. Reg. § 25.2701-1(c)(4), which provides that "§ 2701 does not apply to a transfer by an individual to a member of the individual's family of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all Applicable Family Members in the aggregate immediately before the transfer."[55]

[55] Treas. Reg. § 25.2701-1(c)(4).

b. For purposes of the Vertical Slice exception, it is interesting to note that the interests transferred by the Transferor are aggregated with any interests transferred simultaneously by the Transferor's spouse, any ancestors of the Transferor and the Transferor's spouse, and the spouses of any such ancestors. Thus, if a Transferor owned 100% of the common interests in an entity and only 25% of the preferred interests, with the other 75% of the preferred interests being owned by the Transferor's parent, a transfer to a junior family member by the Transferor of 50% of the common interests and 25% of the preferred interests could be aggregated with an additional transfer of 25% of the preferred interests by the Transferor's parent to satisfy the Vertical Slice exception.

The logic behind this exception, presumably, is that by making a Vertical Slice transfer parent has reduced every equity interest in the fund on a pro-rata basis, consequently, the opportunity to disproportionately shift wealth to the next generation, through the retention of some artificially inflated equity interests and the transfer of an artificially depressed different interest, does not exist. Instead, the Vertical Slice results in the younger generation and parent sharing proportionally in the future growth, or decrease, in value, of the fund and thus prevents a shift in value away from the parent to the younger generation by way of the non-exercise of discretionary rights.

3. Limitations of the Vertical Slice Approach.

While this approach has the advantage of being relatively straightforward to implement and easiest conceptually to digest, it often prevents the client from fully achieving his or her wealth transfer objectives. The problem is that very often the principal wants to transfer all or most of his or her carried interest but only some or none of his or her limited partner interest, for both economic reasons (Transferor wants to retain some portion of his or her capital investment in the fund) and gift tax reasons (Transferor does not want to make a taxable transfer of high-value assets). Because a disproportionate transfer does not fit within the Vertical Slice exception, fund principals are frequently advised to transfer a smaller percentage of the general partner interest so that a proportional limited partner interest can be transferred in

compliance with the Vertical Slice exception without triggering a deemed gift.[56]

B. Achieving "Verticality"

1. Individual Slices.

If the client desires to make a transfer of his or her fund interests using the Vertical Slice approach, verticality can be achieved in a number of different ways. First, the Vertical Slice could be achieved by making a transfer of a proportionate interest of each interest that the client has in the fund and related entities. For instance, the Fund Principal could make a transfer of his interest in the GP (including a proportional transfer of the capital and profits interest), and a proportional LP interest in the fund in such a way that reduces his interest in each of these entities, separately, by the same percentage (e.g., a 25% reduction across the board). This approach can be quite involved and cumbersome, however, and may provide a greater chance of this proportional ownership being disrupted in the future after the initial transfers are made; and the resulting risk of such an event potentially constituting a subsequent "transfer" for Section 2701 purposes at that time. Also, to the extent that additional transfers are desired in the future, further transfers would again need to be coordinated with fund counsel and perhaps require additional approvals or other compliance aspects to be addressed, not to mention a new Section 2701 analysis at that time.

2. Holding Entity to Achieve Verticality.

Another method of achieving verticality may be through the implementation of a holding vehicle such as a limited partnership or an LLC (referred to in this outline as "Vertical Slice Holding Entity"). In this instance, the Fund Principal would transfer some or perhaps all of his interest in all the entities related to the Fund as an initial capital contribution into Vertical Slice Holding Entity,

[56] While beyond the scope of this outline, it is important to note that some uncertainty exists as to whether the fund principal's interest in the management company should also be included when making a transfer of a Vertical Slice of all of his or her equity interests in the fund. The analysis of whether an interest in the management company should be included in the Vertical Slice revolves around whether an interest in the management company would be considered to be an "equity interest" in the fund. Arguably, an interest in the management company should not considered to be an "equity interest" in the fund since typically the relationship between the fund and the management company is more of a contractual arrangement to be paid a percentage of assets under management as a fee.

While also beyond the scope of this outline, it should be noted nonetheless that the utilization of the Vertical Slice exception is not the only way to address the application of Section 2701 in the context of carried interest planning. There are other exceptions as set forth in the statute and techniques that have been developed that might be considered, each of which have their relative pros and cons. *See generally*, Angkatavanich & Stein, *Going Non-Vertical*, *supra* note 53.

which would be structured as a single class entity. Subsequently, Fund Principal would make a transfer of an interest in Vertical Slice Holding Entity to child or perhaps a trust for child's benefit. By placing the ownership of the fund entity interests within Vertical Slice Holding Entity, a gift of a Vertical Slice may be achieved in a more streamlined fashion by way of a simple transfer of a percentage ownership interest in the holding entity. In addition, going forward, this will ensure that the same proportional ownership is maintained. Further transfers in the future could be achieved by making additional transfers of interests in the Vertical Slice Holding Entity. Additionally, these should not require an additional round of approvals, qualifications and/or consents at the fund level, as what would be transferred would be interests in Vertical Slice Holding Entity, rather than interests in the fund entities.

3. Getting Cut by a Bad Vertical Slice.

As noted above, Section 2701 is a very thorny and draconian provision that can apply in a number of situations, even where it might seem that no gift tax intention or implications would exist. To complicate matters even further, within the context of Vertical Slice planning, it is possible, due to the exceptionally broad and hyper-technical provisions of the statute, that a Fund Principal could, after consideration of all the options, decide and fully intend to make a Vertical Slice transfer, yet still unintentionally violate Section 2701.

Section 2701 applies when a transfer has been made by the Transferor to a Member of the Transferor's Family, after which time the Transferor or an Applicable Family Member retains an Applicable Retained Interest. In the context of carried interest transfer planning, if, for instance, the Fund Principal makes a Vertical Slice transfer of a percentage of some or all of his interests in the fund entities to his children or their trusts, but the Fund Principal's parent or the Fund Principal's spouse's parent, both of whom are Applicable Family Members, continues to own an interest in the LP, then the deemed gift tax rules under Section 2701 could still be implicated. This is because the Fund Principal, as the Transferor, has made a transfer of an interest (albeit an attempted Vertical Slice transfer of his interests); however, the Transferor's parent or in-law, who is also an Applicable Family Member, has retained a limited partnership interest in the fund, which could be the retention of a Distribution

Right and, therefore, an Applicable Retained Interest, subject to the zero valuation rule.

When analyzing this issue, it is also critical to consider the attribution rules under Section 2701, as discussed in Section V above.

The long and short of the analysis is that, even when attempting to apply this more straightforward Vertical Slice approach, it is extremely important that the practitioner be mindful of these technical rules and how they may thwart an otherwise intended Vertical Slice transfer.

C. Section 2036 Implications with Vertical Slice Holding Entity Approaches

The creation of a Vertical Slice Holding Entity to achieve a Vertical Slice can be an efficient way to address the Section 2701 issue in the context of carried interest transfer planning. However, the creation of a holding entity to achieve such verticality also presents unique issues that should be considered under Section 2036(a). The IRS has had a history of challenging the funding and subsequent transfer of interests in so-called family limited partnerships under a number of different theories; the most notable and successful of these challenges being under Section 2036(a)(1) as a transfer with retained interest and to a lesser extent under 2036(a)(2) as a transfer with retained control. While the typical so-called "FLP" that the Service has challenged has often involved entities formed for much different reasons than a Vertical Slice Holding Entity contemplated herein, nonetheless, the creation of an entity with subsequent transfers of interests should be examined in this light. Even in the event that an argument could be sustained that Section 2036(a) applied to the capitalization of Vertical Slice Holding Entity, the consequence would be blunted by Section 2043, which would provide a partial estate tax offset to the extent that adequate and full consideration was paid to the decedent.

In a number of cases the IRS has been able to successfully argue that Section 2036(a)(1) applied to cause inclusion in a decedent's gross estate of assets that he or she contributed into an FLP (despite the fact that the decedent may have transferred those partnership interests out of his name prior to his death) under the theory that the decedent transferred assets into the FLP subject to an implied understanding that he would continue to have enjoy of those assets until his death.

D. The Bona fide Sale Exception

One possible way to avoid the application of Section 2036(a)(1) and Section 2036(a)(2) altogether is to satisfy the "bona fide sale" exception to that section. In the context of creating a Vertical Slice Holding Entity, if the Fund Principal's initial capital contribution to the entity is considered to be a "bona fide sale" for "adequate and full consideration" then Section 2036 is not applicable. If this exception is satisfied, then, as a technical matter, the retained "control" issue under Section 2036(a)(2) as well as any "implied understanding" issues under Section 2036(a)(1) should not be an issue, because the application of Section 2036 to the transfer of assets into the entity should be "off the table." This exception, however, is not simple to satisfy, and, in practice, it appears that the analysis of the courts of whether a decedent's contribution of assets into a partnership constituted a bona fide side for adequate and full consideration appears, at least in part, to be somewhat intertwined with a determination as to whether an "implied understanding" existed under Section 2036(a)(1). Indeed, in only one case on this issue did the Court first determine that the bona fide sale exception was not satisfied, but nevertheless next determined that there was not an implied understanding under Section 2036(a)(1).[57] In all of the other relevant cases, once it was determined that the bona fide sale exception was not satisfied, the court further went on to determine that an implied understanding existed so as to cause estate tax inclusion under Section 2036(a)(1).

The cases on this issue have made clear that in order to avoid the application of Section 2036(a) under the "full and adequate consideration" exception, there must exist both "adequate and full consideration" and a "bona fide sale."[58] A legitimate business purpose and/or substantial non-tax purposes is required to establish that a "bona fide sale" existed. On this point, while family transactions may satisfy this standard, they are generally subject to a greater level of scrutiny.[59]

What is clear from the jurisprudence over approximately the past 20 years in the family limited partnership arena is that to the extent that it can be shown that the initial transfer of assets by the parent into a family limited partnership or limited liability company in connection with the initial capitalization constitutes a "bona fide sale for adequate and full consideration," then such will satisfy the exception to the application of

[57] *Kelly v. Comm'r*, T.C. Memo. 2012-73. See: Akers, *Estate Planning Current Developments and Hot Topics*, December 2012.

[58] *Thompson v. Comm'r*, T.C. Memo 2002-246 (Sept. 26, 2002), aff'd 382 F.3d 367 (3d Cir. 2004); *Strangi v. Comm'r*, T.C. Memo. 2003-145 (May 20, 2003).

[59] *Stone v. Comm'r*, T.C. Memo. 2003-309 (Nov. 7, 2003); *Bongard v. Comm'r*, 124 T.C. 95 (2005).

Section 2036(a) and the assets transferred (the Fund entity interests) into the entity (in this context, the Vertical Slice Holding Entity), will not be included in the gross estate of the decedent. The case law that has come out over the past 15 years has clarified that in order to satisfy this exception, there must be a showing by the estate that the transfer of assets into the entity was made in furtherance of a legitimate business purpose and/or substantial and non-tax purposes. Thus, in the context of fund carried interest planning, if it can be demonstrated that the capital contribution of fund entity interests into the Vertical Slice Holding Entity was made in furtherance of a legitimate and significant non-tax business purpose, this should eliminate the Section 2036 estate tax exposure.

Historically, FLP vehicles have been created for a number of reasons. However, they have typically provided some estate or gift tax advantages in the form of potential for valuation discounts. A Vertical Slice Holding Entity created for purposes of creating an efficient and streamlined approach to comply with the Vertical Slice exception to Section 2701 and provide a vehicle to continue to be used in the future for such purposes without having to go through the compliance and approval process in the future would appear to provide a meaningful distinction from a "garden variety" FLP. Of course, one of the downsides with attempting to rely upon the bona fide sale exception is that there is no way to actually determine with any degree of certainty whether this exception to Section 2036(a) has been satisfied or not satisfied; that is, until the Fund Principal has passed away and the estate is in the midst of an estate tax audit and is arguing that Section 2036(a) does not apply because of the satisfaction of this exception.

V. Preferred Partnership Approach to Carried Interest Transfer Planning[60]

As previously noted, the Vertical Slice exception is not the only statutory way to comply with Section 2701. There are a number of other ways that Fund entity interests could be structured to avoid the application of the zero valuation rule under Section 2701. These other approaches rely upon provisions in the Code and Treasury Regulations exempting the parental retention of certain mandatory and quantifiable interests.[61]

In other circumstances, the Treasury Regulations also acknowledge that if a parent has not retained certain types of suspect interests in the entity, then the zero

[60] This section of this outline is descriptive of Angkatavanich & Stein, *Going Non-Vertical*.

[61] Conceptually, these exceptions are very similar to the logic applied under Section 2702 in the GRAT context where the parent has retained a "qualified interest" in creating a GRAT to avoid the application of similar zero valuation deemed gift rules. If the interest retained by the parent is mandatory and quantifiable from inception, then the perceived "wealth shifting" abuse would not exist and would not warrant the application of the zero valuation deemed gift rule.

valuation rule likewise should not apply. For example, the zero valuation rule does not apply if the parent transfers interests of the same class as those retained. This "same class" exception offers trust and planners yet another way to avoid the zero valuation rule. It is within these various other exceptions that the authors suggest that additional planning opportunities may exist with respect to the transfer of carried interests. These potential opportunities exist not as a replacement of the Vertical Slice approach, but as other approaches to consider when structuring carried interest transfers.

A. Non-Vertical Holding Entities

Non-Vertical Holding Entity approaches involve the creation of a family holding entity such as an LLC or a limited partnership, into which the parent would first contribute all of his Fund interests, both general and limited partnership interests. These approaches rely upon the application of the so-called "same class exception" in combination with another exception to Section 2701. The same class exception is provided under Treas. Regs. § 25.2701-1(c)(3), which states that "§ 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest."

1. Mandatory Payment Right Holding Entity.

In the first variation, the parent would contribute his LP and GP interests to the holding entity in return for common and preferred interests. The preferred interest holder would be entitled to receive a sum certain on a fixed future date. The common interest holder would be entitled to all of the upside beyond the amount needed to repay the preferred interest holder. The parent would then transfer some or all of the common interests to younger generational family members.

If the parent continues to own common interests in the holding entity, those interests should fall within the same class exception and not be treated as an Applicable Retained Interest. If properly structured, the parent's retained preferred interests should fall within the definition of a "mandatory payment right" and thus avoid classification as an Applicable Retained Interest pursuant to Treas. Regs. § 25.2701-2(b)(4). Treas. Regs. § 25.2701-2(b)(4)(i) defines a "mandatory payment right" as a "right to receive a payment required to be made at a specific time for a specific amount" and gives as an example a redemption right with respect to preferred stock that requires the stock to be redeemed at its fixed

par value on a date certain. Because a mandatory payment right bears certain similarities to debt, care should be taken to ensure that a mandatory payment continues to qualify as equity, rather than debt, for tax purposes.

Since neither the retained common interests nor the retained preferred interests would fall within the definition of an Applicable Retained Interest, Section 2701 shouldn't apply to the transfer.

2. Qualified Payment Right Holding Entity.

Same class exception with qualified payment right (QPR). A QPR means "a right to any periodic dividend on any cumulative preferred stock (or a comparable payment on partnership interest) to the extent such dividend (or comparable payment) is determined at a fixed rate." This approach involves the same basic holding entity structure as the Mandatory Payment Right Holding Entity; however, the retained preferred interest would be structured to contain a QPR rather than a mandatory payment right. Flexibility can be built into the structure, as a qualified payment can be paid up to four years after its required due date and can be paid with a promissory note with a maturity of up to four years.

Since a QPR is a Distribution Right in the context of a family controlled entity such as the holding entity, the preferred interest would become an Applicable Retained Interest at the time a parent transfers his common interest in the holding entity to the next generation and Section 2701 would apply to such transfer. Unlike other Distribution Rights, however, Treas. Regs. § 25.2701-1(a)(2)(ii) exempts a QPR from zero valuation and allows it to be valued under traditional valuation principles. Thus, for purposes of calculating the amount of the parent's gift under Section 2701, the retained preferred interest would be accorded its full fair market value unless another provision of Section 2701 applied. In determining the preferred interest's Fair Market Value, the rate set for the coupon will be critical. If deemed insufficient based on the holding entity's anticipated ability to make payments and on the current rate for coupons on similar interests in the market, the value of the preferred interest may be less than its par value and a deemed gift could still result.

One provision that may impose some practical limitation to this approach is the minimum value rule, which provides that the value of a junior equity interest can't be less than its pro rata portion of

10% of the sum of (1) the total value of all equity interests, and (2) the total amount of indebtedness owed to the transferor and Applicable Family Members. Since the common interests would be junior equity interests, the rule would cause the value of the gifted common interests to be at least 10% of the total value of all equity interests. Thus, even if the zero valuation rule didn't apply, the parent may still be treated as making a partial gift in excess of the FMV of the interests transferred if the retained preferred interest exceeds 90% of the capitalization of the holding entity. Another variation would be for the parties to consider structuring the holding entity LLC as a reversed preferred entity, in which the parent would hold the common and the family members would hold the preferred interest. In such cases, the parent's retained common interest shouldn't trigger Section 2701. (Note, however, that no Extraordinary Payment Rights should be held by parent.)

3. Holding Entity with Debt.

Same class exception with debt. This approach is essentially a variation on a traditional gift/sale transaction to a trust. It involves the same basic structure as the two holding entities discussed above, except, rather than making a capital contribution, the parent would sell the LP interests to the holding entity LLC in exchange for a promissory note. Since Section 2701 applies with respect to related equity interests and not debt, the parent's gift of LLC equity interests shouldn't trigger Section 2701. Arguably, with the LLC approach, the traditional nine-to-one debt-to-equity ratio could be exceeded with less downside risk. If, for instance, the Internal Revenue Service successfully argued that the debt was disguised equity, it could still qualify as a mandatory payment right and not be subject to zero valuation.

4. Holding Entity Pressure Points.

With all three holding entity approaches, one potential concern is that the IRS could argue that the parent's two distinct classes of retained interest should be viewed as a single, combined "super class" and argue that the same class exception wouldn't be satisfied. Treas. Regs. § 25.2701-7 provides some support for the proposition that these classes should be considered separate and not combined. Specifically, it states that the Treasury Secretary may, by regulation, revenue ruling, notice or other document of general application, prescribe rules under which an Applicable Retained Interest is treated as two or more separate interests for

purposes of Section 2701 and notes that the Commissioner may, by ruling issued to a taxpayer upon request, treat any Applicable Retained Interest as two or more separate interests. While no regulations or other rules have been issued on this point and the implication from the latter half of the regulation is that the taxpayer may not merely elect to treat an Applicable Retained Interest as two or more separate interests, the legislative history appears to encourage the issuance of regulations to that effect.

a. Structuring the Non-Vertical Holding Entity

The three Non-Vertical Holding Entity approaches discussed essentially rely upon the creation of some form of a Preferred Partnership holding vehicle created within the statutory confines of Section 2701 and the exceptions thereunder. Such interests are preferred vis-à-vis the common interests in that they have priority over the common interests with respect to the payment of a fixed coupon on the holder's investment and in the event of a bankruptcy. They do not, however, participate in the upside growth of the partnership as all the future appreciation in excess of the preferred coupon inures to the benefit of the other class, the common class, of partnership interests, typically held by the younger generation or trusts for their benefit. The preferred interests are usually held by a senior generation family member.

b. Valuation of the Preferred Coupon

Even if the Parent's preferred interest is properly structured to avoid the potentially draconian aspects of Section 2701, there are still deemed gift issues to consider as the foregoing structuring merely ensures that the Fund Principal's preferred interest is not valued at "zero" for purposes of determining Fund Principal's gift to younger generation family members. There may still be a partial gift under traditional valuation principals if the Fund Principal's retained preferred coupon is less than what it would have been in an arms'-length situation. For example, if the Fund Principal's retained coupon under the partnership agreement is a 5% coupon but a 7% return would be required in an arms'-length transaction then a deemed gift has still been made by the Parent to the extent

of the shortfall; albeit not as potentially dramatic a gift as would occur by violating Section 2701.

Vital to arriving at the proper coupon rate is the retention of a qualified appraiser to prepare a valuation appraisal to determine the preferred coupon required for the parent to receive value equal to par value for his or her capital contribution. In preparation of the appraisal the appraiser will typically take into account the factors set forth by the IRS in Revenue Ruling 83-120. The starting point under this guidance is to analyze comparable preferred interest returns on high quality publicly-traded securities. Additional factors for consideration include the security of the preferred coupon, the size and stability of the partnership's earnings, asset coverage, management expertise, business and regulatory environment and any other relevant facts or features of the Preferred Partnership. The partnership's coverage of the preferred coupon, which is the ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the partnership, will impact the required coupon. A higher percentage of the partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the partnership's ability to pay the coupon on time; this translates to weaker coverage of the coupon, and thus greater risk, and ultimately a higher required coupon to account for this greater risk. Conversely, a partnership that has a higher percentage of common interests relative to preferred would provide stronger coverage which would result in lower risk and consequently a lower required coupon. A lower coupon may be more desirable from a wealth transfer standpoint as growth above the lower coupon will shift to the younger generation owning the common interests.

VI. Proactive Planning with Section 2701 and Preferred "Freeze" Partnerships.[62]

[62] For excellent comprehensive discussions of Preferred Partnership planning, *see generally* Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle,* 35-3 Univ. of Miami Law Center on Est. Planning (Jan. 2001). *See also* Paul S. Lee & John W. Porter, *Family Investment Partnerships: Beyond the Valuation Discount* (Sept. 2009), available at http://apps.americanbar.org/rppt/meetings_cle/joint/2009/ Materials/Stand_Alone_Programs/LeeFamilyInvestmentPartnershipsOutlineSeptember2009.pdf

Preferred Partnerships are often referred to as "Freeze Partnerships" because such partnerships effectively "freeze" the return of one class of partnership interests at a fixed rate. Such interests are preferred relative to the common interests in that they have priority over the common interests with respect to the payment of a fixed coupon on the holder's investment and up liquidation of the entity. They do not, however, participate in the upside growth of the partnership as all the future appreciation in excess of the preferred coupon and liquidation preference inures to the benefit of the common "growth" class of partnership interests, typically held by the younger generation or trusts for their benefit. The preferred interests are typically held by the senior generation family member.

1. Structuring the Preferred Interest.[63]

   A parent's Preferred Partnership interest is typically structured as a "qualified payment right" in accordance with Section 2701 to prevent the parent's contribution of assets to the Preferred Partnership from being a deemed gift under the Section 2701 "zero valuation" rule. To be a qualified payment right, the parent generally must receive a fixed percentage payment on his or her capital contribution, payable at least annually and on a cumulative basis. The use of this "qualified payment right" structure will result in the parent's preferred interest being valued under traditional valuation principles for gift tax purposes, and not the unfavorable "zero valuation rules" of Section 2701.

   Typically, the preferred interest would also provide Parent with a priority liquidation right in addition to the preferred coupon; meaning that upon liquidation, parent will first receive a return of his or her capital before the common interest holders receive their capital. Parent, however, will not receive any of the potential upside growth in the Preferred Partnership above his or her preferred interest.[64] Anything in excess of the amount needed to pay the preferred coupon will accrue to the benefit of the common interest holders (*i.e.*, child, or trust for the child's benefit).

2. Valuation of the Preferred Coupon.

   Even if the parent's preferred interest is properly structured to avoid the draconian aspects of Section 2701, there are still deemed

[63] For a more detailed discussion of planning with Preferred Partnerships, *see generally* N. Todd Angkatavanich & Edward A. Vergara, *Preferred Partnership Freezes: They Come in Different "Flavors" and Provide a Menu of Creative Planning Solutions*, TR. & EST. (May 2011).

[64] Typically, the parent will also receive a 1% common interest to make his or her preferred interest not re-characterized as debt. Such common interest would participate by its terms in any upside experienced by the Preferred Partnership.

gift issues to consider as the foregoing structuring merely makes the parent's distribution right component of the preferred interest not valued at "zero" for purposes of determining parent's deemed gift to younger generation family members. However, there may still be a partial gift under traditional valuation principals if the parent's retained preferred coupon is less than what it would have been in an arm's -length situation. For example, if the parent's retained coupon under the partnership agreement is a 5% coupon but a 7% return would be required in an arm's-length transaction then a deemed gift has still been made by the parent to the extent of the shortfall; albeit not as dramatic a gift as would occur by violating Section 2701.

a. Vital to arriving at the proper coupon rate is the retention of a qualified appraiser to prepare a valuation appraisal to determine the preferred coupon required for the parent to receive value equal to par value for his or her capital contribution. In preparation of the appraisal the appraiser should take into account the factors set forth by the IRS in Revenue Ruling 83-120.[65] The starting point under this guidance is to analyze comparable preferred interest returns on high quality publicly-traded securities. Additional factors for consideration include the coverage of the preferred coupon and liquidation preference, the size and stability of the partnership's earnings, asset coverage, management expertise, business and regulatory environment and any other relevant facts or features of the Preferred Partnership.

b. The partnership's "coverage" of the preferred coupon, which is the ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the partnership, will be important factors in determining the required coupon. A higher percentage of the partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the partnership's ability to pay the coupon on time; this translates to weaker coverage of the coupon, and thus greater risk, and ultimately a higher required coupon to account for this greater risk. Conversely, a partnership that has a higher percentage of common interests relative to preferred would provide stronger coverage which would result in lower risk and consequently a lower required coupon. A lower coupon may be more desirable from a wealth transfer standpoint as growth above the lower

[65] Rev. Rul. 83-120, 1983-2 C.B. 170.

coupon will shift to the younger generation owning the common interests.

B. Gift Tax Formation Issues.

There are various issues that must be considered in connection with the formation of a newly created Freeze Partnership. The most notable issue is Section 2701 of the Code, which generally can result in a deemed gift upon a Senior Family Member's capital contribution of assets into a Freeze Partnership in which he or retains senior equity interests, unless very specific requirements are satisfied with respect to the Senior Family Member's preferred interest. A "transfer" that can potentially trigger a deemed gift under Section 2701 is broadly defined and includes not only traditional gift transfers, but also capital contributions to new or existing entities, redemptions, recapitalizations or other changes in the capital structure of an entity.[66]

C. Structuring the Preferred Interest.[67]

1. Qualified Payment Right.

A Senior Family Member's preferred partnership interest is most typically, but not always, structured as a "qualified payment right" under Section 2701 to ensure that the Senior Family Member's contribution of assets to the Freeze Partnership is not considered a deemed gift under the Section 2701 "zero valuation" rule. The use of this "qualified payment right" structure will result in the Senior Family Member's retained preferred interest being valued under traditional valuation principles for gift tax purposes, and not under the unfavorable "zero valuation rule" of Section 2701.

This generally requires that the Senior Family Member's preferred interest be structured as a fixed percentage return on capital, that is payable at least annually and on a cumulative basis.[68] When a Senior Family Member retains a preferred interest that satisfies the requirements of a "qualified payment right," the Senior Family Member's preferred interest, or more accurately, the "distribution right" component of the preferred interest (that is, the right to receive distributions with respect to such equity interest) will not

[66] Treas. Reg. § 25.2701-1(b)(2)(i).

[67] For a more detailed discussion of related technical rules, see *infra* Section IX. *See also,* N. Todd Angkatavanich & Edward A. Vergara, *Preferred Partnership Freezes: They Come in Different "Flavors" and Provide a Menu of Creative Planning Solutions*, TR. & EST. (May 2011).

[68] Section 2701(c)(3)(A).

be valued at "zero" for gift tax valuation purposes, determined under a subtraction method of valuation, but, rather, such distribution right will be valued under traditional valuation principles.[69]

To ensure the preferred coupon does not fail to qualify merely because cash-flow is not sufficient to make the preferred payment in a given year, the Code provides that each preferred coupon payment can be made up to four years after its original due date and the payment will still be considered to be made on a timely basis.[70] The interest rate compounds should a payment go unpaid for an extended period, so the accrued interest amount can become substantial, but the deferral ability does nevertheless provide some flexibility.[71]

2. Liquidation Preference.

In addition to being entitled to a preferred coupon payment, typically, the preferred interest would provide the Senior Family Member with a priority liquidation right, meaning that upon liquidation, Senior Family Member will receive a return of his or her capital before the common interest holders receive a return of their capital. Senior Family Member, however, will not receive any of the potential upside growth in the Preferred Partnership based on his, her or its preferred interest.[72] Anything in excess of the amount needed to pay the preferred coupon and liquidation preference will accrue to the benefit of the common interest holders (*i.e.*, child, or a trust for the child's benefit).

D. Subtraction Method of Valuation

If Section 2701 applies to a transfer, the value of an interest transferred to a Junior Family Member will be determined by subtracting from the value of all family held interests the value of the interest retained by the Senior Family Member. A deemed gift will occur from the Senior Family Member to the Junior Family Member to the extent of the value of all family held interests, less the value of any interests retained by the Senior

[69] Treas. Reg. § 25.2701-2(a)(2).

[70] Section 2701(d)(2)(C).

[71] Section 2701(d)(2)(A)(i).

[72] Typically, the Senior Family Member will also retain at least a 1% common interest to ensure that his or her preferred interest is not recharacterized as debt. Such common interest would participate by its terms in any upside experienced by the Freeze Partnership.

Family Member, as determined under the Subtraction Method of valuation.[73]

E. Valuation of the Preferred Coupon.

Even if the Senior Family Member's preferred interest is properly structured to avoid the "zero value" deemed gift rule under Section 2701, there are still other gift tax issues to consider under traditional gift tax principals. Properly structuring the frozen preferred interest merely ensures that the distribution right component of the Senior Family Member's preferred interest is not valued at zero, under the Subtraction Method of valuation, for purposes of determining whether and to what extent a deemed gift has been made to Junior Family Members in connection with the transfer. However, there may still be a partial gift under traditional valuation principals if the Senior Family Member's retained preferred coupon is less than what it should be when measured against an arm's-length transaction. For example, if the Senior Family Member's retained coupon under the partnership agreement is a 5% coupon but a 7% return is determined to be required to equal par, then a deemed gift has still been made by the Senior Family Member to the extent of the shortfall in value, despite the fact that the preferred interest is structured to not violate Section 2701; albeit such would not be as dramatic a gift as would occur if Section 2701 is violated and the "zero value" deemed gift rule is triggered.

Vital to arriving at the proper coupon rate is the retention of a qualified appraiser to prepare a valuation appraisal to determine the preferred coupon required for the Senior Family Member to receive value equal to par for his or her capital contribution. In preparation of the appraisal, the appraiser will typically take into account the factors set forth by the IRS in Revenue Ruling 83-120.[74] The primary factors indicated are:

a. Comparable preferred interest returns on high-grade publicly-traded securities.

b. The Freeze Partnership's "coverage" of the preferred coupon, which is the ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the Freeze Partnership, will impact the required coupon.

[73] Treas. Reg. § 25.2701-1(a)(2).

[74] Rev. Rul. 83-120, 1983-2 C.B. 170.

(1) Generally, a higher percentage of the Freeze Partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the Freeze Partnership's ability to pay the coupon on time; this translates to weaker coverage of the coupon, and thus greater risk, and ultimately a higher required coupon to account for this greater risk.

(2) Conversely, a Freeze Partnership that has a higher percentage of common interests relative to preferred would provide stronger coverage which would result in lower risk and consequently a lower required coupon. A lower coupon may be more desirable from a wealth transfer standpoint as growth above the lower coupon will shift to the younger generation owning the common interest.

c. Valuation discounts and other relevant factors.[75]

F. Lower of Rule.

Even if the preferred interest is structured as a qualified payment right, it is critical that no "extraordinary payment rights" be retained by the Senior Family Member, in order to avoid the "lower of" rule. These include discretionary rights, such as puts, calls, conversion rights and rights to compel liquidation, the exercise or non-exercise of which affects the value of the transferred interest.[76] Inadvertently retaining an extraordinary payment right along with a qualified payment right could still result in a deemed gift upon the Senior Family Member's capital contribution under the "lower of" rule, which essentially requires that the preferred interest be valued not at the determined value of the qualified payment right, but based upon the "lower of" the qualified payment right and any extraordinary payment rights, which could potentially be lower, perhaps significantly lower (for instance if the preferred contained a put right at a value that is lower than the value of the quailed payment right).[77]

[75] On August 2, 2016, the Department of the Treasury issued proposed regulations under Sections 2704 and 2701 that are expected to have a significant impact on the valuation of family controlled entities. 81 Fed. Reg. 51413 (Reg. 163113-02) Aug. 4, 2016. Taken in conjunction with Rev. Rul. 83-120, these proposed regulations could arguably be read as having the potential to improve coupon coverage for certain Freeze Partnerships, thereby reducing the required preferred payment. However, at the time of writing this outline, the proposed regulations have not been finalized and it remains to be seen what (if any) impact they will have on the valuation of Freeze Partnerships.

[76] Treas. Reg. § 25.2701-1(a)(2)((i).

[77] Treas. Reg. § 25.2701-2(a)(3).

G. Ensuring Preferred Equity Interest is not Recharacterized as Debt.

One issue to be considered is whether the IRS could assert that preferred interests should be recharacterized as debt, rather than as equity in the Freeze Partnership. This is largely a facts and circumstances determination that has been developed through a large body of case law and which takes into account a number of factors (not necessarily related to preferred equity specifically, but rather, equity interests in general), such as:[78]

"(i) the denomination of the interests as debt or equity,

(ii) the presence or absence of a fixed maturity date,

(iii) the provision of a fixed interest rate or a specified market interest rate,

(iv) the unconditional or contingent nature of any payment obligation,

(v) the source of the payments,

(vi) the right to enforce the payment,

(vii) participation in management,

(viii) voting rights, if any,

(ix) subordination to the rights of general creditors,

(x) any securitization arrangements or the equivalent, such as the provision for a sinking fund,

(xi) thin or adequate capitalization,

(xii) the extent to which the identity of the preferred interest holders overlaps with the identity of the non-preferred interest holders,

(xiii) the general creditworthiness of the partnership,

(xiv) the degree of risk that payments or distributions will not be made, and

[78] A compilation of these factors was originally included in Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle,* 35-3 Univ. of Miami Law Center on Est. Planning 3 (Jan. 2001). *See also Fin Hay Realty Co. v. Comm'r*, 398 F.2d 694 (3d Cir. 1968); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); Gen. Couns. Mem. 38275 (Feb. 7, 1980).

(xv) the intent of the parties."

Unfortunately, there is no black and white test as to what will constitute sufficient evidence that a preferred interest in a partnership is an equity interest. Ensuring that the preferred interest is structured taking into consideration of as many of the above factors as possible should help bolster the argument that the preferred interest is equity rather than debt. Some commentators have suggested "stapling" a participation feature to the preferred interest, thereby creating a hybrid interest that is more likely to be respected as an equity interest in the Freeze Partnership.

H. Section 2036 Considerations.

Given the Section 2036(a)(2) issues that currently exist with family limited partnership structures, it may be advisable for the parent to own limited partnership or non-voting interests in the Freeze Partnership, rather than general partner or voting interests in order to address the Section 2036(a)(2) “retained control” issue.[79]

Additionally, from a “bad facts” or “implied understanding” Section 2036(a)(1) perspective, it is important to ensure that the formalities of the Freeze Partnership arrangement are respected.[80] To bolster the legitimacy of the partnership structure, it is advisable to adhere to best practices in the administration of the vehicle, such as:

a. Making sure that the preferred coupon is paid to the Senior Family Member on time, as scheduled, and if a payment is late, the Senior Family Member should take steps to ensure the payment is made.

[79] *See generally*, DOUGLAS K. FREEMAN & STEPHANIE G. RAPKIN, PLANNING FOR LARGE ESTATES 3-71 (LexisNexis 2016) (noting that the IRS could argue for inclusion under Section 2036(a)(1) to the extent that a partner also acts as the managing or general partner of the Freeze Partnership and retains control over, or the power to designate who may enjoy, the property of the Freeze Partnership).

[80] *Id. See also, Estate of Liljestrand v. Comm'r*, T.C. Memo 2011-259. In addition to a litany of bad facts that lead to an unfavorable result in *Liljestrand*, the Tax Court specifically held as follows:

> "As part of the partnership agreement, Dr. Liljestrand was guaranteed a preferred return of 14 percent of the value of his class A limited partnership interest. Dr. Liljestrand's class A limited partnership interest was valued at $310,000, thus Dr. Liljestrand was guaranteed annual payments equal to $43,400. Moss-Adam's appraisal estimated the partnership's annual income would equal $43,000. We find this guaranteed return indicative of an agreement to retain an interest or right in the contributed property. . . Dr. Liljestrand received a disproportionate share of the partnership distributions, engineered a guaranteed payment equal to the partnership expected annual income and benefited from the sale of partnership assets. The objective evidence points to the fact that Dr. Liljestrand continued to enjoy the economic benefits associated with the transferred property during his lifetime."

b. Ensure the preferred coupon does not match anticipated partnership annual income.[81]

c. Recall that Section 2701 does permit a four-year deferral for a qualified payment right preferred coupon payment.[82]

d. A preferred payment can be satisfied through the issuance of a promissory note with a term no longer than four years.[83]

A Freeze Partnership is, economically, entirely different than the typical so-called "FLP" involved in the various cases decided under Section 2036(a)(1), since the parties from inception are entering into this type of transaction based upon an affirmative decision to split their economic arrangement into guaranteed preferred cash-flow on the one hand and upside growth potential on the other. The decision to receive preferred or common interests will be guided by the relative needs of the Senior Family Member and the Junior Family Member, based upon a risk vs. reward analysis, taking into consideration each partners' relative investment horizon, appetite for risk and need for liquidity, much the same as those individuals would allocate their investment portfolios between fixed income and equities.

Thus, a decision to invest in a Freeze Partnership should itself provide a good argument that the "bona fide sale exception" to Section 2036 should be satisfied, since such decision is made in furtherance of a legitimate and significant non-tax purpose. In the case of the creation of a new Freeze Partnership, the Junior Family Member will be making a significant and independent capital contribution of previously existing assets into the Freeze Partnership in exchange for common interests. This should support an argument that the Senior Family Member's transfer to the Freeze Partnership was made for "adequate and full consideration" and, therefore, falls within the statutory exception to Section 2036(a). To the extent that separate counsel is retained to represent the parties in connection with the negotiation and formation of the Freeze Partnership, and an independent appraisal is obtained to determine the adequacy of the preferred coupon, such should help to support this argument further.

VII. REVERSE FREEZE PARTNERSHIP

[81] *Id.; Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958) (noting that to avoid the reach of Section 2036(a), a payment obligation must, among other things, "not [be] determined by the size of the actual income from the transferred property at the time the payments are made").

[82] Section 2701(d)(2)(C).

[83] Treas. Reg. § 25.2701-4(c)(5). A debt obligation issued to satisfy a qualified payment must also bear compound interest from the due date of the qualified payment at the appropriate discount rate.

A. <u>General</u>.

A "Reverse Freeze Partnership" is conceptually similar to a Freeze Partnership in that the entity can provide an effective means of shifting assets between different partners, based upon relative needs and risk tolerance. However, the economics with this type of vehicle are "reversed." Thus, instead of the Senior Family Member holding the preferred interest, as in the Freeze Partnership, the Senior Family Member retains the common "growth" interest and transfers the preferred "frozen" interest to the Junior Family Member, or perhaps these interests are received in connection with the initial capitalization of the Reverse Freeze Partnership. This can have the potential to provide fixed cash flow to the Junior Family Members in the form of preferred interests.

B. <u>Section 2701 Not Applicable</u>.

The use of a Reverse Freeze Partnership is attractive because, unlike a forward Freeze Partnership, it is generally not subject to Section 2701, which allows for greater flexibility in structuring the preferred payment. This is because in a Reverse Freeze Partnership, the Senior Family Member holds a "subordinate interest" in the form of the common interest, which prevents the Senior Family Member's interest from being a "distribution right" subject to the zero valuation rule under Section 2701.[84] In such case, however, it is critical to ensure that the Senior Family Member does not hold any Extraordinary Payment Rights in connection with the common interests, as such rights could still be valued at zero under Section 2701, even in the case of a Reverse Freeze Partnership.[85]

C. <u>Valuation Considerations</u>.

As with the forward Freeze Partnership, it is necessary to obtain an appraisal of the preferred interest to ensure that an adequate coupon percentage is being paid to the preferred interest holders. If the ratio of preferred versus common used in structuring the Reverse Freeze Partnership is higher such that it effectively increases the entity's preferred payment obligations, and consequently diminishes the strength of the entity's coupon coverage (thereby making the preferred interest a much riskier investment), such would increase, perhaps significantly under the factors set forth in Revenue Ruling 83-120, the coupon required to be paid to the Junior Family Members as the preferred interest holders. In the Reverse Freeze Partnership scenario, the preferred interest payment would

[84] Treas. Reg. § 25.2701-2(b)(3)(i).

[85] Treas. Reg. § 25.2701-2(b)(2).

increase the value that would have to be paid to younger generations (in the form of a much higher preferred coupon) and, consequently, may contain the extent of the future growth in the value of the common interests held by the Senior Family Members. If the entity does not grow at least at the rate of the preferred coupon required to be paid to the younger generation, it is possible that the common interests will actually decrease in value over time, which would reduce the asset value of the Senior Family Member; if the entity grows above the preferred coupon then that growth will inure to the benefit of the common interests owned by the Senior Family Member, thereby increasing his or her estate.

VIII. FREEZING A QTIP TRUST.

A. Advantages of Freezing a QTIP Trust.

A Freeze Partnership can be an effective vehicle to combine with a QTIP Trust during the lifetime of a surviving spouse/beneficiary. Properly created, a Freeze Partnership in which a QTIP Trust holds a preferred interest could be advantageous in that it would provide a steady and mandatory income stream to the QTIP Trust that would be paid out to the surviving spouse/beneficiary. Additionally, the future growth of the QTIP Trust would be limited to the preferred coupon plus its liquidation preference; however, any further growth would occur in the common interest, which presumably would be held by other, more tax efficient, owners (e.g., the children or perhaps a credit shelter trust). Because a QTIP Trust will necessarily be subject to gross estate inclusion upon the death of the surviving spouse/beneficiary under Section 2044, containing the future growth that occurs in the QTIP Trust in favor of a more tax efficient recipient of the common interest growth, such as the next generation beneficiaries or trusts for their benefit, can be advantageous.[86]

B. QTIP Section 2519 Issue.

It is critical to consider Section 2519 when coupling a Freeze Partnership with a QTIP Trust. Section 2519 provides that if the income interest holder (i.e., the surviving spouse/beneficiary) of a QTIP Trust transfers the income interest, then the income interest holder will be deemed to have made a taxable gift of the entire interest of the QTIP Trust. In the context of a Freeze Partnership, the question is whether the creation of the partnership with the capital contribution by the QTIP Trust of its assets into the partnership will be considered to be a disposition of the surviving

[86] Practitioners should be aware that the surviving spouse who is the beneficiary of a QTIP trust generally would have the right to compel the trustees to make trust property income-producing to satisfy the requirements of Treas. Reg. § 20.2056(b)-(5)(f)(1).

spouse's income interest in the QTIP Trust, thereby triggering a gift under Section 2519?

There is some guidance that, while not directly on point, should support the position that a properly structured Freeze Partnership should not be deemed a disposition of an income interest under Section 2519. In Field Service Advice 199920016, the IRS considered a situation where a QTIP Trust and various family members created a single economic class family limited partnership in which the QTIP Trust received limited partnership interests in exchange for its capital contribution. The partnership made regular distributions of income to its partners. Based upon these facts, the IRS determined that no disposition would be made under Section 2519 of the surviving spouse's income interest in the QTIP Trust. The conclusion of the IRS under Section 2519 was based upon the fact that the QTIP Trust was receiving regular distributions of income from the partnership so that there was no disposition of an income interest. Additionally, it was noted that the surviving spouse/beneficiary had the right to compel the QTIP Trustee to convert the Trust's assets into income producing property, which further supported that no disposition of an income interest occurred as a result of the capital contribution. Under the logic of this FSA, a good argument should exist that in the case of a Freeze Partnership, no Section 2519 disposition should occur upon the formation and capital contribution by a QTIP Trust, particularly in light of the fact that the QTIP Trust would be actually *entitled* to a preferred coupon payable on an annual basis cumulatively (rather than having a mere expectation or pattern of distributions), and those distributions would be required to be made before any distributions could be made to the common interest holders.

IX. GRAT ETIP ISSUE: PREFERRED PARTNERSHIP GRAT. [87]

A. The ETIP Issue.

The general inability to allocate generation skipping transfer ("GST") tax exemption to a GRAT is another negative planning aspect, as it effectively prevents practitioners from structuring GRATs as multi-generational, GST-Exempt trusts, in a tax-efficient manner. This is because of the "estate tax inclusion period" rule (the "ETIP Rule"), which basically provides that GST exemption cannot be allocated to a trust during its trust term if the assets would otherwise be included in the grantor's estate if he or she died during that term. If the grantor were to die during the annuity term, a portion of the GRAT assets would be included in his or her estate. As a result, the ETIP Rule would preclude the grantor from allocating

[87]N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC J. 290 (2009).

GST exemption to a GRAT until the end of the ETIP (i.e., the end of the annuity term). Because of this limitation, there would be little if any ability to leverage the grantor's GST exemption with a GRAT. Allocation of the grantor's GST exemption to the trust at the end of the ETIP would have to be made based upon the then values of the trust's assets, and therefore would be an inefficient use of GST exemption. As a result, GST exemption is very often not allocated to a trust remaining at the expiration of a GRAT annuity term; as a consequence, such assets will typically be subject to estate tax at the death of the second generation beneficiaries or will be subject to a GST tax upon a GST event at the second generation's death.

B. Preferred Partnership GRAT to address ETIP Issue.

The creation of a "Preferred Partnership GRAT," which involves the combination of a statutory GRAT with a statutory Preferred Partnership, may provide a way to obtain the statutory certainty of a GRAT while at the same time shifting future appreciation into a GST-Exempt trust and, perhaps even containing the amount of potential estate tax inclusion if the grantor dies during the GRAT term. This technique dovetails the planning advantages of the Preferred Partnership with those of a GRAT by combining these two statutorily mandated techniques.

With this technique, parent could create a Preferred Partnership, initially owning both common "growth" and preferred "frozen" interests. Thereafter, the parent would make gift transfers of preferred interest to a long-term Zeroed-Out GRAT, which would not trigger any gift taxes. Parent would also create a GST-Exempt trust into which parent would make taxable gifts of common interests, and would allocate GST exemption. The GRAT would be structured so that the preferred payments made annually to the GRAT would be sufficient to satisfy its annuity payments to the grantor. The GST-Exempt trust owning the common interests would receive all growth above the preferred coupon payable to the GRAT. At the end of the GRAT term, if the parent is living, the GRAT remainder would be distributed to the remainder beneficiaries, however these assets would have been "frozen" to the amount of the liquidation preference and the coupon (as this would be payable in a non GST-Exempt manner). Any appreciation above the coupon will exist in the common interests held by the GST-Exempt trust.

If the grantor dies during the GRAT's annuity term, the estate tax inclusion would be limited to the frozen preferred interest gifted into the GRAT. However, because the common "growth" interest would never have been held in the GRAT, but, rather, it was obtained by the GST-

Exempt trust via initial capital contribution, the grantor's death during the annuity term would become irrelevant with respect to the appreciated common interests.

C. "Rolling" Preferred Partnership GRAT

A variation on the Preferred Partnership GRAT would be to make "rolling" annuity payments to the parent from the GRAT (that are in turn funded by the preferred payments paid by the Freeze Partnership to the GRAT). That is, each time that the parent receives his or her GRAT payment(s), parent could reinvest such payment(s) into the Freeze Partnership in exchange for additional preferred interests. If desired, the parent could then make additional gifts of the preferred payments into new GRATs.

X. INTENTIONALLY TRIGGERING SECTION 2701 – INTENTIONALLY DEFECTIVE FREEZE PARTNERSHIPS.

Despite the conventional wisdom that triggering Section 2701 should be avoided when structuring a Freeze Partnership, in certain circumstances it may prove useful to intentionally cause a deemed gift under Section 2701.[88]

A. Utilizing Gift Tax Exemption During Lifetime

If a Senior Family Member is not otherwise inclined to make taxable gifts during lifetime a Freeze Partnership may provide a way to take advantage of the gift tax exemption while providing cash flow to the Senior Family Member. One way to do this may be to form or recapitalize an "intentionally defective" Freeze Partnership that generates a taxable gift by intentionally triggering a deemed gift under Section 2701. The preferred interest could be structured to fall outside the "qualified payment" exception by, for example, providing for non-cumulative preferred payments and a put right equal to the liquidation preference. Under the subtraction method of valuation, the distribution right attributable to the preferred interest would be given a value of zero, as would the put right as an extraordinary payment right, resulting in a taxable gift equal to nearly all, or perhaps all, of the full value of the parent's contribution to the partnership (taking into account any applicable valuation discounts).

While this may seem like a worst case scenario, as the retained preferred interests would trigger a deemed gift and would still be included in the

[88] These situations have been thoughtfully discussed in Michael N. Gooen & Tracy A. Snow, *Tasty Freeze: Preferred Partnership Tax Recipe*, 42 ESTATE PLANNING 5 (May 2015) and Christoher Pegg and Nicole Seymour, *Rethinking I.R.C. § 2701 in the Era of Large Gift Tax Exemptions*, 87 FL. BAR J. 9 (Nov. 2013).

parent's taxable estate at death, the Treasury Regulations under Section 2701 provide for an offsetting adjustment for the prior taxable gift to prevent double taxation. The adjustment is equal to "the amount by which the initial transferor's taxable gifts were increased as a result of the application of Section 2701 to the initial transfer."[89] Stated differently, the adjustment permitted in the Treasury Regulations will effectively "net out" the value of the preferred interest included in the parent's taxable estate.[90] The non-cumulative nature of the retained preferred interest permits the parent to retain a somewhat flexible income stream during his or her lifetime, although the potential implications of Section 2036 favor substantial compliance with the terms of the partnership agreement.

B. Maximizing the Value of DSUE in the Case of Multiple Deceased Spouses[91]

Another scenario in which intentionally triggering Section 2701 would be beneficial is one in which a taxpayer has elected to take advantage of the benefits offered by "portability," which permits a surviving spouse to take advantage of the deceased spouse's unused transfer tax exemption amount. One negative aspect of portability, however, is that a surviving spouse who chooses to remarry will lose the deceased spousal unused exclusion ("DSUE") amount if she is predeceased by her new spouse. [92] However, lifetime gifts by a surviving spouse that use the first deceased spouse's DSUE amount are not recaptured or "clawed back" should the surviving spouse be predeceased by her new spouse.[93] This "use it or lose it" aspect of portability may conflict with the surviving spouse's reluctance to make a gift substantial enough to capture the entire DSUE amount. An "intentionally defective" Freeze Partnership, therefore, may present an opportunity for individuals who have elected portability from a deceased spouse and likely will require a stable stream of income from a gift that she would otherwise like to make outright as part of more conventional tax planning.

As with a typical Freeze Partnership, the surviving spouse would make contributions to a new partnership or recapitalize an existing entity, taking back two classes of equity interests – preferred interests and common

[89] Treas. Reg. § 25.2701-5(a)(3).

[90] Treas. Reg. § 25.2701-5(d)(3), Ex. 2.

[91] Section 2010(c)(2). *See generally,* Gooen & Snow, *Tasty Freeze*, *supra* note 85.

[92] *See* Section 2010(c)(4)(B) and Reg. 20.2010-3. This is the result of the operation of the "last deceased spouse" rule whereby Reg. 20.2010-1(d)(5) defines the "last deceased spouse" for purposes of porting DSUE as "the spouse the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse."

[93] Reg. 20.2010-3(b).

interests. The preferred interests would be entitled to a fixed annual payment and would be retained by the surviving spouse, while the common interests would participate in the upside growth potential of the Freeze Partnership and would be gifted to the surviving spouse's descendants (or a trust for their benefit). However, instead of structuring the preferred interests to comply with the terms of Section 2701, would either be structured to intentionally violate those terms (perhaps by making the preferred payments non-cumulative) or an election would be made under Section 2701(c)(3)(C) to intentionally trigger the zero valuation rule. As a result, the retained preferred interest would be valued at zero and value of the gift made to the younger generation would be maximized, instead of minimized, using up as much as the first deceased spouse's DSUE as possible before the surviving spouse's second marriage. In addition, the surviving spouse would continue to enjoy a stream of income from the transferred assets by virtue of the preferred interest, as with a typical Freeze Partnership. As discussed above, the value of the preferred interest would be included in the surviving spouse's estate, but would be offset by the special adjustment rules under Section 2701 to avoid double taxation.

C. Modest Estates That Have Assets with Substantial Growth Potential.

For a taxpayer whose estate is under the estate tax threshold, but who owns assets with the potential for substantial appreciation, using a preferred partnership while intentionally triggering Section 2701 could have all the usual benefits of a Freeze Partnership (e.g., removing future growth from the older generation's estate, retaining a stream of cash flow and obtaining basis step-up, etc.) while avoiding the various restrictions imposed by techniques designed to comply Section 2701.

If a particular estate is well under the estate tax threshold and the taxpayer has a significant amount of unused gift tax exemption, the deemed gift resulting from intentionally triggering Section 2701 is less unappealing because, to the extent the deemed gift is less than the taxpayer's unused gift tax exemption, no gift tax will actually be due upon the transfer. Accordingly, employing an intentionally defective Freeze Partnership without may provide an efficient way to obtain the some of the benefits of a Freeze Partnership, including retaining a stream of income from the underlying assets, freezing the estate and obtaining basis step-up, while lessening some of the compliance burdens ordinarily associated with such a structure. Moreover, as discussed above, Treas. Reg. § 25.2701-5 would reduce the estate inclusion resulting from the retained preferred interest by an amount equal to the gift tax that was paid or credited earlier for the

same transferred property, essentially providing a low-hurdle estate freeze while maintaining significant access to a steady stream of income.

XI. Consideration of Unique Gift Tax Issues With Next Generation Ownership of Family Office

Estate and gift planning for ultra-wealthy families often goes well beyond standard generation to generation transfers. Integral to the coordination of multigenerational estate planning when dealing with a family office structure is ensuring that ownership and transfer of interests in the family office entity or entities is properly structured from both a tax and non-tax standpoint. These rules apply with equal vigor to any type of family held entity, including partnerships, corporations, limited liability companies or other entities. In the case where there is more than one class of equity in the family office entity, or perhaps if there is more than one entity involved with the overall integrated family office structure it is critical to consider the special valuation rules under Chapter 14 of the Internal Revenue Code before implementing any division of ownership between different generations.

When creating a family structure involving a profits interest that will be owned by or for the benefit of younger generation family members, such will potentially involve the application of the "deemed gift tax" rules under Section 2701 of the Internal Revenue Code. Specifically, Section 2701 of the Code contains extremely thorny deemed gift tax rules that can cause an unexpected deemed gift to occur upon a transfer of one class of equity ownership in a partnership, LLC or corporation between senior and junior generations of a family.

While there are many complexities with this section, in essence, the risk posed is that a transaction (referred to as a "Transfer") resulting in the ownership by younger generation family members ("Junior Family Members") of a "Subordinate" equity interest (sometimes, but not always, associated with a profits interest) in an entity, when the senior generational family member ("Senior Family Member") retains a "Senior" equity interest, could trigger an unanticipated deemed gift by the Senior Family Member of some portion or potentially even all of the equity interests that he/she still continues to own. In other words, the application of Section 2701 could be to cause the patriarch to be treated as if he made a taxable gift of some or potentially most or all of the equity interests that he did not actually give away; when the Senior Family Member owns substantial equity interests, such as the limited partnership interests in the various family partnerships triggering a deemed gift of those interests could have draconian results.

A. Section 2701 Generally.

Section 2701 can cause a deemed gift to occur typically in connection with a "transfer" of Subordinate equity interest in an entity (such as family partnerships), to a Junior Family Member when certain other equity interests (typically, but not necessarily associated with preferred interests) are retained by a Senior Family Member. While not limited to this situation, the classic example of a transfer to which Section 2701 can potentially apply is when a parent who initially owns both common and preferred equity interests in a partnership transfers the common stock to his children (or trusts for their benefit) while retaining the preferred interest. The reach of the statute, however, is much broader than in just the preferred and common equity structure and, therefore, can apply in other situations such as when profits interests are issued.

Broadly speaking, Section 2701 applies and can cause a deemed gift to occur when a senior generation family member (referred to in the statute as an "Applicable Family Member") holds an "Applicable Retained Interest" after a "transfer" to a junior family member (referred to in the statute as a "Member of the Family") or trusts for their benefit. For these purposes, a "transfer" is very broadly defined to include, not only a traditional gift transfer (e.g., I give my child ten shares of common stock), but also capital contributions, redemptions, recapitalizations, or other changes in the capital structure of an entity.[94]

There are two types of rights, the retention of which by a Senior Family Member can trigger the problematic Applicable Retained Interest status, and thus the Section 2701 zero valuation rule with respect to those retained rights: "Distribution Rights" (associated with a "Controlled Entity") and "Extraordinary Payment Rights." If Section 2701 is applicable and if the interest retained by the Senior Family Member is not a specific type of interest that fits into one of the exceptions to the statute, then these two types of rights associated with the Applicable Retained Interest held by the Senior Family Member are valued at "zero" for gift tax purposes. The impact of this zero valuation being ascribed to the equity that the Senior Family Member owns is that an inflated (perhaps extremely inflated) value can be ascribed to the interest that is transferred to the Junior Family Member for gift tax purposes.[95] This can result in some or perhaps even all of the Senior Family Member's retained interest in the entity being attributed to the interest that was transferred to the Junior Family Member, thereby causing a deemed inflated gift of some or

[94] Treas. Reg. § 25.2701-1(b)(2)(i).

[95] Treas. Reg. § 25.2701-2(a)(1) & (2).

potentially all of the interests that the Senior Family Member still continues to own.

The application of the rules of Section 2701 revolves around different definitions:

1. Transfer

   The term "transfer" is broadly defined, and includes, in addition to a traditional transfer, a capital contribution to a new or existing entity, as well as a redemption, recapitalization or other change in the capital structure of an entity.[96]

2. Applicable Retained Interests

   The application of a gift under Section 2701 occurs by way of mechanical rules that revolve around the definition of an "Applicable Retained Interest." Thus, Section 2701 applies to a transfer to a Member of the Family (essentially Junior Family Members or their trusts) if a Senior Family Member holds an "Applicable Retained Interest" immediately after the transfer.

   There are two types of rights the retention of which will cause an Applicable Retained Interest to exist: (1) Distribution Rights; and (2) Extraordinary Payment Rights.

   A Distribution Right is a right to receive distributions with respect to an equity interest in a Controlled Entity (subject however to exceptions for retention by the Senior Family Member of the "same class" or "subordinate class" as the interest transferred to the Junior Family Member).

   An Extraordinary Payment Right include puts, calls and conversion rights *the exercise or non-exercise of which would affect the value* of the transferred common interest when the holder of such rights has discretion as to whether (or when) to exercise them. A call right includes any warrant, option, or other right to acquire one or more equity interest(s).

3. "Reversing" the Profits Interest:

   There are various possible approaches to try to avoid the application of these potentially harsh rules when structuring the

[96] Treas. Reg. § 25.2701-1(b)(2)(i)

ownership of profits interest to be held by the Family Office, when the desire is for the Family Office to be owned by Junior Family Members. It should be noted, however, that many of these approaches are not considered to be "mainstream" approaches, and the design of these approaches will be bespoke and "untested." Essentially, the approach(es) to structuring the ownership of the Family Office with the profits interest by the Junior Family Members would involve restructuring the underlying family partnership entities so that the equity interest owned by the Family Office (which would be owned by or for the benefit of the Junior Family Members) would constitute a "Senior" equity interest (rather than a "Subordinate" equity interest); accordingly, the limited partnership interests in the family partnership (which are currently owned by both the Senior and Junior Family Members) would constitute the "Subordinate" equity interests – this would position the restructured entity in such a manner such that an exception to Section 2701 would presumably apply (that exception provides that Section 2701 will not be triggered if the Senior Family Member continues to own either a "same class" or "subordinate class" of equity as the Junior Family Member).

In addition, because it is anticipated that ownership of the Junior Family Member's interests would be via trusts for their benefit, which are currently "grantor trusts" as to the patriarch-Senior Family Member, in order for such an approach to be viable, the "grantor trust" status of these trusts would need to be "turned off." This is necessary in order to avoid the interests in these grantor trusts being attributable to the Senior Family Member/Grantor under the "Grantor Trust Attribution Rules," which would implicated the so-called Multiple Attribution Tie-Breaker Rules.

The first, and most typical, type of right that will result in an Applicable Retained Interest is a "Distribution Right," which is the "right to receive distributions with respect to an equity interest" in a "Controlled Entity."[97]

Thus, a limited partnership interest in a family partnership could be a Distribution Right in the absence of an exception applying. To this end, a Distribution Right does not include a right to receive distributions with respect to an interest that is of the "same class"

[97] Treas. Reg. § 25.2701-2(b)(1)(ii) & (3). In the case of a limited partnership, the holding of any interest as a general partner by a broad group of family members including junior and senior family members as well as siblings in the aggregate. Additionally, "in the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership." Treas. Reg. § 25.2701-2(b)(5).

as, or a class that is "subordinate to," the transferred interest. So the retention by the Senior Family Member of the "same" equity class as is transferred to the Junior Family Member will not cause Section 2701 to apply generally (for instance, the transfer and retention of the same common equity class).[98]

Additionally, and relevant for our purposes, if a Senior Family Member retains an interest that is "subordinate" to the equity class transferred to the Junior Family Member, then such interest will not be considered a Distribution Right, and therefore will not trigger Section 2701.[99]

For these purposes, a "Subordinate Equity Interest" is defined as "an equity interest … as to which an Applicable Retained Interest is a Senior Equity Interest." A "Senior Equity Interest" is defined as "an equity interest … that carries a **right to distributions of income or capital** that is preferred as to the rights of the transferred interest."[100] Based upon these definitions, to the extent that the Junior Family Member retains an interest that carries a right to distributions that are preferred as to distributions of **either** income or distribution of capital, such should be considered a Senior Equity Interest for purposes of Section 2701. In the most typical application of the rule, a Subordinate Equity Interest would be a common interest in a preferred partnership in which a preferred interest is the Senior Equity Interest.

In the context of the restructuring of a family partnership, to the extent that the profits interest held by the Family Office (which would be owned by the trusts for the benefit of the Junior Family Members) is structured to satisfy the definition of a "Senior Equity Interest" (due to its right to distributions that are preferred as to **income or capital**), such should not trigger Section 2701 where the Senior Family Member retains limited partnership interests in the entities, which would be structured as Subordinate Equity

[98] Treas. Reg. § 25.2701-1(c)(3) provides that "Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (*e.g.,* section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by reason of Federal or State law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purposes of section 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee."

[99] Treas. Reg. § 25.2701-2(b)(3)(i).

[100] Treas. Reg. § 25.2701-3(a)(2)(ii) and (iii)

Interests, and fall within the exception to a Distribution Right under Section 2701. Presumably, restructuring the partnerships so as to provide that the Family Office is entitled to a preferred return of **both income and capital**, such would bolster the argument that such interest is a Senior Equity Interest.

4. Subtraction Method

If Section 2701 applies to a transfer, the value of an interest "transferred" to a Junior Family Member will be determined by subtracting from the value of the entire family-held interests the value of the interest retained by the Senior Family Member. Under this "Subtraction Method," a deemed gift will have occurred from the Senior Family Member to the Junior Family Member of the value of all family held interests less the value of the senior interests retained by the Senior Family Member.[101]

5. Section 2701 Applied to Profits Interests Held by Junior Family Member

In CCA 201442053, the IRS determined that Section 2701 was triggered in connection with the recapitalization of an LLC. In the CCA, an existing single class LLC owned by mother, sons and grandchildren was recapitalized so that all future profits or gains would be allocated to the sons only, as consideration for the sons agreeing to manage the LLC. Following the recapitalization, the mother's only interest was the right to the return of her capital account upon liquidation based on her membership interest as it existed immediately prior to the recapitalization.

The IRS determined that the recapitalization was a Section 2701 "transfer" under Treas. Reg. § 25.2701-1(b)(2)(B)(2). It reasoned that the mother held an Applicable Retained Interest (her "Distribution Right") both before and after the recapitalization, and that her sons' right to receive future profits was a subordinate interest.[102]

In an article criticizing the CCA, Richard L. Dees argues that the IRS should withdraw the CCA and criticizes it as containing a rather muddled analysis in determining that the mother's retained interest was an "Applicable Retained Interest" due to the fact that

[101] Treas. Reg. § 25.2701-1(a)(2)

[102] For a comprehensive and critical commentary on this CCA, *see* Richard L. Dees, *Is Chief Counsel Resurrecting The Chapter 14 "Monster?"* TAX NOTES (December 15, 2014).

"[b]oth before and after the recapitalization, Donor held an Applicable Retained Interest, an equity interest in the LLC coupled with a Distribution Right." Dees argues that the mother's right to receive her capital account upon termination of the LLC was not an "Applicable Retained Interest;" rather, such would have been either a "Mandatory Payment Right" or a "Liquidation Participation Right," neither of which is subject to zero valuation under Section 2701. Additionally, he points out that the mother did not retain an "Extraordinary Payment Right" since she did not have the discretionary right to withdraw her capital interest from the LLC which was subject to a stated term. (Since the publication of Dees' article, it has since been determined that mother had a large enough percentage interest to unilaterally liquidate the LLC, which would have constituted an Extraordinary Payment Right.[103]) After the recapitalization, mother retained no rights to receive distributions with respect to her equity interests, but only the right to a return of her capital account.[104]

6. Vertical Slice Exception

Perhaps the most elegant solution these draconian rules is for the transfer to the next generation to constitute a "vertical slice" or proportional reduction of each and every class of equity ownership owned by the senior generational family member. There are a number of other approaches to achieving the solution that does not implicate these harsh gift tax rules that are very complex and beyond the scope of this article, but the so-called vertical slice is the most elegant and easy to implement exception.

Essentially, this exception would involve the transfer resulting in proportionate ownership by the Senior and Junior Family Members of each and every class of equity interest. In the case of a family entity in which a profits interest is issued to the Family Office, proportional ownership of each interest would satisfy this exception. For example, 75%/25% ownership of the profits interest and limited partnership interests in a family limited partnership owned by the Senior and Junior Family Members respectively.

[103] Richard L. Dees, *The Preferred Partnership Freeze And The Reverse Freeze (Part II) - IRC Section 2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute*, at 6-39 (September 17-18, 2015).

[104] For an excellent in-depth discussion of CCA 201442053 and further analysis of Section 2701 generally, *see generally*, Richard L. Dees, *The Preferred Partnership Freeze And The Reverse Freeze (Part II) - IRC Section 2701 And The Regulatory Scheme, Forty-First Notre Dame Tax and Estate Planning Institute* (September 17-18, 2015).

One practical limitation with this approach is that with large family entities, there are natural limitations on the ability to transfer ownership of a proportional limited partnership interest in a family limited partnership to the Junior Family Member without triggering a gift tax.

7. The Section 2701 Attribution Rules.

Various attribution rules apply under Section 2701 with respect to equity interests indirectly owned by way of entities as well as through trusts.[105] In addition, these rules are further complicated by the fact that it is possible to have "multiple attribution" in which the rules determine an equity interest to be owned by different people for purposes of Section 2701. In such case, certain "tie-breaker" rules apply, which set forth ordering rules as to whom will be attributed ownership of a particular interest depending upon the particular generational assignment of certain individuals as well as whether the equity interest in question is a senior interest or a subordinate interest. Importantly, seemingly negligible changes in any of the foregoing factors can produce quite different results under the trust attribution rules and, in turn, the Section 2701 analysis.

[105] Treas. Reg. § 25.2701-6.