FEATURE:
ESTATE PLANNING & TAXATION

By **James G. Blase**

The Minimum Income Tax Trust

Drafting techniques to help unburden estate planners

The federal income tax law contains many unfair, if not punitive, clauses applicable to the estate-planning area. While most of the unfairness can be eliminated by simply removing all trusts from the client's estate plan or having the trust distribute all income (including, where possible, all capital gains) to the trust beneficiaries currently, doing so also means eliminating or seriously undermining all the benefits the trusts were designed to achieve.

The minimum income tax trust (MIT Trust) isn't a separate trust document in and of itself, but rather represents several techniques for drafting revocable and irrevocable trusts intended to sidestep the federal income tax law's aforementioned unfairness. The goal of the MIT Trust is to minimize overall income taxes for clients and their families without disrupting the clients' non-tax estate-planning objectives.

Unfair Laws

Here's a sampling of some of the unfair income tax laws applicable to estate planning.

1. A maximum federal income tax rate of 39.6 percent on trusts applicable to levels of trust taxable income in excess of only $12,150, whereas single individuals don't reach the 39.6 percent bracket until their taxable incomes exceed $400,000;
2. A 5 percent surtax on capital gains and qualified dividends of trusts applicable when trust taxable income is in excess of only $12,150, whereas single individuals don't pay the same surtax until their taxable incomes exceed $400,000;
3. A 3.8 percent surtax on items of net investment income of trusts when adjusted gross income (AGI) exceeds only $12,150, whereas single individuals don't pay the same surtax until their AGIs exceed $200,000;
4. At the first spouse's death, a new income tax basis for the surviving spouse for all community property owned by a married couple which isn't income in respect of a decedent (IRD), however titled, but for residents of non-community property states, a new income tax basis only for non-IRD assets includible in the first spouse to die's gross estate for federal estate tax purposes; and
5. A loss of a new income tax basis on non-IRD assets when most trusts terminate as a result of the death of the life beneficiary, whereas non-IRD assets owned outright by an individual generally receive a new income tax basis at the individual's death.

Minimizing Taxes on Trusts

Minimizing the effect of the current high income tax rates on trusts, without undermining the purpose of the trusts through unnecessary outright distributions of trust income and capital gains, involves using Internal Revenue Code Section 678. The aim is to cause the trust beneficiary, rather than the trust, to be taxed on the trust's taxable income, including capital gains, by vesting the beneficiary with a sole power of withdrawal over the trust income. IRC Section 678 provides that:

> . . . [a] person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise

James G. Blase is a principal at Blase & Associates in St. Louis and is an adjunct professor of estate planning at St. Louis University School of Law

> modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject the grantor of a trust to treatment as the owner thereof.[1]

If desired, an estate planner can limit the beneficiary's withdrawal power to the types of trust income that are taxed at the highest federal income tax rates only, for example, by excluding qualified dividends and capital gains taxed at still favorable (though, as discussed above, not as much for most trusts) income tax rates, as well as items of federally tax-exempt income. The so-called "portion rules," under IRC Section 671 and the related regulations,[2] are what allow for this "tax tracing" treatment. The withdrawal power holder would naturally possess the ability to withdraw any income necessary to pay his additional income taxes resulting from the Section 678 power, or an independent trustee could reimburse the power holder for this amount.

Estate planners should ensure that no provision of the trust document will infringe on the power holder's Section 678 "sole power to vest" the trust income for the current tax year (including, if desired, capital gains) in himself. For example, a disinterested trustee may possess the power to suspend the beneficiary's withdrawal power (if, perhaps, the beneficiary is exercising his withdrawal power unwisely or if the beneficiary gets divorced or is the subject of a lawsuit), but only if the suspension power is exercised prior to the beginning of the trust's applicable tax year.

IRC Section 2514(e) provides that:

> . . . [t]he lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power [i.e., a potential taxable gift]. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts: (1) $5,000, or (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.

Therefore, to avoid an annual taxable transfer by the beneficiary, the beneficiary's withdrawal power over trust income should be limited to 5 percent of the value of the trust, per year. The scope of the 5 percent limitation should also, generally, be broadened to its fullest extent possible, by making it clear in the trust document that the trustee may satisfy the beneficiary's withdrawal right by liquidating any asset of the trust, including those payable to the trust over time, such as benefits payable under individual retirement accounts, qualified plans and nonqualified annuities.

Distributions Over 5 Percent

If distributions in excess of 5 percent of the trust value are determined to be desirable in any given year (for example, because the trust has a significant amount of capital gains or IRA/qualified plan receipts during the year), a disinterested trustee may be given the authority to make such excess distributions to the beneficiary. Capital gains, however, must first be properly allocated to the distributable net income (DNI) of the trust; otherwise, they won't "carry out" to the beneficiary.

> The IRS regulations establish alternatives for recognizing capital gains as part of distributable net income.

The IRS regulations establish alternatives for recognizing capital gains as part of DNI by providing that an allocation to income of all or a part of the gains from the sale or exchange of trust assets will, generally, be respected if it's made pursuant to either: (1) the terms of the governing instrument and applicable local law, or (2) a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.[3]

Allocations pursuant to terms of governing instrument and local law. The Uniform Principal and Income Act (UPAIA) unequivocally recognizes the allocation

of capital gains to income if the allocation is required under the terms of the trust instrument.[4] As long as the trust instrument doesn't require that all income be distributed currently to the beneficiaries (which could potentially overfund trust distributions), this technique for characterizing capital gains as trust accounting income will, generally, be a successful strategy, at least for trusts governed by state income and principal rules similar to the UPAIA. Because the disinterested trustee won't be required to distribute the capital gains to the beneficiaries, the disinterested trustee will be able to monitor the situation to make the most prudent decisions possible, including, for example, situations in which a beneficiary: (1) is likely to be subject to federal estate tax, (2) turns out to be a spendthrift or otherwise unfit to receive the additional distributions, or (3) has special needs.

The IRS regulations effectively eliminate the second UPAIA alternative.

Allocations pursuant to impartial exercise of discretionary power. If the trust instrument requires that all income be distributed currently to the beneficiaries, it may not be a wise drafting strategy to have all capital gains automatically allocated to trust income, because to do so could result in a level of current distributions to the trust beneficiary that the grantor neither contemplated nor desired. Rather, some sort of discretionary allocation would be preferable in these situations. Fortunately, as alluded to above, the IRS permits capital gains to be characterized as part of DNI if the allocation is made "pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law."[5]

UPAIA Section 103(b) permits a discretionary allocation of capital gains to income if the allocation is made "impartially, based on what is fair and reasonable to all of the beneficiaries" or if the terms of the trust "clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries."[6] The IRS regulations effectively eliminate the second UPAIA alternative from the DNI equation by providing that the only discretionary allocations of capital gains to income that the IRS will respect for DNI purposes are ones that are reasonably and impartially made by the trustee.

Thus, for a trust that's required to distribute all of its income currently, the UPAIA, as further limited by the IRS regulations, permits no more than a "reasonable and impartial" portion of the capital gains allocated to income to be included in the trust's DNI. What's considered a "reasonable and impartial" portion will depend on individual facts and circumstances, but, generally, the trustee may not completely favor the trust income beneficiaries at the expense of the remaindermen. Requiring that the trustee adhere to this limitation in exercising his discretionary power to allocate capital gains to trust accounting income could also help avoid any potential adverse gift or other transfer tax consequences when the trustee is also the current income beneficiary of the trust.[7]

For a trust that's not required to distribute all of its income currently, on the other hand, a discretionary allocation of capital gains to trust accounting income shouldn't be viewed as partial towards any beneficiary for purposes of the UPAIA as well as the IRS regulations. The allocation should, therefore, be respected for DNI purposes, and a discretionary distribution of the capital gains in excess of the 5 percent Section 2514(e)(3) limitation should, likewise, be respected for purposes of IRC Sections 661 and 662.

Regardless of the income distribution terms of the trust, for discretionary allocations of capital gains to trust income to be effective for purposes of determining the trust's DNI, it remains essential that the applicable state law first be examined to ensure that it satisfies the IRS' above-referenced regulatory requirement that discretionary allocations of capital gains to trust accounting income be "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)."[8]

Special Needs Beneficiaries

If the beneficiary has special needs, consider granting someone other than the beneficiary (for example, a sibling) the Section 678 withdrawal power over trust income, to minimize overall income taxes. Having the special needs beneficiary possess the full withdrawal power would reduce the amount of government aid

available to the beneficiary. The "substitute" withdrawal power holder's rights would, again, naturally include the ability to withdraw any trust income necessary to pay his additional income taxes, or an independent trustee could reimburse the power holder for these amounts. The special needs beneficiary (or his legal representative) should be granted the power to suspend the withdrawal rights of the power holder, for example, in the event of abuse of the withdrawal right by the power holder or a lawsuit against the power holder.[9]

Note that this particular strategy won't work with a supplemental needs payback trust established pursuant to 42 U.S.C. Section 1396p(d)(4)(A), because these types of trusts must be for the sole benefit of the special needs beneficiary. Further, in situations in which the withdrawal power in a third party is granted, an independent trustee should be given the power to suspend the third party's Section 678 power when the tax benefits of Section 642(b)(2)(C)'s higher exemption for a trust that qualifies as a qualified disability trust outweigh the tax benefits of having the trust income taxed to the lower income tax bracket third party.

Plan Benefits Payable to Trust

If benefits under an IRA, qualified plan or nonqualified annuity are payable to the trust, consider structuring the trust as two separate shares, or "subaccounts," similar to the manner in which a typical client's brokerage account is often already divided. Share A of the trust would be for the IRA, qualified plan and/ or nonqualified annuities payable to the trust, and Share B would be for all other assets of the trust. Share A would be drafted to make it impossible for trust assets to pass to anyone older than the oldest income beneficiary of the trust, thus nullifying the effect of several recent IRS private letter rulings that effectively include all contingent takers and potential takers under a limited power of appointment (POA) as beneficiaries of the trust for required minimum distribution purposes. Share B would contain no such restrictions and include a clause allowing for a "priority distribution" to any older contingent or other beneficiary of Share A who was eliminated from the share to maximize the deferral period for the IRA, qualified plan and/or nonqualified annuity.[10]

The beneficiary could then withdraw the Share A and Share B income in the same Section 678 manner described above. Also, similar to the Section 678 approach, Share A would include an ability in an independent trustee to suspend the beneficiary's withdrawal power in appropriate cases, as well as specially designed provisions for special needs beneficiaries, and distributions in excess of the IRC Section 2514(e) limitation could be made in the discretion of an independent trustee.

Structuring the trust in this two-share fashion eliminates all of the shortcomings of the IRS-encouraged "conduit trust" approach to paying IRA and qualified plan benefits to a trust on a tax-deferred basis, because the two-share approach doesn't require outright distributions of annual IRA and qualified plan payments to the beneficiary to achieve its dual income tax minimizing and deferral objectives. The conduit trust approach undermines the purposes of the trust by effectively forcing the outright distribution of all of the IRA and qualified plan benefits to the beneficiary, over his lifetime.

Around 98 percent of married couples no longer need to concern themselves with the federal estate tax.

New Income Tax Basis at Death

The objectives here are to achieve a new income tax basis: (1) for a married couple, when the first spouse dies, and (2) when any other trust beneficiary (including a surviving spouse) dies during the term of a trust established for his benefit. The second portion of the dual objective is actually much easier to achieve than the first.

Achieving new income tax basis at a trust beneficiary's death. Achieving new income tax basis if a beneficiary (including a surviving spouse beneficiary under a traditional bypass trust) should die during the term of the trust involves granting the beneficiary a conditional testamentary general POA (typically limited to the creditors of the beneficiary's estate) over the trust assets, to the extent the same won't result in any federal or state estate or inheritance tax liability to the beneficiary's estate.[11] If an individual is a beneficiary of more than one trust, the conditional testamentary general POA is allocated among the relevant trusts, based on the fair market value of the respective trust assets at the beneficiary's death.

An exception to this automatic rule is, typically, included when the beneficiary is survived by a spouse, to preserve the full availability of the federal spousal portability election. Instead of using an automatic testamentary general POA, an independent trustee can be granted the discretionary ability to add the power, to the extent it's deemed beneficial, as well as the discretionary ability to remove it.[12] Another alternative in these situations would be to grant the beneficiary a testamentary limited POA over the trust assets, and then allow the beneficiary to intentionally violate IRC Section 2041(a)(3) (the so-called "Delaware tax trap"), to the extent it won't cause estate or inheritance taxes to be payable at the beneficiary's death.[13] Employing the latter alternative will be difficult in statutory or common law rule against perpetuities jurisdictions and may be impossible in jurisdictions that have passed special legislation aimed at preventing inadvertent violations of IRC Section 2041(a)(3).

Regardless of how the conditional testamentary general POA is included in the trust, it's important to fashion the testamentary general POA in a manner that applies to the most appreciated assets of the trust first, to wipe out the most potential capital gains tax possible in the event a testamentary general POA over the entire trust would generate estate or inheritance taxes.[14] It may also be advisable to structure the testamentary general POA so that it doesn't apply to any trust assets that have depreciated in value over their historical income tax basis.

Achieving new income tax basis for married couples. Around 98 percent of married couples no longer need to seriously concern themselves with the federal estate tax, as a result of the combination of a much larger federal estate and gift tax exemption than in years past, coupled with the availability of the new spousal portability election. In light of the recent dramatic change in the federal estate and gift taxation of married couples, we should re-examine the various previously tried techniques for these clients for achieving a "community property-like" new income tax basis for all of the couple's assets at the first spouse's death. These techniques each, historically, suffered from significant income and transfer tax uncertainties[15] and didn't generate a second level

of income tax basis step-up at the surviving spouse's death. How would such a revised plan look?

Under the most basic plan, a joint revocable trust agreement is prepared that grants each spouse the unfettered lifetime right to withdraw, without the consent of the trustee or other spouse and without the need to account for the same to the other spouse, distributions of income and principal from the entire trust for his "welfare and happiness." Because this right of withdrawal isn't limited by an ascertainable standard, doesn't require the consent of the other spouse to be exercised and doesn't leave the other spouse with any rights in the withdrawn property, full inclusion of the trust corpus in each spouse's gross estate is achieved, under a combination of IRC Sections 2036, 2038 and 2041.[16] Even if a decedent has only a lifetime general POA that can't be exercised by will, he's treated as having the power at death for Section 2041 federal estate tax inclusion purposes.[17]

The suggested income and principal withdrawal right not only causes complete gross estate inclusion for the first spouse to die for federal estate tax purposes, but also, it does so in a fashion that doesn't violate the IRC Section 1014(e) exception to the new income tax basis rule for gifts to the decedent within one year of the decedent's death. The Section 1014(e) exception is avoided because the surviving spouse never makes a completed gift to the decedent spouse under this arrangement, as demonstrated by Treasury Regulations Section 25.2511-1(h)(4):

> If A creates a joint bank account for himself and B *(or a similar type of ownership by which A can regain the entire fund without B's consent)*, there is a gift to B when B draws upon the account for his own benefit, to the extent of the amount drawn without any obligation to account for a part of the proceeds to A.[18]

Because the trust document provides that either spouse can demand the entire trust income and corpus for his own individual welfare and happiness, a right that's not limited by a fixed or ascertainable standard, each spouse can, effectively, regain his own contributed share of the trust corpus and, as a result, hasn't made a completed gift.[19] The trust document is also drafted to allow each spouse the unrestricted ability to revoke his contributions to the trust during the couple's joint lifetimes (and the entire trust after the first spouse dies), thus lending further support for the absence of a completed gift.[20]

It might be argued that only one-half of the value of the trust should be includible in the gross estate of the first spouse to die, as a "qualified joint interest" pursuant to IRC Section 2040(b); therefore, only only-half of the trust should receive a new income tax basis at the death of the first spouse to die. In cases involving joint trusts that applied the IRC of 1939, courts have so ruled.[21] Significantly, however, whereas the 1939 IRC (and the Revenue Act of 1926, which preceded it) employed the term "joint tenants," the 1954 IRC added the words, "with right of survivorship," presumably, in an effort to clarify that one of the two joint tenants can't simply take the entire joint interest as his own, thereby effectively eliminating the other joint tenant's right of survivorship.

More importantly, in the cases involving joint trusts decided under the 1939 IRC, there was no ability for one of the trust beneficiaries to receive a greater share than the other during their joint lifetime, which would have been a violation of the "unity of possession" requirement of a joint tenancy. The type of joint revocable trust agreement described above is distinguishable from the cases decided under the 1939 IRC and, as such, wouldn't constitute a qualified joint interest under Section 2040(b). The interests of the first spouse to die should, therefore, be fully includible in his gross estate, under a combination of Sections 2036, 2038 and 2041.[22]

Achieving new income tax basis with larger estates. Although I don't advocate the use of joint trusts to ensure the full utilization of each spouse's separate federal estate tax exemption amount, for larger estates, a combination "single share" and "separate share" joint revocable trust can achieve a new income tax basis to the maximum extent. Here's how the trust drafting and funding would look:

1. The revocable trust document would divide the initial trust corpus into three shares. The first share would be the joint share. The other two shares would be separate revocable shares for the husband and wife, which, for our purposes, will be labeled Share H and Share W.
2. The revocable share of the first spouse to die would essentially become a bypass trust (including spendthrift provisions) for the benefit of the surviving spouse.
3. Each revocable share would be funded with at least the minimum level of assets needed to minimize the federal estate tax exposure at the surviving

spouse's death, after factoring in the potential availability of the spousal portability election. Thus, for example, if a couple owns a combined estate of $6 million, including $2 million worth of appreciated assets, they could place the $2 million of appreciated assets in the joint share and transfer $2 million of other assets each into Shares H and W, thus minimizing their exposure to federal estate tax at the surviving spouse's death.

4. The joint share would then be funded with the most highly appreciated assets to ensure a full income tax basis step-up for all of these highly appreciated assets at the first death. Assets that have depreciated in value should, typically, not be transferred to the joint share, to preserve the deductible income tax loss in such assets. It's also generally not advisable to transfer assets to the joint share that have neither appreciated nor depreciated in value, because transferring these assets to either Share H or Share W may help insulate the same from lawsuits after the first spouse's death and may help ensure that no estate or inheritance taxes are payable at the surviving spouse's death. The income tax capital gains exclusion, which a surviving spouse may receive on the sale of his principal residence, should also be factored in when funding the joint share.

Clients should always be cautioned of the non-tax risks involved prior to using any type of joint plan.

5. For even larger estates, the couple would fund each of revocable share with at least the federal estate tax exemption amount (after factoring in adjusted taxable gifts and assets passing outside of the trust to third parties) and would fund the joint share with all or a portion of their assets that have appreciated in value. Thus, for example, a couple with a $20 million net worth (including $5 million of appreciated assets) might elect to place approximately $7.5 million worth of the non-appreciated assets in each of Share H and Share W and place the $5 million worth of appreciated assets in the joint share. In this fashion, all of the couple's appreciated assets will receive a new income tax basis at the first spouse's death, while the separate revocable share of the first spouse to die will be protected from lawsuits as against the surviving spouse and from estate taxes at the surviving spouse's death.[23]
6. The trust instrument would obviously be drafted to allow for the movement of trust assets among the three shares, to account for changes in the tax law and the size of the couple's estate, as well as for future appreciation or depreciation in the couple's assets.

Risks associated with the joint share. It must be emphasized that, because the consent of the other spouse isn't required for either spouse to withdraw the entire trust corpus of the joint share with impunity, for non-tax reasons, the joint trust strategy may not be appropriate or advisable in many instances, including recent second marriages or other situations in which the couple isn't comfortable with granting each spouse a basically unrestricted unilateral power of withdrawal over the trust corpus.

Also, transferring tenancy by the entirety property to the joint share, generally, will terminate the asset protection characteristic of that property[24] because the requisite "unity of possession" of the tenancy will have been destroyed. Achieving a new income tax basis while preserving tenancy by entirety asset protection may be possible under a statute similar to the recently enacted Missouri Qualified Spousal Trust (MQST)[25] statute, which specifically allows married couples to preserve tenancy by the entirety protection when they transfer the property in trust. The question is whether non-resident married couples owning tenancy by the entirety property may use a Missouri-type trust to achieve a new income tax basis at the first spouse's death, while still preserving their tenancy by the entirety asset protection during their joint lifetime.

Missouri law provides that the meaning and effect of the terms of a trust may be governed by its law provided: (1) the trust terms provide for the same, and (2) the designation isn't contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue.[26] A recent federal bankruptcy case illustrates that one shouldn't count on a strong public policy argument turning in favor of the debtor, unless the preponderance of the contacts are located in the governing law state. Because the non-resident married couple would only be transferring previously protected tenancy by the entirety property to the MQST, however, there's actually a good chance that the court of the forum

state may not view Missouri's law as contrary to its state's strong public policy; therefore, it may uphold the protections afforded by the Missouri law.

Note also that it would be a relatively easy matter in any state that recognizes a tenancy by the entirety in personal property to structure an agreement between a married couple that grants each spouse a unilateral and unrestricted power to freely withdraw assets from a joint brokerage account, thus achieving a full income tax basis step-up at the first spouse's death. The requisite unity of possession of the joint brokerage account would then be destroyed, however, and as a consequence, so too would the tenancy by entirety creditor protection of the account. For a similar reason, half of the joint account, even a joint account that doesn't qualify as a tenancy by the entirety, may actually be subject to probate at the first spouse's death because without the requisite unity of possession, a tenancy in common is, typically, created.

Clients should always be cautioned of the non-tax risks involved prior to using any type of joint plan designed to achieve a new income tax basis at the first spouse's death. Estate-planning advisors should also be mindful of any state estate or inheritance tax laws that may, for example, provide exemptions which are smaller than the current federal estate tax exemption amount, and adjust the MIT Trust plan accordingly.

Existing Irrevocable Trusts

Many clients are beneficiaries of existing irrevocable trusts that, typically, won't include any of the above-described MIT Trust provisions. In these situations, if the governing law of the trust is that of a state that has passed so-called "decanting trust" legislation,[27] it may be possible, depending on how the trust and the state's particular decanting trust statute each read, to prepare a new irrevocable trust that will include one or more of the MIT Trust provisions, and then transfer the assets from the existing irrevocable trust to the "decanting trust." Although a complete discussion of state decanting trust legislation is beyond the scope of this article, in states that impose a fiduciary duty on the trustee previous to transferring assets to a decanting trust, ample benefit to all of the beneficiaries of the trust, both current beneficiaries and remaindermen, should be easy to demonstrate. The larger problem will be ensuring that the particular trust document and decanting trust statute permit the contemplated transfer.[28]

Another potential route for achieving MIT Trust income tax benefits for an existing irrevocable trust may arise if the existing trust instrument includes a so-called "trust protector" clause. Depending on how the particular clause is crafted, it may include within its scope permissible amendments to the trust to achieve income tax advantages for the trust and its beneficiaries. Some states may also have "trust modification" statutes that permit revisions to irrevocable trust documents under specified circumstances, with or without court approval, including revisions to achieve tax advantages.

An estate-planning attorney must also be mindful of all the potential transfer tax issues that may attend transferring trust assets to a decanting trust,[29] exercising a trust protector power, or otherwise participating in a modification of an irrevocable trust. These potential transfer tax issues include generation-skipping transfer tax issues involving grandfathered and other currently exempt trusts, as well as other estate and gift tax questions. In most situations, it should be possible to navigate these potential transfer tax issues, however, through careful analysis and planning.

If the existing irrevocable trust happens to include a testamentary limited POA in the beneficiary, a final tool the beneficiary may have to at least achieve a new income tax basis for his heirs in the trust's most appreciated assets at his death, is to follow the plan already outlined above of intentionally violating Section 2041(a)(3), at least to the extent of the most appreciated assets of the trust, but without causing estate or inheritance taxes to be payable at the beneficiary's death.[30] For this planning technique to succeed, however, it must first be determined that the strategy isn't already foreclosed by the provisions of the applicable trust document or by applicable state law.

Role of Estate Planner

For reasons that aren't always completely self-evident, Congress and the IRS have chosen to impose significant income taxes on our clients' estate plans, the same level of which doesn't typically exist outside of the estate-planning arena. It's incumbent on the estate planner to: (1) address this unfairness with the client; (2) assist the client in determining which, if any, of the above-described MIT Trust drafting techniques are appropriate in the client's particular situation; and (3) carefully implement the plan that the client ultimately selects.

Endnotes

1. *See also* James G. Blase, "Recent Tax Acts Require Focus on Income Tax Aspects of Estate Planning," 30 *ETPL* 617 (December 2003); James G. Blase, "Drafting Tips That Minimize the Income Tax on Trusts—Part 1," 40 *ETPL* 28 (July 2013).
2. Treasury Regulations Section 1.671-3.
3. Treas. Regs. Section 1.643(a)-3(b), 1.643(b)-1. *See also* James G. Blase, "Drafting Tips That Minimize the Income Tax on Trusts—Part 2," 40 *ETPL* 22 (August 2013) (Drafting Tips—Part 2). The regulations also include two additional situations in which capital gains allocated to the principal of the trust may be included in the trust's distributable net income, if permissible under local law, or the trust instrument, if not prohibited by local law, but these alternatives tend to be difficult to work with and somewhat inflexible: "(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." Treas. Regs. Section 1.643(a)-3(b)(2), (3).
4. Uniform Principal and Income Act (UPAIA) Section 103(a)(1).
5. Treas. Regs. Sections 1.643(a)-3(b), 1.643(b)-1.
6. UPAIA Section 103(b).
7. The alternative would be only to authorize a disinterested trustee or co-trustee to allocate capital gains to trust accounting income when the trust instrument requires that all or a portion of the trust's income be distributed currently.
8. Treas. Regs. Section 1.643(a)-3(b).
9. The ability of the special needs beneficiary to permit or suspend the power holder's rights shouldn't present any adverse gift tax consequences because, by definition, a special needs beneficiary has no legal rights in the trust.
10. Treas. Regs. Section 20.2041-1(b)(3) provides that a beneficiary may possess a general power of appointment (POA) over only a part of the trust assets.
11. The independent trustee's removal of the POA shouldn't be considered a taxable "lapse" of the power under Internal Revenue Code Section 2041(b)(2) because the beneficiary wouldn't have possessed an exercisable POA immediately prior to the removal.
12. Treas. Regs. Section 20.2041-3(e)(2) includes an example that clarifies that a partial violation of IRC Section 2041(a)(3) is possible.
13. *See also* James G. Blase and Mimi G. Sharamitaro, "Consider the MAT," *Trusts & Estates* (February 2010), at p. 38; Drafting Tips—Part 2, *supra* note 3.
14. *See also* Drafting Tips—Part 2, *supra* note 3.
15. These uncertainties include those related to loss of income tax basis step-up at the death of the first spouse to die, pursuant to the Internal Revenue Service's application of IRC Section 1014(e); an, at best, questionable gift tax marital deduction at the death of the first spouse to die, by the surviving spouse; and potential estate tax inclusion for the bypass trust established for the benefit of the surviving spouse at the death of the first spouse to die.
16. Note that this requisite unrestricted nature of each spouse's unilateral power of withdrawal may not be appropriate for or acceptable to all married couples, and clients should, therefore, be cautioned of the obvious risks involved prior to funding the joint trust.
17. *See, e.g., Snyder v. United States*, 203 F. Supp. 195 (W.D. Ky. 1962); *Jenkins v. U.S.,* 428 F.2d 538 (5th Cir. 1970). *See also* Private Letter Ruling 200210051 (Dec. 10, 2001).
18. Emphasis added. *See also* Treas. Regs. Section 25.2511-2(b), (c). This position is supported in PLR 200210051 (Dec. 10, 2001). Under the facts of that particular PLR, however, there was a completed gift by the surviving spouse at the death of the first spouse to die because, at that point, the surviving spouse no longer retained the power to revest the beneficial title to the property in himself. The type of joint revocable trust contemplated in this article is, thus, distinguishable from the one described in the PLR.
19. Treas. Regs. Section 25.2511-2(g).
20. Compare PLR 200210051 (Dec. 10, 2001), in which, on similar facts, the IRS agreed there was no gift by either spouse during their joint lifetime, but there was a gift at the death of the first spouse to die because (unlike the joint trust arrangement contemplated by this article), at that point, the surviving spouse's ability to revoke the surviving spouse's portion of the trust terminated. For some reason (probably because it wasn't material to the outcome of the ruling), the IRS didn't attempt to argue the applicability of IRC Section 2514(e) when the surviving spouse's lifetime general POA over the first spouse to die's share of the joint trust lapsed at the first spouse to die's death.
21. *See, e.g., Derby v. Commissioner*, 20 T.C. 164 (1953); *Hornor's Estate v. Comm'r,* 130 F.2d 649 (3d Cir. 1942).
22. The trust interest would also not be includible under the general IRC Section 2040(a) because it doesn't amount to a deposit "with any person carrying on the banking business, in their joint names and payable to either or the survivor." *See also* PLRs 200101021 (Oct. 2, 2000) and 200210051 (Dec. 10, 2001), in which, on similar facts, the IRS made no effort to argue IRC Section 2040 applied. The IRS also didn't attempt to argue that IRC Section 2041 was inapplicable because the consent of the other spouse was required to exercise the general POA, the fact that either spouse could revoke the trust apparently not being relevant to the IRS..
23. Note, however, that for non-tax reasons, maximum funding of the joint share may not always be appropriate or advisable. Note also that the Share H or Share W of the first spouse in this fact pattern would break into separate bypass trust and qualified terminable interest property trust shares after the first spouse's to die's death.
24. This is because the requisite unity of possession would no longer exist.
25. RSMo Section 456.950.
26. RSMo Section 456.1-107(1).
27. *See, e.g.,* RSMo Section 456.4-419. For a discussion of whether a trustee located in a state that doesn't boast a decanting statute may successfully move the trust to another state that does, *see* Rashad Wareh and Eric Dorsch, "Decanting: A Statutory Cornucopia," *Trusts & Estates* (March 2012), at p. 22.
28. Note also that in some states where decanting trust legislation hasn't been passed, decanting trust-type transfers may, nevertheless, still be permitted, pursuant to the common law of the particular state.
29. *See* IRS Notice 2011-101, 2011-2 C.B. 932 (Dec. 27, 2011).
30. Treas. Regs. Section 20.2041-3(e)(2) includes an example that makes it clear that a partial violation of IRC Section 2041(a)(3) is possible.