Tax Management

Estates, Gifts and Trusts Journal

BNA TAX Management
America's Tax Authority

The Case for the Continued Viability of Trusts in Estate Planning

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BACKGROUND

Over the course of the past two Congresses, estate planners and their clients have been forced to endure excruciating delays and endless inaction as ultimately: (a) no action was taken with respect to the one-year repeal of the federal estate tax for 2010;[2] (b) a temporary two-year lowering of the maximum federal estate and gift tax to 35% (or half of what it was 30 years earlier) and raising of the federal estate, gift, and generation-skipping transfer tax exemption to $5 million (including inflation adjustments) was enacted late in 2010, which temporary law also added the so-called "spousal portability election";[3] and (c) beyond the stroke of midnight in 2012, "permanent" estate tax compromise legislation was passed that retained the spousal portability election and the $5 million estate, gift, and generation-skipping transfer tax exemption, but raised the maximum federal estate and gift tax rate (and therefore generation-skipping transfer tax rate) to 40%.[4]

While beneficial estate and gift tax legislation at the federal level has been the general norm over the course of the last dozen years, the federal income tax treatment of trusts has headed in the opposite direction. The IRS issued its final regulations relative to qualified plan and IRA benefits payable to trusts in early 2002, and released several private letter rulings thereafter that appear to make it much more difficult for clients to protect the plan and IRA benefits for their heirs. Effective this year, most trusts now have to deal with an additional 4.6% increase in the maximum federal income tax rate, the addition of a 3.8% "net investment income tax,"[5] and an increase in the maximum federal income tax rate on qualified dividends and capital gains from 15% to 20%, all at levels of trust income as low as $12,000[6] — while individuals face each of these new taxes only at much higher levels of income.

What do all of these changes in the direction of the federal estate and income tax laws mean as they relate to the continued viability of trusts in estate planning?

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[2] *See* Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16.

[3] *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312.

[4] *See* American Taxpayer Relief Act of 2012, P.L. 112-240.

[5] *See* §1411.

[6] For tax years beginning in 2013, a trust's income over $11,950 is subject to the maximum §1(e) rate of tax. Rev. Proc. 2013-15, 2013-5 I.R.B. 444, §2.01. *See also* §§1(h), 1411(a)(2).

IMPACT OF THE HIGHER ESTATE, GIFT, AND GST EXEMPTION

The (literally) 3,000% increase in the size of the federal estate tax exemption since 1981 obviously means that the vast majority of individuals are no longer subject to the federal estate tax. As a consequence, how should we be preparing our estate planning documents for most clients today? Is it simply a matter of eliminating the ''old-fashioned'' bypass trust concept for most married clients? What about trusts for children and other descendants, including generation-skipping transfer tax-exempt trusts (sometimes referred to as ''dynasty trusts'')? Should we be eliminating these trusts too, precisely at the time when most jurisdictions have extended their ''useful life,'' i.e., by eliminating or substantially modifying the rule against perpetuities?

Trusts, of course, maintain their utility in numerous situations that have nothing to do with the federal estate tax. There are, for example, state inheritance and estate taxes to think about. More importantly, trusts provide protection: (1) for young and/or spendthrift beneficiaries; (2) as against future potential lawsuits involving the beneficiary; (3) from the rights of an ex-spouse of the beneficiary; (4) in second marriage situations where a client wishes to provide for his or her spouse but have the remaining trust assets eventually pass to his or her children; and, most obviously (5) in special needs situations. Holding assets in trust could also make a difference in the event a future Congress and President should decide to lower the effective estate tax exemption amount and/or the clients' net worth should substantially appreciate, including as a result of an inheritance.

Therefore, unless none of the above issues is of concern to the clients, on the surface, trusts remain a desirable tool in estate planning, notwithstanding their potential federal estate tax saving benefits.

COUNTERVAILING FACTOR: THE FEDERAL INCOME TAX TREATMENT OF TRUSTS

The dilemma that rapidly presents itself, however, is that although the federal estate tax exemption has risen over the last three decades to a level where very few individuals are subject to the federal estate tax, as described above, federal income tax rates on trusts have headed in the opposite direction, to a point where, at first blush, one wonders why anyone would want to even use a trust any longer. Moreover, as a result of the new higher GST exemption level, most trusts will not be includible in the beneficiary's gross estate for federal estate tax purposes and, therefore, the recipients of the trust property at the beneficiary's death will receive a carryover income tax basis, thus further reducing the overall benefits to be achieved through using trusts in estate planning.

As already summarized above, at trust income levels of as low as $12,000, we now have a maximum ''regular'' federal trust income tax rate of 39.6%, plus a new 3.8% tax on net investment income. Team this with state trust income tax rates of 6% or more (up to 13.3% for trusts subject to California fiduciary income tax, or over 12% for combined New York City and state fiduciary income tax), and the combined income tax rate on trust income in excess of $12,000 can exceed 50%. Add to this the fact that trusts with income of as low as $12,000 are now subject to a 20% tax rate on qualified dividends and capital gains, and the income tax problems associated with trusts become apparent.

Three decades ago trusts were still taxed like individuals, so as a result there was no particular tax benefit to be derived from having the trustee automatically distribute all of the income to the trust beneficiary, and in the course minimizing the ''beneficiary protection'' reasons the trust was established in the first instance. Also, with a federal estate tax exemption of only $175,625 and a maximum federal estate tax rate of 70%, thoughts of achieving a new income tax basis at the beneficiary's death were the last thing on the estate planner's mind.

But with very few individuals still subject to the federal estate tax, and with only the top 1% or 2% of individuals in the new maximum federal income tax bracket for individuals, the temptation now is to: (a) automatically distribute all trust income to the trust beneficiary; and/or (b) eliminate the trust altogether, in order to minimize current income taxes and achieve a new income tax basis at the individual beneficiary's death. In other words, the urge is to minimize the trust's role in estate planning through these distribution and termination techniques, notwithstanding all of the above-described non-tax benefits trusts have to offer.

The situation is even more dire when it comes to estate planning for qualified plans benefits and IRAs (''plan benefits'') payable to trusts. Through its regulations[7] and private letter ruling[8] positions, the IRS appears to have essentially forced planners to advise either eliminating trusts altogether, as a recipient of plan benefits, or resort to using a so-called ''conduit trust,'' the latter of which is actually only one step removed from not utilizing a trust at all, because it mandates that each required minimum distribution payment to the trust be immediately distributed, outright, to the trust beneficiary.

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[7] Regs. §1.401(a)(9)-5, Q&A-7, *Ex. 2*.

[8] *See* PLRs 201021038, 200843042, 200610026.

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If a conduit trust is not utilized, the IRS's private ruling position is that all potential beneficiaries of the trust, including contingent takers (often older heirs-at-law and/or charity) as well as permissible appointees under a lifetime or testamentary power of appointment (including, potentially, a surviving spouse or charity), must be considered for purposes of determining the oldest beneficiary of the trust and, therefore, the trust's ''designated beneficiary''[9] and the maximum required minimum distribution payout period.

THE TRUST VIABILITY ISSUE

So herein lies the dilemma: As estate planning attorneys, we know the important roles trusts play in estate planning, as already outlined above. Their primary role is protection. They protect assets from estate taxes, divorce rights, and creditors. They protect assets for the trust remainder beneficiaries in second marriage situations, and they protect assets for young and spendthrift beneficiaries. And they definitely play a major protection role in special needs situations. But with Congress and the IRS now basically forcing estate planning attorneys to prepare trust documents that require the mandatory distribution of trust income (including capital gains) and all plan benefits payable to trusts, and with the prospect of carryover income tax basis facing the trust remainder beneficiaries if the trust is not terminated during a beneficiary's lifetime, how should estate planning attorneys be advising their clients with respect to the continued role of trusts in estate planning?

Phrased another way, do estate planning clients now need to settle for trust documents that are drafted in a manner that only partially accomplishes their ultimate goals? Or do the existing federal tax laws allow clients to still ''have their cake, and eat it too?''

The answer to the latter question is yes, provided an approach to trust drafting similar to one that incorporates each of the following three steps, is utilized.

Step 1: Avoiding the High Federal Income Tax Rates on Trusts Without Distributing All of the Trust Income to the Beneficiary

This step involves utilizing §678 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. Section 678(a) provides:[10]

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

If desired, the drafter can even limit the beneficiary's withdrawal power to the types of trust income that are taxed at the highest federal income tax rates, i.e., exclude qualified dividends and capital gains taxed at favorable income tax rates. The balance of the trust taxable income items filling out the lower brackets of the trust can also be excluded, as of course would items of federally tax-exempt income. The so-called ''portion rules'' under §671 and the related regulations[11] are what allow for this tax treatment.

Of course, the withdrawal power holder would possess the ability to withdraw any income necessary to pay his or her additional income taxes resulting from the §678 power, or an independent trustee could reimburse the power holder for this amount. Care should be taken to ensure that no provision of the trust document will infringe upon the power holder's ''sole power to vest'' the trust income (including, if desired, capital gains) in himself or herself.

Caution also needs to be the rule before granting the beneficiary a power of withdrawal over income that exceeds 5% of the value of the trust, annually, and it should be made clear that the trustee can satisfy the beneficiary's withdrawal demands by liquidating any asset of the trust, including assets payable to the trust over time, e.g., plan benefits and nonqualified annuities. Section 2514(e) provides:

> The 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 taxable gift]. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the

[9] *See* Blase & Sharamitaro, ''Consider the MAT,'' 149 *Tr. & Est.* 38 (Feb. 2010).

[10] *See also* Blase, ''Recent Tax Acts Require Focus on Income Tax Aspects of Estate Planning,'' 30 *Estate Planning* (*ETPL*) 617 (Dec. 2003); Blase, ''Drafting Tips That Minimize the Income Tax on Trusts — Part 1,'' 40 *ETPL* __ (July 2013).

[11] Regs. §1.671-3.

ISSN 0886-3547

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.

If distributions in excess of 5% of the trust value are deemed desirable in any given year (e.g., because the trust has a significant amount of capital gains or plan receipts), an independent trustee can be given the authority to make such distributions to the beneficiary. Unlike types of highly-taxed income that may be best subject to withdrawal powers under §678, however, it is important that any capital gains first be properly allocated to the distributable net income of the trust; otherwise they will not ''carry out'' to the beneficiary. The alternative procedures for accomplishing this goal are described in the regulations.[12]

A trustee not having a beneficial interest in the trust should be given the power to suspend the beneficiary's withdrawal powers, either in the event of abuse by the beneficiary or in the event the beneficiary is involved in a creditor or divorce predicament. If the beneficiary is in a special needs situation, consideration should be given to having someone other than the beneficiary (e.g., a sibling or siblings) possess all or a portion of the §678 withdrawal power, in order to minimize overall income taxes, and because obviously having the beneficiary possess the full withdrawal power would reduce the amount of government aid available to the beneficiary. Again, the ''substitute'' withdrawal power holder would be granted the ability to withdraw any trust income necessary to pay his or her additional income taxes, or an independent trustee could reimburse the power holder, and the special needs beneficiary (or his or her legal representative) should be granted the power to suspend the rights of the power holder, in the event of abuse, etc.[13]

Step 2: Avoiding the Use of Conduit Trusts Without Accelerating Post-Death Benefit Payments

This step involves structuring the trust as two separate shares or ''sub-accounts,'' similar to the manner in which a typical brokerage account is divided, with one or more ''IRA'' sub-account(s) and one or more joint or individual sub-accounts. Share A of the trust would be for the plan benefits payable to the trust, and Share B would be for all other assets of the trust. Share A would be drafted in a manner that would make it impossible for trust assets to pass to anyone older than the oldest income beneficiary of the trust. Share B would contain no such restrictions, and would include a clause allowing for a ''priority distribution'' to any older contingent or other beneficiary of Share A who was eliminated from the Share in order to maximize the benefit deferral period.[14]

The Share A and Share B income would then be withdrawable by the beneficiary in the same §678 manner described above. Also, similar to the §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 need beneficiaries. Distributions in excess of the §2514(e) limitation could be made in the discretion of an independent trustee.

This ''modified accumulation trust'' approach to drafting eliminates all of the aspects of the conduit trust approach that undermine the ''beneficiary protection'' elements of the trust by making outright distributions of benefit payments to the trust mandatory.

Step 3: Minimizing Carryover Income Tax Basis Treatment Without Terminating the Trust

This final step involves granting the beneficiary a conditional testamentary general power of appointment (normally limited to the creditors of the beneficiary's estate) over the trust assets to the extent it will not result in any federal or state estate or inheritance tax liability to the beneficiary's estate. An exception to this automatic rule is typically included when the beneficiary is survived by a surviving spouse, in order to preserve the full availability of the spousal portability election. Instead of utilizing an automatic testamentary general power of appointment in a situation where there is a surviving spouse, an independent trustee can be granted the discretionary ability to add the power to the extent it is deemed beneficial, as well as the power to revoke the same.

The testamentary general power of appointment can be fashioned in a manner that applies to the most appreciated assets of the trust first, in order to wipe out the most potential capital gain tax possible. Re-

[12] Regs. §1.643(b)-1.

[13] The ability of the special needs beneficiary to permit or suspend the power holder's rights should not present any adverse gift tax consequences, because by definition a special needs beneficiary has not legal rights in the trust.

[14] *See also* Blase & Sharamitaro, ''Consider the MAT,'' 149 *Tr. & Est.* 38 (Feb. 2010); Blase, ''Drafting Tips That Minimize the Income Tax on Trusts — Part 2,'' 40 *ETPL* __ (Aug. 2013).

ISSN 0886-3547

gardless of any special features employed, the general power of appointment must be carefully limited in situations where more than one of such conditional testamentary general powers in the beneficiary is possible, in order to avoid unintended federal or state estate or inheritance taxes.[15]

EXAMPLE

Dr. and Mrs. A are each age 65. They have a 40-year-old son, who is also a doctor, and a 35-year-old daughter who lives in Hawaii with her second husband. They also have a 20-year-old adopted son, who, in their words, is ''struggling.'' Their goal for their 20-year-old son is that he graduate from college, and make something of himself. Their largest asset is the husband's IRA, which they would like to pay to trusts for their three children when they are both gone. Their combined estate, while significant, is substantially less than two times the federal estate tax exemption amount.

In this situation, trusts for the surviving spouse and for the couple's three children are warranted, for similar and dissimilar reasons. Concerns regarding the physician son relate to protection from malpractice suits and estate taxes, and potentially also divorce, while concerns for the daughter in Hawaii relate to divorce protection and possibly also estate taxes and lawsuits. The clients are primarily concerned that their 20-year-old adopted son will utilize his inheritance prudently, and graduate from college.

The above-described steps to trust drafting will help achieve each of the clients' goals, but without penalizing the family in the process with excessive income taxes related to the trust income. A ''by-pass'' trust will continue to be established for the surviving spouse, in order to insulate the trust assets from estate taxes at the surviving spouse's death, and to protect the trust assets from lawsuits and from a new spouse in the event of remarriage. The bypass trust will also be designed to achieve as much income tax basis step up as possible for the children, at the surviving spouse's death.

All three children will be able to defer the IRA receipts over the life expectancy of the physician son (say 40 years), and all of the trust assets will be protected from lawsuits, divorce, and estate taxes at their deaths. All or most of the trust income will be taxed no higher than at the income tax rates of the children, including the 20-year-old son, who presumably has no other significant sources of taxable income. The independent trustee will be able to suspend the 20-year-old son's withdrawal rights, in the event of immature and unwise use, and the physician son's withdrawal rights may be suspended in the event of a malpractice lawsuit. Any child's withdrawal rights can be suspended in the event of a divorce. The maximum possible income tax basis step up will be achieved as each child dies, but without unnecessarily exposing the trust assets to estate taxes, misuse, lawsuits, and divorce rights, in the process.

CONCLUSION

Although Congress and the IRS appear to be doing everything in their power to undermine the use of trusts in estate planning, it is still possible, utilizing existing Internal Revenue Code sections and IRS regulations, to achieve all of the clients' non-income tax related goals without costing the family unnecessary income taxes.

[15] *See also* Blase, ''Drafting Tips That Minimize the Income Tax on Trusts — Part 2,'' 40 *ETPL* __ (Aug. 2013).

ISSN 0886-3547