TAX NEWS & COMMENT

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IRS MATTERS

2011 REGS., RULINGS & PRONOUNCEMENTS OF NOTE

2012 RECENT DEVELOPMENTS

A. Recent IRS Developments

Field audits of taxpayers with incomes exceeding $200,000 rose 34 percent in fiscal 2011 to 78,392. IRS Deputy Commissioner Steve Miller stated that "[w]e are looking more at taxpayers at these income levels because we find more issues there."

Much of the audit increase is attributable to IRS efforts to pursue revenue from undeclared offshore accounts. Audits of Sub S corporations also rose by 13 percent in 2011. In 2011, the IRS recommended 1,622 criminal prosecutions, up 7 percent from 2010. The conviction rate was 93 percent, and the average sentence

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FROM THE COURTS

2011 GIFT & ESTATE TAX DECISIONS OF NOTE

A. Issues Arising Under IRC §2036

An important objective in estate tax planning is to transfer of assets out of one's taxable estate, while retaining a degree of beneficial enjoyment over the transferred property. Where the IRS believes too much beneficial enjoyment had been retained, it may invoke IRC §2036 in an attempt to pull the assets back into the decedent's taxable estate.

In *Estate of Riese*, T.C. Memo 2011-60, the decedent continued to live in a residence that had been transferred to a QPRT following the trust term. The Tax Court found that even though no rent was paid by the

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FROM WASHINGTON

TAX OUTLOOK FOR 2012 AS BUSH ERA TAX CUTS SET TO EXPIRE

DIFFERING TAX VISIONS OF PRESIDENT OBAMA AND GOVERNOR ROMNEY

Tax Editorial

Much has been made of the recent revelation that Governor Romney enjoyed a 14 percent tax rate on "carried interest," which Congress permits to be reported as capital gain. Investors such as Mr. Romney pay a lower rate of tax because of the favorable capital gains tax rate. Any taxpayer with income over $34,500 per year is by definition taxed at a higher rate than a person the majority of whose income derives from capital gains. Right or wrong, the favorable rate for long term capital gains has long been a part of the

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Medicaid and Supplemental Needs Trusts

Estate Planning

I. Medicare

Medicare is a federal insurance program which provides health insurance to persons aged 65 or over, and to persons under 65 who are permanently disabled. Medicare was signed into law by President Johnson in 1965 as part of the Social Security Act. Medicare is entirely funded by the federal government.

Medicare pays for 80 percent of medical cost; the remaining "Medicare Supplement" must be cov-

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Modifying or "Decanting" Irrevocable Trusts

I. Introduction

Decanting is useful for many reasons, one being where existing trust provisions do not reflect the present circumstances of beneficiaries. If a trust is revocable, the grantor may revoke or amend the trust. However, trusts are often made irrevocable for tax or other reasons. Revoking or modifying irrevocable trusts while not impossible may be extremely difficult, especially if minor beneficiaries are involved.

Before decanting statutes proliferated, modification of trusts could

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FEBRUARY COMMENT

"Portability" of Spousal Exclusion Useful But No Substitute for Planning

Tax Planning

I. Introduction

As part of the 2010 Tax Act, Congress enacted a statute allowing a surviving spouse to utilize the unused portion of the predeceasing spouse's lifetime estate tax exemption. This option offers protection to spouses who have not engaged in any estate planning. However, persons with estates large enough to benefit from the provision would be remiss in relying solely on the efficacy of portability as the cornerstone of their prudent estate plan.

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tax law.

Perhaps the outcry may be partially attributable to President Obama, who makes no secret of, and clearly bridles at, the "inequity" of wealthy taxpayers paying a lower rate of tax rate in part because of the lower capital gains tax rate. However, it would be somewhat unfair to blame any such inequity solely on the Republicans. The recent history of the capital gains tax demonstrates that Democrats and Republicans alike have long favored a lower capital gains rate. President Clinton, hardly a Reagan conservative, himself supported a reduction in that tax rate during his presidency. Ironically, President Reagan himself signed a bill that increased in the capital gains tax rate during his first term.

In 1986, President Reagan forged a compromise with a Democratic Congress that raised the capital gains rate and lowered the tax rate on earned income so that both were taxed at the same rate. From 1988 through 1990, that rate was between 28 and 33 percent. During the term of President George H. Bush, the maximum rate of tax on ordinary income rose, while that of capital gains remained at 28 percent.

During the first term of President Clinton, the capital gains rate remained at 28 percent. However, during his second term, Mr. Clinton signed a Republican bill that cut the capital gains tax rate to 20 percent. Former Fed Chairman Alan Greenspan, testified before Congress at the time and said "the major impact" of capital gains tax is to "impede entrepreneurial activity and capital formation" and that "[t]he appropriate capital gains tax rate is zero." Congressional Republicans, including Speaker Newt Gingrich agreed, stating at the time that "[i]f you really wanted the most wealth created over the next 20 years, you would have a zero rate for capital gains tax."

The capital gains tax rate declined to 15 percent during the first term of President George W. Bush in 2003. The favorable rates for capital gains and ordinary income was to sunset on December 31, 2010. However, Congress and President Obama agreed to extend the Bush tax cuts until December 31, 2012.

If Congress does nothing in 2012, the favorable capital gains rates will expire on December 31, and the long term capital gains rate will revert to 20 percent. A new 3.8 percent Medicare tax on households earning more than $250,000 also goes into effect in 2013. This tax will apply to passive income from dividends, capital gains, interest and other unearned income sources. Thus, for higher income households, the long term capital gains rate will approach 25 percent in 2013. The highest income tax rate for ordinary (nonpassive) income will also rebound to 39.6 percent if the Bush tax cuts are permitted to expire on December 31, 2012.

* * *

If President Obama is reelected in November, and history is a guide, the House will remain Republican. No further action would be required by Mr. Obama to effectuate an increase in income tax rates and capital gains rates to the highest level they have been in twenty years. An increase in the capital gains rate past 25

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percent or in the ordinary income rate past 39.6 percent appears unlikely since President Obama does not seem to want that and, in any event, a Republican House would not pass such legislation.

Actually, it appears just as likely that President Obama might approve another extension of the Bush tax cuts to stimulate the economy, and to attract voters in Florida, the Midwest, and other swing States. Although Mr. Obama spoke frequently during his earlier campaign of imposing additional income tax on those earning more than $250,000, less has been said on that subject of late, perhaps because Mr. Obama, if reelected, will have the opportunity to get that wish by permitting the Bush tax cuts to expire.

Mr. Gingrich and some Republicans favor eliminating the capital gains tax entirely, as well as the tax on dividends and interest. During a heated exchange in the recent Republican debates, Mr. Romney asked Mr. Gingrich what rate of tax he would impose on capital gains. When Mr. Gingrich responded "zero," Mr. Romney replied, "then I would have paid no tax."

Mr. Romney favors making the Bush tax cuts permanent. He also favors reducing the corporate tax rate, which is among the highest in the world, to 25 percent, and eliminating capital gains tax on taxpayers whose income is less than $200,000. Though Mr. Romney is clearly more moderate than Mr. Gingrich, important philosophical differences exist between Mr. Romney and Mr. Obama in how the federal tax system should operate.

With respect to the estate tax, President Obama favors retaining it, presumably at its current levels. Mr. Romney favors eliminating the estate tax. However, even though Mr. Romney supports repeal, it is far from certain that he would actively push for repeal since the revenues generated by gift and estate taxes may be too significant to forego: The Congressional Budget office estimates that estate and gift taxes will generate $197 billion of revenue from 2011 through 2015, which is equal to 11.6 percent of the expected revenue from corporate income tax during the same period.

One striking difference between the position of President Obama and Mr. Romney appears to center around the taxation of investment income of wealthy individuals. While Mr. Romney, himself a beneficiary of a lower tax rate on carried interest, might not object to eliminating the current rule that allows carried interest to be reported as capital gain, he certainly does not favor increasing the capital gains tax.

Mr. Obama has not expressed a interest in increasing the capital gains tax rate past 25 percent, or the ordinary income tax rate past 39.6 percent, which is where they will be if the Bush tax cuts expire. However, Mr. Obama appears resolute in his determination to prevent wealthy persons with large amounts of investment income from being taxed at lower effective rates than most taxpayers. Without raising the capital gains rate, this objective could only be achieved by imposing a new tax on the affluent.

The Obama administration recently advanced a proposal whereby the alternative minimum tax would apply only to those with adjudged gross income exceeding $1 million. Those taxpayers would first calculate their income tax based upon the current tax rules. If their effective rate were less than 30 percent, an additional tax equal to the difference between 30 percent and the calculated tax would be payable. If their effective rate were higher than 30 percent, the taxpayer would pay the higher rate.

Mr. Obama also favors reducing or eliminating the mortgage interest deduction and the child tax credit for the top 2 percent of earners. The deduction for charitable gifts would remain unchanged.

Both Mr. Obama and Mr. Romney have stated a desire to simplify the tax law. Mr. Obama speaks of eliminating loopholes that favor wealthy corporations and individuals. Eliminating inappropriate tax expenditures (loopholes) is of course a worthwhile objective. The complexity of the Internal Revenue Code is arguably necessary to ensure that tax policy is carried out effectively. While the observation that only a tax lawyer or accountant can comprehend the Internal Revenue Code may be true, it does not necessarily follow that making the Code more simple to understand would further sound federal tax policy.

* * *

With the lifetime exemption now $5 million, or $10 million for a married couple, lifetime gifts may be an important part of estate planning in 2012. The Generation Skipping Tax (GST) exemption parallels the gift and estate tax exemption in 2012. Therefore, the $5 million GST exemption can be applied to gifts made in trusts to "skip" persons.

Use of the $5 million gift tax exclusion can be leveraged in a variety of ways, including (i) making installment sales to grantor trusts; (ii) GRATs and QPRTS; or (iii) fractionalizing family entities. Careful planning is necessary in order to ensure that discounts taken for family entities will not backfire, as the IRS has taken an aggressive stance toward these discounts in recent years. The IRS has enjoyed considerable success in challenging discounts where the taxpayer has retained too much control over the assets gifted to the entity.

The transferee of a lifetime gift takes a carryover basis in the assets, while the beneficiary of an estate takes a stepped up basis. This means that the sale by the donee of a gift will generate capital gains tax, while the sale by a beneficiary of an estate will generate estate tax to the estate. When estate tax rates were 45 percent and capital gains rates were 15 percent, this disparity tended to favor the gifting of assets likely to be sold compared to estate inclusion. However, with gift and estate tax rates now 35 percent, and capital gains rates scheduled to increase to 20 percent at the end of 2012, the attraction of making lifetime gifts to avoid estate tax has declined.

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Nevertheless, a countervailing factor favors lifetime gifts in New York: Such gifts will reduce the size of the estate for New York state estate tax purposes without triggering a gift tax, because New York has no gift tax. For federal transfer tax purposes, the gift will have no effect, since the gift and estate tax regime has been reunified — the $5 million exclusion applies first to lifetime gifts and the remaining portion to the decedent's gross estate.

If donor makes a $5 million gift 2012, what will be the result if Congress reduces the applicable exclusion amount to $3.5 million for both gifts and estates in 2013 and decedent dies in that year? In calculating the decedent's estate tax, would the estate be required to "give back" $1.5 million in previously used exclusion?

On the one hand, it would seem unfair to impose estate tax on the estate of the decedent when, at the time the gift was made, the gift was fully covered by the exclusion amount. On the other hand, the estate of similarly situated decedent who had made no lifetime gifts would be allowed only the $3.5 million exclusion amount. Congress has not addressed the issue.

Although the estate of the decedent will have achieved somewhat of a windfall by a gift of $5 million at the time when the exclusion amount was also $5 million, it seems unfair to retroactively impose a tax on the decedent's estate. Since it could appear unseemly for Congress to attempt to "recapture" the previously used exemption amount at a time when that amount was higher, 2012 seems like a prudent for persons with large estates to consider making such gifts.

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decedent prior to his death, the executor properly excluded the value of the residence from the gross estate, since the decedent's daughter was in the midst of preparing a lease agreement when the decedent died suddenly. The contemplated existence of an express agreement calling for rent was sufficient to defeat the application of IRC §2036.

In *Estate of Adler*, T.C. Memo 2011-28, the decedent years earlier had deeded a one-fifth interest in a 1,100 acre tract of land in Carmel, California to each of his five children, reserving the "full use, control, income and possession" of the property for his life. His estate claimed a 32 percent lack of marketability discount and a 16 percent minority interest discount.

The Tax Court had no problem finding that neither of these discounts was applicable. The retention of enjoyment was express, and IRC §2036 (a)(1) clearly applied, since the gift was in effect testamentary. The more difficult question was whether a partition discount was applicable. The court found that it was not: Since Adler had continued to enjoy full use of the property, ownership was not deemed to have been divided until Adler's death.

In *Estate of Van*, T.C. Memo, 2011-22, the decedent transferred title to her residence, but continued to reside there without payment of rent. Although some consideration for the residence was paid to her by her children, this was insufficient to defeat the application of IRC §2036. Since nonpayment of rent in this case was a factor in a ruling against the taxpayer, a parent who wishes to continue residing in a residence following its legal transfer should rent pursuant to a lease providing fair rental value. Where ascertaining fair rental value is difficult, engaging a real estate professional to assist in that determination would be advisable.

B. Step Transaction Doctrine

Another weapon at the disposal of the IRS in attacking discounts taken through family entities is the step transaction doctrine. The step transaction doctrine emphasizes substance over form and may be invoked by the IRS to collapse a multi-step transaction into a single transaction for tax purposes. The doctrine limits the taxpayer's ability to arrange a series of business transactions to obtain a tax result that would be unavailable if only a single transaction were used. The Supreme Court in *Court Holding Company v. Com'r*, observed:

> *To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. 45-1 USTC ¶9215, 324 U.S. 331, 65 S.Ct. 707 (1945).*

In *Linton v. U.S.*, 630 F.3d 1211 (9th Cir. 2011), *aff'g* in part, *rev'g* in part, and *rem'g* 638 F Supp 2d 1277 (D. Wash 2009), the Ninth Circuit reversed the District Court, which had applied the step transaction doctrine. In a meeting with their attorney, the Lintons executed documents transferring real estate and other assets to a limited liability company. At the same meeting, the Lintons signed trust documents giving their children interests in the LLC. The trust documents were undated.

The District Court granted the government's motion for summary judgment, finding that the gifts to the LLC and the funding of the trusts were in essence simultaneous. Therefore, under the step transaction doctrine, the Lintons had made gifts to their children of the LLC interests. Since the gifts were made before the formation of the LLC, the valuation discounts taken by the Lintons were disallowed.

The Ninth Circuit reversed, finding that the Lintons had merely prepared to make a gift to the trust, but had not actually done so. The court noted that rather than focus on the traditional test for invoking the step transaction doctrine, *i.e.,* whether there was a "binding commitment" to take the later step, the more relevant inquiry was whether the lapse of time between the completion of steps resulted in there being any "real economic risk."

C. Partnership Formalities

The failure to follow partnership formalities when engaging in estate planning using family entities is a regrettable lapse, since adherence to formalities is not especially difficult. Four cases decided in 2011 illustrate the pitfalls which taxpayers can encounter if formalities are not observed.

In *Estate of Jorgensen*, 107 AFTR2d 2011-2069 (9th Cir. 2011), *aff'g* T.C. Memo 2009-66, the Ninth Circuit affirmed a decision of the Tax Court finding that the entire value of two partnerships should be included in the estate. The partnership had failed to properly maintain books and records, the decedent had used partnership assets to pay personal expenses and had paid partnership expenses with personal assets.

The Ninth Circuit also found that the Tax Court had not erred in finding an implied agreement that the decedent would be permitted to continue to benefit from partnership assets. The court found that no "legitimate and significant nontax reason" existed for creating the family limited partnership since no special investment skills are required to perpetuate a "buy and hold" investment philosophy.

In *Estate of Turner*, T.C. Memo 2011-209, the decedent and his wife had made transfers to a family limited partnership but retained sufficient assets outside of the partnership to support themselves. Shortly before the decedent's death, he made gifts in trust to his children. The IRS found that the exception in IRC §2036(a) for transfers made in exchange for "for adequate and full consideration" was inapplicable. To qualify under the ex-

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ception, the transfer must have had a "legitimate and significant nontax" purpose. Agreeing with the IRS, the court found that consolidation of assets may underlie a significant nontax purpose, but only where the assets require active management.

In *Estate of Liljestrang*, T.C. Memo, 2011-259, the decedent transferred various real estate holdings worth about $6 million to a family limited partnership. The decedent transferred limited partnership interests to trusts for his children, but retained all of the general partnership interests.

The Tax Court held that the undiscounted value of the partnership interests were includible in the decedent's estate under IRC §2036(a), since there no legitimate and significant nontax reason existed for creating the partnership. Although the estate claimed that by transferring the real estate holdings into a trust they would be centrally managed, the Tax Court found that the decedent's son was already responsible for managing the holdings through an employment agreement in effect with the trust.

D. Valuation Discounts

With proper planning and execution, the decedent will not have retained interests in the transferred property that would operate to pull the assets back into the gross estate. However, having crossed that threshold, another obstacle remains: The estate may be called upon to justify valuation discounts taken either on filed gift tax returns, or on the estate tax return.

Obtaining an expert appraisal when determining the proper valuation discount is critical in justifying the value of the interest given or sold to a trust. Experts use a variety of methods of determining the proper discounted value. Two such methods are the "cash flow" method and the "asset valuation" method.

The cash flow method involves determining the present value of the discounted cash flow, allowing for any valuation discounts. The asset valuation method determines the total liquidation value of the assets of the entity.

In *Estate of Guistina*, T.C. Memo 2011-141, the Tax Court determined that the value of the partnership interest in timberlands should be determined using a hybrid of the two valuation methods. The court remarked: "In our view, the cash flow method is appropriate to reflect the value of the partnership if it is operated as a timber company, and the asset method is appropriate to reflect the value of the partnership if the assets are sold. Accordingly, the percentage weight to be accorded the cash flow method should be equal to the probability that the partnership would continue to be operated as a timber company.

The court found that assets of the partnership were worth $150.68 million, and the present value of the discounted cash flow was $51.7 million. Since the business had been in the family for many years, and there was no indication that it would be sold, the court's finding that the assets of the partnership were three times the cash flow appeared to augur well, since the cash flow method appeared to be the applicable test.

A 25 percent lack of marketability discount was applied to the cash flow method. However, no valuation discount was allowed in determining the asset value of the partnership, since the agreed value of the partnership already took into consideration a marketability discount.

Although the family appeared to have no intention of selling the timberlands, the Tax Court nevertheless ascribed a 25 percent probability to the asset (liquidation) value, and only 75 percent to the discounted cash flow value. In justifying this allocation, the court dryly observed that "people tend to prefer $143 million to $52 million.".

The result of the hybrid approach of the Tax Court resulted in a deficiency, since the estate had used the discounted cash flow value, assuming that the business would not be sold. The Tax Court determination concerning the value of the assets resulted in the estate having reported a value which was less than 50 percent of the value determined by the Tax Court. This triggered a 20 percent undervaluation penalty under IRC §6662 (a), unless the court found that the reasonable cause exception applied. The court found that the exception did apply: The taxpayer had relied on the lawyer who prepared the estate tax return. The lawyer hired an appraiser. The court found that it was reasonable for the appraiser to assume that the business would not be sold.

It is interesting that in determining the value of the business for estate tax purposes, the Tax Court ascribed a 25 percent probability to the business being sold, but later, in considering whether the undervaluation penalty should be remitted, the court found that the appraiser had been justified in assuming that the business would not be sold after the decedent's death.

The importance of obtaining a professional appraisal was painfully demonstrated in *Estate of Gallagher*, T.C. Memo 2011-148. The president and CEO of a closely held newspaper company himself determined the value of the estate's units in the company at $34.94 million one week after the decedent's death. In audit, the IRS asserted the value was $49.5 million. The estate then hired two appraisers, who determined the value of the decedent's interest as being $26.6 million and $28.2 million. An expert hired by the IRS ascribed a value of $40.86 million.

Since the value the estate reported on the estate tax return was greater than the value as determined by the estate's experts, the Tax Court found this to constitute an admission against interest. However, the court noted that it was not bound by the higher amount, noting that "such an admission is not conclusive and the trier of fact is entitled to determine . . . what weight, if any, should be given to the admission."

Using a discounted cash flow method, the Tax Court ultimately

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found that the value of the interest was within $1 million of what the taxpayer had reported on the estate tax return. In arriving at its determination, the Tax Court utilized its own discounted cash flow analysis, rather than the analysis posited by the experts for the estate or for the IRS.

In *Estate of Levy*, 106 AFTR2d 2010-7205 (5th Cir.), *aff'g* 2008 WL 5504695 (W.D. Texas 2008), *cert. denied*, 2011 WL 1481312, the decedent's estate brought a refund suit after paying a deficiency determined on audit by the IRS. The Estate claimed that the IRS had valued real property at its rezoned value, whereas at the time of the decedent's death the change in zoning was highly unlikely.

The Estate also argued that the trial count improperly admitted hearsay evidence. The Fifth Circuit affirmed, finding first that offers from "sophisticated investors" were properly admitted, since the developers could have been called upon to testify at trial. The appeals court dismissed the estate's rezoning argument, finding that the town's rezoning plan strongly suggested that the land would be rezoned.

In *Estate of Mitchell*, T.C. Memo, the IRS challenged the values of two paintings reported on the estate tax return. The estate had valued a Remington at $1.2 million and a Russell at $750,000. The IRS valued the paintings at $2.3 million and $2 million, respectively. At trial, the IRS Art Advisory Panel determined the values to be substantially less than those reported by the taxpayer.

[The Art Advisory Panel is comprised of a collection of unpaid art experts. The panel reviews audited returns on which an item of art is valued at $20,000 or more, or returns in which the IRS believes that the fair market value exceeds $20,000. To ensure objectivity, the Panel is unaware of whether the appraisal is for estate tax purposes or charitable deduction purposes.]

The IRS asserted that the Art Advisory Panel was unfamiliar with western art, and that its valuations were disparate. However, the Tax Court found that IRS staff appraisals were unreasonably high and accepted the values reported by the estate.

E. Powers of Appointment

The use of a credit shelter trust can be an effective means of keeping assets transferred to that trust out of both the estate of the decedent and the estate of the decedent's spouse. Often, the decedent's spouse is given ample rights with respect to that trust during his or her lifetime. If drafted correctly, those rights given to the surviving spouse should not cause estate tax difficulties in the estate of the surviving spouse. However, if the surviving spouse is a trustee as well as a beneficiary, and the power to distribute principal is too great, the power could be deemed to constitute a general power of appointment under IRC §2041. If so, the entire trust would be included in the estate of the surviving spouse.

Regs. §20.2041-1(c)(2) provides that "[a] power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041 (b)(1)(A), not a general power of appointment.

In *Estate of Chancellor*, T.C. Memo, 2011-172, the surviving spouse, who was also a trustee and beneficiary, was given the power to distribute principal "for the necessary maintenance, education, health care, sustenance, welfare or other appropriate expenditures" of the beneficiaries. The IRS argued that the decedent's power over the trust rose to that of a general power of appointment, and consequently the entire trust should be included in her estate.

The court found that although the right to withdraw for spouse's "welfare" may not correlate exactly with the right to withdraw for the "health, education, support, or maintenance," the inclusion of the word "necessary" indicated that the distribution standard was a function of the decedent's accustomed standard of living. The *Chancellor* case illustrates that the inclusion of even one objectionable word in a trust could result in deleterious estate tax consequences. Fortunately, in this case, the trust was held not to have deviated too far from the standards imposed in the Regulations.

F. Statutes of Limitations

Statutes of limitations can be the bane of both taxpayers and tax professionals. In *Dickow v. U.S.*, 654 F.3d 144 (1st Cir. 2011), the Executor requested an automatic six month extension to file an estate tax return under IRC §6081(a), and then a second automatic extension. Just less than three years later, the Estate filed a claim for refund. The First Circuit upheld an order granting summary judgment to the IRS.

The Executor erred in requesting a second extension, since the Regulations provide that only one six-months extension may be requested. Furthermore, the refund request was not timely since under IRC §6511 to be timely, a refund claim must be made within the later of three years after filing the return or two years of payment of the tax.

The First Circuit found the District Court had properly rejected the taxpayer's argument that the IRS should be "equitably estopped" from asserting the statute of limitations, since it had "misrepresented" to him that the second extension requested had been granted by not explicitly rejecting the extension request. The court found that equitable exceptions to the statute of limitations for refund claims under IRC §6511 do not exist. The First Circuit also observed that even if such an exception did exist, the executor had not shown that the IRS had "misrepresented" any fact.

In *Baccei v. U.S.*, 632 F.3d 1140 (9th Cir. 2011), the Executor hired a CPA to prepare an estate tax return. The Form 706 was timely filed,

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but the CPA failed to complete Part III of the extension, which contained a request for an extension of time in which to pay the tax. Although a letter was appended to the extension request, the District Court found that the request was improper, and that the estate had not established a reasonable cause for the estate's failure to pay. The Ninth Circuit affirmed. The doctrine of "substantial compliance" was inapplicable; and compliance with the terms of the application for an extension "is essential to the Service's tax collection efforts." The executor's reliance on a "well-qualified and knowledgeable CPA" failed to constitute reasonable cause for the abatement of penalties.

Although reliance on a tax professional time timely file a return will not operate to justify remission of late-filing penalties, reliance on a tax professional as to a *substantive tax issue* may constitute reasonable cause and justify the abatement of penalties. Such was the case in *Estate of Liftin v. U.S.,* USTC ¶60,630 (Fed. Cl., Nov. 8, 2011).

In *Liftin*, the decedent's widow was in the midst of applying for citizenship, which would allow the estate to take a full marital deduction. The executor hired an estate planning attorney, who advised that filing the estate tax return after the due date would not trigger a penalty provided the return was filed within a "reasonable time" after the widow became a U.S. citizen. Although the advice was incorrect, the Court of Claims found that reasonable cause may exist where the taxpayer relies on an expert's erroneous advice. The court denied the government's request for summary judgment.

G. Formula Clauses

When structuring sales to grantor trusts for estate planning purposes, use is often made of formula clauses, which operate to redistribute interests in the event of a successful IRS challenge to the asserted value of assets sold or transferred to the trust. These changes could occur either because the IRS claims that the value of the asset was higher than reported, or that the valuation discount taken was excessive.

In *Estate of Petter*, 653 F.3d 1012 (9th Circuit), *aff'g* T.C. Memo 2009-280, Petter, an heir to the founder of UPS, made gifts to grantor trusts equal to "one-half the minimum dollar amount that can pass free of federal gift tax by reason of the Transferor's applicable exclusion amount." The trust indenture provided that if the amount finally determined for federal gift tax purposes exceeded the amount described in the trust instrument, the excess would be transferred to a charitable foundation.

On audit, the IRS found the formula clause unenforceable, as it violated public policy. However, the Tax Court found that the gifts of an "ascertainable dollar value of stock" defined by formula were valid. The charitable beneficiaries were also represented by independent counsel, were not subservient to the taxpayer, and were not motivated by a desire to reduce the tax liability of the donor. The Ninth Circuit affirmed.

The Tax Court also approved the formula clause in *Hendrix v. Com'r*, T.C. Memo, 2011-133. In *Hendrix*, a formula clause was employed to determine the number of shares of closely held Subchapter S stock to be transferred to trusts, and the number of shares that would be transferred to a charitable foundation. The Tax Court approved the use of the formula clause to determine the amount of stock transferred. The stock was difficult to value, and the court found no evidence of collusion. The court noted that the formula clause also furthered the public policy of encouraging charitable gifts.

H. Annual Exclusion Gifts

Use of the annual exclusion to cover gifts made to an irrevocable life insurance trust (ILIT) is important in leveraging the gift tax exclusion. The right of beneficiaries to withdraw an amount equal to the annual exclusion renders those transfers gifts of a present interest. *Crummey* letters (named after the case) are ordinarily sent to beneficiaries on an annual basis, advising the beneficiaries of their right of withdrawal.

In *Estate of Turner*, T.C. Memo 2011-209, the taxpayer established an ILIT for the benefit of his children and grandchildren. Upon the death of the taxpayer, the IRS denied the annual exclusion, asserting that *Crummey* letters were not always sent. However, the Tax Court found that the right of the beneficiaries to withdraw amounts from the ILIT created a present interest. The fact that some of the beneficiaries may have been unaware of their right to withdraw was immaterial, since it did not prevent the creation of a present interest. The court noted that in the *Crummey* case itself, notice was not given.

I. IRS Subpoenas

Placing a family member on a deed to real property may be done for a variety of reasons, but whatever the reason, the transaction will generally result in a taxable gift. Nevertheless, taxpayers sometimes fail to file gift tax returns reporting the transfer. While some earlier case law found that there could be an absence of donative intent and, *ergo*, no taxable gift, where the donor made the transfer to avoid probate, the authority for this proposition is not compelling.

Recognizing this situation, the IRS petitioned the District Court in California to issue a summons to the California Board of Equalization requesting that the Board furnish the IRS with its database in order to determine donors who had failed to file a gift tax return. Under California law, transfers between parents, children and grandparents cannot be subject to reassessment. The District Court rejected the IRS request, finding that the information was available through other means. In *dicta*, the court also questioned whether a "John Doe" summons could be issued to a sovereign

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state.

J. Acknowledgement of Charitable Gifts

IRC §170(f)(8)(A) requires, as a condition to taking a charitable deduction, that the charity provide the taxpayer with a contemporaneous written acknowledgment. In *Bruce v. Com'r*, T.C. Memo 2011-153, the taxpayer reached a settlement agreement with his county concerning a driveway easement. The county furnished the taxpayer with a letter of acknowledgment, but the IRS found that the letter did not satisfy IRC §170. The Tax Court agreed with the IRS, and disallowed the taxpayer's $1.87 million deduction. The court found that the acknowledgment was not contemporaneous since the rights and obligations created under the agreement were conditioned upon the county obtaining approval for the settlement.

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was 25 months. The percentage of e-filed returns increased to 77 percent in 2011, up from 69 percent in 2010.

The IRS recently announced renewal of the Offshore Voluntary Disclosure Initiative program. Begun in 2009, OVDI has now yielded $4.4 billion in tax collections. In contrast to the earlier programs, which imposes deadlines, the new initiative will continue until further notice.

National Taxpayer Advocate Nina Olsen in a report to Congress stated that IRS underfunding has resulted in harm to taxpayers and an inability of the IRS to raise tax revenue. The report cited the failure to classify most inquiries as audits, thus depriving taxpayers of audit rights. Another problem cited concerned IRS notices of mathematical errors on returns. The notices are often vague, making the assessment difficult to contest. The report called for the enactment of a new comprehensive taxpayer bill of rights.

B. New Regulations

Section 403 of the Energy Improvement and Extension Act of 2008 amended the Internal Revenue Code to mandate that every broker required to file a return with the IRS reporting gross proceeds from the sale of a covered security also report a customer's adjusted basis in the security and whether any gain or loss on the sale is classified as short-term or long-term. The amendments direct brokers to follow customers' instructions and elections when determining adjusted basis.

Those cost basis rules, instituted on January 1, 2011, will be entirely phased in this year. The new reporting requirements apply with respect to stock bought in 2011. However, the cost basis of shares bought in 2011 but not sold will not be reported until the shares are sold. Additionally, the basis of stock sold in 2011 but purchased in earlier years will not be subject to the new reporting rules.

Effective June 24, 2011, Regs. §1.6081-6 reduce the automatic extension of time to file a fiduciary income tax return Form 1041 to five months from six months. The rationale for this change is to allow tax preparers additional time to complete income tax returns for individuals who receive Forms K-1 from fiduciaries.

C. Proposed Regulations

The alternate valuation date election permits an executor to value the estate six months after the death of the decedent. Prop. Regs. §20.2032-1 (c)(1)(i) ignore during alternate valuation date changes in value which occur by reason of deemed distributions or sales. In a related development, PLR 2011122009 allowed a late election pursuant to Regs. §301.9100 of the alternative valuation date, since the election was made within one year of the due date of the estate tax return, with extensions.

Treasury in 2011 proposed regulations requiring that a new category of restrictions, "Disregarded Restrictions," be applied in valuing an interest in a family owned entity for Alternate Valuation Date (AVD) purposes. In a significant departure from current law, disregarded restrictions would include those more restrictive than a standard found in the regulations. Previously, only those restrictions more restrictive than those found in state law would be disregarded. The proposed regulations followed the Tax Court decision in *Kohler v. Com'r*, T.C. Memo, 2006-152, *non-acq*., 2008-9 IRB 481. In *Kohler,* which the IRS lost, a tax-free reorganization under IRC §368(a)(1)(E) following death greatly reduced the value of the estate at the AVD.

IRC §67(a) provides that miscellaneous itemized deductions are allowed only to the extent that those deductions exceed 2 percent of AGI. IRC §67(e) provides that AGI of an estate or trust is computed like that of an individual, except that costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust are allowable in **arriving** at AGI. Consequently, those costs are not subject to the two percent floor.

Although the statutory language appears benign, the Supreme Court in *Knight v. Com'r*, 552 U.S. 181 (2008) held that fees customarily or generally incurred by an estate or trust are not uncommonly incurred by individual investors. Therefore such expenses are subject to the two percent floor. The court acknowledged it was conceivable "that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper."

Taking its cue from *Knight*, Treasury has withdrawn earlier proposed regulations, and advanced new proposed regulations. Under new proposed regulations, in order to avoid the two-percent floor, the trust or estate must show that (i) the investment advisory fee exceeds that normally charged to individual investors; and (ii) the excess is attributable to an unusual investment objective of the trust or estate. In offering limited relief, the IRS has stated that taxpayers will not be required to determine the portion of a "Bundled Fiduciary Fee" that is subject to the two-percent floor under Section 67 for taxable years beginning before the date that the regulations become final.

Treasury in 2011 promulgated temporary regulations which updated mortality tables reflecting longer life expectancies. The result of the new mortality tables is to increase the value of lifetime interests and to decrease the value of future (remainder) interests. Under the new tables, QPRTs are less attractive since the grantor is less likely to die within the term of the QPRT. This in turn reduces the value of the reversionary interest, and increases the amount of the gift. On the other hand, Self-Cancelling Installment Notes, or SCINs, will be more attractive. The buyer of a SCIN must pay a premium which takes into ac-

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count the actuarial probability that the seller will die before the term of the note. Since there is less of a probability that the seller will die, the premium is reduced, thus making the SCIN a more attractive estate planning vehicle. T.D. 9540, 76 Fed. Reg. 49570.

C. New Rulings and Procedures

The IRS in Notice 2012-4 estimated that taxpayers underpaid their taxes by $385 billion in the tax year 2006. Individuals and corporations paid 85.5 percent of their actual tax liability in 2006, compared with 86.3 percent in 2001. The amount underreported by individuals was more than three times that of all corporations; and among individuals, the largest element of noncompliance related to undeclared income by businesses on Schedule C, and by farms on Schedule F.

The IRS provided guidance for filing protective refund claims for an estate in Rev. Proc. 2011-42. Generally, only claims that are actually paid or ascertainable with reasonable certainty are allowed as an estate deduction. A protective claim would be made where these conditions are not met when the estate tax return is filed. Rev. Proc. 2011-42 articulates the manner in which the protective claim is made, the necessary contents of the claim, and the requirement that a clear identification of the claim be made. A protective claim must be filed within three years from the date the return was filed or within two years from the date when the tax was paid, whichever is later.

In PLR 201118014 the IRS permitted a QPRT to be modified to permit the grantor to continue to reside in the residence after the retained use period. The QPRT provided the grantor with a right to use the residence after the initial term. The grantor's children possessed a remainder interest. As trustee, the grantor and her children executed a modification to the QPRT which granted the children the right to amend and restate the trust to allow the grantor to continue to use the residence for a term of years after the retained use period. The IRS stated that the modification did not violate IRC §2702(a)(1). However, the transfer of the term interest constituted a taxable gift by the children to the grantor, the value of which was the actuarial value of the term interest given to the grantor.

TAM 201126030 illustrates the need for clarity and precision in a Will. The Will in question stated "it is my desire" that certain assets pass to the testator's children. The IRS was asked whether the bequest to the children was mandatory or merely precatory. Consulting applicable state law, the IRS concluded that where an instruction to a beneficiary is stated as a desire, the direction is usually precatory; but where an instruction to an executor is stated as a desire, the direction is usually mandatory. Since the direction in question was made to the executor, the IRS concluded that the direction was mandatory. Since a mandatory direction resulted in the beneficiaries becoming entitled to specific bequests, the marital deduction was reduced.

D. Other Treasury Proposals

Treasury fiscal year 2012 proposed that there be a requirement that values reported for income tax purposes match values reported for transfer tax purposes. This "duty of consistency" would ameliorate the situation where, after estate tax audit, the IRS increases the value of an asset. Since the asset will have been reported to the beneficiary at a lower basis, the beneficiary would incur excessive capital gains tax when the asset is sold prior to the conclusion of estate litigation. Treasury believes that requiring that the value used for estate tax purposes match that used for capital gains purposes would encourage more realistic estate valuations as an initial matter.

Another Administration proposal that has been circulating for the last few years would impose a minimum 10-year term for GRATs. Treasury believes that taxpayers are avoiding gift tax by using short term ("zeroed out") GRATs that impose little or no gift tax. However, Treasury does not object to the use of zeroed out GRATs for 10-year GRATs.

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ered by private health insurance or be paid out of pocket. Medicare is financed by payroll taxes imposed pursuant to the Federal Insurance Contributions Act (FICA).

In general, all five-year legal residents of the U.S. over the age of 65 are eligible for Medicare. Medicare covers (i) inpatient hospital stays and brief stays for convalescence in a skilled nursing facility (Part A); (ii) physician and nursing services (Part B); and (iii) prescription drugs (Part D). Medicare may require premium payments and the payment of deductibles, some of which are calculated based upon the number of quarters the enrollee has paid payroll tax.

II. Medicare and Medicaid Contrasted

The most significant difference between Medicare and Medicaid is that Medicaid is need-based, rather than entitlement based, as is Medicare. Medicare is federally funded and administered. Medicaid is a federal program jointly funded and administered by the States. Financial resources play no role in determining Medicare eligibility. Eligibility for Medicaid is limited to persons with limited income and limited financial resources. Medicaid covers substantially more health care services than Medicare, and is intended to cover long-term care for elderly and disabled persons who are unable to pay for such care.

III. Medicaid Eligibility

Elderly and disabled persons are more likely to require continuing long-term care not covered by Medicare. A serious medical illness such as a stroke, requiring a long period of convalescence, the costs of which are not covered by Medicare, could consume all of the financial resources of an individual or family.

Thus, Medicaid will cover many long-term health costs that Medicare will not. However, ownership of substantial assets or, in some states, the right to monthly income above certain thresholds ("resources") will preclude Medicaid qualification. Before qualifying for Medicaid, a person with substantial assets would be required to deplete ("spend down") those assets.

To avoid the scenario in which nearly all of one's assets might be required to be paid to a nursing home before becoming eligible for Medicaid, some persons choose to transfer in advance assets that would impair Medicaid eligibility. Such transfers might be outright to a spouse, to other family members such as children, or to a trust.

However, recognizing the increased cost to the government of intentional transfers to become eligible for Medicaid, Congress in the Deficit Reduction Act of 2005 (DRA) created a five-year "look back" period relating to the transfer of assets either outright or in trust. Essentially, any transfers made during the five-year period preceding a Medicaid application are ignored. Despite the five year look-back period, courts have upheld Medicaid planning as an appropriate objective of a guardian's proposed transfer, and have held that such transfers do not violate public policy.

If, after making a transfer of assets to qualify for future Medicaid, a person requires Medicaid assistance during the five year look-back period, all of the assets transferred in the preceding five year period must be privately paid before Medicaid assistance will become possible. Transfer penalties are based on the monthly cost of nursing home care in the applicant's state. For example, if the cost of nursing home care in New York is $7,000 per month, and the person transferred $70,000, that person would be ineligible for Medicaid for ten months. An exception provides that transferring assets, including one's house, to the spouse will not trigger the transfer penalty.

Determining the right amount of assets to transfer is an important inquiry. Transferring many assets, while helpful for Medicaid eligibility purposes, may leave the potential Medicaid applicant with insufficient assets to live on. Transferring too few assets will create a larger reserve of assets that will have to be "drawn down" once the five year look-back period has been reached before Medicaid will begin paying out.

III. Medicaid Exempt Assets

Certain resources are exempt from determining Medicaid eligibility. The recipient's residence is an exempt resource to the extent of $758,000 in equity. If the applicant is in a nursing home, the residence remains an exempt asset provided the applicant has a "subjective intent" to return to his home. Exempt assets may be transferred without penalty because such assets would impair Medicaid eligibility even if not transferred.

New York may impose a lien on a personal residence even though ownership of the residence would not impair Medicaid eligibility. However, no lien may be imposed unless the person is permanently absent is not reasonably expected to be discharged. N.Y. Soc. Serv. Law §369(2)(a)(ii); 18 N.Y.C.R.R. §360-7.11(a)(3)(ii). Prior to filing a lien, New York must satisfy notice and due process requirements, and must show that the person cannot reasonably be expected to return home. 42 U.S.C. §1396p(a)(2). If the person does return home, the lien is vanquished by operation of law. 18 N.Y.C.R.R. §360-7.11(a)(3)(i).

IV. Recovery From Estate

New York has a legal right to recover from the estate exempt assets which had no bearing on Medicaid eligibility. However, no recovery from an estate may be made until the death of a surviving spouse. N.Y. Soc. Serv. Law §366(2)b)(ii). For purposes of New York Medicaid recovery, the term "estate" means property passing by will or by intestacy. No right of recovery exists with respect to property passing in trust, by right of survivor-

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ship in a joint tenancy, to a trust beneficiary, or to the beneficiary of a bank or retirement account.

The amount that may be recovered from an estate for a lien against a personal residence cannot exceed the value of services provided while the Medicaid recipient was absent from the home. N.Y. Soc. Serv. Law §369 (2)(a)(ii). A lien may be waived in cases of undue hardship. N.Y. Soc. Serv. Law §369(5).

V. Medicaid Trusts

A Medicaid trust provides income to the grantor or to the grantor's spouse. Transfers to a Medicaid trust may facilitate eligibility for Medicaid since trust assets are excluded when determining Medicaid eligibility, provided the five year look-back period is satisfied. Furthermore, a transfer in trust will effectively bar any right of recovery by New York if a lien had been placed on the residence.

Most trusts created to facilitate Medicaid planning will be drafted to be irrevocable. Although residences transferred to revocable trusts will also avoid probate and thereby also defeat New York's right to estate recovery, revocable trusts provide no asset protection. Accordingly, irrevocable trusts are generally preferable to revocable trusts for Medicaid planning.

If a residence is transferred to a Medicaid trust, the "income" permitted to be paid to the grantor will consist of the grantor's retained right to reside in the residence. If the Medicaid trust is structured as a grantor trust, the capital gains exclusion provided by IRC §121 will be available if the residence is sold by the trust.

The grantor of a Medicaid trust will want the assets to be included in his or her estate at death, in order to receive a basis step up under IRC §1014. This can be achieved if the grantor retains a limited power of appointment. Retaining a limited power of appointment will also enable the grantor to retain the ability to direct which beneficiaries will ultimately receive trust assets.

Inclusion of trust assets will ordinary not be problematic since the federal estate tax exemption is $5 million, and the NYS lifetime exemption is $1 million. If outright gifts and transfers to a Medicaid trust are both anticipated, transferring the low basis property to the trust will be preferable, since a step up in basis will be possible with respect to those assets if the trust is includible in the applicant's estate. The recipients of gifts, on the other hand, will take a carryover basis.

The trust must provide that no distributions of principal may be made to the grantor or the grantor's spouse. Any provision in a Medicaid trust authorizing the trustee to make distributions of income or principal to the grantor for his or her general welfare will result in the entire trust being considered an available asset for Medicaid eligibility purposes. Since New York is a "unitrust" jurisdiction, the beneficiary may be entitled to distributions of principal. Any trust provisions authorizing such distributions must be redrafted to prevent any distributions of principal to the beneficiary.

In addition, the trust (i) may provide for discretionary trust distributions to beneficiaries (other than the grantor or the grantor's spouse) during the grantor's lifetime or at death; and (ii) may provide that upon the death of the grantor, the trust corpus will be distributed outright to beneficiaries, or held in further trust.

The trustee of a Medicaid trust should be persons other than the grantor or the grantor's spouse. However, the trust may allow the grantor to replace the trustee. Since assets transferred to a Medicaid trust are transferred irrevocably, it is important that the grantor and his or her spouse consider the nature and extent of assets to be retained, since assets must remain to provide for daily living expenses.

VI. Special Needs Trusts

A Special Needs Trust (SNT) established for a person with severe and chronic disabilities may enable a parent or family member to supplement Medicare or Supplemental Security Income (SSI), without adversely affecting eligibility under these programs, both of which impose restrictions on the amount of "income" or "resources" which the beneficiary may possess. 42 U.S.C. § 1382a.

Federal law authorizes the creation of SNTs that will not be considered "resources" for purposes of determining SSI or Medicaid eligibility where the disabled beneficiary is under age 65, provided the trust is established by a parent, grandparent, legal guardian, or a court. Thus, personal injury recoveries may be set aside to supplement state assistance. The beneficiary's income (which includes gifts, inheritances and additions to trusts) will reduce available SSI benefits. However, assets owned by the SNT will not be deemed to be owned by the beneficiary.

The SNT may be created by either an *inter vivos* or testamentary instrument. If an *inter vivos* trust is used, the trust may, but is not required to be, irrevocable. Provided the beneficiary may not revoke the trust, trust assets will not constitute income or resources for SSI or Medicaid purposes. A revocable *inter vivos* trust also permits the parent or grandparent, for example, to modify the trust to meet changing circumstances. If the trust is revocable the trust assets will be included in the settlor's estate under IRC §2038.

A testamentary SNT may be established at the death of a surviving parent for a disabled adult child. Such testamentary trust may be established either by will or by revocable *inter vivos* trust. In *Matter of Ciraolo*, NYLJ Feb. 9, 2001 (Sur. Ct. Kings Cty), the court allowed reformation of a will to create an SNT out of an outright residuary bequest for a chronically disabled beneficiary. Neither the beneficiary nor the beneficiary's spouse should be named as trustee, as this might result in a failure to qualify un-

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der the SSI and Medicare resource and income rules. A family member or a professional trustee would be a preferable choices as trustee.

EPTL 7-1.12 expressly provides for special needs trusts and includes suggested trust language. The statute imposes certain requirements for the trust. The trust must (i) evidence the creator's intent to supplement, rather than impair, government benefits; (ii) prohibit the trustee from expending trust assets in any way that might impair government benefits; (iii) contain a spendthrift provision; and (iv) not be self-settled (except in narrowly defined circumstances).

EPTL 7-1.12 further provides that notwithstanding the general prohibition imposed on the trustee from making distributions that might impair qualification under federal programs, the trustee may have discretionary power to make distributions in the best interests of the beneficiary.

A "third party" SNT is a trust created by a person other than the beneficiary (*e.g.,* a parent for a developmentally disabled child) and does not require a "payback" provision. A payback provision mandates that on trust termination the trustee must reimburse Medicaid for benefits paid to the beneficiary. Only a "first-party" (self-settled) SNT, which is an SNT funded by the beneficiary himself, must include a payback provision. *Inclusion in the trust of a payback provision where none is required could result in a windfall to Medicare at the expense of remainder beneficiaries.*

DECANTING TRUSTS, CONT.

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be made under the Uniform Trust Code (UTC). Under the UTC, a non-charitable irrevocable trust may be modified "upon the consent of all beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust." However, for the required court approval, either all beneficiaries must consent or the interest of those not consenting must be shown to have been adequately protected.

Thus, trust modification under the UTC or under common law may simply not be possible. In those cases, the ability to modify the trust using a decanting statute becomes paramount. New York was the first state to enact a decanting statute, which effectively permits the trustee acting alone to amend the terms of an irrevocable trust.

II. Statutory Revision of Law

On August 17, 2011, Governor Cuomo signed legislation revising New York's decanting statute. Revised EPTL §10-6.6(b) is effective for trusts created before or after that date. Under prior law, decanting was possible only if the trustee had "absolute discretion" with respect to making distributions of principal. That requirement has now been relaxed, and even trusts in which the trustee possesses only limited discretion with respect to distributions of trust principal may now qualify for decanting. EPLT 10-6.6(j)(3) also now authorizes the trustee to decant only some of the assets of the old trust into a new trust.

If the trustee has **unlimited discretion** with respect to distributions principal, the trustee may decant the trust in favor of one or more trust beneficiaries to the exclusion of other trust beneficiaries. The rationale for this rule is that since the trustee has unlimited discretion with respect to the decanted trust, the trustee had the implicit authority to distribute the entire trust to a single beneficiary.

If the trustee has only **limited discretion** to distribute trust principal, EPTL 10-6.6(c) provides that the current and remainder beneficiaries of both the decanted trust and the appointed trust must be identical. The appointed trust must also contain the same standard for distributions of income and principal. However, the term of the appointed trust may be longer than that of the decanted trust, and the distribution provisions may be modified during the extended period.

In general, the power to appoint trust assets may not reduce or limit the right of any current beneficiary to receive mandatory distributions of income or principal. Nevertheless, even a mandatory right may be abridged if the power to appoint trust assets is made in favor of a supplemental needs trust created under EPTL 7-1.12.

The revised decanting statute now makes explicit the fiduciary obligation imposed on the trustee: The trustee must exercise the power to decant as would a prudent person in the best interest of the trust beneficiaries. The trustee may not exercise the power if there is substantial evidence that the settlor would not have intended that the power be exercised. Nevertheless, the mere inclusion of a spendthrift clause will not alone constitute evidence of a contrary intent.

III. Procedure for Invoking Decanting Statute

The procedure for invoking EPTL §10-6.6(b) is straightforward:

First, the trustee must sign a notarized document which effectuates the decanting.

Second, filing requirements must be satisfied: Under the old statute, filing with Surrogates Court having jurisdiction over the trust was always required. Under the revised statute law, the filing requirement is dispensed with for all *inter vivos* trusts (unless Surrogate Court proceedings have already taken place with respect to the trust).

Third, the trustee must serve a copy of the acknowledged decanting instrument indicating what percentage of the trust is being decanted upon all "interested" persons by personal delivery or certified mail, return receipt. An interest person is someone who would be entitled to service in an accounting proceeding under SCPA §315. A copy of both the decanted trust and the appointed trust must also be attached. The exercised power becomes effective 30 days from the date of service. Any interest person may serve an objection prior the expiration of the 30-day notice period.

EPTL §10-6.6(b) provides that the fixed income right of any beneficiary cannot be reduced by an appointment of trust assets. One purpose of this requirement is to ensure that the marital deduction for estate and gift tax purposes is preserved, since the surviving spouse must have a right to all of the income during her life from the trust to ensure the availability of the deduction.

While court approval is no longer required for decanting a trust, the trustee may seek court approval if the trustee is unsure as to whether the decanting statute applies, or if the trustee is concerned with potential exposure from claims made by recalcitrant or litigious beneficiaries.

[The revised New York statute now resembles the decanting statutes of Delaware and Alaska. Del. Code Ann. title 12 § 3528; Alaska Stat. § 10 -6.6(b)(1). Despite the liberalization of the New York statute, circumstances may arise where the trustee wishes to avail himself of the Delaware law. Under the Delaware statute, if the statutory requirements are met, a trustee may decant the trust in favor of a new trust without court approval and without notice to or consent of beneficiaries. However, a written instrument signed and acknowledged by the trustee must be filed with the court.]

IV. Circumstances Favoring Decanting

A trustee might seek to utilize EPTL §10-6.6 to accomplish any of the following objectives: (i) to extend

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the termination date of the trust; (ii) to add or modify spendthrift provisions; (iii) to create a supplemental needs trust for a beneficiary who is or has become disabled; (iv) to consolidate multiple trusts; (v) to modify trustee provisions; (vi) to change trust situs; (vii) to correct drafting errors; (viii) to modify trust provisions to reflect new law; (ix) to reduce state income tax imposed on trust assets; (x) to vary investment strategies for beneficiaries; or (xi) to create marital and non-marital trusts.

For example, an irrevocable trust might provide for a mandatory distribution of principal at age 25, with final principal distribution at age 30. However, such mandatory distributions might be inadvisable if the beneficiary has creditor problems, or is profligate or immature. In *In re Rockefeller*, NYLJ Aug. 24, 1999 (Surr. Ct. N.Y. Cty.), the Surrogate allowed trust assets to be decanted into a new trust which contained a spendthrift provision.

The beneficiary may have become subject to a disability after the trust had been drafted. To become (or maintain) eligibility for public assistance, it might be necessary for the trust assets to be distributed to a supplemental needs trust. The Nassau Surrogate, in *In Re Hazan*, NYLJ Apr. 11, 2000 authorized the trustee of a discretionary trust to distribute assets to a supplemental needs trust whose term had been extended to enable the beneficiary to continue to be eligible for public assistance.

If more than one trust has been created for a beneficiary, overall liquidity may be enhanced by transferring the assets of one trust into another trust. So too, combining multiple trusts into a single trust may greatly reduce administrative expenses. In *In Re Vetlesen*, NYLJ June 29, 1999 (Surr. Ct. N.Y. Cty.), the court authorized the trustee to appoint trust assets to a testamentary trust with identical provisions to reduce administrative expenses.

EPTL §10-6.6(b) is particularly well suited to address problems where it may be desirable to appoint new trustees. *In re Klingenstein*, NYLJ, Apr. 20, 2000 (Surr. Ct. Westchester Cty.) authorized the decanting of assets into multiple trusts which granted the beneficiary of each trust the power to remove the trustee. The creation of new trusts in *Klingenstein* also allowed the removal of the impractical limitation requiring any trustee acting as sole trustee to appoint a corporate co-Trustee, and allowed for the elimination of successor Trustee appointments. The decanting statute could also be utilized to modify trustee compensation.

EPTL §10-6.6(b) may also be utilized to change the situs of a trust for privacy reasons. The grantor of a trust may not want minor beneficiaries to become aware of the trust. To preserve secrecy, the trustee might wish to change the situs of the trust to Delaware, which limits the trustee's duty to disclose. If trust property is also located out of New York, changing the situs of the trust might also facilitate trust administration.

Drafting errors or changes in the tax law may also be occasions for seeking to distribute trust assets into a new trust. The Surrogate in *In re Ould Irrevocable Trust,* NYLJ Nov. 28, 2002 (Surr. Ct. N.Y. Cty.) authorized the transfer of trust assets into a new trust where the retention of certain powers by the insured in the original trust might have resulted in inclusion in the gross estate for federal tax purposes.

New York income tax considerations may provide a compelling reason for decanting trust assets. Under Tax Law §603(b)(3)(D), even if the trust is sitused in New York, if there is (i) no trustee domiciled in New York, (ii) no New York source income, and (iii) no real or tangible property located in New York, the accumulated income and capital gains will not be subject to New York income tax. Accordingly, if a trust sitused in New York holds considerable assets outside of New York, decanting those assets into a trust in another jurisdiction might avoid New York income tax on capital gains and accumulated income sourced outside of New York.

If a single trust contains many beneficiaries, one investment strategy might not satisfy the differing objectives and needs of each individual beneficiary. Splitting the trust into individual trusts for each beneficiary could enable the trustees to manage each trust in accordance with the differing objectives of each beneficiary. The Surrogate in *In Re Estate of Scheuer*, NYLJ July 10, 2000 (Surr. Ct. N.Y. Cty.) authorized the trustees of the original trust to appoint trust assets into ten new trusts to accomplish this objective.

Estate tax planning considerations may also warrant consideration of EPTL §10-6.6(b). For example, the statute could be used to create GST Exempt and GST Non-Exempt trusts. Investment strategy for the GST Exempt trust — which would not be subject to GST tax — could be aggressive, while investment strategy for the GST Non-Exempt trust could be used to make distributions to children who are exempt from the GST tax. For example, these distributions could be made for tuition or medical care. [PLR 200629021 ruled that dividing a GST exempt trust into three equal trusts to facilitate investment strategies for different beneficiaries would not taint GST exempt status.]

Dividing a trust into marital deduction and nonmarital deduction trusts may also accomplish both tax and nontax objectives. Assets decanted into the marital deduction trust, which will ultimately be included in the estate of the spouse, could be invested in conservative securities and be used for distributions of principal to the spouse. To the extent the marital trust is depleted, the amount of assets ultimately included in the spouse's gross estate would be reduced. Assets in the non-marital trust, which would not be subject to estate tax in the estate of the spouse, could be in invested in growth assets for future beneficiaries.

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DECANTING TRUSTS, CONT.

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V. Tax Consequences of Decanting

Under New York's revised decanting statute, the trustee is explicitly permitted to consider tax consequences of decanting. In furtherance of the objective to provide sanguine tax results, the statute provides that no power to appoint trust assets may be exercised if such exercise would imperil (i) the marital deduction; (ii) the charitable deduction; (iii) the gift tax annual exclusion under IRC §2503(b); or (iv) any transfer tax benefit.

A. Transfer Tax Consequences

A GST Exempt Trust is not subject to Generation Skipping Transfer Tax. Treas. Reg. §26.2601-1(b)(v)(B) states that the extension of an Exempt Trust in favor of another trust will not trigger GST tax. However, actual additions or deemed additions to a GST Exempt Trust would cause it to lose its exempt status. Therefore, care must be taken when utilizing EPTL §10-6.6(b) not to make an actual or deemed addition to the trust which would cause a GST Exempt Trust to lose its exempt status. If GST implications resulting from distributions to a new trust under EPTL §10-6.6(b) are unclear, a private letter ruling from the IRS should be obtained in advance.

The IRS could argue that decanting causes a taxable gift by the beneficiary to the trust: If the beneficiary is entitled to receive trust distributions at a certain age, and decanting the trust assets would result in a longer trust term, unless the beneficiary objects to the decanting, the IRS could argue that the beneficiary has released a general power of appointment, which would result in a taxable gift. The problem with this argument is that since the beneficiary likely does not have a strong argument for objecting to the decanting, the beneficiary may actually posses no general power of appointment. The beneficiary cannot release a power he does not possess.

On the other hand, if the beneficiary could actually forestall an attempt by the trustee to decant, then the gift tax argument gains credibility. To attenuate the argument that a taxable gift may have occurred, the beneficiary could be given a limited power over trust assets in the new trust. The retention of a limited power of appointment generally should prevent the release from being a taxable gift. Treas. Reg. §25.2511-2(b).

B. Income Tax Consequences

Decanting should result in no adverse income tax consequences. For gain or loss to occur, there must be either a sale or exchange of property, or the property received must be materially different from the property surrendered. Treas. Reg. §1.1001-1(a). The Supreme Court in *Cottage Savings Ass'n v. Com'r.*, 499 U.S. 554 (1991) seemed to read out the word "materially" from the term "materially different" in holding that an exchange of similar mortgages triggered a taxable event. Nevertheless, the IRS has stated in recent rulings that a distribution in further trust will not trigger income tax provided the distribution is permitted either by the trust instrument or by local law.

If encumbered property is distributed pursuant a decanting statute, a potential income tax problem could arise under *Crane v. Com'r.*, 331 U.S. 1 (1947), which held that the amount realized includes relief from liability. An argument could be made otherwise: IRC §643(e) provides that distributions from a trust generally do not produce taxable gain. Therefore, substantial authority would appear to exist for the reporting position that decanting produces no realized gain even if liabilities exceed basis. In view of the preparer penalties under IRC §6694, practitioners might consider disclosing the position on the return.

The decanting statutes of states having decanting statutes provide that the ability to decant trust assets into a new trust is the default rule, but that the default rule may be overridden by the trust instrument. Therefore, the grantor may wish to include in newly drafted trust instruments a provision specifically addressing the grantor's desires with respect to future trust decanting. The grantor may wish to limit the trustee's future ability to modify the trust or may want to give the trustee complete discretion to decant. In either case, specific reference to the grantor's wishes should be included in the trust instrument.

PORTABILITY OF EXCLUSION, CONT.

(Continued from page 1)

The problem which Congress sought to ameliorate would arise where the predeceasing spouse made a bequest to the surviving spouse of the entire estate. While this disposition is not uncommon and would succeed in eliminating estate tax at the death of the first spouse by virtue of the unlimited marital deduction, it would also entirely waste lifetime exclusion of the predeceasing spouse.

Before the enactment of the portability statute, spouses who had not done any estate planning could find themselves in a situation where the estate of the surviving spouse could needlessly incur estate tax liability if the estate, now augmented by the estate of the predeceasing spouse, exceeded the applicable exclusion amount.

The concept of "portability" allows the surviving spouse to increase the available lifetime exclusion by the unused portion of the predeceasing spouse's lifetime exclusion. Thus, in exactly the same situation, the applicable exclusion of the surviving spouse would be augmented by that of the predeceasing spouse. In technical terms, new IRC § 2010 provides that the applicable exclusion amount equals (i) the "basic exclusion amount" plus (ii) "the deceased spousal unused exclusion amount ("DSUEA," pronounced "de-sue-ay")

The basic exclusion amount is, for 2011 and 2012, $5.12 million ($5 million indexed for inflation). If the lifetime exclusion amount were to decrease, the basic exclusion amount would also decrease. The "deceased spousal unused exclusion amount" is the *lesser of* (i) the unused portion of the first deceased spouse's unused exclusion amount and (ii) the basic exclusion amount.

II. Mechanics of Calculating Portability

To illustrate, assume first that Spouse A dies in 2012 and utilizes only $1 million of that spouse's exclusion amount. Spouse B dies in 2013, at a time when Congress has decreased the exclusion amount to $3.5 million. In this case, the surviving spouse's "basic exclusion amount" would be $3.5 million. Although the predeceasing spouse had $4 million of exclusion in reserve when that spouse died, since the applicable exclusion amount in 2013 was only $3.5 million, in calculating the exclusion amount of the second spouse, the "basic exclusion amount" would be $3.5 million. The "deceased spousal unused exclusion amount" would be the lesser of (a) $4 million or (b) $3.5 million, or $3.5 million. Thus, the applicable exclusion amount allowed the surviving spouse would be $7 million.

Note that only the unused exclusion amount of the last spouse of the surviving spouse may be used. Therefore, in a second marriage situation the unused exclusion amount of available to the surviving spouse would be that of the deceased spouse to whom the surviving spouse was married. Therefore, a second marriage to a person who had made lifetime gifts and exhausted his lifetime exclusion would result in no portability to the surviving spouse. The converse would also be true.

There is a further limitation: When calculating the unused exclusion amount of the predeceasing spouse, only that portion of the predeceasing spouse's own basic exclusion amount may be used. In other words, the predeceasing spouse's unused exclusion amount will not include any portion of that spouse's "inherited" unused exclusion.

To illustrate, Bob is married to Carol. Carol dies penniless and made no taxable gifts during her life. Therefore, Bob's exclusion amount is $10 million. Bob then marries Alice. Bob dies. In calculating Alice's exclusion amount, she may use her own $5 million exclusion amount, and the deceased spousal unused exclusion amount of $5 million. The portion of the unused applicable exclusion amount that Bob inherited at the death of Carol would be lost.

III. Electing Portability

The availability of portability is not automatic. In order to benefit from portability, the executor of the estate of the first spouse to die must file a federal estate tax return, federal Form 706. The mere filing the form will result in an election to utilize portability — nothing further is required. The election, once made, is irrevocable. If the executor elects to forego portability, this can be accomplished either by failing to file Form 706, or by stating on the Form 706 that the election is not being made.

In situations where portability will benefit the estate of the surviving spouse, no estate tax return will likely be required at the death of the first spouse, for the simple reason that the estate will have no estate tax liability. For this reason, the executor of the estate of the first spouse may not wish to incur the additional expense of filing an estate tax return, since it will not benefit from that filing.

If discord existed between the surviving spouse and the children of the deceased spouse, and one of the children is executor, he or she could decide not file an estate tax return. It is unclear what remedy, if any, the surviving spouse would have in this situation, although it is clear that if no estate tax return is filed, the deceased spousal unused exclusion amount will be unavailable to her estate. It is possible that the IRS may in the future allow the estate to file a "short form" 706 if the first estate is under the exemption amount.

Another related problem occurs where the estate planning of the couple consisted of a funding a revocable trust and a pour over will. Often, the pour over will is never probated, since most if not all of the assets have already been transferred to the trust. Although the trustee of an *inter vivos* trust has authority to file an estate tax return, it might be preferable to probate

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the will anyway. This would avoid any future complaint by the IRS concerning the requirement that the estate tax return be filed by the executor.

For purposes of calculating the second spouse's applicable exclusion amount, IRC § 2010(c)(5)(B) provides that the IRS may examine the predeceasing spouse's estate tax return to determine the unused exclusion amount of the first spouse to die. This is true even if the statute of limitations for examining the estate tax return for the first spouse has otherwise expired. Therefore, if spouse 2 dies five years after spouse 1, the IRS could not audit the return of the first spouse to increase that spouse's estate tax liability, but could audit the return for purposes of calculating the applicable exclusion amount of the surviving spouse.

The concept of portability applies to the gift tax as well. Therefore, if neither spouse had made any taxable gifts during their respective lifetimes, and spouse A died in 2012, the exclusion amount for spouse B would be $10 million.

IV. Shortcomings of Portability

Despite the allure of portability, many reasons, some subtle, counsel against relying on portability for one's estate plan. One reason is that the portability provision may itself be fleeting: It will expire on December 31, 2012, unless Congress extends it. One reason is technical but obvious: If the surviving spouse remarries, that spouse will lose the unused exemption of the first spouse. While the surviving spouse may utilize the unused exemption of the new spouse, that unused exemption may be depleted.

In contrast, if a credit shelter trust were employed, full use of both exclusions could be vouchsafed. However, here there is a basis trade off with the use of a credit shelter trust. With portability, all of the assets will receive a step up in basis when included in the estate of the second spouse. If a credit shelter trust is used, the assets funding the trust will receive a basis step up only at the death of the first spouse.

The pendulum may swing the other way if the surviving spouse lives for many years after the death of the first spouse, and the assets appreciate greatly during that time. Although it is true that the assets will receive a second basis step up at the eventual death of the surviving spouse, the appreciation of those assets could themselves create estate tax liability. In contrast, assets funding a credit shelter trust are forever removed from the estates of both spouses.

Although Congress provided for portability of the estate tax exemption, and the provision is coordinated with lifetime gifts, Congress did not elect to include in the concept of portability the generation skipping tax (GST) exemption. This could be a significant drawback in estates requiring the use of the GST exemption to increase the amount of assets passing in trust to grandchildren and future descendants.

V. Advantages of Credit Shelter Trust

The credit shelter trust also enables the deceased spouse to ensure that children of the deceased spouse ultimately receive the trust assets, while providing, if necessary, for the needs of the surviving spouse during that spouse's life. A credit shelter trust also offers significant asset protection, and thus can be protected from the claims of creditors of the beneficiaries.

The credit shelter trust may also be preferable to portability with respect to deterring IRS audits. Since the IRS is less likely to audit an estate which will produce no estate tax revenue, assets funding a credit shelter trust would appear less likely to attract an IRS audit. However, the IRS would be free to audit the estate of the second spouse where portability is in issue. In conducting such audit, the IRS could audit the estate of the first spouse for purposes of determining whether the unused exclusion amount that was transferred was correct. This type of audit could involve valuations and issues relating back to the death of the first spouse, which might have occurred years earlier.

VI. State Considerations

Neither New York nor other state has followed the federal lead in enacting the statue permitting portability of the estate tax exclusion. New York has a $1 million estate tax exemption. Couples making full use of portability will have foregone the use of the $1 million New York State exclusion. Therefore, even if a couple elects to go the route of portability as the primary estate planning vehicle, that couple should consider disposing of at least $1 million by means of trust or outright disposition at the death of the first spouse to avoid New York state estate tax on that $1 million at the death of the second spouse. Note that if $1 million is used to fund a credit shelter trust or disposed of outright, this bequest would reduce the amount available for portability to $4 million.