Basis Bonanza: Dealing with Consistency Rules and Generating Step-Up

Estate Planning Council of St. Louis

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* * * * * * * * *

TABLE OF CONTENTS

Page

Basis Bonanza: Dealing with Consistency Rules and Generating Step-Up

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I. BASIS CONSISTENCY AND REPORTING RULES FOR PROPERTY ACQUIRED FROM A DECEDENT

[Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41 (July 31, 2015); Notice 2015-57, 2015-36 I.R.B. 294 (August 21, 2015); Notice 2016-19, 2016-9 I.R.B. (February 11, 2016); Form 8971, Information Regarding Beneficiaries Acquiring Property From a Decedent (January 29, 2016); T.D. 9757 (March 4, 2016); Notice 2016-27 (March 23, 2016)]

A. Introduction

President Obama signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41) (the "Act") into law on July 31, 2015. The Act was effective immediately and affects all United States Estate (and Generation-Skipping Transfer) Tax Returns (Form 706) filed after July 31, 2015. Section 2004 of the Act added Internal Revenue Code ("IRC") § 1014(f), new IRC § 6035 and amends IRC §§ 6662 and 6724.

B. Basis Consistency

IRC § 1014(f) provides rules requiring that the basis of IRC § 1014(a) property (*i.e.*, certain property acquired from a decedent) not exceed the final value of such property as determined for estate tax purposes, or if the final value has not been determined, the value of that property as reported on a statement to the decedent's recipients under new IRC § 6035.

C. Reporting Requirements

IRC § 6035 imposes reporting requirements for individuals who are required to file a Form 706 under IRC § 6018(a) (*i.e.*, the executor) or under IRC § 6018(b) (*i.e.*, the decedent's recipients). If a Form 706 must be filed under IRC § 6018, the reporting party is now also required to report valuation information to the Internal Revenue Service ("IRS") and to each person acquiring any interest in property included in the decedent's gross estate. IRC § 6035 provides that such statements must be furnished at the time prescribed in regulations, but no later than the earlier of: (1) 30 days after the return's due date, including extensions; or (2) 30 days after the return is filed. If valuation or other adjustments are made after the statements are furnished, a supplemental statement shall be filed within 30 days of the date of the adjustment.

D. Penalties

IRC § 6662 was amended by adding subsections (e) and (k), which provide that accuracy-related penalties apply to a taxpayer who reports a higher basis than the estate tax value that applies under IRC § 1014(f). Furthermore, IRC § 6724 was amended to treat Form 8971 as an "informational return" and as a "payee statement." Thus, failure to provide Forms 8971 will result in penalties as provided in IRC §§ 6721 and 6722.

E. Temporary and Proposed Regulations

On March 4, 2016, the Department of Treasury published temporary and proposed regulations ("proposed regulations") providing guidance regarding the basis consistency and information reporting rules of IRC §§ 1014(f) and 6035. The proposed regulations apply to property acquired from a decedent or by reason of the death of a decedent whose federal estate tax return is filed after July 31, 2015.

The proposed regulations clarify various definitions contained in IRC §§ 1014(f) and 6035. "Information Return" means Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent," and the "Statement" required to be furnished to each beneficiary. Prop. Reg. § 1.6035-1(g)(2). "Statement" means the payee statement described as Schedule A of the Information Return. Prop. Reg. § 1.6035-1(g)(2).

The proposed regulations also provide guidance on the following topics: (1) property subject to the basis consistency rules; (2) reporting requirements; (3) property subject to the reporting requirements; (4) reporting due dates; (5) the effect of post-death adjustments to basis; (6) identity of the beneficiaries who must receive a Statement; (7) supplemental information and treatment of subsequently-discovered property; (8) reporting subsequent transfers; and (9) beneficiaries' inability to contest estate tax value.

1. *Property Subject to the Basis Consistency Rules*

Generally, all property included in the decedent's gross estate (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) that generates a federal estate tax in excess of allowable credits (other than a credit for a prepayment of tax) is subject to the basis consistency rules. Prop. Reg. § 1.1014-10(b)(1). If the estate pays no federal estate tax, then none of the estate property is subject to the basis consistency rules. Prop. Reg. § 1.1014-10(b)(3).

Property that qualifies for an estate tax charitable or marital deduction under IRC §§ 2055, 2056 or 2056A are excluded from the property subject to the basis consistency rules because such property does not generate estate tax liability. Prop. Reg. § 1.1014-10(b)(2).

In addition, tangible personal property for which an appraisal is not required under Treas. Reg. § 20.2031-6(b) is not subject to the basis consistency rules. The proposed regulations are not clear whether this exception applies if the aggregate value of all tangible personal property is under the $3,000.00 threshold provided in Treas. Reg. § 20.2031-6(b) or whether the exception applies to each item of tangible personal property the value of which is under the $3,000.00 threshold. However, an example in the proposed regulations indicates that this exception applies for any individual item the value of which is under $3,000.00. Prop. Reg. § 1.6035-1(b)(2), Ex.1. A further indication that the exception applies to each item the value of which is under $3,000.00 is found in the Instructions to Form 706, which requires an appraisal only for those items valued at more than $3,000.00.

2. *Reporting Requirements*

An "executor" who is required to file a federal estate tax return pursuant to IRC § 6018(a) is required to provide an Information Return (i.e., Form 8971 and Schedule A) to the IRS and a Statement (i.e., Schedule A) to all beneficiaries who will receive property that was included in the decedent's gross estate. Prop. Reg. § 1.6035-1(a)(1). This reporting requirement does not apply if the executor is not required by IRC § 6018(a) to file a federal estate tax return, but files a federal estate tax return for other reasons (*e.g.,* to make a portability election, a GST exemption allocation or a protective filing to avoid any penalty if an asset value is later determined to require the filing of a return). Prop. Reg. § 1.6035-1(a)(2).

3. *Property Subject to the Reporting Requirements*

Generally, all property required to be reported on a federal estate tax return (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) is subject to the reporting requirement. Prop. Reg. § 1.6035-1(b)(1). This includes property included in the gross estate but not held by the estate, such as property held in a revocable trust established by the decedent. Regarding property owned by a deceased nonresident alien, only the property that is subject to the U.S. estate tax is reportable. Prop. Reg. § 1.6035-(b)(1). For a decedent holding community property, the reporting requirement only applies to the decedent's one-half of community property. Prop. Reg. § 1.6035-(b)(1).

Four classes of property are exempt from the reporting requirement: (a) cash (other than a coin collection or other coins or bills with numismatic value); (b) income in respect of a decedent (as defined in IRC § 691); (c) tangible personal property for which an appraisal is not required under Treas. Reg. § 20.2031-6(b); and (d) property sold, exchanged or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized. Prop. Reg. § 1.6035-(b)(1) (i)-(iv).

4. *Reporting Due Dates*

The due date for providing an Information Return and Statement to the IRS and the Statements to the beneficiaries is the earlier of 30 days after the due date of the federal estate tax return or 30 days after the date the federal estate tax return is actually filed. Prop. Reg. § 1.6035-1(d)(1). Transitional relief regarding the initial time for filing is provided so that if the due date is before June 30, 2016, the executor need not submit the Information Return and Statements until June 30, 2016. Prop. Reg. § 1.6035-1(d)(2); Notice 2016-27.

5. *Effect of Post Death Adjustments*

The proposed regulations recognize that post-death adjustments to a property's basis may still occur after the valuation date for estate tax purposes. A beneficiary's initial basis in property acquired from the decedent or as a result of the decedent's death will be the value of such property as reported on the federal estate tax return. However, the beneficiary's initial basis may be adjusted due to the operation of other provisions of the Internal Revenue Code governing basis. Prop. Reg. § 1.1014-10(a)(2). Such adjustments could include gain recognized by the decedent's estate upon distribution of the property, post-death capital improvements and depreciation and post-death adjustments to the basis of an interest in a partnership or S corporation. Prop. Reg. § 1.1014-10(a)(2). The basis of property subject to debt (whether recourse or non-recourse) is the gross up value of the property and thus, post-death payments on such debt will not result in an adjustment to the property's basis. Prop. Reg. § 1.1014-10(a)(2).

6. *Identity of the Beneficiaries Who Must Receive a Statement*

Statements must be provided to any person receiving reportable property (referred to as a "beneficiary"). Prop. Reg. § 1.6035-1(c)(1). There is no exception to exclude reporting to a beneficiary who receives property which is not subject to the basis consistency rules (*i.e.*, bequests that qualify for the marital or charitable deduction). If a beneficiary is a trust or another estate, the Statement is provided to the trustee or the executor not the beneficiaries of that trust or estate. Prop. Reg. § 1.6035-1(c)(2).

If the executor has not identified the property that will be distributed to each beneficiary by the due date for submitting the Information Return and Statements, the executor must report on the Statement for each such beneficiary all of the reportable property that could be used to satisfy that beneficiary's interest. Prop. Reg. § 1.6035-1(c)(3); Prop. Reg. § 1.6035-1(e)(3)(ii), Ex. 2. "Once an exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement." Prop. Reg. § 1.6035-1(c)(3).

If a beneficiary cannot be located by the reporting due date, the executor must still file the Information Report and must explain the efforts made to located the beneficiary. Prop. Reg. § 1.6035-1(c)(4). A supplemental report must be filed within 30 days of locating the beneficiary. Prop. Reg. § 1.6035-1(c)(4).

For life estates, a beneficiary includes "the life tenant, the beneficiary of a remainder interest is remainderman(men) identified as if the life tenant were to die immediately after the decedent, and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of the Form 8971. If the contingency subsequently negates the inheritance of the beneficiary, the executor must do supplemental reporting…to report the change of beneficiary." Prop. Reg. § 1.6035-1(c)(1). The inclusion of a contingent beneficiary as a beneficiary who must receive a Statement may be a drafting error, but until such time as the proposed regulations are finalized or amended, executors must report the basis of life estate property to contingent beneficiaries.

7. *Supplemental Information and Subsequently-Discovered Property*

An executor must file supplemental Information Returns and Statements if any change occurs that causes the reported information to be incorrect. Prop. Reg. § 1.6035-1(e)(2). No supplement is required to: (i) correct an inconsequential error or omission within the meaning of Treas. Reg. § 301.6772-1(b); or (2) specify the actual distribution of property previously reported as being available to satisfy the interests of multiple beneficiaries. Prop. Reg. § 1.6035-1(e)(3). The due date of the supplement is 30 days after: (1) the final value is determined, (2) incorrect or incomplete information is discovered or (3) a supplemental federal estate tax return is filed reporting additional assets. Prop. Reg. § 1.6035-1(e)(4)(i).

If property is later discovered and reported on a supplemental federal estate tax return before the period of limitation on assessment of tax expires, such property's basis for basis consistency purposes will be the final value as shown on the supplement to the federal estate tax return. Prop. Reg. § 1.1014-10(C)(3)(i)(A). However, if the discovered property is not reported on a supplemental federal estate tax return before the limitation period expires, the basis of such property is zero. Prop. Reg. § 1.1014-10(c)(3)(i)(B).

8. *Reporting Subsequent Transfers*

If property that previously was reported or is required to be reported is distributed or transferred (by gift or otherwise) by the beneficiary to a related transferee in a transaction in which the related transferee determines its basis, in whole or in part, by reference to the beneficiary/transferor's basis, the beneficiary/transferor must, within 30 days of the transfer, file with the IRS a supplemental Statement and furnish a copy to the transferee. Prop. Reg. § 1.6035-1(f). If the subsequent transfer occurs before the final value is determined for estate tax purposes then the transferor must also give the executor a copy of the Statement. Prop. Reg. § 1.6035-1(f). "A related transferee means any member of the transferor's family as defined in IRC § 2704(c)(2), any controlled entity…and any trust of which the transferor is a deemed owner for income tax purposes. Prop. Reg. §1.6035-1(f).

9. *Beneficiaries' Inability to Contest Estate Tax Value*

The proposed regulations do not provide a process by which a beneficiary could challenge a value reported on a federal estate tax return, rather, the IRS believes that a beneficiary can use state law avenues (*i.e.,* a breach of fiduciary duty claim) to pursue remedies against the executor.

II. PLANNING TO ACHIEVE BASIS STEP-UP

While a primary goal of estate planners in the not-so-distant past was to avoid inclusion of the value of property in a decedent's gross estate, today, with portability and an historically high basic exclusion amount, inclusion of the value of trust assets in a beneficiary's gross estate will more often be desirable. This inclusion will allow a step-up the basis of the assets to their fair market value as of the decedent's death (IRC § 1014(a)) thereby minimizing what could otherwise have been a sizable capital gains tax upon a sale or exchange of low-basis, high-value assets out of the trust. At the same time, so long as the value of the beneficiary's gross estate is equal to or less than his or her unused basic exclusion amount, no federal estate tax will result.

A. Outright Distributions

The clearest, simplest and most direct method of causing inclusion in the gross estate of a trust beneficiary of the value of assets is to distribute the assets to the beneficiary.

In pursuing distribution strategies with a view towards optimizing basis step-up, a trustee should be mindful of his, her or its fiduciary duties to all trust beneficiaries – current, future and remainder beneficiaries, vested and contingent. By increasing current trust distributions to put low basis assets into the hands of beneficiaries, the trustee may be making distributions that are excessive in relation to the distributee's needs, the size of the trust and the standards set out in the trust's governing instrument for the making of distributions. Moreover, by maximizing current trust distributions with a singular focus on tax planning, the trustee may be jeopardizing the interests of other or future or remainder beneficiaries by depleting the trust's asset base and depriving those other or future or remainder beneficiaries of their legitimate beneficial interests in the trust.

The Uniform Trust Code (enacted in 32 states and the District of Columbia to date) provides that a "trustee who acts in reasonable reliance on the terms of the trust as expressed in the trust instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from the reliance." Uniform Trust Code § 1006. Applicable state law and the terms of the trust will guide the trustee and delineate the authorities and powers of the trustee. A trustee, in considering whether to make distributions to beneficiaries with a view to minimizing income taxes, should ascertain that the governing instrument would allow maximizing distributions of income to promote tax advantages.

B. General Power of Appointment

Not only do many clients anticipate having no estate tax issues, they reasonably believe their children and grandchildren will also have no such issues. Nevertheless, trusts for clients' children and more remote descendants (at least until they reach designated ages) remain as viable and important as ever.

It is possible to design trusts for clients' descendants in a manner that will cause the value of the assets in such trusts to be included in their respective gross estates just up to the point beyond which estate tax would be incurred.

IRC § 2041(b)(1) defines a general power of appointment as a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. IRC § 2041(a)(2) provides that "the power of appointment shall be considered to exist on the date of the decedent's death even though the exercise of the power is subject to a precedent giving of notice or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the date of the decedent's death notice has been given or the power has been exercised."

Whether the holder of a testamentary power of appointment chooses to exercise it, the property that was subject to the power will be deemed to have been acquired from the deceased testator and will, therefore, qualify for the step-up in basis. *See* Treas. Reg. §§ 1.1014-2(a)(4), (b)(2). Thus, it is important to consider under what circumstances and to what extent it is wise to confer a general power of appointment with respect to property held in trust to generate basis step-up and income tax savings.

1. *By Formula*

A testamentary general power of appointment can be conferred by means of a formula in such a way that the power would be exercisable only to the extent holding such power would not, by itself, cause imposition of any estate tax. Such a formula could effectively be further refined in such a way so as to have effect only with respect to certain assets in a trust, or to subject to such power, first, those trust assets having a cost basis for federal income tax purposes as of the day before the powerholder's date of death that is the smallest percentage of fair market value as of the powerholder's date of death and, then, cascading, in order, to each asset having a cost basis for federal income tax purposes as of the day before the powerholder's date of death that is the next the smallest percentage of fair market value as of the powerholder's date of death until holding the power would no longer not cause any imposition of estate tax.

2. *Allowing an Independent Trustee or Trust Protector to Grant*

A trust instrument could also be drafted in such a way that an independent trustee or a trust protector may grant a general power of appointment (perhaps, a formula general power of appointment, as described above) to a beneficiary after having examined the income and transfer tax consequences of so doing. Conditioning the grant of a general power of appointment to the determination of an independent trustee or a trust protector may provide more flexibility than having the trust instrument itself confer the general power of appointment. Consider, however, whether a given independent trustee will have the willingness and sophistication to grant a general power of appointment to a beneficiary and whether such independent trustee will even be available when needed for such purpose.

3. *Decanting, Modification, Non-Judicial Settlements*

Even when the provisions of an irrevocable trust instrument would not allow or are affirmatively designed to prevent inclusion of the value of trust property in the gross estate of a beneficiary, there are various mechanisms that may be available under state law by which a general power of appointment could be added to a trust.

Decanting is the process by which a trustee of an irrevocable trust with discretionary distribution authority may, without court approval, transfer the trust property into a new, separate trust. The governing instrument of the new trust has administrative and/or dispositive terms different from those contained in the original trust instrument.

The decanting statutes in the various states whose laws authorize decanting vary widely. Under many such statutes, however, it would be possible (or would certainly appear to be possible) for a trustee to decant to a new trust whose terms would confer a general power of appointment on a beneficiary, thereby generating basis step-up with respect to the assets of the trust at the beneficiary's death.

Notice 2011-101, 2011-52 I.R.B. 932, requests comments regarding the income, gift, estate and GST tax consequences arising from a decanting that changes a beneficiary's interest. Since the IRS has not yet issued decanting regulations, and has not listed decanting regulations in its latest priority guidance plan (s*ee* Department of the Treasury, *2013-2014 Priority Guidance Plan*, November 20, 2013; Belcher, Donaldson, Kaufman, "Recent Developments – 2012," 47TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, Ch. 1 (2013), any decanting that changes beneficial interests should be undertaken with care.

A result similar to the decanting result described above may also be achieved by means of judicial or non-judicial modification or non-judicial settlement. *See*, *e.g.*, §§ 111, 411, 412 and 416 of the Uniform Trust Code. In addition, under common law, beneficiaries, trustees and any other interested parties effectively often have the power to agree among themselves privately to modify trust terms. Acker, *Modifying, Reforming and Terminating Irrevocable Trusts (the Uniform Trust Code Has Made This Harder!)*, 45TH ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, Ch. 10 (2011). In some states and under some circumstances, whether such a modification or settlement could be used to insert a general power of appointment may turn on whether such a change would be considered to violate a material purpose of the trust and could be properly approved by the court.

C. Delaware Tax Trap

The so-called Delaware Tax Trap is an estate planning concept that, given the low estate tax exemption amounts of the past, was indeed a "trap" usually to be avoided. However, with the historically high basic exclusion amounts of today and the next several years, the trap may, in some cases, be an "opportunity."

In the past, as interest in long-term trusts increased, estate planners sought to set up trusts that would last beyond the time permitted by the common law rule against perpetuities by utilizing limited or general powers of appointment. Delaware's statutory framework allowed such long-term trusts to exist indefinitely through the exercise of limited powers of appointment in successive generations. Such technique allowed multi-generational transfers without ever subjecting the trust assets to federal transfer tax liabilities. In response to this tax avoidance technique, and to dissuade a holder of a limited power of appointment created under Delaware law from exercising such power in a manner to avoid the restrictions ordinarily imposed by the rule against perpetuities, Congress enacted IRC § 2041(a)(3). Pursuant to this statute, property subject to a limited power of appointment (ordinarily, of course, not estate tax sensitive) may be includable in the holder's gross estate if the power is exercised by granting another power of appointment which under state law can be validly exercised to postpone the vesting of any interest in the property for a period ascertainable without regard to the date of the creation of the first power.

Today, because of the very high basic exclusion amount, a client's overall tax strategy in connection with estate planning may be focused on achieving the step-up in basis rather than avoiding estate taxes. In this environment, the Delaware Tax Trap is quite attractive and promotes great flexibility. If the holder of a non-general power of appointment exercises it in the manner described in IRC § 2041(a)(3), the trap is sprung and estate tax inclusion (and basis step-up with respect to the assets subject to the power) results. Perhaps, the exercise of such a power could be carried out by means of a formula to ensure that estate tax liability is not triggered. If the holder does not exercise such power, then the power remains an innocuous power the mere possession of which has no tax consequence.

D. Portability

1. *Outright to Surviving Spouse at Death of Predeceased Spouse*

One of the most important aspects of American Taxpayer Relief Act of 2012 (P.L. 112-240, H.R. 8, 126 Stat. 2313, enacted January 2, 2013) for estate planning professionals is that it made portability permanent (to the extent anything emanating from Washington can be said to be "permanent"). The term "portability" is shorthand among estate planners to refer to the ability of a predeceased spouse's executor to transmit to the surviving spouse the predeceased spouse's "deceased spousal unused exclusion amount" (DSUEA). As a result, measured by 2018 numbers, spouses with an aggregate net worth of up to $22,360,000, without having to reallocate ownership of assets between them before either of them has died, would be able to transfer all of their assets to any one or more persons, whether through judiciously timed gifts during life or testamentary transfers at death, and pay no federal gift or estate tax.

When portability was introduced into the law (Section 302(a)(1) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (P.L. 111-312, H.R. 4853, 124 Stat. 3296, enacted December 17, 2010), amending IRC Section 2010(c)), it was hailed as a concept that would greatly simplify estate planning for married couples. No longer would it be necessary for each spouse to own sufficient assets and have an estate plan in place that would facilitate use of the predeceased spouse's applicable exclusion amount regardless of which spouse died first (the traditional approach). By now, attentive estate planners have come to realize that portability has not resulted in simplification. If anything, portability has complicated estate planning by introducing yet another option that a married couple must consider.

There are significant limitations regarding the utility of portability. The DSUEA, unlike the basic exclusion amount, is not adjusted for inflation. Further, any income and appreciation accruing after the predeceased spouse's death are not sheltered by the DSUEA. Also, there is no portability for the GST exemption. In addition, the executor of the predeceased spouse must timely file an estate tax return and make an election (IRC § 2010(c)(5)) to allow the surviving spouse to take the DSUEA into account for purposes of calculating the surviving spouse's applicable exclusion amount.

All that said, a major advantage of portability is that all assets that, at the death of the first spouse to die, would have passed under that spouse's estate plan, in the absence of portability, to a credit shelter trust using the traditional approach, instead pass to the surviving spouse and will be included in the surviving spouse's estate at his or her subsequent death – thereby generating a step-up in basis of the assets to their then fair market value (IRC § 1014(a)) and minimizing future capital gains taxes when they are sold -- without subjecting the surviving spouse's estate to estate tax liability.

2. *To QTIP Trust at Death of Predeceased Spouse*

A few advantages are forfeited by employing portability to leave assets outright to a surviving spouse as postulated above. First, the GST exemption (IRC §2631), unlike the basic exclusion amount, may not be elected to be used by a surviving spouse. Second, all assets owned by a surviving spouse are fully exposed to claims of his or her creditors. Third, any post-predeceased spouse's death growth in the value of the assets that would have passed to a credit shelter trust at the death of the first spouse to die using the traditional credit shelter trust approach, and so would have been excluded from the gross estate of the surviving spouse, will be included in the surviving spouse's gross estate.

A possible way to solve the first two of those portability disadvantages would be to structure the spouses' estate plan so that, at the death of the first spouse to die, everything owned by that spouse passes to a QTIP trust instead of outright to the surviving spouse. The reverse QTIP election (IRC §2652(a)(3)) could be made, thereby enabling the predeceased spouse's GST exemption to be used, and the assets and income of the QTIP trust, for so long as such assets and income remained in the trust, would be exempt from the claims of the surviving spouse's creditors. At the same time, the value of all QTIP trust property at the surviving spouse's death will be included in the surviving spouse's estate at his or her subsequent death (IRC § 2044(a)) – thereby generating a step-up in basis of the assets to their then fair market value (IRC § 1014(a)).

A QTIP election that is not necessary to reduce estate tax liability to zero is <u>not</u> automatically disregarded. Rev. Proc. 2016-49, 2016-42, I.R.B. 462 (October 17, 2016).

E. Designing Spousal Asset Ownership Structure to Ensure Some Basis Step-Up at Death of First Spouse to Die

Portability notwithstanding, where spouses have unequal net worth, they may benefit from dividing their estates and allocating their wealth more evenly between them. Unequal allocation of wealth between spouses can result in forfeiture of valuable basis step-up and payment of unnecessary capital gains taxes.

Assume one spouse owns substantially all the couple's assets (the "wealthy spouse") and that the aggregate value of such assets exceeds one basic exclusion amount. Such assets are highly appreciated. The other spouse (the "poor spouse") is the first to die. If assets had been transferred to the poor spouse more than a year before the poor spouse died (*see* IRC § 1014(e)), such assets would have been included in the poor spouse's gross estate, would have received a full step-up in basis to fair market value as of the poor spouse's date of death and could have passed to the wealthy spouse free of estate tax. While it is true that the executor of the poor spouse could elect portability and transmit the DSUEA to the wealthy spouse, note that in this scenario the wealthy spouse will not own any assets during his or her remaining life that have a stepped-up basis. Accordingly, if any of the couple's assets need to be sold during the surviving spouse's remaining life to generate cash to pay for the surviving spouse's health, maintenance, support, care, comfort, etc., all that is available to be sold are highly appreciated, low basis assets. Had the spouses reallocated their assets between them while both were alive, then, at the death of the first spouse to die, there would have been a meaningful amount of assets with a stepped-up basis that could have been sold at minimum capital gains tax cost to generate cash to pay for the surviving spouse's health, maintenance, support, care, comfort, etc.

F. Use Elderly Parents

Wealthy clients with elderly less wealthy parents (even incapacitated less wealthy parents) could consider giving low-basis property to an irrevocable trust for the lifetime benefit of a parent, or selling such property to an irrevocable grantor trust for the lifetime benefit of a parent, in either case naming the client or the client's descendants as remainder beneficiaries and conferring on such parent a narrowly circumscribed formula general power of appointment of the type described above. A client considering this strategy would need to have substantial confidence that the parent would not attempt to divert the property away from the client at the parent's death and that there would be no undue risk under applicable state law that the parent's creditors could gain access to the trust property. In fact, given that an individual is deemed to possess a general power of appointment conferred on him or her even if he or she is unaware of it, an adventurous client without less wealthy parents might consider using a variation of this strategy with an elderly person who is a perfect stranger as the lifetime beneficiary of such a trust!

G. Avoiding IRC Section 1014(e)

1. *Credit Shelter Trust*

IRC § 1014(a) provides that the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent, shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death. IRC § 1014(e) provides an exception to the general rule for transfers of appreciated property that were acquired by the decedent within one year of his or her death. It states that, if appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent's death and such property is acquired from the decedent by (or passes from a decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent. IRC § 1014(e)(1). A close reading of the statute seems to suggest that the provisions of IRC 1014(e) could be avoided in certain transfers of assets involving spouses and trusts created by them that take place within one year of death of either spouse.

Assume that a soon-to-be surviving spouse transferred her assets to the soon-to-be-deceased spouse and it is inevitable that the predeceasing spouse will die within one year of such transfer. If, instead of directing a transfer of all of the predeceased spouse's assets to the surviving spouse outright upon predeceased spouse's death, the predeceasing spouse creates (or, as in the case of a Supercharged Credit Shelter Trust[sm], is deemed, under IRC § 2044(c), to have created) a credit shelter trust and provides that all assets passing by reason of his death be transferred to the credit shelter trust, all assets in the credit shelter trust should be eligible to receive a step-up in basis pursuant to IRC § 1014(a). While it is common for the surviving spouse to be a beneficiary of a credit shelter trust created by a predeceased spouse, the surviving spouse's powers and beneficial interest in the credit shelter trust are usually limited – precisely in order to avoid inclusion of the value of the trust property in the surviving spouse's gross estate under IRC § 2041. In this scenario, the surviving spouse does not acquire her assets back from the predeceased spouse. The assets are acquired by the credit shelter trust. Thus, IRC § 1014(e) cannot apply.

2. *QTIP Trust*

Although *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, primarily dealt with the gift tax consequences of a deferred private annuity and qualifying income interest for life disposition issues under IRC § 2519, the case, in passing, addressed the step-up in basis of property that had been transferred to an *inter vivos* QTIP trust by a wife for the benefit of her husband who died a week after the establishment of such trust, which resulted in such property being held in a QTIP trust for the benefit of the wife that was treated, under IRC § 2044(c), to have passed from the husband.

The decedent was the beneficiary of several trusts of which her predeceased husband had been the beneficiary. One of the trusts was a QTIP trust that the decedent had created for the benefit of Mr. Kite. The decedent had funded the trust by contributing 120,670 shares of common stock of Oklahoma Gas & Electric Co ("OG&E stock"), with an adjusted basis of 34 cents per share and an aggregate fair market value of $4,246,075.60. The trust instrument provided that, upon the death of Mr. Kite, the decedent was to be the sole income beneficiary of the QTIP trust. The decedent's three children were remainder beneficiaries of the trusts. Upon funding the QTIP trust, the decedent filed a federal gift tax return and deducted the value of the property conveyed to the trust as a marital deduction transfer under IRC § 2523.

Mr. Kite died one week after the decedent created the QTIP trust. The Tax Court noted in footnote 9 of the case that the "executor of Mr. Kite's estate reported a gross estate of $15,480,131, a marital deduction of $15,279,725, and zero federal estate tax. The marital deduction included the following trust allocations: (a) $4,291,327 to QTIP trust-1, (b) #825,213 to QTIP trust-2, and (c) $10,143,808 to the marital deduction trust (collectively, the marital trusts). All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014."

Given the Tax Court's analysis in footnote 9, it could be surmised that IRC § 1014(e) was determined not to apply. It is not clear whether and to what extent the Tax Court's last sentence in footnote 9 can be relied on when designing and implementing a strategy whereby a donor transfers property to a QTIP trust for the benefit of his or her spouse and, from and after the death of the spouse within a year after such transfer, the property of the QTIP trust is held in a follow-on QTIP trust for the benefit of the donor.

A QTIP trust, in some ways similar to a credit shelter trust as discussed above, has limitations on the surviving spouse's ability to access and exert control over trust principal. Were this not the case, the trust would not be a QTIP trust; it would be an IRC § 2056(b)(5) trust. While the donor/beneficiary of the QTIP trust must be entitled to receive the entire net income of the trust, at least annually, and while the value of QTIP trust property is includable in the gross estate under IRC § 2044, a QTIP trust and its beneficiary are not one and the same person. *See, e.g., Estate of Bonner v. United States*, 84 F.3d 196, 77 A.F.T.R.2d 96-2369 (5th Cir. 1996).

Although the argument for avoiding the effect of IRC § 1014(e) when the donor spouse is the beneficiary of a QTIP trust deemed to have passed from the donee spouse may not be quite as strong as where the donor spouse is the beneficiary of a credit shelter trust established or deemed to have passed from the donee spouse, the Tax Court in *Kite* seems implicitly to have acknowledged that the argument has merit. The argument would appear to have more weight in a circumstance where the donor spouse is not the sole trustee, or better yet, not a trustee at all, and where the donor spouse's interest in principal is more, rather than less, restricted, *i.e.*, no testamentary power of appointment and narrow, if any, ability to receive discretionary principal distributions.

H. Using a Community Property Trust

IRC § 1014(b)(6) provides, in general, that a surviving spouse's one-half share of community property is considered to constitute property "acquired from or to have passed from the decedent." Thus, the basis of the surviving spouse's one-half share of community property is its fair market value at the date of the predeceased spouse's death.[1] Since, by reason of IRC § 1014(b)(1), the basis of the predeceased spouse's one-half share of community property would, quite naturally, be established under the general rule of IRC § 1014(a), the overall result of IRC § 1014 is that *both halves* of community property receive a basis equal to fair market value at the date of the predeceased spouse's death.

Married couples residing in community property states can very easily avail themselves of this remarkable benefit. Obtaining this benefit is more of a challenge for spouses living in common law property states.[2] It may be possible, however, if they are willing to transfer assets to an Alaska, Tennessee or South Dakota community property trust.[3] A community property trust is, essentially, a trust whose dispositive and administrative provisions mimic the beneficial interests and rights of spouses in community property not held in trust. Specifically, each spouse ultimately has control, during life and at death, unless or until intentionally relinquished, over half of the assets in trust. In addition, the governing instrument contains a declaration that the assets transferred to the trust are community property (Alaska and South Dakota) or that the trust

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[1] IRC § 1014(a).

[2] For ease of reference, in this article, Alaska, Tennessee and South Dakota are not included within the term "common law property state" even though common law property is the default property ownership regime for spouses in all three states.

[3] *See* AS § 34.77.100; Tenn. Code Ann. §§ 35-17-101, *et. seq.*; S.D.C.L.§§ 55-17-1, *et seq.*

is a community property trust (Tennessee). South Dakota law imposes a requirement that additional language be included in the governing instrument.

Unfortunately, there is no statute, regulation, ruling or case specifically and unambiguously saying that assets conveyed to a community property trust by a spouse or spouses domiciled in a common law property state are "community property" within the meaning of IRC § 1014(b)(6).

Three fundamental questions must be addressed in discerning whether assets placed in a community property trust by nonresidents of Alaska, Tennessee or South Dakota are "community property" within the meaning of IRC § 1014(b)(6). First, will property be recognized as "community property" for purposes of IRC § 1014(b)(6) if community property status was implemented by a voluntary act as opposed to automatically flowing from the owners' status of living in a community property state and being married? Second, is it possible for property to be recognized as "community property" for purposes of IRC § 1014(b)(6) if legal title to the property is held in trust? IRC § 1014(b)(6) became law in 1948, long before the proliferation of *inter vivos* trusts, and so it is reasonable to believe that Congress, in enacting IRC § 1014(b)(6), did not contemplate that community property could be owned, in a legal sense, by any person or persons other than spouses outright. Third, in answering the first two questions, is it relevant that the spouses are nonresidents of Alaska, Tennessee or South Dakota and are in fact residents of a common law property state?

The answer to the first question appears to be "probably." In *McCollum*,[4] spouses made a choice (a voluntary act), as then permitted by applicable state law, to own certain real estate as community property. Following the death of the first to die, the survivor asserted that IRC § 1014(b)(6) applied in determining the basis of the survivor's half of the property. The District Court agreed and distinguished *Harmon*,[5] a Supreme Court case that was somewhat analogous but did not concern IRC § 1014(b)(6).[6] Furthermore, in Revenue Ruling 77-359,[7] the Internal Revenue Service ruled that a legally enforceable agreement between husband and wife (again, a voluntary act) that certain property that had been separate property should henceforth be considered community property would be recognized for income tax purposes.

The second question seems to be answered definitively by Revenue Ruling 66-283.[8] In that ruling, a husband and wife had transferred their community property to a revocable trust. Under applicable state law, community property could be held in trust without losing its character as such. The Internal Revenue Service ruled that, at the death of the predeceased spouse, the basis of the surviving spouse's one-half share of the community property held in trust would be established under IRC § 1014(a) because of IRC § 1014(b)(6).

The answer to the third question seems the most elusive. If nonresidents of Alaska, Tennessee or South Dakota, residing in a common law property state, were to create in Alaska,

[4] *McCollum v. United States*, 58-2 U.S.T.C. ¶ 9957 (D. Okl. 1958).
[5] *Commissioner v. Harmon*, 323 U.S. 44 (1944).
[6] IRC § 1014(b)(6) was not enacted until four years after *Harmon* was decided.
[7] Rev. Rul. 77-359, 1977-2 C.B. 24.
[8] Rev. Rul. 66-283, 1966-2 C.B. 297.

Tennessee or South Dakota what was ostensibly a community property trust but whose validity was later determined *not* to be governed by the law of Alaska, Tennessee or South Dakota, IRC § 1014(b)(6) would be rendered inapplicable because there would be no community property. To minimize the possibility of this result, it would be important that the trust have a "substantial relation" to Alaska, Tennessee or South Dakota (a requirement seemingly satisfied because, under the applicable community property trust statute, the trust would be required to have an Alaska, Tennessee or South Dakota resident Trustee), that application of Alaska, Tennessee or South Dakota law not violate a strong public policy of the state with which the trust has its most significant relationship (a requirement less easily satisfied depending on the state with which the trust is considered to have its most significant relationship, the public policies of that state and the strength of those public policies) and that the trust instrument operate as a valid post-nuptial agreement.[9]

If clients and their advisers approach the community property trust technique with sound judgment and careful attention to detail, it may in some circumstances be an excellent basis-boosting strategy.[10]

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[9] *See* Restatement (Second) Conflict of Laws § 270 (1971). *See, also,* M. Read Moore and Nicole M. Pearl, *Coming Soon to Your State: Community Property*, 48 U. MIAMI HECKERLING INSTITUTE ON ESTATE PLANNING (2013).

[10] There are further caveats and complications involved in using community property trusts that are beyond the scope of this article. Additional issues include unanticipated gift tax consequences, whether one or both of the spouses desire all the consequences of a community property arrangement and possible loss or reduction of protection against creditors' claims.