LOOKING FOR BASIS IN ALL THE RIGHT PLACES: INCOME TAX BASIS ADJUSTMENTS IN ESTATE PLANNING AND ADMINISTRATION

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- Adjunct Professor, University of Houston Law Center, 1988–2017, teaching Income Taxation of Trusts and Estates and Postmortem Estate Planning
- Best Lawyers in America, Trusts and Estates; Texas Super Lawyer, *Texas Monthly* and *Super Lawyers Magazine*
- Named *Best Lawyers'* 2013 Houston Trusts and Estates "Lawyer of the Year"
- Named by *Texas Lawyer* as a 2013 "Top Notch Lawyer" for Trusts and Estates
- Awarded 2017 Jim D. Bowmer Award for Outstanding Contributions to the Profession by the Texas Bar College
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- Member of the Board of Directors, ACTEC Foundation (2013-2018) (Chair: Grant Committee 2015-2018)
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BOOKS, RECENT SPEECHES AND PUBLICATIONS:

- Author: DAVIS'S TEXAS ESTATE PLANNING FORMS (Thomson Reuters - O'Connor's, 2017-2023, updated annually)
- Editor: O'CONNOR'S TEXAS PROBATE FORMS (Thomson Reuters - O'Connor's, 2019-2023, updated annually)
- Co-Author: Streng & Davis, RETIREMENT PLANNING–TAX AND FINANCIAL STRATEGIES (Checkpoint/RIAG/WG&L 2009-2021)
- Co-Chair: The University of Texas School of Law Annual Tax Conference – Estate Planning Workshop, 2016-2023
- Co-Author/Speaker: Income Taxation of Trusts and Estates, The Center for American and International Law Annual Short Course on Estate Planning, 2023
- Course Director: 24th Annual State Bar of Texas Annual Building Blocks of Wills, Trusts and Estate Planning/Live Satellite Broadcast, 2023
- Co-Author/Co-Presenter: Ten Things Every Estate Planner Needs to Know About Subchapter J, 49th Annual Midwest/Midsouth Estate Planning Institute, 2022
- Co-Author/Panel Moderator: The Point and Counterpoint of Different Estate Planning Strategies, ACTEC 2022 Summer Meeting
- Co-Author: Estate Planners' Toolbox: Reading the Tea Leaves for the Good, the Bad, and the Ugly, State Bar of Texas 28th Annual Advanced Estate Planning Strategies Course, 2022
- Co-Presenter: A Focus on Estate and Gift Tax Updates, The University of Texas School of Law 69th Annual Tax Conference – Estate Planning Workshop, 2021
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- Co-Author/Co-Presenter: What Every Estate Planner Needs to Know about Fiduciary Litigation, 27th Annual Advanced Estate Planning Strategies Course, 2021
- Co-Author/Co-Presenter: Ten (okay, Fourteen) Tools Every Estate Planner Should Know How to Use, 47th Annual Midwest/Midsouth Estate Planning Institute, 2020
- Co-Author/Panelist: Ten Things Every Estate Planner Needs to Know About Subchapter J, 60th Annual Probate & Estate Planning Institute, Michigan's ICLE, 2020; Texas Tech Estate Planning & Community Property Law Journal CLE & Expo; Southern Arizona Estate Planning Council, 2019; 54th Annual Southern Federal Tax Institute, 2019; Dallas Bar Association Probate, Trusts & Estates Section, 2019; 44th Annual Notre Dame Tax and Estate Planning Institute, 2018

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· Co-Author/Panelist: *Running the Gamut on Planning for the Middle-Rich*, 57th Annual Heckerling Institute on Estate Planning, 2023
· Co-Author/Co-Presenter: *Ten Things Every Estate Planner Needs to Know About Subchapter J*, 49th Annual Midwest/Midsouth Estate Planning Institute, 2022; 60th Annual Probate & Estate Planning Institute, Michigan's ICLE, 2020; Southern Arizona Estate Planning Council, 2019; 54th Southern Federal Tax Institute, 2019; Dallas Bar Association Probate, Trusts & Estates Section, 2019; 44th Notre Dame Tax and Estate Planning Institute, 2018
· Co-Author/Panelist: *Estate Planners' Toolbox: Reading the Tea Leaves for the Good, the Bad, and the Ugly*, State Bar of Texas 28th Annual Advanced Estate Planning Strategies Course, 2022
· Co-Author/Panelist: *Finding the Success in Business Succession*, 56th Annual Heckerling Institute on Estate Planning, 2022
· Panelist: *Current Developments in Estate and Tax Planning 2021*, ACTEC-ALI CLE Webcast, 2021
· Co-Presenter: *A Focus on Estate and Gift Tax Updates*, The University of Texas School of Law 69th Annual Tax Conference – Estate Planning Workshop, 2021
· Co-Author/Panelist: *Fundamentally Fun Solutions to Perilous Income Tax Pitfalls in Estate Planning*, 55th Annual Heckerling Institute on Estate Planning, 2021
· Co-Presenter: *The SECURE Act: What Estate Planners Need to Know*, The University of Texas School of Law 68th Annual Tax Conference – Estate Planning Workshop, 2020
· Co-Author/Co-Presenter: *Ten (okay, fourteen) Tools Every Estate Planner Should Know How to Use;* 47th Annual Midwest/Midsouth Estate Planning Institute, 2020
· Co-Author/Co-Presenter: *Ten Things Every Estate Planner Needs to Know About Subchapter J*, 60th Annual Probate & Estate Planning Institute, Michigan's ICLE, 2020; Southern Arizona Estate Planning Council, 2019; 54th Southern Federal Tax Institute, 2019; Dallas Bar Association Probate, Trusts & Estates Section, 2019; 44th Notre Dame Tax and Estate Planning Institute, 2018
· Author/Speaker: *Income and Transfer Tax Issues of Settlements and Modifications*, 60th Annual Probate & Estate Planning Institute, Michigan's ICLE, 2020
· Co-Author/Co-Presenter: *Estate Planning for Married Couples in a World with Portability and the Marital Deduction*, 60th Annual Probate & Estate Planning Institute, Michigan's ICLE, 2020; 44th Annual Midwest/Midsouth Estate Planning Institute, 2017; 38th, 39th Annual ALI CLE Planning Techniques for Large Estates, 2018, 2019
· Author/Speaker: *Getting the 411 on 199A: Just the Facts, Ma'am*, 53rd Annual Heckerling Institute on Estate Planning, 2019; IRS Estate and Gift Tax Attorney and Paralegal CPE IVT, 2019

TABLE OF CONTENTS

LOOKING FOR BASIS IN ALL THE RIGHT PLACES: INCOME TAX BASIS ADJUSTMENTS IN ESTATE PLANNING AND ADMINISTRATION

I. INTRODUCTION

Historically high federal gift and estate tax exclusions, plus the potential portability of any "excess" estate tax exclusion in the case of spouses, mean that for many taxpayers, estate and gift taxes are simply no longer a primary concern. At the same time, Congressional adjustments to income tax rates and brackets has brought a new focus on the importance of income tax planning. The combined effect of these changes has given rise to a new emphasis on potentially maximizing a taxpayer's basis in property acquired from a decedent.

II. THE NEW TAX ENVIRONMENT

A. ATRA, TCJA, and Rates and Exclusions

With the passage of the American Taxpayer Relief Act of 2012, P.L. 112-240, 126 Stat. 2313 (2013) ("ATRA 2012"), estate planners and their clients began to see a new focus on the role of income taxes as part of estate planning. ATRA 2012 reunified and made "permanent" the estate, gift, and generation-skipping transfer ("GST") tax laws. As part of these new laws, the highest tax bracket for estate, gift, and GST tax purposes went from 35% to 40%, making the spread between these transfer tax rates and the highest income tax rate closer than they had been in years. Combining the large (and inflation-adjusted) estate tax exclusions, together with portability, higher income tax rates, and a new income tax, estate planners had to change their conversations with clients during the estate planning and the estate administration process.

With the enactment of the Tax Cut and Jobs Act of 2017, P.L. 115-97, 131 Stat. 2054 (2017) ("TCJA 2017") on December 22, 2017,[1] significant changes were once again made to the income and transfer tax laws. TCJA 2017 essentially doubled the estate and gift tax exclusions and GST tax exemption for persons dying and transfers made between 2018 and 2025. As a result, we have unified estate, gift and GST tax laws with an exclusion (or exemption) temporarily set at $10,000,000, as adjusted annually for inflation after 2011 (scheduled to return to $5,000,000 after 2025, as adjusted for inflation after 2011), and a top transfer tax bracket of 40%.[2] For 2023, after applying the inflation adjustment, the exclusion is $12,920,000.[3]

B. The Net Investment Income Tax

Coincidentally, although not a part of ATRA, January 1, 2013 also ushered in a new 3.8% income tax. The Health Care and Education Reconciliation Act of 2010, P.L. 111-152, 124 Stat. 1029 (2010) ("HCA 2010") imposes an additional 3.8% income tax on individuals, trusts, and estates, and that tax began being imposed in 2013. For individuals, the tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For individuals who are married filing jointly, the threshold is $250,000; for married filing separately, $125,000 each; and for single individuals, $200,000. For estates and trusts, the 3.8% tax applies to the lesser of *undistributed* net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts, which is $14,450 for 2023. When combined with the top 37% income tax rate established by TCJA 2017, the additional 3.8% tax on net investment income yields a top tax rate of 40.8% on ordinary income and a top tax rate of 23.8% on capital gains and qualified dividends. Even after the changes to the income tax rates brought about by TCJA 2017, the spread between the top income and estate tax rates is virtually nil.

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[1] The technical name of the Act is "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018", but "AAPRPTIIVCRBFY 2018" seems to be a remarkably unhelpful acronym. Some have suggested "the Act Formerly known as TCJA 2017," or perhaps its abbreviation, "AFKATCJA."

[2] Prior to TCJA 2017, inflation was measured by changes to the Consumer Price Index ("CPI"), published by the U.S. Bureau of Labor Statistics. TCJA 2017 modified the index to the "Chained Consumer Price Index," ("C-CPI-U" or "Chained CPI"), which generally grows more slowly than CPI. Using CPI, the 2018 figure would have been $11.20 million instead of the $11.18 million that results from using C-CPI-U. Although many of the provisions related to individuals in TCJA 2017 are only effective for years 2018-2025, Chained CPI as the method of inflation adjustment is "permanent."

[3] 2023 inflation-adjusted figures were announced in Rev. Proc. 2022-38, 2022-45 IRB 445. For 2022, the exemption was $12,060,000. Rev. Proc. 2021-45, 2021-48 IRB 764. For 2021, the exemption was $11,700,000. Rev. Proc. 2020-45, 2020-46 IRB 1016 § 3.41.

C. Portability

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P.L. 111-312, 124 Stat. 3296 (2010) ("TRA 2010") added, and ATRA made permanent, the notion of "portability" of a deceased spouse's unused exclusion amount. In essence, portability provides that upon the death of one spouse[4], the executor of that spouse's estate may file an estate tax return and elect on that return to allow the surviving spouse to effectively inherit any unused federal estate tax exclusion of the deceased spouse. In other words, the deceased spouse's unused exclusion amount can be "ported" to the surviving spouse. IRC § 2010(c)(2)(B). Final regulations were issued effective June 12, 2015 which provide guidance regarding portability. Treas. Reg. §§ 20.2010-2, -3. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount," otherwise known as the "DSUE amount." Once a spouse receives a DSUE amount, the surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse." A simple example illustrates this concept.

Example 1: H dies in 2011 with an estate of $3 million. He leaves $2 million outright to his wife W, and the balance to his children. As a result, his taxable estate is $1 million ($3 million, less a $2 million marital deduction). The executor of H's estate elects to file an estate tax return using $1 million of H's $5 million estate tax exclusion to shelter the gift to the children, and pass (or "port") the other $4 million of H's estate tax exclusion to W. As of the date of H's death, W would then have an estate and gift tax exclusion of $9 million (her own $5 million exclusion plus H's unused $4 million exclusion).[5]

TCJA 2017 did not change the rules for portability. As a result, married couples can effectively shelter up to $25.84 million (using 2023 figures) in wealth from federal gift or estate tax without utilizing any sophisticated estate planning techniques.

III. WHAT IS BASIS?

Basis is a fundamental concept in income tax planning. A taxpayer may incur a tax liability whenever he or she sells assets at a gain. Gain is measured by the excess of the amount realized from a disposition of property over the taxpayer's adjusted basis in that property. IRC § 1001. Basis also establishes the amount upon which depreciation deductions are based. IRC § 167(c). In general, a taxpayer's basis in an asset is measured by its cost, with certain adjustments. IRC §§ 1012, 1016. However, a special rule applies if the property in question is acquired from a decedent. IRC § 1014(a).

A. Basis in Property Acquired from a Decedent

With a few exceptions, 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, is equal to: (i) the fair market value of the property at the date of the decedent's death;

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[4] A "spouse" may include persons other than those ceremonially married in the jurisdiction in which the decedent died. For example, persons who are married under the common law of one jurisdiction may be recognized as married for federal tax purposes, even if they later move to a jurisdiction that does not recognize common law marriage. *See* Rev. Rul. 58-66, 1958-1 CB 60. In addition, same-sex couples who are lawfully married in the jurisdiction in which the marriage ceremony is celebrated will be considered spouses for all federal tax purposes, even if they reside in a jurisdiction that purports not to recognize same-sex marriage. *United States v. Windsor*, 133 S.Ct. 2675 (2013); Rev. Rul. 2013-17, 2013-38 IRB 201. Subsequent to the issuance of Revenue Ruling 2013-17, the U.S. Supreme Court ruled that the Fourteenth Amendment of the U.S. Constitution requires states to license marriages between two people of the same sex, and to recognize all marriages between two people of the same sex when their marriage was lawfully licensed and performed out-of-state. *Obergefell v. Hodges*, 135 S.Ct. 2584 (2015). As a result, the marriage of a same-sex couple that is lawful in the state in which the marriage was performed cannot be ignored in other states for purposes of applying their laws. The constitutional basis for this holding likely means that laws in states that purport to limit marriage to one man and one woman can never have had valid application. A discussion of this issue is beyond the scope of this paper. For convenience, some examples in this paper denominate spouses as H and W. The IRS issued Notice 2017-15, 2017 IRB 783 which outlines procedures to allow taxpayers and executors to recalculate remaining applicable exclusion amounts and GST exemption to the extent that exclusion amounts were used or exemption was allocated by a taxpayer lawfully married to a person of the same sex who the IRS did not treat as a spouse before the *Windsor* decision was issued. Unfortunately, the procedures outlined do not address the proper re-computation of adjusted taxable gifts, so further guidance is expected.

[5] Although the surviving spouse's exclusion amount would be adjusted each year for inflation and applicable law changes, the $4 million DSUE amount would not. Thus, if the surviving spouse died in 2023, his or her applicable exclusion amount would be the basic exclusion amount of $12,920,000 plus the DSUE amount of $4 million, for a total exclusion amount of $16,920,000.

(ii) if an "alternate valuation date" election is validly made by the executor of the decedent's estate, its value at the applicable valuation date prescribed by Section 2032 of the Internal Revenue Code (the "Code")[6]; and (iii) if a "special use valuation" election is validly made by the executor of the decedent's estate, its value for special use valuation purposes prescribed by Code Section 2032A. IRC § 1041(a). In short, then, in most cases, the basis in property inherited from a decedent is the value of that property for federal estate tax purposes. When a trust or an estate distributes property to a beneficiary, the beneficiary's basis in the property will be equal to the trust or estate's basis before distribution, adjusted for any gain or loss recognized by the trust or estate as a result of the distribution. IRC § 643(e)(1). Although often called a "step-up" in basis, the basis in various assets may be stepped up *or down*. Therefore, it is more accurate to call it a basis adjustment. Original basis is simply ignored and federal estate tax values are substituted. The adjustment to the basis of a decedent's assets occurs regardless of whether an estate tax return is filed, and regardless of whether the estate is even large enough to be subject to federal estate tax.

1. Basis Consistency. Although the basis adjustment occurs regardless of whether an estate tax return is filed, Code Section 1014(f), enacted on July 31, 2015 as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (P.L. 114-41) ("Transportation Act"), provides that basis of certain property acquired from a decedent, as determined under Code Section 1014, may not exceed the value of that property as finally determined for federal estate tax purposes, or if not finally determined, the value of that property as reported on a statement made under Code Section 6035. Code Section 6035, also enacted as part of the Transportation Act, provides that the executor of any estate that is required to file an estate tax return under Code Section 6018 (i.e., an estate that exceeds the estate tax filing threshold) must furnish to the IRS and to each person acquiring any interest in property included in the decedent's gross estate for federal estate tax purposes a statement identifying (1) the value of each interest in that property as reported on the estate tax return, and (2) any other information that the IRS might require. IRC § 6035(a)(1). Note that the reporting requirement is limited to the value of the property as finally determined for estate tax purposes; it is <u>not</u> a requirement to report basis of the property in the hands of the distributee. In addition, each person required to file a return under Code Section 6018(b) (persons other than executors holding estate property) must furnish to the IRS and to each other person who holds a legal or beneficial interest in the property to which that return relates a statement identifying the information described above. IRC § 6035(a)(2). The IRS is required to prescribe any regulations that are necessary to carry out these rules, including rules applicable to estates for which no estate tax return is required to be filed, and for situations where a surviving joint tenant or other recipient might have better information than the executor regarding the basis or fair market value of the property. IRC § 6035(b). In January 2016, the IRS issued Form 8971 "Information Regarding Beneficiaries Acquiring Property from a Decedent" to be used to provide the required information to the IRS, and Schedule A to Form 8971 to provide the required information to beneficiaries. Updated instructions to Form 8971 and Schedule A were released in September 2016. On March 4, 2016, the IRS issued proposed and Temporary Regulations under Code Sections 1014(f) and 6035. *See* TD 9757. Pursuant to the proposed regulations, Form 8971 is termed an Information Return, and Schedule A is termed a Statement. Prop. Treas. Reg. § 1.6035-1(g).

Suffice it to say, many questions remain unanswered by the proposed regulations. Comments to the proposed regulations were invited and groups such as The American College of Trust and Estate Counsel ("ACTEC") and the American Institute of Certified Public Accountants ("AICPA") submitted comments.

We do know that if a federal estate tax return is required to be filed pursuant to Code Section 6018, the executor must report certain information to the IRS, and must provide certain information to each beneficiary of the property, including a description of the property and its value. Prop. Treas. Reg. § 1.6035-1(a), (b), (c). In identifying the beneficiaries to whom the information is to be provided, if a beneficiary is a trust, the information is furnished to the trustee. Prop. Treas. Reg. § 1.6035-1(c)(2). In the case of an estate where the property passing to a beneficiary has not been identified by the due date for reporting, such as when funding decisions have not been made, the executor must provide information regarding all property that may be used to fund the beneficiary's interest to each beneficiary that may be affected, and must provide the information to all potential beneficiaries of the property. Prop. Treas. Reg. § 1.6035-1(c)(3). Once this information is given, no further reporting is required, regardless of which (if any) assets are ultimately distributed to each beneficiary. *Id*.

We also know that Form 8971 and Schedule A must be furnished no later than the earlier of (1) 30 days after the date on which the estate tax return is required to be filed (including extensions), or (2) 30 days after the date the estate tax return is filed. IRC § 6035(a)(3)(A); Prop. Treas. Reg. § 1.6035-1(d)(1). In addition, IRS Notice 2016-27, 2016-15 IRB 1,

[6] References herein to “Section(s)” or to “Code” are to the Internal Revenue Code of 1986, as amended.

published on March 24, 2016 provides that for any reporting due before June 30, 2016, reporting was not required until June 30, 2016. Final Treasury Regulation § 1.6035-2 was issued on December 2, 2016 confirming that the first required reporting was on June 30, 2016.[7] *See* TD 9797. The proposed regulations confirm that the value as finally determined for federal estate tax purposes serves as the beneficiary's initial basis in the property and the beneficiary's basis is capped by the estate tax value (i.e., basis consistency), although post-death events may cause adjustments to the property's basis. Prop. Treas. Reg. § 1.1014-10(a), (c).

Although property that qualifies for the marital or charitable deduction is excluded from the basis consistency rules of Code Section 1014(f), that property is not excluded from the reporting requirements of Code Section 6035. Prop. Treas. Reg. §§ 1.1014-10(b)(2), 1.6035-1(b). Certain property is excluded from the reporting requirements of Code Section 6035, however, including cash (other than collectible cash), income in respect of a decedent (IRD), certain tangible personal property, and property sold or otherwise disposed of (and thus not distributed to a beneficiary) by the estate in a manner in which capital gain or loss is recognized.[8] Prop. Treas. Reg. § 1.6035-1(b). In addition, if an estate is below the filing threshold for federal estate tax purposes but the return is filed for another reason, such as to make a portability election, the executor is not subject to the reporting requirements of Code Section 6035. Prop. Treas. Reg. §1.6035-1(a)(2).

One of the more surprising (and shocking) provisions in the proposed regulations has to do with property that is later-discovered or was otherwise omitted from a federal estate tax return. If a federal estate tax return was never filed and after-discovered or omitted property is discovered that would generate or increase estate taxes, the basis in that property is zero until the federal estate tax value is determined. Prop. Treas. Reg. § 1.1014-10(c)(3)(ii). In contrast, if a federal estate tax return is filed and additional property is discovered, as long as the executor includes the property on an estate tax return prior to the expiration of the statute of limitations on assessment, the final value (and therefore, the beneficiary's initial basis) in the property will be the federal estate tax value of the property. However, if the limitations period has expired, the basis in the after-discovered or omitted property is deemed to be zero, with no recourse. Prop. Treas. Reg. § 1.1014-10(c)(3)(i).

If there is an adjustment to the information required to be filed with the IRS or reported to a beneficiary that would cause the reported information to be incorrect or incomplete, a supplemental statement must be filed no later than the date 30 days after the adjustment is made. IRC § 6035(a)(3)(B); Prop. Treas. Reg. § 1.6035-1(e)(1), (2), (4). An adjustment includes a situation in which a beneficiary different than one who previously received a Schedule A receives property identified on the Schedule A, such as because of a disclaimer or because of a value change as a result of audit. Supplemental reporting is not required, however, if reporting of the same asset was made to multiple beneficiaries because a funding decision had not been made at the time of the initial reporting. *Id*.

Another surprising provision in the proposed regulations is the requirement to report subsequent transfers. The proposed regulations provide that for property reported pursuant to Code Section 6035, if that property is subsequently transferred to a related transferee and the transferee determines its basis, in whole or part, by reference to the transferor's basis, the transferor must file a supplemental Schedule A with the IRS and provide a copy to the transferee within 30 days of the transfer. A related transferee is defined to include a member of a transferor's family as defined in Code Section 2704(c)(2), an entity controlled by the transferor or the transferor's family as defined in Code Section 2701(b)(2)(A), and a trust of which the transferor is the deemed owner for income tax purposes. Prop. Treas. Reg. § 1.6035-1(f). Presumably, the requirement for reporting subsequent transfers extends indefinitely.

2. Holding Period. A person acquiring property from a decedent whose basis is determined under Code Section 1014 is considered as being held by the person for more than one year. IRC § 1223(9). Therefore, any post-death gains will be treated as long-term capital gain, even if the property is sold within one year of the decedent's death.

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[7] This Notice was the third extension of the due date for the first reporting required pursuant to IRC § 6035. Although the first due date was August 30, 2015, Notice 2015-57 was issued on August 21, 2015, extending the due date for the first reporting to February 29, 2016, and then Temporary Treasury Regulation § 1.6035-2T was issued providing a transitional rule extending the due date for the first reporting to March 31, 2016. Twenty days after the regulation was published, Notice 2016-27 was issued.

[8] Many questions remain as to the nuances of these exclusions, but those questions go beyond the scope of this paper.

B. What Property is "Acquired from a Decedent"?

Most people think of property "acquired from a decedent" as simply property passing to them under the will of a deceased person. For purposes of determining basis, however, the Code lists ten separate methods by which property can be acquired from a decedent. Some of the listed methods contain effective dates that have since passed, which make parsing the statute somewhat difficult. In summary, the current applicable list includes the following seven items:

1. **Inherited Property.** Property acquired by bequest, devise, or inheritance. The statute makes clear that the basis adjustment applies not only to beneficiaries, but also to the decedent's property held by his or her estate. IRC § 1014(b)(1).

2. **Revocable Trust Property.** Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust. IRC § 1014(b)(2).

3. **Property with Retained Right to Control Beneficial Enjoyment.** Property transferred by the decedent during his lifetime and placed in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust. IRC § 1014(b)(3).

4. **Property Subject to a General Power of Appointment.** Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will. IRC § 1014(b)(4).

5. **Both Halves of Community Property.** Property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state or possession of the United States,[9] or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate for federal estate tax purposes. Thus, unlike the surviving spouse's separate property, *both halves* of a couple's community property receive a new cost basis upon the death of either spouse. IRC § 1014(b)(6).

6. **Other Property Includable in the Decedent's Gross Estate.** Property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate for estate tax purposes. IRC § 1014(b)(9). Clearly, the provision applying a basis adjustment for property "included in determining the value of the decedent's gross estate" overlaps with several other provisions. Revocable trust property, property with a retained right to control beneficial enjoyment, property passing pursuant to the exercise of a power of appointment, and QTIP property are all included in determining the value of the decedent's gross estate. But this catch-all provision of Section 1014(b)(9) alone is subject to a curious limitation. As discussed below, any basis adjustment allowed solely by reason of Section 1014(b)(9) is reduced by "the amount allowed to the taxpayer as deductions . . . for exhaustion, wear and tear, obsolescence, amortization and depletion on such property before the death of the decedent."

7. **QTIP Property.** Property includible in the gross estate of the decedent under Code Section 2044 (relating to property for which a "QTIP" marital deduction was previously allowed). IRC § 1014(b)(10).

C. Exceptions

Not all property acquired from a decedent receives a new cost basis at death.

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[9] Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. Wisconsin also has a form of community property, and Alaska, Florida, Kentucky, South Dakota, and Tennessee have enacted a form of "opt-in" community property. In Rev. Rul. 87-13, 1987 CB 20, the IRS acknowledged that the Wisconsin system creates community property that will be recognized as such for federal tax purposes. However, the IRS has not yet ruled whether the form of ownership described by Alaska, South Dakota, or Tennessee as "community property" creates community property within the meaning of Section 1014(b)(6). *Cf. Comm'r v. Harmon*, 323 US 44 (1944) (holding that taxpayers in opt-in community property states could not split their income for federal income tax purposes). Importantly, the court in *Harmon* did not base its holding on the fact that opt-in community property regimes do not create genuine community property, but rather analyzed the issue on an assignment-of-income theory. Rev. Rul 77-359, 1977-2 CB 24, which gave effect to the transmutation of separate property into community property, noted that such a transmutation did not overcome the assignment-of-income doctrine decided in *Harmon.*

1. Assets Representing Income in Respect of a Decedent. Most notably, items which constitute a right to income in respect of a decedent ("IRD") under Code Section 691 do not receive a new cost basis. Instead, the basis in an IRD asset is equal to its basis in the hands of the decedent. The Code does not provide a specific definition of IRD and the definition in the Treasury regulations is not particularly helpful, but generally, IRD is comprised of items that would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and income tax reporting method, are not reportable as income on the decedent's final income tax return. IRC § 691; Treas. Reg. § 1.691(a)-1(b). IRD may be included in the gross income of the decedent's estate or by one or more of the estate beneficiaries at the time the estate or beneficiary, respectively, collects the item of income. Examples of IRD include (1) accrued interest, (2) dividends declared but not payable, (3) unrecognized gain on installment obligations, (4) bonuses and other compensation or commissions paid or payable following the decedent's death, (5) interests in partnerships that hold unrealized receivables or inventory items, and notably, (6) amounts in IRAs and qualified benefit plans upon which the decedent has not been taxed (which would not include Roth IRAs and nonqualified retirement plan contributions, but pursuant to Revenue Ruling 75-125, 1975-1 CB 254 would include net unrealized appreciation in employer securities distributed from a qualified retirement plan and for which no election was made to include the appreciation in income). Note this means that Roth IRAs and nonqualified contributions to retirement plans are not IRD. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981): (i) the decedent must have entered into a "legally significant transaction" – not just an expectancy; (ii) the decedent must have performed the substantive tasks required of him or her as a precondition to the transaction; (iii) there must not exist any economically material contingencies which might disrupt the transaction; and (iv) the decedent would have received the income resulting from the transaction if he or she had lived. The basis in an IRD asset is equal to its basis in the hands of the decedent; no basis adjustment occurs at death. IRC § 1014(c). This rule is necessary to prevent recipients of IRD from avoiding federal income tax with respect to items in which the income receivable by a decedent was being measured against his or her basis in the asset (such as gain being reported on the installment basis). Keep in mind that not only is the receipt of IRD income taxable to the recipient of the income, the IRD asset is includible in the decedent's estate for estate tax purposes. IRC § 2033.

2. Distributions from Trusts and Estates. Although a beneficiary's basis in property distributed to it from a trust or an estate is generally equal to the trust or estate's basis before distribution, the basis must be adjusted for any gain or loss recognized by the trust or estate as a result of the distribution. IRC § 643(e)(1). Trusts and estates do not generally recognize gain or loss on the distribution of property, but recognition can occur if (1) a distribution of property is made to satisfy a pecuniary obligation and the trust or estate's basis in the property is less than fair market value on the date of distribution, (2) a distribution of property, other than cash, is made to fund a bequest of "a specific dollar amount," or (3) an election is made to recognize gain on the distribution. IRC § 643(e); Treas. Reg. § 1.661(a)-2(f) (gain or loss is recognized if distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed); Rev. Rul. 74-178, 1974-1 CB 196; *see also* Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 CB 286; *Kenan v. Comm'r*, 114 F2d 217 (2d Cir. 1940). In most cases a trust or an estate cannot recognize a loss that would otherwise occur on a distribution, however, an estate may recognize a loss if the estate distributes an asset in satisfaction of a pecuniary bequest and that asset has a basis in excess of fair market value. IRC § 267(b)(13). Note, however, that loss recognition is denied to trusts used as estate surrogates by application of the related party rules of Code Section 267(b)(6), except for qualified revocable trusts electing to be treated as estates under Code Section 645.

3. Property "Re-Inherited" Within One Year of Gift. A special exception is provided for appreciated property given to a decedent within one year of death, which passes from the decedent back to the donor or the donor's spouse as a result of the decedent's death. IRC § 1014(e). This rule is designed to prevent taxpayers from transferring property to dying individuals, only to have the property bequeathed back to them with a new cost basis.

4. Depreciable Property Owned by Others. As noted above, if a basis adjustment arises solely from the application of Section 1014(b)(9), the basis adjustment is reduced by the amount allowed "to the taxpayer" for depreciation, amortization, or depletion prior to the decedent's death. IRC § 1014(b)(9). This limitation apparently applies only when someone other than the decedent owns depreciable, amortizable or depletable property which is nevertheless includible in the decedent's taxable estate. The Treasury Regulation interpreting the provision is entitled, "Special rule for adjustment to basis when property is acquired from a decedent prior to his death." It appears to have originated at a time when assets given away within three years of death were taxed to the decedent under a prior version of Code Section 2035. *See* Treas. Reg. § 1.1014-6(a)(3) Ex. 1. Its application is not, however, limited to that situation. Thus, for example, the provision has been applied to depreciated property held by the decedent and another as joint tenants with rights of survivorship. *See* Treas. Reg. § 1.1014-6(a)(2). It has also been applied to property held by spouses as tenants by the entirety. Rev. Rul. 58-

130, 1958-1 CB 121. If an owner of the property was able to claim a deduction for depreciation, amortization or depletion during the decedent's lifetime, this provision prevents the owner from recouping that deduction as a result of having the property included in another person's estate. Thus, for example, assume that A made a gift of depreciable property with a basis of $50,000 to B, and retained a life estate. Prior to A's death, B claimed depreciation deductions of $20,000. When A dies, the property, valued at $80,000, is included in determining the value of A's gross estate under Section 2036(a)(1). Pursuant to Section 1014(b)(9), B's adjusted basis in the property as of the date of the decedent's death is $60,000 ($80,000, the fair market value at the decedent's death, less $20,000, the total depreciation deduction actually allowed to B). *See* Treas. Reg. § 1.1014-6(c).

5. Property Subject to a Conservation Easement. Property that is the subject of a conservation easement is entitled to special treatment for estate tax purposes. In general, if the executor so elects, the value of certain conservation easement property may be excluded from the value of the decedent's estate under Code Section 2031(c), subject to certain limitations. To the extent of the exclusion, the property retains its basis in the hands of the decedent. IRC § 1014(a)(4).

D. Persons Dying in 2010

For estates of decedents dying in 2010 whose executors elected not to have the federal estate tax apply, the foregoing basis adjustment rules did not apply. For those estates, property acquired from these decedents was treated as transferred by gift, with a special $1.3 million allowance for basis adjustments, plus an additional $3 million basis adjustment for property passing to a spouse (or qualified trust for a spouse). The 2010 basis adjustment rules are set forth in Exhibit A.

E. Contrast Basis in Property Acquired by Gift

Unlike property acquired from a decedent, property acquired by gift (whether the gift is made outright or in trust), generally receives a "carryover" basis. There are, however, some special rules that apply.

1. Donee's Basis to Determine Gain. For purposes of determining gain (and for purposes of determining depreciation, depletion, or amortization), the basis of property acquired by gift is the same as it would be in the hands of the donor or, in the case of successive gifts, of the last preceding owner by whom it was not acquired by gift. IRC § 1015(a). Special rules, discussed below, may apply to transfers between spouses or in trust for a spouse's benefit.

2. Donee's Basis to Determine Loss. Unrecognized losses incurred by the donor do not carry over to the donee. Solely for determining a donee's loss on a sale of a gifted asset by the donee, the donee's basis cannot exceed the fair market value of the property at the date of the gift. IRC § 1015(a). In other words, if the donor's basis in an asset exceeds its fair market value at the date of the gift, the donee's basis may be one number for purposes of determining depreciation or gain on a later sale, and another for purposes of determining loss (i.e. dual basis). Fair market value for this purpose is determined in the same manner as it is for purposes of determining the value of the property for gift tax purposes. Treas. Reg. § 1.1015-1(e).

Example 2: X gives stock to Y with a fair market value of $100 and an adjusted basis of $270. The following year, Y sells the stock for $90. Since Y is selling the stock at a loss, Y must use the lesser of X's basis or the stock's fair market value ($100) as the basis, and may recognize a loss of only $10. The $170 loss in value suffered by X is forgone. If instead, Y sold the asset for $150, a paradox arises. If Y were permitted to utilize X's basis of $270, Y would incur a $120 loss on the sale. However, Code Section 1015 provides that if a loss would otherwise arise, Y's basis is the lesser of X's basis or the stock's fair market value ($100). But Y's basis cannot be the fair market value on the date of the gift ($100), because fair market value is used as the donee's basis only when a loss would be recognized, and no loss would be recognized if there were a $100 basis in the stock. Therefore, Y recognizes neither a gain nor a loss. If Y is X's spouse, the gain or loss determination would be the same as if X sold the stock.

3. Basis for Gift Tax Paid. The basis of gifted property is increased for pre-1977 gifts by any gift tax paid. IRC § 1015(d)(1). For gifts made after 1976, the basis of gifted property is increased (but not to above its fair market value) by that portion of the gift tax paid which is attributable to the donor's net appreciation in the gifted assets. IRC § 1015(d)(6).

Example 3: Assume that the donor has used all of his applicable exclusion amount (and annual exclusion amount for the year) and gives stock having a basis of $200 and a fair market value of $1,000 to child, thereby paying $400 of gift tax. The basis adjustment for the gift tax paid is [($1000 minus $200)/$1000] times $400, or $320. The donee's basis becomes $200 plus $320, for a total basis of $520.[10]

4. Basis for Transfers Between Spouses. The "lower of fair market value or basis" rule described above does not apply to transfers between spouses, whether made incident to a divorce or otherwise. IRC § 1015(e). Instead, in most cases, the basis of the property in the hands of the transferee spouse is equal to the transferor spouse's adjusted basis. IRC § 1041(b)(2). If a spouse transfers property in trust for the other spouse (rather than transferring the property outright) and that property is subject to debt or has debt that the trust assumes, and such debt exceeds the basis of the transferred property, the transferor spouse will recognize gain on the transfer. IRC § 1041(e). The basis of the transferred property will then be increased by the amount of the gain. *Id*. The general rule that transfers between spouses do not cause recognition of gain or loss does not apply if the transferee spouse is a nonresident alien, which means a basis adjustment may result from the transfer. IRC § 1041(d). If assets pass to a qualified domestic trust ("QDOT") for the benefit of a non citizen surviving spouse, a distribution to the surviving spouse is subject to estate tax. IRC § 2056A(b)(1)(A). However, the distribution is treated as a gift for purposes of determining the surviving spouse's basis in the property, and the tax paid is gift tax for purposes of making adjustments pursuant to Code Section 1015. IRC §§ 1015(d), 2056A(b)(13); Treas. Reg. §§ 1.1015-5(c)(4), 20.2056A-12.

5. Basis for GST Tax Paid. The basis of gifted property is also increased (but not above its fair market value) by any generation-skipping transfer taxes paid and which are attributable to the donor's net appreciation in the gifted asset. IRC § 2654(a). This basis adjustment for GST taxes paid is applied after any basis adjustment made pursuant to Code Section 1015. In contrast, if the GST tax is paid as a result of someone's death, a distinction is made as to whether the transfer is a taxable termination or a taxable distribution. If the transfer is a taxable distribution, meaning a distribution from a trust to a skip person, other than a taxable termination or direct skip, the basis rules applicable to gifted property discussed above apply. IRC §§ 2612(b), 2654(a)(1). If the transfer occurs at death, the inclusion ratio is one, and the transfer is a taxable termination (meaning in essence that only skip persons will have an interest in the property or receive further distributions from the trust), then the basis in the property is adjusted as provided in Code Section 1014(a) giving a new basis equal to fair market value at date of death. IRC § 2654(a)(2). If the inclusion ratio is less than one, however, the inclusion ratio will limit the basis adjustment by a pro rata amount. *Id*. Note that if a transfer could be treated as a taxable termination or a taxable distribution, Code Section 2612(b) provides that the transfer will be treated as a taxable termination because the definition of taxable distribution excludes taxable terminations.

6. Holding Period. Generally, the holding period for an asset begins when a taxpayer acquires an asset. The holding period determines whether any gain on the disposition of the asset is short-term or long-term, the latter generally being taxed at more favorable rates. However, in determining the holding period for property that has the same basis in whole or in part in someone's hands as it would have in the hands of another person, the taxpayer may add, or tack, on the period which the property was held by the other person. IRC § 1223(2). As a result, when property is acquired by gift, the donee can generally tack onto his or her holding period the holding period of the donor.

7. Basis of Suspended Passive Losses. Any suspended passive activity losses attributable to a gifted asset are added to the donee's adjusted cost basis and benefit the donee (although a dual basis may exist, and such addition to basis, to the extent it causes basis to exceed the fair market value of the property at the time of the gift, will not benefit the donee in a loss transaction). IRC § 469(j)(6).

Example 4: Assume that the donor has an asset with a fair market value of $100, an adjusted cost basis of $70, and a suspended passive activity loss of $40. When the asset is given to the donee, the donee will have a $100 basis for loss purposes and a $110 basis for gain purposes.

8. The Cost of Forgoing Basis. One of the main transfer-tax advantages of making a gift is that any post-gift appreciation is not subject to estate tax. But, as noted above, one cost of lifetime gifting is that there will be no basis

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[10] Note that if any part of the gift qualified for the annual exclusion, Treasury Regulation Section 1.1015-5(c) helpfully apportions the tax only to the taxable portion of the gift, which maximizes the basis adjustment. For example, assume that the donor gives stock with a basis of $5,000 and a fair market value of $33,000. Further assume the gift qualifies for the $17,000 annual exclusion and after taking it into account, the taxable gift is $16,000, resulting in gift tax of $6,400. The gift tax basis adjustment is [($16,000 minus $5,000)/$16,000] times $6,400, or $4,400. The key is that the divisor is equal to the taxable portion of the gift rather than the fair market value of the gifted property.

adjustment for the gifted asset at death. As a result, the asset may need to appreciate significantly after the gift in order for the 40% estate tax savings on the appreciation to offset the loss of basis adjustment for the asset. For example, assume a gift is made of a $1 million asset with a zero basis. If the asset does not appreciate, the beneficiaries will lose the step-up in basis. At a 23.8% effective capital gain rate (if the beneficiaries are in the top tax bracket), this means the beneficiaries will receive a net value of $762,000 from the asset after it is sold. If the donor had retained the asset until death, and if the property does not appreciate, the transfer tax implications would be the same (since the adjusted taxable gift rules under Code Section 2001(b)(1)(B) effectively use up an equivalent exclusion at death). But if the asset was held until death, the basis adjustment would save $238,000 of capital gain taxes. In order for the estate tax savings on post-gift appreciation to offset the loss of basis adjustment, the asset would have to appreciate from $1,000,000 to $2,469,136 (nearly 147%) (appreciation of $1,469,135 x .40 estate tax rate = gain of $2,469,135 x .238 capital gain rate). *See* McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 U. MIAMI HECKERLING INST. ON EST. PL. 4, ¶ 403.5 (1999); Mahon, *The 'TEA' Factor*, TR. & EST. (Aug. 2011). Keep in mind that the income tax is incurred only if the beneficiaries sell the asset. If the beneficiaries will retain the asset indefinitely, if the beneficiaries have their own capital losses that would offset any capital gains, or if real estate investment changes could be made with like-kind exchanges, basis step-up is not as important.

IV. DO OUR OLD PLANNING TOOLS STILL WORK?

Traditionally, estate planners have recommended that their clients incorporate a variety of techniques into their estate plans which were designed to avoid, defer, or minimize the estate tax payable when property passed from one taxpayer to another. These strategies have often involved the use of one or more trusts which were aimed at minimizing transfer taxes. A corollary effect of many of these techniques was that income taxes payable might be increased in some cases, but when estate and gift tax rates exceeded 50%, and capital gain rates were only 15%, the income tax "cost" associated with many common estate planning tools seemed worthwhile. Under the current tax regime, higher estate tax exclusions and the availability of portability mean that many clients are no longer subject to estate or gift taxes, regardless of whether the estate planning strategies recommended in the past are employed. At the same time, the income tax cost of these strategies has increased, due to the enactment of higher federal income tax rates and the adoption of the 3.8% tax on net investment income. In short, common strategies previously employed to save estate tax may now fail to reduce estate taxes owed, and may instead increase income tax exposure.

A. Using Bypass Trusts

1. No Basis Adjustment at Second Death. For years, estate planners have designed bypass trusts with the express goal of excluding those assets from the taxable estate of the surviving spouse for estate tax purposes. While estate taxes were avoided, so too was a cost basis adjustment in those assets upon the death of the surviving spouse. For many clients, bypass trusts are still important to help achieve a number of non-tax goals, which are discussed at IV.B, below. For clients with estates subject to the estate tax, these trusts often have the felicitous effect of lowering overall taxes for the family as well.[11] With fewer estates subject to estate tax, however, achieving the clients' non-tax objectives may come at the price of higher overall taxes.

Example 5: H and W have a community property estate of $6 million (or simply two relatively equal estates totaling $6 million). H dies with a Will that creates a traditional bypass trust for W. W outlives H by 10 years. Over that time, the trustee distributes all of the bypass trust's income to W, but the fair market value of the trust's assets has doubled to $6 million. Meanwhile, W has retained her own $3 million in assets, which have held their value at $3 million. At the time of W's death, no estate tax will be due on her $3 million estate. The assets in the bypass trust will not be included in her estate for federal estate tax purposes, so they will not receive a new cost basis at the time of her death. As a result, H and W's children will inherit assets in the bypass trust with a value of $6 million, but with a basis of only $3 million. If instead, H had left the property outright to W (and if H's executor had filed an estate tax return electing portability to save estate tax if W dies after 2025), no estate tax would be owed on W's $9 million estate. Had H left his assets to W outright (or to a

[11] Although beyond the scope of this paper, in states where a state income tax applies, those additional taxes must also be considered.

differently designed trust), the children would have received a new cost basis of $6 million in the assets passing from H to W, potentially saving them $714,000 in taxes ($3,000,000 x 23.8%).[12]

2. Higher Ongoing Income Tax Rates. For years 2018 through 2025, TCJA 2017 has modified both the tax rates and tax brackets applicable to individual taxpayers, estates, and trusts. Beginning in 2018, single individuals are subject to the highest income tax rate (now 37%) on income in excess of $500,000, and are subject to the tax on net investment income if their income exceeds $200,000. IRC §§ 1(j)(2), 1411.[13] In contrast, income not distributed from a trust is taxed at the top income tax rate to the extent it exceeds $14,450 (for 2023), and is subject to the net investment income tax if its undistributed net investment income exceeds that amount. *Id.* Therefore, under the foregoing example, unless the wife's taxable income would otherwise exceed $510,300 ($612,350 if she remarries and files jointly), most taxable income accumulated in the bypass trust will be taxed at a higher income tax rate than it would if no trust had been used. Including the tax on undistributed net investment income, the trust's top federal income tax rate would be 40.8% for short term capital gains and ordinary income and 23.8% for long term capital gains and qualified dividends. Contrast these rates to 2019 rates of only 24% for ordinary income if the wife remains single and her taxable income were between $84,200 and $160,725 (or between $168,400 and $321,450 if she remarries), using 2019 income tax brackets. IRC § 1(j)(2). TCJA 2017 oddly decoupled ordinary and capital gain tax brackets, so that the wife's capital gain tax rates would be 0% if her income was less than $39,375, 15% if her income was between $39,376 and $434,550, and 20% if her income was more than $434,550. If she remarried, the brackets would adjust at $78,750 and $488,850. For trusts and estates, the 0% capital gain tax bracket applies for income up to $2,650; thereafter, the 15% bracket applies to income up to $12,950 (not $12,750); and the 20% bracket applies to income above $12,950. IRC § 1(j)(2).[14]

3. Some Assets Cause Greater Tax Burdens. A client's asset mix may impact the importance of these tax issues. For example, assets such as IRAs, qualified plans, and deferred compensation may give rise to ordinary income taxes, without regard to their basis, other than distributions that qualify as the owner or other recipient's "investment in the contract" as that term is defined for these assets. Retirement plan assets left outright to a spouse are eligible to be rolled over into the spouse's name, which may make them eligible for a more favorable income tax deferral schedule than if they passed into a bypass or other trust. A personal residence may be eligible to have all or a portion of any capital gains tax recognized on its sale excluded from income if owned outright. IRC § 121(a). The exclusion is not available to the extent that the residence is owned by a non-grantor trust. *See* TAM 200104005. Some types of business entities (notably, S corporations) require special provisions in the trust to ensure that they are eligible to be treated as "Qualified Subchapter S Trusts" or "Electing Small Business Trusts." If these provisions are omitted or overlooked during the administration of the trust, substantially higher taxes may result to all shareholders of the entity.[15] For assets that the family has no intention of selling or depreciating (such as a family vacation home), a basis adjustment may be unimportant. Similarly, with regard to an investment account that is actively traded, capital gains and losses may be recognized as a result of frequent trades, and the basis in the investments at the time of the surviving spouse's death may very nearly equal the fair market value of those investments at that time, making a basis adjustment less important.

Example 6: H has an IRA worth $1 million which earns 6% per year, the beneficiary of which is the trustee of a bypass trust for his wife W and children. H dies when W is 60 years old. W is the oldest (but not the only) beneficiary of the trust. Because the IRA is payable to the trust, W cannot roll the IRA over into her own IRA. Instead, she must begin to take

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[12] Of course, an outright bequest might have a much worse tax result if the wife had remarried, her second husband had died leaving her no DSUE amount, and W died after 2025 with a reduced basic exclusion amount. Moreover, an outright bequest might yield a higher overall tax if H's property had declined in value, thereby causing a step-down in basis.

[13] IRC § 1(j). In 2023, the highest income tax rate for single individuals is reached at $578,125. Rev. Proc. 2022-38, 2022-45 IRB 445.

[14] In the last quarter of each year, the IRS issues a Revenue Procedure that provide the inflation-adjusted numbers for a variety of items. Revenue Procedure 2017-58, 2017-45 IRB 489 was issued on October 19, 2017 and provided the tax rate tables for taxpayers for the year 2018. However, as noted above, for several items, TCJA 2017 modified the index used to compute inflation from the Consumer Price Index ("CPI"), published by the U.S. Bureau of Labor Statistics, to the "Chained Consumer Price Index," ("C-CPI-U" or "Chained CPI"), which generally grows more slowly than CPI. Accordingly, on March 2, 2018, the IRS issued Revenue Procedure 2008-18, 2018-10 IRB 392 to update these inflation-adjusted items for 2018 under the new method. As noted earlier, the 2023 inflation-adjusted figures were announced in Revenue Procedure 2022-38, 2022-45 IRB 445.

[15] *See* Davis, *Income Tax Consequences (and Fiduciary Implications) of Trusts and Estates Holding Interests in Pass-Through Entities*, State Bar of Texas 25th Ann. Adv. Est. Pl. & Prob. Course (2001).

minimum required distributions in the year following H's death, based upon her single life expectancy. IRC § 408(d)(3)(C); Treas. Reg. §§ 1.401(a)(9)-5, A-5(a), A-5(c)(1), A-7(c)(3), Ex. 1(iii). If instead, the IRA had been payable to W, she could have rolled the IRA over to her own IRA, deferred minimum required distributions until age 70 ½, and used the more favorable unified table for her life expectancy. IRC §§ 401(a)(9)(A), 402(a)(7), 402(c)(9), 408(d)(3); Treas. Reg. § 1.408-8, A-5(a), A-7. If W lives to age 90 taking only minimum required distributions, then in either event, W would receive about $1.4 million after tax from the IRA. If the IRA was payable to the bypass trust, it would then hold about $2.75 million. If instead, the IRA had been payable to W, her ability to defer distributions for an additional 10 years would mean that the IRA would hold nearly $4 million!

4. Disclaimer Bypass Trusts. Married couples can structure their wills or revocable trusts to allow the surviving spouse to take a "second look" at their financial and tax picture when the first spouse dies. If the total combined estates will be less than the applicable exclusion amount (including any DSUE amount) then the survivor can accept an outright bequest of assets, and if desired, the executor can file an estate tax return making the portability election. If the total value of the estate is expected to exceed the applicable exclusion amount, then the surviving spouse can disclaim all or any part of the inheritance. Language in the will or revocable trust could provide that the disclaimed amount passes into the bypass trust. In order for the disclaimer to be effective, it must comply with the technical requirements of local law and the Code. *See, e.g.,* TEX. PROP. CODE Chpt. 240; IRC § 2518. The disclaimer must be filed within nine months of the date of death *and* before any benefits of the disclaimed property are accepted in order to be valid under federal law. The disclaimed property must generally pass in a manner so that the disclaiming party will not benefit from the property. An important exception to this rule, however, permits the surviving spouse to disclaim property and still be a beneficiary of a trust, including a bypass trust, to which the disclaimed property passes. IRC § 2518(b)(4)(A). More troubling is the requirement that the disclaimed property must pass without direction or control of the disclaiming party. This requirement generally prevents (or at least greatly restricts) the surviving spouse from retaining a testamentary power of appointment over the bypass trust to which assets pass by disclaimer. *See* Treas. Reg. §§ 25.2518-2(e)(1)(i), (e)(5), Exs. (4), (5).

B. Advantages of Trusts over Outright Bequests

With the advent of very high estate tax exclusions and portability, estate planners and their clients concerned about the foregoing issues, or simply seeking "simplicity," may conclude that using trusts in estate planning is no longer warranted. But tax issues are only one part of the equation. In many respects, outright bequests are not nearly as advantageous as bequests made to a trust. In an ideal world, the estate plan would be designed to capture all of the benefits of trusts, without the tax downsides. Why might someone choose to make a bequest in trust instead of outright, despite the potential tax costs?

1. Control of Assets. A trust allows the grantor to better ensure that the assets are managed and distributed in accordance with his or her wishes. Many clients express confidence that their spouses will not disinherit their family or other beneficiaries, but they still fear that a second spouse, an unscrupulous caregiver, or other unforeseen person or event may influence the surviving spouse to change the estate plan in ways that they do not intend. Placing property into trust allows the grantor to control to a large degree how much (if at all) the surviving spouse can alter the estate plan. The grantor can name a trustee other than the spouse if desired. In addition, even if the surviving spouse is the trustee, if he or she later becomes incapacitated, a successor trustee can manage the trust assets, thereby avoiding the need for a guardian or other type of court-appointed conservator.

2. Creditor Protection. If an inheritance passes outright and free of trust, the property will be subject to attachment by outside creditors unless the property is otherwise exempt from attachment under local law (in Texas, for example, exempt assets might include a homestead or an interest in a retirement plan). Assets inherited in trust are generally protected from creditors so long as the trust includes a valid "spendthrift" clause. *See, e.g.,* TEX. PROP. CODE § 112.035. State law greatly controls the extent of these protections.[16]

3. Divorce Protection. Inherited assets constitute separate property of the recipient, which provides some measure of divorce protection. *See, e.g.*, TEX. FAM. CODE § 7.002. However, in Texas, if those assets are commingled, the

[16] For an example of a case where an appellate court upheld a trial court decision allowing a third-party settled, discretionary, spendthrift trust to be part of the property divisible in a divorce proceeding, see the very fact-driven decision in *Pfannenstiehl v. Pfannenstiehl*, 37 NE3d 15 (Mass. App. 2015). The Massachusetts Supreme Judicial Court overturned the trial court decision (and thereby the Appeals Court as well) in *Pfannenstiehl v. Pfannenstiehl*, 475 Mass. 105, 2016 WL 4131248 (Mass. 2016).

community property presumption may subject them to the claims of a spouse upon divorce. *See* TEX. FAM. CODE § 3.003. Similar laws regarding marital property may apply even in non-community property states. If the assets pass in trust, however, the trustee's ownership of the trust assets helps ensure that they will not be commingled. In addition, both the assets held in an irrevocable trust during marriage *and the income distributed* from the trust are generally treated as that spouse's separate property. *See, e.g., Sharma v. Routh*, 302 SW 3d 355 (Tex. App.-Houston [14th Dist.] 2009, no pet.) (holding that distributions of trust income from irrevocable trust during marriage is community property only if recipient has "present possessory right to part of the corpus" because possessory right means that recipient is effective owner of trust corpus). Again, state law may place limits on this protection as in Texas, where spendthrift provisions do not prevent trust assets from being used to pay child support claims. *See, e.g.,* TEX. FAM. CODE § 154.005.[17]

4. Protection of Governmental Benefits. If the surviving spouse is eligible (or may become eligible) for needs-based government benefits (e.g. Medicaid), a bypass or other trust may be structured to accommodate eligibility planning. An outright bequest to the spouse may prevent the surviving spouse from claiming those benefits. However, a testamentary bypass trust with appropriate spendthrift provisions will generally not be considered to be a resource of the surviving spouse for purposes of determining eligibility for Medicaid. *See* SSA Program Operations Manual System § 01120.200.D.2.

5. Protection from State Inheritance Taxes. Assets left outright may be included in the beneficiary's taxable estate for purposes of state estate or inheritance tax. While the inheritance tax in many states has been repealed or is inoperable so long as there is no federal estate tax credit for state death taxes paid, there can be no assurance that the beneficiary will reside (or remain) in one of those states. Currently, 17 states and the District of Columbia impose a separate stand-alone estate or inheritance tax.[18] The potential exposure depends upon the exemptions and rates applicable at the time of the beneficiary's death, but the applicable taxes can be surprisingly high. *See, e.g.,* Minn. Stat. §§ 291.016(3)(b), 291.03 (imposing a 13% state estate tax on 2019 estates exceeding $2.7 million in value, with rates reaching 16% for estates exceeding $10.1 million).

6. Income Shifting. If permitted, income earned by a trust can be distributed to trust beneficiaries who may be in lower income tax brackets than the surviving spouse or the trust. IRC §§ 651, 661. Income from assets left outright cannot be "sprinkled" or "sprayed" to beneficiaries in lower tax brackets. For many families, a trust's ability to shift income may lower the overall family income tax bill.

7. Shifting Wealth to Other Family Members. While a surviving spouse might make gifts of his or her assets to children, elderly parents, or other family members, those gifts use up the spouse's gift and estate tax exclusion to the extent that they exceed the gift tax annual exclusion amount. If assets are held in a bypass trust, and if the trust permits distributions to other family members, the amounts distributed to them are not treated as gifts by the surviving spouse, and do not use any of the spouse's gift or estate tax exclusion or annual exclusion, regardless of the amount of the distributions.

8. No Inflation Adjustment. The DSUE amount, once set, is not indexed for inflation, whereas the surviving spouse's basic exclusion amount (the $10 million base) is adjusted for inflation after 2010 (being $11.4 million in 2019). In addition, if assets are inherited in a bypass trust, any increase in the value of those assets remains outside the surviving spouse's estate. The importance of this feature increases: (i) as the value of a couple's net worth approaches $20 million; (ii) if asset values are expected to increase rapidly; and (iii) if the surviving spouse may be expected to outlive the decedent by many years.

Example 7: H dies in 2019 with a $9.5 million estate. His Will leaves everything to W, and a portability election is made. W has her own estate, also worth $9.5 million. During the next seven years, the estate grows at 6% per year, while inflation is only 3% per year. W dies in 2025 (just before exclusions are scheduled to return to $5 million, indexed for inflation). At that time, her estate (plus the amount she inherited from H) has grown to about $28.5 million, while her basic exclusion amount has grown to only about $13.7 million. When combined with the $11.4 million DSUE amount received from H,

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[17] *See Pfannenstiehl*, fn. 16. for an even broader example of trust assets being considered by a Massachusetts court in a divorce proceeding.

[18] The states that impose an estate or inheritance tax at death are Connecticut, District of Columbia, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska (imposed by counties), New Jersey (although its estate tax was repealed as of 1/1/2018, its inheritance tax was not), New York, Oregon, Pennsylvania, Rhode Island, Vermont and Washington. *See* the ACTEC State Survey, Murphy, *State Death Tax Chart*, available at http://www.actec.org/resources/state-death-tax-chart/ (last revised February 13, 2023).

her applicable exclusion amount is about $25.1 million, resulting in federal estate taxes of about $1.36 million. If instead, H's $9.5 million estate had passed into a bypass trust for W, W's basic exclusion amount of $13.7 million plus her DSUE amount of $1.90 million would exceed her $14.2 million estate. Instead of paying $1.36 million in estate tax, no estate tax would be due on her estate, and no estate tax would be paid on the now $14.2 million held in the bypass trust. If W died in 2026, after the reduction of her basic exclusion amount, relying on portability alone would result in a $4.2 million estate tax, versus a $2.3 million estate tax if a bypass trust were used—a cost of over $1.9 million.

9. Risk of Loss of DSUE Amount. As mentioned above, the surviving spouse is entitled to use the unused estate tax exclusion only of the most recently deceased spouse, i.e., the last deceased spouse. IRC § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, the new spouse (who may have a substantial estate, or for whose estate an estate tax return may not be filed to pass along any DSUE amount), becomes the last deceased spouse. Unless the surviving spouse makes taxable gifts before the new spouse's death (thereby using the DSUE amount of the first deceased spouse), any unused exclusion of the first spouse to die is then lost. If no DSUE amount is acquired from the new last deceased spouse, the cost to the family could be $4.56 million or more in additional estate tax (40% of $11.4 million). This risk does not apply if assets are inherited in a bypass trust.

Example 8: W1 dies in 2011, leaving her entire estate to H, and a portability election is made with regard to W1's estate on a timely filed estate tax return. H marries W2 in 2014. W2 dies in 2019 leaving her sizable estate to the children of her first marriage. As a result, no DSUE amount is available to H with regard to W2's estate. Since W2 is now H's "last deceased spouse," H has no DSUE amount. The DSUE amount formerly available from W1 is lost.

10. No DSUE Amount for GST Tax Purposes. There is no "portability" of the GST tax exemption. In 2019, a couple using a bypass trust can exempt $22.8 million or more from both estate and GST tax, if not forever then at least a long as the Rule Against Perpetuities allows. A couple relying only on portability can only utilize the GST tax exemption of the surviving spouse ($11.4 million in 2019).

Example 9: Assume the same facts as in Example 7, with W dying in 2025. If no bypass trust is used, about $27.1 million after tax ($28.5 million less $1.36 million in estate tax) is left to pass to trusts for children. W may shelter only $13.7 million of that amount from GST tax, since only her (inflation-adjusted) GST tax exemption is available to allocate to the children's trusts. The balance ($13.4 million) will not be exempt from GST tax, and will likely be taxed in the estate of the children. If instead, H's estate had passed into a bypass trust, H's GST exemption could have been allocated to the bypass trust, and the exemption would have continued on in trusts for children. In addition, W could allocate her GST tax exemption to shelter almost all of her $14.2 million after-tax estate. Not only would the children inherit $1.36 million more, but virtually all of the inheritance could pass to them in GST tax-exempt trusts.

Efficient use of a couple's GST tax exemption may be more important if the couple has fewer children among whom to divide the estate, especially when those children are successful in their own right.

Example 10: H and W, a married couple with a $20 million estate, both die in 2019 leaving everything outright to their only child C. As a result, C immediately has a taxable estate. If instead, after leaving everything to each other (using portability), the survivor leaves assets to a lifetime trust for C, only about half of the estate can pass into a GST tax-exempt trust, using the surviving spouse's GST tax exemption. The balance will pass into a non-exempt trust for C (usually with a general power of appointment), which can lead to an additional $10 million (plus growth) added to C's estate. If the first spouse's estate had passed into a bypass trust (or, as discussed below, into a QTIP trust for which a "reverse" QTIP election was made for GST tax purposes), the entire $20 million could pass into a GST tax-exempt trust for C, completely avoiding estate and GST tax at the time of C's death.

11. Must File Estate Tax Return for Portability. In order to take advantage of the DSUE amount, the executor of the deceased spouse's estate must file a timely and complete estate tax return. Once the last timely estate tax return is filed, any election regarding portability is irrevocable. If there is no appointed executor, the regulations provide that persons in possession of the decedent's assets (whether one or more) are the "executor" for this purpose. If those persons cannot agree upon whether to make the portability election, a probate proceeding may be advisable, simply to appoint an executor.

12. Impact on Life Insurance Planning. Clients who choose to utilize portability planning rather than implementing more traditional bypass trust planning should consider the use of life insurance, and especially insurance owned by younger-generation family members or by an irrevocable life insurance trust as a "hedge" against some of the shortcomings that may arise by counting on the use of the DSUE amount. For example, life insurance can make up for (or at least provide liquidity for the payment of) estate, inheritance, or GST taxes that might result from the (i) lack of an inflation adjustment for the DSUE amount; (ii) loss of the DSUE amount as a result of re-marriage and subsequent death of the surviving spouse; and (iii) lack of a DSUE amount for GST tax purposes. Life insurance owned by an irrevocable trust may substitute in whole or in part for the loss of control that results from forgoing bypass trust planning. That is, the irrevocable nature of such a trust allows the insured spouse to name beneficiaries other than the surviving spouse and may ensure that the surviving spouse cannot divert assets away from those beneficiaries. In addition, at least in Texas, creditors cannot generally attach the cash value of a life insurance policy, so having the surviving spouse invest in a life insurance policy may provide creditor protection benefits that are missed if a bypass trust is forgone.

C. Using QTIPable Trusts

Placing property into a trust eligible for the estate tax marital deduction offers many of the same non-tax benefits as bypass trusts but without many of the tax detriments.

1. Control, Creditor, and Divorce Protections. Like a bypass trust, a QTIP trust offers creditor and divorce protection for the surviving spouse, potential management assistance through the use of a trustee or co-trustee other than the spouse, and control over the ultimate disposition of assets for the transferor.

2. Less Income Tax Exposure. To be eligible for QTIP treatment, QTIP trusts must distribute all income at least annually to the surviving spouse. IRC § 2056(b)(7)(B). While QTIP trusts are subject to the same compressed income tax brackets as bypass trusts, since all fiduciary income must be distributed, less taxable income is likely to be accumulated in QTIP trusts at those rates. Keep in mind that the requirement that a QTIP trust must distribute all of its income means only that its income measured under state law and the governing instrument need be distributed to the surviving spouse. IRC § 643(b). In measuring fiduciary accounting income, the governing instrument and local law, not the Code, control. Nevertheless, the "simple trust" mandate that a QTIP trust distribute all of its income at least annually will typically mean that less taxable income is subjected to tax in a QTIP trust than in a bypass trust.

3. New Cost Basis at Second Spouse's Death. If a valid QTIP election is made under Code Section 2056(b)(7)(B)(v), which requires the filing of an estate tax return, then upon the death of the surviving spouse, the assets in the QTIP trust are treated for basis purposes as though they passed from the surviving spouse at the second death. IRC § 1014(b)(10). As a result, they are eligible for a basis adjustment at the death of the surviving spouse. It is important to remember that a QTIP election does not have to be made on an all-or-nothing basis, but rather a partial QTIP election may be made. Treas. Reg. § 20.2056(b)-7(b)(2)(i). Accordingly, in providing for the surviving spouse, if the estate plan provides for one trust for the sole benefit of the survivor and the other requirements to qualify the trust as a QTIP trust are met, the executor could make a partial QTIP election (perhaps severing the trust into two parts), resulting in both a bypass trust and a QTIP trust for the surviving spouse's benefit. This technique is often referred to as a "one-lung trust."

4. Preservation of GST Tax Exemption. If no QTIP election is made for the trust by filing an estate tax return, the first spouse to die is treated as the transferor for GST tax purposes, so the deceased spouse's GST tax exemption may be allocated (or may be deemed allocated), thereby preserving the GST tax exemption of that spouse. *See* IRC § 2632(e)(1)(B). If a QTIP election *is* made for the trust, the executor may nevertheless make a "reverse" QTIP election for GST tax purposes, again utilizing the decedent's GST tax exemption to shelter the QTIP assets from tax in succeeding generations. *See* IRC § 2652(a)(3).[19]

5. QTIPs and Portability. From an estate tax standpoint, making the QTIP election means that the assets passing to the QTIP trust will be deductible from the taxable estate of the first spouse, thereby increasing the DSUE amount available to pass to the surviving spouse. IRC § 2056(b)(7). (*But see* the discussion of Revenue Procedures 2001-38 and 2016-49 at page 16 below.) Of course, the assets on hand in the QTIP trust at the time of the surviving spouse's death will be subject to potential estate tax at that time as though they were part of the surviving spouse's estate. IRC § 2044. But if the surviving spouse's estate plus the QTIP assets are less than the surviving spouse's basic exclusion amount (or if a portability election has been made, less than the surviving spouse's applicable exclusion amount) then no estate tax will be due.

[19] Although a reverse QTIP election generally applies to the entire QTIP trust, it may be possible under state law or the governing instrument to sever the QTIP trust into two trusts, and then make the reverse QTIP election for only one of the severed trusts. *See, e.g.,* PLRs 201825023, 201845007.

6. QTIPs and Using the DSUE Amount. One strategy that a surviving spouse might consider, especially if remarriage is a possibility, is to make a taxable gift prior to remarriage (or at least prior to the death of a new spouse) to be sure to capture the DSUE amount of the prior spouse. If the spouse is a beneficiary of a QTIP trust, one possible form of that gift would be to intentionally trigger a gift of the QTIP trust assets under Code Section 2519. Section 2519 provides that if a surviving spouse releases *any* interest in a QTIP trust, transfer taxes are assessed as though the entire QTIP trust (other than the income interest) had been transferred. If the surviving spouse were to release a very small interest in the QTIP trust, the result would effectively be to make a gift of the entire QTIP, thereby using his or her DSUE amount, even though the surviving spouse would retain the use of the unreleased income interest. Despite making a gift of some interest in the QTIP trust while retaining substantially all of the income interest, the trust assets will be treated as passing from the surviving spouse at death, thereby receiving a new cost basis. IRC § 1014(b)(4). Moreover, because estate tax inclusion arises under Code Section 2036 and not Section 2044, a corresponding adjustment will be made to the surviving spouse's computation of adjusted taxable gifts at death. *See* Treas. Reg. § 20.2044-1, Ex. 5.[20] It should be noted that in the context of a QTIP trust, the purchase of the remainder interest may also be treated as a "disposition" of that interest by the spouse pursuant to Code Section 2519, and, as a result, the spouse may be treated as having made a taxable gift to the remainder beneficiaries equal to the value of the purchase price. Rev. Rul. 98-8, 1998-1 CB 541; s*ee also* PLR 201426016. Of course, the gift may be sheltered by the spouse's remaining applicable gift tax exclusion amount, which would include any DSUE amount.[21] Note that this technique is limited to the use of the surviving spouse's DSUE amount. The IRS's anti-abuse anti-claw-back rules do not permit a "failed" Section 2702 transfer of this nature to use the surviving spouse's "excess" exemption available under current law until 2026. Prop. Reg. § 20.2010-1(c)(3).

Example 11: W has a $10 million estate. W dies in 2023 with a Will leaving all to a QTIP trust for H. W's executor files an estate tax return making both the QTIP and the portability elections. Immediately thereafter, H releases 0.5% of the income interest in the QTIP trust assets. The release of the income interest is a taxable gift of the 0.5% interest under Code Section 2511, but more importantly, the release also constitutes a gift of the balance of the trust assets under Code Section 2519. Because the interest retained by H is not a qualified annuity interest, Code Section 2702 precludes any discounts associated with H's retained income interest when valuing the gift. The effect is for H to have made a $10 million gift, all of which is sheltered by W's DSUE amount. Even though the DSUE amount has been used, H still retains 99.5% of the income from the QTIP trust for life. In addition, the QTIP trust assets are included in H's estate under Code Section 2036, so a new cost basis will be determined for the assets when H dies. Because the assets are not included in the estate under Section 2044 of the Code, the taxable gift will not be treated as an adjusted taxable gift when H dies, and his entire applicable exclusion amount *plus* W's DSUE amount applied to H's taxable gift will be available to shelter any tax. Treas. Reg. § 20.2010-3(b).

D. QTIP Trust Disadvantages

Even in the current tax regime, QTIP trusts pose some disadvantages when compared to bypass trusts. In particular:

1. No "Sprinkle" Power. Because the surviving spouse must be the sole beneficiary of the QTIP trust, the trustee may not make distributions from the QTIP trust to persons other than the surviving spouse during the surviving spouse's lifetime. IRC § 2056(b)(7)(B)(ii)(II). As a result, unlike the trustee of a bypass trust, the trustee of a QTIP trust cannot "sprinkle" trust income and principal among younger-generation family members. Of course, this places the surviving spouse in no worse position than if an outright bequest to the spouse had been made. The surviving spouse can still use his or her own property to make annual exclusion gifts to those persons (or after a portability election, make even larger taxable gifts by using his or her DSUE amount) without paying any gift tax.

2. Estate Tax Exposure. Presumably, the QTIP trust has been used in order to achieve a step-up in basis in the inherited assets upon the death of the surviving spouse (which, of course, assumes that the trust assets appreciate in value – remember that the basis adjustment may increase or decrease basis). The basis adjustment is achieved by subjecting the assets to estate tax at the surviving spouse's death. The premise of using this technique is that the surviving spouse's basic

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[20] This technique is discussed in detail in Franklin and Karibjanian, *Portability and Second Marriages—Worth a Second Look*, 39 TAX MGMT. ESTS., GIFTS & TRUST J. 179 (2014).

[21] Note that Code Section 2519 generally applies to the entire QTIP trust. If the plan is to give assets of less than all of the QTIP, it may be possible first to partition the QTIP trust into two separate trusts, and then undertake Section 2519 planning for one of the partitioned trusts but not the other. *See, e.g.,* PLR 201834011.

exclusion amount (or applicable exclusion amount, if portability is elected) will be sufficient to offset any estate tax. There is a risk, however, that the "guess" made about this exposure may be wrong. Exposure may arise either from growth of the spouse's or QTIP trust's assets, or from a legislative reduction of the estate tax exclusion, or both (and, of course, under TCJA 2017, the basic exclusion amount is scheduled to be reduced for persons dying after 2025). If these events occur, use of the QTIP trust may expose the assets to estate tax. Again, this risk is no greater than if an outright bequest to the spouse had been made. However, if the source of the tax is appreciation in the value of the QTIP trust assets between the first and second death, and if the income tax savings from the basis adjustment is less than the estate taxes payable, then with hindsight, one could argue that using a bypass trust instead would have been more beneficial to the family.

3. Income Tax Exposure. A QTIP trust is a "simple" trust for federal income tax purposes, in that it must distribute all of its income at least annually. Remember, however, that simple trusts may nevertheless pay income taxes. As noted above, a trust which distributes all of its "income" must only distribute income as defined under the governing instrument and applicable state law (typically, the Uniform Principal and Income Act), which is not necessarily all of its taxable income. Thus, for example, capital gains, which are taxable income, are typically treated as corpus under local law and thus not distributable as income. Other differences between the notions of taxable income and state law income may further trap taxable income in the trust. Although simple trusts often accumulate less taxable income than complex trusts, they may nevertheless be subject to income tax at compressed tax rates.

4. Is a QTIP Election Available? In Revenue Procedure 2001-38, 2001-1 CB 1335, the IRS announced that "[i]n the case of a QTIP election within the scope of this revenue procedure, the Service will disregard the election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The Revenue Procedure provides that to be within its scope, "*the taxpayer must produce sufficient evidence*" that "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." *Id*. (emphasis added). The typical situation in which the Revenue Procedure applies is the case where the taxable estate would have been less than the basic exclusion amount, but the executor listed some or all of the trust property on Schedule M of the estate tax return and thus made an inadvertent and superfluous QTIP election.

An executor must file an estate tax return to elect portability, even if the return is not otherwise required to be filed for estate tax purposes. In that case, a QTIP election is "not necessary to reduce the estate tax liability to zero," because there will be no estate tax in any event. However, a QTIP election might still be made to maximize the DSUE amount, gain a second basis adjustment at the death of the surviving spouse, and support a reverse-QTIP election for GST tax purposes. Until recently, the concern was that Revenue Procedure 2001-38 could mean that the IRS might determine that a QTIP election made on a portability return "was not necessary to reduce the estate tax liability to zero" and therefore treat the QTIP election as "null and void." Adding to those concerns, when issuing final regulations with regard to making a portability election, the IRS stated that it would later issue guidance addressing whether a QTIP election made under Section 2056(b)(7) may be disregarded and treated as null and void when an executor has elected portability of the DSUE amount.

Thankfully, on September 27, 2016, the IRS issued Revenue Procedure 2016-49, 2016-42 IRB 462, which modifies and supersedes Revenue Procedure 2001-38 and outlines new procedures under which the IRS will disregard a QTIP election, but it provides that these procedures are unavailable if a portability election was made for the DSUE amount under Section 2010(c)(5)(A). The IRS will, however, continue to disregard an unnecessary QTIP election and treat the election as null and void solely "for estates in which the executor neither has made nor has considered to have made the portability election."

Specifically, Revenue Procedure 2016-49 treats QTIP elections as void if three requirements are satisfied: (1) the estate's federal estate tax liability was zero, so the QTIP election is unnecessary to reduce federal estate tax liability; (2) the executor did not make and was not considered to have made a portability election under Section 2010(c)(5)(A); and (3) specific procedural requirements for relief to treat a QTIP election as void as outlined in Section 4.02 of the Revenue Procedure are satisfied.

Conversely, the revenue procedure does not treat as void a QTIP election in any of the following situations: (1) a partial QTIP election was required for a trust to reduce estate tax liability but the executor made the election for more property than was necessary to bring the estate tax liability to zero; (2) a QTIP election was made "in terms of a formula designed to reduce the estate tax to zero"; (3) the QTIP election constituted a protective election under Treasury Regulation Section 20.2056(b)-7(c); (4) the executor made a portability election "even if the decedent's DSUE amount was zero based on values as finally determined for federal estate tax purposes"; or (5) the procedural requirements for relief to treat a QTIP election as void as outlined in Section 4.02 of the Revenue Procedure are not satisfied.

The Revenue Procedure also notes that, going forward, the procedures set out in the Revenue Procedure "must be used in lieu of requesting a letter ruling." In addition, QTIP elections for which relief was granted under Revenue Procedure 2001-38 do not fall within the scope of Revenue Procedure 2016-49.

Thus, Revenue Procedure 2016-49 accomplishes three things. First, taxpayers now have certainty that a QTIP election made solely to increase a DSUE amount will not be ignored or treated as void. Second, it expands the grounds for automatic relief for invalidating QTIP elections when the election provides no benefit. Third, as IRS user fees for private letter rulings continue to climb, taxpayers can now rely on Revenue Procedure 2016-49 for certainty in lieu of a costly and lengthy private letter ruling process.

5. *Clayton* QTIP Trusts. When the statute authorizing QTIP trusts was first enacted, the IRS strictly construed language in Section 2056(b)(7) of the Code requiring the property in question to pass from the decedent. In *Estate of Clayton v. Commissioner*, 97 TC 327 (1991), the IRS asserted that no marital deduction was allowed if language in the will made application of QTIP limitations contingent upon the executor making the QTIP election. Regulations at the time also adopted this position. After the Tax Court found in favor of the IRS's position, the Fifth Circuit reversed and remanded, holding that language in a will that directed property to a bypass trust to the extent no QTIP election was made did not jeopardize the estate tax marital deduction. *Est. of Clayton v. Comm'r*, 976 F2d 1486 (5th Cir. 1992). After other courts of appeal reached the same result and a majority of the Tax Court abandoned its position, the Commissioner issued new regulations that conform to the decided cases and permit a different disposition of the property if the QTIP election is not made. Treas. Reg. §§ 20.2056(b)-7(d)(3)(i), 20.2056(b)-7(h), Ex. 6. The final regulations explicitly state that not only can the spouse's income interest be contingent on the election, but the property for which the election is not made can pass to a different beneficiary, a point that was somewhat unclear under the initial temporary and proposed regulations issued in response to the appellate court decision. As a result, it is now clear that a will or a revocable trust can provide that if and to the extent that a QTIP election is made, property will pass to a QTIP trust, and to the extent the election is not made, the property will pass elsewhere (for example, to a bypass trust). Including this *Clayton* QTIP language in a client's will or revocable trust would allow the executor of the estate[22] of the first deceased spouse additional time compared to a disclaimer bypass trust to evaluate whether a QTIP or bypass trust is best. Because the QTIP election would need to be made on a federal estate tax return, the *Clayton* option would require the filing of an estate tax return if property is to pass to the QTIP trust. Presumably, since a QTIP election can be made on an estate tax return filed on extension, a *Clayton* QTIP would give the executor fifteen months after the date of death to evaluate the merits of the election. In addition, since no disclaimer is involved, there is no limitation on the surviving spouse holding a special testamentary power in the bypass trust that receives the property as a result of the *Clayton* election. Sample language invoking a *Clayton* QTIP trust is attached as Exhibit B.

If a *Clayton* QTIP election is contemplated, may the surviving spouse serve as the executor? There is a concern that the spouse's right to alter the form of her bequest from a bypass trust that may "sprinkle and spray" among family members to an "all income for life" QTIP trust might give rise to gift tax exposure to the spouse for making (or failing to make) the election. Most commentators agree that the safest course is for the spouse not to serve as the executor. A somewhat more aggressive approach may be for the spouse to serve, but to require the surviving spouse/executor to make (or not make) the QTIP election as directed by a disinterested third party. Consider whether state law allows for a "special executor" that may serve only for this purpose (in Texas, this is not possible) or whether a "special trustee" under a post-death revocable trust may make the election. Note that these concerns should not apply to a one-lung trust because a partial QTIP election does not alter the surviving spouse's beneficial interest.

6. The QTIP Tax Apportionment Trap. Remember that if estate tax ultimately proves to be due as a result of having made the QTIP election, the source of payment for these taxes becomes important. Under federal law, except to the extent that the surviving spouse in his or her will (or a revocable trust) specifically indicates an intent to waive any right of recovery, the marginal tax caused by inclusion of the QTIP assets in the surviving spouse's estate is recoverable from the assets of the QTIP trust. IRC § 2207A(1). Many state tax apportionment statutes adopt this rule, either expressly or by reference. *See, e.g.,* TEX. ESTS. CODE § 124.014. When the beneficiaries of the surviving spouse's estate and the remainder

[22] Keep in mind that for estate tax purposes, the executor is defined as the court-appointed executor, or if there is no appointed executor, the person in actual or constructive possession of property of the decedent. IRC § 2203.

beneficiaries of the QTIP trust are the same persons, this rule generally makes little difference. Where they differ, however, the result could be dramatic, and highlights the need to check the "boilerplate" of clients' wills.

Example 12: H and W each have a $25 million estate. H dies with a Will leaving all to a QTIP trust for W, with the remainder interest in the trust passing upon W's death to H's children from a prior relationship. H's executor files an estate tax return making both the QTIP and the portability elections. W immediately thereafter, knowing she can live from the QTIP trust income, makes a gift of her entire $20 million estate to *her* children. No gift tax is due since W can apply her applicable exclusion amount to eliminate the tax (i.e., her basic exclusion amount plus H's DSUE amount of $12.92 million). Upon W's later death, the remaining QTIP trust assets are subject to estate tax under Section 2044 of the Code. Since W used nearly all of her applicable exclusion amount to shelter her gift to her children, none of her exclusion (or a nominal amount because of the inflation adjustment of her basic exclusion amount) is available to shelter estate tax, and the entire $25 million (assuming no changes in value) is taxed. All of this tax is attributable to the QTIP trust assets, so unless W's Will expressly provides otherwise, the estate tax liability of about $10 million is charged to the trust (and therefore, in effect, to H's children). As a result, H's children are left with $15 million from the remainder of the QTIP assets, while W's children receive $25 million tax free. Note that this same result occurs if W makes no gift! Unless W's Will provides otherwise, her applicable exclusion amount (including H's DSUE amount) would shelter her assets from estate tax, with the QTIP paying all of the marginal tax caused by the inclusion of its assets in W's estate.

One solution to this problem may be to have H and W enter into a post-nuptial agreement whereby each agrees that if the executor of the first deceased spouse's estate makes both a QTIP and a portability election, the surviving spouse will sign a Will that equitably apportions any estate tax due upon the surviving spouse's death. Alternatively, H's executor could agree to the portability election only if W (i) agrees to waive estate tax recovery under Section 2207A except to the extent of pro rata taxes (instead of marginal taxes); and (ii) agrees to retain sufficient assets to pay applicable estate taxes associated with her property transfers, whether during lifetime or at death. As one might imagine, drafting such an agreement would not be a trivial matter.

E. Is a "LEPA" Trust a Better Choice?

A QTIP trust isn't the only method of obtaining a marital deduction for property passing into trust for a surviving spouse. Long before the advent of QTIP marital trusts, another form of marital trust was available. Unlike the more familiar QTIP trust format, this trust is available without the need to file an estate tax return.

1. Structure of LEPA Trusts. Code Section 2056(b)(5) permits a marital deduction for property passing into trust for a spouse so long as the surviving spouse is entitled for life to the income from all or a specific portion of the trust, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the trust property (exercisable in favor of the surviving spouse or the estate of the surviving spouse, or in favor of either, whether or not the power is exercisable in favor of others), so long as no power is given to anyone to appoint any part of the trust to anyone other than the surviving spouse. This so-called Life Estate Power of Appointment ("LEPA") trust thereby allows a marital deduction without many of the other restrictions applicable to QTIP trusts. Note that the spouse must be given the right to income from all of the trust (or a specific portion of the trust determined on a fractional or percentage basis) that is intended to qualify. The power of appointment must be exercisable by the spouse alone, and may be inter vivos or testamentary, as long as it is exercisable over all of the trust property from which the spouse has a right to the income. IRC § 2056(b)(5).

2. Benefits of LEPA Trusts. Since the advent of QTIP trusts, estate planners have generally preferred them, since they allow the creator of the trust to restrict the disposition of any trust property remaining at the death of the surviving spouse, by restricting or even eliminating the surviving spouse's power to appoint the trust property. However, LEPA trusts do cause inclusion in the surviving spouse's estate, thereby providing a basis adjustment in the trust's assets at the death of the surviving spouse. IRC § 1014(b)(4). In addition, they provide many of the other trust benefits such as creditor protection and divorce protection, as well as management assistance through the use of a trustee or co-trustee other than the spouse. While neither the income nor the associated tax liability of a LEPA trust may be shifted to others, a LEPA trust may avoid application of compressed tax rates if the surviving spouse has a general power to appoint property to him- or herself during lifetime. IRC § 678. Especially in smaller estates of couples with children of the same marriage, and in states with no state estate tax, the LEPA trust may see a rise in popularity because couples with smaller estates don't need to file an estate tax return to obtain the second basis adjustment.

3. Disadvantages of LEPA Trusts. LEPA trusts do have some drawbacks. Most notably, while a QTIP trust permits preservation of the decedent's GST tax exemption by making a "reverse" QTIP election for GST tax purposes, there is no "reverse" LEPA election. Assets in the trust are simply included as part of the surviving spouse's estate at the time of his or her death, and the surviving spouse is thereby treated as the transferor of the trust property for GST tax purposes. In addition, granting the surviving spouse a general testamentary power of appointment over trust assets may not be compatible with every client's estate plan. Also, the grant of a general power of appointment, whether inter vivos or testamentary, may subject the property to the spouse's creditors in some jurisdictions. This topic is discussed in more detail in section V.B.5 below at page 24.

V. A NEW ESTATE PLANNING PARADIGM

Marital trust planning, whether taking the form of QTIP or LEPA trusts, can allow clients to obtain many of the income tax basis benefits of the outright/portability option, while at the same time achieving the estate preservation and asset protection planning advantages of a bypass trust. Thus, marital trusts can help solve the "loss-of-basis" disadvantages of bypass trusts discussed above, and can solve many of the disadvantages of outright planning. But is there an even better solution? Marital trusts, by causing trust property to be included in the surviving spouse's estate, actually achieve a full basis adjustment, which means that the assets in the trust receive not only a second step-up in basis if they appreciate, but also a second step-*down* in basis if their values decline. In addition, unlike bypass trusts, marital trusts cannot "sprinkle" income and assets to other beneficiaries. Moreover, they are somewhat "leaky," for both asset protection and income tax reasons, because of their mandatory income requirements.

A. Creative Options to Create Basis

Estate planners have suggested a number of other tools that could be brought to bear on the drawbacks presented by bypass trusts. Each of these options have advantages and disadvantages, and it appears that there may be no "one-size-fits-all" (and perhaps not even a "one-size-fits-most") solution to the problem. A word of caution is warranted in that just because there may be the ability do something doesn't mean it should be done; in other words, just because there may be the ability to implement a technique for basis adjustment purposes does not mean that it will be appropriate in every situation and it may simply be inappropriate. The client needs to understand the risks involved, such as whether a technique may expose assets to creditors or potential estate or inheritance tax, and the practical implications for each technique, whether it require the client or someone else to act and if fiduciary duties may arise. One or more of these issues apply to just about every basis adjustment idea.

1. Distribution of Low-Basis Assets. Perhaps the most straight-forward approach involves simply having the trustee of a bypass or other trust distribute to the surviving spouse low basis assets with a total value that, when added to the value of the surviving spouse's other assets, will cause his or her estate to be less than his or her available applicable exclusion amount. If the distribution can be justified as having been made for the spouse's health, education, maintenance or support (or however the trust's applicable distribution standard reads), then arguably, this distribution could be undertaken with no other special language in the governing instrument. So long as the spouse passes these assets at death to the same person(s) who would have received them from the trust, there is presumably no one to complain. The remaindermen receive the assets with a higher cost basis, so they are actually better off than if the distribution had never been made. This approach has several shortcomings. For example: (i) the trustee must identify the low-basis assets and distribute them to the spouse in the proper amount, presumably shortly before the spouse passes away; (ii) if the surviving spouse dies with substantial creditors or changes his or her dispositive plan before death, the remaindermen may be injured by the distribution (for which the trustee could presumably be liable if it can be shown that the distribution was not made pursuant to the applicable distribution standard); and (iii) if the surviving spouse truly has no need for the distribution, the IRS might argue that the distribution was unauthorized, asserting that a constructive trust or resulting trust was thereby imposed for the remainder beneficiaries, effectively excluding the assets from the spouse's estate (and precluding any step-up in basis). *See Stansbury v. U.S.,* 543 F Supp 154 (ND Ill 1982), aff'd 735 F2d 1367 (7th Cir. 1984) (holding, in an entirely different context, that assets subject to a constructive trust were excluded from the estate of the nominal owner for estate tax purposes); *Est. of Halpern v. Comm'r*, TC Memo 1995-352 (Tax Court analyzed IRS argument that unauthorized trust distributions should be included in decedent's estate in light of how decedent would have prevailed if she had pursued recovery in state court); PLR 9338011 (holding that assets improperly distributed to a trust beneficiary would be deemed under local law to be held in a "resulting trust", and as a result, were not includable in the decedent's estate under IRC § 2033).

2. **Granting Broad Distribution Authority to a Third Party.** One option may be to designate an independent trustee (or co-trustee, or "distribution trustee") in a bypass trust, and to grant that person broad discretion to distribute up to the entire amount in the bypass trust to the surviving spouse. The theory would be that if the surviving spouse were nearing death with an estate valued below his or her applicable exclusion amount, the person holding this authority could simply distribute low-basis assets to the surviving spouse outright, thereby causing them to be included in the surviving spouse's estate, thus receiving a new cost basis at death. This authority could also be exercised more broadly if the family simply decided that the benefits of the bypass trust were not worth its costs (or not worth it as to certain assets), and the trustee/trust protector agreed to distribute the assets. Since the surviving spouse would not hold this authority, the assets remaining in the bypass trust would not be included in his or her estate. So long as the trustee/trust protector were not a remainder beneficiary of the trust, no gift would arise as a result of the exercise (or non-exercise) of the power. However, one would need to ensure that appropriate successors were named in case the first designated person failed or ceased to serve, and it would be prudent not to allow the surviving spouse or other beneficiaries of the trust to remove, replace, or fill a vacancy in the position by a person related to or subordinate to the trust beneficiaries under Code Section 672(c). IRC § 672(c); *see* Rev. Rul. 95-58, 1995-2 CB 191.

Critics of this approach note that it is often impractical and requires considerable proactivity and perhaps even clairvoyance (not to mention potential liability) for the trustee/trust protector. Is it possible to find one person (let alone one or more back-ups) to fill this role? Can we expect the trustee/trust protector to know when the surviving spouse is likely to die, to know the cost basis of trust assets and to know an accurate net worth of the surviving spouse? Some posit that the duty could be drafted to arise only upon the request of the surviving spouse or one (or all) of the remainder beneficiaries. Even in that case, it seems likely that the trustee/trust protector may wish to hire counsel, to analyze the medical condition of the spouse, get signed waivers, and/or consult a distribution committee, time for which may be scarce in a situation where the surviving spouse is hospitalized or terminally ill. And what happens if the spouse gets better? Finally, an outright distribution of property to the surviving spouse would subject the distributed property to the claims of the creditors of the surviving spouse, which could in a worst-case scenario be the equivalent of a 100% "tax" on the distributed assets.

3. **Giving a Third Party the Power to Grant a General Power of Appointment.** A related technique advocates giving an independent trustee or trust protector not the distribution authority directly, but rather the power to grant to the surviving spouse (or others) a general testamentary power of appointment. The idea is that if it is apparent that no estate tax will be due upon the survivor's death, the power could be exercised to grant the spouse a general power, and thereby achieve a basis adjustment. This approach might protect the trust assets from creditors during the surviving spouse's lifetime, but it suffers from many of the same shortcomings as the technique just described. In particular, (i) it must have been included in the governing instrument; (ii) a person (or persons) willing and able to hold this power must be identified; (iii) the person must be willing to exercise the authority at the right time; and (iv) the surviving spouse might actually exercise the power and divert the assets outside the family. Any person given this authority must be concerned about being held liable by the trust's remaindermen for improvidently exercising (or failing to exercise) the power, or by the spouse if the power is exercised at a time when the spouse is expected to die but doesn't. More problematic is the concern that under Code Section 2041(b)(1)(C) a general power of appointment that is exercisable in conjunction with another person is nevertheless a general power if the other person does not have an adverse interest, and it is a general power as to the entire value of the trust property if the other person is not a permissible appointee. A trust protector would typically not have an adverse interest or be a permissible appointee. At least one commentator[23] has questioned whether there is any real difference between a power that is conferred by the protector and a power held jointly with the protector. If the IRS views them as the same, then the surviving spouse (in this example) would be deemed to hold a general power over *all of the trust assets* in all events, regardless of the size of the estate and *regardless of whether the protector exercised the authority to grant the power*.

4. **Granting a Non-Fiduciary Power to Appoint to the Surviving Spouse.** Some commentators have suggested that the fiduciary liability concerns associated with giving a trustee or trust protector broad distribution rights could be overcome by giving another party (typically a child, perhaps another family member, friend of the spouse, or non-beneficiary), a non-fiduciary limited lifetime power to appoint property to the surviving spouse. A power of appointment granted in a non-fiduciary capacity may be exercised arbitrarily. RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER

[23] *See* Aucutt, *When is a Trust a Trust?* printed as part of *It Slices, It Dices, It Makes Julienne Fries: Cutting Edge Estate Planning Tools*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

DONATIVE TRANSFERS § 17.1 (2011). Since the power would be granted with the express authority to exercise it (or not exercise it) in a non-fiduciary capacity, the power holder should be less concerned about exposure to claims of imprudence by trust beneficiaries. If the person holding the power is a beneficiary of the trust, its exercise may cause gift tax concerns. *See* Treas. Reg. §§ 25.2514-1(b)(2), -3(e), Ex. 3; PLR 8535020; PLR 9451049. If the person holding the power is not a beneficiary, however, the exercise or non-exercise of the power should have no tax implications to the power holder. But, as noted with respect to distributions by an independent trustee or trust protector, appointing assets outright to the surviving spouse risks subjecting those assets to the spouse's creditors, and further exposes family members to the risk that the surviving spouse may disinherit them. In this regard, trust assets are a bit like toothpaste: once the assets are out of the trust "tube," you can't simply put them back in and have the same tax results.

5. Decanting the Bypass Trust to a Trust that Provides Basis. If the bypass trust does not by its terms contain provisions that would allow a basis adjustment at the death of the surviving spouse, some commentators have suggested that the trust be modified or decanted into a trust that has more favorable terms. While the intricacies of trust modifications and decanting are well beyond the scope of this paper, one need only note that this form of decanting may not be available in all jurisdictions. For example, under the current Texas decanting statute, no change may be made to the dispositive (as opposed to administrative) provisions of a trust via decanting unless the trustee's distribution power is not subject to limited discretion. *See generally* TEX. PROP. CODE §§ 112.073 (stating the law governing distribution of property in a second trust when the trustee has limited discretion), 112.071(6) (defining limited discretion to be mandatory distribution of principal with no discretion or a power to distribute principal limited to an ascertainable standard including health, education, maintenance and support); *see also* TEX. PROP. CODE § 112.072(a). In addition, even if a trustee has unlimited discretion (a true rarity, and one which would seem to obviate the need to decant to achieve the aims discussed above), under Texas's original decanting statute, no decanting could occur if it would "materially impair the rights of any beneficiary," although this provision has been deleted from the statute effective September 1, 2017. TEX. PROP. CODE § 112.085(2). Decanting to a trust that grants a spouse broad powers of appointment might "materially impair" the rights of remainder beneficiaries. Finally, no matter the state involved, a trustee's power to decant is subject to the trustee's overall fiduciary duties, and may have tax consequences apart from achieving the basis aims discussed here. For a thorough discussion of decanting generally, *see* Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, 6 EST. PLAN. & COMMUNITY PROP. L. J. 35 (2013).[24]

6. Making a Late QTIP Election. If the bypass trust happens to otherwise qualify as a QTIP trust, and no federal estate tax return was ever filed to not make a QTIP election, it may be possible to file an estate tax return to make a late QTIP election. Although somewhat rare, some bypass trusts qualify for QTIP treatment with a proper election. Specifically, the bypass trust must provide that the surviving spouse is the sole beneficiary during his or her lifetime, is entitled to demand or receive all net income at least annually, and can require unproductive property be made productive. Somewhat surprisingly, a QTIP election can be made on the last timely filed estate tax return, or, *if no return is filed on time, on the first late-filed return*. Treas. Reg. § 20.2056(b)-7(b)(4)(i). If the estate of the first spouse to die was below the estate tax filing threshold, it is likely that no estate tax return was ever filed. That means that long after the fact (conceivably, even after the death of the surviving spouse) a return could be filed that relates back to the time of the first spouse's death, thereby causing the trust assets to be included in the surviving spouse's estate and resulting in basis adjustment in the trust's assets at the second death. Note that it is unlikely that anything like surgical precision would be possible in this circumstance. Although partial QTIP elections are permitted, it is unlikely that the election could be made only as to those assets whose values increased between the first and second death. *See* Treas. Reg. § 20.2056(b)-7(b)(2).

7. Investing in Life Insurance. While there has been much wringing of hands about the loss of basis adjustment for assets held inside a bypass trust, that concern is premised upon the trust holding assets that appreciate during the surviving spouse's lifetime which, when liquidated, will generate taxable gain. Consider, however, a bypass trust that holds or purchases a life insurance policy on the life of the surviving spouse. Regardless of the amount invested in the policy, the death benefit, received in cash, will be income tax free to the beneficiary of the policy (e.g., the bypass trust or its remainder beneficiaries). IRC § 101(a)(1). No "step-up" in basis is required to obtain a favorable income tax result for this investment, since the cash proceeds in effect have a basis equal to the amount paid under the policy. If funds are needed during the surviving spouse's lifetime for his or her health, support, maintenance or education, the trustee can typically borrow from

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[24] For a version of this paper, see Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, presented to the Corpus Christi Estate Planning Council (March 2015), available at http://tinyurl.com/o7rnh7w. Note that the paper does not discuss amendments to the Texas decanting statute that took effect as of September 1, 2017.

the insurance policy's cash value and use the income-tax-free loan proceeds to make distributions to or for the benefit of the spouse, so long as the policy is not a "modified endowment contract" as defined in Section 7702A of the Code. IRC § 72(e)(10). If the spouse's health declines, the trustee could obtain a pre-payment of the death benefits if available under the policy. If the trustee of the bypass trust elects to receive payments at a time when the insured is terminally ill or chronically ill[25], the payments may be excluded from gross income. IRC § 101(g). The exclusion for prepayment of accelerated death benefits applies only to payments received from the insurance company that issued the policy, or from certain licensed third party "viatical settlement providers." To be considered "terminally ill," the insured must be certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less. IRC § 101(g)(4)(A). A person is considered "chronically ill" if he or she is unable to perform, without "substantial assistance," at least two activities of daily living for at least 90 days due to a loss of functional capacity, or because of severe cognitive impairment, requires substantial supervision to protect him or her. *See* IRC §§ 101(g)(4)(B); 7702(c)(2)(A). The exclusion for chronically ill taxpayers is subject to a per-diem cap ($370 per day, or $135,050 per year for 2019). IRC §§ 101(g)(3)(D); 7702B(d); Rev. Proc. 2018-57, 2018-49 IRB 827, § 3.61. Even if borrowing or a viatical settlement isn't chosen, the trustee might simply cash in the policy, although doing so might result in taxable gain (taxed as ordinary income) if the proceeds received exceed the trust's investment in the contract. *See, e,g.*, *Nesbitt v, Comm'r*, 43 TC 629 (1965). TCJA 2017 provides that a taxpayer's basis in a life insurance policy (referred to as one's investment in the contract) is based upon the amount of premiums paid minus sums returned under Code Section 72(e)(6), and is not reduced by some factor reflecting the cost of insurance coverage. This change retroactively reverses the IRS's position on this issue expressed in Revenue Ruling 2009-13, 2009-21 IRB 1029. IRC §§ 72(e)(6), 1016(a)(1)(B). Naturally, care must be taken to ensure that the spouse, whether as trustee of the bypass trust or otherwise, does not hold any incidents of ownership over the policy. Otherwise, the death benefit of the policy will be included in the spouse's estate for estate tax purposes and may thus be subject to estate tax. IRC § 2042(2).

B. The Optimal Basis Increase Trust ("OBIT")

In an ideal world, estate planners would design a trust that ensures that upon the surviving spouse's death, its assets get a step-up, but not a step-down in basis, doesn't generate any federal estate tax (or any extra state estate tax), achieves better ongoing income tax savings than a typical bypass or marital trust, and preserves asset protection benefits, all without the drawbacks described above. One approach to such a trust has been suggested by attorney Edwin P. Morrow, III who describes employing a combination of techniques with a bypass/marital trust plan to create what he refers to as an "Optimal Basis Increase Trust" or "OBIT."[26] The key feature of this plan is to make creative use of testamentary general and limited powers of appointment to (i) assure that assets in the trust receive a step-up in basis, but never a step-*down* in basis; and (ii) dynamically define or invoke these powers so as to not cause additional estate tax.

1. Granting a General Power of Appointment to Obtain Basis. As part of a traditional bypass trust, an OBIT might grant the surviving spouse a testamentary limited power of appointment (or no power at all) over all IRD assets (which cannot receive a new cost basis) and over assets with a basis higher than the fair market value at the time of the surviving spouse's death (for which no new basis is desired). However, it would grant the surviving spouse a general testamentary power of appointment ("GPOA") over any assets that have a fair market value greater than their tax basis.[27] Such a "split" power of appointment would assure that appreciated assets in the trust would receive a step-up in basis, but no assets would receive a step-down.

2. Applying a Formula to Avoid Estate Tax. What if the value of the appreciated assets in the bypass trust, when added to the value of the surviving spouse's estate, exceeds the surviving spouse applicable exclusion amount at the time of his or her death? In that event, basis would be acquired, but at the cost of paying estate tax. One alternative is to restrict the surviving spouse's GPOA by a formula. The formula would, in effect, provide that the GPOA is only applicable to

[25] If the insured is chronically ill, payments of certain death benefits are tax-free only if detailed requirements are met. For example, the payment must be for costs incurred for qualified long-term care services. These costs include both medical services and maintenance or personal care services provided under a prescribed plan of care. Also, the payment must not be for expenses reimbursable under Medicare, other than as a secondary payor. IRC § 101(g)(3).

[26] Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust* printed as part of *Recipes for Income and Estate Planning in 2014*, State Bar of Texas 20th Ann. Adv. Est. Pl. Strat. Course (2014).

[27] As discussed below, this targeted estate tax inclusion and resulting basis adjustment may also be accomplished by granting the surviving spouse a limited power of appointment that is exercised in a manner to trigger the Delaware Tax Trap.

appreciated trust assets to the extent it does not cause increased federal estate tax. (As a further refinement, the formula might also take into account state estate tax, if it is potentially applicable). Estate planners have been drafting formula powers of appointment for years (usually in the context of avoiding GST taxes) which limit the scope of the GPOA either as to appointees or assets. There is no reason one cannot grant a general power of appointment over less than 100% of trust assets, or by formula. *See* Treas. Reg. § 20.2041-1(b)(3). In fact, one might further fine-tune the formula to limit its application first to those assets with the greatest embedded gain (or those assets whose sale would result in the most federal income tax, taking into consideration not only the amount but the character of the gain involved). In this regard, the drafting difficulty arises not so much with describing the upper limit on the GPOA, but in creating an ordering rule which appropriately adjusts the formula based upon the circumstances that one might reasonably expect to be applicable at the death of the surviving spouse.[28]

3. Designing the Formula. In its simplest form, the formula GPOA might apply to a pecuniary amount rather than to specific assets. However, funding such a pecuniary amount would require the trustee to determine the assets over which it applies. That discretion might result in undesired income tax consequences. In particular, distributions that satisfy a pecuniary obligation of the trust are recognition events for the trust. The fair market value of the property is treated as being received by the trust as a result of the distribution; therefore, the trust will recognize any gain or loss if the trust's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, gains or losses could be recognized by the trust if the formula gift describes a pecuniary amount to be satisfied with date-of-distribution values, as opposed to describing specific trust assets or a fractional share of the trust. *See* Treas. Reg. §§ 1.661(a)-2(f)(1), 1.1014-4(a)(3); Rev. Rul. 60-87, 1960 1 CB 286. As a result, one should avoid simple powers of appointment over, for example, "assets with a value equal to my [spouse's] remaining applicable exclusion amount."

On the other hand, if the surviving spouse's testamentary power potentially extends to all of the applicable property equally, but is fractionally limited, all property subject to that provision should get a fractional adjustment to basis. A pro rata adjustment would result in wasted basis adjustments, since a $1,000,000 asset with $1 gain would use just as much of the surviving spouse's applicable exclusion amount as a $1,000,000 asset with $900,000 gain. The result would be better than no extra basis at all, but not as optimal as the trustee limiting the surviving spouse's GPOA, or establishing an ordering rule to determine to which specific property the power pertains.[29]

By specifying that the GPOA applies on an asset-by-asset basis to the most appreciated asset first, cascading to each next individual asset until the optimal amount is reached, the difficulty with pecuniary funding can likely be avoided. Since the ordering formula necessarily means that the GPOA could never apply to depreciated assets, the IRS would have no statutory basis to include them in the surviving spouse's estate (or accord them an adjusted basis). The GPOA would apply to specific property, and not a dollar amount or a fraction. Applying the formula would likely require the creation by the trustee of a rather elaborate spreadsheet when dealing with numerous individual assets (think of brokerage accounts with dozens of individual stock positions), but the result would be a well ordered cascade of basis increase.[30]

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[28] Morrow notes:

> Assets that may incur higher tax rates, such as collectibles . . . would be natural candidates for preference. On the opposite end of the spectrum, other assets might have lower tax rates or exclusions, such as qualifying small business stock or a residence that a beneficiary might move into, but those would be relatively rare situations. Most families would prefer the basis go to depreciable property, which can offset current income, before allocating to stocks, bonds, raw land, family vacation home, etc. Therefore, ultimately a weighting may be optimal, or even a formula based on tax impact, but at the most basic level practitioners would want the GPOA to apply to the most appreciated assets first.

See Morrow, fn. 26.

[29] Morrow suggests that an independent trustee might be given a fiduciary limited power of appointment to choose the appointive assets subject to the surviving spouse's GPOA. The trustee's fiduciary power could arguably limit the spouse's GPOA over only specific assets chosen by the trustee, since the trustee's power would also be limited. While this is fundamentally different in many ways from traditional marital deduction funding formulas that involve trustee choice, the IRS could conceivably seek to apply a "fairly representative" requirement, or otherwise impose limits on trustee authority comparable to those described in Rev. Rul. 64-19, 1964-1 CB 682. *See* Davis, *Funding Unfunded Testamentary Trusts*, 48 U. MIAMI HECKERLING INST. ON EST. PL. ch. 8, ¶ 804.3 (2014). Morrow concludes that the more conservative and simpler approach is probably just to make it clear that the GPOA never applies to the less appreciated assets, and is never subject to any power holder's discretionary choice.

[30] For a formula that seeks to exercise a power of appointment in this cascading asset-by-asset fashion (although in the context of springing the "Delaware Tax Trap" which is discussed below), see Exhibit C.

If the spouse serves as the (or a) trustee, might the IRS argue that he or she has an indirect power to manipulate gains and losses on investments, and therefore basis, which in effect gives the spouse a GPOA over all of the trust's assets up to the remaining applicable exclusion amount? Presumably not. Treasury Regulation Section 25.2514-1(b)(1) provides that "[t]he mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment."

4. Limiting a GPOA to Avoid Diversion of Assets and Loss of Asset Protection. Just how broad of a general power must the surviving spouse have to obtain a new cost basis? From a tax standpoint, the goal of the formula GPOA should be like an often-expressed wish for children (to be seen but not heard) or perhaps like a grantor's intent with typical *Crummey* withdrawal rights (to be granted but not exercised). After all, it is the *existence* of the GPOA that gives rise to the basis adjustment—not its exercise. The IRS has historically had every incentive to find a GPOA even on the narrowest of pretexts, since in the past, a GPOA typically produced more revenue in the form of estate tax than it lost by virtue of basis adjustments. Courts have gone along, finding a GPOA to exist even where the holder of the power didn't know it existed, or couldn't actually exercise it due to incapacity. *See, e.g., Fish v. U.S.*, 432 F2d 1278 (9th Cir 1970), *Est. of Alperstein v. Comm'r*, 613 F2d 1213 (2nd Cir 1979), *Williams v. U.S.*, 634 F2d 894 (5th Cir. 1981). The breadth of the statutory language and Treasury regulations in finding a GPOA, together with favorable law in the asset protection context, mean that GPOAs can be drafted to pose little threat to the estate plan.

If a LEPA trust (described above at page 18) is used, the general power of appointment must include the spouse or spouse's estate (and not just creditors of the spouse's estate), and must be "exercisable by such spouse alone and in all events." IRC § 2056(b)(5). However, if no marital deduction is to be claimed, as is typically the case with a bypass trust OBIT, some limitations may be included.

For example, a GPOA may limit the scope of eligible beneficiaries so long as creditors of the power holder are included. As an illustration:

> My [spouse] shall have a testamentary power to appoint, outright or in trust, any property remaining in the trust to any one or more persons related to me by blood, marriage or adoption or to any charity or charities. In addition, my [spouse] shall have a testamentary power to appoint [optimal trust property] to the creditors of [his/her] estate.

See IRC § 2041(b)(1); Treas. Reg. § 20.2041 3(c)(2); *Jenkins v. U.S.*, 428 F2d 538, 544 (5th Cir. 1970).

Furthermore, a general power is still a GPOA if it may only be exercised with the consent of a non-adverse party. IRC § 2041(b)(1)(C)(ii). In fact, even a trustee that owes fiduciary duties to beneficiaries whose interests are adverse to the power holder is not, by that status alone, considered adverse. *See* Treas. Reg. § 20.2041-3(c)(2), Ex. 3; *Est. of Jones v. Comm'r*, 56 TC 35 (1971); *Miller v. U.S.*, 387 F2d 866 (3rd Cir. 1968). For example, one might add to the above language: "However, my [spouse] may exercise [his/her] power of appointment only with the consent of [name of non-adverse party, and/or] the trustee, who must be a non-adverse party." The document would then need to include provisions to enable appointment of a non-adverse party as trustee if, for instance, the spouse was a trustee. If a non-adverse party is named, it would be prudent to name alternates in the event the first is deceased or incapacitated.[31]

Moreover, a GPOA is "considered to exist on the date of a decedent's death even though the exercise of the power is subject to the 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 decedent's death notice has been given or the power has been exercised." Treas. Reg. § 20.2041-3(b). Including these sorts of requirements would make GPOAs more difficult to actually exercise, yet still come within the safe harbor of a Treasury regulation.

5. Creditor Exposure. Does granting a surviving spouse a testamentary power to appoint trust property to the creditors of his or her estate mean that those creditors can reach the trust property even if the property is not so appointed? The answer will depend upon local law. For example, it would not appear so in Texas. The spendthrift provisions of the

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[31] The use of a non-adverse party in this context should be contrasted with the problems under Code Section 2041(b)(1)(C) discussed beginning at page 20 above regarding naming a third party with the right to grant the spouse a general power of appointment. In the present context, the spouse already holds the optimum power; the requirement of consent from a third party is included only to make it harder for the spouse to actually exercise the power in a manner inconsistent with the grantor's wishes.

Texas Trust Code generally allow a grantor to provide by language in the trust agreement that the interest of a beneficiary in the income or in the principal of the trust, or in both, may not be voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. *See, e.g.*, TEX. PROP. CODE § 112.035. While in most cases, the spendthrift provisions do not apply to trusts of which the grantor of the trust is also a beneficiary, Texas law provides that a beneficiary of the trust may not be considered to be a grantor, to have made a voluntary or involuntary transfer of the beneficiary's interest in the trust, or to have the power to make a voluntary or involuntary transfer of the beneficiary's interest in the trust, merely because the beneficiary, in any capacity, holds or exercises a testamentary power of appointment. *Id.* at (f)(2). This rule is in contrast to the exposure of a *presently exercisable* general power, which is discussed below.[32] In Texas, there are certain circumstances where the initial grantor may end up being a later beneficiary of a spendthrift trust, and the trust will maintain its spendthrift protections as to all beneficiaries, including the now grantor-beneficiary. Namely, if a spouse establishes a trust for his spouse and at the spouse's death, the donor spouse becomes a beneficiary of the trust, or if a grantor establishes a trust for someone else and either the trust property was subject to a general power of appointment held by someone else or if the property later passes back in trust for the benefit of the grantor as the result of someone else's exercise of a limited power of appointment over the trust property, the trust will maintain its spendthrift protections. *Id.* at (d), (g). In states with statutes that have adopted the Restatement (Third) of Trusts, the result would be different. The comments to Section 56 of the Restatement provide that for a decedent who merely has a testamentary general power of appointment, regardless of whether the power is exercised, the trust property is subject to claims of creditors of the decedent's estate if the estate is insufficient to satisfy the claims. In all events, assessing the powerholder's potential exposure to creditors is essential.

C. Using the Delaware Tax Trap Instead of a GPOA to Optimize Basis

A power of appointment that the power holder cannot exercise in favor of him- or herself, his or her creditors, his or her estate, or the creditors of his or her estate, is known as a "special" or "limited" power of appointment. Normally, holding or exercising a limited testamentary power of appointment over property does not cause that property to be included in the power holder's estate for federal estate tax purposes. IRC § 2041(b)(1)(A). However, estate tax inclusion does result if the power is exercised:

> by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power.

IRC § 2041(a)(3).[33]

Exercising a limited power of appointment in this manner triggers the so-called "Delaware Tax Trap" ("DTT"). If the surviving spouse exercises the power in this fashion, the property so appointed is includable in the surviving spouse's estate for federal estate tax purposes, and therefore receives a new cost basis upon the death of the surviving spouse. IRC § 1014(b)(9). As indicated above, an OBIT may be designed to grant a carefully tailored GPOA to the surviving spouse to achieve optimum basis increase. But what if your client does not want to grant his or her spouse a general power of appointment, no matter how narrowly drawn? Or what if you are dealing with an existing funded bypass trust that lacks such a formula power? The Delaware Tax Trap can be used to accomplish the same result with a *limited* power of appointment. The technique involves the affirmative use of what has previously been perceived as a tax "pitfall" in the rules involving the exercise of limited powers of appointment.

1. General Principles. While applying the DTT to specific situations can be somewhat complex, the statutory language noted above is relatively straightforward. The statute causes property to be included in the power holder's estate, even if the power holder has only a limited power of appointment, if it is *actually exercised* by appointing property and granting a new power of appointment in a way that restarts the running of the Rule Against Perpetuities without regard to the date that the original power of appointment was created. Specifically, the DTT is "sprung" when (i) someone exercises a power of appointment (ii) to create a second power of appointment that (iii) under applicable law can be validly exercised to (iv) postpone the vesting of an estate or interest in property (or suspend the absolute ownership or power of alienation of

[32] Whether a power of appointment is testamentary or a lifetime (presently exercisable) GPOA also makes a difference in bankruptcy. *See* 11 USC § 541(a)(1), (b)(1), (c).

[33] *See also* Treas. Reg. § 20.2041-3(e). There is a gift tax analog, IRC § 2514(e), but triggering gift tax typically only increases basis to the extent of gift tax actually paid, so its application is extremely limited.

property) (v) for a period not ascertainable without regard to the date of the exercise of the first power.[34] Since exercising a limited power of appointment (usually thought of as "safe" for estate tax purposes) in a way that restarts the Rule Against Perpetuities might cause inadvertent estate tax inclusion, many states have enacted "savings clauses" into their statutes that restrict the ability of the holder of a limited power to trigger the trap in most instances.[35] In addition, some estate planning attorneys have drafted tightly drawn Rule Against Perpetuities savings clauses in wills or trust agreements that prevent limited powers of appointment from being exercised in a way to trigger the trap. If the drafting language does not prevent triggering the trap, then despite most state law restrictions, there is usually one method left out of state savings statutes that appears to be available in most states.[36] Since a fundamental principle of triggering the DTT is the extension of the Rule Against Perpetuities, in states where there is no Rule, it appears impossible to trigger the trap. *See*, *e.g.* N.J. REV. STAT. § 46:2F-9, SDCL § 43-5-8.

2. Granting a PEG Power. Specifically, if the surviving spouse holds a *limited* power of appointment which permits appointment in further trust, and the surviving spouse appoints trust assets into a separate trust which gives a beneficiary a *presently exercisable general* power of appointment (sometimes referred to as a "PEG power"), the appointment would, under common law, reset the "clock" on the running of the Rule Against Perpetuities. *See* RESTATEMENT (THIRD) OF TRUSTS § 56 cmt. b. This exercise thereby "postpones the vesting" for a period "ascertainable without regard to the date of the creation of [the spouse's limited] power." The effect of postponing vesting is to trigger Code Section 2041(a)(3), causing the appointed property to be included in the surviving spouse's estate for federal estate tax purposes. Estate tax inclusion results in an adjustment to the basis of the property under Code Section 1014(b)(9).

Might an argument be made that in order to trigger estate tax inclusion, the power must be exercised in favor of someone other than the person who would receive the property in default of the exercise? Fortunately, Treasury regulations make it clear that is not the case. Treasury Regulation Section 20.2041-1(d) provides: ". . . a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment."

3. Gaining a Step-Up. Issues associated with springing the DTT could themselves be the subject of an entire seminar, but suffice it to say that under common law, for the surviving spouse to exercise the power of appointment in order to cause estate tax inclusion, he or she must effectively grant someone a presently exercisable general power of appointment. Thus, for example, the surviving spouse could appoint low-basis bypass trust property into trusts for his or her children which then grant the children inter vivos general powers of appointment.[37] The exercise of a limited power of appointment in this manner would permit the children to appoint the property in further trust, restarting the applicable Rule Against Perpetuities. As a result, the exercise of the limited power of appointment would generate a step-up in basis at the surviving spouse's death under Section 1014(b)(9) of the Code. As mentioned above, Code Section 1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. As a result, if an

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[34] *See* Nenno, *Getting a Stepped-Up Income-Tax Basis and More by Springing–or Not Springing–the Delaware Tax Trap the Old-Fashioned Way*, 40 TAX MGMT. ESTS., GIFTS AND TRUST J. 215, 218 (2015).

[35] *See, e.g.,* CONN. GEN. STAT. § 45a-492; N.J. REV. STAT. § 46.2F-10(a)(3); N.Y. EST. POWERS & TRUST LAW § 10-8.1(a); *see also*, *Est. of Murphy v. Comm'r*, 71 TC 671 (1979). For a survey of state law provisions, see Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law*, pp. 8-10 available at: tinyurl.com/zwomagt (although use with caution since the survey has not been updated since 2012). *See also* Blattmachr and Pennell, *Using the Delaware Tax Trap to Avoid Generation Skipping Transfer Taxes*, 68 J. OF TAX'N 242 (1988); Blattmachr and Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the Delaware Tax Trap*, 24 REAL PROP. PROB. & TR. J. 75 (1989). While the cited articles do not discuss using the DTT for basis planning, the discussion is nevertheless helpful. For a more current discussion, see Nenno, fn. 34; Spica, *A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*, 41 RPTL J., 167 (Spring 2006); Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 EST. PLAN. 2 (2001); Culler, *Revising the RAP*, PROB. L.J. OHIO (Mar./Apr. 2012).

[36] Somewhat ironically, Delaware amended its Rule Against Perpetuities statute to preclude use of the Delaware Tax Trap, including for trusts with a zero inclusion ratio for GST tax purposes, which would include most bypass trusts. 25 DEL. CODE §§ 501, 503, 504(a). A recent amendment to Delaware law, however, now once again allows the trap to be used for trusts with a zero inclusion ratio for GST tax purposes, if done so explicitly. *Id*. §§ 504(b), 505.

[37] Treas. Reg. § 20.2041-3(e)(2).

exercise of the power causes depreciable property to pass to a taxpayer that has been entitled to claim depreciation on the appointed property, the basis adjustment may be limited.

4. Drafting to Enable Use of the DTT. The use of the DTT strategy does not require any particularly complex drafting in the bypass trust. It should be sufficient that the trust grants the surviving spouse a limited testamentary power of appointment, and that any Rule Against Perpetuities savings clause in the will does not prevent exercising that power in a manner that restarts the Rule. The surviving spouse will need to draft a will that exercises the power in a very precise manner, either by expressly exercising it over specific assets whose combination of basis increase and value create favorable tax results, or by exercising it in a formula manner to achieve optimal basis adjustment results. The cascading asset-by-asset formula approach described above beginning on page 23 with regard to formula GPOAs could be adapted to cause this result. Sample language providing for a formula exercise of the Delaware Tax Trap is included as Exhibit C.

5. Costs of Using the DTT. Granting a beneficiary a PEG power impairs asset protection much more than does granting a testamentary power. In most states, the creditor of someone holding only a testamentary power of appointment cannot attach trust assets, even upon the death of a beneficiary. In contrast, if the beneficiary holds an inter vivos general power of appointment, exposure of trust assets to a beneficiary's creditors is not generally limited by spendthrift language. *See, e.g.,* UNIF. TRUST CODE § 505(b)(1) (2010); RESTATEMENT (THIRD) OF TRUSTS § 74(2) (equating holder of PEG power with grantor of revocable trust). When a PEG power is granted, a beneficiary's creditors can reach any of the trust's assets at any time. In addition, a PEG power may preclude shifting taxable income to other trust beneficiaries, because the existence of a presently exercisable general power generally causes the trust to be treated as a grantor trust as to the power holder—the trust's income is taxed to the holder of the power if he or she has the power to appoint trust income to him- or herself, exercisable solely by him- or herself. IRC § 678. Moreover, the PEG power prevents the beneficiary from making gift-tax-free distributions of trust property to other trust beneficiaries, and results in state and federal estate taxation inclusion (and a possible step-down in basis) at the time of the power holder's death. IRC §§ 1014(b)(4), 2041. These disadvantages may make using the DTT to harvest a basis adjustment an unattractive tool, especially for clients who wish to use lifetime trusts for their children's inheritance. The "price" of new cost basis when the surviving spouse dies is creditor exposure and estate tax inclusion for the person to whom the PEG power is granted. It may, however, be the only tool available (if a somewhat unpalatable one) in the context of preexisting irrevocable trusts that already contain limited powers of appointment. And if the existing bypass trust terminates in favor of children outright anyway, and no disclaimer funding is anticipated, this route may be the easiest and most flexible to take, since outright ownership by the children has all of the same shortcomings as does granting them a PEG power. Note that if the bypass trust in question arose by virtue of the surviving spouse's disclaimer of assets, the DTT would not be available. As noted above, a "disclaimer bypass" trust generally precludes (or at least markedly limits) the spouse from retaining a limited power of appointment which is necessary to "spring" the DTT.

6. Mitigating the Costs. If the spouse wishes to preserve creditor protections for the children, he or she could presumably appoint the assets into trust for them, but grant some *other party* the PEG power. Note, though, that whomever holds the power would have estate tax inclusion of the assets subject to the power (or would be treated as having made a gift if the power were released), and the assets would be subject to the claims of that person's creditors. So long as the person holding the PEG power has applicable exclusion amount (and GST tax exemption) to spare, however, the property could continue in GST tax-exempt creditor-protected trusts for the children.

Example 13: W died many years ago with a Will that created a bypass trust for H, granting H a testamentary limited power to appoint property outright or in trust for H and W's children. In default of H's exercise of his power of appointment, the property passes into lifetime spendthrift trusts for the children that would be exempt from estate tax upon the children's death, and exempt from the GST tax when property passes to grandchildren. The bypass trust holds low basis stock, the fair market value of which, when added to the value of H's other assets, does not exceed H's applicable exclusion amount. H in his Will appoints the stock into new trusts for the benefit of his children, identical to the trusts created in W's Will, except that H's younger sister S is granted a PEG power over the trusts, and the Rule Against Perpetuities for the new trusts begins to run at the time of H's death. S's estate, including the projected value of the stock, is expected to be well below her applicable exclusion amount. Upon H's death, the stock so appointed is included in H's estate under Code Section 2041(b)(1)(A), and as a result, it receives a new cost basis at the time of H's death under Code Section 1014(b)(9). H's GST exemption may be allocated (or may be deemed allocated) to the trusts. Upon S's later death, the stock is included in her estate under Code Section 2041(a)(2), and receives another basis adjustment under Code Section 1014(b)(4). S's GST exemption may be allocated (or may be deemed allocated) to the trusts. The children's trusts thus inherit the stock with an adjusted basis, but without exposing it to the children's creditors, or to estate or GST tax upon the children's death.

7. State Law "Fixes." If PEG powers are granted to children or other descendants in order to "spring" the DTT, they might cause the next generation to obtain a new cost basis at the expense of forgoing asset protection, income shifting, and GST tax exemption. These difficulties could be avoided if states would amend their Rule Against Perpetuities statutes (or their statutes governing powers of appointment) to permit the exercise of limited powers of appointment to restart the Rule Against Perpetuities by creating further *limited* powers, instead of PEG powers, while expressly declaring an intention to thereby trigger the DTT. For example, Arizona's Rule Against Perpetuities apparently permits such an exercise.[38]

D. Is the DTT Safer than a Formula GPOA?

Some practitioners may prefer using the Delaware Tax Trap for another reason altogether. They may fear that if a formula GPOA is given to a surviving spouse, the spouse's ability to control the value of his or her own net taxable estate value (either through spending, or by leaving assets to charity or new spouse), may permit indirect control of the value of the assets in the bypass trust subject to the formula GPOA. If that argument were to prevail, the IRS might seek to include all of the bypass trust assets in the surviving spouse's estate, and not just the "optimum" amount. Proponents of the formula GPOA approach note that formula funding clauses based on a surviving spouse's available GST tax exemption amount have been used for decades without giving rise to this argument by the IRS.[39] However, there is some plausibility to the argument.

Estate of Kurz. With regard to this issue, *Estate of Kurz v. Commissioner,* 101 TC 44 (1993), *aff'd* 68 F3d 1027 (7th Cir. 1995) is instructive. In *Kurz*, the husband's estate plan provided for a marital trust that gave his wife an unrestricted lifetime GPOA. The bypass trust provided that if the marital trust was exhausted, the wife also had a lifetime 5% withdrawal power over the bypass trust. Upon the wife's death, the IRS argued that not only was the marital trust included in the wife's estate, but that 5% of the bypass trust was also included. The estate argued that the 5% was not in the estate because the marital trust had not been exhausted by the time of the wife's death, so the condition precedent to her 5% withdrawal right had not been met.

The IRS contended that all the wife needed to do to obtain 5% of the bypass trust assets was to withdraw or appoint the assets in the marital trust. Both the Tax Court and the appellate court agreed with the IRS, concluding that the wife held a GPOA over 5% of the bypass trust's assets since she could effectively withdraw the 5% at any time during her lifetime, for any reason, without affecting her estate.

The Tax Court's rationale was that the condition precedent cited by the estate was illusory and lacked any independent non-tax consequence or significance. The appellate court preferred a test that looked through the formalities to determine how much wealth the decedent actually controlled at the time of her death. It looked to examples in the relevant Treasury regulations and noted that the examples of contingencies which precluded inclusion were not easily or quickly controlled by the power holder.

1. Impact of *Kurz.* Interestingly, both sides of the debate on formula GPOA clauses cite *Kurz*. Opponents note that the amount of the formula GPOA in the bypass trust is conditioned upon the size of the surviving spouse's taxable estate, and since the surviving spouse has the ability to control that (through lifetime or testamentary charitable or marital gifts, or through consumption of his or her assets), the amount of the property subject to the formula GPOA is likewise in his or her control. Proponents of formula GPOA clauses (like OBIT advocate Morrow) note that the typical formula GPOA clause is not a *lifetime* GPOA.

More importantly, unlike *Kurz*, it is not subject to a condition precedent, nor does the capping of the GPOA hinge **at all** on Treas. Reg. § 20.2041-3(b) [regarding conditional powers of appointment]—it is pursuant to other treasury regulations cited herein [specifically, Treas. Reg. § 20.2041-1(b)(3): Powers over a portion of property]. Additionally, unlike the ability of a beneficiary to withdraw at will as in *Kurz*, which the appellate court deemed "barely comes within the common understanding of 'event or . . . contingency'", the ability of an OBIT formula GPOA powerholder (if it would otherwise be

[38] ARIZ. REV. STAT. § 14-2905 C. *See* Raatz, *'Delaware Tax Trap' Opens Door to Higher Basis for Trust Assets*, 41 EST. PLAN. 2 (2014). Mr. Raatz, an attorney from Phoenix, Arizona, has argued that the same opportunity may be available in any state that has adopted the Uniform Statutory Rule Against Perpetuities.

[39] *See* Morrow, fn. 26.

capped) to increase their testamentary GPOA would require giving away or spending a significant portion of their assets (quite unlike *Kurz)*—a significant "non-tax consequence" if there ever was one.[40]

Until greater certainty is provided on the issues, whether by the IRS or the courts, some practitioners may prefer avoiding even the hint of a *Kurz*-type argument against formula GPOA caps. The more conservative approach would be to require the GPOA formula to be applied, ignoring any charitable or marital deduction otherwise available to the surviving spouse's estate.[41] In most cases and estate plans, surviving spouses are unlikely to be making large charitable or marital gifts, so formulae that require one to ignore these adjustments is unlikely to make much, if any, difference in the use or availability of the GPOA.

Unlike a formula GPOA, the Delaware Tax Trap is only applicable to the extent that the surviving spouse affirmatively exercises his or her limited power of appointment ("LPOA") to trigger the trap. There is no danger of the mere existence of an LPOA (or a lapse of an LPOA) causing inclusion under Code Section 2041(a)(3) just because the surviving spouse has the authority to exercise it. Therefore, using the Delaware Tax Trap technique is immune from *Kurz*-type arguments. As a result, many attorneys may prefer it.

VI. OTHER STRATEGIES FOR BASIS ADJUSTMENT

A. Transmuting Separate Property into Community Property or Vice Versa

As noted earlier, a basis adjustment at death applies not only to the decedent's interest in community property but also to property which represents the surviving spouse's one-half share of community property. IRC § 1014(b)(6). Therefore, a strategy to obtain an increase in basis may be to transmute (i.e., convert) low-basis separate property into community property. *See* Rev. Rul. 77-359, 1977-2 CB 24 (agreement to convert separate property into community property valid under state law will be given effect for federal income tax purposes). Doing so ensures that no matter the order the spouses' deaths may occur, the surviving spouse will receive a new cost basis in all of the property. On the other hand, a few cautions to this strategy are necessary. If property is transmuted, all or part of the separate property being converted to community property may become subject to the liabilities of both spouses. In addition, all or part of the separate property being converted to community property may become subject to either the joint management, control, and disposition of both spouses or the sole management, control, and disposition of the other spouse alone. Finally, of course, if the marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of the spouse or the spouse's heirs. Don't forget to consider the converse strategy for depreciated community property assets. If it appears that one spouse may have a shortened life expectancy and death may result in a loss of basis, consider partitioning the depreciated property into separate property (or as discussed below, giving the depreciated property to the healthy spouse). Doing so will avoid the loss in basis at the first spouse's death to the extent of the surviving spouse's separate interest in the property.

B. Transferring Low Basis Assets to the Taxpayer

Since assets owned by an individual may receive a new cost basis at death, taxpayers may consider transferring low basis assets to a person with a shortened life expectancy, especially if the person will return the property at death by will or other arrangement. This basis "gaming" may be easier in an environment with substantial estate and gift tax exclusions, since those exclusions may be used to avoid transfer tax on both the gift and the subsequent inheritance. If the person to whom the assets are initially transferred does not have a taxable estate, substantial additional assets may be transferred, and a new basis obtained, without exposure to estate tax. While transfers among family members may involve taxable gifts, transfers between spouses do not give rise to gift tax exposure, regardless of amount, if the donee spouse is a U.S. citizen. IRC § 2056.

1. Gifts Prior to Death. One gifting strategy involves transferring property that has *appreciated* in value to a less healthy (or even terminally ill) family member with the expectation that it will receive a favorable basis adjustment at death. Note that if obtaining a basis increase is the goal, Congress is aware that someone could acquire an artificial step-up in basis by giving property to a terminally ill person, and receiving it back with a new basis upon that person's death. As a result, the Code prohibits a step-up in basis for appreciated property given to a decedent within one year of death, that then passes from the decedent back to the donor (or to the spouse of the donor) as a result of the decedent's death. IRC § 1014(e). If

[40] Morrow, fn. 26, at p. 37.

[41] *See* Nunan, *Basis Harvesting*, PROB & PROP. (Sept./Oct. 2011) (which includes sample language in its appendix with both options).

the property passes back to the donor or the donor's spouse at death, a new basis is achieved only if the taxpayer lives for at least one year after receipt of the property. One might also consider the opposite strategy for gifts of *depreciated* assets by an unhealthy (or terminally ill) family member before death with a goal of avoiding a step-down in basis. By making such a gift of depreciated property, when the donee later sells the property, gain recognition by the donee is minimized to the extent of the donor's basis since the carryover basis rules would apply to the gifted property. There is no one-year rule to contend with when this strategy is employed.

2. Granting a General Power. Rather than giving property to a terminally ill individual, suppose that you simply grant that person a general power of appointment over the property. For example, H could create a revocable trust, funded with low basis assets, and grant W a general power of appointment over the assets in the trust. The general power of appointment will cause the property in the trust to be included in W's estate under Section 2041(a)(2) of the Code. In that event, the property should receive a new cost basis upon W's death. IRC § 1014(b)(9). The IRS takes the position that the principles of Section 1014(e) apply in this circumstance if H reacquires the property, due either to the exercise or non-exercise of the power by W. *See* PLR 200101021 ("Section 1014(e) will apply to any Trust property includible in the deceased Grantor's gross estate that is attributable to the surviving Grantor's contribution to Trust and that is acquired by the surviving Grantor, either directly or indirectly, pursuant to the deceased Grantor's exercise, or failure to exercise, the general power of appointment", citing H.R. Rept. 97 201, 97th Cong., 1st Sess. (July 24, 1981)). If W were to actually exercise the power in favor of (or the taker in default was) another taxpayer, such as a bypass-style trust for H and their descendants, the result should be different.

C. Transferring High Basis Assets to a Grantor Trust

An intentionally defective grantor trust, or "IDGT," is one in which the grantor of the trust is treated as the owner of the trust property for federal income tax purposes, but not for gift or estate tax purposes. If the taxpayer created an IDGT during his or her lifetime, he or she may consider transferring high basis assets to that trust, in exchange for low basis assets of the same value owned by the trust. The grantor trust status should prevent the exchange of these assets during the grantor's lifetime from being treated as a sale or exchange for federal income tax purposes. Rev. Rul. 85-13, 1985-1 CB 184. The effect of the exchange, however, will be to place low basis assets into the grantor's estate, providing an opportunity to receive a step-up in basis of those assets at death. But for the exchange of these assets, the low basis assets formerly held by the trust would not have acquired a step-up in basis as a result of the grantor's death. The IRS has officially confirmed its position that this is the case. Rev. Rul. 2023-2, 2023-16 IRB 1. At the same time, if the grantor transfers assets with a basis in excess of fair market value to the trust, those assets will avoid being subject to a step-down in basis at death. Since the grantor is treated for income tax purposes as the owner of all of the assets prior to death, the one-year look-back of Section 1014(e) of the Code should not apply to limit the step-up in basis of the exchanged assets.

D. Capturing Capital Losses

If a terminally ill individual has incurred capital gains during the year, he or she may consider disposing of high basis assets at a loss during his or her lifetime, in order to recognize capital losses to shelter any gains already incurred during the year. As noted earlier, assets the basis of which exceed their fair market value receive a reduced basis at death, foreclosing recognition of these built-in capital losses after death. Moreover, losses recognized by the estate after death will not be available to shelter capital gains recognized by the individual before death. If, on the other hand, the individual has recognized net capital losses, he or she may sell appreciated assets before death with impunity. Net capital losses are not carried forward to the individual's estate after death, and as a result, they are simply lost. Rev. Rul. 74-175, 1974-1 CB 52.

E. Spousal Trusts Providing Basis Adjustments At Each Death

As noted above, spouses who hold all of their assets as community property get a full basis adjustment on both halves of their community property at the death of the first of them to die, regardless of the order of their death. IRC § 1014(b)(6). If that property passes outright to the surviving spouse, or passes in a way that the surviving spouse is treated as owning the property at death for Section 1014 purposes (perhaps using one of the techniques described above), the assets may receive a second basis adjustment when the surviving spouse dies. Spouses who don't have access to community property regimes may be able to get a similar result using specially designed trusts that both benefit one another and achieve dual estate tax inclusion. Where the likely order of death for married clients is apparent, dual basis adjustments can be achieved by transferring low basis assets to the spouse whose death is most likely, and arranging that spouse's estate plan to return the assets to the surviving spouse. Assuming that the "re-inheritance"-within-one-year rule of Section 1014(e) can be avoided, such a plan would accomplish a basis adjustment at each death. For clients whose mortality is less obvious, a more technical approach is sometimes needed. The technique typically involves transferring low-basis assets to a trust for the spouse, and granting the spouse a power of appointment over those assets. Two variations on this theme are the "Joint Estate Step-Up Trust ("JEST") and the Step-Up Grantor Retained Income Trust ("SUGRIT").[42] We outline the latter technique here.

A SUGRIT is an irrevocable trust into which a married grantor transfers low-basis assets, reserving an income interest in the trust for life. If the grantor is the first spouse to die, the assets held by the SUGRIT will be included in the grantor's estate due to Code Section 2036, and the assets will receive a basis adjustment at that time. IRC §§ 1014(a), (b)(1), (b)(9). The trust instrument provides that upon the death of the grantor's spouse, the SUGRIT's assets will be transferred to the non grantor spouse's estate, causing them to be included in that spouse's estate under Code Section 2033, and the trust's assets will receive a basis adjustment at that time. *Id.* The non grantor spouse's estate plan would presumably leave these assets to the grantor in a manner that causes them to be included in the grantor's estate, so that if the non grantor spouse dies first, the assets will receive a second basis adjustment at the grantor's death. The intended result is to obtain a basis adjustment at the death of the first spouse to die, regardless of the order of their deaths. If the grantor's spouse dies within one year of the creation of the SUGRIT, Section 1014(e)(1)(B) denies a basis adjustment at the non grantor spouse's death (although no one-year rule would apply if the grantor dies first). If both spouses survive for a year after assets are transferred to the SUGRIT, however, the basis in the trust's assets should adjust when the first spouse dies.

When the SUGRIT is created, a taxable gift occurs. The grantor's retained right to income is not a qualified (annuity or unitrust) interest under Code Section 2702(a), so in valuing the gift, the interest retained by the grantor is valued at zero and the full fair market value of the assets transferred to the trust is treated as a taxable gift. IRC § 2702(a)(2). In addition, the interest received by the surviving spouse (the right to have property paid to his or her estate at death) is not an interest that qualifies the entire transfer for the unlimited gift tax marital deduction under Section 2523, although the actuarial value of the remainder interest may qualify. *See* Rev. Rul. 54-470, 1954-2 CB 320. As a result, the grantor will have made a taxable gift when the SUGRIT is funded. However, when the grantor dies, the transferred property will be included in the grantor's estate, meaning that the transfer to the SUGRIT will not be treated as an "adjusted taxable gift" by the grantor under Code Section 2001(b). Therefore, the transfer is not counted twice against the grantor's gift and estate tax exclusion. This same result arguably arises if the grantor's spouse dies first and transfers the assets back to the grantor (Section 2001(b) speaks only of the transferred assets being included in the gross estate of the donor, without specifying the manner by which they are included). In any event, a SUGRIT would typically be used by couples who are unlikely to fully utilize their estate tax exclusions (remember that this is a basis-enhancing tool and not an estate-tax-savings strategy). Variations on this theme include the Step-Up Personal Residence Trust ("SUPRT") and the Tangibles SUGRIT, which each, due to the unique tax treatment granted to the assets transferred, have slightly different income, gift, and estate tax features.[43]

F. Accidentally Perfect Grantor Trusts

When the federal estate tax exemption grew to $3.5 million in 2009 and the gap between the estate tax rate and the highest income tax rate was closing, several things caught our attention and made us question why the pattern was to routinely think of planning down generations instead of up. We had clients who wanted to care for their parents, who were of modest means, while at the same time provide for their children and other descendants. Their parents in turn wanted to provide for their children and other descendants. The parents' estates were well below the estate tax exemption, meaning that even at the death of the second parent, there would be excess exemption that would be "lost." In addition, clients and their advisors were becoming more focused on income taxes and the potential for a basis adjustment at death. So how could a parent's excess exemption be captured to include assets in that parent's estate so that a basis adjustment would occur at the parent's death? An easy and obvious solution would be to simply have the child give the parent assets, but when looking at various estate planning techniques such as IDGTs and sales to IDGTs, we realized there was a way to get a better overall result by standing some traditional estate planning tools on their heads. Looking back to 2009, maybe we could have found a more clever name with a catchier acronym, but regardless, the "Accidentally Perfect Grantor Trust" ("APGT") was

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[42] The JEST is described in Gassman, Denicolo, & Hohndell, *JEST Offers Serious Estate Planning for Spouses – Parts 1 and 2*, 40 EST. PL. 3, 24 (2013). The SUGRIT and its cousins are detailed in Bramwell, Dillon, & Socash, *The New Estate Planning Lexicon: Sugrits and Other Grantor-Retained Interest Step-Up Trusts*, 123 J. TAX'N 196 (Nov. 2015).

[43] *See* Bramwell *et al.*, fn. 42.

presented. Since then, what may be termed upstream estate planning has evolved, with others providing variations on the technique with acronyms such as UPSTAT and POAST.[44]

Although the concept of an APGT is somewhat different than our traditional planning techniques, in the right circumstances, the benefits could be dramatic. Again, the typical candidate is a self-made individual whose parents are people of modest means. Using this technique can actually benefit the donor fairly directly, in a tax-advantaged way.

Overview. An APGT is a trust established by a junior family member, typically for the benefit of his or her children or other descendants. The trust may also provide benefits for the grantor's parents or more senior family members. Junior gives low-basis or highly appreciating assets to the trust. Alternatively, junior structures the trust as an IDGT, contributes appropriate "seed" money, and loans money to the trust for the trust to buy an asset with lots of appreciation potential from junior.[45] Regardless of whether the trust is funded primarily by a gift or a sale of assets, this trust has a twist. From day one, the trust has language built into it that causes the trust assets to be *included in the estate of a senior generation family member for federal estate tax purposes*. As a result, upon the death of the senior family member, the trust assets will receive a new cost basis. A similar result could be achieved by having the junior family member simply give property to the senior family member with the hope that the senior family member bequeaths the property back to junior in trust. The APGT, however, may allow junior to (i) protect assets from the creditors of the senior family member; (ii) use less of junior's gift tax exclusion (by selling assets to the IDGT for a note); and (iii) allow junior to prescribe the terms of the trust into which the assets pass upon the death of the senior family member. In addition, depending upon the structure, the resulting trust may be a grantor trust as to junior even after the senior generation family member is gone, providing a vehicle for future tax planning.

Example 14: Jenny owns the stock in a closely held business that she thinks is about to explode in value. She would like to transfer future appreciation to her children, but does not want to give up all of the value, and doesn't like the fact that the stock will have such a low cost basis. Jenny's mom Mary has a net worth of perhaps $500,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. Jenny then sets up an IDGT, or APGT, for the benefit of her children (and perhaps Mary), and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary and the children to make sure that the sale is respected for income and gift tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (The IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment, although this dynasty trust may be only for Jenny's descendants.) When Mary dies four years later, the stock has appreciated to $5 million in value. Because the APGT assets are included in Mary's estate, the stock gets a new cost basis of $5 million. The value of the trust assets, when added to the value of Mary's other assets, is well below Mary's applicable estate tax exclusion amount. Mary's executor uses some of Mary's GST tax exemption to shelter the APGT trust assets from estate tax when Jenny dies. Despite the fact that Jenny, or perhaps only Jenny's descendants, will now have the lifetime use of the new trust's property: (i) it can't be attached by the beneficiaries' creditors; (ii) it can pass to children of the beneficiaries, or whomever they wish to leave it to, without estate tax; (iii) principal from the trust can be sprinkled, at the trustee's discretion, among the beneficiaries and the beneficiaries' descendants without gift tax; and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at the trustee's discretion, among the beneficiaries and their descendants, thereby providing the ability to shift the trust's income to taxpayers in lower income tax brackets.

Specifics.

1. Structure of a APGT. Although the term "accidentally perfect" distinguishes this trust from an "intentionally defective" trust, there is nothing accidental about it. The key to the success of an APGT is the creation by a junior family

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[44] For more recent descriptions and discussions of the UPSTAT, or upstream sale to a power of appointment trust, see Berry, Blattmachr, and Harrington, *Powers of Appointment in the Current Planning Environment*, 53 U. Miami Heckerling Inst. On Est. Pl. ch. 11 (2019), and of the POAST, or power of appointment support trust, see Law and Zaritsky, *Basis After the 2017 Tax Act – Important Before, Crucial Now*, 53 U. Miami Heckerling Inst. On Est. Pl. ch. 1 (2019).

[45] In addition to the discussion above regarding the use of intentionally defective grantor trusts, see Hodgman, *IDGTs on Steroids: Current Conditions Strengthen Benefits*, 38 EST. PLAN. 7, 3 (2011), and Akers, *Transfer Planning, Including Strategies to Maximize Benefits of GRATs and Sales to Grantor Trusts Given Recent Market Declines*, Dallas Estate Planning Council, May 2009.

member of an irrevocable trust that (i) successfully avoids estate tax inclusion for the junior family member under Code Sections 2036 through 2038; but (ii) will intentionally cause estate tax inclusion for a senior family member who has estate tax exclusion (and GST tax exemption) to spare. The APGT would typically be structured as an IDGT as to the junior family member, and if a sale is involved, it would buy rapidly appreciating assets from the junior family member. It would maintain grantor trust status as to the junior family member at least until the purchase price is paid. The difference is that the agreement establishing the APGT also grants a senior family member a general power of appointment over the trust, thereby ensuring inclusion of the trust assets in his or her taxable estate (and thereby ensuring a new cost basis at the time of the senior family member's death). Because the senior family member is given a general power of appointment, it is essential to evaluate the creditor exposure of the senior family member and whether he or she may be a candidate for governmental benefits – both of which could be impacted. The amount of the APGT's property subject to the general power could be limited by a formula to ensure that (i) only appreciated non-IRD assets could be appointed; and (ii) inclusion of those assets in the senior family member's taxable estate doesn't cause estate tax to be payable when that person dies. When the junior family member sells appreciating assets to the APGT, the trust's IDGT provisions ensure that the sale is ignored for federal income tax purposes. *See* Rev. Rul. 85-13, 1985-1 CB 184. Nevertheless, the assets are subject to estate tax (with the attendant income and GST tax benefits) upon the death of the senior family member.

For the basis adjustment to be recognized, the general power of appointment has to exist. Clients sometimes want tax provisions in their trusts to be like an often-expressed wish for children (to be seen but not heard). For example, clients often insert typical *Crummey* withdrawal rights in trusts with the hope that although granted, they will not be exercised. We don't want the IRS to argue that the senior family member's general power is illusory. *Cf. Cristofani v. Comm'r*, 97 TC 74 (1991) (IRS argued that *Crummey* withdrawal rights granted to persons with no other interest in the trust were illusory). This issue suggests that the powerholder should perhaps be a permitted distributee of trust income and/or principal during his or her lifetime, a feature that many grantors will desire in any event. Remember, though, that it is the *existence* of the general power that gives rise to the basis adjustment – not its exercise. The IRS has historically had every incentive to recognize and give effect to general powers since they have traditionally produced more revenue from estate tax than they lost due to basis adjustments. Courts have agreed, finding general powers to exist even where the holders of the powers didn't know they existed, or couldn't actually exercise them due to incapacity. *See, e.g., Fish v. U.S.*, 432 F2d 1278 (9th Cir 1970); *Est. of Alperstein v. Comm'r*, 613 F2d 1213 (2nd Cir 1979); *Williams v. U.S.*, 634 F2d 894 (5th Cir. 1981). In the APGT context however, one should expect that the general power will be known about, and in some cases even exercised.

2. Basis Issues. If the senior family member exercises the general power of appointment, the assets of the APGT receive a new cost basis pursuant to Code Section 1014(b)(4). But even if the power of appointment is not exercised, the assets of the APGT are included in determining the value of the estate of the senior family member under Code Section 2041(a)(2). As a result, those assets receive a new cost basis in the hands of the taxpayer to whom they pass. IRC § 1014(b)(9). If the junior family member gives assets to a senior family member, and those same assets pass by inheritance to the donor (or the donor's spouse) within one year, there is no step-up in the basis of the assets. IRC § 1014(e). With an APGT, however, upon the death of the senior family member, the assets do not pass back to the donor/junior family member, but to a different taxpayer–a dynasty trust of which the donor/junior family member may be a beneficiary. Although the IRS has privately ruled otherwise, (*see, e.g.*, PLR 200101021), the fact that the recipient of the property is a trust, and not the donor, should permit a basis adjustment, even if the senior family member dies within a year of the assets being transferred to the APGT. Of course, if the senior family member survives for more than a year, the limitations under Section 1014(e) won't apply. Suppose that the junior family member sold assets to the trust for a note. If the asset is worth $1 million, but is subject to a debt of $900,000, then presumably only $100,000 is includable in the senior family member's estate. Nevertheless, the basis of the asset should be adjusted to its $1 million value, and not just $100,000. *See Crane v. Comm'r*, 331 US 1 (1947).

There are two areas that may raise issues regarding a full basis adjustment at death, one in the case of a sale of assets to the APGT and one in the case of property being depreciated where the senior member does not exercise the power of appointment. Despite the clear holding in *Crane*, the first issue is found in Treasury Regulation Section 20.2053-7. The regulation provides that a decedent's estate will include the full value of property for which the estate is liable for any indebtedness on the property, whereas only the net value of the property *need be returned* if the estate is not liable. Although the regulation appears to address a reporting position only and does not provide that the full value of the property may not be reported, it may be prudent to have the senior family member personally guarantee the payment of the debt to ensure that all of the property and not just the net value will be reportable as part of his or her estate. Regarding the second issue, note that if the power of appointment is not exercised by the senior family member, the basis adjustment arises under Code

Section 1014(b)(9) instead of Code Section 1014(b)(4). Unlike the other provisions of Code Section 1014, as mentioned above, Section 1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. Because the APGT is a grantor trust, the junior family member is presumably "the taxpayer" for this purpose. The Section 1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the junior family member prior to the death of the senior family member. As a result, if the APGT remains a grantor trust as to the junior family member after the senior family member's death, then the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the junior family member prior to the senior family member's death. *See* Treas. Reg. § 1.1014-6.

3. Impact of Interest Rates. As with IDGTs, when interest rates are low, sales to APGTs become very attractive, since any income or growth in the asset "sold" is more likely to outperform the relatively low hurdle rate set by the IRS for the note. Remember, in a sale context, it is the growth in excess of the purchase price (plus the "applicable federal rate" of interest under Code Section 7872 on any part of the deferred purchase price) that is kept out of the estate of the junior family member, and instead ultimately lands in a dynasty trust for the junior family member.

4. Benefit to Heirs. The property in the APGT passes to a new dynasty trust for the ultimate beneficiaries (typically one or more generations of junior family members). With a sale to an APGT, if the purchased assets grow faster than the interest rate on the note, the excess growth is held in the APGT, ultimately becoming available to the beneficiaries of the APGT. The goal of an APGT is the same regardless: The assets ultimately pass for the benefit of the grantor and/or his or her descendants in a creditor-proof, estate-tax exempt, and GST-tax exempt trust, with a new cost basis equal to the fair market value of the trust assets at the time of the senior family member's death, all without estate tax, and possibly without gift tax.

5. Income Tax Issues. During the lifetime of the senior family member, the trust typically remains a grantor trust as to the junior family member. If, however, the senior family member has a general power of appointment exercisable during lifetime (i.e., an inter vivos general power), and that power is exercisable solely by the senior family member, the trust would be treated as a grantor trust as to the senior family member. IRC §§ 678(a), (b). What is the income tax status of the dynasty trust that is formed after the death of the senior family member? If the junior family member is a beneficiary, and the successor dynasty trust arises as a result of the failure of the senior-generation family member to exercise the power of appointment, one can make a compelling argument that the trust can be characterized as a grantor trust as to the junior family member, since he or she is the only transferor of property to the trust. Treas. Reg. § 1.671-2(e)(5). On the other hand, if the successor trust arises as a result of the senior family member actually exercising the power of appointment, then the senior family member will be treated as the grantor of the successor dynasty trust for federal income tax purposes, even if the junior family member was treated as the owner of the original trust. *Id*. The regulations thus appear to provide a choice, to be made by the selection of language in the senior generation family member's will, to decide whether the successor trust will be a "defective" trust as to the junior family member after the death of the senior family member. If grantor trust treatment is maintained, the resulting trust would have the features of a so-called "beneficiary defective grantor trust" but without the attendant requirement that the trust always remain a grantor trust after the death of the senior family member.[46]

6. Estate Tax Issues. As noted above, estate tax inclusion in the estate of the senior family member (with its resulting basis adjustment) is one of the goals of the APGT. But can the IRS argue that the dynasty trust that arises for the benefit of the junior family member after the death of senior is includable in junior's estate? As noted above, junior may be treated as the grantor of the resulting trust for income tax purposes. For estate tax purposes, however, because the senior family member has a power of appointment should cause the senior family member to be a new transferor. So long as the resulting trust is drafted as a typical descendant's or dynasty trust which limit junior's rights with respect to the trust (e.g., limiting junior's right to make distributions to him- or herself by an ascertainable standard, and allowing only limited powers of appointment), there should be no inclusion of the trust's assets in junior's estate at the time of his or her later death. *See, Est. of Ford v. Comm'r*, 53 TC 114 (1969); PLR 200210051; *see also* PLRs 200403094, 200604028.

In a somewhat analogous setting, the IRS argued that an asset (a life insurance policy) transferred from husband to his wife, and passed at her death into a trust of which he was the trustee, should be included in husband's estate upon his

[46] *See, e.g.*, Hesch et al., *A Gift from Above: Estate Planning on a Higher Plane*, 150 TR. & EST., Nov. 2011, at 17; Oshins and Ice, *The Inheritor's Trust™; The Art of Properly Inheriting Property*, 30 EST. PLAN. 9, 419 (2003).

later death. Both the Tax Court and the Second Circuit analyzed the case under Code Sections 2036 and 2038. The Second Circuit held that Section 2036 was clearly not triggered because it applies only to a power retained by the grantor over the income from property transferred to another. In analyzing Section 2038, the court noted that cases cited by the IRS were all cases in which the decedent retained the power, and distinguished those cases from the situation where the decedent acquires the power long after he had divested himself from all interests in the transferred property, noting that the "difference between powers retained by a decedent and powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance." *Skifter v. Comm'r*, 468 F2d 699, 703-04 (2d Cir. 1972). The court found when the power comes about later or through the action of another, it is difficult to construe this later-acquired power as a testamentary substitute to which Section 2038 was aimed, and held for the taxpayer that the property was not included in the decedent's estate. After *Skifter*, the IRS issued Revenue Ruling 84-179, 1984-4 CB 195 in which the IRS essentially conceding the court's holding if the original donor was not involved in the reacquisition of the property. Specifically, the Revenue Ruling conditioned exclusion on a finding that the devolution of powers over the property to the donor is not part of a prearranged plan involving participation of the donor. This suggests that the senior family member should have independent advice about whether to exercise the general power.

In some states, since the APGT was originally created by junior, a court might be empowered to award trust assets to junior's creditors if junior becomes a beneficiary of the trust. In that event, the IRS might assert that Section 2041(a)(2) of the Code (transfer with a retained right to appoint property to one's creditors) applies to subject the resulting trust to estate tax in junior's estate. States with domestic asset protection trust statutes may avoid this concern. In addition, other states may have features in their spendthrift statutes or otherwise to provide protection in this circumstance. *See, e.g.,* TEX. PROP. CODE § 112.035(g)(3)(B) (beneficiary's possession of general power of appointment precludes trust contributions from being treated as being made by grantor for purposes of applying Texas spendthrift protection).

7. GST Tax Issues. The donor can allocate GST tax exemption to any gift to the APGT, but if the entire trust is expected to be included in the taxable estate of the senior family member, the donor would probably not do so. To maximize the benefits, the executor of the estate of the senior family member can allocate GST tax exemption to property subject to the general power of appointment. *See* IRC § 2652(a)(1)(A); Treas. Reg. § 26.2652-1. As a result of allocation, the dynasty trust that receives the APGT assets will have a GST tax inclusion ratio of zero, which means that all of those assets (both any seed money and the growth) can pass into trust for the APGT grantor, and ultimately on to grandchildren or more remote generations, with no additional estate or gift tax. This multi-generational feature makes a sale to an APGT a very powerful transfer tax tool.

8. Selling Discounted Assets. As with sales to more traditional intentionally defective grantor trusts, rapidly appreciating or leveraged assets are ideal candidates for sale. The use of lack-of-marketability and minority-interest discounts can increase the benefits of the technique.

9. Combining with Other Techniques. The APGT is outlined here as a tool for use with a sale to an IDGT, but its application need not be limited to this structure. The senior family member's otherwise-wasted estate tax exclusion and GST tax exemption might be put to good use in other contexts, limited only by the imagination of the estate planner (combined with a healthy dose of caution). For example, grantor retained annuity trusts and charitable remainder unitrusts are valuable estate planning tools, especially when interest rates are low, but neither of them are efficient vehicles for allocating the grantor's GST tax exemption. Consider whether, on the termination of these trusts, the assets might pour into a trust over which a senior family member holds a formula general power of appointment. Upon the powerholder's death, otherwise wasted GST tax exemption might be applied to exempt the trusts' assets from GST tax while generating a favorable basis adjustment. The same approach might be used for gift trusts in general, especially for example, a trust of which a spouse is a beneficiary (and hence the ETIP rules of Code Section 2642(f) prevent allocation of the grantor's GST tax exemption). Even older trusts might benefit. Consider, for example, a trust that is intended to be a grantor trust under Code Section 674 because someone has been granted the power to add beneficiaries to the trust. Perhaps this power might be exercised to add a senior family member as a beneficiary and grant that individual a formula general power of appointment. Even absent such authority, perhaps the addition could be effected under state decanting laws. In either event, a basis adjustment could result.[47]

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[47] Many of these techniques are discussed in Davis & Willms, *Estate Planning for Married Couples in a World with Portability and the Marital Deduction*, AM. LAW INST. PL. TECHS. FOR LARGE ESTS. (2019).

VII. BASIS ISSUES WITH FLOW-THROUGH ENTITIES

A. Partnerships

1. **Entity Not Taxed.** Partnerships are subject to a unique set of rules under the Code. On the one hand, the law sometimes views a partnership as a legal entity. In other contexts, a partnership is viewed as an aggregate of individual partners. Congress chose the latter approach in taxing income derived through a partnership. In other words, unlike an individual, trust, or corporation, a partnership itself is not subject to income tax. Instead, the partnership serves only as a reporting vehicle for the partners. The partners themselves must pay tax on the income generated by partnership operations. This pass-through theory of taxation is sometimes difficult to apply. Most taxpayers operate on a cash basis, and pay tax based upon their own realization events (and cash flow). Unlike the conduit theory of trust and estate income taxation, the flow-through of partnership-level items is not based upon distributions from the partnership. The partnership itself never pays tax. It simply records realization events at the partnership level and reports them to the partners (and the IRS); all tax attributes are reported by the partners themselves on their own income tax returns, irrespective of partnership distributions.

2. **Taxation of Partners.** The partners in a partnership are the taxpayers with respect to partnership income, losses, deductions, and credits. These items, as they arise at the partnership level, are treated as having occurred at the partner level, and are allocated among the partners in accordance with the terms of the partnership agreement. Partners are taxed on partnership activities regardless of whether the partnership makes distributions to the partners, which can result in what is known as "phantom income." In that regard, a partner in a partnership is not taxed based upon the cash flow rules which most individual taxpayers are otherwise accustomed. Partners need not apportion individual items of income, loss, deduction, or credit among them equally or in the ratio of their contributions. They may agree to any form of allocation. In order to ensure that the allocation of these items is not manipulated by the partners to artificially minimize taxation, the allocations are given effect only if they have a substantial basis in economic reality as among the partners themselves. IRC § 704.

3. **Basis Issues.** As with other taxpayers, basis plays a key role in measuring partnership gains and losses. Partnerships present an unusual layering of these rules, however, since a partner may be treated as having sold his or her interest in the partnership's assets if the partnership sells assets, but a partner can also sell his or her partnership interest itself. Thus, separate measures must be made of the partnership's basis in its assets, and the partners' respective bases in their partnership interests.

a. **Inside Basis.** The partnership's basis in the assets held by the partnership (referred to as "inside basis") is figured much like a corporation's basis in its assets. Thus, for example, assets contributed by the partners to the partnership generally have a carryover of the contributing partner's basis (increased by any gain recognized on the transfer), and the holding period of the contributing partner in the assets carries over to the partnership as well. IRC §§ 723, 1223(1). Assets acquired by the partnership have a basis equal to cost. Depreciation may be taken at the partnership level (and passed through to the partners), thereby decreasing the partnership's basis in the depreciated assets.

b. **Outside Basis.** For most tax purposes, the partners are not treated as the owners of partnership assets; they instead own partnership interests (or LLC membership interests). Each partner separately maintains a basis in that interest (referred to as "outside basis"). Partners who enter the partnership by contributing assets generally begin with a basis in their partnership interest equal to the basis of the assets contributed, and their holding period in the contributed assets becomes their holding period in the partnership interest. IRC §§ 722, 1223(1). Partners who acquire their interest by purchase from another partner begin with a basis equal to the purchase price. IRC § 1012(a). Partners who acquire their interest by gift receive a carryover of the donor's basis in the interest, while partners who acquire their interest by inheritance receive a new basis in the partnership interest equal to the fair market value of that interest at the time of the deceased partner's death. IRC §§ 1014(a), 1015(a). Regardless of how basis is initially set, each partner's basis in their partnership interest constantly goes up and down like an old-fashioned thermometer. It goes up by his or her share of partnership income and the basis of assets later contributed to the partnership, and goes down by his or her share of partnership losses and the basis of property distributed to him or her by the partnership. IRC §§ 705(a), 723, 733. If a partnership makes distributions of money (which includes cash and marketable securities) to its partners in excess of their unrecovered basis in the partnership, those distributions are generally taxed to the partners. IRC § 731(a)(1). If the partnership makes a distribution of property other than money, no gain recognition occurs and the partner's basis in the distributed property is the lesser of the partnership's basis in the property or the partner's outside basis. IRC §§ 731(a)(1), (b), 732(a).

4. Basis and the Section 754 Election

a. Rationale for the Election. Upon the death of a partner, the partner's partnership interest is revalued based on its value on the partner's date of death or the alternate valuation date, if applicable. IRC § 1014(a). However, this basis adjustment affects only the partner's outside basis in the partnership interest. It has no direct effect on the partnership's inside basis in its assets. IRC § 734. If the partnership sells an appreciated asset after the death of the deceased partner, the successor partner generally must report his or her share of any gain recognized at the partnership level as if no basis adjustment of the asset sold had occurred. IRC § 743. To alleviate this result, the Code offers a unique tax advantage to a successor of a decedent's partnership interest. Namely, upon a partner's death (or upon the sale or exchange of a partnership interest) the partnership's basis in property owned by the partnership is adjusted under Code Section 743 if the partnership makes (or has in effect) an election under Code Section 754. If the partnership makes an election under Code Section 754, the successor partner (but not the other partners) can change his or her share of the inside basis of partnership assets by the difference between the adjusted outside basis and the decedent's old share of the inside basis of the partnership assets. If the partner's outside basis in his or her partnership interest increases, this adjustment in inside basis allows the inheriting partner to recognize less gain (or more loss) when assets are later sold by the partnership. If there is depreciable property, the inheriting partner can claim higher depreciation deductions than the other partners based on the higher inside depreciable basis. Conventional wisdom thus usually suggests making the Section 754 election on the death of a partner. However, a Section 754 can be a two-edged sword. It has several disadvantages. As one might imagine, a Section 754 election can dramatically increase the partnership's record keeping requirements, especially if several partners die (or sell their interests). Second, the election may cause a *step-down* as well as a step-up in basis if the fair market value of the deceased partner's interest is less than the partnership's inside basis of its assets. Unfortunately, once the partnership makes a Section 754 election, it cannot be changed without the consent of the IRS. It forevermore affects all the other partners in the partnership when any other partner dies, or a distribution of property to any partner is made in later years. Finally, changes made by The Taxpayer Relief Act of 1997 to the basis allocation rules on liquidation of a partner's interest in a partnership and changes to Treasury regulations under Sections 754, 755, 743, 734, and 732 have caused advisors to reconsider the benefits of a Section 754 election. In some cases, a liquidation might offer preferential tax treatment over a Section 754 election. For a detailed discussion of these issues, see Cantrell, *Practical Income Tax Guidance on Forming, Operating, and Liquidating Your Family Limited Partnership*, State Bar of Texas 22nd Annual Advanced Estate Planning and Probate Course (1998).

b. Manner and Timing of Election. A Section 754 election is made by the partnership by attaching a written statement, signed by any one of the partners, to the partnership's timely filed (including extensions) tax return for the year in which the death of the partner occurred. Once made, the election is effective until revoked with the approval of the IRS. Treas. Reg. §§ 1.754-1(b), (c). If the partnership determines that a Section 754 election is desirable after the due date has passed, an automatic extension of twelve months from the original due date may be granted provided that the partnership files an original or amended partnership tax return attaching the required election statement with "FILED PURSUANT TO TREAS. REG. 301.9100-2T" printed at the top of IRS Form 1065 or the attached election statement. No user fees apply. If a partnership has other partnership interests as part of its portfolio, each partnership must make a separate election. Rev. Rul. 87-115, 1987-2 CB 163.

c. Application to Both Halves of the Community. Section 743(b) of the Code permits an adjustment to the basis of partnership property "in the case of a transfer of an interest in a partnership . . . upon the death of a partner." However, in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington), the surviving spouse's interest in the partnership is not "transferred" upon the death of the decedent. Nevertheless, the IRS has ruled that the Section 754 optional basis adjustment applies to the entire partnership interest owned as community property, including the surviving spouse's share. The ruling also states that the same result would apply if the non-partner spouse predeceased the partner spouse. Rev. Rul. 79-124, 1979-1 CB 224.

d. Tax Effects of Election. A basis adjustment in the partner's outside basis of the partnership interest may occur when a partner dies, regardless of whether a Section 754 election is made. A step-up in basis eventually provides tax savings for the successor-in-interest when the partnership interest is sold or liquidated. The effect of the Section 754 election is to accelerate the benefit of any step-up in basis by immediately passing it through to the inside basis of the individual assets as to the decedent partner's interest only. Thus, when a Section 754 election is made, if a partnership interest is transferred (including transfers arising at death), and if the basis of the transferee partner's partnership interest (the outside basis) is greater than the former partner's share of the partnership's "inside" basis in the partnership's assets, then the election will give the new partner a stepped-up basis in the partnership assets. As a result, if the partnership thereafter depreciates an asset, the transferee partner's share of depreciation will be higher. Similarly, if the partnership later sells an asset, the transferee's share of gain on the sale of the asset will be lower. The successor partner will then benefit immediately, due to the higher basis in the decedent's share of assets inside the partnership, and as noted above, most commentators agree that it is advantageous to estate beneficiaries to have the partnership make a Section 754 election as of the year of death if the fair market value (and hence basis) of the decedent's interest in the partnership exceeds the decedent's share in the basis of the partnership's assets. The method by which the partner's increased (or decreased) basis is allocated among specific partnership assets is complex, involving first a separation of the partnership's ordinary income assets from its capital assets, followed by an allocation among specific assets within each class. This system yields rough justice, but does not truly put the transferee in the position of a purchaser of an undivided interest in partnership assets if some of the partnership's assets have appreciated and others have depreciated. The basis adjustment is not necessarily tied to the change in basis between the old and new partner; rather, it is a function of the relationship between the outside basis in the partnership interest and the partnership's inside basis in its assets which are allocable to that partner. If a partnership does not make a Section 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which might also be an event triggering a basis adjustment.[48]

5. Limited Partnership Planning Opportunities

a. Eliminating Partnership Discounts. One hoped-for feature of many partnerships established among family members has been the reduction in value of interests held by senior family members. Value reductions arise from discounts associated with lack of control and lack of marketability associated with typical limited partnership interests. These discounts have enabled taxpayers to transfer interests by gift or at death at a fair market value less than the liquidation value of the partnership interests transferred. By holding these partnership interests at death, the goal is to reduce estate taxes payable, albeit at the cost of a lower outside basis in the partnership interest. For clients with taxable estates, any discounts available to save estate taxes may be welcome. With many clients now no longer subject to estate tax, however, the costs associated with basis reduction may no longer be offset by estate tax savings. For these clients who nevertheless wish to maintain their partnerships in place for the many non-tax advantages they offer, consideration should be given to whether the partnership agreement can be modified to eliminate the discounts associated with the limited partnership structure. One approach might be to provide in the partnership agreement that senior family members (or the personal representative of their estates) have the right to sell their limited partnership interests to the partnership at any time at their full liquidation value. This "put" right should have the effect of eliminating usual discounts if a willing buyer could succeed to those rights.

b. Other Partnership Issues. There are a number of basis management tools for practitioners who are willing to master the complex tax rules relating to basis for partners and partnerships. As noted above, the difference between a partner's outside basis in a partnership interest and the partnership's inside basis in its assets can give rise to opportunities to obtain favorable basis adjustments upon the death of a partner. Other basis planning opportunities can be used by taking advantage of the rule that, in most cases, allows partnerships to distribute non-cash assets to partners without either the partnership or the partner recognizing any gain. Generally, a partner that receives a distribution in kind from a partnership receives a carryover basis in any distributed asset, and reduces his or her outside basis in the partnership by the basis of the asset received. If the partnership's inside basis in the distributed asset exceeds the partner's outside basis in his or her partnership interest, however, the basis in the partner's outside basis in the partnership interest becomes the partner's basis in the property received, and the partner's basis in his or her partnership interest goes to zero. *See* IRC §§ 732(a)(1), 733. Thus, for example, if a partner with a $50,000 outside basis receives a partnership asset worth $100,000, but with an inside basis of only $10,000, the distributee partner recognizes no gain, but instead takes a $10,000 basis in the distributed property and reduces his or her outside basis in the partnership interest by a corresponding amount. If instead the partnership's basis in the distributed asset was $60,000, then the partner's basis in the asset would be $50,000 and the outside basis in his or her partnership interest would be reduced to zero. In either event, if the distributed asset and/or the partnership interest are held at the time of the partner's death, they would receive a new cost basis equal to their fair market value at that time, and

[48] *See* Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications* (available by emailing the author at sgorin@thompsoncoburn.com to request a copy or request to subscribe to his newsletter *Gorin's Business Succession Solutions*).

if the partner's estate or heirs ultimately sell the asset, the substantial built-in gain would not be recognized. These rules can be complex, especially if the partnership property is encumbered by debt. *See* IRC § 752. In addition, special rules may apply if the partnership holds so-called "hot assets" (generally, ordinary income assets such as unrealized receivables or substantially appreciated inventory), which might cause the partner to recognize income upon distribution of assets, even if the only assets distributed are capital assets. *See* IRC § 751.[49]

B. S Corporations

Most corporations are taxed upon the income earned by the corporation. If income is later distributed to the corporation's shareholders, that income is again taxed at the shareholder level as a dividend. This regime of double taxation can make operation as a corporation unattractive for many businesses. At the same time, however, the limited liability afforded to corporate operations under state law makes operating as a corporation extremely attractive for businesses. To address this dilemma, Congress permits certain qualified corporations and their shareholders to opt out of the usual tax system for corporations (described in Subchapter C of the Internal Revenue Code) and instead elect to be taxed much as a partnership (under Subchapter S of the Code).

1. **Qualification.** Only eligible small business corporations may elect to avoid the double tax regime applied to most corporate taxpayers. IRC § 1362. An eligible small business is one which does not have more than 100 shareholders (with aggregation rules expanding this number for certain related shareholders), all of whom are individuals (or estates or certain eligible trusts), and none of whom are nonresident aliens.[50] IRC § 1361(b). In addition, the corporation must not have more than one class of stock (except that voting and non-voting common stock is permitted). *Id*. If the corporation meets these threshold requirements, and if the corporation and each shareholder makes an election to be taxed as an "S Corporation," then the corporation itself is generally not taxed.

2. **Entity Not Taxed.** An S corporation is not itself subject to tax (except in rare instances which are beyond the scope of this overview). IRC § 1363. Instead, the entity is treated for most purposes like a partnership. The shareholders are subjected to tax on the S corporation's items of income, losses, deductions, and credits (regardless of whether the corporation pays any dividends to its shareholders), much like the partners of a partnership. IRC § 1366. Since S corporations must have only one class of stock, these items cannot be specially allocated among the shareholders. Instead, they are generally passed out to the shareholders pro rata, based upon their respective shareholdings.

3. **Basis Issues**. S corporation basis issues are similar to those arising with partnerships. The corporation must keep track of its basis in the assets owned by the corporation. At the same time, the shareholders themselves must keep track of their outside basis in their stock, which is adjusted to reflect income and losses of the corporation, as well as contributions by and distributions to shareholders. IRC § 1367.

4. **Ownership by Trusts and Estates**. In adopting the S corporation rules, Congress sought to limit their application to those entities whose owners are identifiable U.S. identifiable individuals. Since an individual is mortal, the rule was extended to permit estates of decedents to remain as shareholders of S corporations during a reasonable period of administration. Congress apparently viewed trusts with somewhat more suspicion, as potential vehicles to shift income away from individuals, or at least to complicate identification of the appropriate taxpayers. As a result, only a limited class of trusts are permitted to be S corporation shareholders. Ownership of S corporation stock by prohibited trusts terminates the S corporation election. Code Section 1361(c)(2)(A) limits trust ownership of S corporation stock to:

- Trusts that qualify as grantor trusts (the grantor is treated as the taxpayer);
- Trusts receiving stock pursuant to the terms of a Will, for a period of two years, beginning on the date that the stock is transferred to the trust, not the date of death (the trust is treated as the taxpayer);

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[49] For a more thorough discussion, see Yuhas and Radom, *The New Estate Planning Frontier: Increasing Basis*, 122 J. of Tax'n 4, 13-23 (2015) and Lee, *Putting it On & Taking it Off: Tax Basis Management Today (for Tomorrow)*, The University of Texas School of Law 66th Annual Tax Conference (2018).

[50] TCJA 2017 revised the rules regarding nonresident aliens and ESBTs, discussed below. As of January 1, 2018, if a nonresident alien is a potential current beneficiary of an ESBT, the S election is not automatically terminated. IRC § 1361(c)(2)(B)(v).

- A Qualified Subchapter S Trust ("QSST"), which is a trust with a single income beneficiary who is entitled to receive all income annually, and that requires any principal distributions during the beneficiary's lifetime be made only to that beneficiary (the beneficiary makes the QSST election and is treated as the taxpayer); and
- An Electing Small Business Trust ("ESBT"), which is a trust that has only eligible individuals, estates, or certain charities as beneficiaries, and for which the trustee makes an election to have the S stock treated as a separate trust, (the trust is treated as held by a separate trust, (the trust is treated as the taxpayer, taxed at the highest marginal federal income tax rate, regardless of whether its income is distributed).

IRC §§ 1361(c)(2)(A), (d), (e).

5. **Eligibility Issues**. A decedent's estate qualifies as an S corporation shareholder for the entire period of administration. IRC § 1361(b)(1)(B). For purposes of ensuring that the corporation has no more than 100 shareholders, the estate counts as only one shareholder. Treas. Reg. § 1.1361-1(e)(1). In addition, the fact that an estate has one or more beneficiaries who are not eligible to be S corporation shareholders does not disqualify the S election so long as the estate retains the stock and does not distribute it to the ineligible shareholder. These rules give an executor time to analyze the consequences of a distribution of stock, and to take necessary actions to ensure that the beneficiaries who receive the stock are eligible shareholders. These actions might include reforming a recipient trust to ensure that it is eligible to hold S corporation stock. Note, however, that the administration of an estate for tax purposes cannot be prolonged beyond the period necessary for its administration under state law. Treas. Reg. § 1.641(b)-3(a). If an estate is unduly prolonged, the IRS might assert that the estate has in effect become a trust, and therefore is no longer an eligible shareholder. *See Old Virginia Brick Co. v. Comm'r*, 367 F.2d 276, 66-2 USTC ¶ 9708 (4th Cir. 1966); *see also* Tenney and Belkap, *Postmortem Planning for Interests in Pass-Through Entities*, 27 EST. PLAN. J., No. 6, p. 250 (July 2000).

6. **Using Basis in S Corporation Stock to Avoid Gain on Sale of S Corporation Assets**. If the business of the S corporation will be discontinued after the death of the decedent, the executor (or remaining officers) may choose to sell the company. Buyers of operating concerns often prefer to purchase assets, and not stock (to avoid liability for past actions of the business and to facilitate an increased basis for acquired assets). Note, however, that the assets of the corporation do not receive a new cost basis at death. Only the stock held by the decedent receives a new basis. Unlike a partnership, no Section 754 election is permitted for S corporations to transfer their shareholders' adjusted stock basis through to the corporation's underlying assets. As a result, any gain realized by the corporation will be passed through to its shareholders, further increasing basis, which can then enable an offset upon liquidation. Timing here, however, is critical.

Example 15: An estate holds all of the stock of an S corporation, whose fair market value on the date of death is $1,000,000. The executor thus has a basis in the stock of $1,000,000. The corporation holds assets with a fair market value of $1,000,000, and a basis of $100,000. If the corporation sells its assets, the corporation recognizes a gain of $900,000, which is passed through to the estate. The estate reports a capital gain of $900,000, and adds $900,000 to the basis of its stock, for a total basis of $1,900,000. If the corporation liquidates, transferring the $1,000,000 sales proceeds to the estate, it will apply its basis of $1,900,000, resulting in a $900,000 loss (which exactly offsets its gain). Note, however, that if the sale takes place in the estate's first fiscal year, and the liquidation occurs in the second, the estate will have to report, and pay tax on, the $900,000 gain in year one. The $900,000 loss in year two can be carried forward, but cannot be carried back to offset the prior year's gain.

C. Limited Liability Companies

A limited liability company is in large measure a hybrid entity under state law. It typically operates much as partnership under applicable state statutes, but has the uniquely corporate characteristic of limited liability. That is, unlike a general partnership (or the general partner(s) of a limited partnership), the owners of a limited liability company have no personal liability to the creditors of the entity. Members of an LLC are in that respect very much like the shareholders of a corporation. The Code does not set forth separate treatment for limited liability companies. Instead, unless the entity elects otherwise, it is taxed as a partnership for federal income tax purposes. Theoretically, the LLC could elect to be taxed as a corporation, and then if it met the eligibility requirements, it could make an S election. Most LLCs, however, simply accept partnership tax treatment. In that regard, they may adopt special allocation rules to apportion profits and losses among members and obtain flow-through tax treatment (like a partnership), while retaining limited liability under state law (like a corporation). The tax status chosen for the LLC will determine which of the rules outlined above will apply to the interests owned by and the assets held by the LLC.

D. Income Tax Consequences of Funding Bequests with Partnership Interests and S Corporation Stock

1. Satisfaction of Specific Bequests. If an estate make a distribution of property in kind, including a distribution of a partnership interest or S corporation stock, to satisfy a gift of a "specific dollar amount" (i.e., a pecuniary bequest) or a gift of specific property with property other than that specified in the governing instrument, then the estate will recognize gain or loss, based on the difference between the fair market value of the asset on the date of the distribution and the date of death basis of the property. Treas. Reg. § 1.661(a)-2(f). This rule applies whether the gift is a fixed dollar amount or a formula fixed dollar amount. *See* Rev Rul. 60-87, 1960-1 CB 286. Thus, if an appreciated partnership interest is used to fund a pecuniary bequest, gain may be required to be recognized by the estate upon the funding of the bequest. Of course, a partnership interest or S corporation stock can decline in value as well as appreciate between date of death and date of funding. Generally, any losses realized from date of death values will be subject to the related party rules and be denied to non-electing trusts. However, an estate may recognize losses incurred in funding pecuniary bequests. IRC § 267(b)(13).

2. Basis Issues. Except for estates of decedents dying in 2010 whose executors opted out of the federal estate tax, the basis to the decedent's estate of a partnership interest or S corporation stock will be its fair market value on the decedent's date of death (or on the alternate valuation date, if the estate is eligible and the decedent's executor so elects). Treas. Reg. § 1.1014-1(a). When the estate distributes an asset to an individual or a trust, the basis is generally a carryover basis of the adjusted basis in the hands of the estate prior to distribution, adjusted by the gains or losses recognized by the estate during the administration, and any gain or loss triggered on the distribution. IRC § 643(e)(1). If the distribution does not trigger gain or loss to the estate, then the beneficiary would expect to receive a carryover basis in the interest distributed. If, however, the distribution occurs pursuant to a Will or other situation that triggers gain or loss recognition, the beneficiary will obtain an additional step-up or step-down in basis equal to the gain or loss recognized upon the distribution. In addition, since the distribution constitutes a sale or exchange, in the case of a partnership interest, the beneficiary will be afforded the opportunity to adjust the inside basis of assets as to the beneficiary if the partnership makes (or has made) a Section 754 election. IRC § 743(b). In situations where the discounts and potential step-down indicate that a Section 754 election might not have been desirable in the year of death, the potential benefit of a Section 754 election should be revisited in the year of distribution.

VIII. CONCLUSION

With the enactment of "permanent" estate, gift, and GST laws, much of the uncertainty that existed prior to ATRA was quelled. The fact that "permanent" changes lasted only a few years reminds us that we live in a volatile legislative environment. Nevertheless, the simultaneous existence of very high estate tax exclusions that will continue to grow (at least for now), together with the added benefit of portability, and the imposition of income tax rates and new income taxes that nearly equal estate tax rates, emphasizes the need to change the conversations that we have with clients during the estate planning and the estate administration process. Legislative changes have reduced estate tax savings opportunities for many of our clients, but may bring income tax savings techniques to the fore. The negative impact on income taxes that flow from the use of traditional estate planning tools are now more pronounced. As a result, those techniques may need to be reevaluated and adapted to minimize their negative impact. Adding features to an estate plan to obtain basis is likely to have increasing importance to our clients. As always, as we continue to watch for potential changes to the income and transfer tax laws, we live in an ever evolving but never boring world of estate planning.

EXHIBIT A

Basis Rules for Persons Dying in 2010

I. Persons Dying in 2010. For estates of decedents dying in 2010 whose executors elected not to have the federal estate tax apply, property acquired from these decedents was treated as transferred by gift. As a result, the basis of that property was the lesser of (i) the adjusted basis of the decedent; or (ii) the fair market value of the property as of the date of the decedent's death. Former IRC § 1022(a). There were two important adjustments to this basis.

A. The $1.3 Million Adjustment. First, a general basis adjustment equal to $1.3 million was available for property \that was "owned by the decedent" and "acquired from a decedent." Former IRC § 1022(b). The $1.3 million amount was increased by the sum of (i) any capital loss carryover determined under Section 1212(b); and (ii) the amount of any net operating loss carryover determined under Section 172, which would (but for the decedent's death) be carried from the decedent's last taxable year to a later taxable year of the decedent. Former IRC § 1022(b)(2)(C). The $1.3 million amount was further increased by the sum of the amount of any losses that would have been allowable under Code Section 165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death. *Id*. In the case of a decedent nonresident not a citizen of the United States, the general basis increase was limited to $60,000. Former IRC § 1022(b)(3).

B. The $3 Million Adjustment for Qualified Spousal Property. Second, there was a spousal basis adjustment equal to $3 million for "qualified spousal property." Former IRC § 1022(c). Qualified spousal property means either: (i) property that would not be treated as nonqualified terminable interest property under the federal estate tax marital deductions rules ("Outright transfer property"); or (ii) property that would be treated as qualified terminable interest property (QTIP) under those rules ("Qualified terminable interest property"). *Id*.

C. The "Owned-by-the-Decedent" Requirement. Basis increases were available only for property that was "owned" by the decedent at the time of death. Former IRC § 1022(d)(1). For purposes of this rule, property that was owned with the surviving spouse either jointly with right of survivorship or as tenants by the entirety, was treated as being owned 50% by the decedent. Former IRC § 1022(d)(1)(B(i). Other survivorship property was treated as being owned in the proportion that the decedent furnished consideration, unless acquired by gift, bequest, or inheritance, in which case the decedent was treated as owning a fractional part of the property determined by dividing the value of the property by the number of joint tenants with rights of survivorship. *Id.* In addition, the decedent was treated as owning property in a revocable trust for which the election under Section 645(b)(1) was available to treat the trust as part of the decedent's estate (essentially, a trust that was revocable by the decedent immediately before death). Former IRC § 1022(d)(1)(B)(ii). Finally, a surviving spouse's interest in community property was treated as owned by, and acquired from, the decedent if at least one-half of the whole of the community interest in that property was treated as owned by, and acquired from, the decedent. Former IRC § 1022(d)(1)(B(iv). A decedent was not treated as owning any property by reason of having a limited or general power of appointment with respect to such property. Former IRC § 1022(d)(1)(B)(iii). In addition, property acquired by the decedent from anyone except the surviving spouse during the three-year period ending on the decedent's death for less than adequate and full consideration in money or money's worth was not treated as owned by the decedent. Former IRC § 1022(d)(1)(C). Property acquired from the surviving spouse during such period was, however, treated as owned by the decedent unless the spouse acquired the property by gift or inter vivos transfer for less than adequate and full consideration in money or money's worth. *Id*.

D. "Property Acquired from the Decedent". For purposes of the modified carryover basis rules, property acquired from the decedent included: (i) property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent; (ii) property transferred by the decedent during his lifetime to a qualified revocable trust as defined in Code Section 645; (iii) property transferred by the decedent to any other trust with respect to which the decedent reserved the right to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust; and (iv) any other property passing from the decedent by reason of death to the extent that such property passed without consideration. Former IRC § 1022(e).

E. Ineligible Property. Certain property was not eligible for any basis adjustment. The carryover basis rules did not apply to items of income in respect of a decedent. Former IRC § 1022(f). In addition, no basis adjustment was permitted for stock or securities in a foreign personal holding company; a DISC (domestic international sales company); a foreign investment company; and a passive foreign investment company (unless it is a qualified electing fund as described in Section 1295 with respect to the decedent). Former IRC § 1022(d)(1)(D).

F. Limited to Fair Market Value. The basis adjustments did not increase the basis of any asset above its fair market value as of the date of the decedent's death. Former IRC § 1022(d)(2). The executor must have made the allocation of the basis adjustments on the return required by Section 6018 (IRS Form 8939, due January 17, 2012). Once basis was allocated, changes in the allocation could be made only as provided by the Secretary of Treasury. Former IRC § 1022(d)(3); Notice 2011-66, 2011-35 IRB 179 § I.D.2; Notice 2011-76, 2011-40 IRB 479.

G. Certain Liabilities in Excess of Basis. In determining whether gain was recognized on the acquisition of property (i) from a decedent by a decedent's estate or any beneficiary other than a tax exempt organization; and (ii) from the decedent's estate by any beneficiary other than a tax exempt organization, and in determining the basis of such property, liabilities in excess of basis were disregarded. Former IRC § 1022(g).

H. Holding Period. The automatic one-year holding period of Section 1223(9) did not apply to estates of persons dying in 2010 whose executors opted out of the federal estate tax and into the modified carryover basis rules. Instead, the holding period of inherited property was likely determined under Section 1223(2), which is the rule generally applicable to property acquired by gift. The IRS has ruled that to the extent the recipient's basis in property acquired from the decedent is determined under Former Section 1022, the recipient's holding period of that property will include the period during which the decedent held the property, whether or not the executor allocates any Basis Increase to that property. Rev. Proc. 2011-41, 2011-35 IRB 188, § 4.06(1).

EXHIBIT B

Sample *Clayton* QTIP Trust Language

1. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, so elects for some or all of my net residuary estate to qualify for the federal estate tax marital deduction under Section 2056(b)(7) of the Code (the "QTIP election"), I direct that my net residuary estate shall be divided into two portions, to be known as Portion A and Portion B.

a. Portion A shall consist of that share of my net residuary estate, if any, with respect to which my Executor has made the QTIP election. I give, devise and bequeath Portion A to the Trustee hereinafter named, IN TRUST, to be held as a separate [QTIP] trust and disposed of in accordance with the provisions of paragraph ___ of Article ______.

b. Portion B shall consist of the balance, if any, of my net residuary estate. I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article _____.

2. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, does not make a QTIP election with respect to some or all of my net residuary estate, I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article ______.

3. Each of Portion A and Portion B is intended to be a fractional share which participates in appreciation and depreciation occurring in the property disposed of under this Article. Subject to the provisions of paragraph ___ of Article ______, each portion may be funded with cash or other property, or a combination thereof, and any such other property so used shall be valued as of the date of distribution.

EXHIBIT C

Sample Exercise of Formula Power of Appointment Triggering Delaware Tax Trap[51]

_____. Exercise of Powers of Appointment.

A. Identification of Power. Under the Last Will and Testament of my deceased [spouse] dated _________, ("my [spouse]'s Will") the _________ Trust (the "Trust") was created for my primary benefit. Pursuant to Section ___ of my [spouse]'s Will, I have a Testamentary Power of Appointment to appoint all of the remaining property of the Trust (outright, in trust, or otherwise) to any one or more of my [spouse]'s descendants.

B. Exercise of Power. I hereby appoint the property described in Subsection ___. below to my children who survive me, in equal shares. However, if any child fails to survive me but leaves one or more descendants who survive me, I give the share that child would have received (if he or she had survived) per stirpes to his or her descendants who survive me. All of the preceding distributions are subject to the provisions of Article ___ (providing for lifetime Descendant's Trusts [*that grants the primary beneficiary thereof (or others) a presently exercisable general power of appointment*] for my children and other descendants).

C. Extent of Exercise. The foregoing exercise does not apply to the following assets held by the Trust: (i) cash or cash equivalent accounts (such as savings accounts, certificates of deposit, money market accounts or cash on hand in any brokerage or equivalent accounts); (ii) property that constitutes income in respect of a decedent as described in Code Section 1014(c); (iii) any interest in any Roth IRA accounts or Roth variants of other retirement plans, such as Roth 401(k)s, 403(b)s, 457(b)s, and the like; and (iv) any interest in any property that has a cost basis for federal income tax purposes that is greater than or equal to the fair market value of the property at the time of my death (the "Excluded Assets"). If, after eliminating the Excluded Assets, the inclusion of the value of the other assets in the Trust in my taxable estate for federal estate tax purposes would not increase the federal estate tax and state death taxes payable from all sources by reason of my death, this power of appointment shall apply to all remaining assets of the Trust other than the Excluded Assets (the "Included Assets"). However, in the event that the inclusion of the value of all of the Included Assets in the Trust in my taxable estate for federal or state estate or inheritance tax purposes would increase the taxes so payable, the assets of the Trust appointed by this Section shall be further limited as follows: The Trustee shall for each of the Included Assets evaluate the ratio of the fair market value at the time of my death to the cost basis immediately prior to my death first (the "Gain Ratio"). The Trustee shall thereafter rank the Included Assets in order of their respective Gain Ratio. The appointment shall apply first to the Included Asset with the largest Gain Ratio, and thereafter in declining order of Gain Ratio to each of the subsequent Included Assets; however, as such point that inclusion of the next in order of the Included Assets would otherwise cause an increase in my estate's federal or state estate tax liability as described above, my appointment pursuant to this Section ___ shall be limited to that fraction or percentage of that Included Asset that will not cause any federal or state estate tax liability, and all lower ranked Included Assets shall be excluded from the exercise of this power of appointment.

D. Statement of Intent. It is my intention by the foregoing exercise of my power of appointment to trigger Code Section 2041(a)(3) by postponing the vesting of an estate or interest in the property which was subject to the power for a period ascertainable without regard to the date of the creation of my power, and to thereby obtain for the assets of the Trust the maximum possible increase in the cost basis of those assets as may be permitted under Code Section 1014 as a result of my death without causing any increase in the federal estate tax and state death taxes payable from all sources by reason of my death. This Will shall be administered and interpreted in a manner consistent with this intent. Any provision of this Will which conflicts with this intent shall be deemed ambiguous and shall be construed, amplified, reconciled, or ignored as needed to achieve this intent.

[51] This language is loosely adapted from Morrow, "The Optimal Basis Increase and Income Tax Efficiency Trust" available at http://tinyurl.com/qen5gwl at pp. 86-87.