UNWINDING ESTATE PLANS BECAUSE OF CHANGED CIRCUMSTANCES

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I. INTRODUCTION

Stuff happens. An estate plan that looked good ten years ago may not be good today. Given the significant increase in the "applicable exclusion amount" for federal wealth transfer taxes, as well as the increase in federal income tax rates for the most affluent taxpayers, the old mantra of "better to avoid estate tax now even if it means deferred capital gains later" may now be flat-out wrong for some clients. That invites discussion of the need to "unwind" one or more of the techniques implemented as part of a prior estate plan. These materials suggest several strategies to consider for undoing many of the common estate planning techniques used in the past generation. Many of the strategies discussed in these materials are explained in greater detail in John Bergner's outstanding materials from the 49th Annual Heckerling Institute on Estate Planning, *Curing Estate Plans That No Longer Make Sense in Light of the American Taxpayer Relief Act*.

II. UNWINDING TRUST TRANSFERS THAT REMOVE PROPERTY FROM THE GROSS ESTATE

A. Why to Unwind. When estate tax rates are significantly higher than income tax rates, it makes sense for a wealthy individual to transfer ownership of assets during life so as to avoid wealth transfer taxation of the appreciation in the value of the assets between the date of the transfer and the individual's death. Transferred assets will not get a stepped-up basis for federal income tax purposes, but where income tax rates are significantly lower and not likely to be incurred until many years later, that is a small price to pay for exemption from higher estate taxes that would come due sooner. Usually, such transfers will be made in trust because the grantor does not want the beneficiary or beneficiaries to experience a sudden surge in net worth. Transfers in trust may also allow for the grantor to retain some control over or access to the gifted assets.

While the federal estate tax rate (40%) is generally higher than federal income tax rates (the highest rate on capital gain and dividend income is 23.8% and the highest rate on ordinary income is 40.8%), the estate tax comes with a large exemption: currently $11.7 million for a single person and $23.4 million for a married couple. So estate tax exposure may not be as significant as income tax exposure. Where that is the case, a grantor may regret certain lifetime transfers, especially those to irrevocable trusts. The assets inside the standard irrevocable trust do not get a stepped-up basis on the death of the grantor. This first section, then, considers strategies for unwinding lifetime transfers made in trust.

B. Possible Strategies

1. Exercise a Swap Power. Most irrevocable trusts are structured as "grantor trusts" for federal income tax purposes, and probably the most common technique for conferring grantor trust status is to give the grantor a power (exercisable in a non-fiduciary capacity and without anyone else's consent) to substitute property of equivalent value (a "swap power"). If the grantor's death is imminent, the grantor might exercise a swap power by substituting high-basis assets for the trust's low-basis assets. This way, the grantor dies holding low-basis assets that will be eligible for a stepped-up income tax basis. The high-basis assets swapped into the trust will not be included in the grantor's gross estate, and the exchange of assets is not a taxable event. Since those high-basis assets have the same value as the low-basis assets, the grantor has preserved the asset appreciation inside the trust while maximizing use of the basis step-up at death for assets included in the gross estate.

For example, suppose Grantor transferred $1 million in non-depreciable assets (with an aggregate basis of $100,000) to an irrevocable trust in Year One. The trust instrument gave the grantor a swap power. By the end of Year Seven, the assets had grown in value to $3 million. Grantor owned $3 million in cash outside of the trust. Grantor expected to die early in Year Eight, so at the end of Year Seven, Grantor transferred the $3 million in cash to the trust in exchange for the trust's assets. At Grantor's death in Year Eight, the $3 million in low-basis assets is included in Grantor's gross estate, but the $3 million in cash, now held by the trust, is not included. The basis in the assets included in Grantor's gross estate is stepped up to $3 million. By making the swap shortly before death, Grantor's gross estate is the same size ($3 million is still included), but Grantor gets a $2.9 million increase in income tax basis.

In other contexts, attempts to get a last-minute step-up in basis are often thwarted through §1014(e). This provision states that if a donor makes a gift to a donee who dies within a year of the gift, the gifted property will not receive a step-up in basis to fair market value if the property is bequeathed or devised back to the donor. This rule does not apply to the exercise of a swap power because there is no "gift" of the low-basis assets to the grantor. Put another way, since the grantor and the trust are the same person for federal income tax purposes, there cannot be the gift required to invoke §1014(e).

Swaps also work well where the grantor holds loss property. Just as there is a step-up in basis at death for appreciated assets, there is a "step-down" in basis at death for loss assets. By swapping those assets into a grantor trust before death, the loss is preserved inside the trust.

2. Purchase Assets from Grantor Trust. If the trust does not confer a swap power to the grantor, the same result can be reached by the grantor's purchase of the assets from a grantor trust prior to death. The sale transaction is not recognized for income tax purposes, and the low-basis assets formerly inside the trust are now part of the grantor's estate. This strategy requires the consent of the trustee, and the trustee will have to consider how a proposed sale affects the trustee's duties of loyalty to the beneficiaries and of being a prudent investor. Because of these duties, a sale may be a more attractive option closer to the grantor's death.

3. Trust Modification or Decanting. State statutes often allow for the modification of irrevocable trusts because of changed circumstances. Under the Uniform Trust Code, for example, any provision of a trust may be modified with the consent of the grantor and all beneficiaries. Where the grantor is unable to consent, the beneficiaries may (by unanimous vote) make any modification to a trust provided a court of competent jurisdiction concludes the proposed modification is not inconsistent with a material purpose of the trust. Even where the beneficiaries do not agree unanimously, a court may approve a proposed modification if it is satisfied both that the modification does not go against a material purpose of the trust and that there is adequate protection for the interests of a non-consenting beneficiary. The Uniform Trust Code also authorizes a court to modify a trust in order to achieve the grantor's tax objectives, provided the modification is not contrary to the grantor's "probable intention." So one possible strategy is for the grantor and/or the beneficiaries to invoke the procedures available under the application trust modification statute to achieve the desired result, whether that is the modification or termination of the trust.

More recently, states have added decanting statutes as an additional arrow in the quiver. Decanting statutes allow the trustee to move assets into a new trust with more favorable terms without undergoing the procedures outlined in the traditional trust modification statute. Allowing the trustee to take the corrective action without needing the express approval of the beneficiaries and/or the grantor may be more efficient and practical. As of the start of 2021, ten states (Alabama, California, Colorado, Illinois, Nebraska, New Mexico, North Carolina, Virginia, Washington, and West Virginia) have enacted the Uniform Trust Decanting Act. The Uniform Law Commission summarizes the Uniform Trust Decanting Act as follows:

> The UTDA includes one stricter set of rules that apply when the settlor gave the trustee limited discretion over distributions, and another more liberal set of rules that apply when the trustee has expanded discretion. In both cases, the person exercising the decanting power is subject to all applicable fiduciary duties, including the duty to act in accordance with the purposes of the first trust.
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> When the trustee has limited discretion over distributions, decanting is permitted for administrative or tax purposes, but the beneficial interests under the second trust instrument must be substantially similar to the beneficial interests under the first trust. In other words, the trustee may not exercise the decanting power to reduce or eliminate the interest of any beneficiary. However, if the trustee already has expanded discretion to reduce or eliminate the interest

of beneficiaries under the terms of the first trust, the UTDA provides more flexibility.

One common reason for decanting is to provide for a beneficiary who becomes disabled after the settlor executed the first trust. If the settlor did not anticipate the possibility of disability, the beneficiary may be ineligible for governmental benefits that would otherwise be available. Section 13 of the UTDA gives additional flexibility to trustees with respect to disabled beneficiaries.

The UDTA limits decanting when it would defeat a charitable or tax-related purpose of the settlor, and Section 14 provides for prior notice to the state official that is responsible for protecting charitable interests. Section 16 prohibits decanting for the purpose of adjusting trustee compensation without the unanimous consent of the beneficiaries or court approval.

In summary, the UDTA provides a more complete set of rules for decanting than currently exists in any state. It is appropriate for states that have adopted the Uniform Trust Code and for states that have a non-uniform trust law statute.

III. UNWINDING CREDIT SHELTER TRUSTS

A. Why to Unwind. The credit shelter trust assumes that estate tax savings are a priority of the estate plan. The credit shelter trust works best where assets appreciate substantially between the death of the first spouse and the death of the surviving spouse. But sometimes surviving spouses do not survive for very long. And with a higher basic exclusion amount for federal estate tax purposes, sheltering appreciated assets from estate tax may no longer be a priority. Indeed, where the estate tax savings from the credit shelter trust are not as important as the income tax benefit from a stepped-up basis, the decedent’s beneficiaries may prefer to unwind the credit shelter trust.

B. Unwinding Funded Trusts

1. Distribute Assets to the Surviving Spouse. If the trust instrument permits, the trustee could distribute appreciated assets to the surviving spouse so that those assets get a stepped-up basis on the surviving spouse’s death. If the trustee is concerned that a distribution is beyond the scope of discretion given to the trustee under the trust instrument and applicable state law, the trustee might seek written release from the beneficiaries prior to making the distribution. Of course, assets distributed to the surviving spouse would make those assets subject to the claims of the surviving spouse’s creditors.

2. Have Surviving Spouse Exercise Limited Power of Appointment by Creating General Power of Appointment. The trust instrument may give the surviving spouse a limited power to appoint the remainder of the trust, often among the descendants of the spouses. Often this is a testamentary power but it may also be exercisable during the surviving spouse's lifetime. If the spouse exercises this power by giving one or more of the remainder beneficiaries a presently exercisable general power of appointment over the trust property, §2041(a)(3) (known as the "Delaware Tax Trap") requires the trust property to be included in the surviving spouse's estate. This gives the trust assets a stepped-up basis for income tax purposes on the surviving spouse's death. Because the other beneficiary has a general power of appointment, however, it is important to know that the other beneficiary's creditors would then have access to the trust property.

3. Give Surviving Spouse a General Power of Appointment. Some trust instruments give independent third parties the power to confer a power of appointment to any beneficiary. If the trust contains this feature, the third party could simply give the surviving spouse a general power of appointment. This causes the property to be included in the surviving spouse's estate, even where it is unexercised. That, in turn, gives the trust assets a stepped-up basis on the death of the surviving spouse. It should be noted that while the general power of appointment is in existence, the beneficiary holding the power will very likely be the deemed owner of the trust for federal income tax purposes. It should also be noted that under the law of most states, the spouse's general power of appointment will subject the trust property to the claims of the surviving spouse's creditors no matter whether the spouse exercises the power.

4. Appoint Surviving Spouse as Trustee. If the trust does not prohibit the surviving spouse from serving as trustee, naming the surviving spouse as trustee could work to give the assets a stepped-up basis on the surviving spouse's death where the trustee powers are equivalent to a general power of appointment. If the trust instrument limits the trustee's distribution discretion to an ascertainable standard related to maintenance, education, support, or health, however, this will not work.

5. Trust Modification or Decanting. Here too, the beneficiaries may be able to amend the terms of the trust by using either a trust modification statute or a decanting statute.

C. Unwinding a Trust Not Yet Funded

1. Agreement Not to Fund. State law may permit the decedent's beneficiaries to agree among themselves to a different distribution of the estate. It may be possible, then, to avoid the creation of a credit shelter trust altogether if the beneficiaries consent. Beneficiaries should understand, however, that there may be transfer tax implications to any such arrangement. If the remainder beneficiaries of the credit shelter trust consent to the outright distribution of the property to the surviving spouse, for instance, they are making completed gifts of their remainder interests to the surviving spouse. Perhaps those beneficiaries need to receive amounts outright themselves as consideration for their release of the remainder interests.

2. Trust Modification of Decanting. This may be the best time to convince a court to modify the terms of a testamentary trust to achieve the grantor's tax objectives. See the prior discussion about trust modification statutes and decanting statutes.

IV. UNWINDING IRREVOCABLE LIFE INSURANCE TRUSTS

A. Why to Unwind. Irrevocable life insurance trusts (ILITs) are often used to provide liquidity to the grantor's estate (or to the estate of the surviving spouse, in the case of a second-to-die policy), often principally for the payment of federal estate tax. But with higher exclusions, there may be no need for the extra liquidity at death. In addition, the trust may present unnecessary compliance complexities. Finally, in the case of a whole life policy, the policy may not be meeting investment expectations.

B. Possible Strategies

1. Transfer the Policy to the Grantor. Transferring the policy to the insured simplifies the ownership structure. Where gross estate inclusion of the death benefit is not a problem, having the policy in the hands of the insured instead of the trust may be preferred because it allows the insured the power to change the policy's beneficiary designation easily. If the trust gives the grantor a swap power, the grantor can simply reacquire the policy by swapping in property with an equivalent fair market value. Even if the grantor lacks a swap power, the purchase of the policy will not give rise to federal income tax consequences if the ILIT is a grantor trust for income tax purposes. If the ILIT is not a grantor trust, then there will be tax consequences to the sale as if the grantor was a third party, as explained below.

2. Sell the Policy to a Third Party. Upon the sale of an insurance policy, the seller realizes gain when a life insurance policy is sold for more than its adjusted basis. If a policy is sold for less than its adjusted basis, the loss is likely not deductible. The adjusted basis of a life insurance policy is the amount of premiums and other consideration paid, with no reduction for the cost of insurance coverage from year to year that expires over the life of the policy. Any gain is ordinary income to the extent the cash surrender value of the policy exceeds premiums and other consideration paid (the "inside build up"); any additional gain is capital gain.

For policies held in an ILIT, the seller is the trustee, though for income tax purposes the trust is likely to be a grantor trust. This has two implications. First, the trustee is the party that effects the sale, so the trustee must determine that the sale is consistent with the trustee's duties as a prudent investor with loyalty to the beneficiaries. Second, any gain resulting from the sale will be taxed to the grantor. This is usually good news, as there is a better chance less income tax will be paid if the gain is taxed to the grantor instead of the trust.

3. Surrender the Policy. When a life insurance policy is surrendered the amount received (other than as an annuity) is included in gross income to the extent it exceeds the investment in the contract. The "investment in the contract" is the total of premiums and other consideration paid less all amounts previously received under the contract that were not included in gross income. (Presumably, the amount of any policy loans that were outstanding against the policy would be treated as part of the consideration received.) Any gain from the surrender is ordinary income because the surrender of a policy is not a “sale or exchange.” If the trust receives less than the net amount of premiums and other consideration paid, no deduction for the loss is allowed.

4. **Trust Modification or Decanting.** Yet again the planner can consider whether to use the procedures under applicable state statutes to modify the trust, terminate it, or decant the policy into a new-and-improved trust.

V. UNWINDING GRATs

A. Why to Unwind. A grantor-retained annuity trust (GRAT) may not make sense if gross estate exclusion no longer matters. If there is no longer an estate-tax savings element for the trust, the grantor might prefer to own the asset outright, not only to retain the cash flow from the GRAT assets but also to ensure those assets get a stepped-up basis on the grantor’s death.

B. Possible Strategies

1. **Have Grantor Purchase Remainder.** Although the GRAT regulations prohibit the prepayment of the grantor’s annuity interest, they do not prohibit the grantor from buying the remainder interest. Assuming such a purchase is not precluded by a spendthrift provision in the trust, the grantor can purchase the remainder interest from the remainder beneficiaries, effectively leaving the grantor with outright ownership of the trust’s assets. This strategy is often used when the grantor wants to cap the maximum benefit passing to the remainder beneficiaries; now it has utility as a method for unwinding the GRAT where the estate tax benefit no longer matters.

The purchase price would be the present value of the remainder interest, which in turn is a function of the trust’s term, the chances of the grantor’s death during the term, the value of the trust’s assets, and the assumed interest rate in play at the time of the purchase.

2. **Exercise Swap Power**. A GRAT can give the grantor a swap power. If it does, the grantor could swap in high-basis assets in exchange for the low-basis assets of the GRAT. This is another technique for controlling the trust’s cash flow.

VI. UNWINDING QUALIFIED PERSONAL RESIDENCE TRUSTS

A. Why to Unwind. Qualified Personal Residence Trusts (QPRTs) were all the rage when the §7520 rates were higher, as they allowed the transfer of a residence at a cost far less than the value of the property. QPRTs are used chiefly to shift appreciation in the value of residence between the date of the trust’s creation to the date of the grantor’s death. Where estate tax is no longer an issue for the grantor, the grantor may prefer that the house get a stepped-up basis on the grantor's death. In addition, the grantor may prefer to avoid the hassles associated with the QPRT, like leasing the property back at the end of the trust term and all the restrictions required in a QPRT instrument.

B. Possible Strategies

1. **Have Grantor Purchase Remainder.** Modern QPRTs must provide that the grantor cannot purchase the residence from the trustee at any time. The same prohibition must extend to the grantor's spouse. But nothing prohibits the grantor from buying the remainder interest from the beneficiaries for fair market value, provided the remainder beneficiary is either an individual or a trust that is not a grantor trust. By purchasing the remainder, the theory is that a merger would occur since the grantor would own all the beneficial interests in the trust.

2. **Have the Grantor Continue to Occupy the House After the Trust Term Without Paying Rent.** The thinking here is that if the grantor continues to occupy the home after the QPRT's lead term expires, there would be inclusion in the grantor's gross estate under §2036 because of an implied right to occupy that continues for a period that does not end before death. There is a risk, however, that the remainder beneficiaries would be seen as making a gift to the grantor equal to the rental value of the property during the period following expiration of the initial term.

3. **Have the Grantor Buy the House from the Remainder Beneficiaries.** If the trust has already terminated, the grantor and the remainder beneficiaries may want to enable the grantor to re-obtain the home in order to get a stepped-up basis. Of course, to the extent the grantor pays fair market value for the home, the utility of this strategy is compromised. But one solution posed by John Bergner is to have the grantor make cash loan to the trust while it's in existence. The trustee would use the loan to make improvements to the home. The improvements would increase the value of the home, but likely not by the full cost. When the trust terminates the trustee distributes the property subject to the obligation to repay the grantor's loan. The grantor can then acquire the home for fair market value, financed in part by cancelling the loan. The transaction would be taxable to the remainder beneficiaries, so for this strategy to get the best result the grantor should live a long time so that there is meaningful appreciation in the value of the home.

4. **Have Grantor Buy Home from Older QPRT.** QPRTs created before May 16, 1996, are not required to have the provisions prohibiting sale of the residence to the grantor or the grantor's spouse. For an older QPRT, then, the grantor could purchase the residence from the trustee. That shifts post-sale appreciation back to the grantor, and allows for a stepped-up basis on the grantor's death. The purchase and sale would not be taxable since the QPRT is most likely a grantor trust. Following the sale, the trust will no longer be a QPRT. Under the regulations, then the trustee must either distribute the newly-acquired funds back to

the grantor or convert the grantor's retained interest into an annuity interest for the balance of the term.

5. Trust Modification or Decanting. Usually the client seeking to unwind the QPRT wants the house back. For that reason, trust modification or decanting the QPRT property into a new trust may not be the best solution. But it is an option to consider where the client wants to keep the property in a trust that's more flexible or easier to administer than a QPRT.

VII. UNWINDING §678 TRUSTS

A. Why to Unwind. The beneficiary of a §678 trust may not have a taxable estate. In that case, inclusion of the trust assets in the beneficiary's gross estate will be helpful for federal income tax purposes.

B. Possible Strategies

1. Purchase Appreciating Assets from Trust. The beneficiary can purchase assets from the trust for fair market value. There is no federal income tax consequence since the beneficiary is the deemed owner of the trust for income tax purposes. To avoid potential gift tax implications, the purchase and sale agreement could contain a defined value clause.

2. Trust Modification, Termination, or Decanting. If the beneficiary seeks the assets for reasons apart from the step-up in basis (e.g., the trust has become unmanageable and/or inefficient), there may be a persuasive case for terminating the trust. Failing that, there are the same trust modification and decanting options available here too.

VIII. UNWINDING VALUATION DISCOUNTS IN CLOSELY-HELD ENTITIES

A. Why to Unwind. Valuation discounts reduce the amount of transfer tax due on gifts and testamentary transfers. But with the enactment of §1014(f), the step-up in basis cannot exceed the finally determined value of property for estate tax purposes. Property subject to valuation discounts for estate and gift tax purposes, therefore, are limited in their ability to claim a maximum step-up in basis for income tax purposes. Where the transferor no longer has a taxable estate, or where maximizing the step-up is more important than minimizing the value of assets for transfer tax purposes, the transferor might wish to "undo" transactions that gave rise to discounts.

B. Possible Strategies

1. Consolidate Fractional Interests. A client could eliminate fractional interest discounts either by acquiring the interests of co-owners or passing the client's interest to other co-owners. Such transactions may be gifts subject to gift tax or sales subject to income tax, but to the extent the transactions are at arms-length and between the client and a grantor trust (or between spouses) they can be tax-free.

2. Amend Partnership Agreement to Pay Liquidation Value. Most partnership and LLC operating agreements provide that a retiring or deceased owner will be paid fair market value for his, her, or its interest. "Fair market value" reflects applicable discounts for lack of marketability and, where appropriate, being a minority interest. But a partnership agreement could be amended to provide that withdrawing or deceased owners are entitled to liquidation value (net asset value) instead of fair market value. That increases the fair market value of the ownership interests. To the extent this change affects all owners, there should be no income or gift tax consequences to the amendment.

3. Convert a Limited Partnership to a General Partnership. Converting the entity from a limited partnership to a general partnership is not a taxable event, and to the extent doing so gives all ownership interests some voice in management, the fair market value of the formerly limited partnership interests should increase. There is a non-tax cost in that the formerly limited partners would now have the duties of a general partner.

4. Acquire Voting Interests in the Closely-Held Entity. If the client owns only nonvoting interests in a closely-held business or family entity, the client could consider acquiring a voting interest in the entity in order to depress the minority interest discount and (to a lesser extent) the marketability discount. The acquisition may be a taxable event, but generally will not be a transfer subject to gift taxes as long as the client pays fair market value for the acquired interest.

5. Liquidate the Family Limited Partnership or LLC. If the net asset value of a family entity exceeds the aggregate bases of the owners' partnership interests, a partner may prefer that the entity liquidate. By owning assets outright instead of through a partnership, there will be a greater step-up in basis for income tax purposes. The liquidation of the partnership is generally not a taxable event where the partners receive non-cash property. Put differently, a liquidating distribution is taxable to the extent a partner receives cash in excess of the partner's basis in the partnership interest. The partner receiving property will generally take a basis in that property equal to the basis the partner had in the partnership interest. The liquidation does not give rise to any gifts assuming all partners receive distributions in accordance with their interests in the entity. Before implementing this strategy, partners should consider the extent to which a distribution will increase the pool of assets from which their creditors may make claims.

6. Have Partnership Redeem Interest for Cash. If a client's basis in the partnership interest exceeds its distribution value, a redemption by the partnership may be the preferred strategy. The cash distribution would not be taxable since it would not exceed the partnership's basis in the partnership interest. There would be no transfer tax consequence provided the redeemed partner receives an amount equal to the fair market value of the redeemed interest.

IX. CONCLUSION

These materials have offered some suggestions for undoing wealth transfers and transfer restrictions where doing so might produce a better result for the client. None of these transactions should be entered into lightly, for it is always possible that the laws could change (again) to make a now-outdated plan appropriate once more. In addition, many of these strategies could raise issues with respect to creditor protection, fiduciary duties, fulfilling the transferor's intent, and others that are raised only briefly herein, to say nothing of important issues like family dynamics and personal liability. Local law will also affect the number of viable choices. Professionals should collaborate throughout the discussion of these options to reach results for clients.