

Estate Planning in Changing (and Challenging) Financial Times

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Estate Planning in Changing (and Challenging) Financial Times

I. Introduction. A dramatic drop in investment values coupled with historically low interest rates and a 75% increase in the federal estate tax exemption, all in the course of just a few months, may have created a perfect storm for estate planners. Can we still use the tools and techniques that estate planners have grown to know so well to plan for wealthy individuals? For clients of more modest means, how will the focus of our estate planning change to take new estate planning realities into consideration? And what about clients who may now see the estate planning that we have done in the past as "over-planning"? Are there new (or not-so-new) tools and techniques available to allow us to undo what we may have already done? In view of the volatile estate planning landscape, coupled with important non-tax factors, is it wise to assist our clients in attempting to undo prior planning? The goal of this outline is to address these issues in the context of the current financial and legal environment.

II. What's Going On?

A. Financial Issues. According to the October, 18, 2008 Wall Street Journal, "[t]he economy is a mess, home prices are reeling, and stocks have plunged. But for those likely to become ensnared in the estate tax, there's a silver lining: These troubled times offer some of the best opportunities in years to transfer wealth to younger generations, without triggering much or any inheritance tax along the way."

1. Investments. Many of our clients have seen their investment portfolios plunge in value. While the media may be responsible for much of the gloom and doom, we all remember not-so-distant times when the Dow Jones Industrial Average was thousands of points above where it stands today. Real estate prices, especially in areas like California and Florida that once regularly experienced rapid inflation, have dropped precipitously. While Texans, who missed much of the run-up, have also been spared much of the fall, the general sense is that property values are still below long-term market expectations.

2. Interest Rates. Our clients may be less likely to follow current interest rates. As advisors, we know that these rates (such as the Section 7520 rate) can have a big impact upon which estate planning tools work best. Attached as an Exhibit is a chart depicting the Section 7520 rate from January, 1991 through August, 2009. As the exhibit shows, throughout the '90s, this rate hovered between 6 and 10%. As recently as 2007, the Section 7520 rate began to drop steadily. In January, 2008 it fell below 5%. In February, 2009 it dropped to 2%, an all-time low, forcing the IRS to re-publish its tables (which previously began at 2.2%).

B. Tax Issues.

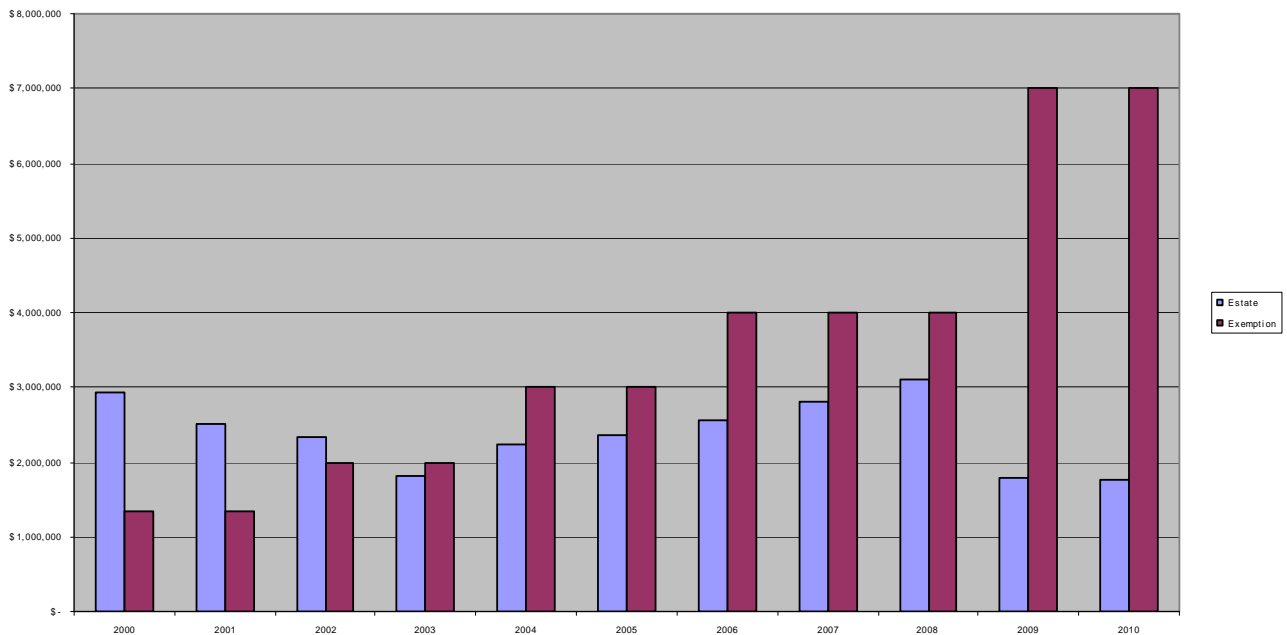
1. Estate Tax Exemption. It is a striking contrast that in a year that the Dow dropped from 13,264 (December, 2007) to 6,440 (March, 2009), the estate tax exemption increased from \$2 million per person to \$3.5 million per person. This 75% increase in exemption is by far the largest in recent memory. While the fate of the estate tax is still uncertain, most commentators and political pundits assume that Candidate Obama's pledge to freeze the estate tax at 2009 levels will be implemented by President Obama and the Democratic Congress, at least long enough to prevent a "repeal" of the estate tax in 2010. Whether the exemption will remain at \$3.5 million, return to \$1 million, or take some other form is anyone's guess. The chart on the next page contrasts the changes in net worth with the estate tax exemptions that would be available to a hypothetical married couple who had about \$3 million

invested in the S&P 500 Index in January, 2000. It is small wonder that many of our "wealthy" clients are now so little concerned with estate tax exposure.

2. Income Tax Issue.

a. Rates. While most people are beginning to view the estate tax world with 2009 glasses, the same can't be said for income tax rates. President Obama has recently renewed his vow not to raise income tax rates on those earning less than \$200,000 (or \$250,000 for married couples). *See New York Times*, August 4, 2009, p. A12 (New York ed.). This vow brings little comfort to those of our clients whose income far exceeds this amount. Their fears are heightened by the deficit projections brought about by the economic downturn, bipartisan efforts to spend tax dollars to revive the economy, and the projected cost of health care reform. Clients understand that the government will have to pay for this spending, and if taxes on the poor and middle class are fixed, there is only one place for this payment to come from

b. Basis. In the days of soaring stock market values and real estate prices, many of our clients had large built-in gains. While many have taken comfort in a capital gain rate equal to what many people pay for good service at a restaurant, there is a real concern that this rate will not stay around for long. On the other hand, plunging prices have brought many portfolios down to the point where values once again approach (or have fallen below) basis. Those entering the market at an opportune time, and who expect a rapid rise in values (the Dow rose an astounding 47% from its March, 2009 low to its close in late August, 2009), may begin to worry again about capital gain tax exposure.



Net Worth vs. Estate Tax Exemption

III. What Works Now?

A. Inter-Family Loans. One of the most attractive wealth-transfer strategies is also one of the simplest—a family loan. The IRS permits relatives to lend money to one another at the

"Applicable Federal Rate," which the IRS sets monthly. With these loans, relatives can charge far less than a bank. For example, in July, 2009, when Bankrate.com quoted the rate on a 30-year mortgage at around 5.5%, the Applicable Federal Rate ranged from 0.82% to 4.36%, depending on the loan's term.

The Technique. With banks tightening credit standards, the appeal of The Bank of Mom & Dad is obvious. These loans and their super-low interest rates are also great estate-planning opportunities. If the borrower (say, your child) invests the loan's proceeds wisely, he or she will have something left over after repaying the lender (say, you). This net gain acts like a tax-free gift to the borrower.

Example: In June, 2009, Mom loans \$400,000 to her daughter and son-in-law to purchase a home. In this real estate market, the couple is able to buy a great house. Mom structures the loan with a thirty year amortization, but with a balloon payment due at the end of nine years. Because the couple was able to lock in an interest rate of just 2.25% over the next nine years instead of the 5% offered by their bank, the couple will save nearly \$11,000 in interest costs the first year alone, while reducing their monthly payments from \$2,147 to \$1,529. The young couple will profit as long as the home appreciates by more than the modest cost of interest. To further reduce the cost of the loan, and put even more potential profits in her kids' pockets, Mom might use another estate-planning technique. She and her husband can use the \$13,000 each is able to give tax-free to their daughter and son-in-law every year to pay down the loan's principal. (See Outright Gifting, below). By reducing the size of the loan, this tactic would slash the total amount of interest the young couple will owe on this debt. By helping the couple retire its \$400,000 debt to her, Mom will also reduce her estate by as much as \$400,000. That can cut her estate tax bill by \$180,000.

Specifics. Family loans are governed by Section 7872 of the Internal Revenue Code (the "Code"). This section of the Code generally deals with interest-free or "below-market" loans between related taxpayers. For family loans, it provides that a below-market loan will be treated as a gift loan, resulting in the imputation of a gift from the lender to the borrower in an amount equal to the foregone interest. In addition, a below-market loan results in a deemed payment of interest by the borrower to the lender for income tax purposes. Section 7872 not only spells out the consequences of a "below-market" loan, but also requires the IRS to set the "market" rate for loans each month. With IRS interest rates at historically low levels, there is no need for families to make "below-market" loans. A loan at the market rate set by the IRS works just fine.

1. Term Loans. A term loan will not be treated as a gift loan as long as the interest rate applicable to the term loan equals or exceeds the Applicable Federal Rate promulgated by the IRS as of the day on which the loan was made, compounded semi-annually. The interest rate depends on the term of the note. For a promissory note with a maturity of three years or less, the federal short-term rate must be used. For a promissory note with a maturity in excess of three years but not more than nine years, the federal mid-term rate must be used. For a promissory note with a maturity in excess of nine years, the federal long-term rate must be used. These rates are the floor used to avoid any adverse results. IRC § 7872(e).

2. Demand Loans. A demand loan will not be treated as a gift loan, provided that the interest rate applicable to the demand loan is at least equal to the short-term Applicable Federal

Rate for the period in which the loan is outstanding, compounded semi-annually. IRC § 7872(f)(2).

3. Note Terms. With regard to a term loan, to ensure that the IRS will respect the validity of the loan, the note evidencing the loan should ideally contain a fixed maturity date, a written repayment schedule, a provision requiring periodic payments of principal and interest and a provision regarding collateral. In addition, actual payments on the note should be made from the junior family member to the senior family member. For demand notes, if the senior family member never demands payments or if the junior family member does not have the ability to satisfy the loan, an inference can be made that the senior family member never intended the loan to be repaid. If the IRS does not respect the note, the transfer of the loan proceeds from the senior family member to the junior family member could be reclassified as a taxable gift as of the date of the loan. See *Estate of Lillie Rosen v. Comm'r*, T.C. Memo 2006-115.

4. Impact of Interest Rates. If the property acquired with funds loaned from the senior family member to the junior family member appreciates at a rate faster than the prevailing interest rate and/or earns income in excess of the prevailing interest rate, then the loan effectively shifts value estate-tax free from one generation to the next.

5. Income Tax Issues. Tax implications for family loans must include consideration of federal (and state) income taxes on senior and junior family members. More specifically, the senior family member will generally have interest income to recognize as part of his or her taxable income, but the junior family member will generally not be able to deduct the interest paid from his or her taxable income unless the interest constitutes investment interest or home mortgage interest to the borrower. IRC § 163(h).

6. Death During Term. If the lender dies during the term of the loan, any unpaid balance will generally be included in the taxable estate of the lender. Note, however, that the value of the note is generally limited to the value of the collateral and the net worth of the borrower, without regard to any amount the borrower might inherit. See *Est. of Elizabeth v. Harper*, 11 TC 717 (1948); TAM 9240003 (\$235,000 note owed to estate of uncle by insolvent nephew properly valued at substantially less than face value despite testamentary forgiveness of debt and \$1 million bequest to nephew from uncle). If the junior family members have paid back any portion of the loan, the repaid funds will likewise be included in the lender's estate. It is the earnings from the loan proceeds in excess of the IRS interest rate that escapes estate taxation. Of course, the senior family members may use their gift tax annual exclusion to reduce the outstanding principal balance, thereby reducing estate inclusion at the time of their deaths.

7. Use with Grantor Trusts. To ameliorate the impact of income taxes, instead of a loan from senior family members to junior family members, senior family members could create a "intentionally defective" grantor trust for the benefit of junior family members and make a loan to the grantor trust.

a. Borrower Credit-Worthiness. If the senior family member wants to loan money to a grantor trust, the grantor trust should be "seeded" with sufficient assets to make the trust a credit-worthy borrower (most commentators suggest a 10% seed money gift). Without this equity, the IRS might doubt the trust's ability to repay the loan, especially if the trustee

invests the loan proceeds in illiquid or volatile investments. If the loan can't be repaid, the IRS might instead treat it as a gift.

b. Non-Tax Aspects. It may be advisable for the grantor trust to be structured as a so-called "perpetual" or "dynasty" trust for the senior family member's descendants, leaving giving the trustee broad discretion to make distributions, rather than mandating any distributions. These trusts have substantial non-tax benefits. For example, if the client's descendants have problems with creditors, the creditors can attach assets that are distributed to them outright. In contrast, trust assets are generally exempt from attachment as long as the trust has "spendthrift" language. Similarly, a spouse of a descendant may become a creditor in a divorce situation. Outright distributions that are commingled with a spouse could be classified as community property, subject to division by a divorce court. Properly maintained trust assets cannot be commingled. Also, outright distributions may allow assets to be given away to individuals outside of the senior family member's bloodline. With a trust, the senior generation can choose to put limits on the people that will benefit from the gift. In addition, upon the death of a beneficiary, if an outright distribution is made, the beneficiary's share would be included in his or her gross estate for federal estate tax purposes. If, however, the grantor trust is exempt from the generation-skipping transfer tax ("GSTT") (i.e., the senior family member's available GSTT exemption has been allocated to the grantor trust), these assets can remain in trust and pass to trusts for even more junior family members without being subject to estate or generation-skipping transfer tax.

8. Rates and Yield Curves. Although short-term interest rates are normally lower than the mid-term and long-term rates, there are times when the mid-term interest rates and the long-term interest rates are less than the short-term interest rates. Furthermore, there are periods of time where the spread between short-term rates and long-term rates is minimal. As a result, it can be advantageous to try to time the loans to coincide with favorable interest rates. The IRS generally publishes rates for the following month about ten days in advance. So, for example, they published the September, 2009 rates on August 18th. Therefore, near the end of a month, planners can preview upcoming rates to time a transaction to take advantage of the most favorable rates.

9. Current Rates. The current annual interest rates (for September, 2009) are as follows:

- a. Short-term annual interest rate – 0.84%
- b. Mid-term annual interest rate – 2.87%
- c. Long-term annual interest rate – 4.38%

Rev. Rul. 2009-29, 2009-37 IRB ____.

10. Using A Balloon Note. As long as the interest rate on the note is less than the return earned by the borrower, it may make sense to maximize the loan for as long as possible. The more principal that is paid back during the term of the note, the less wealth transfer potential there is from senior family members to junior family members. As a result, it may be best to draft the note to provide for the payment of interest only during its term, with principal due only at maturity. While the unpaid principal balance will be included in the lender's estate if he or she dies before the loan is repaid, a note providing for interest-only payments lets junior family

members use funds as long as possible (and may provide more of an opportunity for senior family members to reduce the principal balance through annual exclusion gifts, if they choose to do so).

11. Payment at Maturity. Upon maturity, junior family members can either repay the loan or renegotiate the terms of the note. If interest rates decline during the term of the note, or if they are lower at maturity, it may be possible to renegotiate at a time when interest rates are favorable. To allow for this option, the promissory note should contain a provision which allows the outstanding principal balance to be repaid at any time without any penalty. *See Blattmachr et al., "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," 109 J. OF TAX'N 22 (2008).*

B. Sale to An Intentionally Defective Grantor Trust. Although a popular trust strategy, a sale of an asset to an Intentionally Defective Grantor Trust, or IDGT, can be somewhat complex to explain and expensive to set up. Why bother? For one thing, the payoff is potentially greater than with other strategies. In addition, a sale to an IDGT can provide a tax-advantaged way to pass assets to children and grandchildren while keeping the value of the trust's assets out of the estates of junior family members, as well as out of the estates of senior family members.

The Technique. An IDGT is a trust typically established by senior family members for the benefit of junior family members. Senior family members loan the trust money to buy an asset from the senior generation that has the potential to appreciate significantly. Many people use IDGTs to purchase family businesses or homes. Sales of interests in family limited partnerships are also popular. Most commentators agree that to be a credit-worthy borrower, the IDGT must have some assets in excess of the borrowed funds with which to repay the note. "Seed money" in the amount of 10% of the purchase price is typically recommended. In times of low interest rates, some estate planners consider IDGTs to be the ultimate freeze technique. They combine the interest rate benefits of intra-family loans with the discounting benefits of lifetime gifts. As with outright gifts, this technique works especially well if the sale can be consummated when market values are depressed.

Example: Clint has established a family limited partnership that holds \$12.5 million in cash and securities. Clint has recently had his interest appraised at \$10 million (a 20% discount). In August, 2009, Clint establishes an IDGT for the benefit of his children. To buy the limited partnership interest from Clint, the IDGT will need some cash, so Clint gives the trust \$1 million. Why \$1 million? That's the amount he's allowed to give away free of gift tax during his lifetime. Because Clint wants this trust to endure for generations, he will also use some of the \$3.5 million GST exemption he's allowed to shelter from the GST tax. With \$1 million in cash, plus a \$9 million loan from Clint, the trust will buy Clint's limited partnership interest valued at \$10 million. The note from the IDGT to Clint bears interest at the Applicable Federal Rate, which for loans of more than 9 years was 4.26% in August, 2009.

Of course, the goal is for the trust's assets to earn enough to cover the loan, while leaving something more for Clint's children and grandchildren. Based on past performance, Clint expects the partnership's investments to appreciate at least 8% a year—that would be more than enough to make the 4.26% interest payments. Over the next 20 years at 8%, Clint can expect

that the \$12,500,000 owned by the partnership will grow to around \$41 million, even after paying out \$383,400 per year to cover the interest on the note. At the end of the 20-year term, the trust will repay Clint his \$9 million. After repaying the note, the trust will hold nearly \$32 million, which will be available to Clint's children and grandchildren without having paid any gift or estate tax.

Because IDGTs are grantor trusts, Clint won't owe any income tax on the gains he realizes by selling his limited partnership interest to the trust, nor will he have to pay income tax on the interest payments he receives. As far as the IRS is concerned, it's as if Clint sold the asset to himself. Clint will, however, owe income tax on the partnership's earnings. In this example, though, the interest paid to Clint will more than offset his tax liability so long as the effective tax rate (earned through a combination of dividends, capital gains, and other income) is less than 22% or so. There are plenty of caveats. Neither the tax code nor case law specifically addresses IDGTs, and the IRS has been known to challenge them on occasion. Perhaps the biggest risk is that of the trust going bust. If its assets decline in value, the IDGT will have to come up with the cash to pay Clint. It can always use the money Clint gave it—the \$1 million. If that happens, Clint won't be able to reclaim his \$1 million gift tax exemption. It will have been wasted.

Specifics.

1. Structure of the IDGT. The key to the success of an IDGT transaction is the creation by senior family members of an irrevocable trust that (i) successfully avoids estate tax inclusion under Sections 2036 through 2038 of the Code; but (ii) which will be treated as a grantor trust for income tax purposes under Sections 671 through 677 of the Code. The so-called "string statutes" (statutes that cause trusts to be ignored if the grantor retains too many "strings") are similar in the income and transfer tax areas, but they are not the same. There are a number of "strings" on the list for grantor trusts in the income tax code that have no counterpart when it comes to estate and gift taxes. As a result, clients can create an IDGT, which is ignored for income tax purposes, but which will be given full effect for gift and estate tax reasons. When the senior family members sell limited partnership interests or other appreciating assets to the IDGT (typically for an interest-only promissory note with a balloon payment), the sale is ignored for federal income tax purposes. *See* Rev. Rul. 85-13, 1985-1 CB 184.

2. Seeding of Trust. The IRS has offered no official guidance, but most practitioners recommend that the trust have "equity" of about 10% of the purchase price. In most cases, clients provide this "seed" money by making a taxable gift of cash or assets to the trust, typically sheltering the gift from tax by using some of their unified credit. A gift tax return is filed, reporting both the seed gift and the sale, thereby starting the gift tax statute of limitations running on the values used in the sale. Some clients can use an existing grantor trust which already has sufficient assets to provide the seed money. Sometimes it may be impractical for a trust to be seeded with the appropriate level of assets (i.e., the senior family member is unwilling to incur a sizable taxable gift). Instead of (or in addition to partially) seeding the IDGT, the beneficiaries could personally guarantee the promissory note. However, the beneficiaries should independently have sufficient net worth to cover the amount of the guarantee. There is an element of risk with the guarantee approach because the IRS might take the position that the guarantee constitutes a gift from the beneficiary to the grantor trust. One way to reduce this risk is to have the trust pay the guarantor(s) a reasonable fee for the guarantee. *See* Hatcher &

Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 J. TAX'N 152 (Mar. 2000).

3. Impact of Interest Rates. When interest rates are low, sales to IDGTs 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.

4. Servicing the Debt. With regard to servicing the interest payments on the promissory note, the sale to the IDGT works especially well when rental real estate or other high cash-flow investments are sold. If these assets are contributed to a family limited partnership prior to being sold to the IDGT, a distributions of partnership rental or investment income to the IDGT can be used to service the note payments.

5. Grantor Trust Implications. Senior family members must thoroughly understand the notion of a grantor trust. They should understand their obligation to pay tax on the IDGT's income, even if the IDGT does not have cash flow to make interest payments (or if the interest payments are insufficient to service the debt or pay these taxes).

6. Death of Note Holder. As with an inter-family loan, if the lender dies during the term of the loan, any unpaid balance will generally be included in the taxable estate of the lender. Again, however, the value of the note is generally limited to the value of the collateral and the net worth of the borrower, without regard to any amount the borrower might inherit. *See Est. of Elizabeth v. Harper.*, 11 TC 717 (1948); TAM 9240003. If the grantor dies before the note is paid in full, or if grantor trust treatment is otherwise terminated before the note is paid off, there may be adverse income tax consequences, including recognition of gain on the sale, and future recognition of interest income on the note payments. *See Madorin v. Comm'r*, 84 TC 667 (1985); Treas. Reg. § 1.1001-2(c), Example 5; Rev. Rul. 77-402, 1977-2 CB 222; *Cf. Estate of Frane v. Comm'r*, 93-2 USTC ¶ 50,386 (8th Cir. 1993) (gain on SCIN recognized by *estate of payee* upon death of note holder); Peebles, "Death of an IDIT Noteholder," TRUSTS & ESTATES (August, 2005), p. 28.

7. Benefit to Heirs. The property in the IDGT in excess of the note obligation passes to the ultimate beneficiaries (typically junior family members, either outright or in further trust) with no gift tax liability. This is the goal of a sale to an IDGT. If the contributed assets grow faster than the interest rate on the IDGT's note, the excess growth passes to the IDGT beneficiaries with no additional gift or estate tax. With a sale to an IDGT, the IRS requires that the gift tax consequences be evaluated when the assets are sold in exchange for the note—not when the note is paid off.

8. GST Issues. Unlike a GRAT (discussed below), the senior family member can allocate GSTT exemption to the seed money contributed to the IDGT. As a result of that allocation, the IDGT has a GST inclusion ratio of zero, which means that all of the assets in the IDGT (both the seed money and the growth) can pass on to grandchildren or more remote generations with no additional estate or gift tax. This multi-generational feature can make a sale to an IDGT a much more powerful transfer tax tool than other similar wealth-shifting techniques.

9. Selling Discounted Assets. Appreciating or leveraged assets are an ideal candidate for sale. As noted in the example above, use of lack-of-marketability and minority interest discounts

can provide more bang for the buck. The trust pays interest at favorable rates on the discounted value, while the underlying assets grow at full market rates.

C. Grantor Retained Annuity Trusts. With a grantor retained annuity trust, or GRAT, heirs typically won't receive quite as much as they would with an IDGT. But GRATs, are also less risky, in part because they can be setup to completely avoid any gift tax consequences. Moreover, because the Code sanctions them, there is very little risk of running afoul of the IRS. In fact, GRATs have been so successful that the IRS has asked Congress to impose some restrictions on their use, for example, requiring them to have a term of at least ten years. See U.S. Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," p. 123 (May 11, 2009) (commonly called the "Greenbook"), which can be found at <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>. So far, Congress has not acted on this request.

The Technique. In many ways, GRATs resemble loans. As with a loan, they mature within a specified number of years. As a result, any money (or assets) that the client puts into the GRAT will be returned by the time the trust expires. So, what's in it for the client's heirs? Assuming all goes well, a big chunk of the earnings will go to them, free of gift and estate taxes.

Because a successful GRAT is one that appreciates a lot, it's best to select an asset that the client thinks is on the verge of a rapid run-up. The classic example: shares in a privately held company that is likely to go public. These days, beaten-down shares are also good candidates. In reality, any asset that the client expects to rise in value more rapidly than the IRS interest rate works—the higher the appreciation, the better.

Example: Greta owns all of the stock in her closely held business. Although there is no deal on the table, some potential buyers have expressed an interest in buying the company for \$15 million. Nevertheless, a business appraiser valued a one-third interest in the company at \$3 million (applying traditional lack-of-marketability and minority interest discounts). Greta decided to transfer a third of her stock to a GRAT, retaining the right to get back the \$3 million of value she put into the trust in equal annual installments. Greta will also receive a little extra—an annual interest payment designed to make sure she takes back what the IRS assumes the stock will be worth in 10 years, when the trust expires. To estimate the rate at which investments in these trusts will grow, the IRS uses the so-called "7520 rate," which is based upon 120% of the monthly mid-term Applicable Federal Rate. When Greta set up her GRAT in June, 2009, the 7520 rate was 2.8%. (In August and September of 2009, the rate was 3.4%)

If Greta's stock appreciates by more than the 2.8% annual hurdle rate, the excess profits will remain in the trust and eventually go to her two children. In fact, if the sale eventually goes through, the trust will hold \$5 million (remember that Greta only gave away one-third of her stock). If that happens, nearly \$2 million in value will pass to the kids with no gift or estate tax. If the sale doesn't happen and the stock doesn't increase in value, the trust will simply give Greta her stock back over the term of the trust. In that event, Greta may have wasted some money on professional fees (the attorney, accountant and appraiser fees she spent to set up the trust, report the gift and value the stock). But the GRAT will simply pay her back what's left of her investment by the time it expires—no one is required to make up for a shortfall.

Clients with diversified investment portfolios might want to use a separate trust for each class of investments they own. For example, a client might set up three \$1 million GRATs—one composed of U.S. small-cap stocks, another of commodities, and a third of emerging-markets stocks. If any of these three asset classes outperform the 7520 rate, the client will have effectively shifted wealth. Those assets that underperform will simply be returned to the client, perhaps to be "re-GRATed". Had the client instead combined these three volatile investments into a single GRAT, he or she would run a risk that losses on one might offset gains on another. Many advisers favor limiting GRAT terms to as few as two years. That way, if a particular investment soars, the client will be able to get the gains out of the GRAT before the market cycles back down again.

As with IDGTs, GRATS are grantor trusts. As such, they allow the grantor to pay capital-gains and income taxes on the investments in the GRAT on behalf of his or her heirs. Because the IRS doesn't consider such tax payments a gift, they are another way to transfer wealth to the next generation free of gift and estate taxes.

As with any estate planning technique, there are drawbacks. Because GRATs have to pay higher interest rates than short-term and medium-term family loans, they pass along slightly less to heirs. In addition, GRATs must make fixed annual payments. Unlike a sale to an IDGT, the grantor can't defer the bulk of the payments for years into the future by using a balloon note. The biggest risk with a GRAT is that the client might die before the trust ends. In that situation, it's as if the GRAT never existed: Its entire value—including returns—is generally included in the client's estate and subject to estate tax.

Specifics.

1. Structure. In the typical GRAT, a senior family member transfers assets to a trust, which provides that he or she will receive an annual annuity payment for a fixed number of years. The annuity amount can be a fixed dollar amount, but most estate planners draft the GRAT to provide for the payment of a stated percentage of the initial fair market value of the trust. That way, if the IRS challenges the initial valuation, the payment automatically adjusts. As discussed below, most GRATs are "zeroed out"—that is, payments are usually set so that the actuarial value of the interest passing to the heirs is very close to zero. Once property is contributed to the GRAT (i) no additional assets can be contributed; and (ii) the GRAT cannot be "commuted" or shortened by accelerating payments.

2. Setting the Annuity. The annuity can be a level amount, or an amount that increases each year, although the IRS regulations limit the amount of each annual increase to not more than 20% per year. By providing for an increasing annuity payment each year, payments can be minimized in early years leaving more principal to grow in the GRAT for a longer period of time. If the asset consistently grows in value at a rate that exceeds the GRAT interest rate, retaining these extra funds will allow the principal to generate additional appreciation.

3. Gift on Formation. Upon the creation of the GRAT, the grantor is treated as making a gift to the ultimate beneficiaries equal to the initial value of the trust assets, reduced by the present value of the annuity payments retained by the senior family member. Since a GRAT results in a gift of a future interest, no annual exclusion can be used to shelter the gift tax. As a result, taxpayers who set up GRATs must file gift tax returns to report the transfer. The present

value computation of the retained annuity is based upon the term of the GRAT and the Section 7520 rate in the month that the GRAT is created. Fortunately, the IRS is bound by the actuarial computation performed in the month the GRAT is created. They can't come back and the end of the GRAT term and re-assess how the GRAT actually did to measure the gift tax.

4. Impact of Interest Rates. The common wisdom is that GRATs work best in times of low interest rates and depressed markets. This notion is based upon the fact that the lower the Section 7520 rate, the lower the annuity payments need to be to zero out the GRAT. As a result, at the end of the annuity term, more assets will be available to pass to the ultimate beneficiaries gift tax free. Surprisingly, studies have shown that for short-term GRATs, current interest rates have very little impact on the success rate of the GRAT. Instead, GRATs work best when the value of the assets contributed to the GRAT are depressed and rebound in the short term to far exceed their value at the time of contribution. In fact, one study showed that the success of short-term GRATs are impacted only about 1% by the Section 7520 rate, 66% by first-year growth, and 33% by second-year growth. *See* Zeydel, "Planning in a Low Interest Rate Environment: How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies?" 33 ESTATES, GIFTS & TRUSTS J. 223, 226 (2008).

5. Zeroed-Out GRATs. The most popular form of GRAT involves a short-term, "zeroed out" GRAT, in which the term of the GRAT is limited to no less than two years, and the present value of the retained annuity amount is structured to nearly equal the amount transferred to the GRAT. This approach produces a very small (near zero) taxable gift. As noted earlier, the IRS would like to see Congress require longer term GRATs, and limit the payments so that the value of the remainder interest is at least 10% of the value of the initial contribution. If the senior member survives the annuity term, none of the GRAT assets will be includible in his or her gross estate for estate tax purposes.

6. Death During GRAT Term. If the senior family member dies during the annuity period, the senior family member's estate will include the lesser of (i) the GRAT assets at the date of death; or (ii) the amount necessary to yield the remaining annuity. *See* Treas. Reg. §§ 20.2036-1(c), 20.2039-1(e); T.D. 9414 (7/14/08). In many cases, the amount necessary to yield the remaining annuity is very close to the entire value of the GRAT, so virtually the entire GRAT value gets included in the estate of the deceased senior family member.

7. Payments in Kind. The annuity does not have to be paid in cash. Instead, it can be paid "in kind" (i.e., with a portion of the assets initially contributed to the GRAT). However, if the GRAT assets are rapidly appreciating, a return of these assets creates a "leak" in the freeze potential of the GRAT. One partial solution to this "leak" is to have the grantor contribute the distributed assets into a new GRAT. The GRAT must expressly prohibit the use of a promissory note to make the GRAT payments.

8. Benefit to Heirs. At the end of the annuity period, the property remaining in the GRAT (after paying the senior family member the annuity) passes to the ultimate beneficiaries (typically junior family members, either outright or in further trust) with no further gift tax liability. This is the goal of a GRAT, and why highly appreciating assets work best. If the contributed assets grow faster than then GRAT interest rate, the excess growth passes to the GRAT beneficiaries. Remember, the IRS requires that the gift tax consequences be evaluated when the GRAT is created—not when the GRAT term comes to an end.

9. GST Issues. Unfortunately, the senior family member cannot allocate GSTT exemption to the GRAT until the end of the GRAT term (i.e., the end of the estate tax inclusion period or "ETIP"). *See* IRC § 2642(f). Therefore, the senior family member cannot leverage the GSTT exemption by allocating it to the GRAT property before it appreciates in value. (To circumvent the ETIP rules, some practitioners have suggested that the remainder beneficiaries of the GRAT could sell their remainder interest to a GSTT exempt dynasty trust, from which distributions can be made to future generations free of transfer taxes; however, there are no cases or rulings approving this sort of transaction). The ETIP rules mean that GRATs do not allow for efficient allocation of GSTT exemption. Therefore, GRATs are typically drafted to avoid the imposition of GSTT. For example, children can be given a "conditional" or standard general power of appointment. Naturally, if the GRAT assets are expected to continue to appreciate after the GRAT term ends, GSTT exemption can be allocated to the trust, based upon the fair market value of the assets retained by the trust at the end of the GRAT term.

10. Short-term v. Long-term GRATs. As indicated above, the use of short-term (i.e., 2-year) GRATs have typically been more popular than using longer term GRATs. The reasoning behind the preference for short-term GRATs is twofold. First, using a short-term GRAT reduces exposure to the risk that the senior family member will die during the term, which, as stated above, would cause all or a portion of the value of the GRAT assets to be included in the senior family member's gross estate. Second, a short-term GRAT minimizes the possibility that a year or two of poor performance of the GRAT assets will adversely impact the overall effectiveness of the GRAT. When funding a GRAT with volatile securities, a series of short-term GRATs typically perform better than a single long-term GRAT. Notwithstanding the benefits of short-term GRATs illustrated above, in times of low interest rates, a longer term GRAT may be more desirable because it allows the senior family member to lock in a low 7520 rate for the duration of the GRAT term. *See* Melcher, "Are Short-Term GRATs Really Better Than Long-Term GRATs?" 22 ESTATE PLANNING 23 (2009).

11. Insuring the GRAT. As mentioned above, if the senior family member dies during the annuity term, all or a portion of the GRAT assets will be included in his or her gross estate. In that event, the GRAT would be ineffective to pass assets to the senior family member's beneficiaries free from estate or gift tax. In order to "insure" that the GRAT technique works, a life insurance policy can be purchased on the senior family member's life which coincides with the term of the GRAT and the assets contributed to it (e.g., for a 10-year GRAT, the client would buy a 10-year term policy with a face value equal to the projected estate tax that would otherwise be imposed if the GRAT fails). Such a policy would presumably be purchased by an irrevocable life insurance trust ("ILIT") so that the proceeds of the policy would not be subject to estate tax upon the senior family member's death.

D. Charitable Lead Annuity Trusts. Similar to GRATs, charitable lead annuity trusts ("CLATs") can pass most of their investment gains to heirs, while reducing or eliminating gift and estate taxes. But unlike a GRAT, which returns interest and principal to the grantor, a CLAT typically gives everything away, first to charity, and then to junior family members.

The Technique. Annual payments, typically of a fixed amount, must go to charity. What's left is generally earmarked for junior family members. Of course, it makes little sense for a client to set up a CLAT unless he or she is charitably inclined. But for clients with charitable objectives who own assets that they expect to appreciate at rates higher than current IRS interest rates, these

trusts can be better than giving the assets away outright, because they can also permit a tax-free (or at least tax-advantaged) transfer of wealth to the next generation. There is more than one way to structure a CLAT. For example, the tax treatment will vary, depending on whether the client wants to receive an upfront income tax charitable deduction. The availability of the deduction can be especially important to clients who will have a "liquidity event" (with resulting high taxes) in a single year. The trade-off, however, is that taxes payable in later years may potentially go up.

Example: Charlie, 61, sold his business this year for \$10 million. He started the business years ago on a shoe string, so he has a large capital gain. In addition, part of the purchase price was for a "non-compete" agreement, which will be ordinary income to Charlie. He contributed \$1,000,000 to a 20 year CLAT in June, 2009. He structures the CLAT to pay out 5% of the value initially contributed to the trust, so the CLAT will pay his favorite charity \$50,000 per year for the next 20 years. (Charlie was already contributing this much to charity, so he no longer needs to budget for that from his other funds). In addition to benefiting charity over the long run, Charlie gets a \$786,870 income tax deduction, which goes a long way toward offsetting the income-tax bill he triggered earlier in the year. The remaining value (\$213,130 in this example) will be treated as a gift by Charlie to the remainder beneficiaries of the CLAT (in his case, his children). Charlie can use part of his \$1 million lifetime gift tax exemption to prevent paying tax on the gift to his kids. If the trust invests its assets at an average return of 8% per year, the trust will have nearly \$2.4 million in it at the end of the 20th year, even after paying \$50,000 per year to Charlie's favorite charity. This property will pass to Charlie's kids at a cost of only \$213,130 of Charlie's gift tax exemption. One caveat that clients have to remember: As with most gifting strategies, once you put money into one of these trusts, you can't get it back. The trust has to be irrevocable and unamendable to work.

Some—most famously Jacqueline Onassis—leave instructions in their Will to create these trusts after death. But those who set them up while alive have a big advantage: They can select the most opportune moment to act. When interest rates are low, they are very attractive. The charity benefits from the annual annuity, and if the market outperforms the IRS rate over the term of the CLAT, heirs benefit too.

Specifics.

1. **Basic Structure.** In the usual case, senior family member transfers assets to the CLAT. The trust pays a fixed dollar amount to one or more charities for a specified number of years. Alternatively, the CLAT may be structured to last for the life or lives of (a) the senior family member; (b) his or her spouse; and/or (c) a lineal ancestor (or spouse of a lineal ancestor) of all of the remainder beneficiaries (or a trust in which there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus). Treas. Reg. §1.170A-6(c)(2)(i)(A). Unlike a GRAT (or a charitable remainder trust), a CLAT is not subject to any minimum or maximum payout. The CLAT may provide for an annuity amount that is a fixed dollar amount, but which increases during the annuity period, so long as that the value of the annuity is ascertainable at the time the trust is funded. *See* Rev. Proc. 2007-45, 2007-29 IRB 89. Instead of paying a fixed dollar amount, the trust can be set up to pay a set percentage of the value of its assets each year, in which event it is called a "charitable remainder unitrust" or "CLUT." In inflationary times, a CLAT tends to pass more property to remainder beneficiaries than a CLUT, so a CLAT is the more common structure. The CLAT can be created during the

senior family member's lifetime or upon his or her death pursuant to his or her will or revocable trust. The charity receiving payments may be a public charity or a private foundation, but in the case of a private foundation, the grantor cannot participate in any decisions regarding the amount distributed from the CLAT to the private foundation. (In order to prevent this participation, the foundation's organizational documents should be reviewed and modified accordingly. *See* PLR 200108032, 200138018.)

2. Gift on Formation. When the senior family member contributes assets to a CLAT, he or she makes a taxable gift equal to the present value (based on IRS tables) of the remainder interest that will pass to the non-charitable beneficiaries. Like "zeroing out" a GRAT, CLATs can be structured so that the gift or estate tax on the remainder interest will be small or non-existent. This result is accomplished simply by ensuring that the present value of the payments to be made to charity (using IRS rates at the time the trust is formed) is equal to the value of the initial contribution.

3. Setting the Interest Rate. The value of the non-charitable beneficiaries' interest is calculated using the Section 7520 rate in effect for the month that the assets are transferred to the CLAT. The transferor has the option, however, to use the Section 7520 rate in effect for either of the two months preceding the transfer. IRC § 7520(a). To make the election, the grantor attaches a statement to his or her gift tax return identifying the month to be used. Treas. Reg. § 25.7520-2(b). Because IRS rates are published around the third week of each month, the grantor in effect has the option of picking from four months of Section 7520 rates (including the rate in the current month, the preceding two months and the succeeding month).

4. Income Tax Issues. If the CLAT is structured as a grantor trust for income tax purposes, then the grantor is entitled to receive an up-front income tax charitable deduction equal to the present value, based on IRS tables, of the interest passing to charity. IRC § 170(f)(2)(B). The charitable deduction is typically subject to the 30%-of-AGI deduction limitation, since the gift is treated as a gift for the use of charities. Treas. Reg. § 1.170A-8(a)(2). Of course, to get this deduction, the CLAT has to be a grantor trust, which means that the grantor must pay tax on all of the CLAT's income during its term. If a grantor trust structure is chosen, the grantor gets no additional deduction for amounts paid by the trust to the charity during the term of the CLAT. If the CLAT is *not* structured as a grantor trust, then the grantor is not entitled to any income tax charitable deduction for amounts paid to charity. Instead, the CLAT is responsible for the payment of the income taxes attributable to any income earned by the CLAT. In that event, the CLAT receives an income tax deduction for the amount paid to charity each year. IRC § 642(c)(1).

5. Death During Term. If the grantor dies during the term of the CLAT, none of its assets will be included in the grantor's estate, since the grantor has not retained any interest in the trust. If grantor trust treatment was used to give the grantor an initial income tax deduction, and if the grantor dies (or grantor trust treatment is otherwise terminated) during the trust term, the original income tax charitable deduction, less the discounted value of trust income already paid to charity, must be recaptured. IRC § 170(f)(2)(B).

6. Benefit to Heirs. At the end of the annuity term, the assets remaining in the CLAT pass to one or more non-charitable beneficiaries, such as the senior family member's children or other family members (or to one or more trusts for their benefit). If, over the annuity term, the

CLAT generates total returns higher than the Section 7520 rate, the excess growth passes to the non-charitable beneficiaries free from any estate or gift tax.

7. GST Issues. Unlike with a GRAT, the grantor is technically permitted to allocate a portion of his or her GSTT exemption to the CLAT at the time the CLAT is funded. *See* IRC § 2632(a); Treas. Reg. § 26.2632-1(a), (b)(4). If the CLAT is structured so that the taxable gift is small or non-existent, the GSTT exemption allocated to the CLAT would be nearly zero. Unfortunately, the actual amount of GSTT exemption allocated to the CLAT is determined when the CLAT terminates. IRC § 2642(e)(1). The amount of GSTT exemption allocated is treated as growing at the Section 7520 rate, and not at the real rate of growth of the trust assets. IRC § 2642(e)(2). If the value of the non-charitable remainder interest exceeds the GSTT exemption initially allocated to the CLAT, as increased by the prevailing 7520 rates, the grantor can allocate any portion of his or her remaining GSTT exemption to the excess at the time the charitable interest terminates.

8. CRATs and Business Interests. There can be complications if the CLAT is funded with interests in a closely held entity such as a family limited partnership ("FLP"), membership units in an LLC or (non-voting) shares in a corporation. CLATs generally are subject to the same rules as private foundations. If the charitable value of the interest of the CLAT is greater than 60% of the fair market value of the assets contributed to the CLAT, the "excess business holding" rules will apply. In that case, the CLAT may face an excise tax if it does not divest itself of the FLP units within five years of their contribution to the CLAT. Selling the FLP units may prove to be difficult for the CLAT because the only willing buyers may be members of the donor's family, and the rules against self-dealing (which apply even if the value of the charitable interest is less than 60% of the fair market value of the CLAT) would prevent a sale to a family member. Furthermore, if a valuation discount is applied in valuing a gift of FLP units to a CLAT, additional complications may arise if the charitable beneficiary of the CLAT is a private foundation that is controlled by the donor or his or her family. In that event, an overly aggressive discount, which substantially reduces the required annuity payments to the foundation, may be viewed as an act of self-dealing on the part of the trustees of the CLAT.

9. Best Time for CLATs. CLATs are most attractive when interest rates are low. The lower the interest rate, the greater the potential for tax-free wealth transfers using a CLAT. In addition, the lower the interest rate, the lower the taxable gift and the greater the income tax charitable deduction. In addition, like other techniques discussed above, because the gift to remainder beneficiaries is tied to growth above the IRS interest rate, CLATs work best when the value of the assets contributed to the CLAT are depressed and the value is expected, over the term of the CLAT, to rebound to or exceed its former value.

E. Outright Gifting. Outright gifts lack the sizzle and sophistication of the alphabet soup of more exotic techniques. Simple annual exclusion gifts, however, can have a dramatic impact on wealth shifting over time. For clients willing to pay a current gift tax, the results can be even more impressive. The impact of gifting can be even more impressive when the value of the assets given are depressed, and when the number of donees is large.

The Technique: Outright gifts can be as simple as handing cash or writing a check to the donee. Gifts can take the form of stock, real estate (or undivided interests in real estate), life insurance policies, or family limited partnership interests. Gifts to minors can be placed into custodial

accounts (although to ensure that the assets are not included in the donor's estate if he or she dies before the donee reaches age 21, the donor should not serve as custodian). Section 529 plans offer another opportunity for gifting to minors, although gifts to Section 529 plans must take the form of cash. For donors who feel that the estate tax is here to stay, even taxable gifts may make sense, since the gift tax is tax exclusive (i.e., it is based upon the net amount received by the donee), whereas the estate tax is tax inclusive (i.e., all dollars are subject to the estate tax, including the dollars used to pay the tax).

Example: Gary and Gwen have four married children and seven grandchildren. In March, 2009, they decide to make gifts to their children, in-laws and grandchildren using their annual gift tax exclusion (\$13,000 in 2009). With four children, their four spouses, and seven grandchildren, Gary and Gwen can each make 15 annual exclusion gifts, for a total of \$390,000. Gifts to the grandchildren are placed into custodial accounts, with each grandchild's parent serving as custodian. In this case, each donee used the funds received to buy a Dow Jones index fund when the average stood at 6,600. With the Dow now trading near 9,500, the value of assets transferred out of Gary and Gwen's estate exceeds \$575,000.

Example: Dave has a large estate well in excess of any funds he will spend during his lifetime. He has used all of his gift tax exemption, and plans to transfer \$12 million to his children either now or when he passes away. If he waits until his death, the tax on \$12 million (if the estate tax is not repealed) will be \$5,400,000, (45% of \$12 million) leaving \$6,600,000 for his children. If Dave makes the gift today, he could give the kids \$8,275,862, in which case the gift tax (ignoring annual exclusions) would be \$3,724,138 (45% of \$8,275,862), fully exhausting Dave's \$12 million. Assuming that Dave lives for at least three years after the gift, the net result is an additional \$1,675,862 to the children. While Dave will have to pay the gift tax next April 15th instead of waiting to pay the estate tax at death, the kids will have the \$8.2 million, *plus growth* during Dave's lifetime, without any additional gift or estate tax.

Specifics:

1. What to Give. Despite the basis issues discussed below, estate planners generally recommend making outright gifts when market conditions are depressed—sometimes called "natural discounting" (i.e., making gifts of stock when the stock market takes a significant downturn, or gifts of real estate when the real estate market is depressed). As mentioned above, post-gift appreciation lands in the junior generation's hands with no gift or estate tax. In the first example above, if Gary and Gwen consistently make annual exclusion gifts for 10 years, and if the donees invest the funds only at 5% per annum, Gary and Gwen could move over \$5.1 million from their estates with no gift or estate tax. In the second example above, even if no additional gifting were done, if Dave's kids invested the gifted property at 5% per annum for ten years, the property would grow to over \$13 million. All of this growth would be removed from the senior family member's estate and pass to the junior family members, free of gift and estate tax.

2. Paying Gift Tax. Since 2001, donors have been reluctant to make gifts in excess of their \$1 million gift tax exemption, because if the estate tax is actually repealed, the tax payment would be unnecessary. The donor would pay gift tax now, but no estate tax would be due if the property was held until death. With the prospect of estate tax repeal now unlikely, clients with estates in excess of the estate tax threshold should re-evaluate this strategy.

3. Gift Tax and the Three Year Rule. If gift tax is actually paid, the tax saving that results from the tax-exclusive nature of the gift tax is available only if the senior family member lives for at least three years after making the gift. Congress, recognizing that the gift tax is cheaper than the estate tax, imposes a special rule to prevent death-bed gifts to minimize tax. As a result, if a donor dies during the 3-year period after making the gift, any gift taxes attributable to the gift are added to the donor's gross estate for federal estate tax purposes. IRC §2035(b). In Dave's example, adding the \$3,724,138 in gift taxes paid to Dave's estate would increase his estate tax by \$1,675,862, exactly recapturing the benefit that the kids received from the gift.

4. Carry-Over Basis. In making gifts, the issue of basis is always important. While an inherited asset generally gets a new cost basis equal to its value for federal estate tax purposes, property received by gift generally receives a carry-over of the donor's basis, increased (but not above fair market value) by the amount of the gift tax paid with respect to the gift. IRC § 1015. In fact, if the beneficiary sells the property for less than the donor's basis, the beneficiary may have his or her basis limited to the fair market value of the property at the date of the gift, if that value is less than the donor's basis. IRC § 1015(a). However, with capital gains rates at 15% and the top estate tax rate at 45%, in most situations, a gift is still more beneficial from an overall tax perspective.

5. Income Tax Issues. As with intra-family loans, the impact of income taxes on the junior family members needs to be considered. If the senior family members want to assume responsibility for tax on the income earned on the gifted property, the gift can be made to a grantor trust instead of outright to the junior family members. That way, the income tax burden on the assets gifted to the junior family members can remain the responsibility of the senior family member without any additional gift tax. *See* Rev. Rul. 2004-64, 2004-2 CB 7.

6. Giving Discounted Assets. Gifting for wealth transfer usually focuses on giving low valued assets. These values may be the result of market forces, or may result from introduced factors such as gifts of interests in businesses that have lack-of-marketability and minority interest discounts. If, for example, a fractional interest in real estate is being gifted or a limited partnership interest in a family limited partnership, the leveraging can be magnified.

F. SCINs and Private Annuities. What if your client may not survive to his or her actuarial life expectancy? People in this unfortunate situation may consider selling assets (especially undervalued assets) to a junior family member. If a simple note is given for the purchase price, the potential to move appreciation is the same as for other transactions discussed above. But where life expectancy is an issue, the payment given in exchange for the asset can take the risk of death into account. The most popular forms of payment in these circumstances are self-cancelling installment notes ("SCINs") and private annuities.

The Technique: As its name suggests, a self-cancelling installment note is a promissory note providing that if the seller dies before the note is paid in full, any unpaid amounts are cancelled. The seller's death during the term of the note creates a windfall to the buyer, because he or she won't have to make any further payments on the note, regardless of the amount of the outstanding balance. To compensate the seller for the risk of losing money because of an early death, the note provides a "kicker," in the form of extra interest, extra principal, or both, that will be received if the seller survives. A private annuity is a similar arrangement. Instead of giving a note, the buyer promises to make a fixed annual payment to the seller for life, no matter how

long the seller lives. Since the payment obligation (whether the SCIN or the annuity) terminates at death, no value is included in the seller's estate for any unpaid amounts. Of course, the amounts received by the seller during his or her lifetime (to the extent not consumed, given away, or otherwise disposed of) will be included in the seller's estate. The IRS publishes life expectancy tables that can be used to value the SCIN premium or the private annuity, so long as the seller isn't "terminally ill." In either event, the buyer can be a junior family member, or an IDGT. *See* Bisignano, "Estate Planning for the 'Terminally Ill' Client—A Checklist for the Estate Planning Advisor," 33rd Annual State Bar of Texas Adv. Est. Planning & Prob. Course (2009).

Example: In January 1995, Scott, then age 70, was not terminally ill but was not expected to live for his actuarial life expectancy. Scott sold FLP units having an undiscounted value of \$10,000,000 and a discounted value of \$7,000,000 to an IDGT for the benefit of his children and grandchildren in exchange for a 9-year SCIN. Scott died at the beginning of year 8 of the 9-year term, when the FLP assets had appreciated to \$20,000,000 (or roughly 10.4% per year, compounded annually). The required interest rate on the SCIN, including the mortality risk premium, would have been 13.864%, corresponding to an annual interest payment of \$970,480. Over the first 7 years of the SCIN, the trust would have paid the Scott a total of \$6,793,360 in interest payments. The remaining \$13,206,640 of value of the FLP units would have been retained by the IDGT. If, instead, this transaction had occurred in June, 2009, the required interest rate on a SCIN for a 70-year-old, including the mortality risk premium, would have been 6.357%, corresponding to an annual interest payment \$444,990. Over the first 7 years of the SCIN, the trust would have paid the Scott a total of \$3,114,930 in interest payments. The remaining \$16,885,070 of value of the FLP units (over \$3.5 million more than that in the prior example) would have been retained by the trust.

Example: In January 1995, Patrick, then age 70, sells FLP units having an undiscounted value of \$10,000,000 and a discounted value of \$7,000,000 to a defective grantor trust for the benefit of his descendants in exchange for a lifetime annuity. Patrick dies 9 years later, when the assets held by the FLP have appreciated to \$18.7 million (roughly 7.2% per year, compounded annually). In 1995, the applicable interest rate would have been 9.6%, requiring the trust to pay Patrick \$1,067,399 annually. Over the 9-year term of the annuity, Patrick would have received a total of \$9,606,591 in annuity payments. The remaining \$9.1 million of value would have been retained by the trust. If, instead, the sale had taken place in June, 2009, the applicable interest rate would have been 2.8%, requiring the trust to pay Patrick only \$631,427 per year. Over the 9-year term of the annuity, Patrick would have received only \$5,682,843 in annuity payments, leaving over 13 million in value in the trust (over \$4.1 more than in the prior example).

Specifics:

1. SCIN Terms. A SCIN is similar to a sale of assets for a traditional interest-only note with a balloon payment due upon maturity, except that the note terminates upon the earlier of the note's maturity date or the senior family member's death.

2. Risk Premiums. Because the buyer's obligation to pay back the note could terminate on the senior family member's death during the note term, a mortality risk premium must be charged. This risk premium can take the form of a higher interest rate, a higher sales price, or both. In any event, the exact amount of the premium is determined by the senior family member's actuarial life expectancy (based on IRS tables). The older the senior family member

is, the higher the risk premium must be. If a premium is not paid, the transaction may constitute a bargain sale, resulting in a gift from the senior family member to the buyer. *See Costanza Est. v. Comm'r*, 320 F.3d 595 (6th Cir. 2003).

3. Death Before Maturity. If the senior family member dies prior to the SCIN's maturity date, any unpaid principal or accrued interest is not includible in his or her estate. *Estate of Moss*, 74 TC 1239 (1980), *acq. in result in part* 1981-2 CB 2. On the other hand, if the senior family member lives until the note fully matures, he or she will receive not only the full payment price, but also the interest or purchase price premium. While Section 61(a)(12) of the Code generally treats debt forgiveness as income to the borrower, forgiveness of indebtedness that takes the form of an inheritance is an example of the "detached and disinterested generosity . . . affection, respect, admiration, charity or like impulses" that characterize a gift excludable from the recipient's income. *See, Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960). It is well settled that cancellation of a debt can be the means of effecting a gift. *See, e.g., Helvering v. American Dental*, 318 U.S. 322 (1943). A testamentary cancellation of a debt owing to the decedent can similarly be the means of effecting a gift in the form of a bequest. TAM 9240003

4. Impact of Life Expectancy. SCINs work best when the senior family member is not expected to live for the duration of his or her life expectancy, provided that he or she is not "terminally ill." If the senior family member is terminally ill, the standard mortality tables of Section 7520 of the Code may not be used. Treas. Reg. § 25.7520-3(b)(3). The Treasury Regulations provide that an individual is terminally ill if he or she has at least a 50% chance of dying within one year. *Id.* However, the taxpayer benefits from a rebuttable presumption that the individual is not terminally ill if he or she lives for at least 18 months after the date of the SCIN. *Id.*

5. Impact of Interest Rates. As the foregoing example illustrates, like traditional intra-family loans, SCINs work best when interest rates are low. In a low interest rate environment, the interest rate on a SCIN, including the mortality risk premium, can be significantly lower than even a traditional note in a high interest rate environment. Likewise, a SCIN's benefits can be amplified when used in conjunction with a sale of discounted or appreciating assets, such as limited partnership units in an FLP, membership units in an LLC or (non-voting) shares in a corporation, to a defective grantor trust.

6. Private Annuities. A private annuity works much like a SCIN. The senior family member transfers assets to a junior family member in exchange for junior's promise to make fixed payments to senior for the remainder of senior's life. Because the annuity terminates upon the senior family member's death, it is not includible in his or her estate. For gift tax purposes, the value of the annuity payments is based on the 7520 rate and the senior family member's life expectancy. If the fair market value of the assets transferred from senior to junior equals the value of the annuity, there is no gift tax due. As with a SCIN, the senior family member may use the standard mortality tables of Section 7520 of the Code, provided that he or she is not "terminally ill." Treas. Reg. § 25.7520-3(b)(3). As explained above, the Treasury Regulations provide that an individual is terminally ill if he or she has at least a 50% chance of dying within one year, but there is a rebuttable presumption that the individual is not terminally ill if he or she lives at least 18 months after the transfer. *Id.*

7. Income Taxation of Annuity Payments. Until recently, the IRS treated a private annuity much like a SCIN for income tax purposes, with the senior family member reporting any gain ratably over the annuity term. *See* IRC § 72; *see also* Rev. Rul. 69-74, 1969-1 CB 43. However, under proposed regulations, the ratable recognition approach is not available in the context of a sale for a private annuity. Instead, the senior family member is required to recognize gain at the time the assets are transferred in exchange for the annuity. Prop. Treas. Reg. §1.1001-1(j). Note, however, that these regulations are merely proposed, and are not binding on taxpayers until they become final. Note also that if the assets are sold to a grantor trust, no gain is recognized on the sale. *See* Rev. Rul. 85-13, 1985-1 CB 184.

8. Outliving the Tables. Unlike a SCIN, the payments under a private annuity don't end at a fixed maturity date. While both a SCIN and a private annuity risk added value to the senior family member's estate if he or she lives to maturity, the private annuity payments must continue to be paid for life. If the senior family member lives substantially beyond his or her life expectancy, these additional payments can add substantial value (and taxable income) to the recipient's estate.

9. Best Time for Private Annuities. Like SCINs, private annuities can be used in conjunction with a sale of appreciating assets, such as limited partnership units in an FLP, membership units in an LLC or (non-voting) shares in a corporation, to a defective grantor trust. They work best when interest rates are low because the annuity payments required to be made by the buyer to the senior family member will be lower, thereby allowing the trust to retain more of the transferred assets at no transfer tax cost to the senior family member. *See* Tiesi, "The Beauty of SCINsurance," TRUSTS & ESTATES (June 2009), p. 32.

G. Sale to "Accidentally Perfect Grantor" Trusts. With a much larger federal estate tax exemption, maybe we should consider standing some traditional estate planning tools on their heads. Instead of an Intentionally Defective Grantor Trust, why not what I am christening an "Accidentally Perfect Non-Grantor Trust" ("APGT")? This one may be a little bit out there, but in the right circumstances, the benefits could be dramatic. The typical candidate is a self-made individual whose parents are people of modest means. Unlike the tools discussed above, this technique can actually benefit the donor fairly directly, in a tax-advantaged way.

The Technique. An APGT is a trust established by a junior family member for the benefit of his or her parent or a more senior family member. Junior loans the trust money to buy an asset with lots of appreciation potential from the junior family member. Initially, the trust would be set up as an IDGT for the benefit of the senior generation, but this is an IDGT with a twist. After the note is paid off, grantor trust treatment can terminate. In addition, from day one, the trust has language built into it that causes the trust assets to be *included in the estate of the senior generation for federal estate tax purposes*. Note that a similar effect can be achieved by having the junior family member 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, allows junior to prescribe the terms of the trust and protect assets from the creditors of the senior family member.

Example: Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary's net worth is perhaps \$100,000. Jenny recapitalizes the company so that

it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary's benefit, 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 to make sure that the sale is respected for 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 (Just in case, the IDGT contains the same trust to receive the property if Mary fails to exercise her power of appointment). When Mary dies four years later, the stock has appreciated to \$2 million in value. Because the trust assets are included in Mary's estate, the stock gets a new cost basis of \$2 million. The trust assets, when added to Mary's other assets, are well below the estate tax exemption of \$3.5 million. Mary's executor uses some of Mary's \$3.5 million GST exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property: (i) it can't be attached by her creditors; (ii) it can pass to Jenny's children, or whomever Jenny wishes to leave it to, without estate tax; (iii) principal from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants without gift tax; and (iv) income from the trust can be sprinkled, at Jenny's discretion, among herself and her descendants, thereby providing the ability to shift the trust's income to taxpayers in low income tax brackets.

Specifics.

1. Structure of the APGT. While I call this trust "accidentally perfect" to distinguish it from an "intentionally defective" trust, there nothing accidental about it. The key to the success of an APGT is the creation by a junior family member of an irrevocable trust that (i) successfully avoids estate tax inclusion for the junior family member under Sections 2036 through 2038 of the Code; but (ii) which will intentionally cause estate tax inclusion for a senior family member who has estate tax (and GSTT) exemption to spare. The APGT would typically be structured as an IDGT, buying rapidly appreciating assets from the junior family member. It would maintain all of the trappings of a traditional IDGT, at least until the purchase price is paid. But the agreement establishing the APGT trust also grant 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. If the trust assets, together with those of the senior family member, were expected to grow beyond the available estate tax and GSTT exemption, a formula general power could be used to allow the senior family member to appoint the smallest amount of property which, when added to their other assets, would not cause his or her estate to exceed the exemption equivalent. When the junior family members sells appreciating assets to the APGT, its 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 GSTT benefits) upon the death of the senior family member.

2. Basis Issues. If the junior family member gives assets to a senior family member, and those same assets are inherited by 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, the senior family member appoints the assets back not to the donor, but to a different taxpayer—a dynasty trust of which the donor happens to be a beneficiary. This distinction should permit a new basis, even if the donor dies within a year of the assets being given 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.

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, it is the growth in excess of the purchase price (plus the AFR on any part of the deferred purchase price) that ultimately lands in the dynasty trust for the junior family member.

4. Benefit to Heirs. The property in the APGT in excess of the note obligation passes to a new dynasty trust for the ultimate beneficiaries (typically one or more generations of junior family members). This is the goal of a sale to an APGT. If the contributed assets grow faster than the interest rate on the IDGT's note, the excess growth passes back to the grantor of the APGT in a creditor-proof, estate-tax exempt, and GST-tax exempt trust, and 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 gift or estate tax.

5. GST Issues. To maximize the benefit of a sale to an APGT, the executor of the estate of the senior family member can allocate GSTT exemption to property subject to the general power of appointment. As a result of that allocation, the dynasty trust that receives the APGT assets will have a GST inclusion ratio of zero, which means that all of those assets (both the 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.

6. Selling Discounted Assets. As with IDGTs, the use of rapidly appreciating or leveraged assets are an ideal candidate for sale. The use of lack-of-marketability and minority interest discounts can increase the benefits of the technique.

IV. What is Out?

A. Irrevocable Life Insurance Trusts. An irrevocable life insurance trust ("ILIT") is an arrangement whereby an individual establishes a trust to acquire or own insurance on the life of the individual so that the death benefit of the insurance will not be included in the insured's taxable estate. In order to accomplish this objective, the insured must not possess any direct or indirect interest in the insurance proceeds owned by the trust. If the insured possesses any "incident of ownership" over the policy, the policy proceeds are subject to federal estate tax in the insured's estate. IRC § 2042. Using an ILIT involves a trade-off between estate exclusion and flexibility of ownership. If the client owns the policy, he or she may change the beneficiary, borrow cash value, pledge the policy as collateral for a loan, and otherwise enjoy the benefits of policy ownership. None of these benefits can be maintained if the policy is acquired by or transferred to and ILIT. In addition, creation of an ILIT involves legal fees, the complexity of maintaining separate trust accounts, ensuring that the trustee issues annual *Crummey* withdrawal rights, etc. When the federal estate tax applies to a significant portion of estate planning clients, the benefits of ILITs are seen by many as overcoming their shortcomings. If the estate tax exemption stays at or near its present level, many people who created ILIT to provide a fund to pay estate taxes may find that the need for these funds no longer exists. Certainly, fewer clients will find it necessary to avoid personal ownership of life insurance.

B. Qualified Personal Residence Trusts. A qualified personal residence trust ("QPRT") is an arrangement whereby an individual transfers a personal residence to family members at a reduced transfer tax cost. In a typical QPRT, a senior family member transfers a

personal residence into a trust, retaining the exclusive right to use the residence for a term of years. The trust typically also includes a clause providing that if the senior family member dies during the term, the residence will revert to the transferor's estate. If the senior family member survives the term, the residence belongs to the remainder beneficiaries of the trust (typically junior family members or trusts for their benefit). Unlike a GRAT, in a QPRT, the interest retained by the grantor consists solely of the right to live rent-free in the house. As a result, there is no way to adjust the value of the grantor's retained interest to reduce the value of the remainder interest passing to junior family members. The simple fact is that the gift tax value of a QPRT is a function of: (i) the value of the residence; (ii) the term of the trust; and (iii) the applicable interest rate used to compute the discount. Since the grantor must survive the term of the QPRT for value to be shifted to junior family members, there is a limited opportunity to extend trust terms to improve discounts. Even in a depressed housing market, gift tax values for QPRTs remain high in periods with historically low interest rates. Lower 7520 rates result in higher gift values. For example, contrast a 15 QPRT created in January, 1995 (when the Section 7520 rate was 9.6%), with the same trust created in August, 2009 (when the discount rate is 3.4%). If the house was worth \$1 million in 1995, the gift would have been \$171,520. To get the same discount today, the house would have to have depreciated to only \$263,285. Nevertheless, because the actuarial value of the reversion (the right to get the house back if the grantor dies before the QPRT ends) can increase discounts for elderly clients, some commentators continue to recommend QPRTs for clients who are older but in excellent health, and who wish to transfer homes that are currently substantially depressed in value. See Mariani, "QPRTs Can Be a Good Deal Now," TRUSTS & ESTATES (April 2009), p. 15.

C. Charitable Remainder Unitrusts and Annuity Trusts. A charitable remainder unitrust ("CRUT") is a trust that is required to pay to one or more persons (other than a charity) at least 5% and not more than 50% of the fair market value of its assets each year. If the payment is expressed as a fixed dollar amount (called a charitable remainder annuity trust or "CRAT"), the payment must be at least 5% and not more than 50% of the trust's *initial* asset value. In either event, the term of the trust must be for the lifetime of one or more persons, or for a term not to exceed 20 years. In addition, the actuarial value of the interest passing to charity is computed using the Section 7520 rate, and must be at least 10% of the initial fair market value of the trust property. Unlike a CLAT, CRATs and CRUTs are themselves tax-exempt entities, so they can sell appreciated assets without paying tax on the gains that they recognize (although distributions to the non-charitable beneficiaries carry out trust income each year on a "WIFO"—worst-in, first-out basis). While the gift of the remainder interest to charity qualifies for a gift (and income) tax charitable deduction, the gift of the unitrust or annuity interest is subject to gift tax. When interest rates are high, the IRS assumes the amount passing to charity will be large, even after making the annual payments to the junior family members. When interest rates are very low, the payments made to non-charitable beneficiaries may well exceed the income that the IRS assumes that the trust will earn, thereby reducing the charitable deduction. The actuarial impact of low interest rates means that in the case of a term-of-years CRUT or CRAT, certain levels of annual payments will cause the value of the charity's interest to fall below the required 10% minimum value. In the case of a lifetime CRUT or CRAT, low interest rates will make it impossible for a trust with a young measuring life to qualify, again, because the 5% minimum payout will cause the value passing to charity to fall below the 10% minimum. For example, at a 3.8% Section 7520 rate (the best rate available for a CRUT formed in June, 2008), a lifetime CRUT can't meet the 10% minimum requirement if the measuring life is younger than 25 years

old. If the rate drops to 2.8% (the best rate available for a June, 2009 CRUT), the measuring life must be at least 27 years old. At a 3.8% Section 7520 (June, 2008) rate, a lifetime CRAT can't meet the 10% minimum requirement if the measuring life is younger than 44. If the rate drops to 2.8% (June, 2009), the measuring life must be at least 54. See Zeydel, "Planning in a Low Interest Rate Environment: How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies?" 33 ESTATES, GIFTS & TRUSTS J. 223, 224 (2008).

V. Undoing What We've Done.

What if our estate planning has been too effective? Some clients are asking if we can safely "undo" some of the estate planning that has already been done.

Example: In October, 1994, A and B transferred their residence, then valued at \$500,000, into a 15-year qualified personal residence trust. The house recently appraised for \$1 million, with a fair rental value of \$10,000 per month. A and B's other assets total around \$2 million. They are now asking you why they have to start paying their children \$10,000 per month in rent. When you remind them that they removed \$1 million from their taxable estates at a gift tax cost of only \$116,970, they point out to you that even if they still owned the house, their combined estates would be well below the federal estate tax exemption, so no estate tax has been saved. When you remind them that the estate tax exemption is scheduled to return to \$1 million in 2011, they are dubious. They are not at all happy that (i) the kids now own their house; (ii) they have to pay rent; (iii) the kids will pay income tax on the rent (with no corresponding deduction for A and B); and (iv) the costs basis to the kids is the \$250,000 that A and B paid for the house in 1985. None of these problems would apply if only the QPRT hadn't been done.

Example: H dies with typical tax-planned wills when the total value of the community estate is \$3 million. The wills were signed by the clients in 1996, when the federal estate tax exemption equivalent was \$600,000 per person. The wife is convinced that the federal estate tax exemption will stay at \$3.5 million or more, and that her estate is very unlikely to grow. She insists that the only reason that the bypass trust was included was to save estate tax for the kids at the second death, and that the bypass trust is unnecessary to accomplish that objective. She is not at all happy that (i) she has to go through the hassle of setting up and funding the trust; (ii) the trust will pay income tax on its undistributed ordinary income at a very high rate; (iii) her two kids, as remainder beneficiaries, can second-guess her investment choices as trustee; (iv) if her house is used to fund the bypass trust, she won't be able to exclude any future gain from income taxes; (v) the trust assets won't get a step-up in basis at her later death; and most importantly, (vi) she can't prevent Junior (currently in jail, *again*) from receiving half of the remaining trust property when she dies.

Example: In 2000, Ina and Izzie had an illiquid community property estate with a total value of about \$5 million. Their advisors counseled them that even with bypass trust planning in their Wills, the estate taxes due at the second death would be about \$1.5 million. The couple, anticipating additional growth in their estates comparable to the growth they experienced in the 1990s purchased \$2 million of second-to-die life insurance. Their attorney advised them to create an ILIT to acquire the insurance, in order to provide their children with the liquidity need to pay these estate taxes. Ina and Izzie's estate is now worth \$6 million. They no longer feel the same concern about estate tax exposure. Instead, they have grown weary paying premiums, ensuring that *Crummey* notices are sent, filing gift tax returns to allocate GST exemption, etc.

A. Unwinding Irrevocable Trusts. Clients should be disabused of the idea that they can simply terminate an ILIT or other irrevocable trust and receive back the cash value or other property in the trust. Remember that the first I in ILIT stands for "irrevocable." While the clients can always decide to stop making gifts, or refuse to fund future premiums, the trust will continue on in accordance with its terms. Irrevocable trusts created by mom and dad are typically structured to benefit their children. In many cases (particularly with ILITs) they are set up to last at least until both husband and wife are deceased.

1. Cashing In. If the trustee decides to cash in the policy or liquidate the investments of the trust, and if the trust agreement permits the trustee to make distributions (other than *Crummey* withdrawal rights) during the grantors' lifetimes, the trustee may be able to effectively terminate the trust by distributing the trust property to the children or other current beneficiaries. Often, however, the trust instrument permits distributions only for the health, support, maintenance and education of the distributees. The trustee would need to be certain that the distributions are justifiable under this standard, since after all the trustee owed duties not only to the current, but also to the remainder beneficiaries. Tex. Prop. Code § 114.001. When a trust runs out of property, it terminates, regardless of the termination date contained in the trust instrument. *See* Tex. Prop. Code §112.005. Depending upon the trust terms, the beneficiaries' creditor and marital issues, and a number of other factors, the trustee might be better served investing trust assets, or re-investing any cash obtained for a life insurance policy that the trust can no longer maintain, in alternative investments (such as a diversified portfolio of equities and bonds) and maintaining the trust, rather than distributing the cash.

2. Fiduciary Duties of the Trustee. If the grantors inform the trustee that they no longer intend to fund the payment of premiums, the trustee should not automatically assume that cashing in the policy is the best solution. The trustee owes a fiduciary duty to the trust beneficiaries to maximize the value of the trust. Depending upon the age and health of the insured(s), the most prudent course of action for the trustee might be to (i) use any cash in the policy to purchase paid up additions, or continue to fund the premiums through policy borrowings; (ii) ask the trust beneficiaries or others to continue to fund the payment of premiums, perhaps by making loans to the trust; or (iii) offer to sell the policy in the secondary market. Third parties may be willing to pay the trustee more than the cash surrender value of the policy, and a trustee could be properly criticized by the trust beneficiaries for failing to explore this option. For example, in *Allard v. Pacific National Bank*, 663 P.2d 104 (Wash. 1989), the court held that a trustee must attempt to obtain the highest possible price in the sale of a trust asset, either by soliciting bids or by obtaining an appraisal of the asset from an independent, qualified appraiser. 663 P.2d at 111.

B. Failure to Fund. Some clients whose spouses have died with tax-planned wills suggest that the bypass trust simply shouldn't be funded, since in the current economic and estate tax environment, it isn't necessary to save taxes. In our roles in advising executors, we must sometimes remind them that in order to qualify, they have filed an oath with the probate court promising to faithfully fulfill all of the terms of the decedent's will. While a family may enter into a family settlement agreement deviating from the terms of a will, failure to fund a bequest can, in the best of circumstances, be treated as a taxable gift by the persons who acquiesce in the failure. In the case of failing to fund a bypass trust, the children or other remainder beneficiaries would likely be treated as the donors if they don't insist that the trust be funded. *See* Rev. Rul. 84-105, 1984-2 CB 197. In a more contentious setting, the deprived remainder beneficiaries may

be in a position to assert a claim in damages for failing to fund the bequest. *See, e.g., of Estate of Bailey v. Comm'r*, 741 F.2d 801, 54 AFTR 2d 84-6527 (5th Cir. 1984) (mother's failure to pay \$73,396.68 bequest to son entitled son to damage claim of \$765,282.50 against mother's estate when failure was subsequently discovered). *See also. Batmanis v. Batmanis*, 600 S.W.2d 887 (Tex. Civ. App.–Houston [14th Dist], 1980, writ ref'd n.r.e.); *Pierce v. Sheldon Petroleum Company*, 589 S.W.2d 849 (Tex. Civ. App.–Amarillo, 1979); *Sibley v. Sibley*, 286 S.W.2d 657 (Tex. Civ. App.–Dallas 1955, writ dism'd).

C. The Role of Trusts. If we, as estate planners, have created trusts to achieve what now appear to be illusory estate tax savings, can we "undo" that planning when those tax savings don't materialize? We may start by questioning the premise. While estate tax savings are often a major motivating factor in a client's decision to include a trust in an estate plan, we all know, and we tell our clients, that trusts serve a number of other functions:

- Property inherited in a trust with appropriate "spendthrift" language cannot be attached by the beneficiary's creditors;
- Undistributed trust property cannot be commingled to become characterized as community property subject to divorce court jurisdiction;
- Management assistance is available for trust property through the use of a trustee, and even if the beneficiary is the initial trustee or a co-trustee, the trust provides a mechanism to provide future assistance if the beneficiary cannot or chooses not to serve;
- Income tax savings may be available by distributing trust income to beneficiaries in low income tax brackets; and
- The creator of the trust can determine the ultimate disposition of property to remainder beneficiaries upon the death of the initial beneficiaries or some other event.

Weighing against these benefits are a number of disadvantages for the use of trusts as a repository for inherited assets. These included:

- Administrative costs that result from increased record keeping and income tax compliance work;
- Reduced flexibility in terms of investment options, since trustees are subject to the prudent investor rule, while individuals are not;
- Reduced flexibility in terms of ultimate disposition of property, both during the beneficiary's lifetime or at death (unless the beneficiary holds a broad special power of appointment);
- Exposure to high trust income tax rates on accumulated ordinary income; and
- Loss of a step-up in basis at the beneficiary's death for assets not included in the beneficiary's taxable estate.

D. Rethinking the Role of the Bypass Trusts. With estate tax savings as our primary objective, most estate planners have sought to maximize the amount passing to the bypass trust. The rationale for this focus has been that estate tax savings, even at a historically low 45% rate, would offset the costs and inconveniences associated with the use of trusts. If the estate tax savings "payoff" is eliminated, whether due to an increased estate tax exemption, a

decline in wealth, or both, the "costs" associated with the use of trusts may be more prevalent in the client's thinking.

1. No Trusts But For Estate Tax. For clients who view estate tax savings as the only justification for trusts, estate planners might consider turning their thinking about bypass trusts around by 180 degrees. Perhaps the new goal should be to *minimize* the funding of the bypass trust. While accomplishing this goal is admittedly more difficult (how are we to know what value the surviving spouse's estate and the estate tax exemption will be when the second spouse dies?), there are at least three approaches that can be considered if minimal use of bypass funding is desired:

a. Use of Disclaimer Planning. One option to minimize the use of bypass trusts and provide for flexibility is for couples to include a qualified disclaimer option in their estate plans. In a typical "disclaimer bypass" plan, wills are drawn to pass all property to the surviving spouse. The wills also contain a bypass trust to receive any property disclaimed by the surviving spouse. When the first spouse passes away, the surviving spouse can take a second look at their financial and tax picture. If the surviving spouse determines that the total estate will be less than the estate tax exemption then in effect, the survivor can accept the outright bequest. No trust is utilized, since no estate tax exposure exists. If the total value of the estate is expected to exceed the estate tax exemption then in effect, the surviving spouse can disclaim all or any part of the inheritance, causing the disclaimed amount to pass into the bypass trust. In order for the disclaimer to be effective, it must comply with certain technical requirements of the Texas Probate Code and Internal Revenue Code. See Tex. Prob. Code § 37A; IRC § 2518:

(i) The disclaimer must be filed within nine months of the date of death and before any benefits of the disclaimed property are accepted.

(ii) The disclaimed property must generally pass in a manner 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 retain benefits from the bypass trust. IRC § 2518(b)(4)(A).

(iii) The disclaimed property must pass without direction or control of the disclaiming party. This requirement prevents the surviving spouse from serving as a trustee of the bypass trust, unless the trustee's powers are limited by an "ascertainable standard" i.e., health, education, maintenance and support. See Treas. Reg. § 25.2518-2(e)(2); Treas. Reg. § 25.2518-2(e)(5) Examples (4) (5). A bypass trust that contemplates that the surviving spouse will serve as a trustee will generally already contain these limitations. See Treas. Reg. § 20.2041-1(c)(2).

(iv) Perhaps more problematic, the "without the direction or control" requirement prevents the surviving spouse from holding a power of appointment over the property at death. Unlike assets in a "mandatory" bypass trust, property disclaimed into a bypass trust cannot be later redirected by the spouse in his or her will. If the bypass trust into which funds are disclaimed purports to grant a testamentary power of appointment to the spouse, that power must likewise be disclaimed, or the disclaimer will be ineffective. Treas. Reg. § 25.2518-2(e)(2). The lack of a power of appointment may prove particularly unpalatable in a blended family setting or a setting in which the remainder beneficiaries are apt to criticize the amount and nature of any benefits passing to the spouse.

b. The "Maximum Benefit" Bypass Trust. Another method of minimizing the disadvantages of a bypass trust is to draft the trust so as to grant the surviving spouse the maximum benefits allowed by law. As noted above, not all of these benefits can be retained if the trust is funded as a result of disclaimer. Nevertheless, they can all be included in a mandatory bypass trust, and a significant number of them can be retained in a disclaimer bypass trust:

(i) Permit (but don't require) distributions to the spouse for health, support, maintenance and education (this is the "ascertainable standard" which prevents the trust assets from being part of the spouse's estate, even if she is the trustee of the trust). IRC § 2041; Treas. Reg. § 20.2041-1(c)(2).

(ii) Permit (but don't require) distributions to a broad class of other individuals, including descendants and other natural objects of the testator's bounty. If the distributee is or may become the trustee (or someone that the trustee is legally obligated to support), or if the trustee is the surviving spouse who funded the trust by disclaimer, then distributions should be limited to health, support, maintenance and education. Distributions to other distributees need not be limited by any particular standard. Income tax savings can perhaps be achieved by distributions to beneficiaries who are in low tax brackets. See IRC §§ 661, 662.

(iii) Give the surviving spouse a veto power over distributions, so that the spouse retains control over the trust assets, even if he or she is not serving as the trustee.

(iv) Give the surviving spouse a "special" power of appointment to direct disposition of trust assets by Will (or during lifetime). This special power can permit the spouse to appoint trust property to anyone other than himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate. Treas. Reg. § 20.2041-1(c)(1). (Note that many clients prefer to require equal distributions among children upon the termination of the trust, without giving the surviving spouse the power to alter this arrangement.)

(v) Give the surviving spouse the right to withdraw property from the trust for any reason. Neither the granting of this withdrawal right nor its lapse will cause the entire trust to be included in the surviving spouse's estate, so long as the right is limited to the greater of \$5,000 or five percent of the trust property per year. IRC § 2041. (Any amount subject to withdrawal at the surviving spouse's death would be taxed in the spouse's estate.)

(vi) Give the surviving spouse the right to designate trustees, co-trustees, and successor trustees. An independent trustee can be given the authority to make distributions to the spouse and other family members in any amount and without regard to any standard. Caution should be exercised when granting broad powers to remove and replace a trustee, since the IRS has taken the position that if a beneficiary has the right to replace the independent trustee, the beneficiary has the powers of the trustee. See PLR 8916032; but *Cf. Estate of Wall v. Comm'r*, 101 T.C. 300 (1993); *Estate of Vak v. Comm'r*, 973 F.2d 1409 [70 AFTR 2d ¶ 92-6239] (8th Cir. 1992). The IRS has acquiesced that removal and replacement powers won't attribute trustee powers to the beneficiary, so long as the successor trustee is not a related or subordinate party. See Rev. Rul. 95-58, 1995-2 CB 191.

(vii) Include broad investment and exoneration powers, and expressly permit the trustee to make investments, distributions, and other decisions that favor the

surviving spouse, even at the expense of the other beneficiaries of the trust. Note that if the spouse is the trustee, these broad powers cannot extend to the point of removing the actions of the trustee from all court supervision without risking inclusion of the trust's assets in the surviving spouse's estate.

c. *The Formula General Power.* If the main concern is to grant the surviving spouse the maximum flexibility at the second death, and to receive the maximum step-up in basis for assets in the bypass trust, the surviving spouse could be given a formula "split" power of appointment, granting a general testamentary power of appointment over the amount of the trust (or over "those assets with the lowest cost basis whose aggregate fair market value for federal estate taxes is equal to") an amount needed to increase the surviving spouse's estate to the largest amount that can pass free from federal estate tax (or perhaps, free from federal and state transfer taxes). This type of "split" power has often been granted to descendants in minimizing application of the generation-skipping transfer tax. It can readily be adapted to grant the surviving spouse broad control over bypass trust assets at death, with the added benefit of providing a second step-up in basis. (Note that a general power of appointment is not sufficient to permit a step-up in basis in the unlikely event that the limited step-up rules now scheduled to go into effect in 2010 actually become law. See IRC § 1022(d).)

2. **Reasons Not to Limit Bypass Trusts.** Of course, for some clients, a bypass or similar trust will be an important element in their estate plans even if there is no estate tax. As noted earlier, trusts serve a number of important functions beyond avoiding estate tax at the second death. Among these are: (i) protection from attachment by the beneficiary's creditors; (ii) avoidance of commingling, thereby avoiding divorce court jurisdiction; (iii) providing management assistance for beneficiaries who cannot or simply choose not to manage funds; (iv) establishing a fund to allow income (or principal) to be "sprinkled" among multiple beneficiaries (including beneficiaries in low income tax brackets; and (v) determining the ultimate disposition of property to remainder beneficiaries upon the death of the initial beneficiaries or some other event. They are also important for achieving a variety of diverse objectives, from ensuring a spouse's continued eligibility for Medicaid, to granting a surviving spouse the limited ability to redirect assets at his or her later death.

E. **Modifying and Terminating Trusts.** What if our estate planning was not so far-sighted as to put all of the flexibility we want into the estate plan? Is it too late to modify or terminate the so-called "irrevocable" trusts that we have created? If they can be changed, what are the tax and other consequences of doing so? For an excellent discussion of the procedures and issues involved in terminating and modifying trusts, see Reis, "Irrevocable or Not? Modifications to Trusts," 33rd Annual State Bar of Texas Adv. Est. Planning & Prob. Course (2009). For another outstanding discussion, see, Karisch, "Modifying and Terminating Irrevocable Trusts," 23rd Annual State Bar of Texas Adv. Est. Planning & Prob. Course (1999) (see updated version at <http://www.texasprobate.com/articles/modifyingorterminatingtrusts.pdf>).

1. **Modifications Under Common Law.** The common law has long contained a well established, if very limited, notion of trust modification, known as the "doctrine of deviation." In fact, even prior to the adoption of the Texas Trust Code in 1983, the legislature recognized this rule. Section 46(c) of the Texas Trust Act provided:

Nothing contained in this Section of this Act shall be construed as restricting the power of a court of competent jurisdiction to permit and authorize the trustee to

deviate and vary from the terms of any will, agreement, or other trust instrument relating to the acquisition, investment, reinvestment, exchange, retention, sale, supervision or management of trust property.

Tex. Rev. Civ. Stat. Ann., Art. 7425b-46(c) (Vernon, 1981) (repealed effective January 1, 1984).

The doctrine of deviation was summarized by the Dallas Court of Civil Appeals:

A court of equity is possessed of authority to apply the rule or doctrine of deviation implicit in the law of trusts. Thus a court of equity will order a deviation from the terms of the trust *if it appears to the court that compliance with the terms of the trust is impossible, illegal, impractical or inexpedient, or that owing to circumstances not known to the settlor and not anticipated by him, compliance would defeat or substantially impair the accomplishment of the purpose of the trust.* [citation omitted]. In ordering a deviation a court of equity is merely exercising its general power over the administration of trust; it is an essential element of equity jurisdiction.

Amalgamated Transit Union v. Dallas Pub. Transit Bd., 430 S. W. 2d 107, 117 (Tex. Civ. App.—Dallas 1968, writ ref'd) [emphasis added]. See also RESTATEMENT OF LAW OF TRUSTS, (2nd ed.) §167.

Courts have frequently exercised the power to deviate from the administrative provisions of a trust instrument in order to give full effect to its dispositive or beneficial provisions. See RESTATEMENT OF LAW OF TRUSTS, (2nd ed.) §167. Scholars have maintained, however, that courts should proceed more carefully when deviating from the dispositive or beneficial scheme. See Bogert, TRUSTS AND TRUSTEES (2nd ed.) §561. This limitation doesn't preclude a court from altering the settlor's dispositive scheme. Rather it means the court must exercise more care. Examples in Bogert where the dispositive scheme may be altered are cases where a statute (such as Tex. Trust Code §112.054, discussed below) supports the court action or cases where the parties to litigation enter into a compromise agreement altering trust terms which the court finds to be fair and reasonable. See Bogert, TRUSTS AND TRUSTEES (2d Ed. Rev.), §994. It appears that, notwithstanding the common law authority to modify and terminate trusts, Texas courts have traditionally shown reluctance to apply these equitable principles. For example, in *Frost National Bank v. Newton*, 554 S. W. 2d 149 (Tex. 1977), the Texas Supreme Court held that a trust could not be terminated on the basis that its principal purposes had been satisfied because the court could not substitute its judgment for that of the settlor in determining which purposes she considered "principal" and which were merely "incidental." 554 S. W. 2d at 154.

2. Texas Trust Code Section 112.054. Perhaps in response to the general unwillingness of courts to act, in 1984, the Texas legislature adopted a statutory provision adopting the doctrine of deviation as stated in Section 167 of the Restatement 2d of the Law of Trusts and in *Amalgamated Transit Union*. In 2005, legislation sponsored by the Real Estate, Probate and Trust Law Section of the State Bar of Texas broadened Section 112.054 of the Texas Trust Code. The legislation added many of the trust modification and termination provisions outlined in the Uniform Trust Code. These changes generally expand the bases for judicial modification or termination of irrevocable trusts, making it easier to meet the statutory standard.

a. Statutory Language. The current version of the statute provides:

Sec. 112.054. JUDICIAL MODIFICATION OR TERMINATION OF TRUSTS.

(a) On the petition of a trustee or a beneficiary, a court may order that the trustee be changed, that the terms of the trust be modified, that the trustee be directed or permitted to do acts that are not authorized or that are forbidden by the terms of the trust, that the trustee be prohibited from performing acts required by the terms of the trust, or that the trust be terminated in whole or in part, if:

- (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill;
- (2) because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;
- (3) modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration;
- (4) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or
- (5) subject to Subsection (d):
 - (A) continuance of the trust is not necessary to achieve any material purpose of the trust;
 - (B) the order is not inconsistent with a material purpose of the trust.

(b) The court shall exercise its discretion to order a modification or termination under Subsection (a) in the manner that conforms as nearly as possible to the probable intention of the settlor. The court shall consider spendthrift provisions as a factor in making its decision whether to modify or terminate, but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust.

(c) The court may direct that an order described by Subsection (a)(4) has retroactive effect.

(d) The court may not take the action permitted by Subsection (a)(5) unless all beneficiaries of the trust have consented to the order or are deemed to have consented to the order. A minor, incapacitated, unborn, or unascertained beneficiary is deemed to have consented if a person representing the beneficiary's interest under Section 115.013(c) has consented or if a guardian ad litem appointed to represent the beneficiary's interest under Section 115.014 consents on the beneficiary's behalf.

b. Application of the Statute. While the statute appears to provide a comprehensive way to modify trusts, its application is in many ways quite limited.

(i) Trustee or Beneficiary May Bring Suit. Section 112.054(a) provides that a trustee or a beneficiary may petition the court. A "beneficiary" is a person "for whose benefit property is held in trust, regardless of the nature of the interest." Tex. Trust Code §111.004(2). It therefore appears that any beneficiary—income, remainder, contingent remainder—has standing to bring a modification or termination suit. Note that the statute does not authorize a settlor to bring a suit. A settlor may be an "interested person" for purposes of Section 115.011 (the "parties" section), but the statute doesn't empower actions by interested parties. It seems unlikely that a settlor would survive a standing challenge if the settlor sought to initiate a Section 112.054 action.

(ii) Authority of Court. Section 112.054 is entitled "Judicial Modification or Termination of Trusts." It nevertheless authorizes the court to do more than modify administrative terms or terminate a trust. In particular, the statute authorizes the court to: (i) change the trustee; (ii) modify the terms of the trust; (iii) direct or permit the trustee to do acts that are not authorized or that are forbidden by the terms of the trust; (iv) prohibit the trustee from performing acts required by the terms of the trust; or (v) terminate the trust in whole or in part. While this list is fairly broad, it certainly does not authorize a court to ignore a trust in its entirety or re-write the trust from scratch.

(iii) Findings Required. Prior to the 2005 changes, the court could act under Section 112.054 only if it found that (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; or (2) because of circumstances not known to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of the purposes of the trust. The new statute keeps the first ground, but substantially reduces the burden for establishing the second ground (from "defeat or substantially impair" to "further the purpose of the trust"). In addition, the new statute adds three new grounds for modifying or terminating a trust, allowing changes: (i) to nondispositive terms of the trust if necessary or appropriate to prevent waste or avoid impairment of the trust's administration; (ii) to achieve the settlor's tax objectives if not contrary to the settlor's intentions; or (iii) to terminate a trust that is not necessary to achieve any material purpose of the trust, or if termination is not inconsistent with a material purpose of the trust

(iv) Spendthrift Clauses Not an Impediment. Texas Trust Code Section 112.054(b) provides that a court must consider spendthrift provisions as a factor in making its decision whether to modify or terminate, but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust. This provision is important because most irrevocable trusts include spendthrift provisions. Absent this statutory language, it would not be unexpected for a court to conclude that the settlor did not want the beneficiaries to have the power to deal with and/or receive the trust property prior to the time for distribution under the trust instrument. Under the statute, the court should consider the spendthrift provision as a factor, but its inclusion is not an automatic bar to modification or termination.

(v) Virtual Representation and Related Issues. It is often difficult or impossible to get all beneficiaries before the court. Beneficiaries who are minors, incapacitated, unborn or unascertained cannot themselves participate in a judicial modification or termination proceeding. Trustees and other persons interested in the trust are understandably reluctant to take actions involving the trust which do not bind these beneficiaries. One alternative is to have a guardian of the estate or a guardian ad litem appointed for such persons. *See* Tex. Prop. Code § §115.014(a); 115.013(c)(2)(A). Fortunately, Section 115.014(c) of the Trust Code now permits a guardian ad litem to "consider general benefit accruing to the living members of a person's family" in deciding how to act. This makes it easier to obtain guardian ad litem approval to a modification that provides no direct benefit to minor or unascertained beneficiaries but which benefits the family (and, presumably, the minor or unascertained members of the family) generally. In addition, under Section 115.013(c) of the Texas Trust Code, if there is no conflict of interest and if no guardian of the estate or guardian ad litem has been appointed, a parent may represent his minor child as guardian ad litem or as next friend. Also, an unborn or unascertained person who is not otherwise represented is bound by an order to the extent his interest is adequately represented by another party having a substantially identical interest in the proceeding. While this statutory statement of "virtual representation" is limited to parents acting for their minor children and other beneficiaries acting for unborn or unascertained persons, the cases do not appear to limit virtual representation to minors and unborns. *See, e.g., Mason v. Mason*, 366 S.W.2d 552 (Tex. 1963) (doctrine of virtual representation not limited to beneficiaries representing other beneficiaries where trustee was found to have virtually represented the beneficiaries in suit challenging the validity of the trust). In short, Section 115.013(c) (together with the necessary parties statute—Section 115.011) provides a safe harbor in most cases where trust modification or termination is sought. If all of

the necessary parties described in Section 115.011 can be served or otherwise brought into the suit, if all minors can be represented by their parents without a conflict of interest, and if the interests of all unborn or unascertained persons are adequately represented by another party having a substantially identical interest, then a guardian ad litem generally can be avoided and the parties can have a moderate level of comfort that the modification or termination order will be binding on all beneficiaries. If some or all of these requirements cannot be met, then one or more ad litem probably are necessary under Section 115.014.

(vi) No Justiciable Controversy Required. Proceedings under Section 112.054 do not require a justiciable controversy. *Gregory v. MBank Corpus Christi, N.A.*, 716 S.W.2d 662 (Tex. App.—Corpus Christi 1986, no writ). Therefore, a modification or termination suit is not subject to attack merely because there is no actual controversy before the court.

3. Reformation and Rescission. Reformation and rescission suits are similar to modification and termination suits, but the basis for the suit is different.

a. Reformation. Reformation suits are based on mistakes of fact at the inception of the trust, not deviation from the trust terms due to changed circumstances. If, due to a mistake in the drafting of the trust instrument, the instrument does not contain the terms of the trust as intended by the settlor and trustee, the settlor or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms which were actually agreed upon. Bogert, TRUSTS AND TRUSTEES (2nd ed.) § 991. Most courts have held that reformation must be based upon a mistake of fact, not a mistake of law. *See, e.g., Community Mut. Ins. Co. v. Owen*, 804 S.W.2d 602 (Tex. App.—Houston [1st Dist.] 1991, writ denied). However, this limitation on reformation has usually been applied to mistakes of fact regarding the general rules of law, and not to a mistake regarding particular private legal rights and interests. In other words, if parties contract under a mutual mistake and misapprehension as to their specific rights, the agreement may be set aside as having proceeded upon a common mistake. *Furnace v. Furnace*, 783 S.W.2d 682, 686 (Tex. App.—Houston [14th Dist.] 1989, writ dismissed w.o.j.). In *Furnace*, for example, the parties were mistaken as to what effect a sale would have on their interests in a trust. Dicta in the opinion indicates that this was a mistake of fact, not of law, even though legal interpretations of instruments were involved. (Despite the dicta, the court of appeals in *Furnace* found that the parties waived this issue by failing to submit it at trial.) In addition, courts in other jurisdictions have extended the doctrine of reformation to mistakes of law made by the scrivener of the trust agreement, where the settlor relied on the scrivener and could not reasonably be expected to have know the legal implications of language in the trust agreement. *See Carlson v. Sweeney*, 895 N.E. 2d 1191 (Ind. 2008). *See also Loeser v. Talbot*, 589 N. E. 2d 301, 412 Mass. 361 (1992) (trust may be reformed to effect settlor's clearly stated intent to save generation-skipping taxes); *Cf duPont v. Southern National Bank of Houston*, 575 F. Supp. 849 (S. D. Texas 1983), aff'd in part, vacated in part, on other issues 771 F. 2d 849 (5th Cir. 1985) (insufficient evidence that the settlor would not have created the trust but for his alleged mistake as to tax consequences).

b. Rescission. If a settlor never intended to create a trust, then rescission is the proper remedy. In *Wils v. Robinson*, 934 S.W.2d 774 (Tex. App.—Houston [14th Dist.] 1996), *judgment vacated without reaching merits* 938 S.W.2d 717 (Tex. 1997), the court of appeals found that Section 112.054(a)(2) was not a basis for terminating a trust which

the settlor said he never intended to create. Rather, rescission was the proper remedy, based on mistake, fraud, duress or undue influence. 934 S. W. 2d at 779.

4. Termination by Agreement of Settlor and Beneficiaries. If a settlor of a trust is alive and all of the beneficiaries of an irrevocable spendthrift trust consent (and if there is no incapacity to consent by any of the parties), the settlor and all of the beneficiaries may consent to a modification or termination of the trust. *Musick v. Reynolds*, 798 S.W.2d 626 (Tex. App.—Eastland 1990, no writ); *Becknal v. Atwood*, 518 S.W.2d 593 (Tex. Civ. App.—Amarillo 1975, no writ); and *Sayers v. Baker*, 171 S.W.2d 547 (Tex. Civ. App.—Eastland 1943, no writ). Texas case law appears to make no provision that the trustee consent or even be a party to the agreement to modify or terminate a spendthrift trust. In contrast, Section 112.051(b) of the Texas Trust Code provides that the settlor of a trust may modify or amend a trust that is revocable, but the settlor may not enlarge the duties of the trustee without the trustee's express consent. The necessity of obtaining the trustee's consent before enlarging the trustee's duties is certainly proper. One can only assume that a modification of a trust must not enlarge the duties of a trustee, or the trustee must be made a party. There are two serious practical impediments to terminating a trust by agreement of the settlor and all beneficiaries. First, the settlor often is dead, rendering this method ineffective. Second, the concept of virtual representation available in judicial proceedings to modify or terminate trusts does not appear to be available, and all too often there are minor or contingent beneficiaries who cannot enter into the agreement.

5. Trust Combinations and "Mergers". If the substance of a trust instrument is acceptable, but the administrative provisions are problematic, an alternative to a modification action under Section 112.054 might be to seek a trust combination, or "merger." Section 112.057 of the Texas Trust Code was amended in 2005 to give trustees broader authority (without judicial intervention) to divide and combine trusts. Prior to the 2005 amendment, the Trust Code authorized a trustee to merge trusts only if the trusts had "identical terms" and only if the trustee determined that the merger would result in significant tax savings. See former Tex. Prop. Code § 112.057(c). In 2005, the legislature adopted language based on the Uniform Trust Code, which gives the trustee significantly broader authority to combine trusts. Although this combination of trusts is often referred to as "merging" two trusts, the revised statute uses the term "combine," perhaps (i) to avoid confusion of the common law notion of merging interests, the effect of which is to terminate a trust (*see* Tex. Prop. Code § 112.034); and (ii) to avoid any suggestion that the trusts may be combined without income tax effects (*see* IRC § 368(a)(1)(A), describing tax-free mergers of corporations).

a. No Impairment. The statute now requires that the trustee show the combination of the two trusts will not "impair the rights of any beneficiary or adversely affect achievement of the purposes of one of the separate trusts." Tex. Prop. Code § 112.057(c). The Trust Code does not define what constitutes impairing the rights of a beneficiary. The drafters of the Uniform Trust Code, which contains similar language, expressed the notion this way:

Typically the trusts to be combined will have been created by different members of the same family and will vary on only insignificant details, such as the presence of different perpetuities savings periods. The more the dispositive provisions of the trusts to be combined differ from each other the more likely it is that a combination would impair some beneficiary's interest, hence the less likely that the combination can be approved.

Unif. Laws. Ann. (Unif. Trust Code) § 417 comment (2006).

b. No Consent Required. If the trustees of the two trusts determine that the trusts can be combined, they may do so without the consent of the beneficiaries, but must give notice of the combination to the beneficiaries not later than thirty days prior to the effective date of the combination. Texas Prop. Code § 112.057(c)(1).

6. Sale of Assets to New Trust. Another option for moving assets from a "bad" trust into a "good" trust is for the settlor to create a new trust having different terms, and then encourage the trustee of the old trust to sell its assets to the new trust. This technique is often used in the context of irrevocable inter vivos trusts. For example, the trustee of an irrevocable life insurance trust that does not have GST planning might sell a policy of life insurance it owns to a new trust having the desired GST provisions. The trustee of the old trust might then make discretionary distributions of the cash received from the sale to the beneficiaries to terminate the old trust.

a. The Prudent Investor Rule. In most circumstances, the issue faced when selling assets to a new trust is not whether the trustee of the old trust has authority to sell its assets, but whether the trustee is properly exercising that authority. Under the Texas prudent investor rule the trustee must exercise reasonable care, skill, and caution, "as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." Tex. Prop. Code § 117.004(a). Particularly with respect to the sale of trust assets, the trustee must "exercise such care and skill as a person of ordinary prudence would exercise," and therefore cannot properly make a sale for "an unreasonably low price or on unreasonable terms." *Id.*

b. Income Tax Issues. When selling assets, the selling trust may very well be required to recognize a gain on the sale of its assets. In the context of the sale of a life insurance policy by an irrevocable life insurance trust, the purchasing trust may have an even more vexing income tax problem. The "transfer for value" rule under Section 101(a)(2) of the Code provides that the purchaser of a life insurance contract will ultimately be taxed on the death benefit it receives unless certain exceptions apply. IRC § 101(a)(2). Section 101(a)(2)(A) of the Code provides an important exception to the transfer for value rule if the policy has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference to such basis in the hands of the transferor. In addition, Section 101(a)(2)(B) of the Code provides an exception where the transfer is "to the insured, a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer." Recently, the IRS has approved another approach. If both the old trust and the new trust are grantor trusts in which the insured is the grantor, the transfer will be disregarded for federal income tax purposes and for purposes of the transfer for value rule. *See*, Rev. Rul. 2007-13, 2007-11 IRB 684.

7. "Decanting"—The New Kid in Town. For certain trusts, "irrevocable" doesn't mean "unchangeable." Several states (not yet including Texas), permit a trustee who has discretion to make distributions to or for the benefit of the beneficiary to make a distribution into a new trust for that beneficiary. In 2005, the Texas legislature adopted a very limited version of this ability to "decant" from one trust to another. Section 113.021(a) of the Texas Trust Code provides that a trustee who holds property for a beneficiary who is "a minor or a person who in the judgment of the trustee is incapacitated by reason of legal incapacity or physical or mental

illness or infirmity" may retain trust property as a separate trust on the beneficiary's behalf. Several states (starting with Delaware, New York and Alaska, but recently including Tennessee, Florida, South Dakota and others) have broadened this authority to enable a trustee to distribute or "decant" assets from an old "bad" trust into a new "good" trust. See Wareh, "Trust Remodeling," TRUSTS & ESTATES (August, 2007), 18.

a. Discretionary Authority Required. The decanting statutes are generally an extension of the common law, which has typically provided that, absent limitations imposed by the settlor, a power of appointment held by a trustee (including a simple right to make discretionary distributions) includes the authority to make distributions subject to such terms and conditions as the trustee may desire. RESTATEMENT (2D) OF TRUSTS § 19.3, Note 3 (1986). See also SCOTT ON TRUSTS § 17.2 (4th Ed., 2001); 94 ALR 3rd 895.

b. Statutory Provisions. Decanting statutes allow a trustee with discretionary distribution authority over a trust, in effect, to modify the trust's terms and conditions by pouring trust assets into a new trust with, for example, more or less restrictive dispositive provisions, different successor trustees, different governing law provisions, etc. Generally, neither the consent of the settlor nor the beneficiaries is required. The authority to decant seems to vary by state. For example, Delaware requires that the new trust have as its beneficiaries only persons who are "proper objects" of the exercise of the trustee's power. 12 Del. Code Ann. § 3528(a)(1). In other words, beneficiaries of the new trust must be limited to those persons who were beneficiaries of the old trust and for whose benefit the trustee of the old trust had the discretion to make distributions. A 2009 change to the Delaware statute clarifies that any standard that limits the trustee's authority to make distributions from the first trust must be followed by the trustee when exercising the authority to decant. New York allows decanting only where the trustee's discretion is "absolute." N.Y. E.P.T.L. § 10-6.6(b)(1). The Alaska statute had the same limitations, but was amended in 2006 to permit decanting even when the trustee's authority is limited by a standard. Ala. Stat. § 13.36.157.

c. An Example: The South Dakota Statute. South Dakota currently has perhaps the broadest decanting statute. It permits a trustee to decant if the trustee has discretionary authority to make distributions (regardless of whether that authority is "unfettered" or "absolute"). In addition, the beneficiaries of the new trust need only be either "proper objects" of the exercise of the distribution power or "one or more of those other beneficiaries of the first trust to or for whom a distribution of income or principal may have been made in the future from the first trust at a time or upon a happening of an event specified in the first trust." S.D. Stat. § 55-2-15. It would appear that the language of the South Dakota statute would permit the new trusts into which old trusts are decanted to have different beneficial interests. It would even seem to allow formerly contingent beneficiaries to become current beneficiaries and share equally (or pursuant to a different allocation) with those beneficiaries who previously were the only current beneficiaries. However, the statute does restrict a trustee's exercise of the decanting authority in that he must take into account the purposes of the trust from which property is to be decanted, the terms of the new trust and the consequences of the decanting. *Id.* In addition, the statute imposes the following limitations:

(1) No trustee of the first trust may decant to a second trust if the trustee is a beneficiary of the first trust, or if any beneficiary may change the trustees of the first trust, unless the distribution rights are limited to health, education, maintenance, or support. In addition, no decanting is allowed if doing so would

have the effect either of (i) increasing the distributions that can be made in the future from the second trust to the trustee of the first trust or to a beneficiary who may change the trustees of the first trust; or (ii) removing restrictions on discretionary distributions imposed by the agreement under which the first trust was created, except that in either case, participating in a change that is needed for the health, education, maintenance, or support of any such beneficiary is permitted;

(2) In the case of a Section 2503(c) trust, the governing instrument for the second trust cannot extend the vesting date beyond the date that the interest would have vested under the terms of the governing instrument for the first trust;

(3) Decanting can't be used to reduce an income interest of any income beneficiary of a QTIP or LEPA marital deduction trust, a charitable remainder trust, or a grantor retained annuity trust;

(4) Decanting can't be used to cut off a presently exercisable "*Crummey*" withdrawal right;

The exercise of the authority to decant is not prohibited by the presence of a spendthrift clause or by a provision in the trust instrument that prohibits amendment or revocation of the trust. It can be used for any trust governed by South Dakota law, including a trust whose governing jurisdiction is transferred to South Dakota.

d. Is Decanting for You? Is decanting available to Texans? As of the date of this writing, the Texas Trust Code does not have an express statute allowing decanting (although decanting may effectively be permitted under common law). Commentators suggest that anyone can decant, simply by evoking the law of a state with favorable decanting rules. While a trustee cannot simply choose to apply the law of a state to which the trust has no nexus, it may be fairly easy to establish the required nexus. The most common approach is to seek appointment of a corporate fiduciary with offices in the desired state. Absent language in the governing instrument prohibiting a change of situs, having a Delaware, Alaska or South Dakota corporate trustee will likely establish a close enough connection to permit the trustee to use the law of that state.

VI. Problem Areas In Trust Modifications and Terminations.

A. Tax Issues. The foregoing discussion focused primarily on the state law issues surrounding trust modifications and termination. Equally important are the tax issues which might arise. For detailed discussions of some of these issues, *see, e.g.*, Kelly, "Tax Aspects of Family Settlement Agreements," 22nd Annual State Bar of Texas Adv. Est. Planning and Prob. Law Course (1998); Pacheco & Davis, "Tax Considerations in Settlements and Judgments," 29th Annual State Bar of Texas Adv. Est. Planning and Prob. Law Course (2005).

1. Gift Tax Issues. Perhaps the most obvious tax issue associated with a trust termination is the potential gift tax problem.

a. General Gift Issues. Can the IRS argue that trust combinations, terminations, "decanting" and the like give rise to taxable gifts? Section 2512(b) of the Code provides that where a transfer of property is made for less than adequate consideration, the amount in excess of fair consideration will be treated as a gift. On the one hand, a transfer of property by an individual in compromise and settlement of threatened estate litigation is a

transfer for full and adequate consideration in money or money's worth and, thus, is not a gift for federal gift tax purposes. See *Irma Lampert*, T.C.M. 1184 (1956); see also *Righter v. United States*, 66-2 USTC ¶ 1242, 258 F. Supp. 763 (8th Cir. 1966) *rev'd and remanded on other grounds* 68-2 USTC ¶ 12554, 400 F.2d 344 (8th Cir. 1968). Private Letter Ruling 8902045 involved a will contest settlement and considered the issue of whether transfers pursuant to the settlement were subject to the gift tax. The IRS stated that intra-family settlements should not result in shifts between the parties' economic rights, that the economic values of the parties' claims should be determined "with appropriate allowances for uncertainty," and that "differences may be justified on the basis of compromise." PLR 8902045. On the other hand, where there is no adequate consideration for the settlement agreement, gift tax consequences will arise. See *Nelson v. United States*, 89-2 USTC ¶ 13,823 (D.N.D. 1989); PLR 9308032. For example, if a remainder beneficiary agrees to the termination of a trust and gives up his or her interest in the trust in favor of the income beneficiary, the remainder beneficiary may be treated as having made a gift subject to the gift tax. See Rev. Rul. 84-105, 1984-2 CB 197. The gift tax implication may arise notwithstanding the fact that the value of the foregone interest may be difficult to value. This difficulty in valuing the gift could make it possible to value the gift at a relatively low value. See PLR 9451049. In the context of a trust reformation to conform a trust to the settlor's original intent, the IRS had found no gift to have arisen, despite a shift of beneficial interests. See PLR 200318064

b. Exercise, Release or Lapse of General Power of Appointment. The exercise, release or lapse of a general power of appointment is deemed a transfer of property by the individual possessing the power. IRC § 2514(b). To avoid gift tax implications when trusts are modified or terminated, one must determine whether trustees who are also beneficiaries possess general powers of appointment over trust property and whether the modification or termination of the trust results in the creation, exercise, release or lapse of a general power of appointment.

2. Income Tax Issues. Trust modifications, terminations and combinations often results in income tax consequences for the trusts or their beneficiaries. For a general discussion of income tax issues associate with trusts, see Davis, "Income Taxation of Trusts and Estates," 33rd Annual State Bar of Texas Adv. Est. Planning & Prob. Law Course (2009). Income tax issues associated with trust modifications, terminations and combinations may include:

a. Distributions and DNI. The general rule is that any distribution from a trust will carry with it a portion of the trust's distributable net income ("DNI"). IRC §§ 651, 661. Trust distributions are generally treated as coming first from the trust's current income, with tax-free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is allocated to them pro rata. If a trust terminates, current income is carried out, as are any unused capital losses, net operating losses, and expenses incurred in excess of income. IRC § 642(h). Thus, when two trusts combine or "merge," no provision of the Code provides that the combination of trusts is tax-free. Instead, the likely treatment is that the terminating trust will be treated as making a terminating distribution, carrying out its DNI, unused losses, and excess deductions, to the surviving trust.

b. Gains. Treasury Regulation Section 1.1001-1(a) provides that gain from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income. In certain situations, the IRS

might argue that a trust modification may be treated as a distribution followed by an exchange of interests among the beneficiaries, resulting in recognized gain for income tax purposes. *See* Rev. Rul. 69-486, 1969-2 CB 159. In Private Letter Ruling 200231011, the taxpayer asked the IRS to rule about the tax consequences of a proposed trust modification. Under the terms of a testamentary trust, the testator's grandson was to receive a fixed dollar amount each year during his life, with the remainder interest passing to various charities. The trust was later restructured to provide for annual income distributions in accordance with a performance chart. Subsequently, disputes arose regarding the administration of the trust. Under the terms of a settlement, the charities would receive an immediate distribution of corpus in termination of their interest. The remaining amount would continue in trust for the grandson, providing a 7% unitrust amount, plus distribution of principal as needed for his reasonable support. On his death, the remaining corpus would be distributed in accordance to the grandson's general testamentary power of appointment. The IRS, citing *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991), ruled that an exchange of property results in the realization of gain or loss under Section 1001 if the properties exchanged are materially different. The IRS then compared the proposed modification to the modifications in two other cases. The first case, *Evans v. Comm'r*, 30 T.C. 798 (1958), involved the exchange of an income interest in a trust for an annuity which the court concluded was a realization event. The second case, *Silverstein v. U. S.*, 419 F.2d 999 (7th Cir. 1969), found that the exchange of an interest in a trust for a right to specified annual payments from the remainder beneficiary did not result in a realization event because the taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The IRS determined that the proposed settlement at issue more closely resembled the situation in *Evans* than in *Silverstein* because grandson was currently entitled to trust income subject to a floor and ceiling, but under the proposed settlement he would receive annual unitrust payments and could receive additional discretionary distributions. The IRS stated, "[e]ven assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required" under the current terms of the trust. He also would not be limited by the maximum annual payment ceiling and payments would be determined without regard to trust income. Therefore, the grandson's interest in the modified trust would entail legal entitlements different from those under the current trust agreement.

c. *Basis Disregarded.* Section 1001(e) of the Code provides a special rule for determining gain or loss from the disposition of a term interest in property. Under Section 1001(e), in determining gain or loss from the disposition of a term interest, generally, the adjusted basis of the interests determined under Code Sections 1014 (inheritance), 1015 (gift) or 1041 (transfers between spouses) is disregarded. A "term interest in property" for purposes of Section 1001(e) means a life interest, an interest for a term of years, or an income interest in a trust. IRC § 1001(e)(2). An exception to this rule applies where the sale or disposition is part of a transaction in which the entire interest in property is transferred. IRC § 1001(e)(3). In PLR 200231011 (discussed above), after concluding that the grandson's interest as modified would entail different legal entitlements from those he possessed under the original agreement thus resulting in gain recognition, the IRS went on to explain that, under Section 1001(e)(1), the portion of the adjusted uniform basis assigned to the grandson's interest in the trust is disregarded because it was a term interest. Accordingly, the grandson was required to recognize gain on the entire amount received.

3. **Estate Tax Issues.** Does the settlor run any risks in participating in the modification or termination of an irrevocable trust, either by agreement or by judicial proceeding? In particular, one might be concerned that the state law basis for trust modification or termination would be used to find that the settlor somehow retained a power of change or revocation when he or she created the otherwise-irrevocable trust. This retained power might be asserted by the IRS to cause estate tax inclusion to the settlor. Treasury Regulation Section 20.2038-1(a)(2) provides, however, that Section 2038 (power to revoke) does not apply if a power can be exercised only with the consent of all parties having an interest (vested or contingent) in the trust, and if the power adds nothing to the rights of the parties under local law. Therefore, terminations and modifications involving the settlor's participation should not implicate estate tax issues for the settlor. *See* PLRs 200919008; 200919009; 200919010.

4. **Generation-Skipping Transfer Tax Issues.** A trust which was irrevocable on September 25, 1985, is exempt from the generation-skipping transfer tax, so long as no additions to or modifications of the trust were made after that date. *See* Treas. Reg. §26.2601-1(b); Tax Reform Act of 1986, Pub. L. No. 99-514, §1433(b)(2)(A), 100 Stat. 2731 (1986). Actual or constructive additions to one of these "grandfathered" trusts make a proportionate amount of distributions from and terminations of interests in property in the trust subject to the GST tax. Examples of constructive additions are the release, exercise, or lapse of a power of appointment. *See* Treas. Reg. §26.2601-1(b)(1)(v). In ruling on GST matters, the IRS generally focuses on whether a trust modification results in a change in the value of interests, in beneficial enjoyment, and/or timing of enjoyment (even an acceleration of the receipt of property by a skip person, which would result in exposing the trust property to transfer taxation more rapidly than if the grandfathered trust held the property for the full term). If such a change occurs, the trust will lose its grandfathered status. *See, e.g.,* PLR 8851017. On the other hand, various administrative changes appear not to jeopardize the grandfathered status. *See, e.g.,* PLR 8902045; PLR 8912038; PLR 9005019; PLR 9849007. As a result, one must be extremely careful in modifying any trust created prior to September 25, 1985. The GST tax implications should be considered before proceeding with the modification. For an in-depth discussion of this subject, *see* Harrington, "Repairing Generation Skipping Planning Trusts," 21st Annual State Bar of Texas Adv. Est. Planning and Prob. Law Course (1992). *See also* Reis, "Irrevocable or Not? Modifications to Trusts," 33rd Annual State Bar of Texas Adv. Est. Planning & Prob. Law Course (2009).

B. Charitable Beneficiaries.

1. **Cy Pres.** The doctrine of *cy pres* is not a trust termination or modification provision. Rather, it is an equitable rule of construction that allows the intentions of the settlor to be carried out as near as may be, when it would be impossible or illegal to give it literal effect. More commonly, it is the equitable power which enables the court to give effect to a testamentary or inter vivos trust established for a particular charitable purpose if the settlor has expressed general charitable intent, and for some reason his purpose cannot be accomplished in the manner specified in the will or trust instrument. Section 113.026 of the Texas Trust Code now permits the settlor or trustee of a charitable trust to select a new charity without court involvement to replace the failed charity when the trust instrument is silent. As with other actions affecting charitable trusts, the Texas Attorney General must be given notice, and the charity selected still has to fall within the scope of the grantor's general charitable intent.

However, if the Attorney General chooses not to intervene, the replacement of the failed charity can occur non-judicially.

2. Involvement of the Attorney General. In actions involving a trust with charitable beneficiaries, any modification or termination may affect the interest of the charity as beneficiary. As a result, the charity must be made a party. In addition, Texas law requires the party initiating any proceeding involving a charitable trust to give notice to the Texas Attorney General by sending the Attorney General, by registered or certified mail, a copy of the petition or other instrument initiating the proceeding involving a charitable trust within 30 days of the filing of the petition or other instrument, but no less than 10 days prior to a hearing in the proceeding. Tex. Prop. Code § 123.003(a). At any time the Attorney General is a proper party and may intervene in a proceeding involving a charitable trust. Additionally, the Attorney General may enter into a compromise, settlement agreement, contract or judgment relating to a proceeding involving a charitable trust. Tex. Prop. Code § 123.002. In this author's experience, if the charity is represented by qualified independent counsel, the office of the Attorney General rarely gets involved in these matters. However, if they choose to do so, their involvement may slow or complicate any trust modification or termination.

VII. Conclusion.

Tumbling investment values, historically low interest rates, and a 75% increase in the federal estate tax exemption, all in the course of just a few months, have reshaped the landscape for estate planners. For clients with continued estate tax exposure, these factors create a tremendous opportunity to shift wealth to future generations without exposure to gift or estate tax. Tools and techniques that have served us well can be brought to bear with dramatically greater impact. For clients of more modest means, we may need to adapt our practices to refocus our estate planning goals. The emphasis for those clients may be to build additional options into their estate plans to allow them to adapt to future circumstances. Clients who now appear to have "over-planned" may continue to test our ingenuity in determining just how adaptable our previous estate planning tools have been. As we continue to re-evaluate our estate planning tool box, and sharpen our skills with some new tools, we can count on estate planning to remain a challenging endeavor for years to come.

Historical Section 7520 Rates 1991-2009

