IT'S ALL GREEK TO ME: EXPLAINING TAX-DRIVEN TRUST PROVISIONS FOR NON-TAX ATTORNEYS

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Christian's estate planning and wealth preservation practice is focused on achieving clients' legal and personal goals. Maintaining wealth is often more difficult than building it in the first place, particularly over successive generations. While some clients' planning can be relatively straightforward, others require more sophisticated solutions to suit a particular family's needs. Christian understands that no single solution is appropriate for all situations, and his experience and training allow him to skillfully craft individualized plans for a wide array of clients. This process can be daunting but Christian takes the time necessary to educate and familiarize clients with the tools available to them so they understand both why a particular solution makes sense and how it will fit into their lives. Whether they are simply trying to protect their minor children, mitigate tax exposure, or shield assets from creditor claims, Christian strives to build the right plan for each client in a way that they can understand.

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II. INTRODUCTION

Not long ago, I was assisting another lawyer at my firm with a litigation matter. Our client was suing a trustee for breach of fiduciary duty. Among other misdeeds, the trustee had made improper distributions to himself. One day, the other lawyer called and asked me to turn to a particular section in the trust instrument. "Look," said the other lawyer, "he's not allowed to distribute property to himself. We've totally got him. I didn’t notice this before because it's way back in the boilerplate."

I turned to the section and immediately saw what my colleague was looking at. "That doesn’t say what you think it says," I hold him. "This says a beneficiary can't appoint property to himself, his creditors, his estate, or the creditors of his estate."

"Right, and that’s what he did. He violated the trust."

"No, he distributed property to himself, he didn't appoint property to himself."

"Is there a difference?"

"Yes, several. But most importantly, he distributed property to himself in his capacity as trustee. If he had appointed property to himself, he would have done so as a beneficiary."

"Look, they must have put this language in the trust for a reason. It says he can't give himself property. At the very least, it shows that [the grantor] didn't want him to have any of this property. That helps us, right?"

"It was put in the trust agreement for a very good reason. It prevents a big tax problem. This is savings language to keep beneficiaries from having a general power of appointment that would cause the entire trust corpus to be includible in their estates. It doesn't prevent him, as trustee, from making distributions to himself."

"I just don’t understand all this tax stuff. It's all Greek to me!"

The fact is, most lawyers shy away from tax. Most lawyers find tax mystifying and are content remaining blissfully ignorant on the subject. Many law firm representation agreements require clients to expressly exclude all tax advice from the representation. And yet, tax pervades much of what we, as estate planners and probate attorneys, do on a daily basis. Much of the

language in modern American trust instruments is there to prevent various tax problems. There are even non-tax statutes that have been crafted to track language in the IRC.[1] So, why do so many attorneys ignore something that is so fundamental to their work?

This paper seeks to expose and explain some of the tax-driven provisions that are regularly found in trust instruments. It is premised on the notion that planners and litigators will serve their clients better if they have some background information. It is also drafted for practitioners who do not consider themselves tax attorneys. Although by no means comprehensive, this paper is intentionally broad and shallow, intended to provide a high-level perspective on many of the most influential rules in a manner that is easily digested by seasoned attorneys who do not wish to practice tax law, as well as, novice attorneys who are just starting to learn about trusts. If this describes you, I hope you find the information below helpful. Enjoy!

III. HISTORY AND SOURCES OF TRUST LAW IN TEXAS

The law of trusts in Texas comes from a confusing array of sources. In order to better understand this patchwork, a brief review is in order.

A. History

The concept of a trust relationship is hundreds, if not thousands, of years old. Scholars theorize that the ancient Romans utilized a rudimentary form of a trust relationship to circumvent laws preventing the devise of property to certain incompetent individuals. Other writers attribute the first traces of trust law to unique features of the German Lex Salica, or law of the Salian Franks, that appeared in the fifth century. Still others point to the seventh century Muslim tradition of charitable endowments called *waqfs* as the origins of modern trusts.

However, there can be no denying the preeminence of English common law in developing and furthering the widespread use of trusts. Beginning in the 1320s, English landholders would transfer legal title in real property to a group of individuals who would hold the property for the initial benefit of the original landholder and, eventually, for the benefit of whoever the landholder designated in his Will. This practice conveniently sidestepped feudal laws regarding forced heirship and wardship by the Crown. Legal scholars have since coined this early social practice as the *feoffment of uses*. Over the succeeding centuries, the disputes between *feoffors* and the *feoffees* eventually became a mainstay of the ecclesiastical and chancellors' courts. Thus, a cohesive body of law developed that became known as the feoffees' fiduciary duty and the modern trust was effectively born.

B. The Texas Trust Code

The Texas Trust Code (herein, the "**TTC**") is contained within Title 9 of the Texas Property Code, specifically, §§ 111.001 *et seq*. The TTC contains most (but not all) of the statutory provisions relevant to the day-to-day activities of trustees. Most of the TTC provisions are default

[1] See e.g., TTC § 112.035(f)(1)(A)(ii), providing spendthrift protection where a trust's beneficiary is also its trustee but is subject to an ascertainable distribution standard.

provisions which may be overridden in a trust instrument.[2] In practice, many of the statutory provisions, which are designed to be especially conservative, are regularly overridden by standard provisions in trust instruments to more effectively achieve the goals behind the trusts they govern. The provisions of the TTC which may not be waived, overridden, or otherwise limited by a trust instrument are found in § 111.0035.[3]

C. Common Law

Where the TTC is silent, the next source of authority is the common law. TTC § 113.051 provides that "[i]n the absence of any contrary terms in the trust instrument or contrary provisions of [the TTC], in administering the trust, the trustee shall perform all of the duties imposed on trustees by the common law."[4]

Very few trust litigation cases are reported, making it hard to find caselaw that is both biding and on point for a given fact pattern. Given the small number of cases on point, practitioners may be forced to look to extra-jurisdictional authority when seeking guidance for a given position. When doing this, practitioners in Texas should note the wide variation in trust rules adopted by the various jurisdictions. Where lawyers wish to rely on (or distinguish) extra-jurisdictional precedent, they are well-advised to examine the other rules applicable in such jurisdiction and compare them to those applicable in Texas. In other words, if you think a certain rule should be adopted in Texas, you are more likely to win your argument if the law you want to copy here comes from a state with other rules that are similar to ours.

D. Secondary Sources

Although not precedential, an array of secondary sources is both available and frequently relied on by practitioners. While there are many treatises, hornbooks, supplements, outlines, websites, and other sources available, the most important secondary sources are the Restatements of Trusts and the Uniform Trust Code.

The Restatement (Third) of Trusts was promulgated in 2003 and followed the Restatement (Second) of Trusts, which dates to 1959. Texas has not adopted either of these Restatements, but they are nonetheless valuable here for context and guidance. On the other hand, certain provisions in the Restatements are in direct conflict with the TTC, so caution is advised when relying on them. Furthermore, several key differences relate directly to the duty to inform.

The Uniform Trust Code (the "**UTC**") was approved by the National Conference of Commissioners on Uniform State Laws in 2000. Since then, a majority of US states has adopted the UTC. Texas, however, is not one of them, and legislative history indicates that certain UTC

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[2] *See* TTC § 111.0035(b) (West 2019).
[3] *Id.*§ 111.0035(b)(4)(A).
[4] *Id.*§ 113.051.

provisions were specifically rejected in the TTC. However, many provisions of the UTC have been brought into the TTC on a piecemeal basis.[5]

IV. SOURCES OF TAX LAW APPLICABLE TO TEXAS TRUSTS

The various sources of tax law and related guidance is also confusing to those who do not deal with it regularly. Therefore, a short description is once again in order.

A. The IRC

Since no state income or transfer taxes (i.e., estate tax, gift tax, and generation-skipping transfer tax) are imposed in Texas, nearly all taxes applicable to trusts here are federal. Most federal tax laws are found in the Internal Revenue Code of 1986 (the "**IRC**"). The IRC is part of Title 26 of the United States Code. The IRC is complex, and its provisions should always be read in the context of related treasury regulations, as well as court decisions interpreting it.

Trusts (as well as related parties such as grantors and beneficiaries) can be impacted by both income taxes and transfer taxes. Subtitle A of the IRC addresses income taxes and Subchapter J of Chapter 1 (§§ 641 to 692) deal specifically with income taxation of trusts and estates. Subtitle B of the IRC (§§ 2001 to 2704) addresses transfer taxes.

B. Treasury Regulations

The treasury regulations (the "**Regs.**") provide the Department of the Treasury's official interpretation of the IRC and give directions to taxpayers on how to comply with its terms. Although not technically binding, the Regs. are given great deference by tax courts. The Regs. can be found in Title 26 of the Code of Federal Regulations.

C. Other Guidance

In addition to participating in the issuance of Regs., the IRS publishes other forms of official tax guidance, including revenue rulings, revenue procedures, notices, and announcements. These too are generally nonbinding but should be given significant deference.

D. Tax Courts

The United States Tax Court is a federal trial court. It is an independent judicial forum that is not controlled by or connected with the IRS. Congress created the Tax Court as an independent judicial authority for taxpayers disputing certain IRS determinations. The Tax Court is composed of 19 presidentially appointed members. Although the Court is physically located in Washington, D.C., the judges travel nationwide to conduct trials in various designated places of trial.

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[5] See Kara Blanco, *The Best of Both Worlds: Incorporating Provisions of the Uniform Trust Code into Texas Law*, 38 TEX. TECH L. REV. 1105 (2006) Note 8, at 1106.

Tax Court judges issue memorandum opinions and Tax Court opinions. Generally, a memorandum opinion is issued in a regular case that does not involve a novel legal issue. A memorandum opinion addresses cases where the law is settled or factually driven. A memorandum opinion can be cited as legal authority. On the other hand, a Tax Court opinion is issued in a regular case when the Tax Court believes it involves a sufficiently important legal issue or principle. Tax Court opinions can also be cited as legal authority.

V. ESTATE AND GIFT TAX ISSUES

A. The Annual Exclusion

(1). Background

The annual exclusion from gift tax ($17,000 per donor per donee in 2023) is an essential estate planning tool, but its rules are not as straightforward as one might think. Although each of us takes advantage of these rules all the time, most people don't realize that, in the US, all gifts are generally taxable. The annual exclusion is merely an exception to this general rule under which *de minimis* gifts can be made without any tax consequence. But for the annual exclusion, most birthday, holiday, and other gifts would require a gift tax return. Even the United States government recognizes how absurd that would be!

But the annual exclusion applies only to present interests and not to future interests.[6] A "**present interest**" is an unrestricted right to the immediate use, possession or enjoyment of the property or the income from property (such as a life estate or a term certain).[7] Most gifts in trust are classified by the Regs. as future interests,[8] so the annual exclusion does not apply to them. In order to make a gift in trust qualify for the annual exclusion, it must first qualify as a present interest, so one or more beneficiaries must be given an unrestricted right to the immediate possession and enjoyment of the gifted asset.

The easiest way to take advantage of the annual exclusion is with outright gifts. Indeed, the vast majority of gifts made by US taxpayers are outright and covered by the annual exclusion. But sometimes, gifts need to be made in trust for one reason or another. For example, gifts to minor or incapacitated beneficiaries are often made in trust. Similarly, it may be desirable to hold life insurance in trust and pay the premiums with regular gifts. Finally, many of the more sophisticated trusts used for tax planning and wealth transfer can benefit from the annual exclusion. In these situations, a special tool is often deployed.

(2). Crummey Rights

A so-called "**Crummey right**" is a tool by which a gift in trust, which would otherwise be a future interest, is instead turned into a present interest. This is done by granting one or more trust beneficiaries the right to withdraw contributed property for a period of time. Crummey rights

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[6] IRC § 2503(b).
[7] Regs. § 25.2503-3(b).
[8] See definition in Regs. § 25.2503-3(a).

get their name from the seminal case, *Crummey v. Commissioner*[9] which cured a split in law[10] and left taxpayers with two definitive rules: First, by including Crummey withdrawal rights in their trust instruments, settlors can create trusts into which present interest gifts can be made. Second, such rights can even be granted to minors to be exercised, waived, or allowed to lapse, by their parents or other guardians, even if those *de facto* powerholders are also the donors of a particular gift.[11]

Importantly, for a Crummy right to function properly, the beneficiary must be given a realistic and meaningful right to withdraw property.[12] This means the beneficiary must be given sufficient time to consider his or her options and conclude all formal prerequisites for making the withdrawal. For this purpose, two days' notice is insufficient.[13] Similarly, where beneficiaries prospectively and irrevocably waive their Crummey rights, annual exclusions will not be allowed.[14] In response to creative planners' attempts to maximize tax-free gifting by providing unborn beneficiaries with Crummey Rights, a further limitation has been placed on beneficiaries with a "remote contingent interest."[15] After *Crummey*, one additional case really solidified the rules with regard to withdrawal rights and annual exclusion gifts. In *Estate of Cristofani v. Commissioner*,[16] the Tax Court confirmed that a fifteen-day notice period was sufficient to create a present interest in trust gifts.

Although modern Crummey language can appear a bit complicated at first glance, most of the reasoning and logic behind it is in reaction to the evolution of our understanding of present interests as described above. Practitioners may differ in some of the specifics, however. For example, many drafters prefer to give beneficiaries a thirty-day notice period, while others prefer to close the notice period on December 31st of the calendar year in which a particular gift is made.

B. Powers of Appointment

(1). Generally[17]

The tax treatment of trust assets is heavily impacted by powers of appointment. At first glance, this may seem like a simple concept. If a person can appoint property to themself, they might as well own the property outright…and be taxed accordingly. But numerous permutations

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[9] *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968).
[10] Compare generally *Kieckhefer v. Commissioner*, 189 F.2d 118 (7th Cir. 1951) with *Stifel v. Commissioner*, 197 F.2d 107 (2d Cir. 1952).
[11] *Id.*
[12] *Id.*
[13] Rev. Rul. 81-7, 1981 C.B. 474.
[14] I.R.S. Tech. Adv. Mem. 9532001
[15] I.R.S. Tech Adv. Mem. 8727003
[16] 97 T.C. 74, acq. 1992-1 C.B. 1.
[17] This paper considers only powers of appointment created after October 21, 1942. Powers of appointment which were created earlier operate under grandfathered rules, however, these have become so rare that they are not addressed in this paper. See IRC § 2514(c)(2) and related Regs.

in the way powers of appointment can be structured quickly lead to a mind-bending quagmire of complex rules, exceptions, and grey areas.

A power of appointment is a nonfiduciary, power to control the disposition of trust property. Usually, the power can be exercised to override the trust's default provisions for the disposition of trust property. To establish a power of appointment, a "**donor**" (usually the trust's settlor) conveys the power upon a donee or "**powerholder**" using language that stipulates various relevant details. A power of appointment may, *inter alia*, be exercisable immediately, upon the occurrence of some specified event (including the powerholder's death), or upon the satisfaction of some ascertainable standard. A power of appointment may be exercisable in favor of a broad number of appointees, or only in favor of a small group or individual.

The power to alter, amend, or revoke a trust instrument or to terminate a trust is a power of appointment.[18] On the other hand, A power to amend only the administrative provisions of a trust instrument, which cannot substantially affect the beneficial enjoyment of the trust property or income, is not a power of appointment. The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, is not normally a power of appointment, but that can change if the powerholder has the power to enlarge or shift any of the beneficial interests in the trust assets.

A power of appointment is not always conveyed from one individual to another. Sometimes, an individual conveys property and withholds a power of appointment. As described in more detail below, retained powers of appointment are treated differently than those which are received from someone else.

Following the general rule that state law creates property rights and federal law determines how those rights are taxed,[19] for federal transfer tax purposes, a power of appointment includes any power that has the effect of conferring (or withholding) dispositive control as described above.[20] Thus, no specific wording is required to create a power of appointment for federal tax purposes. Indeed, this fact alone is the source of great confusion among many attorneys and their clients.

Importantly, when a power of appointment is granted, one of three things will happen: The power will either (i) be exercised, (ii) be released, or (iii) lapse. Respectively, each of these possibilities may trigger different tax consequences.

(2). General and Limited Powers of Appointment Distinguished

a) Definition and Background

The IRS lumps all powers of appointment into one of two categories. First, a "**general power of appointment**" is any power of appointment that is exercisable in favor of (i) the

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[18] Regs. § 25.2514-1(b)(1).
[19] *Aquilino v. United States*, 363 U.S. 509 (1960); *Morgan v. Commissioner*, 309 U.S. 78 (1940).
[20] Regs. § 25.2514-1(b).

powerholder, (ii) the powerholder's estate, (iii) the powerholder's creditors, or (iv) the creditors of the powerholder's estate.[21]

Any power of appointment which is not a general power of appointment is classified as a "**limited power of appointment**" (sometimes also referred to as a non-general power of appointment). This distinction, which is incredibly important for tax purposes, is deceptively simple. General powers of appointment can spring up unexpectedly and produce disastrous tax consequences. In addition, there are several situations which might appear to deserve treatment as a general power of appointment, but which the rules treat only as limited powers of appointment.

On a more abstract level, the holder of a general power of appointment has so much control over appointive property that he or she should be treated as the outright owner of the property. Thus, where a powerholder can appoint property to satisfy legal obligations, the tax rules seek to treat that property in the same way as other property which may be used in that manner. Conversely, where property cannot be used to satisfy a powerholder's obligations, it is treated more favorably.

b) Basic Tax Treatment

Ferreting out general powers of appointment is important because general powers of appointment generally trigger tax. For estate tax purposes, all appointive property which is subject to a general power of appointment is includable in the powerholder's estate.[22] This is a draconian rule because it usually triggers inclusion of all the assets of a given trust. Clients will often be confused by the fact that the exercise of a general power of appointment is not needed to trigger inclusion. Merely holding the power at death is sufficient.

If holding a general power of appointment at death triggers inclusion, one might think it a good idea to get rid of the power before dying. Unfortunately, this too can be a problem. For gift tax purposes, the exercise or release of a general power of appointment is a taxable transfer.[23] Additionally, the lapse of a general power of appointment is also treated as a taxable transfer to the extent the value of the property subject to lapse in a given calendar year exceeds the greater of $5,000 or 5% of the aggregate value of appointive property.[24]

(3). Special Rules

a) Pitfalls

Sometimes, general powers of appointment creep up unexpectedly. For example, a beneficiary's power, without limitation, to remove and replace the trustee of a given trust will be treated for transfer tax purposes as a general power of appointment.[25] Under this so-called

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[21] IRC § 2514(b).
[22] IRC § 2041(a)(2).
[23] IRC § 2514(b); Regs. § 25.2514-3(a).
[24] IRC § 2513(e).
[25] See PLR 9735023; see also PLR 8916032

"**revolving door theory**," the beneficiary can continue removing and replacing trustees until he or she simply appoints him- or herself or finds a trustee—usually someone who is close or somehow beholden to the beneficiary—who will do whatever the beneficiary wants, regardless of the fiduciary duties imposed by the trust. In other words, according to the IRS, the unfettered power to remove and replace trustees is equivalent to a power of appointment which is exercisable in favor of the powerholder and, thus, a general power of appointment.

Similarly, where a trustee is empowered to distribute property in a manner which would lessen or discharge a legal duty of support, the trustee is considered to hold a general power of appointment over trust property[26] because, from an economic standpoint, this power is the equivalent of allowing the trustee to distribute power to him- or herself or to his or her creditors. Consider, for example, a situation where a parent acts as trustee for a minor child. Texas law imposes a legal obligation on parents to support their minor children by providing them with clothing, food, shelter, education, and medical and dental care.[27] Thus, if the trustee can distribute property to cover these types of expenses, he or she is deemed to hold a general power of appointment over the property of the trust at issue.

A power of appointment exercisable for the purpose of discharging a legal obligation of the powerholder or for the powerholder's pecuniary benefit is considered a power of appointment exercisable in favor of the powerholder or the powerholder's creditors.[28]

Even limited powers of appointment can trigger tax if the circumstances are right. For example, the exercise or release of a limited power of appointment may result in a transfer tax consequence where the exercise or release has a dispositive effect on any other interests the powerholder may have in a given trust. If, for example, a powerholder is entitled to receive the entire trust income and also holds the power to appoint trust property to another party under a limited power of appointment, a gift of the present value of the income interest will occur if and when the power is exercised because doing so will necessarily deprive the powerholder of that income. In other words, the trust cannot distribute income to the powerholder after the assets are appointed out of the trust, so the powerholder is treated as having made a gift of that income stream. Thus, while limited powers of appointment will usually keep taxpayers safe, there are some situations where this may not be the case.

b) Exceptions

The rules above illustrate some of the circumstances in which a general power of appointment might arise unexpectedly. There are a few instances when one might expect a general power of appointment to be present, but which are excepted for one reason or another.

First, a power of appointment is not treated as a general power of appointment merely by reason of the fact that the set of appointees may, in fact, include a creditor of the powerholder or

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[26] Regs. 20.2041-1(c)(1).

[27] TEX. FAM. CODE § 151.001.

[28] *Upjohn v. U.S.,* 30 A.F.T.R. 2d. 72-5918 (W.D. Mich 1972).

the powerholder's estate.[29] Although confusing, this is a necessary rule because without it, every power of appointment would be a general power of appointment. Consider the very common case of a power of appointment exercisable in favor of the grantor's descendants. This is a textbook power of appointment, and the fact that the powerholder might have borrowed money from one of the his or her descendants should not cause the power to be treated as a general power of appointment.

Jointly held powers can be another exception. A power of appointment that is exercisable only in conjunction with another person is subject to some special rules. First, a power of appointment is not considered a general power of appointment if it is not exercisable by the possessor of the power except with the consent or joinder of the creator of the power.[30] Additionally, a power of appointment is not considered a general power of appointment if it is not exercisable by the possessor of the power except with the consent or joinder of a person having a substantial interest in the property subject to the power that is adverse to the exercise of the power in favor of the possessor, his estate, his creditors, or the creditors of his estate.[31] An interest adverse to the exercise of a power is considered substantial if its value in relation to the total value of the property subject to the power is not insignificant.[32]

Yet, another exception applies in the context of certain restrictions on the exercise of a power of appointment. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the possessor that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor is not a general power of appointment.[33] Ascertainable distribution standards are addressed in more detail below.

c) Retained Powers and IRC §§ 2036 & 2038

The rules above relate generally to powers that are conferred upon a powerholder by a grantor. But what if the power is withheld by the grantor? That is, what if a grantor transfers property in trust, but retains a power of appointment over the property. In such cases, it is more likely that appointive property will be treated as being owned by the grantor/powerholder.

IRC §§ 2036 and 2038 are designed to address situations where a transferor has gratuitously transferred property but withholds (or, in some instances, later regains) some control over it. These statutes function to bring such property back into the gross estate of the transferor for estate tax purposes.[34] As one commentator has put it, these sections function like strings which the IRC attaches to transferred assets and uses to draw the assets back into the donor's estate after death.[35]

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[29] Regs. 25.2514-1 to 25.2514-3.
[30] IRC § 2514(c)(3)(A); Regs. § 25.2514-3(b)(1).
[31] IRC § 2514(c)(3)(B); Regs. § 25.2514-3(b)(2).
[32] *Id*.
[33] IRC § 2514(c)(1); Regs. § 25.2514-1(c)(2). (gift tax); IRC § 2041(b)(1)(A) (estate tax).
[34] IRC §§ 2036, 2038.
[35] Matthew A. Reiber, *Untangling the Strings: Transfer Taxation of Retained Interests and Powers*, 48 AKRON L. REV. 455, 456 (2015).

Sections 2036 and 2038 can apply unexpectedly when applicable law permits a trust settlor to modify or terminate a trust. These might occur where, for example, a grantor retains (i) power to revoke or terminate the trust,[36] (ii) the power to add new beneficiaries or to change the beneficial interests under the trust,[37] (iii) unrestricted right to accumulate trust income,[38] or (iv) discretion to direct distributions of trust corpus for the beneficiaries.[39]

The above rules impact trust drafting significantly. Consider, for example, a trust protector or committee[40] with broad dispositive powers. If those powers are exercisable by a trustee, inclusion might be triggered. As a result, prudent drafters should consider withholding triggering powers and/or forbidding settlors from serving as trust protectors or trust committee members. Similarly, TTC § 112.059 allows for the termination of uneconomical trusts. If a settlor is serving as trustee at the time of his or her death, this statute could likewise trigger inclusion under IRC §§ 2036 or 2038. Fortunately, however, the Texas statute is only triggered where the total value of trust property is less than $50,000, so even where inclusion is triggered, its magnitude is *de minimis*. However, many trust instruments allow trustees to terminate trusts whenever the trustee determines them to be uneconomical, or once the value of trust property crosses some higher threshold. In such cases, inclusion may be more of a problem.

For gift tax purposes, a donor cannot reserve a power of appointment.[41] This makes sense because the reservation of a power necessarily contradicts the present intent to give something away. By its very nature, a reserved power of appointment implies the intent to fully manifest a gift at a later time.

(4). Drafting Implications

a) Don't Forget Those Mother's Day Cards

Clients often want to vest members of a senior generation with rights that approach unfettered access to trust assets as nearly as possible without giving up creditor protection or triggering transfer tax. Such clients may wish for their primary trust beneficiaries to be untroubled by the complaints of other, more remote beneficiaries, so the clients will often allow primary beneficiaries to appoint trust assets among junior beneficiaries (and sometime other permissible appointees, such as charities). By doing this, clients can give their primary beneficiaries virtually unlimited discretion to divert trust assets away from remaindermen if and when they make trouble or otherwise fail to please the primary beneficiary. This is particularly effective where the senior

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[36] IRC § 2038(a)(1); note also that trusts are revocable by default in Texas under TTC § 112.051(a).
[37] *Estate of Craft v. Comm'r*, 608 F.2d 240 (5th Cir. 1980).
[38] *Estate of Nichinello v. Comm'r*, 36 T.C.M. 1599 (1977); Treas. Reg. § 20.2038-1(a).
[39] *Estate of O'Connor v. Comm'r*, 54 T.C. 969 (1970); *Comm'r v. Holmes*, 326 U.S. 480 (1946).
[40] Note that, as a general matter, IRC §§ 2036 and 2038 to not include exceptions similar to those found in IRC § 2514(c)(3)(B) which prevent inclusion where a power is only exercisable with the consent of an adverse party, so trust committees remain a problem.
[41] Regs. § 25.2514-1(b)(2).

beneficiary is also serving as trustee of a given trust. To paraphrase the late, great Dallas probate attorney Ed Smith, remainder beneficiaries are well-advised to send Mother's Day cards.

b) The Upjohn Clause

Many trust instruments contain a so-called "**Upjohn clause**." Named after the case of *Upjohn v. U.S.,*[42] the clause prohibits the trustee from acting in such a manner as to relieve themselves of a legal duty under applicable law. As mentioned above, if a trustee has the power to distribute property in a way which would lessen or discharge a legal duty of support, the trustee is considered to hold a general power of appointment over trust property,[43] which, in turn, triggers inclusion of all such appointive property.

There are several support duties that might be implicated in an Upjohn clause, but the most common is the duty owed by a parent to his or her child. Under Texas law, a parent has a legal obligation to provide a child with clothing, food, shelter, and medical and dental care.[44] This obligation of support exists without the need for a court order.[45] Thus, an Upjohn clause will come into effect in situations where an individual is trustee of a trust for the benefit of their child. In such a situation, the trustee/parent may not, for example, use trust funds to pay the child's health insurance premiums. Paying the beneficiary/child's health insurance premium in a situation such as this may require some machinations. For example, if the trustee/parent is also a trust beneficiary, he or she may be able to distribute the funds to him- or herself and then pay the premiums out of a personal account. This, of course, exposes the funds to the claims of trustee/parent's creditors. Alternatively, if an independent trustee can be appointed, they should be able to pay the premium directly because they will not owe the beneficiary/child the same parental duty of support. This is one reason why "**independent trustees**," as described in IRC § 674(c), are sometimes permitted in trust instruments.

Of course, the prohibition is not limited to situations where the trustee is also the parent of a minor beneficiary. The legal duty might arise if the trustee is also the guardian of an adult, but otherwise incapacitated beneficiary. Spouses also have support obligations to each other which can come into play. In Texas, each spouse "has the duty to support the other spouse and [a] spouse who fails to discharge the duty of support is liable to any person who provides necessaries to the spouse to whom support is owed."[46] In any event, the duty referenced in an Upjohn clause has nothing to do with the trustee/beneficiary relationship, so it may be better to say that the prohibition

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[42] *Upjohn v. U.S.,* 30 A.F.T.R. 2d. 72-5918 (W.D. Mich 1972).

[43] Regs. 20.2041-1(c)(1).

[44] *See* TEX. FAM. CODE § 151.001*; See also Daniels v. Allen*, 811 S.W.2d 278 (Tex. App.—Tyler 1991, no writ) (overruled on other grounds); *Tucker v. Thomas*, 419 S.W.3d 292, 299 (Tex.2013) (parent has obligation to support his minor children and provide necessities).

[45] *See In ref A.D.E.*, 880 S.W.2d 241 (Tex. App.—Corpus Christi 1994, no writ) (father has duty to support child, even when not ordered by trial court to make payments of support); *Boriack v. Boriack*, 541 S.W.2d 237 (Tex. App.—Corpus Christi 1976, writ dism'd) (mother, as well as a father, has duty to support her minor children).

[46] TEX. FAM. CODE § 2.501(a) & (b).

is invoked where an individual who happens to be trustee of a given trust also owes a legal duty of support to the individual who happens to be a beneficiary of the trust.

Legal support prohibitions are often contained in the boilerplate of a trust instrument which individual trustees are unlikely to bother reading and even less likely to understand. These trustees can be caught off guard, so planners are well advised to discuss such provisions with their clients in detail. Litigators who specialize in breach of fiduciary duty claims also know to look for these clauses and point out violations when doing so might further their clients' cases.

c) 5 & 5 Powers

Clients sometimes wish to create a trust under which a beneficiary holds an annual, noncumulative right of withdrawal over a portion of the trust corpus that is equal in amount to the annual gift tax exclusion. This technique is frequently seen with irrevocable life insurance trusts, where gifts are made each year to cover insurance premium payments and keep the policy in force. These gifts are typically made subject to Crummey rights because donors seek to take advantage of the annual exclusion to avoid gift tax when making them. Most of the time, the beneficiaries of these trusts allow their Crummey rights to lapse each year, but because the annual exclusion exceeds $5,000, there may be gift tax consequences when this happens. If the annual exclusion amount is greater than five percent of the trust's corpus in a year in which the beneficiary's power of appointment over the annual exclusion amount is permitted to lapse, the failure to exercise the power of appointment will be considered a taxable transfer.[47] Thus, a donor may wish to limit the amount by which a Crummey right lapses in a given year to $5,000 or 5% of the trust's corpus.

d) Ascertainable Distribution Standards

As mentioned above, a power to consume, invade, or appropriate income or corpus, or both, for the benefit of the possessor that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor is not a general power of appointment.[48] Ascertainable standards lie on a spectrum between mandatory distributions, on the one hand, and unfettered distribution at a trustee's discretion, on the other. Distributions for health, education, maintenance, or support ("**HEMS**") form the boundary at which point a trust beneficiary holds a legally enforceable interest in trust property that a court can determine, and on which it might ultimately rule. That is, if a beneficiary's right is any less ascertainable than HEMS, then it is unascertainable and a court cannot compel a distribution. On the other hand, a beneficiary's right may be more ascertainable than HEMS. In such an instance, a court may be able to compel a distribution, but as with HEMS itself, the court should only compel the distribution if it falls within the given standard.

Also, the lapse or other release or exercise of such a power limited by an ascertainable standard will not be a taxable gift for federal gift tax purposes by the beneficiary which held the power.[49] Similarly, where a trust beneficiary holds a fiduciary power during his or her lifetime to

[47] PLR 9804047.
[48] IRC § 2514(c)(1); Regs. § 25.2514-1(c)(2). (gift tax); IRC § 2041(b)(1)(A) (estate tax).
[49] IRC § 2514(c)(1); Treas. Reg. § 25.2514-1(c)(2).

make distributions to or for the benefit of another beneficiary of the same trust, and the power is limited by an ascertainable standard relating to the other beneficiary's health, education, support, or maintenance, such beneficiary/fiduciary will not be deemed to have made a taxable gift for federal gift tax purposes upon exercising (or failing to exercise) such power.[50]

HEMS limitations are pervasive in trust planning. Many planners simply see the HEMS standard as a safe harbor from tax, and deploy it universally. This practice fails to grasp the nuance of the HEMS standard as a concept. For tax purposes, at least, the HEMS limitation is only meant to prevent a trustee/beneficiary's enjoyment of trust property from too closely approaching outright ownership. Thus, where the trustee of a given trust is not also a beneficiary of the trust, HEMS language will not bring any tax benefit and may result in an undue burden.

On the other hand, a trust instrument may seek to achieve maximum flexibility by limiting distributions to a HEMS or other ascertainable standard when a beneficiary is serving as trustee and allowing more liberal distributions when the trustee qualifies as an independent trustee under IRC § 674(c).

Note however, that the limitation of an ascertainable standard (HEMS or otherwise) does not prevent general power of appointment treatment with regard to a trustee's power to distribute property in a way which would lessen or discharge a legal duty of support as contemplated under Regs. 20.2041-1(c)(1). This is why most trust instruments often include both ascertainable distribution standards as well as Upjohn clauses.

C. Marital Deduction Planning

Generally, an unlimited deduction from estate and gift tax is allowed for gifts (during life or at death) from one spouse to another.[51] There are some limitations on this deduction, however. For example, the receiving spouse must generally be a US citizen.[52] Also, the transfer must not be of a nondeductible terminable interest.[53] A terminable interest in property is an interest that terminates or fails because of the lapse of time or the occurrence of an event.[54]

Generally, transfers of terminable interests (such as life estates, terms of years, annuities, etc.) do not qualify for the marital deduction.[55] However, there is an exception for so-called qualified terminable interest property ("**QTIP**") property. Under this exception, if certain conditions are met, a life estate or an interest in trust which is granted to a surviving spouse will not be treated as a terminable interest. Instead, the entire property subject to such an interest will be treated as passing to the spouse and allow the entire value of the transferred property to qualify for a marital deduction.

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[50] Regs. § 25.2511-1(g)(2).
[51] IRC § 2056.
[52] IRC § 2056(d); Note that a qualified domestic trust may provide a viable solution to the citizenship rule.
[53] IRC § 2056(b).
[54] IRC § 2056(b)(1), (3); Regs. §20.2056(b)(3).
[55] See IRC § 6645 for a detailed discussion of the terminable interest rules.

Thus, in order to obtain the unlimited marital deduction for gifts in trust, the trust must meet all the requirements of a QTIP trust. These requirements include the following:

- The surviving spouse must be entitled to receive all the income from the trust for life, payable at least annually in the year earned. [56]
- The accumulated or accrued income at the surviving spouse's death must either be paid to the estate of the surviving spouse or be subject to the surviving spouse's testamentary general power of appointment.[57]
- The surviving spouse must be the only beneficiary of the trust during his or her lifetime.[58]
- An irrevocable election must be made on the deceased spouse's estate tax return opting into QTIP treatment.[59]

Many trust forms contain provisions which track the requirements above. The purpose of this language is to qualify for the unlimited marital deduction between spouses and avoid estate tax on assets that are not covered by a deceased spouse's lifetime exclusion.

VI. INCOME TAX ISSUES

A. Individual Retirement Accounts[60]

A full discussion of individual retirement accounts ("**IRAs**") is beyond the scope of this paper but the special rules which apply to them bears out in the standard language found in many trust instruments, so some discussion is nonetheless warranted here. As a general rule, trusts and IRAs don't mix, and where possible, planners should seek to avoid situations where IRA's might be held in trust. Sometimes, however, mitigating factors come into play. For example, in the context of a blended family, a plan participant may wish to allow a surviving spouse limited access to IRA funds, while also providing some degree of protection for children. Similarly, a plan participant may wish to allow minor children to benefit from an IRA. Under normal circumstances, these goals are well-served by trust planning, but the rules imposed on IRAs make this more difficult than it is with other assets. Furthermore, the Setting Every Community up for Retirement Enhancement Act (the "**SECURE Act**") has made the planning even more complicated.

At the heart of IRA planning are so-called required minimum distributions ("**RMDs**") set out in IRC § 401(a)(9). Under these rules, certain beneficiaries are required to take all assets out

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[56] IRC § 2056(b)(7)(B)(ii).
[57] *Estate of Rose D. Howard, Deceased, Roger W. A. Howard, Volney E. Howard III, Alanson L. Howard, Robert L. Briner, Trustees v. Commissioner*, U.S. Tax Court, CCH Dec. 45,002, 91 T.C. No. 329, 91 T.C. No. 26, (Aug. 23, 1988).
[58] IRC § 2056.
[59] *Id.*
[60] This paper addresses traditional IRAs. Other retirement vehicles, including 401(k)s, 403(b)s, and Roth IRAs may follow different rules.

of an inherited IRA within five years,[61] while other beneficiaries get an extension to ten years.[62] Still other beneficiaries get to stretch their RMDs out over an even longer period.[63]

Whatever the period, tax must be paid on the distributed assets when they come out, so the goal is t structure the distributions in a way that minimizes tax by spreading the distribution out over the longest possible timeframe. In pursuit of this goal, trust instruments usually treat IRA assets differently than other assets. Effectively, IRA's are cordoned off from other trust assets and treated differently, at least for most purposes. Probate attorneys and planners alike are well advised to take careful stock of where these differences do and don't apply.

B. S-Corp Stock

Only certain types of trusts can own s-corp stock.[64] These include (i) a grantor trust treated as owned by an individual who is a U.S. citizen or resident, (ii) a grantor trust before the death of the grantor that continues in existence after the grantor's death, but only for two years after the grantor's death, (iii) electing small business trusts (ESBTs), and (iv) qualified subchapter S trust (QSSTs).[65] As a general rule, most trust forms carve out s-corp stock and treat it specially. They require that s-corp stock be put into either an ESBT or a QSST. Failure to do this can cause the loss of the corporation at issue's s-election, which, in turn, can have major tax ramifications. This is particularly problematic because losing s-corp status impacts the entire corporation at issue and all its shareholders, not just the shares owned by the particular trust and its beneficiaries.

The nuances of ESBTs and QSSTs are beyond the scope of this paper, but suffice to say that every trust form should address s-corp stock, usually by calling for a carveout as described above. If a trustee winds up owning s-corp stock in a trust that does not have appropriate savings language, he or she should explore mitigating strategies. For example, it may be possible to distribute the shares to a permissible s-corp shareholder. Alternatively, the trust may have to be judicially modified to add the requisite language retroactively.

C. Basis Adjustment

Assets which are includable in a taxpayer's gross estate receive a basis adjustment to fair market value.[66] This is typically measured at the decedent's date of death, but it may also be measured on the so-called "**alternate valuation date**," which is the day that is exactly six months after the date of death or, if earlier, the date on which property is sold.[67] This basis adjustment can be up or down, but it is generally thought of as being a "**step-up,**" meaning that the basis of a given asset is increased such that less capital gains tax is due on a subsequent.

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[61] Regs. § 1.401(a)(9)-3.
[62] IRC § 401(a)(9)(B)(ii), as modified by new IRC § 401(a)(9)(H)(i)(I).
[63] IRC § 401(a)(9)(E)(ii).
[64] IRC § 1361(c)(2), (d).
[65] *Id.*
[66] IRC § 1014.
[67] *Id.* See also IRC § 2032.

If a taxpayer is wealthy enough that tax will actually be due upon his or her death, planners will usually do what they can to keep assets out of the taxpayer's estate, even if doing so means forgoing the step-up in basis. For smaller estates, however, estate tax inclusion might actually be desired because it will trigger the step-up. With the lifetime exclusion currently much higher than it has ever been before, more and more taxpayers are seeking to include certain assets in their gross estates so that they can take advantage of the basis adjustment.

One way to achieve the step-up in basis on assets in an otherwise excludable trust is by giving a beneficiary a general power of appointment. For example, a beneficiary might be given the power to appointment trust property equal in value to the beneficiary's remaining lifetime exclusion to the creditors of his or her estate which is. Note that, in the foregoing example, the power is only exercisable in favor of the creditors of the beneficiary's estate. This is because the beneficiary is unlikely to exercise such a power. If, on the other hand, the beneficiary were given the power, during life, to appoint property to him- or herself, then there is a significant danger that the beneficiary would do just that and thwart all of the grantor's careful planning.

The discussion of IRC §§ 2036 and 2038 above focuses on tax traps which can crop up to cause estate tax inclusion unexpectedly. However, these provisions can likewise be leveraged to achieve a basis adjustment of trust assets upon the settlor’s death.[68] This tool can be deployed to cause inclusion of the trust and its assets in the gross estate of the settlor.[69] Where applicable, this is a particularly attractive methodology because, unlike other inclusion-triggering methods, it can avoid potential creditor exposure, the need for further cooperation of beneficiaries and others, and the risk that trust beneficiaries and distribution methods may be changed by others.

D. Grantor Trusts

Grantor trusts are a favorite tool of the estate planner. But what are they and how do they differ from other trusts? In a nutshell, a grantor trust is a trust that doesn't pay its own income tax. As with just about everything tax-related, there is some nuance involved, but that's the important part.

To better understand the concept, a little history may be helpful. Grantor trust rules were first adopted in the Internal Revenue Code of 1954. At the time, Congress felt that wealthy taxpayers were setting up trusts to shift income away from themselves. To combat this practice, rules were put through under which trust income is shifted back to certain individuals in certain circumstances. For a while, grantor trust status was perceived as something to be avoided, but by the mid-1980's, planners began to figure out ways to make these rules work to their clients' advantage.

The current grantor trust rules are found in IRC §§ 671-678. These rules cause a grantor to be treated as the *owner* of trust property if he or she retains too much control over a given trust's income, principal, or both.[70] Under the rules, retained control can take several forms, including

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[68] IRC § 1014(b)(1).
[69] *See* Rieber, *supra* Note 2 and accompanying text.
[70] IRC §§ 671-678, 679.

(i) reversionary interests,[71] (ii) retaining the power to control beneficial interests,[72] (iii) retaining the power to borrow trust property without adequate interest or adequate security,[73] retaining the power to vote stock,[74] (iv) retaining the power to control investments,[75] (v) retaining the power to reacquire the trust corpus by substituting other property of an equivalent value,[76] (vi) retaining the power to revoke the trust,[77] or (vii) retaining the right to income.[78] Admittedly, the above rules may seem like a long list of potential problems for unwary drafters, but they all underscore the simple concept that there are tax consequences of failing to give away enough of the proverbial sticks of property ownership.

At this juncture, it is worth reiterating a rule mentioned above and noting that revocable trusts are grantor trusts.[79] This is convenient for the millions of Americans who use revocable trusts not so much for tax planning but rather for straightforward estate planning. For most of these taxpayers, filing a trust tax return, year in, year out, would be a tremendous burden. Fortunately, they don’t have to worry about this. For all intents and purposes, their revocable trusts are ignored for federal tax purposes thanks to the grantor trust rules.

Where more sophisticated tax planning is desired, the grantor trust rules provide some helpful planning opportunities. First, grantor trusts offer transfer tax benefits. By saddling grantors with the tax burden of a given trust, the trust assets themselves are relieved of that same burden and, effectively, allowed to grow tax free. Stated another way, every tax payment made by a grantor has the same economic effect as a contribution to the trust, but it carries no transfer tax consequence. Second, grantor trust status can sometimes reduce income tax. Of course, this requires the grantor's tax bracket to be lower than the trusts would otherwise be. Third, a grantor can transact with a grantor trust without recognition for income tax purposes. Generally, the sale of property between two taxpayers is a taxable event which triggers tax, but because the grantor is treated as the owner of trust property, for tax purposes, there is no second party involved in a transaction between a grantor and a related grantor trust. This allows the grantor, for example, to sell property to a trust without having to recognize gain.

With all these available benefits, it should come as no wonder that clients regularly use grantor trusts for their planning. This is why many trusts instrument include special language triggering grantor trust status. Most often, planners accomplish this by deploying the administrative powers found in IRC § 675, such as the power to substitute assets, or the power to borrow without adequate interest or security.

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[71] IRC§ 673.
[72] IRC § 674.
[73] IRC § 675(2).
[74] IRC § 675(4).
[75] *Id.*
[76] *Id.*
[77] IRC § 676.
[78] IRC § 677.
[79] IRC § 676.

VII. GENERATION-SKIPPING TRANSFER TAX ISSUES

A. 90-Day Survivorship Provisions and Generational Assignment.

Generation-skipping transfer tax ("**GSTT**") seeks to prevent wealthy people from thwarting the estate and gift tax regimes by making gifts to more remote generations. To accomplish this, the GSTT rules assign people to a certain generation relative to a given grantor.[80] Often, this is a straightforward process. The grandchild of a given donor is generally assigned to a generation which is 2 or more generations below that of the donor, resulting in the grandchild being labeled a "**skip person**" for GSTT purposes.[81] However, if the intervening parent of the grandchild (i.e., the donor's child) has died, then the grandchild is treated as if he belongs to the parent's generation.[82] In this circumstance, the grandchild does not qualify as a skip person, so GSTT does not apply.

A corollary to the generational reassignment rule of IRC § 2651(e) is that any individual who dies within 90 days after a transfer occurring by reason of the death of the transferor is treated as having predeceased the transferor.[83] This means that, in the example above, if the gift occurs as a result of the donor's death and the child/parent outlives the donor by less than 90 days, then he or she is still treated as having predeceased the donor, allowing the grandchild to be assigned to a generation which is less than two generations away from the donor such that he or she does not qualify as a skip person and preventing the application of GSTT. Many practitioners track this rule by providing in their Will and trust forms that beneficiaries must outlive decedents by 90 days in order to be treated as having survived them.[84]

B. Resetting GSTT

GSTT only applies to the extent trust assets are excluded from estate tax. With the increased estate tax threshold, it is possible to include significant assets in a taxpayer's estate without the actual imposition of tax. As mentioned above, appointive property subject to a general power of appointment is includable in the relevant powerholder's estate for estate tax purposes.[85] For GSTT purposes, the individual with respect to whom property was most recently subject to estate or gift tax is the transferor of that property.[86]

In other words, GSTT can effectively be reset by triggering estate tax inclusion in a beneficiary's estate. For this reason, many trust forms include language—often found deep in the boilerplate—conferring upon a beneficiary some general power of appointment to accomplish exactly this. This often makes sense even in a situation where the estate tax threshold is relatively

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[80] IRC § 2651.
[81] IRC § 2613(a).
[82] IRC § 2651(e).
[83] Regs. § 26.2651-1(a)(2)(iii).
[84] Note that, TEC § 121.052 a survival period of only 120 hours. There is no analogous default rule relating to trusts.
[85] IRC § 2041(a)(2).
[86] Regs. § 26.2652-1(a)(1).

low because given the choice between paying estate tax and paying GSTT, estate tax is almost always the lesser evil.

C. Inclusion Ratios

The procedure for calculating GSTT can be daunting. First, a taxable amount must be multiplied by an applicable rate.[87] The applicable rate is equal to the maximum federal estate tax rate times a so-called "**inclusion ratio**."[88] This inclusion ratio is a number between 0 and 1 which, generally speaking, is calculated based on the amount of GSTT exemption that is applied to a given transfer relative to the value of the gift.[89] In other words (and at the risk of greatly oversimplifying the process), if a donor gives a skip person $100 and allocates $100 worth of GSTT exemption to the gift, then the inclusion ratio is 0 and no GSTT is paid. Conversely, if a donor gives a skip person $100 and allocates no GSTT exemption to the gift, then the inclusion ratio is 1 and GSTT must be paid at the full rate. However, if a donor gives a skip person $100 and allocates $50 worth of GSTT exemption to the gift, then the inclusion ratio is 0.5 and GSTT must be paid, but only at half of the normal rate. This complicated process is used because GSTT only applies with respect to trust when assets are distributed or trusts are terminated,[90] not necessarily when gifts are actually made. Therefore, some sort of mechanism is required to equitably apply the tax to assets that have appreciated in value between time that they are contributed to a given trust and the time that they are subsequently distributed from the trust.

We refer to trusts with an inclusion ratio of 0 as being GST-exempt because they will never owe GSTT. Those are easy to deal with. A trustee of a GST-exempt trust can distribute property to a skip person without having to pay GSTT. But where a trust is not GST exempt, it is preferable for it to have an inclusion ratio of 1 (and therefore be fully taxable for GSTT purposes) than it is for the trust to have an inclusion ratio that is between 0 and 1 because GSTT mitigation strategies are more effective when this is the case. Therefore, a trustee is allowed to sever a trust with an inclusion ratio between 1 and 0 into two separate trusts, one with an inclusion ratio of 1 and another with an inclusion ratio of 0.[91]

Making this split allows the trustee to create one GST-exempt trust and another trust that is fully non-exempt for GSTT purposes so that GSTT mitigation strategies can be focused on the non-exempt trust. For example, if the original trust allows for distributions to both skip persons as well as non-skip persons, then the trustee can spend down the non-exempt trust by making distributions to non-skip persons before assets from the GST-exempt trust are used. Similarly, if a beneficiary is given a general power of appointment over a non-exempt trust, only those assets which end out in that trust will be included in the beneficiary's estate and subject (potentially) to his or her creditors. The assets which are allocated to the GST-exempt trust in the severance escape this treatment.

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[87] IRC § 2602.
[88] IRC § 2641(a).
[89] IRC § 2642(a).
[90] See generally IRC §§ 2611, 2016.
[91] IRC § 2642(a)(3).

Many trust instruments contain language which tracks IRC § 2642(a)(3) and allows trustees to sever a given trust if and when appropriate. The language can be a bit complicated, but the general concepts can be boiled down to a more digestible point.

VIII. STATE TAX ISSUES

For Texas trusts, the primary state tax issue is whether homestead, over 65, and other tax exemptions will apply to a primary residence held in trust. Texas Tax Code § 11.13(j) allows real property held in trust to qualify for these exemptions. Most modern, Texas forms cite this statute directly, and their purpose is to allow trust beneficiaries to obtain these types of exemptions for property which would otherwise qualify for the exemptions if the beneficiaries owned the property outright.

Taxing authorities regularly review trust instruments for language that closely tracks the statute and deny exemptions if they do not find what they're looking for. However, where a trust instrument is silent on this issue, for example, because it predates Texas Tax Code § 11.13(j), all may not be lost. One option for obtaining the exemptions may be to distribute a life estate to the qualifying beneficiary. Under Texas law, a life estate should transfer enough rights in the property to qualify for all personal residence exemptions. Of course, this is only possible if and when the trust agreement permits such distributions.

IX. TAKEAWAYS

Trust language and structuring is highly influenced by a variety of different taxes. Without a basic understanding of these taxes and how they apply, much the language of many trust forms may seem nonsensical. Practitioners may be tempted to alter form language in an effort to simplify provisions, but doing this could result in an adverse tax consequence. For this reason, planners are well advised to seek out quality forms and leave tax-triggering provisions intact. Additionally, practitioners in both the planning and probate realms may also wish to seek out seasoned co-counsel to help further elaborate on the more granular details of these rules.