DEAN MEAD

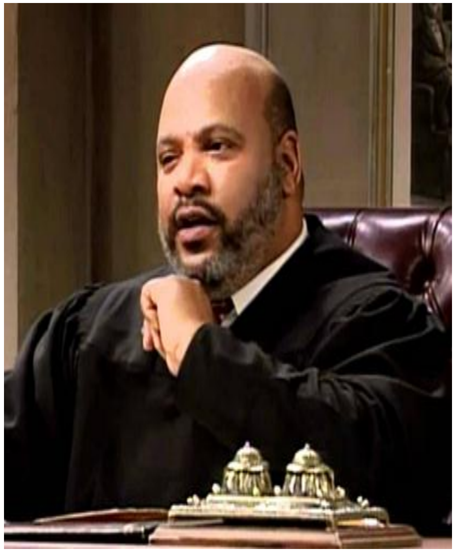
Tax Consequences of Trust and Estate Settlements and Modifications

David J. Akins
Matthew J. Ahearn
Lauren Y. Detzel
Brian M. Malec

August 5, 2014

Case Study #1: Credit Shelter Trust

Phil dies survived by his wife, Vivian, his son, Carlton, and his (adopted) son Will. Phil leaves a credit shelter trust that provides for discretionary distributions to Vivian for HEMS during her lifetime and upon her death, it splits into separate dynasty trusts for Carlton and Will.




Assume the Credit Trust owns $1 million of securities, $2 million of rental properties, and a 100% interest in a family dance studio business (that Carlton now manages) valued at $2 million. Carlton, being a gifted businessman and dancer, expects to double the value of the dance studio over the next 5 years, now that he is in control and can teach the dance moves that he wants to.

Carlton hates the idea that his efforts to enhance the business could benefit Will and Will's descendants in the future.

Will thinks Carlton is a disaster and Will wants nothing to do with the business.

Upon Vivian's death, there is sure to be a fight between Will and Carlton regarding the division of the Trust assets, primarily due to the growth or decline of the business.

However, during Vivian’s lifetime, Will and Carlton will certainly cooperate because they want an inheritance from Vivian.

What can be done to save the Banks family?

Proposed Solution

Sever and modify the Credit Trust into 2 Trusts.

- Trust 1 will be for the benefit of Vivian for life, with a remainder to Will in trust.
- Trust 1 will own the rental properties ($2,000,000) and $500,000 of securities.
- Trust 2 will be for the benefit of Vivian for life, with a remainder to Carlton in trust.
- Trust 2 will own the interest in the family business ($2 million) and $500,000 of securities.
- The remaining terms of the Trusts will be identical to the Credit Trust.

Benefits of Severance and Modification

- Each Trust has assets worth $2.5 million
- Only Vivian, Carlton and his descendants will share in the success or failure of the business. The share for Will and his descendants is not affected by the performance of the business.
- Each Trust has assets that, with Vivian's consent, can be independently invested without the consent of the other child.
- Agreement can be made between Vivian, Will and Carlton that distributions for Vivian will be made equally from Trust 1 and Trust 2.

Options to Accomplish Severance and Modification

Severance

- F.S. § 736.0417 - Permits severance of a trust after notice to qualified beneficiaries

Nonjudicial Modification

- F.S. § 736.0412 - Unanimous agreement of trustee and all qualified beneficiaries

- F.S. § 736.04117 - Decanting (if distributions beyond HEMS are permitted)

Options to Accomplish Severance and Modification (cont.)

Judicial Modification

- F.S. § 736.04113 - Modification due to unanticipated circumstances
- F.S. § 736.04115 - Modification for best interests of beneficiaries

Funding of Trust 1 and Trust 2

- Pro rata funding permitted
- Non-pro rata funding permitted under the terms of the trust or, if not, under state law. F.S. § 736.0816(22)

Trustee Liability

- Releases from all interested persons (if nonjudicial) or court approval (if judicial modification)
- Virtual representation (if minors)

Income Tax Issues

Concern: The exchange of interests by Will and Carlton could be treated as a sale or exchange under IRC § 1001, which could result in gain or loss to Will and Carlton to the extent the amount realized exceeds basis.

Treasury Regulation § 1.1001-1(h)

- The severance of a trust is not an exchange of property for other property differing materially in either kind or extent if (1) the severance is permitted by the trust or state statute, and (2) any non-pro rata funding is authorized by state law or the trust terms.
- If non-pro rata funding is prohibited, but is used anyway, then it will be treated as pro rata funding followed by an exchange of assets between the trusts, which is taxable.

Income Tax Issues (cont.)

Landmark case: *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991)

- Test: Exchange of interests results in a disposition under IRC § 1001 only if the interests exchanged are "materially different in kind or extent."

- Compare the legal entitlements before and after the modification.

- This test has been applied by the IRS in numerous PLRs when analyzing whether a trust modification will be a taxable disposition by beneficiaries for income tax purposes.

Gift Tax Issues

Concern: Will and Carlton could be treated as making a gift to each other by relinquishing their beneficial interest in the other's trust.

Gift will be deemed to be made to the extent the modification shifts value from one beneficiary to the other.

If a bona fide dispute/litigation exists, then a settlement resulting from the dispute should be treated as a transfer for full and adequate consideration and, thus, not a gift for gift tax purposes.

- *Ahmanson Foundation v. U.S.*, 674 F.2d 761 (9th Cir. 1981) – Intrafamily settlements will not be regarded as a bona fide compromise unless the claims were legitimate and are satisfied, to the extent feasible, on an economically fair basis.

GST Tax Issues

Concern: The creation of two new trusts could cause the loss of GST exemption that was allocated to the Credit Trust upon Phil's death.

Preserve GST upon Severance – Treas. Reg. § 26.2642-6 - Qualified severance

- Pursuant to state law or trust terms;
- Effective under local law;
- Funding must occur within 90 days of severance date;
- Original trust is severed on a fractional basis; and
- Resulting trusts must provide for same succession of interests of beneficiaries as the original trust.

GST Tax Issues (cont.)

Preserve GST upon Modification – Treas. Reg. § 26.2601-1(b)(4)(i)(D)

- Modification may not:

  (i) shift a beneficial interest in the trust to a lower generation than those who held interests prior to the modification.

  - shift occurs if there is either an increase in the amount of a GST transfer or the creation of a new GST transfer. A modification to administrative provisions that indirectly increases a GST transfer will not be treated as a shift of a beneficial interest to a lower generation.

  (ii) extend the time for vesting of any beneficial interest beyond the period provided for in the original trust.

Case Study 2: QTIP Trust Settlements

The Tale of

Mone Baggs $mith

Meet Mone Baggs $mith

In 2012, at the age of 89, the Texas oil tycoon married a woman named Vanna Nicole who, at 26, was 63 years his junior!

‘Til Death Do Us Part

- Shortly after their marriage, Mone died and Vanna became the beneficiary of a $45,000,000 QTIP Trust established by Mone

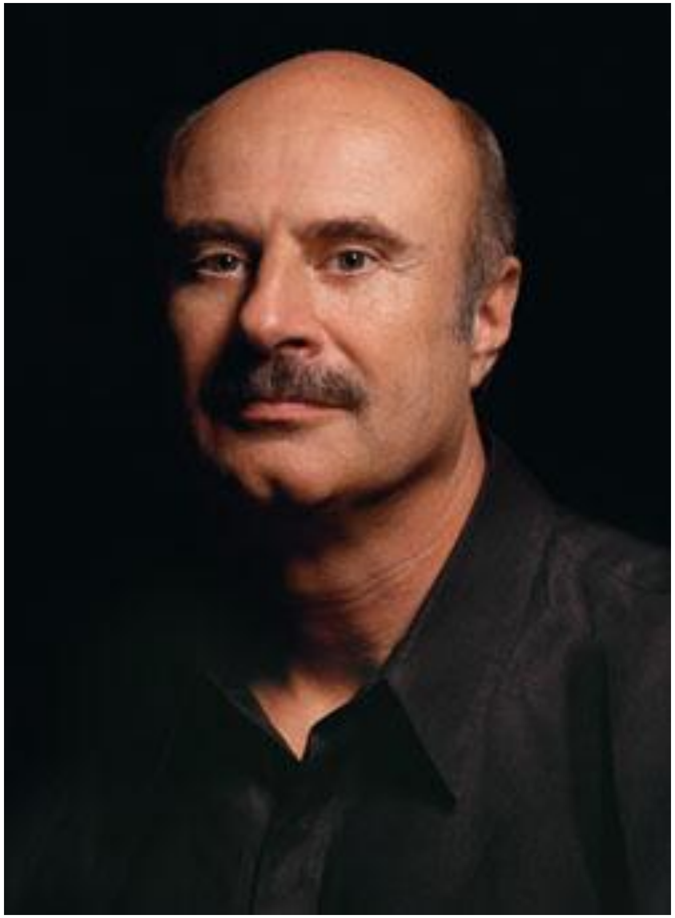
- QTIP Trust pays Vanna all income for life, remainder to Mone’s children (who are 30 years older than her), if living

Vanna Nicole - A Happy Woman

$mith Children, NOT SO MUCH

Disagreements ensue about everything (investments, income distributions, Trustee commissions, administration expenses, etc.)

Problem-Solving Trustee



- Trustee engages Dean Mead to terminate QTIP Trust under Florida Trust Code using a nonjudicial modification. 736.0412

- Requires unanimous consent of all qualified beneficiaries

Scenario 1

- Vanna receives distribution equal to the value of her life income interest based on §7520 rate and her current age (she is now 28); i.e., approximately 65%

- Mone’s children receive the remainder of the QTIP Trust; i.e., approximately 35%

Scenario 1

- Vanna has no assets of her own and has never made any taxable gifts
- Mone used all of his available exemption (i.e., none was portable to Vanna)
- What are the gift, estate and income tax consequences of the termination of the QTIP Trust?

Scenario 1

- Vanna receives $29,152,350 for her life income interest
- Vanna makes a Section 2519 gift of the remainder interest ($15,847,650) in the QTIP Trust to Mone’s children. PLR 200844010
- Section 2519 gift is a “net gift” of $12,845,464 (because the gift tax is paid from QTIP Trust remainder – §2207A)
- Gift tax of $3,002,186

Scenario 1

Estate tax consequences:

1. Vanna loses her estate tax exemption to offset taxes at her death
2. If Vanna dies within 3 years of the termination, Section 2035(b) brings gift tax paid back into Vanna's estate for estate tax purposes. *Estate of Anne Morgens v. Commissioner*
    - consider indemnity agreement from remainder beneficiaries or life insurance to cover the risk

Scenario 1

Income tax consequences to Vanna:

1. Vanna is treated as having received the value of the life interest in exchange for the sale of her entire interest in the Marital Trust. *McAllister v. Comm'r.*
2. Vanna has zero basis in her interest in the Marital Trust, therefore, entire amount received is gain. §1001(e); Treas. Reg. §1.1001-1(f)
3. Treated as amount realized from sale of a capital asset. *McAllister; Rev. Rul. 72-243*
4. Capital gain would be long-term because the termination was more than one year after Mone's death
5. Vanna's income tax basis in the assets she receives is equal to their fair market value. §1012

Scenario 1

- Income tax consequences to QTIP Trust:

1. QTIP Trust does not realize any gain. PLR 200723014
2. Unless appreciated assets are distributed to Vanna. §1001; §1.661(a)-2(f)

- Income tax consequences to $mith children

1. Tax on any capital gain realized by Marital Trust paid from remainder interest, reducing payout to children
2. Children receive carryover basis in assets received. §643(e)

Scenario 2

How would the gift tax consequences change if Vanna agrees to receive less than the §7520 value of her life income interest?

Scenario 2

Vanna now makes 2 gifts:

1. §2519 gift is same
2. §2511 gift = §7520 value less amount received
   - Annual exclusion available
   - No §2207A "net gift"

Scenario 3

How would the gift tax consequences change if the children agree to receive less (but not $0) than the §7520 value of their remainder interest?

Scenario 3

- Same §2519 gift by Vanna
- Children make gifts to Vanna equal to value of §7520 remainder interest less amount received. PLR 199908033

Scenario 4

- Sever QTIP Trust first to minimize tax implications?
- No effect on QTIP Trust that is not terminated. PLR 200723014 and 199926019

Scenario 5

- Assume that Mone had never used any of his applicable exclusion amount
- Assume Mone leaves all assets to a Marital Trust for Vanna with the “hope” that she would disclaim an amount equal to his exemption, which would pass to his children
- Vanna is the Trustee of the Marital Trust
- For reasons known only to Vanna, she makes the QTIP Election and does not disclaim any portion of the Marital Trust
- An estate tax return was filed for Mone and the portability election was made
- Vanna has Mone’s deceased spouse’s unused exemption (DSUE) plus her own basic exclusion amount

Scenario 5

- Vanna then marries Mone’s older brother, Even Richer $mith, who has an even larger estate, but has used all of his exemption through lifetime gifts
- Even collapses from exhaustion on the honeymoon and is given days to live
- With Even on his deathbed, Vanna and Mone’s children agree that she should take steps to use Mone’s DSUE before Even dies, but she does not want to (1) terminate the Marital Trust or (2) even give up the income from the Marital Trust

Scenario 5

- The $45,000,000 Marital Trust is severed into two Marital Trusts, Trust One with $30,110,762 and Trust Two with $14,889,238
- Vanna disclaims 1% of the income interest in Marital Trust Two, which is a §2511 gift of $96,457
- Vanna is treated as having made a §2519 gift of $5,243,543
- Vanna's total gifts are $5,340,000 and the DSUE from Mone offsets the gift tax. §25.2505-2T(b)
- Vanna retains the 99% income interest in Marital Trust Two for the rest of her life

Scenario 5

- At Vanna’s death, 99% of the value the assets in Marital Trust Two will be included in her gross estate. §2036; §20.2036-1(c)
- Vanna’s adjusted taxable gifts (that enter into the computation of her estate tax) are reduced by the §2519 gift of the remainder interest in Marital Trust Two that §2036 includes in her gross estate. §2001(b)
- Vanna has her own basic exclusion amount plus the DSUE from Mone (used to make the gifts) to offset her estate tax. §20.2010-3T(b)(1)(ii)

Scenario 5

- The planning will save approximately $2,000,000 of estate tax at Vanna's death
- Vanna's estate has a right to recover the estate tax due as a result of §2036 from Marital Trust Two, unless she specifically waives the federal right of recovery in her Will or Revocable Trust §2207B

Case Study #3: Will/Trust Contest

Jay and Gloria are a wealthy married couple.

Jay has a daughter from a prior marriage, Claire.

Gloria has a son from a prior marriage, Manny.

Jay and Gloria have a daughter together, Chloe.

Jay dies and is survived by Gloria and all children.

Jay wrote his own revocable trust and stated that half of his "adjusted gross estate" would pass to a marital trust for Gloria and the other half of his adjusted gross estate would pass in equal shares to all children, including Manny, outright.

All net income of the marital trust will be distributed to Gloria annually. The marital trust does not allow for the invasion of principal. Upon Gloria's death, the marital trust passes in equal shares to all children, including Manny.

Years before Jay's death, he and Gloria separated (but did not divorce) and entered into a marital settlement agreement. They later reconciled.

After Jay’s death, his daughter, Claire, claimed Jay’s trust should be set aside and no part of Jay’s estate should pass to Gloria due to the marital settlement agreement.

Jay’s estate, and Chloe and Manny, settle Claire’s claims by buying out Claire’s interest in the marital trust and paying out her share of the residue of the trust early.

General Tax Considerations

No income tax in settlement of will contest if:

- Settlement payment made pursuant to an enforceable right;
- There is a bona fide dispute; and
- The nature of the transfer is that of a gift or inheritance.

Substantiate these elements in the Recitals of the Settlement Agreement. Court approval of settlement agreement bolsters legitimacy of settlement terms.

IRS is not bound, however, by state court ruling, unless it is a decision of the highest state court.

Sale of Interest in QTIP
- Generally -

- Absence of spendthrift clause allows assignment of interest.
- Value paid for interest must account for time value of money and estate taxes upon death of Gloria.
- The marital trust should also be reformed to remove Claire and her descendants as remainder beneficiaries.

Sale of Interest in QTIP
- Income Tax Considerations -

- Sale of remainder interest by Claire to Chloe and Manny is a taxable event.

- The sale is a capital transaction. The basis is divided between the life tenant (Gloria) and the remainder beneficiary (Claire) based on IRS factors.

- Amount paid should account for estate tax liability upon Gloria’s death, thereby reducing (and possibly eliminating) capital gain on the transaction.

- Basis of Chloe and Manny is not important because it will change upon Gloria’s death.

Sale of Interest in QTIP
- Gift Tax Considerations -

- Transfer for full and adequate consideration after arm's length negotiations = no gift.

Sale of Interest in QTIP

- Estate Tax Considerations -

- Purchase must be made by Chloe and Manny from funds outside marital trust in order to preserve marital deduction.

Sale of Interest in QTIP

- GSTT Considerations -

- None. The sale transaction is between children and has no impact on a grandchild or remote descendants.

Acceleration of Interest in Residue
- Generally -

- Shifts audit risk (income, gift and estate) to other beneficiaries, and Claire will want indemnification for such potential tax liability.

- Need affirmation that all known assets have been disclosed.

- Need affirmation that all known gifts have been disclosed.

- Claire will accept payment in full discharge of her interests as a remainder beneficiary.

Acceleration of Interest in Residue
- Income Tax Consequences -

- Inheritance not included in gross income.
- Distribution from residue carries out DNI to Claire.
- No gain or loss on distribution. Non-pro rata funding permitted under Florida law.

Acceleration of Interest in Residue
- Gift Tax Considerations -

- Settlement terms represent full and adequate consideration to each party after arm's length negotiations.

Acceleration of Interest in Residue
- Estate Tax Considerations -

- Tax apportionment.
- Deduction of litigation costs as administration expenses.
- Payment of Claire's legal fees should be part of negotiation and <u>may</u> be deductible as an administration expense if they are paid by the Trust. If so, obtain agreement to provide supporting documentation to IRS.
- Generally, payment of administration expenses must come from residue to avoid impacting the marital deduction.

Acceleration of Interest in Residue
- GSTT Considerations -

- None. The residuary distribution is to a child and has no effect on grandchildren or more remote descendants.

Other Issues
- Elective Share -

- Marital Trust counts against elective share at 50%, and 50% of adjusted gross estate passes to Marital Trust. Thus, it appears Gloria may benefit from an elective share election.

- Qualifies for marital deduction.

- Does not carry out DNI.

Other Issues
- Trust Construction -

- Trust does not contain a true residuary clause and construction action should be included to clarify amount passing to children constitutes residuary gift and marital trust funded as pre-residuary, pecuniary gift.

Case Study #4: Decanting

Camille created a Florida irrevocable trust in 2002 that provides for distributions to or for the benefit of Sarah, and Sarah's descendants, for health, education, maintenance and support. In addition, a disinterested trustee may make distributions for Sarah and Sarah's descendants for their best interests.

The Trust provides that 1/3 of the Trust assets shall be distributed to Sarah once she reaches age 35, 1/2 shall be distributed to Sarah once she reaches age 40, and all remaining assets shall be distributed to Sarah once she reaches age 45. If Sarah dies prior to receiving all of the Trust assets, then the balance is distributed outright to Sarah's descendants, per stirpes.

Sarah has two adult descendants, Amber and Drew.

Camille did not allocate any GST exemption to the Trust.

The Trust assets have grown larger than Camille anticipated and she does not want Sarah or her descendants to receive a large distribution of the Trust assets outright at any age because Camille's new advisor has explained to her the benefits of trusts.

She has concerns that Sarah, Amber and Drew may lose the motivation to “make something of themselves” if they receive a lump sum distribution from the Trust.

What can be done to save the Braverman family?

State Law Issues

- *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (1940)
- F.S. § 736.04117 – Trustee's Power to Invade Principal in Trust
  - Trustee must have "absolute power" to invade principal
    - e.g., best interests, welfare, comfort, happiness. HEMS is not an "absolute power".
    - Second trust may include only beneficiaries of the first trust.
    - Second trust may not reduce fixed income, annuity or unitrust interest.
    - Trustee must notify all qualified beneficiaries within 60 days of exercise.
      - What if a beneficiary objects?
      - What about the Trustee's liability?

State Law Issues (cont.)

- Assume the Trust does not contain an absolute power to invade principal, but only permits distributions for HEMS. Can the Trust still be decanted?
  - Florida does not permit decanting based on an ascertainable standard, but several states do. See Alaska, Arizona, Delaware, Kentucky, Missouri, Nevada, New Hampshire, New York, North Carolina, South Carolina, South Dakota and Tennessee.
  - In total, at least 22 states have a decanting statute, each with their own requirements (Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Missouri, Nevada, New Hampshire, New York, Nevada, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, and Wyoming).
  - Will changes be made to F.S. § 736.04117?

IRS Guidance

- IRS Notice 2011-101 (December 21, 2011) – IRS requested comments regarding the circumstances under which transfers by a trustee of all or a portion of the principal of one irrevocable trust to another irrevocable trust that result in a change in the beneficial interests in the trust are not subject to income, gift, estate or GST taxes.

- IRS has yet to issue final guidance and will not issue private letter rulings in the meantime.

Grantor Trust / Income Tax Issues

- Generally, the grantor of the first trust will remain the grantor of the second trust. Treas. Reg. § 1.671-2(e)(5)

- Decanting from grantor trust to grantor trust = should not be an income tax event. Rev. Rul 85-13.

- Decanting from a non-grantor trust to grantor trust = should not be an income tax event. See Chief Counsel Advice 200923024.

- Decanting from a grantor trust to non-grantor trust = Possible income tax event. See *Madorin v. Commissioner*, 84 T.C. 67 (1985); Treas. Reg. 1.1001-2(c), Ex. 5.

Grantor Trust / Income Tax Issues (cont.)

- Decanting from a non-grantor trust to non-grantor trust = Possible income tax event. See *Cottage Savings Assn. v. U.S.*, 499 U.S. 554 (1991); PLR 200736002.

- However, one principal argument that the decanting should not be an income tax event to the beneficiaries is that the decanting is pursuant to the exercise of a trustee's power under state law. It is not an action by the beneficiaries. If the Trustee is authorized under state law to decant, then the beneficiaries generally do not have the legal authority to prevent the decanting and thus, should not be treated as selling or exchanging their beneficial interest.

Gift and Estate Tax Issues

- Similar to those discussed for the trust modifications in the earlier case studies.

- As with income tax, a principal argument that no gift should be deemed to occur as a result of the decanting is that decanting is the exercise of a trustee's power pursuant to state law. It is not a transfer by the beneficiaries. If the Trustee is authorized under state law to decant, then the beneficiaries generally do not have the legal authority to prevent the decanting. Therefore, they should not be treated as making a gift.

GST Issues

Assume the Trust did not have mandatory distributions once Sarah reached ages 35, 40 and 45, but instead provided for assets to remain in trust for Sarah's lifetime and, upon her death, pay outright to Sarah's descendants, per stirpes. Assume further that the Trust was exempt from GST tax prior to the decanting. Can the Trust be decanted without losing the GST exemption?

- The IRS has stated in non-binding private letter rulings that, at a minimum, a change that would not affect the GST status of grandfathered GST exempt trusts would similarly not affect the exempt status of trusts that are exempt as a result of an allocation of GST exemption. PLR 200839025.

GST Issues (cont.)

Treas. Reg. § 26.2601-1(b)(4)(i)(A) - Safe Harbor Requirements to Preserve Exempt Status

1. Either the terms of the trust authorize decanting without the consent of any beneficiary or court, or at the time the exempt trust became irrevocable, state law authorized decanting without the consent of any beneficiary or court; and
2. Terms of the second trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting or absolute ownership of an interest, measured from the date the first trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years.
    - Postponing or suspending the vesting or absolute ownership of an interest for a term of years that will not exceed 90 years is expressly permitted.