WELLS FARGO

Adaptable Wealth Planning Strategies

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In this special report

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Charles Darwin's Theory of Evolution proffers that complex creatures evolve from more simplistic ancestors naturally over time not because of their strength, speed or smarts. Rather, Darwin's general theory presupposes that a species survives and thrives because of its genetic ability to adapt to change. Adaptability is essential for survival of a species and is increasingly important for a client's wealth and estate plan.

Currently, our wealth transfer tax system is set to undergo a massive makeover beginning in 2013. Barring some legislative act by Congress, the favorable wealth transfer planning provisions found within the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 will terminate at year end. As enacted, the $5 million gift tax exclusion and generation-skipping tax exemption, along with an historically low 35 percent combined estate, gift and generation-skipping tax rate is set to expire on 12/31/2012. Thereafter, the reduced gift tax exclusions and higher transfer tax rates of the Economic Growth and Tax Relief Reconciliation Act of 2001 would apply.

As the deadline quickly approaches for taking advantage of the government's $5 million gift-tax exclusion, more than a few clients are facing the fear of "donor's remorse." Affluent clients who are exploring setting up irrevocable trusts to pass along sizable assets to their heirs without paying gift tax this year may worry they will change their minds later in life or will need to get the assets back one day. Other client concerns regarding gifting to trusts may include addressing unexpected changes in the tax and estate laws, or desiring to change the terms of the trust to keep heirs incentivized and/or to address problematic beneficiary behavior.

We live in insecure planning times, where wealth transfer planning should increasingly be adaptable in order to address the concerns of clients and their descendents. Clients today often feel insecure about transitioning wealth they may themselves need in the future to family members in flux, while advisors clearly lack the ability to forecast the transfer tax laws, creating challenges in assisting clients with wealth planning beyond year end.

Consider the growing list of planning challenges: clients are living longer; health care costs are skyrocketing; family circumstances are continually changing; a deficit-riddled America will likely face austerity; and market volatility abounds with "black swan" events occurring much more frequently than every one hundred years. And from an advisor's vantage point, planning clarity regarding the transfer tax laws terminates altogether on 12/31/2012.

To name but a few of Congress's available options regarding transforming our transfer tax system, Congress could:

- Vote to keep the current 35 percent transfer tax structure with an indexing of $5.12 million exclusion/exemption (estate, gift and generation skipping transfer (GST) tax)
- Eliminate the "death tax" altogether in exchange for raising income tax revenue from the rich
- Continue the step-up in basis on appreciated assets upon death
- Elect to have a Code Sect. 1022, Form 8939, carryover basis type of approach
- Enact a capital gains tax at death as Canada does today
- Keep "portability" or send it packing
- Do nothing and allow the estate tax law to return to 2001 beginning in 2013, with up to a 60 percent transfer tax rate and a $1 million estate tax exclusion
- Address the transfer tax issue retroactively after 12/31/2012
- Adopt the President's proposed plan to return to 2009's $3.5 million estate and $1 million gift tax exclusions and the $1 million GST tax exemption
- Craft up some other short-term patch or political surprise altogether

With limited ability to predict the tax changes that ultimately will be enacted, and more planning vehicles under increased scrutiny, such as the President's newly proposed plan to apply a transfer tax to grantor trusts, prudent planning recommendations increasingly depend upon adaptable planning ideas. From basic to advanced estate planning, flexibility, particularly in reference to irrevocable trusts, is becoming mission critical for there to be a productive long-term planning outcome. This paper takes a brief and non-legalistic look at some of the more prevalent adaptable wealth planning strategies. Adaptable planning in its many forms should be considered for many wealth and estate plans, beginning with a client's foundational estate planning documents and the need for postmortem dispositive flexibility.

Adaptive postmortem planning trusts

Disclaimer trusts

The planning flexibility of disclaimer trusts can make them particularly appealing in this uncertain environment. The essential elements of a qualified disclaimer are:

- The disclaimer must be irrevocable and unqualified
- Made in writing
- Delivered to the transferor within nine months
- The disclaiming party must not have accepted the interest or property being disclaimed
- The interest disclaimed must pass to either the decedent's spouse or to a person other than the disclaimant[1]

Planning pointer: One potential drawback of the disclaimer trust is that the surviving spouse may choose not to make the disclaimer. Further, even if a disclaimer is made, the disclaimed assets do not receive a step-up in basis when the surviving spouse dies. Finally, some planning control is necessarily relinquished since the surviving spouse cannot retain a limited power of appointment and effect control over beneficial enjoyment of the assets within the disclaimed trust.[2]

Clayton Marital & One-Lung Trusts

Consider other flexible post-mortem planning techniques such as the One-Lung Marital Trust (OLMT) and/or the Clayton Contingent Marital Trust (CCMT).[3]

In an OLMT, the decedent's entire estate will be left to a marital trust where the executor can then make a partial QTIP election. Thereafter, there will be two identical trusts: one qualifying for the marital deduction and the other not qualifying for the marital deduction. A limitation of the OLMT is that the surviving spouse must be the sole beneficiary of each trust, to the exclusion of the children.

A CCMT, like an OLMT, also leaves the decedent's entire estate to a single marital trust, where the surviving spouse's income interest in the QTIP is contingent upon a QTIP election. Here again, the executor makes a partial QTIP election. With a CCMT, however, any property that does not qualify for the marital deduction will typically pass to a separate bypass trust, where the terms and beneficiaries can be different from the QTIP trust and therefore can include the children.

Planning pointer: In both the OLMT and CCMT, the QTIP election does not need to be made until 15 months (nine months plus a six month automatic extension) after the decedent's death. As such, the OLMT and CCMT may be more flexible than a disclaimer trust because the disclaimer must be made within nine months of the decedent's death. Further, unlike the disclaimer approach, both the OLMT and CCMT can provide that after the surviving spouse dies the assets of the trust pass to decedent's desired beneficiaries, and in each case, the trust can provide the surviving spouse with a limited power of appointment.

Postmortem dispositive flexibility is an important consideration when working with professional legal advisors in constructing a client's foundational estate planning documents. However, more advanced planning strategies using irrevocable trusts that are designed to utilize today's generous gift tax exclusion or that allow the client to have access to transfer tax-efficient wealth may be even more appealing.

Adaptive advanced trust strategies

Spousal Lifetime Access Trust

Before routinely recommending an Intentionally Defective Grantor Trust (IDGT) or a Grantor Retained Annuity Trust (GRAT), consider the benefits and flexibility of an irrevocable Spousal Lifetime Access Trust (SLAT). Through the use of a SLAT, for example, a husband can benefit his wife as a beneficiary by funding the trust with his separate property for any amount up to his $5.12 million dollar transfer exclusion for 2012 without paying gift taxes.

During the wife's lifetime, the trustee can be the wife alone or in conjunction with an independent trustee, and the trustee (s) can distribute income and principal to the wife under an ascertainable standard. As a result, the husband has indirect access to the trust's income and principal through his wife and upon her demise the assets can potentially pass estate-tax free to the husband's descendants (assuming husband's GST tax exemption was properly allocated to trust contributions).

Planning pointer: Note, upon the wife's death, the husband loses his indirect access to the trust's income and principal. As such, one might consider having the wife create an Irrevocable Life Insurance Trust (ILIT), which does not trigger the reciprocal trust doctrine (discussed below), for the benefit of her husband to replace the wealth lost to the husband through the SLAT.

Some commentators have suggested gift splitting in SLATS is permissible provided distributions to the beneficiary spouse are limited by an ascertainable standard and the beneficiary spouse has sufficient financial assets outside of the SLAT, making a trust distribution very remote (see Qualifying Trust Transfers for Split-gift Treatment by William R. Swindle, July/August 2007, Vol. 81, No. 7, FL Bar Journal). Even so, the more conservative approach is to not use gift splitting in a SLAT as gifts in which the consenting spouse retains an interest may not likely be split. If the gift in the example above made by the husband to the wife (via the SLAT) is not severable from the gift to the children/grandchildren as other beneficiaries, the gift cannot be considered as made one-half by husband and one-half by wife.[4] As such, if one-half of the $10.24 million contribution to the trust cannot be split the client would incur a painful gift tax of nearly $1.8 million.

What if the husband transfers some of his separate property assets to his wife who then turns right around and creates a SLAT for her husband as beneficiary? In such a case, be wary of the *step transaction doctrine* since the assets and the economic risk should be owned and held exclusively by the grantor spouse for a reasonable period of time. Should the husband and wife both create SLATs for one another, seek to avoid the *reciprocal trust doctrine*, where trusts are viewed as part of the same plan and where the parties are left in the same economic position, by incorporating meaningful differences between the two trusts.[5] Seek to have drafting provisions which are substantially different between the trusts, including different assets or value of assets contributed, different trust creation and/or termination dates, different beneficiaries, different standards for distributions, different trustees, different testamentary powers and different powers to remove and replace a trustee.

Beneficiary Taxed Grantor Trust

The Beneficiary Taxed Grantor Trust (BTGT) (also known as a BDIT©) is designed to help minimize transfer taxes and protect trust assets from creditors, while providing uncommon adaptability because the client can have beneficial enjoyment over the irrevocable trust property. A BTGT is an irrevocable dynasty trust that is typically set up by a trusted third party, such as the client's parents, for the benefit of the client in a self-settled trust jurisdiction that has extended or revoked its perpetuities laws. The client is able to be the primary or sole beneficiary with an independent trustee which is often, but not necessarily, an institutional trustee. Because courts and the I.R.S. have not sanctioned this strategy some corporate trustees, including Wells Fargo, will not act as institutional trustee.

Initially, the trusted third party (that is, the client's parent) contributes a nominal amount of money, for example $5,000, to the trust and gives the client the ability to withdraw that amount using a *Crummey* withdrawal power, which the client allows to lapse. By using a *Crummey* withdrawal power the client as a beneficiary becomes the "owner" of the trust for income tax purposes, but not for estate tax purposes.[6]

Planning pointer: Since the trust is a grantor trust with respect to the beneficiary for income tax purposes, the client can sell appreciated assets like a closely held business to the BTGT (just like to an IDGT) in exchange for a promissory note without any capital gains tax consequences.[7] Moreover, because the trust was not created by the client, transfers to the trust are not subject to the normal statute of limitations on fraudulent transfers.

Beyond SLATs and BTGTs, clients may be contemplating making sizable gifts to other irrevocable trusts to take advantage of this year's increased transfer tax exclusions, therefore, clients and their advisors may want to consider incorporating the following flexible features into their trusts.

Adaptive planning pointers and provisions

Defined value clauses. While still scrutinized by the I.R.S., recent judicial rulings regarding defined-value clauses have been encouraging. Clients can limit the quantity of assets gifted or sold until a final IRS determination of value can be made.[8] Generally, defined value clauses provide that any excess value over the final determination amount passes gift tax free to a qualified charity. Note, however, that a recent tax court memo upheld a defined value clause without a charitable component by limiting the gift of partnership units to a stated dollar amount.[9]

Defined value clauses may be particularly helpful with respect to the popular promissory note sale to an IDGT, through seeding the IDGT with the increased $5 million gift tax exclusion and the potential size of the promissory note. With a little more than $10 million worth of seeding available through using husband's and wife's increased gift tax exclusions, a $90 million installment note can be taken back from a sale to the defective grantor trust.

Furthermore, a defined value transfer expressing the transferred assets as a dollar value, rather than as a percentage interest or number of units, combined with a GRAT may provide a strategic solution to valuation deficiencies raised by the IRS.

Powers of appointment. Consider granting broad special powers of appointment exercisable by the primary beneficiary during lifetime and at death that can potentially repurpose the trust among children, grandchildren, charities and friends. Also, including the power to "decant" trust assets may help cure potential trust issues and inadequacies that might arise by allowing the trustee to appoint or distribute the trust corpus from the existing trust to a new trust for the benefit of permissible distributees or appointees.

Drivers for decanting can include situations that are:

- *Administratively driven.* Often seen where a change of situs or governing law is desired or where an expansion of trustee powers is needed.
- *Ambiguity driven.* Employed in cases where there is a need to correct scrivener's errors and/or drafting ambiguities.
- *Beneficiary driven.* Used in circumstances where problem beneficiary behavior occurs, a special needs situation suddenly arises, or simply to divide a pot trust into separate but equal trusts for the beneficiaries.
- *Tax driven.* Frequently occurs where one is desirous of mitigating state income taxes or to convert a grantor trust to a non-grantor trust or vice versa.

Although trustees arguably have the power to decant under applicable state common law, if the trust document does not specifically provide for decanting, it may be worth considering changing the situs and governing law of the trust to one of the existing fifteen states which explicitly permit decanting. And while decanting provisions are likely prudent to include in trust documents, caution should be exercised before actually decanting, particularly where GST trusts are involved and unwarranted tax consequences are to be avoided.

Despite the unambiguous trend to decant, it is important to note that decanting is not the only modification method available to reform irrevocable trusts. Other viable techniques include judicial and non-judicial reformation and the use of trust protectors as set forth below.

Trust protectors. More important than ever in this time of tax and economic uncertainty is the role of the trust protector. A trust protector's role is primarily to ensure that the grantor's wishes are carried out and thereafter to monitor the actions or inactions of the trustee. Most often seen where the beneficiary has the ability to remove and replace a trustee, the use of trust protectors in irrevocable dynastic trusts is clearly on the rise, where their powers can include but are not limited to: oversight functions, mediation, trust modification, and investment or other financial advice.

Even so, careful consideration of the specific powers that should be granted to the trust protector is needed as well as when to grant them and in what capacity. Although a trust protector's powers over the trust may be broad, limitations are often practical. For example, the trust protector should not be able to participate in the exercise of a power that would cause the trust protector to possess a general power of appointment within the meaning of 2041 and 2514 of the Internal Revenue Code. Moreover, while some statutes make clear that a trust protector is not a fiduciary, this does not mean that courts will necessarily concur in the future if the trust protector acts like a fiduciary. Generally, it is more conservative to have the trust protector serve in a fiduciary capacity because the liability risk assumed by the trust protector will be clear from the outset.

Through appointing a trust protector the grantor can address many unforeseen tax, legal and familial circumstances with respect to the trust. Still, the scope of adaptability granted to the trust protector should be balanced with the need for the trust protector to be accountable. In that regard, it may be prudent to impose a "good faith standard" on the trust protector, where liability attaches for an act or omission motivated by an actual intent to harm the beneficiaries of the trust, or where the trust protector engages in an act of self-dealing designed for pecuniary benefit.

Trustee and distribution provisions. Consider allowing the primary beneficiary as the initial sole trustee to make permissible discretionary distributions to himself/herself and to others pursuant to an ascertainable standard. Additionally, consider adding an independent trustee (perhaps springing) in order to make discretionary distributions to the primary beneficiary over and above an ascertainable standard and to hold tax-sensitive administrative powers. In all cases, make sure to prohibit the trustee from making distributions that discharge a legal obligation of support that may result in adverse gift and estate tax consequences for the trustee. Among the more prevalent adaptable provisions used in irrevocable trusts are the following:

- Specify the grantor's intent, if there is a particular preference, or trust purpose
- Offer guidance as to how the trustee should exercise distribution discretion
- Think about permitting trust distributions for weddings, buying a home or car, starting a business and establish parameters around each
- Provide for virtual representation where permissible for unascertainable or unborn beneficiaries
- Allow the trustee to make loans to beneficiaries
- Choose the trustee (individual or corporate) with a view towards flexibility and fiduciary skill-set
- Provide direction for the trustee on whether or not to consider beneficiary resources
- Designate priority among trust beneficiaries

- Grant a beneficiary an automatic annual 5 percent and $5,000 withdrawal power
- Insert tie-breaker language where co-trustees are named
- Allow the trustee to terminate an uneconomical trust
- Permit the trustee to resign and establish a process for naming a successor trustee in the event that those named in the document are unable or unwilling to act
- Allow the trustee to hold "S" corporation stock and preserve the "S" election
- Give the trustee broad discretion regarding investment powers
- Consider appointing a Trust Protector or Special Trustee where the trust owns a closely held business or where the grantor is concerned about a beneficiary's lifestyle choices and/or possible addiction to drugs or alcohol
- Avoid frozen fee language and allow the trustee to receive reasonable compensation for services rendered ("published fee schedule" for institutions)
- Specifically indemnify and direct the trustee to retain a particular asset, concentrated or closely held position if the grantor so desires
- Provide the trustee the power to make a Code Sec. 1035 exchange or sell an insurance policy
- Grant a general power of appointment to the primary beneficiary to avoid the GST tax, only upon the condition that there is an overall reduction in transfer taxes since it is no longer a given that the GST Tax will be lower than the estate tax

Unsure about whether the grantor or the trust should pay for the trust's tax consequences in a vacillating economic environment? One idea that may be worth considering is to craft the trust with an annual "toggle switch" by giving an independent trustee the ability to make loans to the grantor without regard to adequate security. If grantor trust status is desired, the trust could lend funds to the grantor for less than adequate and full consideration. To switch grantor trust status off, have the grantor fully repay the trust loan.[10]

In addition, to help provide for adaptability, consider provisions that allow the trustee to change trust situs and governing law, invoke tax savings clauses, and merge or divide the trust (that is, into GST exempt and GST non-exempt trusts).

One final idea being suggested by some advisors with respect to avoiding a GST tax in this uncertain environment is to utilize at least two trusts; one set up with the 2001 indexed GST tax exemption amount of $1.39 million and another funded with $3.73 million (that is, the difference between the current exemption amount of $5.12 million and the $1.39 million exemption amount). This strategy of multiple trusts is recommended to hedge against potential changes to the transfer tax system should we return to the 2001 GST tax laws.[11]

Conclusion

The preceding paragraphs on adaptability in wealth planning were intended to serve as a primer only on some of the strategies available regarding this expansive and timely topic. Before recommending or implementing any of the aforementioned ideas, a further in-depth analysis is warranted, including exploring the tax and legal implications with professional tax and legal advisors.

Nevertheless, this briefing is a reminder to practitioners and clients alike to consider taking advantage of the generous transfer tax exclusions that are available until the end of the year. Waiting for a new transfer tax law and for "planning clarity" to come may mean losing out on the gifting window of opportunity that is available today. Moreover, wealth transfer planning accomplished though irrevocable trusts should be looked at as a process that does not have to be set in stone. Irrevocable trusts can have flexible features to them.

Perhaps the most appropriate method of planning in today's insecure times is to use wealth transfer planning vehicles that can adapt with the legal, economic and familial circumstances that undoubtedly will change. And in keeping with Darwin's theory, over the course of time adaptable wealth transfer planning strategies are likely to survive as the fittest.

End notes

[1] Code Sec. 2518.

[2] Examples 4, 5, and 6 of Reg. § 25.2518- 2(e)(5); and Code 2041(b)(1)(A).

[3] *A. M. Clayton, Jr. Est.*, CA-5, 92-2 USTC ¶60,121, 976 F2d 1486 (1992) and Code Sec. 2056(b)(7).

[4] Revenue Ruling 56-439, 1956-2 CB 605.

[5] *A. S. Lehman, Exr.* CA-2, 40-1 USTC ¶9148, 109 F.2d 99 (1940), Cert. den.; *J.P Grace Est.*, S Ct, 69-1 USTC ¶12,609, 395 U.S. 316, 89 S Ct 1730 (1969); *B. Bischoff Est.*, TC, Dec. 34,702, 69 T.C. 32 (1977).

[6] Code Sec. 678 (a).

[7] Revenue Ruling 85-13, 1985-1 C.B. 184

[8] *A. E.Petter Est.*, CA-9, 2011-2 USTC ¶60,623, 653 F.3d 1012 (2011), *aff'g* TC, Dec. 58,012(M), 98 TCM 534, T.C. Memo 2009-280 (2009); *C.T. McCord, Jr., Est.*, CA-5, 2006-2 USTC ¶60,530, 461 F.3d 614 (2006), *rev'g* TC, Dec. 55,149, 120 T.C. 358 (2003); and *H.Christiansen Est.*, TC, Dec. 57,301, 130 T.C. 1, reviewed by the Court, (2008), *aff'd*, CA-8, 2009-2 USTC ¶60,585, 586 F.3d 1061 (2009).

[9] *Wandry v. Commissioner*, TCM, Dec. 45,590(M), T.C. Memo. 2012-88 (2012).

[10] Code Sec. 675 (2) and 675 (e).

[11] Carlyn S. McCaffrey and Pam H. Scheider, "The Generation Skipping Transfer Tax", *Trust&Estates*, February 2011.

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