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TRUST TERM CONSTRAINTS AFTER REPEAL OF THE FEDERAL ESTATE TAX

*Kelly A. Moore**

I. INTRODUCTION

State law generally provides settlors with significant flexibility in establishing trust terms.¹ This flexibility is not unfettered, however, as state law typically restricts a settlor's freedom in regards to spousal interests, creditor rights, and rules against perpetuities, if still extant.² Beyond these state imposed restrictions, however, settlors enjoy tremendous freedom under state law to choose the terms that govern their trusts. Yet, for clients whose wealth levels, asset characteristics, or beneficiary attributes trigger the need for advanced estate planning, this freedom may be lost, and the trust documents created can be complex, containing many sophisticated provisions related to federal tax and other laws.³ Among the federal laws constricting trust term selection is the federal estate tax, the long-term status of which is currently uncertain. This article examines the impact of the federal estate tax on the selection of state law trust terms, concluding that permanent repeal of the estate tax will not dramatically reduce the complexities and constraints imposed by federal law in the crafting of estate planning trust documents.

In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act,⁴ ("EGTRRA") affecting a temporal compromise between those seeking

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¹ UNIF. TRUST CODE § 105 (amended 2005).

² Max M. Schanzenbach & Robert H. Sitkoff, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465, 2466 (2006).

³ See, e.g., JEFFREY N. PENNELL, WEALTH TRANSFER PLANNING AND DRAFTING 8-1, 9-1, 10-1, 17-1, 18-1 (2005).

⁴ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) (codified as amended in scattered sections of 26 U.S.C.) [hereinafter EGTRRA].

permanent repeal of the estate tax and those favoring preservation of the estate tax in some form.⁵ For those proposing repeal, the act triggered a one year repeal of the estate tax in calendar year 2010.⁶ This one year “death tax”⁷ holiday follows a staggered increase in the amount of property that could be transferred tax free at death under the estate tax between 2001 and 2009.⁸ For those opposing repeal, the estate tax is reinstated in 2011 at 2001 year levels.⁹ EGTRRA also repealed the generation skipping transfer tax (“GSTT”) for 2010 with an accompanying increase in exemptions prior to 2010 and a reinstatement in 2011, also at 2001 year levels.¹⁰ The gift tax is left in place, with an increase in the amount of property that could be gratuitously transferred *inter vivos* and a reduction in rates.¹¹

Since EGTRRA was enacted, numerous unsuccessful attempts have been made to make the repeal of the estate tax permanent.¹² Putting aside the inherent compliance difficulties in the staged and temporary change and repeal of the estate tax foisted on taxpayers by EGTRRA,¹³ the perceived imposition of compliance complexity by the estate tax on taxpayers is one of the arguments proponents of making permanent the death tax repeal posit.¹⁴ It is said that estate planning documents are longer, more complex and more expensive due to the lawyer’s need to plan around the estate tax.¹⁵ If the estate and GSTT taxes are repealed, the argument continues, this burden on taxpayers and the attendant intrusions on the freedom under state trust law to select trust terms will be removed.¹⁶

⁵ See Reginald Mombrun, *Let’s Protect our Economy and Democracy from Paris Hilton: The Case for Keeping the Estate Tax*, 33 OHIO N.U. L. REV. 61, 61–3 (2007).

⁶ EGTRRA § 901(a)(2) (2001) (providing the return of the estate tax in 2011).

⁷ See Daniel W. Matthews, *A Fight to the Death: Slaying the Estate Tax Repeal Hydra*, 28 WHITTIER L. REV. 663, 665 (2006) (discussing the adoption and manipulation of the term “death tax” by the proponents of repeal to sway public opinion against the estate tax).

⁸ See I.R.C. §§ 2001, 2010 (West 2002).

⁹ *Id.* § 2011.

¹⁰ *Id.*

¹¹ *Id.* § 2011, 2503.

¹² See Dustin Stamper, *GOP Hoping for Resurrection of Estate Tax Reform in 2006*, TAX NOTES TODAY (Tax Analysts), Nov. 16, 2005, at 220–2, available at LEXIS, 2005 TNT 220-2.

¹³ See Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 262 (2002).

¹⁴ See Mombrun, *supra* note 5; see also Kristine M. Schlachter, *Repeal of the Federal Estate Tax and Gift Tax: Will it Happen and How Will it Affect our Progressive Tax System?*, 19 VA. TAX REV. 781, 798 (2000).

¹⁵ Stephen Vasek, *Death Tax Repeal: Alternative Reform Proposals*, 92 TAX NOTES 955, 957 (2001).

¹⁶ See Schlachter, *supra* note 14.

The imposition of this complexity manifests itself in the selection of terms used in trust documents.¹⁷ In a narrow view of estate planning, repeal proponents may be correct. If estate planning is defined solely as the documentation of attempts to avoid and/or minimize only the impact of the estate tax, it is self evident that repealing the tax successfully removes complexity from trust terms. In a broader understanding of estate planning, however, one discovers that estate planning is more than avoiding the “death taxes,” and includes planning tied to specific asset characteristics, and attempts to avail other federal benefits or avoid other federal taxes.¹⁸ This article takes the broader view of estate planning, and evaluates the effect estate tax repeal has on the overall constraints imposed by federal law on the flexibility in trust term selection allowed under state trust law.

The impact of federal estate tax and other laws on trust terms selection takes two avenues: One, the magnitude of its impact as measured by the number of trusts created as a result of planning related to federal laws; and two, the variations in estate planning trust documents dictated by federal law requirements. This paper addresses the second of these avenues. I note, however, that the overall magnitude of the impact of the estate tax may be small. As only 0.3% of Americans incur estate tax liability, on average, 99.7% of Americans are left free to ignore the estate tax in most planning regards.¹⁹ While not every American will create a trust and, perhaps, the repeal of the estate tax may cause a reduction in the number of trusts established, for those that create trusts, federal laws other than the estate tax may limit the trust terms they select. The potential impact of rules related to trusts receiving payments from deferred benefits plans may have on state trust law is significant because 57% of the nation’s households have retirement savings in a deferred format, including 73% of retired households.²⁰ Also, whereas only 6,300 estates may be impacted by the federal estate tax in 2009,²¹ upwards of

¹⁷ See, e.g., I.R.C. §§ 2055–56 (West 2002) (dictating trust terms required for a decedent to obtain estate tax marital and charitable deductions).

¹⁸ See Richard C. Spain, *Estate Planning for a Disabled Beneficiary*, PRAC. LAW., Oct. 1991, at 29; see also FRANK J. CROKE & WILLIAM F. CROKE, FAMILY TRUSTS 35–150 (1998); R. Randazzo, *Elder Law and Estate Planning for Gay and Lesbian Individuals and Couples*, 6 MARQ. ELDER’S ADVISER 1 (2004); *Estate Tax Concerns No Longer Drive Most Planning Decisions*, 14 ELDER L. ISSUES 5 (Fleming and Curti, PLC, Tucson, Ariz.), July 31, 2006, at 5, available at <http://www.elder-law.com/2006/Issue1405.html>.

¹⁹ Pub. Citizen & United for a Fair Econ., *Spending Millions to Save Billions*, TAX NOTES TODAY, (Tax Analysts), Apr. 26, 2006, at 80–28, available at LEXIS, 2006 TNT 80–28 [hereinafter *Spending Millions to Save Billions*].

²⁰ Sharon A. Devaney & Sophia T. Chiremba, *Comparing the Retirement Savings of the Baby Boomers and Other Cohorts*, Bureau of Labor Statistics ed., 2005, <http://www.bls.gov/opub/cwcl/cm20050114ar01p1.htm>.

²¹ See *Spending Millions to Save Billions*, *supra* note 19 (estimating that for 2006 decedents only 6,300 estates will be subject to the estate tax, however with the estate tax exemption amount increasing from \$2 million to \$3.5 million in 2009, the figure may be even lower for 2009 decedents). See also Brian G. Raub, *Federal Estate Tax Returns Filed for 2004 Decedents*, 27 STAT. OF INCOME BULL. 115,

5,000,000 individuals own shares in an S-corporation and may be impacted by the S-corporation eligibility provisions regarding trusts as shareholders.²²

This analysis shall proceed as the combination of several sections, each addressing particular issues relevant to the inquiry. Section II outlines general trust law as typically provided by state law. Section III discusses select limitations imposed on trust term selections by the estate tax. Section IV addresses the change in the step up basis rules which become effective with the repeal of the estate tax, and the possible influence the change may have on trust term selections. Section V evaluates the gift tax's continuing influence on trust term selection. Section VI discusses select income tax and supplementary security income provisions that impinge on state trust law flexibility. Section VII evaluates the federal constraints on trust term selection remaining after repeal of the estate tax, concluding that, although the repeal may somewhat reduce incursions into state law granted flexibility, the overall impact of remaining federal laws mute the repeal's impact. This article does not purport to discuss all of the aspects of the federal laws mentioned. Rather, the goal is to survey features of these laws which estate planners and settlors must consider in drafting trusts to achieve various planning objectives.

II. STATE TRUST LAW

Under state law, settlors, also known as grantors, are generally free to create trusts to accomplish any lawful purpose.²³ The primary restrictions imposed on trust creation by state law are related to grantor capacity, necessary components and parties, creditor protection, spousal property right protection, and rules against perpetuities.²⁴

Having a lawful purpose is a threshold requirement for the creation of a trust.²⁵ Most trusts established for estate planning purposes have a lawful purpose such as asset management at life and/or death, provision for long term care of family

115 (Spring 2008), available at <http://www.irs.gov/pub/irs-soi/04esreturnbul.pdf> (reporting that 19,294 estates incurred estate tax liability for 2004 decedents when the exemption amount was \$1.5 million).

²² Kelly Bennett, *S Corporation Returns*, 22 STAT. OF INCOME BULL. 63, 69 (Spring 2003), available at <http://www.irs.gov/pub/irs-soi/00scorp.pdf>.

²³ See Joel C. Dobris, *Changes in the Role and the Form of the Trust at the New Millennium, or, We Don't Have to Think of England Anymore*, 62 ALB. L. REV. 543, 543-45 (1998); see also UNIF. TRUST CODE § 404 (amended 2005).

²⁴ See GEORGE G. BOGERT & GEORGE T. BOGERT, *THE LAW OF TRUST* 1, 19-26, 178, 183, (Jesse H. Choper et al. eds., 1973); see also J. R. Kemper, *Validity of Inter Vivos Trust Established by One Spouse Which Impairs the Other Spouse's Distributive Share or Other Statutory Rights in Property*, 39 A.L.R. 3d 14 (1971).

²⁵ UNIF. TRUST CODE § 404.

members, minimizing taxes, or insuring access to welfare benefits.²⁶ Unlawful purposes involve requirements for the trustee to commit criminal or tortious acts.²⁷

If the trust is testamentary, the required grantor capacity is the same standard as for wills: knowledge of assets, awareness of natural fruits of bounty and an understanding of what the executed document does.²⁸ If the trust is *inter vivos*, the standard may differ slightly depending upon whether the trust is revocable, only taking final effect upon the settlor's death as a will substitute, or whether it is an irrevocable trust. In the former, the will standard is generally applied. In the latter, a contract capacity is required.²⁹

The necessary parties in a private trust are the settlor, at least one trustee, and at least one individual beneficiary.³⁰ The settlor must manifest intent to create a trust in appropriate form.³¹ Although oral trusts are permissible, in trusts involving real property the statute of frauds typically requires a written declaration of trust.³² The settlor names the trustee and chooses the beneficiaries. Courts will not necessarily invalidate a trust in the absence of a trustee and are hesitant to thrust the mantle of trusteeship on an unwilling party.³³ If a trustee refuses or resigns his position, the courts will appoint a replacement rather than invalidate the trust.³⁴ Trustees are subjected to strict fiduciary obligations to which they must willingly agree, but which the settlor may tailor with the trust's terms.³⁵ Individual beneficiaries are necessary to enforce the terms of the trust against the trustee.³⁶ In charitable trust situations, this requirement is unnecessary because

²⁶ See VALERIE VOLLMAR, AMY MORRIS HESS & ROBERT WHITMAN, AN INTRODUCTION TO TRUSTS AND ESTATES, 173–75 (2002).

²⁷ GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUST AND TRUSTEES § 211 (rev. 2d ed. 1984).

²⁸ UNIF. TRUST CODE §§ 401, 601.

²⁹ RESTATEMENT (SECOND) OF TRUSTS § 19 (1959); RESTATEMENT (THIRD) OF TRUSTS § 11 (2003); UNIF. TRUST CODE § 402.

³⁰ RESTATEMENT (SECOND) OF TRUSTS § 17; RESTATEMENT (THIRD) OF TRUSTS § 10.

³¹ For instance, due to the statute of frauds in most states, a trust involving real property must be in writing. See, e.g., *Dougherty v. Duckworth*, 388 S.W.2d 870, 876 (Mo. 1965).

³² *Id.*

³³ UNIF. TRUST CODE § 701(b); RESTATEMENT (THIRD) OF TRUSTS § 35.

³⁴ UNIF. TRUST CODE § 704(c); see, e.g., *In re Therese D. Steckler Trust*, 678 So.2d 620, 622–23 (La. Ct. App. 1996).

³⁵ UNIF. TRUST CODE §§ 801–804.

³⁶ RESTATEMENT (SECOND) OF TRUSTS § 112 (1959); RESTATEMENT (THIRD) OF TRUSTS § 44; UNIF. TRUST CODE § 402.

the attorney general of the relevant state enforces the trust terms.³⁷ Closely related are honorary trusts, which are allowed under the Uniform Probate Code (“UPC”) in certain situations.³⁸

Another necessary component is the trust property, also known as res.³⁹ Trusts are designed to allow the bifurcation of property rights between legal and equitable rights.⁴⁰ The trustee must be given legal title over the trust property, while the beneficiary will hold beneficial title.⁴¹ The type of delivery required to perfect the trust ranges from actual deeds/titles to symbolic delivery.⁴² Trusts without property are called dry trusts, and were historically ineffective.⁴³ Under the UPC, such trusts are allowed in select situations, such as trusts anticipating receipt of life insurance death proceeds or transfers from a probate estate.⁴⁴

The rule against perpetuities has historically limited the terms of trust duration.⁴⁵ Generally stated, the rule against perpetuities requires that, in the transfer of property, the gift must vest within 21 years of a life-in-being at the beginning of the transfer arc.⁴⁶ This rule is a compromise between not allowing dead hands to control property indefinitely, while allowing settlors to control property for the use of people they theoretically might have known, such as their children and grandchildren.⁴⁷ Recently, states have begun repealing their rules against perpetuities, which has occasioned a liberalization of trust modification procedures to address the changing circumstances that might impact a perpetual trust.⁴⁸

³⁷ See, e.g., Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAWAII L. REV. 593, 622 (1999); cf. UNIF. TRUST CODE § 405(c) (granting settlor standing to enforce a charitable trust).

³⁸ UNIF. PROBATE CODE § 408 (2006) (trusts for care of animal) and § 409 (trusts without ascertainable beneficiary for general noncharitable purposes and trusts for a specific noncharitable purpose other than the care of an animal).

³⁹ RESTATEMENT (SECOND) OF TRUSTS § 74; RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. i.

⁴⁰ RESTATEMENT (THIRD) OF TRUSTS § 3.

⁴¹ *Id.* at Ch. 1, Introductory Note.

⁴² See, e.g., *Newton v. Wimsatt*, 791 S.W.2d 823, 829–30 (Mo. Ct. App. 1990); *Bakewell v. Clemens*, 190 S.W.2d 912, 915 (Mo. 1945) (symbolic delivery).

⁴³ See *Kully v. Goldman*, 305 N.W.2d 800, 802–3 (Neb. 1981); RESTATEMENT (THIRD) OF TRUSTS § 75.

⁴⁴ UNIF. PROBATE CODE § 2-511 (amended 2006).

⁴⁵ See R. Zebulon Law et al., *The Rule Against Perpetuities: An Update*, 24 TAX MGMT, EST., GIFTS & TR. J. 222, 222–23 (1999); David M. Becker, *Tailoring Perpetuities to Avoid Problems*, PROB. AND PROP., March–April 1995, at 11.

⁴⁶ CORNELIUS J. MOYNIHAN & SHELDON F. KURTZ, INTRODUCTION TO THE LAW OF REAL PROPERTY: AN HISTORICAL BACKGROUND ON THE COMMON LAW OF REAL PROPERTY AND ITS MODERN APPLICATION 243 (3d ed. 2002).

⁴⁷ See Schanzenbach & Sitkoff, *supra* note 2, at 2470.

⁴⁸ *Id.* at 2472–81.

Creditor protection is a major component of state law.⁴⁹ As far as the settlor is concerned, if he is insolvent at the time he creates an *inter vivos* trust, his creditors may be able to reach these trust assets, even if the trust is irrevocable.⁵⁰ If a settlor is solvent at the time he creates the trust, but subsequently becomes insolvent, the assets of an *inter vivos* irrevocable trust may not be reachable by the settlor's creditors.⁵¹ If revocable, the assets are reachable whether or not the settlor was insolvent at the time the trust was established.⁵² From the standpoint of the creditors of trust beneficiaries, generally the assets will not be reachable under public policy if the trust has a spendthrift provision.⁵³ Absent such a provision in the trust document, creditors may be able to attach a beneficiary's trust distribution expectancy.⁵⁴

Spousal rights and other support rights may also trump the trust terms otherwise selected by the settlor. This may present itself in one of three forms: the trust was testamentary, the trust was illusory, or the settlor's creation of the trust was intended to deprive the surviving spouse of her statutory distributive share.⁵⁵ These three forms represent the split among the states on the proper method of unwinding the settlor's intent and awarding the surviving spouse her statutory distributive share.⁵⁶ The settlor may not retain such extensive powers of ownership and control as to cause an *inter vivos* trust to be testamentary in nature, in essence a will.⁵⁷ What level of retained powers and ownership is required to render an *inter vivos* trust testamentary is unclear and ultimately is determined on a case-by-case basis.⁵⁸ Generally an *inter vivos* trust will be deemed testamentary in cases where the transfer occurred in contemplation of death.⁵⁹ Illusory trusts can be stricken if it is shown that the settlor's transfer to trust was not genuine, but merely an instrument to hide the settlor's retention of control and ownership.⁶⁰

⁴⁹ *Creditors' Rights Against Trust Assets*, 22 REAL PROP. PROB. & TR. J. 735, 740–41 (1987).

⁵⁰ MO. REV. STAT. § 428.039 (Vernon 2003).

⁵¹ UNIF. TRUST CODE § 505 (amended 2005); *see also* RESTATEMENT (SECOND) OF TRUSTS § 156 (1959).

⁵² *Deposit Guar. Nat'l Bank v. Walter E. Heller & Co.*, 204 So. 2d 856 (Miss. 1967).

⁵³ *See* Ann S. Emanuel, *Spendthrift Trusts: It's Time to Codify the Compromise*, 72 NEB. L. REV. 179, 188 (1993); UNIF. TRUST CODE § 505(a) (trust invalid as to settlor's creditors); *cf.* RESTATEMENT (SECOND) OF TRUSTS § 157(a) (wife or child of beneficiary for support, or wife for alimony, may satisfy claim despite spendthrift provisions).

⁵⁴ UNIF. TRUST CODE § 503(c).

⁵⁵ *See* Kemper, *supra* note 24, at 24.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 14; *see also In re Estate of Weitzman*, 724 N.E.2d 1120, 1123 (Ind. Ct. App. 2000).

⁶⁰ Kemper, *supra* note 24, at 14.

If the settlor's intent when creating the trust is to retain beneficial control and ownership during lifetime and subsequently at death deny the surviving spouse her statutory distributive share, then the trust can be stricken as fraudulent against the surviving spouse.⁶¹

Beyond the preceding overview of state trust law requirements, state law is otherwise very flexible in regards to trust terms chosen by the settlor. For instance, if a trust is established by a settlor with capacity, having all of the necessary components and parties, the settlor is free to define the four main categories of trust terms: retained powers and rights; administrative and fiduciary powers; dispositive schemes; and termination terms.⁶² Retained powers include powers such as the right to revoke, alter, amend, choose between named beneficiaries, invest trust property in a non-fiduciary fashion, and borrow trust assets.⁶³ Administrative and fiduciary powers are those imposed on the trustee and which may trump state law of fiduciary duties in many instances.⁶⁴ These powers may include the discretion to allocate receipts to income and principal in a manner contrary to the state's Principal and Income Act, invest in unproductive property, and hold certain types of assets.⁶⁵ The dispositive scheme relates to the current beneficiary, determining if, when and in what manner such beneficiary is entitled to income and/or principal of the trust.⁶⁶ The termination terms describe the remainder beneficiary, the point of termination, and may include the grant of a power of appointment to one or more individuals.⁶⁷

State law flexibility, however, is constrained significantly by the myriad of federal tax and related provisions. For instance, retaining the power to revoke a trust has gift, estate, and income tax ramifications that, if the settlor wishes to avoid in some manner, the settlor must carefully narrow his term selections. Even after repeal of the estate tax, various other federal laws will restrict trust term selection.

⁶¹ Kemper, *supra* note 24, at 14; *see also* Hanke v. Hanke, 459 A.2d 246, 248 (N.H. 1983).

⁶² *See* UNIF. TRUST CODE § 815 (amended 2005); *cf.* UNIF. TRUST CODE § 816 (enumerating general powers contemplated by the general grant of trusteeship).

⁶³ *See, e.g.*, Cleveland Trust Co. v. White, 15 N.E.2d 627 (Ohio 1938); BOGERT, *supra* note 27, §§ 993, 1061, 1291.

⁶⁴ *See, e.g.*, BOGERT, *supra* note 27, §§ 551, 1292–1302.

⁶⁵ *See, e.g.*, MO. REV. STAT. § 469.901 (Vernon 2003).

⁶⁶ *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 49 (2003); *In re* Madison Cmty. Found., 707 N.W.2d 285 (Wis. Ct. App. 2005).

⁶⁷ *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 61; Tudor v. Vail, 80 N.E. 590, 592 (Mass. 1907) (concerning termination by exercise of power of appointment).

III. FEDERAL ESTATE TAX

The federal estate tax impacts trust term selections in many ways. This article will highlight the terms imposed to obtain estate tax marital deductions, the most prominently sought after method of minimizing the tax. This deduction constrains state trust law flexibility because obtaining the deduction requires compliance with strict statutory requirements.⁶⁸

To obtain the marital deduction for property placed in trust for a surviving spouse, the decedent must provide that the trust is either a general power of appointment trust, qualified terminal interest property trust (“QTIP”), estate trust, or a hybrid marital-charitable remainder trust.⁶⁹ For all but the estate trust, for transfers to these trusts to qualify for the marital deduction, the trust terms must provide the surviving spouse with the right to all trust income for life, at least annually.⁷⁰

For transfers to a general power of appointment trust to qualify for the marital deduction, the trust terms must provide the surviving spouse the power to redirect the property from the settlor’s named remainderman, potentially in direct contradiction of the settlor’s dispositive scheme.⁷¹ Similarly, the estate trust requires the trust property be paid directly to the surviving spouse’s estate, allowing the survivor’s will to dictate the ultimate disposition.⁷²

To optimize minimization of the estate tax, a credit shelter trust is frequently created in tandem with a marital trust.⁷³ A credit shelter trust is designed to take maximum advantage of the estate and gift tax unified credit amount.⁷⁴ A common estate planning technique is designed to create a zero-estate-tax posture in the estate of the first to die.⁷⁵ This is accomplished by dividing the after expense property of the decedent’s gross estate into two shares: one equal to the remaining amount of a decedent’s unified credit amount, and the remainder of the estate to a marital trust.⁷⁶ In so doing, the estate tax liability is kept at zero at the time of the death of the first spouse. The share distributed to the credit shelter trust is shielded by the applicable credit amount stemming from the unified credit

⁶⁸ See I.R.C. § 2056 (West 2002).

⁶⁹ *Id.*; see SEBASTIAN V. GRASSI, JR., A PRACTICAL GUIDE TO DRAFTING MARITAL DEDUCTION TRUSTS 27–31 (2004).

⁷⁰ See I.R.C. § 2056.

⁷¹ *Id.* § 2056(b)(5).

⁷² See Treas. Reg. § 20.2056(c)-2(b) (1994).

⁷³ PENNELL, *supra* note 3, at 7-9.

⁷⁴ See *id.* at 7-5.

⁷⁵ *Id.* at 7-8.

⁷⁶ BORIS I. BITTKER ET AL., FEDERAL ESTATE AND GIFT TAXATION 545–47 (2005).

amount and the balance of the estate is poured into a qualifying marital trust and thereby shielded in the estate of the first spouse to die from transfer taxation by the marital deduction.⁷⁷

The marital deduction is prefaced on the concept that a married couple is one economic unit and should have their combined property taxed only once by the estate tax.⁷⁸ The trust terms imposed to obtain the marital deduction insure this policy, as the required trust terms or attendant elections insure the property in the marital trust be taxed in the surviving spouse's estate at the death of the surviving spouse.⁷⁹ A general power of appointment trust is included in the surviving spouse's estate by virtue of the required power, a QTIP trust requires election by the surviving spouse, and the estate trust is included by virtue of the requirement the trust be paid to the estate of the surviving spouse at the surviving spouse's death.⁸⁰

The credit shelter trust, on the other hand, is designed to avoid the estate tax at the surviving spouse's death, requiring the settlor to carefully choose trust terms to avoid granting the surviving spouse or any other beneficiary any powers, rights, or interest in the credit shelter trust that would trigger estate tax inclusion.⁸¹

IV. CHANGE OF STEP UP REGIME

Currently, the basis of any property included in a decedent's gross estate is stepped up to a date of death value basis, which eliminates built in capital gains when it passes to the decedent's heirs.⁸² For instance, a piece of property with a \$5 basis in the hands of the decedent, but which is included on decedent's estate tax return at a \$10 date of death value, has a \$10 basis in the hands of the estate and ultimate gratuitous recipient. There is an exception for property deemed income in respect of decedent,⁸³ but otherwise this stepped up basis regime eliminates the eventual taxation of any pre-death appreciation of decedent's property.⁸⁴

⁷⁷ *Id.*; PENNELL, *supra* note 3.

⁷⁸ PENNELL, *supra* note 3, at 7-1.

⁷⁹ I.R.C. §§ 2033, 2041, 2044, 2056 (West 2002).

⁸⁰ *Id.*

⁸¹ PENNELL, *supra* note 3, at 5-1, 7-9.

⁸² I.R.C. § 1014; Kent N. Schneider, *The Modified Carryover Basis Rules of IRC § 1022: Current Implications of Fiduciaries*, 58 J. Mo. B. 264, 264 (2002).

⁸³ I.R.C. §§ 691, 1014(c).

⁸⁴ *See Janis v. Comm'r*, 469 F.3d 256, 262 (2d Cir. 2006).

This [step up] rule avoids a double tax on the appreciation in the value of the property that occurred prior to death. The estate tax, which is based on the fair market value at the time of death, taxes this unrealized capital gain. If the cost basis to the heirs was the acquisition cost to the decedent, the unappreciated capital

The repeal of the estate tax is accompanied by repeal of the current step up in basis rules under § 1014.⁸⁵ In the year of repeal, and presumably thereafter if repeal is made permanent, the step up in basis will be lost in some cases. Replacing it will be a step up in basis on the first three million dollars of property passing to a surviving spouse and \$1,300,000 of property passing otherwise.⁸⁶ This change will present many bookkeeping and other difficulties to estates and in some situations may influence trust terms.⁸⁷ For instance, in estate plans with charitable bequests, the document may need to provide that high value, low basis properties are transferred to charity, and thus do not take up the limited allowable step up. The need for separate trusts for surviving spouses to differentiate between the property receiving the step up and property not so receiving may also be necessary.⁸⁸

V. FEDERAL GIFT TAX

EGTRRA left the gift tax in force in 2010, establishing the unified credit amount for life time gifts at \$1,000,000, effectively disunifying the gift and estate tax during the run up to the year of repeal.⁸⁹ Despite some scholars arguing that the gift tax should be repealed if the estate tax is repealed,⁹⁰ the discussions to make EGTRRA repeal permanent currently envision leaving the gift tax in place.⁹¹ Whereas the gift tax's initial purpose was to prevent avoidance of the estate tax through the artifice of lifetime giving, the gift tax is now seen as an anti-income shifting provision.⁹²

gain would be taxed a second time. In order to avoid this result, the cost basis of the property when it is later sold is the fair market value at the time of death. . . . The only gain that is taxed on its subsequent resale is that incurred as a result of an increase in value after the date of death. The statutory scheme "express[es] Congress's intent that unrealized gain taxed to the decedent's estate at his death shall not be subjected to another tax when it is subsequently realized by the estate or a legatee."

Id. (quoting *Levin v. United States*, 373 F.2d 434, 438 (1st Cir. 1967)).

⁸⁵ EGTRRA §§ 541–542 (2001).

⁸⁶ *Id.* § 542.

⁸⁷ See *Federal Estate Tax: Uncertainty in Planning Under the Current Law: Hearing Before the S. Comm. on Fin.*, 110th Cong. (2007) (statement of Conrad Teitell, Principal, Cummings & Lockwood, LLC) (comparing the approach of EGTRRA to a roller coaster ride of increasing exemptions, followed by a precipitous fall in the year of repeal and a return in the next year to the pre-EGTRRA system).

⁸⁸ *Id.*

⁸⁹ EGTRRA §§ 511, 521.

⁹⁰ See Alana J. Darnall, *Toward an Integrated Tax Treatment of Gifts and Inheritances*, 34 SETON HALL L. REV. 671, 688–94 (2004).

⁹¹ *Id.*

⁹² Imposition of gift taxes ensures that taxpayers in high income-tax brackets who transfer income-producing property to those in low income-tax brackets, thereby reducing income taxes

The gift tax provides almost identical marital deduction requirements as the estate tax.⁹³ If properly drafted, a settlor receives a 100% gift tax deduction for all property passing to the trust for the spouse in a properly formed trust.⁹⁴ To obtain a marital deduction through a gift in trust, § 2523 requires the trust be in the same form as the estate tax requires under § 2056, discussed in the previous section.⁹⁵

State trust law permits grantors to retain rights in trusts created *inter vivos*. Grantors may retain rights such as the right to income, or remainders and powers such as the right to revoke. The right to retain either the current or remainder interest in a trust leads to the creation of split interest gifts.⁹⁶ For instance, in cases where the grantor retains the right to the current income interest but irrevocably designates another to receive the remainder, the grantor has made a gift of the remainder interest. The inverse is true in situations where the grantor has retained the right to the remainder but irrevocably gives the current interest to another. Under standard gift tax valuation concepts, the value of the gift given in these cases would be limited to the actuarial valuation of the remainder or current income right in the trust so given.⁹⁷ Although state law allows these split interests trusts, trusts in which grantors retain the income or remainder interest are denied actuarial valuation for gift tax purposes if the interest given is given to a family member.⁹⁸ Instead, § 2702 provides that unless one of two detailed current beneficiary terms are used in the trust, the value of the gift made is the total value of the property transferred to the trust.⁹⁹ In essence, if the prescribed current beneficiary terms are not used, the value of the gift is determined as if the value of the retained interest is zero.¹⁰⁰

To avoid having the retained interest valued at zero for gift tax purposes, § 2702 provides that the current beneficiary interest be either an annuity interest or a unitrust interest.¹⁰¹ An annuity interest is “an arrangement under which a determinable amount is paid periodically, but not less often than annually, for

paid on the income from the property, pay some tax upfront (the gift tax). Hence, the gift tax is said to supplement the income tax in this regard. *See, e.g.*, *Dickman v. Comm’r*, 465 U.S. 330, 339 (1984).

⁹³ *See* I.R.C. §§ 2522–2523 (West 2002).

⁹⁴ *Id.*

⁹⁵ *See* I.R.C. § 2523.

⁹⁶ *E.g.*, F. Ladson Boyle, *Evaluating Split-Interest Valuation*, 24 GA. L. REV. 1, 3 n.7 (1989).

⁹⁷ I.R.C. § 2512; Treas. Reg. § 25.7520-1 (2000).

⁹⁸ I.R.C. § 2702(e).

⁹⁹ *See id.* § 2702.

¹⁰⁰ *Id.*

¹⁰¹ *Id.* § 2702(b).

a specified term of years or for the life or lives of certain individuals.”¹⁰² The unitrust interest is “the right pursuant to the instrument of transfer to receive payment, no less often than annually, of a fixed percentage of the net fair market value, determined annually, of the property which funds the unitrust interest.”¹⁰³ If these terms are followed, the gift tax value is calculated by accounting for the value of the retained interest, thus reducing the value of the potentially taxable gift from 100% of the property transferred.

With repeal of the estate tax, much of the concern addressed by § 2702 seemingly disappears. Federal tax law designates trusts in which the grantor retains rights such as income and remainder interests, or powers to revoke as “grantor trusts.”¹⁰⁴ Under current law, grantor trusts are generally ignored for income tax purposes.¹⁰⁵ Under EGTRRA new § 2511(c), grantor trusts are also ignored for gift tax purposes in the year of repeal (and presumably thereafter if repeal is made permanent).¹⁰⁶ Thus, seemingly no gift can be made of an interest in a grantor retained interest trust once § 2511(c) is in force.¹⁰⁷

The potential removal of restrictions imposed by § 2702 may simply usher in a new tax constraint on trust term selection: namely, settlors may intentionally alter their trust terms to trigger grantor trust status in order to avoid imposition of the gift tax.¹⁰⁸

VI. OTHER FEDERAL LAWS

In addition to the estate and gift taxes, a settlor’s term selections are constrained by a myriad of other federal laws. As it would be impossible to address all of these laws, this section focuses on the impact on settlor term selections of select S-corporation, retirement benefit, and federal supplementary security income provisions.

¹⁰² *Id.*

¹⁰³ I.R.C. § 2702(b); Treas. Reg. § 20.2055-2(e)(2)(vii)(a) (2003).

¹⁰⁴ I.R.C. §§ 671–679.

¹⁰⁵ *Id.* § 677.

¹⁰⁶ EGTRRA § 511(e).

¹⁰⁷ This amendment complements the gift tax’s goal of preventing income tax avoidance: If a transfer is made that does not shift income away from a grantor because of the grantor trust rules, no income attributes have been shifted and imposition of the gift tax is unnecessary.

¹⁰⁸ See, e.g., Michael D. Milligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 1 (1996) (discussing an estate planning technique to avoid transfer tax restrictions by conducting transactions with a trust intentionally termed as a “grantor trust”).

A. S-Corporation

If the res of the trust consists of stock in an S-corporation, the terms of any trust created in an estate plan are severely limited by the eligible shareholder provisions of the income tax code.¹⁰⁹ Normally, C-corporations incur income taxation at both the corporate entity level and the shareholder level.¹¹⁰ S-corporations are a statutory exception to the historical double taxation of C-corporations; they are allowed a conduit form of taxation straight to the shareholder, resulting in only one level of taxation.¹¹¹ Federal law imposes strict requirements for an entity to qualify as an S-corporation, including eligible shareholder requirements.¹¹² Among these requirements are limitations of the types of trusts that may hold S-corporation stock. Only the following trusts may hold stock in an S-corporation: a grantor trust,¹¹³ including two years after the grantor dies; testamentary trusts for two years; voting trusts; qualified subchapter S trusts (“QSSTs”); electing small business trusts (“ESBTs”); and certain retirement plan trusts.¹¹⁴

To establish a trust satisfying any of these allowed trust formats requires the settlor to adhere to strict requirements. For illustration, this article outlines the impact of the QSST constraints on state trust flexibility.

A QSST requires the trust terms to provide that:

- i) there is only one beneficiary;
- ii) corpus distributions during the current beneficiary life can only be made to him;
- iii) the current beneficiaries’ income interest must terminate at earlier of trust termination or his death; and
- iv) trust assets must be distributed to the current beneficiary if his death triggers trust termination.¹¹⁵

The first requirement alone restricts a settlor’s freedom, preventing the use of a spray or sprinkle trust format and forcing the creation of multiple trusts if

¹⁰⁹ I.R.C. § 1361.

¹¹⁰ *Id.* § 301.

¹¹¹ *Id.* § 1361.

¹¹² *Id.* §§ 1361(b), (c).

¹¹³ *Id.* §§ 671–679.

¹¹⁴ I.R.C. § 1361(c)(2).

¹¹⁵ *Id.* §§ 1361(d)(3)(A), (d)(4)(A).

multiple beneficiaries are desired. If a multiple beneficiary trust is desired, ESBT status, which is not as beneficial from a tax standpoint, must be selected.¹¹⁶

B. Retirement Benefits

Federal income tax law allows individuals to defer income tax liability on appropriate contributions made to certain retirement plans.¹¹⁷ Subject to detailed distribution requirements, the contributor does not have to include the contributed amounts in income until withdrawn.¹¹⁸ Upon the death of the contributor, the deferred nature of the balance of the retirement plan may be preserved if the contributor names an allowable “designated beneficiary” to follow the contributor. The rules and regulations governing the creation and management of deferred retirement plans, allowing taxpayers to realize income without recognizing it until withdrawn from the account, are complex. Of particular concern to estate planners are the rules defining the terms necessary to consider a trust a designated beneficiary. The use of trusts as conduits of these benefits for wealth transfer purposes requires the settlor to select precise terms.¹¹⁹

The trust must be valid under state law,¹²⁰ all trust beneficiaries must be individuals not charities or estates,¹²¹ and the trust may not provide for indirect payment of estate debts, expenses, or taxes.¹²² In addition, the beneficiaries must be identifiable from the terms of the trust, and the trust must be irrevocable as of the contributor’s death.¹²³ Only if this format is precisely followed will the trust beneficiaries be treated as designated beneficiaries and deferral of income recognition under the deferred income rules apply.¹²⁴ Even that is limited if the trust has multiple eligible beneficiaries, in which case, the beneficiary with the shortest life expectancy controls the rate of payout.¹²⁵

¹¹⁶ *Id.* §§ 1361(d)(2), (e); Treas. Reg. § 1.1361-1(j)(b) (2001) (QSST requirements); I.R.C. §§ 1361(c)(2)(B)(v), 641(c) (unfavorable tax treatment of ESBT); Jerald David August & Joseph J. Kulunas, *Prop. Regs. On ESBTS: More Guidance For Family Trusts Owning S Stock*, 28 EST. PLAN. 459, 460 (2001) (explaining unfavorable tax treatment of ESBT).

¹¹⁷ Keith A. Herman, *Coordinating Retirement Accounts with Estate Planning 101 (What Every Estate Planner Needs to Know)*, PROB. & PROP., Jan.–Feb., 2006, at 53.

¹¹⁸ *Id.*

¹¹⁹ Treas. Reg. § 1.401(a)(9)-4, Q&A (5)(b) (2004).

¹²⁰ *Id.*

¹²¹ Treas. Reg. §§ 1.401(a)(9)-4, Q&A (5)(c) and 1.401(a)(9)-4, Q&A (3) (2004).

¹²² *See* Treas. Reg. §§ 1.401(a)(9)-8, Q&A (11) (2004) and 1.401(a)(9)-4, Q&A (3).

¹²³ Treas. Reg. § 1.401(a)(9)-4, Q&A (5)(b) (2004).

¹²⁴ I.R.C. § 409(a)(9) (West 2002).

¹²⁵ Treas. Reg. § 1.401(a)(9)-5, Q&A (7)(a)(1) (2007).

C. SSI Planning

Estate planning frequently involves planning for individuals with disabilities. To properly plan for these individuals, the planner must consider the needs of the individual and examine the resources available to the individual, including need-based government programs such as the Federal Supplemental Security Income program ("SSI").¹²⁶ If an intended trust beneficiary is otherwise eligible for SSI, the settlor must use care in crafting trust terms to assure the trust assets do not have to be consumed as a prerequisite to SSI eligibility.¹²⁷ Care must also be taken to avoid claims on the trust assets by public agencies that have provided for the beneficiary.¹²⁸

In general, trust term selection is limited by the need to deny the trust beneficiary rights such as the power to revoke the trust, appoint property of the trust, or otherwise use the trust funds for support or maintenance. If not so limited, the res of the trust may be depleted either before or as a result of the beneficiary's death. In addition, the trust terms must prevent distributions of in-kind income for a beneficiary's basic needs (food, clothing, or shelter).¹²⁹

VII. CONCLUSION

The estate tax restricts the flexibility of settlors in selecting trust terms. If this were the only federal law impacting estate planning decisions, trust documents would be less complex as a result of estate tax repeal. That is not the case. Even if the gift tax joins the estate tax on the dust heap of tax history, the myriad of other statutes similarly impacting trust term selection results in significant complexity which, at most, is only marginally reduced by repeal.

Still, other policy arguments raised by repeal proponents may, in the end, justify permanent repeal of the estate tax. Perhaps it will be determined that the tax does not raise a sufficient amount of tax revenue to justify the cost of administering and complying with the tax. Also, it may be concluded that the social goal of breaking up large accumulations of wealth can better be accomplished with a different taxing method. In terms of repealing the tax to avoid the imposition of complexities on taxpayers as measured by constraints placed on their freedom to select trust terms under state law, however, the complexities placed on many taxpayers by the remaining tax laws and benefits rules dwarf those which would be removed by the repeal. In addition, the changed step up in basis regime that

¹²⁶ 42 U.S.C. § 1382 (2000); 20 C.F.R. § 416.200, et seq. (2008).

¹²⁷ 42 U.S.C. §§ 1382b(e)(5), 1396p(d).

¹²⁸ 42 U.S.C. §§ 1382b(e)(5), 1396p(d).

¹²⁹ 42 U.S.C. § 1382; 20 C.F.R. § 416.1130, et seq. (2008).

comes into force with the repeal of the estate tax, replaces one set of constraints with another set related to marshaling assets in potential trust form to better track and account for basis characteristics.

The estate tax imposes constraints on the selection of trust terms and these will be removed if repeal of the estate tax is made permanent. Those creating trusts for a host of non-estate tax related reasons, however, will find the documents no less complex or restrictive as a result of other federal laws.