Buchheit Law, PLC
Lindsey Buchheit, Attorney
633 1st Street
P.O. Box 533
Sergeant Bluff, Iowa 51054
712.823.1024 (Phone)
712.823.1025 (Fax)
Lindsey@Buchheitlaw.net
www.Buchheitlaw.net

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OPTIMAL BASIS INCREASE TRUSTS ("OBIT")

The OBIT is a product of the Uniform Trust Code ("UTC"). Note, while some states have adopted the Uniform Trust Code ("UTC"), many of these states have made significant modifications. Therefore, it is important to refer to your state laws when drafting OBIT's. In addition there are currently nine (9) community property states, namely, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin (and sometimes Alaska if spouses so agree)). Community property states offer a double step-up in basis for all community property upon the first spouse to die. *See Internal Revenue Code Section 1014(b)(6).* The UTC (UTC Section 504(e)) also protects the assets of a beneficiary who is acting as his/her own trustee as long as the trustee's discretion to distribute assets is limited by an *Internal Revenue Code Section 1041* ascertainable standard.

The jurisdiction of the OBIT, therefore, provides for unique planning opportunities, but may be limited in states which have either not adopted the UTC or have modified the UTC provisions regarding asset protection.

With these caveats aside, what is an OBIT? Simply put, an OBIT is a decedent's irrevocable trust wherein the trust assets will receive a stepped-up basis upon the surviving spouse's death, therefore avoiding the trap of paying capital gains.

OBIT's arose out of the portability provisions which were made permanent in 2012 under the American Taxpayer Relief Act ("ATRA"). The concept of portability is described in Internal Revenue Code ("IRC") Section 2010(c)(4), the "Deceased spousal unused exclusion amount" ("DSUE"). DSUE and portability are synonymous.

Prior to OBIT's, practitioners focused a great deal on the federal estate tax. Now, with portability being permanent and the federal estate tax exemption being much higher, practitioners need to focus on structuring trusts for estate planning in today's environment where "traditional" A-B trust planning (with a marital trust and a bypass trust) has been rendered obsolete for all but the wealthiest clients who no longer face a Federal estate tax. As estate tax exposure diminishes, the focus is shifting instead to maximizing the income tax benefits of estate planning. While just using a marital trust or leaving assets outright to a spouse avoids the most unfavorable aspects of bypass trusts – including compressed trust tax brackets and the loss of a second step-up in basis at the surviving spouse's death – using the emerging technique of an OBIT is becoming popular. As estate planning increasingly shifts away from estate tax planning, expect advanced trusts which maximize an optimal

income tax consequences at death, especially regarding a step-up in basis, to become more popular.

Example: With a $5.45M+ estate tax exemption with no step up in basis upon second death; appreciation is subject to capital gains tax. When the applicable exemption was $1M, the estate tax was 55%, and capital gains tax was 15% at federal rate, practitioners took advantage of AB trust planning.

Currently, the top estate tax rate is 40% and the capital gains tax is 20%. By putting money into a credit shelter trust, the remainder beneficiaries still have to pay the capital gains tax. Now the traditional AB planning doesn't work because we're putting property into the bypass trust, on property we weren't going to pay estate tax on anyway, and not getting a step up in basis on the appreciation. AVOID THIS TYPE OF PLANNING.

OBIT's fall into three general categories. Regardless of the categorization, if the OBIT is properly drafted, it will be irrevocable and the assets will be included in the surviving spouse's taxable estate, thereby minimizing income tax when the surviving spouse's beneficiaries sell the appreciated property (a/k/a the beneficiaries receive a step up in basis). Note, for estate tax planning purposes, to preserve the IRC Section 2056 marital deduction, all three categories still require the surviving spouse to make a timely election with the IRS upon the death of the first spouse. The three general categories of OBIT's are as follows:

1. Credit Shelter Trust – This more traditional AB Trust provides that while the surviving spouse may get some or all of the income, the surviving spouse's right to the trust's principle is limited by an IRC Section 1041 ascertainable standard. The practitioner

may add in a IRC Section 2041 power of appointment, which would call the assets back into the surviving spouse's estate. Under this type of OBIT, the decedent still gets creditor protection while also allowing a step up in basis when the surviving spouse dies.

2. QTIP Trust – provides for "bloodline protection" so long as the decedent is careful in appointing the trustee. A QTIP trust is designed so that the surviving spouse's beneficiaries receive the stepped up basis, but unlike a basic credit shelter trust, the QTIP trust protects and preserves assets for the decedent's heirs. In other words, the QTIP allows an unlimited marital deduction under Internal Revenue Code 2056(b)(7), even though the surviving spouse doesn't have a right to designate where the assets go.

3. Discretionary Marital Deduction Trust with a General Power of Appointment – The customary purpose of this type of planning is creditor protection. An OBIT designed with a general power of appointment ("GPOA") is similar to a bypass trust, in that it limits the surviving spouse's access to the assets in various ways (again, this type of OBIT is generally used for asset protection purposes rather than minimizing estate tax), while still giving the surviving spouse a general power to appoint *appreciated* assets up to his/her remaining applicable exclusion, thereby causing a portion of the assets to be included in his/her estate. The goal here is to partially restrict access to the trust for asset protection purposes, while still providing a step-up in basis for appreciated assets.

Hidden Dangers of "All to QTIP"/Portability Estate Plans

OBITs refer to how we approach estate planning since AB planning has become problematic. In the past, when the estate tax exemption was much lower, AB planning meant understanding the difference between the bypass trust (a/k/a credit shelter trust) and the marital share. A credit shelter trust, generally speaking, is where a decedent's assets up to the applicable exclusion amount flow into the credit shelter trust so that this sheltered amount of first death is saved for death of second spouse to die. Because the current exemption rate for a single individual is $5.45 Million and $10.9 Million for a married couple, AB trust planning is not as important for the majority of clients. To illustrate, a person dying in 2016 will pay 40% on the value of the estate which exceeds $5,450,000, minus any exclusion used during the decedent's life for gifts. The value exceeding the Applicable Exclusion Amount ("AEA") under IRC Section 2010(c)(2) may be sheltered from immediate tax if it passes to a surviving spouse or to a qualifying trust for the benefit of the surviving spouse (*See IRC Section 2056(b)(5) and (7)* regarding life estates with a general power of appointment or QTIP trust).

Portability has been described by many as the "death knell" of the AB Trust ("AB Trust can be hazardous to your health", "Serious tax consequences to AB Trust owners" "Portability Threatens Estate Planning Bar", "Is it time to bypass the bypass trust for good?", etc.). To be sure, there are hidden dangers to traditional AB trust planning:

1. Increased Ongoing Income Tax. Income trapped in a typical bypass or marital trust over a specific amount ($12,400 for 2016 tax year) is generally taxed at rates higher than the beneficiary's rate, unless the beneficiary is very wealthy or near the top tax

bracket. Including the new Medicare surtax, this could result in 43.4% short-term capital gains and ordinary income, and 23.8% for long-term capital gains and qualified dividends.

2. No step up in basis for the bypass trust assets for the next generation. Example:

> *Sara leaves her husband Sam $3M in a bypass trust. Sam survives Sara by ten years. Over this ten year period, the income is spent down but the fair market value doubles to $6M. Sam has his own $3M in assets. Therefore, upon Sam's death, Sara and Sam's children inherit assets in the bypass trust with a mere $3.5M in basis. If Sara had left her assets outright or to a different trust and Sam elected to use his DSUE, the children would receive a step up in basis to $6M, potentially saving a significant amount in taxes.*

3. Special Assets May Cause Greater Tax Burdens. Qualified assets, principle residences, qualifying small business stock, and other special assets generally get better income tax treatment if left outright to a surviving spouse or to a specially designed trust. Many outdated estate plans still contain the bypass / marital trust layout because of the former lower estate tax exemptions.

There are other pitfalls to estate plans which rely upon portability only. For example:

1. Loss of asset protection. If the plan included a bypass trust, assets in the credit shelter trust would be protected to the extent allowed by state law.

2. Greater possibility of paying estate taxes later. If the surviving spouse's assets grow beyond the double exclusion amount, there will be an estate tax. If the client had used the bypass trust the appreciation of income / assets may have been protected from the estate tax.

3. Loss of blood-line protection. The surviving spouse has the ability to change the plan and disinherit the deceased spouse's heirs, thereby not allowing the decedent to properly protect his/her descendants.

4. Decedent loses his/her AEA. If the surviving spouse fails to comply with the statute of limitations and establish the right to portability by filing a timely estate tax return, he/she will inadvertently lose the right to portability. Although portability is currently permanent, in order for a surviving spouse to preserve portability, he/she must file the Federal Estate and Generation Skipping Transfer Tax Return (Form 706) within 9 months of death, with the ability for a 6 month extension. The surviving spouse must decide whether to file Form 706 to preserve portability. To make this decision, consider, among other things, the age of surviving spouse, the size of the estate, and nature of the assets. If the only reason for filing the Form 706 is to preserve portability, there are less requirements such as no need to obtain an appraisal on assets.

Hidden Problems (and Some Practical Solutions) of Typical Disclaimer-Based Plans.

The ability to disclaim, in the estate planning arena, means the right to refuse an inheritance at death or gift during one's life. Disclaimers may be used for tax purposes, such as changing a marital deduction, qualifying an estate for certain tax elections, satisfying state inheritance tax needs, and general skipping planning. However, disclaimers may also be used for non-tax purposes including avoiding creditors, terminating a trust, or rewriting a will.

To avoid gift taxation, a disclaimer must be "qualified" and satisfy the requirements of §2518(b). A qualified disclaimer means no transfer is deemed to have been made for gift or estate tax purposes. Hence, the first problem with relying on disclaimer-based plans is inadvertent disqualification. Even if the drafting attorney complies with the requirements of §2518(b), there can still be an inadvertent disqualification, generally because of an inadvertent acceptance or control.

Another primary disadvantage of disclaimer planning is that it often prohibits the surviving spouse from using powers of attorney for more flexibility and requires timely analysis and action immediately after the death of the first spouse. As a real-life example, *see e.g.*, Rev. Rul. 83-27. *Note, Estate of Leona Engelman*, 121 T.C. No. 4, (7/24/03). Husband and wife created a joint trust. At the death of the first spouse, the trust was to be divided into two trusts, A & B. Trust A was designed to qualify for the marital deduction. The surviving spouse was provided a general power of appointment. Trust B was designed to receive an amount equal to the unified credit. The trust required that all assets flow into Trust A upon the death of the first spouse, except for anything the surviving spouse disclaimed. All disclaimed amounts would flow into Trust B. Husband died. A month later wife exercised her power of appointment by signing a document directing the disposition of the balance of Trust A. Wife died a month later. Two months after wife's death, wife's Executor disclaimed $600,000.00 worth of wife's interest in Trust A. The IRS argued wife's exercise of her power of appointment was an acceptance of the property and the disclaimer was not qualified. The estate argued the disclaimer and the "Relation-Back Doctrine" resulted in the assets being disclaimed as of the first spouse's death, thereby

negating the exercise of the power of appointment. The Relation Back Doctrine refers to the disclaimer operating retroactively to allow the disclaimed property to the alternate beneficiary as of the date of the original transfer – the date of the gift or death. The Court found the Relation-Back Doctrine does not negate the exercise of the power of appointment, and the exercise of the power of appointment resulted in an acceptance which in turned resulted in a *non*-qualified disclaimer.

Practice Tip: If the estate plan provides spouse a LPOA or GPOA, narrowly craft this power and be careful to elect the QTIP of the trust <u>before</u> disclaiming into the alternate trust. These powers may be partially released rather than wholly disclaimed.

Another hidden problem with disclaimer-based planning is the fact that the person making the disclaimer must do so properly and timely. As a general rule, the beneficiary has a limited 9-month window to make a qualified disclaimer. Specifically, the disclaimer must be <u>received</u> by the transferor or his/her legal representative no later than nine months of the date the transfer is made. §2518(b)(2)(A). Sometimes identifying the date of the transfer is not as easy as the date of the decedent's death. To illustrate, *see e.g.* §25.2518-2(c)(5), ex. 1-4.

When the holder of the power of appointment has a GPOA, the starting date for the beneficiary is the date of death (or exercise or termination of the GPOA) of the holder of the power. Alternatively, in the case of a LPOA, the starting date is the date of the creation of the power. Contingent remainder beneficiaries are treated as vested remainder beneficiaries. *See*, §25.2518-2(c)(3) and (5), ex. (1) and (2).

Even though a QTIP trust is included in the estate of the deceased spouse, in order for a remainder beneficiary to effectively disclaim an interest in a QTIP trust, he/she must do so not at the date of the surviving spouse's death but rather, within nine months after the death which creates the QTIP trust (thereby creating the beneficiary's interest therein). Section 25.2518-2(c)(3).

Practice Tip: Leave instructions regarding the importance of prompt analysis following the death of the first spouse. Also ensure a certified public accountant or tax attorney reviews the trust prior to its enactment to identify the beginning of the nine-month window. In addition, if including a QTIP trust, consider a "Clayton QTIP" (a/k/a "Clayton Election") which provides the additional benefit (compared to traditional disclaimer funded trusts) of permitting limited powers of appointment, as well as an *additional* six month window. *See Estate of Clayton v. Commissioner,* 97 T.C. 327 (1991) and *Clack v. Commissioner*, AOD 1996-011. To make the Clayton Election, the marital deduction trust should provide that the trust may be divided into QTIP and non-QTIP property, and the personal representative of the estate must thereafter make this election on the estate tax return.

Finally, there is often uncertainty in disclaimer-based planning with regard to jointly owned assets. Generally, a qualified disclaimer of the survivorship interest to which the survivor succeeds]upon the death of the first joint tenant to die must be made within 9 months of the death of the first joint tenant to die regardless of whether such interest may be unilaterally severed under local law. §25.2518-2(c)(4). Note, however, there are special rules for *joint bank, brokerage, and other investment accounts established between*

persons. In these special cases, if a transferor may unilaterally regain the transferor's own contributions to the account without the consent of the other co-tenant, such that the transfer is not a completed gift under § 25.2511-1(h)(4), the transfer creating the survivor's interest in the decedent's share of the account occurs on the death of the deceased co-tenant. As such, if a surviving joint tenant wants to make a qualified disclaimer with respect to funds contributed by a deceased co-tenant, the disclaimer must be made within 9 months of the co-tenant's death. The surviving joint tenant may not disclaim any portion of the joint account attributable to consideration furnished by that surviving joint tenant. §25.2518-2(c)(4)(iii). *See* paragraph (c)(5), *Examples (12), (13),* and (*14*), of §25.2518-2.

Optimal Basis Increase Trusts - Using Formula Testamentary GPOAs

Powers of appointment (POA) have significant income tax planning potential for stepping up basis for tax purposes, as well as spraying income. A general power of appointment (GPOA), at its basic level, is the power to appoint yourself, your estate, or creditors of either to act on your behalf. The GPOA can be made during your lifetime or become effective upon your death. The GPOA is legally defined under Internal Revenue Code Section 2514. Including a GPOA in a Trust triggers gift and estate tax consequences, as the assets are pulled into the decedent's estate and included under Internal Revenue Code Section 2041.

IRC 2041(b)(1)(C) provides:

> In the case of a power of appointment created after October 21, 1942, which is exercisable by the decedent only in conjunction with another person— **(i)** If the power is not exercisable by the decedent except in conjunction with the creator of the power—such power shall not be deemed a general power

> of appointment. **(ii)** If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment. For the purposes of this clause a person who, after the death of the decedent, may be possessed of a power of appointment (with respect to the property subject to the decedent's power) which he may exercise in his own favor shall be deemed as having an interest in the property and such interest shall be deemed adverse to such exercise of the decedent's power. **(iii)** If (after the application of clauses (i) and (ii)) the power is a general power of appointment and is exercisable in favor of such other person—such power shall be deemed a general power of appointment only in respect of a fractional part of the property subject to such power, such part to be determined by dividing the value of such property by the number of such persons (including the decedent) in favor of whom such power is exercisable.

If the surviving spouse makes the QTIP election under IRC Section 2056(b)(7) on Schedule M of Form 706, the decedent may protect the assets for his/her descendants while also reaping the benefits of portability and the unlimited marital deduction. If this QTIP election is not timely and properly made, the assets must be included in the surviving spouse's estate in order to avoid income tax on appreciation. To maintain the spendthrift protection of the trust and avoid income tax on appreciation, the trust must provide a testamentary power of appointment for the surviving spouse. *See* IRC Section 2041.

When estate tax planning is not of concern, the only likely reason to preserve portability would be if the decedent desires to protect assets for his/her descendants (especially in a blended family scenario). If bloodline protection is not a goal for the decedent, then an outright distribution to the surviving spouse or life estate coupled with a testamentary general power of appointment under IRC Section 2056(b)(5) is probably sufficient. When bloodline protection is important, making the QTIP election on Schedule M Form 706 may be necessary.

A common question among estate planners is whether to give the trust protector the power to add a GPOA. A trust protector is an individual or group of people who are given the power to ensure the terms of an irrevocable trust are satisfied. Many practitioners advise not to give Trust Protectors the power to add a GPOA because this could be deemed a GPOA over the entire Trust. However, it is certainly arguable that if done correctly, giving a Trust Protector the right to add a GPOA may be done without negative consequence. *See* "The Optimal Basis Increase and Income Tax Efficiency Trust," by Edwin P. Morrow III (updated in 2016). As Mr. Morrow suggest, however, why risk it? If allowing a Trust Protector or other party to add or modify a beneficiary's GPOA, in particular if the party is not a fiduciary, it is advisable to limit the potential category and amount of appointive assets.

Optimal Basis Increase Trusts - Using LPOAs and the Delaware Tax Trap

A lifetime limited power of appointment (LLPOA) is the power to appoint anyone other than herself, her estate, or creditors of either as the agent to act on her behalf. Someone exercising a lifetime LPOA has a greater chance of avoiding gift or estate tax inclusion compared to someone with a GPOA. Retaining LPOAs (e.g. using power with ascertainable standard language) or formula GPOAs provide better basis increase at the spouse's death, as well as provide more flexible income tax planning opportunities.

> Unless the appointment triggers the DTT, or unless income must be paid to the powerholder, exercising a LLPOA causes no taxable gift . . . whereas exercising a lifetime LPOA raises complicated issues if those assets are otherwise subject to a formula or capped testamentary GPOA . . . .

> There is no asset protection issue if a powerholder's estate is insolvent and a testamentary LPOA is exercised (or lapses) – creditors have no access. However, if the powerholder had a testamentary GPOA, depending on the state, and potentially whether the GPOA is *exercised*, creditors of the testamentary GPOA powerholder's estate may have access.

"The Optimal Basis Increase and Income Tax Efficiency Trust," by Edwin P. Morrow III (updated in 2016).

An estate planner may use the increased estate tax exemption to reduce taxable income through a step-up in basis of trust assets by including the assets in the gross estate of a decedent with a significant unused estate tax exemption. If the decedent had been given a POA over assets in the trust to distribute, and if the person exercises the power by appointing to another trust in which the beneficiary is given her own power of appointment in a manner to trigger the Delaware Tax Trap ("DTT"), then the trust assets appointed are included in the gross estate. As such, the bases in the appointed assets are stepped up to the fair market of those assets upon the volunteer's death. The DTT is triggered when the state law "Rule Against Perpetuities" (which limits the period of time the beneficiary may exercise her power of appointment) runs from the date the power is exercised rather than from the date the power is created in the original trust. Despite its name, the DTT is often deemed an opportunity to estate planning practitioners to claim a step-up in basis for assets originally intended to be excluded from the decedent's estate, while incurring limited to no federal estate tax.

Generally, the DTT is triggered by exercising the LPOA. Having the grantor (a/k/a "powerholder") exercise the LPOA after the grantor's death (e.g. testamentary versus lifetime gift) allows for creditor protection while also causing inclusion in the grantor's

estate. However an inter vivos / lifetime exercise of the Limited Power may be used if the grantor desires to trigger a retransfer of assets for GST purposes, for example.

For a detailed discussion on the DTT, *see* "Delaware Tax Trap Opens Door to Higher Basis For Trusts Assets (and Avoid GST Tax Problems With Nonexempt Indirect Skip Trusts," by Les Raatz.

Step Up for Both Spouses' Assets in Non-Community Property States (a/k/a JEST Trusts)

When a spouse grants to his/her spouse a lifetime GPOA over the grantor spouse's assets, at the grantor's spouse's death, there is a taxable gift of the amount subject to the GPOA. However, it is uncertain whether the tax will be interpreted as a gift in which Code Section 2523 allows the marital deduction, or the extent Section 1014(e) via a trust. As such, a potential issue in planning for a stepped-up basis for joint lifetime GPOA trusts (a/k/a Joint Exempt Step Up Trust ("JEST")), is whether the gift tax marital deduction will apply to the first transfer of assets from the original owner to the first spouse to die. The IRS has private letter rulings on this subject, and there are valid arguments both for and against the IRS's position. The OBIT essentially eliminates this concern by substituting the marital gift tax deduction for the first gift with the annual exclusion gift tax deduction. *See Code Sections 2523 and 2503(b)).*

Under a JEST, a married couple would create and fund a joint or separate revocable trust. Each spouse would provide would give the other a testamentary GPOA so that some of the trust assets (to the extent there are sufficient trust assets), even if originally

contributed by the surviving spouse, are included in the estate of the first spouse to die under IRC Sec. 2041. As such, the assets of the entire trust obtain a new basis under IRC Sec. 1014 because they are interpreted to have derived from the deceased spouse. Under JEST concepts, none of the credit shelter trust formed by the estate of the first dying spouse would be included in the surviving spouse's estate, even though the contributing spouse is a beneficiary.

Consider, however, the potential risks of JEST:

1. Inclusion of the credit shelter trust in the surviving spouse's estate;

2. Possible loss of creditor protection for the surviving spouse (unless trust is formed in a DAPT jurisdiction);

3. The gift to the surviving spouse may not qualify for lifetime marital deduction;

4. IRC Section 1014(e) may deny the step up because the assets revert to the donor within one year of the death of the first spouse.

Applying or Adding OBIT Techniques to Preexisting Irrevocable Trusts - A HUGE Opportunity

The OBIT concepts may also be applied to inter-vivos irrevocable trusts and trusts continuing for additional generations. Similar techniques can be incorporated in downstream dynastic trusts for better basis increases to future generations (e.g. GST).

There is great value in adapting many pre-existing irrevocable bypass trusts to fully utilize the federal estate tax exemption and portability. This may be done by various ways – triggering the Delaware Tax Trap using a present LLPOA which permits appointment to

trusts; decanting the trust; private settlement agreement or court modification to add a limited or general POA. Again, state law may dictate which of these concepts work best, if at all.

Many beneficiaries do not have assets exceeding the federal estate tax exemption or asset protection issues. Therefore, most of LPOA powerholders and their future appointees may prefer to save income tax with a higher basis than avoid the negatives of a presently exercisable GPOA. The primary reason to forego any use of the Delaware Tax Trap is if a powerholder wants to preserve assets for grandchildren or other beneficiaries.

It's not JUST about Basis - Other Techniques to Lower ONGOING Trust Income Tax

Basis is important when an asset is sold, but there is also the issue of ongoing income from the assets while held in Trust. If not considered in the planning stage the surviving spouse and family could face considerably higher income tax every year going forward.

Effectively using IRC §663 and/or IRC §678a loopholes can ensure that capital gains are not trapped in trust at the highest rates, may be sprayed to beneficiaries in much lower brackets, and may get better tax treatment for special assets. In some states, non-grantor trusts may also have the ability to avoid state income taxation.

Be careful in drafting spray provisions as you cannot do this from a trust where all net income must be paid to surviving spouse.

Charitable 642(c) planning can be advantageous, mandating that the charity's portion as a % of income or that charities distribution come from ordinary income (short-term capital gains, non-qualified dividends, interest).

Using this next technique to its fullest is critical in distributing income and being able to designate who get what character of income (apart from the traditional ordering rules.) Regulations state that the governing instrument can provide a rule and control the character of the income distributed under 642(c) so long as it: "has economic effect independent of income tax consequences." For example, if the trust limits the charities' distribution to gross income from net short-term capital gains, taxable interest, and rents, it avoids income tax consequences because the amount that could be paid to the charity each year depends upon the amount of short term capital gains, taxable interest, and rents the trust earns in the taxable year.

An incomplete, non-grantor trust may allow state income tax savings in narrow circumstances by allowing "above the line" deductions from trust income, so that distributable income (K-1 income) can go to children in lower brackets (this would be a taxable gift, but it is eligible for the annual exclusion amount which is $14,000 for individual or $28,000 for couple).

There are also investment solutions to reducing income tax obligations such as using tax-efficient ETF's, tax-free muni bonds, growth investing vs. income investing using an individual stock portfolio, but this is can be coined the tax tail wagging the investment dog in many cases.

IRC Section 678(a) "beneficiary-defective" "Mallinckrodt" trust gives the beneficiary the right to withdraw income (a GPOA) not only over net accounting income, but even capital gains. This could apply via a formula, it can be over only certain assets and it does not have to be over 100% of the principal. This puts income directly onto the beneficiary's 1040 and not on the Trusts Form 1041/K-1. The beneficiary must have sole, unfettered right; permission of the trustee, trust protector and HEMS limitations would **not** apply. A beneficiary in this instance does not have to actually receive the income for it to be taxable to him/her, unlike the traditional trust K-1 accounting, wherein the income must be distributed. This might be appropriate for a couple with special assets in trust, such as a personal residence or simply to simplify tax reporting. Although this does give the couple slightly less asset protection because of the GPOA. It is not practical for some estate situations, but a flexible 678(a) trust might have more tax flexibility. It is probably not a good option for second marriage situations where principal preservation is critical, but may be appropriate for someone otherwise considering outright transfers or more liberal trust language.

In theory, Treas..Reg 1.643(a)-3(b) may be the easiest to administer but must be done from the start. It requires consistency in treating capital gains on books, records, tax returns as part of beneficiary distributions. It is not possible if 1041's have already been filed to the contrary. Another way is to have trustee allocation net capital gains to income, which will make it a part of DNI, and distributions are income to bene on K-1.

Comparing 678(a) "Beneficiary-Defective" Provisions v. Appointing / Distributing Income via K-1 per 643 Regs.

A Beneficiary Defective Inheritor's Trust ("BDIT") is a trust created by a parent or third party who contributes $5,000 cash to the trust. No other gifts are made to the trust. The beneficiary is especially prohibited from contributing to the trust. The trust creator is the grantor for transfer tax and creditor rights purposes, *but not for income tax purposes*. In other words, the BDIT is intentionally created as a non-grantor trust. The BDIT is irrevocable, fully discretionary, dynasty, and GST exempt (because the creator allocated $5,000 of his or her GST exemption as the only gift to the trust), and the beneficiary has a limited power of appointment over the trust, exercisable during life or at death. Note, the limited power cannot extend to provide life insurance for the beneficiary.

The beneficiary is given a "Crummey" like power to withdraw the original gift, which right lapses. While the power of withdrawal is pending, the beneficiary is treated as the owner of the trust for income tax purposes under IRC Section 678(a)(1). Once the withdrawal right has lapsed under IRC Section 678(a)(2), the beneficiary is deemed the owner of the trust for income tax purposes. Because the beneficiary's power to withdraw lapses within the $5,000/5% lapse protection amount for general powers of appointment, the lapse has no gift or estate tax consequences.

As a grantor trust from the beneficiary's point of view, the beneficiary pays tax on all trust income (with no gift tax). The trustee with power to distribute assets should not be the beneficiary. While the BDIT can give the beneficiary investment control over the trust (except for insurance on his or her life) and a power of disposition over the trust assets at death (and again, except for insurance on his or her life), the trust assets are protected

from creditors and transfer tax. A GST-exempt dynasty trust, the BDIT will continue after the beneficiary's death, subject to his or her special power of appointment, for the beneficiary's heirs, for life, with the same protections.

In contrast to this type of planning, a person may distribute income through a K-1 using IRC Section 643 Regulations. Treas. Reg. § 1.643(b)-1 states that for purposes of taxing estates, trusts (other than grantor trusts) and beneficiaries, generally, "income" is determined under traditional principles of income and principal, allocating ordinary income to trust accounting income and capital gain to principal. That said, if local law permits a different allocation, trust provisions following this law will be respected for tax purposes if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust.

The regulations provide a safe harbor for such a reasonable apportionment by clarifying that a state law providing for a unitrust amount which is between 3% and 5% of the annual fair market of the trust is a reasonable apportionment.

Aside from capital gain treatment, the r intent of the regulation is to allow a trustee to maximize investment performance without robbing the income or remainder beneficiaries. Assuming local law permits, the regulation gives the trustee four ways to define income in the trust:

a. ordinary income under traditional rules;

b. unitrust interest, if allowed by state statute;

c. ordinary income modified by the exercise of an adjustment power, if authorized by state law; and

d. ordinary income plus capital gain when trustee discretion to make the allocation is authorized under state law or trust instrument, using a reasonable allocation of realized capital gain to income.