**Recent Developments Affecting Estate Planning**

**Stanley M. Johanson**

University Distinguished Teaching Professor and

James A. Elkins Centennial Chair in Law

The University of Texas School of Law

Austin, Texas

**Houston Estate and Financial Forum**

Houston, Texas

September 28, 2018

**TABLE OF CONTENTS**

**I. The Federal Estate Tax—*What* Federal Estate Tax?**

A. Estate tax exemption increased to $11.18 million—for now 1

B. Trusts will remain the linchpin of any good estate plan 3

C. Building flexibility into the estate plan—Clayton trust? 6

**II. Section 67—Miscellaneous Itemized Deductions**

A. Estate and trust administration fees can continue to be deductible 7

**III. Section 1014—Basis of Property Acquired From a Decedent**

A. New focus: Income tax planning 7

**IV. Sections 2036 and 2038—Retained Interests or Powers**

A. FLP assets includible even though grantor held only limited partnership interests 9

**V. Section 2041—Powers of Appointment**

A. Why HEMS ascertainable standard should continue to be employed 10

A. Should beneficiaries be given the power to invade for comfort? No. 10

**VI. Section 2056—Marital Deduction**

A. Administrator ordered to make DSUE election despite premarital agreement 12

C. Service properly examined return of deceased spouse to determine DSUE amount 12

# The Federal Estate Tax—*What* Federal Estate Tax?

**A. Estate tax exemption increased to $11.18 million—for now.** The Tax Cuts and Jobs Act of 2017, signed by President Trump on December 22, 2017, doubled the estate, gift and generation-skipping transfer tax exemption, by increasing the exemption from its $5 million base to $10 million in 2018—actually, $11.18 million resulting from CPI adjustments. Effectively, this means $22.36 million in exemptions for spouses.

1. **Preparing and filing estate tax returns is (almost) no longer a part of the practice**. A federal estate tax return is not required to be filed unless the value of the decedent’s gross estate plus “adjusted taxable gifts” (taxable gifts over annual exclusions) exceeds $11.18 million—unless a return is filed in order to make the deceased spouse’s unused exemption (DSUE) portability election.

2. **Higher exemption will sunset at the end of 2025**. Under the TCJA, the higher exemption will continue through 2025. Effective January 1, 2026, the exemption will revert to the former base level of $5 million per person unless Congress extends the higher exemption. This means that we know what the estate, gift and GST exemption will be for the next eight years—unless a Democrat Congress reduces the exemption in the meantime. (Recall that in 2016, the Obama administration proposed reducing the exemption from $5 million to $3.5 million.)

a. **“It’s déjà vu all over again”** said the noted philosopher, Yogi Berra (albeit in a different context). The one constant with respect to transfer taxes has been constant change. It all began with the Tax Reform Act of 1976, which “unified” the federal estate tax and gift taxes, increased the estate tax exemption from $60,000 to $175,625, introduced the first (mercifully short-lived) version of the generation-skipping transfer tax, repealed (for a few years) the “new basis at death” rule, and made other significant changes (and some insignificant changes—remember the orphan’s deduction?). ERTA 1981 increased the estate tax exemption to $600,000 (phased in gradually), introduced the unlimited marital deduction, and gave us QTIP trusts. The Tax Reform Act of 1986 gave us the current generation-skipping transfer tax. In 1990, we were introduced to the Special Valuation Rules of Chapter 14. EGTRRA 2001 increased the exemption in spurts ($1,000,000 in 2002 to $3,500,000 in 2009). After an estate-tax-free year in 2010, in 2012 Congress made the exemption “permanent” at $5,000,000 (with annual CPI adjustments).

1) And now we have an estate tax exemption that will sunset on January 1, 2026. As Yogi Berra also said, “It ain’t over ‘til it’s over.”

b. **“Yes, but every past change in the exemption has resulted in an *increase* in the deduction!”** Yeah, sure! While that is certainly true, don’t put any money on this history being an accurate guide as to where the road will be taking us. Yogi Berra put it well: “When you come to a fork in the road, take it.”

3. **Congress did not merely double the exemption; it generated a *SEISMIC SHIFT IN THE ESTATE PLANNING PRACTICE!*** The Tax Reform Act of 1976 ***tripled*** the estate and gift tax exemption, from $60,000 to $176,525. In response to the specific provisions in the 1976 Act, new estate planning tools and techniques of course were developed—but tripling the exemption did not result in fundamental changes in the estate practice. For many clients, deferral of the estate tax (if not partial or total elimination of the tax) remained a factor in estate planning decisions. The same was true of the 1981 Tax Act, which also ***tripled*** the exemption (to $600,000), and EGTRRA 2001, which ***quintupled*** the exemption (from $675,000 in 2001 to (after spurts) $3,500,000 in 2009. After each of those Acts, many clients continued to have reason to be concerned about the estate tax (and the gift tax, and the generation-skipping transfer tax).

a. **Estate planning concern in all of those earlier years: eliminate (or at least reduce) the estate tax**. Throughout all of those years, with estate tax rates as high as 50 or 55 percent, for many clients a planning objective was to reduce if not wholly eliminate estate taxes on the death of the client and his or her spouse. This could be accomplished through the use of not just marital deduction formula clauses and bypass trusts, but some rather sophisticated planning techniques, including discount planning, all designed to reduce the value of the client’s and the surviving spouse’s gross estate for estate tax purposes.

b. **Under the new law, the vast majority of our clients** **have NO concern about the estate tax!** After Congress increased the exemption to $5 million in 2011, in CLE speeches I sometimes referred to “mere millionaires” who no longer had estate tax concerns—individuals with estates of $3 million to $5 million, or couples with estates of $8 million to $10 million. For the foreseeable future—or at least the immediate future, the class of “mere millionaires” includes individuals with estates of “only” $8 million to $10 million, or couples with a “mere” $15 million to $20 million of accumulated wealth.

c. **An inclusion in the decedent’s gross estate used to be a matter of concern … but now a gross estate inclusion is our *friend***. To the extent that taxes affect estate planning decisions, the concern will be securing, for the client’s beneficiaries, ***the benefits of the “new basis at death” rule***. For this reason, instead of taking steps to *avoid* a gross estate inclusion, many planning decisions will involve efforts to *include* the value of interests in the decedent’s gross estate.

d. **Discount planning has been turned on its head**. Planning techniques that reduced value by way of discounts—fractional interest, minority interest, restrictions on transferability, lack of marketability, etc.—no longer project benefits but are a matter of concern because of the potential *harm* they may cause with respect to the “new basis at death” rule. In more than a few cases, the concern now is to find ways to unwind these transactions so as to avoid valuation reductions.

4. **“But I have all of those sophisticated estate planning tools that I won’t be using anymore! And I spend so much time learning all of those things! Should I consider shifting my practice to another area?”**

**Au contraire!** These “mere millionaire” clients are still going to need wills (with those wills invariably containing at least some trust provisions), and will continue to have concerns about retirement planning, planning for disability and incapacity, creditor protection, second spouse protection, business succession planning, planning for descendants with disabilities, planning for clients who own real property in another state—and that’s just a partial list.

a. January 2017 article from The Onion (“America’s Finest News Source”): “GENEVA, SWITZERLAND—World Health Organization officials expressed disappointment Monday at the group's finding that, despite the enormous efforts of doctors, rescue workers and other medical professionals worldwide, the global death rate remains constant at 100 percent.”

b. **Don’t hit the word processor “delete” button for those sophisticated planning forms, though**. They may come back into play if and when the exemption is replaced by a more modest exemption.

5. **Communicating with existing clients**. The TCJA has had a profound effect on the estate plans for more than a few of your clients. This will be particularly true for ***wills that include one or more formula clauses*** that are triggered by exemption amounts as of the date of death—*e.g*., a formula gift to a QTIPable marital trust, with the residue to pass to a credit shelter trust; or a formula allocation of assets between a GST-exempt trust and a GST-nonexempt trust. If these trusts have different beneficiaries, the increased exemption will have the effect of dramatically shifting beneficial interests.

a. When ERTA introduced the unlimited marital deduction in 1981 (replacing the quantitative “one-half of my adjusted gross estate” limitation on the deduction), many existing wills made formula gifts to spouses of “the maximum allowable marital deduction available to my estate.” To avoid having an act of Congress change the amount of such gifts—to the entire estate, ERTA 1981 included a transition rule, under which formula clauses in wills executed before a certain date were to be construed in accordance with the former law.

b. **There is no transition rule under the TCJA**. Unless wills or other planning documents with formula provisions are revised, Congress through the higher exemption will have made substantive and potentially major changes in the client’s estate plan.

c. **Send a letter along the following lines?**

“Dear \_\_\_\_

“Our records show that you signed your estate planning documents in \_\_\_\_. As you know, Congress recently enacted a comprehensive tax bill that made major changes in our income tax, estate tax, and gift tax laws. These changes may have affected your estate plan. Also, the Texas legislature recently made significant changes relating to powers of attorney and other estate planning instruments. Finally, revisions may be appropriate due to changes in the family, as by the birth of a new family member, the death of a family member, marriages or divorces within the family, changes in financial circumstances, or by other factors such as changes in your goals and desires.

“This may be a good time for you to review your estate plan, to be sure that it is still consistent with your planning objectives. If you would like my assistance in reviewing your estate plan and related documents, please give me a call.

“With best regards,”

**B. Trusts remain the linchpin of any good estate plan.** The Dukeminier & Johanson Wills, Trusts & Estates casebook begins with a letter from prototypical client Howard Brown: “Wendy and I now have very simple wills giving our property to each other in case of death and then to our children when the survivor of us dies…. We think our main objectives should be to avoid probate and eliminate as many inheritance taxes as possible.” We have always been able to tell Howard and Wendy that if they live in Texas, avoiding probate is not a concern because of our independent administration procedures. And now we can tell the Browns that they have absolutely no concern about estate taxes. Does that mean we can tell the Browns that they can and should stay with their current two two-page wills? Absolutely not! For Howard and Wendy Brown—and for many, many clients—trusts will continue to be an integral part of a good estate plan.

1. **A history lesson**. Prior to the 1970s, when one could buy a nice three-bedroom house for $20,000 to $30,000, the $60,000 exemption eliminated all estate tax concerns for many clients. Two-page (“I love you, you love me”) wills were common, and were seen as doing the job reasonably well—or at least adequately. In Texas (and in most of the states outside the East Coast), inter vivos and testamentary trusts were rarely created, and then only for wealthy clients. The Trust Code section of Johanson’s Texas Estates Code Annotated (2018 ed.) cites only 24 cases involving Texas trusts decided before 1950. (That doesn’t count cases involving constructive trusts or resulting trusts, which aren’t really trusts.) The cases that made modern Trust law cases came from states like Massachusetts and New York, not Texas.

a. By the mid-1970s, though, that same house was worth $60,000 to $80,000—meaning that one asset in the client’s estate would “use up” the $60,000 exemption. If the client had a couple of life insurance policies and a pension plan, eliminating or at least tamping down the estate tax became a concern—even for clients with relatively modest estates. Although the exemption was increased in 1976 (phased in gradually, to $175,625 in 1981) and then to $600,000 in 1981 (again, phased in gradually), for many clients a planning objective was to reduce if not wholly eliminate taxes on the death of the client and his or her spouse.

b. While the initial or primary motivation for the use of bypass trusts was to provide economic benefits to the spouse or child without estate tax cost, clients (and their attorneys) came to realize, and appreciate, the myriad non-tax benefits of a trust settlement. These included creditor protection through the use of spendthrift provisions, avoidance of guardianship if the spouse lost his or her capacity, control over the scope of the beneficiary’s interest, and control of the remainder interest by giving the beneficiary (at most) a limited testamentary power of appointment. Middle-America clients also came to realize that trusts for descendants also could provide substantial non-tax benefits.

c. For these non-tax reasons, it is strongly advisable that the estate plans of those “mere millionaire” clients include trusts that will benefit the clients’ surviving family members.

2. **Bypass trusts for spouses**. For a couple in their 40s (or 50s, or 60s, or 70s), bypass trusts, which give the spouse a life income interest and limited invasion powers over trust principal, continue to be important even if there are never going to be any estate taxes to bypass. A trust settlement is overwhelmingly superior to an outright disposition for a number of reasons.

a. A major concern is that if the surviving spouselater becomes **incapacitated**, the result will be a costly and cumbersome guardianship administration. If instead the estate was left in trust—with the spouse serving as trustee (or co-trustee) for as long as her or she is able and so inclined—a guardianship administration will be avoided.

b. A trust gives **spendthrift protection** against creditors’ claims. Yes, but are potential creditors’ claims a real concern for a 75-year-old retiree who has a modest lifestyle and doesn’t drive motorcycles? How likely is it that there will *be* any creditors’ claims to be concerned about? Mr. Murphy (of Murphy’s Law fame) provides the answer to those who would see spendthrift protection as unnecessary: “If anything can go wrong it will, and in the worst possible way.”

c. A trust settlement assures that **on the** **spouse’s death the remainder interest will pass to the children**, rather than to that dreaded “personal trainer” second husband, that trophy second wife, or that too-solicitous caretaker.

d. A trust can and should give the spouse a **special testamentary power of appointment**—the power to appoint the trust property (*e.g.*,) “outright or in further trust to such one or more of my descendants as survive me.” Professor Ed Halbach (University of California) has noted that a power to appoint also gives the power to *dis*appoint, and tends to insure filial devotion: If an elderly mother or grandfather has a special testamentary power to appoint $2 million in assets, how likely is it that he or she will be alone at Thanksgiving?

2. **Bypass trusts for the children**. Another problem with that two-page will:If the children will succeed to more than a modest amount, there are very real advantages in creating trusts for the children's benefit rather than giving them outright ownership of assets. Moreover, each child can be the trustee of his or her own trust, giving the child the power to make management and investment decisions (just as an outright owner would make) while also providing various advantages.

a. **Covering the contingency of divorce**. In today’s world, more marriages are terminated by divorce than by death. If property is bequeathed outright to a child, it is the child's separate property and theoretically is not “on the table” for purposes of division upon divorce. However, all property on hand at the time of divorce (or death) is presumptively community property. To keep its separate property status, the property cannot be commingled with community property, and good records must be kept; otherwise it may not be possible to establish separate ownership so as to overcome the community presumption by the required “clear and convincing” evidence. A trust (even with the child as trustee) is a useful vehicle for segregating and managing separate property separately.

b. **Creditor protection**. If the child is in a profession or line of work in which malpractice suits are a concern (and, in today's litigious society, that includes just about everybody!), property left to a child in a trust can be given spendthrift protection, meaning that no creditors can reach the child's interest in the trust—even if the child declares bankruptcy.

c. **In-law protection.**  Although the child’s marriage is solid and the likelihood of divorce is remote, parents may be concerned that the child’s spouse might take some action that puts the child’s inheritance at risk—*e.g*., by persuading the child to invest in a Subway franchise.

d. **Avoids guardianship** should the child, years from now, suffer diminished capacity.

e. **Bypasses child’s estate for tax purposes** if the child’s estate exceeds his or her exemption equivalent in the year of death.

3. **Contingent trusts.** All wills should include a contingent trust, to cover the contingency that an outright distribution may be made to a minor beneficiary (avoiding guardianship—and avoiding the beneficiary’s succeeding to outright ownership at age 18); to a beneficiary who, it turns out, has filed for bankruptcy; or to a beneficiary who, it turns out, that has special needs. Here is a useful contingent trust clause, developed by Clyde Farrell, an Elderlaw attorney in Austin..

B-2. **Contingent Trusts**. Any portion of my residuary estate, or of the Howard Brown Family Trust or a Contingent Trust upon the trust's termination, which would be distributable to a beneficiary (i) who is under age 23, (ii) who (in the determination of my executor or the trustee) lacks the mental capacity to manage his or her own financial affairs, (iii) who has filed a petition for protection under the Bankruptcy Code within 180 days before my death, or (iv) who has a disability as defined by the Social Security Administration and who (in the determination of my executor or the trustee) needs benefits for which he or she might qualify if distribution is to a trust, instead shall be distributed to the trustee of a Contingent Trust. Each beneficiary's portion so distributed shall be held and administered as a separate trust for the beneficiary.

a. **Distributions**. The trustee may distribute to the beneficiary, from time to time, so much or all of the trust income and principal as the trustee, in its discretion, deems appropriate for the beneficiary's best interest. Any income not so distributed shall be added to the principal of the trust.

b. **Termination**. The trust shall terminate when the beneficiary attains age 25 or dies before that age; or, in the case of a beneficiary who lacks the capacity to manage his or her own financial affairs, when the beneficiary regains that capacity; or, in the case of a beneficiary who has filed a bankruptcy petition or has a disability, when the beneficiary dies or the trustee in its discretion determines that termination of the trust would be in the beneficiary’s best interest. Upon termination, the trust principal and accumulated income shall be distributed:

(1) To the beneficiary.

(2) If the beneficiary is not living, to the beneficiary's descendants.

(3) If none of the beneficiary's descendants is then living, to my descendants.

(4) If none of my descendants is then living, to [“atom bomb” beneficiaries].

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

a. **Bankruptcy concern**. Under §541(a)(5) of the Bankruptcy Code, if a person acquires or becomes entitled to acquire an inheritance within 180 days after filing for bankruptcy, the inherited property is included in the bankruptcy estate. This cannot be avoided by a disclaimer of the inheritance. It is the date of the decedent’s death, and not when the property is received, that controls. The Contingent Trust will cause the beneficiary’s share to pass into a trust protected from creditors. This assumes that (i) the will contains a spendthrift clause, and (ii) the person has elected state law exemptions.

b. **Special Needs concern**. An outright bequest of property may cause the beneficiary to lose eligibility for SSI or Medicaid benefits. The Contingent Trust establishes a very basic Special Needs trust, as the trustee is given unlimited discretion to make distributions (not governed by a support standard of any other standard). Under this simple format for a special needs trust, distributions can be made to cover the beneficiary’s supplemental needs.

**C. Clayton trust?** Where spouses are involved, consideration should be given to the “second look” provided by a so-called Clayton trust, based on *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992). The will leaves the residuary estate to a QTIPable trust which provides that, to the extent a timely QTIP election is not made, the residue will pass to a bypass trust that contains more flexible terms. This gives the executor 15 months to make a decision as to which is the preferred vehicle.

1. When the first spouse dies, the executor can (if appropriate) file a Form 706 that makes a QTIP election (or partial election) and that elects DSUE portability. The **good news** is that on the spouse’s death (i) his or her estate will have a larger exemption, and (ii) the trust assets will receive a new basis for income tax purposes by reason of the §2044 gross estate inclusion. The **bad news** is that the spouse may have been lucky enough to live to see either the sunset of the TCJA’s increased exemption or Congress’s lowering of the exemption, resulting in estate tax.

2. As for the portability election, if a spouse dies while the higher TCJA exemption is in place, the surviving will have the benefit of the deceased spouse’s $11-plus million exemption even if the second spouse dies after the exemption has dropped to a lower amount.

# II. Section 67—Miscellaneous Itemized Deductions

**A. Regulations will clarify that estate and trust administration fees can continue to be deductible.** The Tax Cuts and Jobs Act of 2017 enacted a new §67(g), under which “no miscellaneous itemized deduction shall be allowed for any [taxable year](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=26-USC-1529535480-1197466203&term_occur=971&term_src=title:26:subtitle:A:chapter:1:subchapter:B:part:I:section:67) beginning after December 31, 2017, and before January 1, 2026.” This raised a concern, as the new statute could be read to overturn §67(e)(1), permitting “deductions for costs which are [paid or incurred](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=26-USC-1738140159-1199109695&term_occur=75&term_src=title:26:subtitle:A:chapter:1:subchapter:B:part:I:section:67) in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.”

1. The IRS issued a “clarification” in Notice 2018-61, 2018-31 I.R.B. 278, advising that regulations will be published making it clear that “estates and non-grantor trusts may continue to deduct expenses described in [section 67(e)(1)](https://1.next.westlaw.com/Link/Document/FullText?findType=L&pubNum=1012823&cite=26USCAS67&originatingDoc=I4dde2687939311e8ab20b3103407982a&refType=RB&originationContext=document&transitionType=DocumentItem&contextData=(sc.UserEnteredCitation)#co_pp_06a60000dfdc6) and amounts allowable as deductions under [section 642(b)](https://1.next.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000546&cite=26USCAS642&originatingDoc=I4dde2687939311e8ab20b3103407982a&refType=RB&originationContext=document&transitionType=DocumentItem&contextData=(sc.UserEnteredCitation)#co_pp_a83b000018c76), [651](https://1.next.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000546&cite=26USCAS651&originatingDoc=I4dde2687939311e8ab20b3103407982a&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.UserEnteredCitation)) or [661](https://1.next.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000546&cite=26USCAS661&originatingDoc=I4dde2687939311e8ab20b3103407982a&refType=LQ&originationContext=document&transitionType=DocumentItem&contextData=(sc.UserEnteredCitation)), including the appropriate portion of a bundled fee, in determining the estate or non-grantor trust's adjusted gross income during taxable years.”

2. It is unclear, however, whether beneficiaries can continue to claim, under §642(h), excess deductions on an estate or trust’s termination. Notice 2018-61 states: “The Treasury Department and the IRS are studying whether [section 67(e)](https://1.next.westlaw.com/Link/Document/FullText?findType=L&pubNum=1012823&cite=26USCAS67&originatingDoc=I4dde2687939311e8ab20b3103407982a&refType=RB&originationContext=document&transitionType=DocumentItem&contextData=(sc.UserEnteredCitation)#co_pp_7fdd00001ca15) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of the trust or estate, should continue to be treated as miscellaneous itemized deductions when they are included as a [section 642(h)(2)](https://1.next.westlaw.com/Link/Document/FullText?findType=L&pubNum=1000546&cite=26USCAS642&originatingDoc=I4dde2687939311e8ab20b3103407982a&refType=RB&originationContext=document&transitionType=DocumentItem&contextData=(sc.UserEnteredCitation)#co_pp_1d410000745d2) excess deduction.”

# III. Section 1014—Basis of Property Acquired From a Decedent

**A. New focus: Income tax planning**. For the vast majority of our clients, any concern about taxes will focus on income tax planning—and, in particular, planning to secure a step-up in basis for the client’s successors who acquire property from the decedent. While the ink is not yet dry on suggested planning steps that might be taken to secure a step-up in basis, here is a brief list of techniques that are being discussed.

1. **Give the trustee (not a beneficiary-trustee) a discretionary power to distribute assets out of the trust to the beneficiary**. It would be appropriate to use precatory language as to the settlor’s intent. *E.g.,* “I suggest that the Trustee consider exercising the power so that, upon the beneficiary’s death, his or her estate may utilize the basis increase allowed under Internal Revenue Code Section 1014.”

a. For an existing bypass trust, this would be appropriate if (i) the distribution of principal is authorized and will not breach the trustee’s fiduciary duty to the remaindrmen, and (ii) loss of divorce protection and creditor protection is not a concern.

2. **Give an independent party the power to grant a “limited” general power of appointment to the beneficiary**. Jason Flaherty (Brink Bennett Flaherty, Austin) has suggested this clause:

“The Independent Trustee may grant the beneficiary of a trust a testamentary power to appoint all or part of the trust or trust share to the creditors of the beneficiary’s estate. Any testamentary power of appointment granted by the Independent Trustee must be in writing and may be revoked at any time during the lifetime of the beneficiary to whom the power was given. I suggest that the Independent Trustee consider exercising this authority when it may reduce generation-skipping transfer taxes or so that, upon the beneficiary’s death, his or her estate may utilize the basis increase allowed under Internal Revenue Code Section 1014.”

3. **The Delaware Tax Trap**, leading to a gross estate inclusion if the holder of a special testamentary power of appointment exercises the power by giving the appointee a presently exercisable general power of appointment.

4. **Give a remainderman an inter vivos special power of appointment to appoint assets to the income beneficiary**. The bypass would be drafted so as to give Mom a mandatory or discretionary income interest for life. On Mom’s death the trust is to continue, but is to be divided into stirpital shares for the three children (and their descendants). The trust gives son John a special inter vivos power to appoint trust assets to Mom (and a backup special inter vivos power of appointment to daughter Donna if John predeceases Mom). Mom is now in her 80s and in poor health. The trust includes assets that have appreciated substantially since Dad’s death ten years ago. John exercises the power of appointment by appointing those assets outright to Mom. When Mom dies, the assets will receive a new basis.

a. Will John have made a taxable gift by exercising the power of appointment—when he has a remainder beneficial interest in the trust? (Is it a contingent interest or a vested remainder subject to total divestment? Without reading the trust language I don’t know—and I don’t care.) I do not believe that John will have made a taxable gift; that will be my reporting position. And if that is my “reporting” position, John will not file a Form 709 gift tax return. And even if John has made a taxable gift, so what? He has that $11.18 million exemption.

b. **Is §1014(e) a concern if Mom (the donee) dies within one year?** Under §1014(e)(1), if appreciated property is acquired by the decedent by gift within one year of death and passes from the decedent back to the donor or to the donor’s spouse, “the basis of such [property](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=26-USC-993141291-2033417876&term_occur=1514&term_src=title:26:subtitle:A:chapter:1:subchapter:O:part:II:section:1014) in the hands of such donor (or spouse) shall be the [adjusted basis](https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=26-USC-901776884-1368516903&term_occur=220&term_src=title:26:subtitle:A:chapter:1:subchapter:O:part:II:section:1014) of such property in the hands of the decedent immediately before the death of the decedent.” This should not be a concern, because even if Mom’s will puts the property back into the same trust, it will not have passed “to the donor or the donor’s spouse.”

5. **If the client wants to secure a basis step-up for his own assets, give elderly family member a “circumscribed” general power of appointment**. In “The ‘Hook’ of Increased Tax Basis,” Trusts & Estates 10 (April 2018), Turney Berry (a Louisville ACTEC member) has an article in which he discusses the following plan. (I see Berry’s article as a “think about it” piece—I’m not sure whether Berry is recommending the plan as distinguished from putting it out for discussion.) Client’s estate is (and is likely to remain) less than the exemption amount, and he has assets that have appreciated substantially in value. Client transfers the appreciated assets to an irrevocable inter vivos trust for the benefit of Client’s spouse and descendants (and Client can serve as trustee). This will result in a taxable gift—but in today’s $11.18 million exemption world, who cares? The trust gives an elderly family member who (i) does not have and is not likely to have creditor concerns, and (ii) is likely to die before Client, a “circumscribed” general testamentary power of appointment exercisable only in favor of creditors of the power-holder’s estate, with the power extending only to assets having a value greater than their income tax basis. Power-holder dies, and—voila! The trust assets, includible in the powerholder decedent’s gross estate, will be given a new basis for income tax purposes.

a. “This transaction isn’t for everyone but, then again, can we say that any estate-planning idea is right for absolutely everyone? Of course not!”

# IV. Sections 2036 and 2038—Retained Interests or Powers

**A. FLP assets includible in gross estate under §2036(a)(2) even though decedent grantor held only limited partnership interests**. It has often been said that “hard cases make bad law.” Of *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (2017), it can be said that *bad* cases (here, involving what the concurring opinion called “aggressive deathbed tax planning”) can make *really* bad law. Powell’s son, acting under a power of attorney, contributed $10 million of cash and marketable securities to a family limited partnership, in return for a 99% LP interest. Her two sons contributed unsecured promissory notes in return for the 1% general partner interest. On the same day, the son, acting as agent under the power of attorney, transferred Powell’s 99% LP interest to a charitable lead annuity trust under which an annuity was paid to charity for Powell’s life with the remainder passing to the two sons. The remainder interest was valued by assuming a 25% discount for lack of control and lack of marketability of the 99% LP interest. (Slight problem—among many: the durable power of attorney only authorized gifts with annual exclusions.) Powell died seven days later.

1. Bad facts? Excuse me! The partnership entity was: funded only by assets of the soon-to-be decedent … with only cash and marketable securities … seven days before death (although we are told that Powell died unexpectedly) … a transfer to a CLAT of a charitable annuity for the life of the soon-to-die grantor, and a discounted remainder interest to pass to the two sons … with all of this having been accomplished under a power of attorney, meaning that the son was essentially negotiating with himself. Las Vegas wouldn’t even make book on whether the taxpayer had a chance of winning.

a. And the estate’s argument before the Tax Court was—how to put it as genteely as possible—of the same … quality.

2. The Service assessed a deficiency on the ground that the $10 million of assets contributed to the FLP were includible in Powell’s gross estate (without discount) under one of four theories—actually, all four theories: (i) §2036(a)(1)—retained possession and enjoyment or right to income, (ii) §2036(a)(2)—right in conjunction with any other person to designate who could possess and enjoy the property or its income, (iii) §2038—power to revoke, alter, amend or terminate the transfer, and (iv) §2035(a)—transfer of property within three years of death that otherwise would have been included in the gross estate under §§2036-2038 if the transfer had not been made.

a. The estate did not contest the application of §2036(a)(2) (!!), and did not raise the exception to §2036 for a bona fide sale for full consideration (!!). The only argument made by the estate was that §§2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death—despite the fact that the LP interest had been transferred within three years of death, bringing §2035(a) into play.

3. This was a “reviewed” Tax Court decision, which means that it was considered by the full Tax Court. The majority and concurring opinions both agreed that §2036(a)(2) applied. The majority opinion (Judge Halpern, joined by seven judges) reasoned that Powell, in conjunction with the general partners, could dissolve the partnership; and that Powell, through her son as general partner and as her agent, could control the amount and timing of the distributions. Six judges joined in Judge Lauber’s opinion that §2036(a)(2) applied (without giving any discussion of the basis for its application), but rejected the majority opinion’s discussion of a “double inclusion” issue. This means that fifteen out of seventeen judges saw merit in the application of §2036(a)(2) to an FLP case—the first case to apply §2036(a)(2) where the decedent owned only a limited partnership interest.

a. It would be nice, and comforting, if the decision could be dismissed on the ground that this was essentially a sham partnership whose sole purpose was to produce valuation discounts, and that the taxpayer didn’t deserve to win. Bad facts, yes; but still ... fifteen out of seventeen judge found merit in apply §2036(a)(2) where the decedent owned only a limited partnership interest? The case is appealable to the Ninth Circuit.

# V. Section 2041—Powers of Appointment

**A. Why HEMS ascertainable standard powers should continue to be employed.** A beneficiary’s power to invade trust principal is not a general power of appointment if the power is limited by an ascertainable stander relating to health, education, maintenance or support. For years, HEMS invasion powers have been employed in drafting trusts, to insure that beneficiaries have access to trust principal without causing the property to be included in the beneficiaries’ gross estate. With an $11.18 million estate tax exemption, concern about a gross estate inclusion has disappeared except for very large estates. Instead, it might be advantageous for a beneficiary to hold a general power of appointment, resulting in a stepped-up basis for the trust assets.

1. In *Estate of Vissering v. Commissioner*, 990 F.2d 578 (10th Cir. 1993), V was the beneficiary and co-trustee (along with a bank) of a trust that gave the trustees a discretionary power to distribute principal “as may be required for the continued *comfort*, support, maintenance, or education of said beneficiary.” The government argued that because the distribution power was tied to “comfort,” V held at death a general power of appointment, resulting in a gross estate inclusion. The court (generously) held that the quoted phrase satisfied the HEMS standard because the distribution power was *required* for the *continued* comfort of the beneficiary. The result was reversal of a $708,000 deficiency.

2. If the *Vissering* case had arisen today, it is likely that the parties’ arguments would be reversed. The estate would likely argue that V held a general power of appointment, resulting in a basis step-up for the trust assets; the government would argue no; this indeed met the ascertainable standard test.

**B. Does this suggest that beneficiaries should be given a power to invade for “comfort”? There are two reasons why the answer is NO.** First, **creditor protection given by the trust’s spendthrift clause would be lost**. Property Code §112.035, which authorizes the use of spendthrift provisions in Texas trusts, states, in subsection (d), that ”[i]f the settlor is also a beneficiary of the trust, a provision restraining the voluntary or involuntary of the settlor’s beneficial interest does not prevent the settlor’s creditors from satisfying claims from the settlor’s interest in the trust estate.” However, subsection (f) provides that “[a] beneficiary of the trust may not be considered to be a settlor … merely because the beneficiary, in any capacity, holds or exercises a presently exercisable power to … consume, appropriate, or distribute property to or for the benefit of the beneficiary if the power is … limited by an ascertainable standard, including health, education, support, or maintenance of the beneficiary.”

**Second, there is a Family Law reason relating to divorce**.This could enable the attorney for the soon-to-be ex-spouse to argue that a portion of the beneficiary’s trust interest is “on the table” for a just and right division in a divorce action. Three principles of Texas law are in play. (i) In Texas, only community property is subject to just and right division in a divorce proceeding. The divorce court cannot award one spouse’s separate property to the other spouse. (ii) Property acquired by gift, will or inheritance is separate property. (iii) The income from separate property is community property.

1. In [*Wilmington Trust Co. v. United States*, 4 Cl. Ct. 6, 14 (1983)](https://1.next.westlaw.com/Link/Document/FullText?findType=Y&serNum=1983153733&pubNum=0000852&originatingDoc=Ie80d7c5eb41e11deabdfd03f2b83b8a4&refType=RP&fi=co_pp_sp_852_14&originationContext=document&transitionType=DocumentItem&contextData=(sc.Default)#co_pp_sp_852_14), aff'd, [753 F.2d 1055 (Fed.Cir.1985)](https://1.next.westlaw.com/Link/Document/FullText?findType=Y&serNum=1985105330&pubNum=0000350&originatingDoc=Ie80d7c5eb41e11deabdfd03f2b83b8a4&refType=RP&originationContext=document&transitionType=DocumentItem&contextData=(sc.Default)), a tax law case, the court held that the income from trusts, the corpus over which the income beneficiary had no right or control, constituted the beneficiary’s separate property —the bequest received by the beneficiary was the income interests themselves, and not the underlying assets that produced the income.

2. [In *Marriage of Long*, 542 S.W.2d 712 (Tex. Civ. App.—Texarkana 1976, no writ)](https://1.next.westlaw.com/Link/Document/FullText?findType=Y&serNum=1976137924&pubNum=0000713&originatingDoc=Ie80d7c5eb41e11deabdfd03f2b83b8a4&refType=RP&fi=co_pp_sp_713_717&originationContext=document&transitionType=DocumentItem&contextData=(sc.Default)#co_pp_sp_713_717), H was the income beneficiary of a trust which provided that, upon reaching age 40, H could withdraw all or any portion of the trust assets. If H did not exercise the withdrawal power, the trust continued for H’s life. H did not exercise the age-40 withdrawal power. The court held that the trust income interest and accumulated income were community property. H had a possessory right to the trust corpus, and even though he had chosen not to exercise that right, he was effectively the owner of the trust property—triggering the rule that the income from separate property is community property

3. In *Sharma v. Routh*, 302 S.W.3 353 (Tex. App.—Houston [14th Dist.] 2009, no writ). H was the beneficiary and trustee of a QTIP trust and a credit shelter trust (created by his first wife, will) that gave H HEMS ascertainable standard distribution powers. H, who never exercised the distribution power, married W—and two months later H filed for divorce. In the first draft of its opinion, the court wrote that H’s income interests in the two trusts (and thus a substantial amount of accumulated income) were community property. As to both trusts (said the court in its draft opinion), H’s power to make distributions to himself triggered the *Marriage of Long* result—H owned the trust corpus. Additionally, as to the QTIP trust, it was clear that H owned the trust because upon his death the trust property’s value would be includible in his gross estate for estate tax purposes. (!!)

a. The attorney representing H sent me a copy of the draft opinion, and I almost immediately (the clock was ticking) wrote an amicus brief in which I pointed out (as tactfully as possible) OOPS! (i) The HEMS distribution power was limited, and did not give H an interest in the trust corpus. Because distributions were to take into account other available recourses, H had not taken (and could not have taken) distributions for his support and maintenance. (ii) The §2044 inclusion in H’s gross estate was the result of the QTIP election, and not because H owned the trust property.

b. In its published opinion, the court ruled that H did not “own” the QTIP trust, and that the H would have a present possessory right to receive principal distributions from the trusts only if he determined that such distributions were necessary for his maintenance under the support provision. The record showed no evidence that H was ever entitled to receive distributions of trust corpus.

# VI. Section 2056—Marital Deduction

**A. Personal representative ordered to make portability election notwithstanding general waiver in premarital agreement**. *Estate of Vose v. Lee*, 390 P.3d 238 (Okla. 2017), is a case of first impression as to the duty of a personal representative to make a portability election. Decedent died intestate in 2016, and her surviving spouse (Vose, who married decedent in 2006) was initially appointed administrator of the estate. A premarital agreement was discovered under which Vose had waived his right to be appointed personal representative, and decedent’s son by her first marriage (Lee) was appointed administrator. Although the size of the estate is not mentioned in the court’s opinion, it was less than $5.45 million (the estate tax exemption in 2016), meaning that no federal estate tax return was required to be filed. Vose filed a petition to compel the administrator to file an estate tax return for purposed of making a portability election, agreeing to pay any costs associated with preparing the return. The administrator contested the petition on the ground that the premarital agreement waived “all claims and rights, actual, inchoate, vested, or contingent” in the estate. The Oklahoma Supreme Court affirmed the lower court’s order that the administrator must timely file an estate tax return for purposes of electing portability.

1. The court concluded that Voss’s standing to assert his interest in the DSUE was not barred by the prenuptial agreement. Int. Rev. Code §2010 “grants Vose a potential interest as the surviving spouse in the portability of the DSUE, independent of his ability to take as an heir…. The determinative question, then, is not whether the antenuptial agreement between Vose and Decedent bars him from being a legal heir, but whether the agreement bars him from having any interest in the portability of the DSUE.”

2. The court noted that a waiver of rights is not binding unless made with full knowledge of the rights intended to be waived. The premarital agreement was made in 2006; the law allowing a portability election was enacted in 2010. Although the parties clearly intended a comprehensive waiver of their marital rights under the law as they existed at the time, the agreement was silent as to portability because the change in law was unforeseeable to the parties when the contract was made.

3. “An administrator of an estate occupies a fiduciary relationship toward all parties having an interest in the estate.” The court rejected the administrator’s contention that because the DSUE was valuable only to Vose, he should be allowed to demand consideration from Vose in exchange for making the election.

**B. Service acted properly in examining estate tax return of predeceased spouse to determine correct DSUE amount.** In *Estate of Sower v. Commissioner*, 149 T.C. No. 11 (2017), H died in 2012, survived by his spouse S. The estate tax return for H’s estate, which reported no estate tax liability, elected portability of the deceased spousal unused exclusion (DSUE) in the amount of $1,256,033. The return reported no taxable gifts, but it listed $945,420 in taxable gifts on the worksheet provided to calculate taxable gifts to be reported on the return. (Oops!) On November 1, 2013, the Service issue a Letter 627, Estate Tax Closing Document, which stated that the return had been accepted as filed, and that the Service would not reopen or examine the return unless there was evidence of fraud etc., a substantial error based on an established IRS position, or a serious administrative error.

1. S died in August 7, 2013, and the estate tax return for S’s estate claimed a DSUE of $1, 256,033 from H’s estate. (As with the return for H’s estate, the return did not report a taxable gift of $997,921, but did not include a worksheet showing such a gift.) In the examination of the return for S’s estate, the Service noted the problem with her unreported gifts. The Service also opened an examination of the return for H’s estate to determine the proper DSUE amount, and uncovered the same problem of unreported taxable gifts. This did not cause any tax to be paid from H’s estate, but the Service concluded that the DSUE amount should be reduced to $282,690—and the Tax Court agreed.

2. The court noted that §2010(c)(5)(B) expressly authorizes the Service to look at the predeceased spouse’s return. Moreover, §7602 gives the Service broad discretion to examine a range of materials to ascertain the correctness of any return. Thus, the Service properly exercised the power conferred by these statutes to determine the proper DSUE amount.

3. The estate argued that the Letter 627, which accepted H’s estate tax return as filed, constituted a closing agreement under §7121, which estopped the Service from making changes to the DSUE amount flowing from that return. The court responded that the regulations specifically limit closing agreements to agreements using the prescribed forms Form 866 (Agreement as to Final Determination of Tax Liability) and Form 906 (Closing Agreement on Final Determination Covering Specific Matters).

4. The estate also contended that this was an improper second examination. Not so, said the court. There was no examination because an examination contemplates a report for additional facts. Here, the Service did not request any further facts from H’s estate, but merely reviewed a return that was already in the Service’s possession.