Trusts – Recent Developments and Select Topics

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1. Recent Trust Developments

a. Decanting Act:

The Washington State legislature recently enacted Chapter 11.107 RCW, "Trusts – Decanting Power." The statute applies to trusts created before, on, or after July 23, 2017 which have a situs in Washington or are otherwise governed by the law of this state. RCW 11.107.080(5). It does not apply to trusts over which the grantor has retained the right to revoke or amend. RCW 11.107.080(1). Generally speaking, the decanting power enables a Trustee to distribute income and principal of a "first trust" to one or more "second trusts."

There are three general procedures to exercise the decanting power under RCW 11.107.040:

(1) The trustee exercises the decanting power unilaterally via the notice procedure. Under RCW 11.107.040(1), the trustee may unilaterally exercise the decanting power provided that

> (a) The trustee determines it is consistent with the trustee's fiduciary duties, including the duty to act in accordance with the purposes of the first trust (RCW 11.107.080(1)); and
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> (b) The trustee gives at least 60 days prior written notice to (i) each qualified beneficiary, (ii) each holder of a presently exercisable power of appointment, (iii) each person that currently has the right to remove or replace the trustee, and (iv) if the trust contains a charitable interest, the trustee gives written notice to the attorney general. If all parties waive the 60-day period, the exercise of the decanting power can become effective immediately. RCW 11.107.040(8).

(2) Parties may agree to the trustee's exercise of the decanting power via binding nonjudicial agreement under RCW 11.96A.220. RCW 11.107.040(2).

(3) The Trustee, qualified beneficiary, holder of a presently exercisable power of appointment, or person that has right to remove or replace the trustee may petition the Superior Court regarding exercise of the decanting power. RCW 11.107.040(3).

The extent to which the trustee may exercise the decanting power generally depends upon the extent of the trustee's discretionary powers under the first trust document. RCW 11.107.020 – 030. However, it is important to note that the decanting power generally may not add a new current beneficiary or reduce or eliminate a vested interest. RCW 11.107.020(a). If those changes are desired, the provisions of RCW 11.96A (TEDRA) will continue to provide planning options.

One of the (if not the) most useful applications of the decanting statute will likely be to convert a mandatory distribution trust for a special needs beneficiary to a special

needs trust. In particular, using the 60-day advance written notice procedure is likely to be significantly less complicated and expensive than a similar action brought under TEDRA. More generally, trust decanting may be preferable if obtaining all beneficiary signatures for a TEDRA agreement will be burdensome and/or impractical. However, TEDRA agreements will remain preferable where the desired changes are not among the permitted changes under the decanting statute, or urgent changes need to be made in fewer than 60 days.

b. **Directed Trusts**. Another (less) recent legislative development in trusts was the 2015 enactment of RCW 11.98A (the "Washington directed trust act"). Under the act, a "directed" trust is generally one where certain traditional trustee duties (for example, investments, distributions, or tax decisions) and the corresponding liability are assumed by a third party (called a "statutory trust advisor" in the statute). For example, a trust agreement taking advantage of the new statute could name an investment advisor or committee of investment advisors to assume all investment decisions. Similarly, all distribution decisions could be made by a distribution committee. In essence, the statute enables a trust agreement to narrow a trustee's role (and corresponding liability) to a purely administrative function.

The statute clarifies the duties and liability of the statutory trust advisor with respect to the trustee and beneficiaries. Under the statute, a statutory trust advisor has the fiduciary duty to act according to the terms and purposes of the trust and solely in the interests of the beneficiaries. Importantly, when a trustee of a directed trust acts at the direction of the statutory trust advisor, the trustee is not liable for any losses resulting from such actions. The trustee also has no duty to monitor the statutory trust advisor, to evaluate the statutory trust advisor's actions on behalf of the beneficiaries, or to commence a proceeding against the statutory trust advisor.

A trust agreement must specifically refer to the directed trust statute in order to be a directed trust. All interested parties can agree to convert a traditional trust to a directed trust by TEDRA agreement.[1]

2. **2018 Estate Tax Changes:**

a. Estate and Gift Taxes (Generally): Pursuant to the Tax Cuts and Jobs Act of 2017 (TCJA), the gift and estate tax exemption amount for 2018 is $11.18 million per individual, or $22.36 million per married couple. The current gift and estate tax rate on amounts in excess of the exemption is 40%. The exemptions enable individuals and married couples to make lifetime gifts or leave inheritances up to these limits without paying any federal gift or estate tax. At the federal level, any unused

[1] There may be federal tax consequences to giving a party powers over a trust, which must be carefully analyzed on a case-by-case basis if this conversion is desired.

exemption of the first spouse may be allocated to the surviving spouse by making the appropriate election on the first spouse's federal estate tax return (IRS Form 706).[2]

Generally speaking, lifetime taxable gifts (i.e., those gifts that require filing a federal gift tax return, IRS Form 709) reduce the federal gift and estate tax exemptions on a dollar-for-dollar basis (for example, a lifetime taxable gift of $1,000,000 reduces both the federal gift and estate tax exemptions to $10.18 million).[3] Any lifetime gifts in excess of the $11.18 million individual/$22.36 million married couple exemption, or any amounts transferred on death in excess of the remaining exemption, will be subject to the applicable gift or estate tax at the rate in effect at the time of the transfer. However, annual lifetime gifts can be made tax-free to an unlimited number of recipients without reducing the donor's federal gift and estate tax exemptions so long as the gifts do not exceed the "annual exclusion" from the gift tax. The 2018 annual exclusion for gifts is $15,000 per donor/per beneficiary/per year, or $30,000 per married couple/per beneficiary/per year.

b. Valuation Discounts: The estate tax value of a closely-held (private) entity wholly owned by the decedent at death is likely to equal or approximate the value of the entity's underlying assets. However, where minority interests in such entities are transferred (or owned at death), the value of the interests will likely be eligible for substantial minority interest and lack of marketability discounts, or discounts due to other restrictions on the recipient's ability to subsequently transfer or benefit from the interests. These discounts enable donors to transfer assets out of their taxable estates at a fraction of the proportionate value of the underlying assets, preserving more exemption to allocate to the taxable estate at death.

Example #1: Assume the client's wholly-owned limited liability company (LLC) holds a commercial building with a fair-market value of $9.8 million, and a $200,000 cash account. If the client owns 100% of the entity at death, the estate tax value of the interest is likely equal to the $10 million underlying asset value. However, if the same client transfers 20% interests to each of her five (5) children, such minority-interest transfers may be eligible for substantial valuation discounts. If a hypothetical 40% discount is determined by a certified appraiser, the client effectively moves a $10 million LLC out of her estate at an exemption "cost" of $6 million, preserving an extra $4,000,000 of federal exemption to shield her assets from the 40% estate tax at death.

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[2] IRC Section 2010(c) allows a surviving spouse to claim the deceased spouse's unused exclusion (DSUE) on a timely-filed federal estate tax return.

[3] In contrast, the Washington State per-individual exemption is $2.193 million, indexed to inflation, and there is no Washington State gift or generation-skipping transfer tax. As a result (and unlike the federal tax), Washington State estate tax can be completely avoided by making gifts during life to reduce the retained assets at death below the Washington State estate tax exemption. Although the planning techniques discussed herein are also very effective in reducing Washington State estate tax, these materials focus on the more complex federal tax issues.

c. Estate Freeze Transfers. For individuals with significant wealth, the $15,000 annual exclusion plus the gift and estate tax exemptions may be insufficient to avoid estate tax. In such case, additional estate planning is typically justified. An "estate freeze" generally refers to any transaction that fixes the current value of an asset for the transferor, while moving the value of future appreciation of that asset to the transferee.

Estate freeze transactions may take the form of gifts or sales, or a mixture of both. Generally speaking, making gifts is typically the simplest estate freeze method for transferring business interests to beneficiaries. Gifts are generally appropriate when clients (i) have beneficiaries they wish to benefit, and (ii) are confident they have sufficient other assets to support their accustomed manner of living beyond their expected life spans. In the absence of a separate transaction event fixing the price of the transferred interests, significant wealth can be transferred out of the owners' estates at a fraction of the (or no) transfer tax cost.

Two particularly effective estate freeze strategies that utilize trusts are (i) family entity transfers to generation-skipping trusts; and (ii) sales to intentionally defective grantor trusts, each of which are generally discussed below.

i. Gifts, Generally: Making gifts of stock or other minority entity ownership interests is a very effective estate tax reduction strategy. By gifting entity interests (as compared to cash), any future appreciation above the value of the interests on the date of the gift is transferred out of the estate. No income taxes are due when the gift is made, though the owner's cost basis in the gifted assets transfers over to the gift recipient. Finally, the value of the gifted interests may be eligible for substantial valuation discounts, as discussed above.

ii. Family Entity Transfers to Generation Skipping Transfer Trusts (GST Trusts): Making gifts of closely-held business interests to a Generation Skipping Transfer (GST) tax exempt trust can shield business assets from transfer taxes for several generations. This is primarily due to the combination of (1) the historically high estate and GST tax exemptions, (2) valuation discounts, and (3) the lack of a Washington State GST tax.

A GST Trust is one method to take advantage of an owner's (currently) $11.18 million GST tax (GSTT) exemption. The GSTT generally restricts persons from making substantial tax-free gifts that skip their children and pass directly to their grandchildren and later descendants. Assets in excess of a decedent's GSTT exemption that skip to the grandchildren's level (directly or in trust) are thus subjected to two taxes – the regular estate tax and the GSTT – as if the assets had passed through the children's estates on their way to the grandchildren. As a result, the total combined tax can reach (or exceed) 80% for non-exempt generation-skipping transfers.

Allocating GSTT exemption to a transfer to trust exempts such trust assets from estate and GST tax at multiple deaths for the duration of the trust.[4] Without the application of transfer tax over multiple generations, appreciation can dwarf the initially-transferred (discounted) value, making gifting an owner's business interest prior to an expected significant increase in value very effective for future estate tax reduction: all future appreciation is transferred to the beneficiaries without being subject to transfer taxes in multiple owners' estates.

A. **Example #2**: Again, assume the client's wholly-owned limited liability company (LLC) holds an operating business with a 100% controlled fair market value of $10 million. Assume further that in year one the client transfers 20% interests to GST trusts for each of her five (5) children, and a 40% discount is applied to each transfer by a certified appraiser (using $6 million of her $11.18 million federal GSTT, estate, and gift tax exemptions). Finally, assume in year five that the children's trusts collectively sell 100% of the business to a third party for $14 million. In such case, the client has moved a $14 million asset out of her estate at an exemption "cost" of $6 million, shielding $8 million of assets from the 40% estate tax at death. Additionally, because the trust is GSTT-exempt, it can appreciate to an unlimited extent and escape estate and GST tax at each successive generation for the duration of the trust.

B. IRC § 2036(a) Audit Risk: Discounted transfers of family-entity interests are commonly challenged by the IRS as ineffective to avoid the transferor's future estate tax. The IRS typically argues that, pursuant to Internal Revenue Code ("IRC" or the "Code") § 2036(a), these lifetime transfers should be disregarded and brought back into the estate to be estate taxed at the date of death (or alternate valuation date) value. The recent Tax Court memorandum opinion in *Estate of Purdue*, T.C. Memo. 2015-249,[5] provides a road map for protecting against such aggressive IRC § 2036(a) audits. Generally speaking, pre- and post-transfer facts and activities are critical to the estate's defense. In ruling for the *Purdue* estate, the Tax Court determined that the value of the assets transferred by Mrs. Purdue seven years prior to her death to a family limited liability company, minority interests of which were later gifted at discounted values for the benefit of her family members, was not included in her gross estate under IRC §2036(a) because the bona fide sale for adequate and full consideration exception to IRC § 2036(a) applied. The Court's ruling was dependent, in part, on the following factors.

1. The record established legitimate and significant nontax reasons for creating the family limited liability company (the "FLLC");

2. The Purdues were not financially dependent on FLLC distributions;

[4] RCW 11.98.130 generally limits Washington State trusts to 150 years.

[5] Montgomery Purdue Blankinship & Austin PLLC represented the estate in *Estate of Purdue*. See http://www.mpba.com/blog/tax-court-rules-for-mpba-clients-in-rejecting-aggressive-irs-estate-tax-claim/ for additional detail.

3. The Purdues did not commingle personal funds with FLLC funds;

4. The FLLC maintained clear records and entity formalities were respected;

5. The assets were timely transferred to the FLLC; and

6. The Purdues were not in poor health at the time of the transfers to the FLLC.

> **Planning Tip:** For estate planners assisting clients with a family limited liability or limited partnership transfer strategy, *Estate of Purdue* provides useful guidance on beneficial pre- and post-transfer client activities. In general, advise your clients to be meticulous in (1) documenting and implementing the non-tax reasons for the family business gifting plan, and (2) treating the family business in the same manner as any other business entity, *e.g.*, the owners should conduct regular meetings, adopt and update business and investment plans; and regularly document meetings and decisions with minutes and resolutions.

iii. Sale to an Intentionally Defective Grantor Trust: Although gifting is often the most advantageous estate tax minimization strategy, in many cases, the transferor requires a retained income stream from the transferred business interests. If so, a sale to an intentionally-defective grantor trust (IDGT) is an attractive option. A sale of stock for fair-market value does not use any of the clients' tax exemptions. Moreover, because the IDGT is structured as a "grantor trust"[6] (*i.e.*, it is treated as one and the same as the grantor for income tax purposes), purchase payments from the IDGT to the owner generally are not subject to income tax.[7] As a result, the sale of discounted minority interests to the IDGT can accomplish the same estate freeze technique as the family entity GST Trust gifts described above (and subsequent sale proceeds transfer to the beneficiaries), but also provide an income-tax free sale proceeds stream back to the grantor.

A primary audit concern with IDGT sales is that the IRS may argue that the transferred assets are subject to Code §§ 2036(a), 2701 and 2702, in which case the sale is generally disregarded, and under the worst-case scenario, results in the inclusion of the full date of death (i.e., appreciated) value of all of the trust assets in the estate. Although the IRS ruled that these Code sections did not apply to an IDGT sale in PLR 9535026, the rulings were conditioned on the assumption that the note retained by

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[6] IRC Secs. 671-678 provide the circumstances in which trust income will be taxed as if owned by the grantor or a beneficiary.

[7] See, e.g., PLR 9535026.

the seller was *bona fide* debt. If it was a retained income or equity interest instead, the IRS warned that all three sections could apply.

Many commentators believe that the key to qualifying the promissory note as bona fide debt is to make sure that the trust's debt/equity ratio is not too high by funding the trust with an amount at least 10%[8] of the overall sale transaction (*e.g.*, if the sale is for $1,000,000, the trust should be funded with property worth at least $100,000). The amount the trust is funded with prior to the sale is generally referred to as "seed money." Unfortunately, there is very little specific guidance from the IRS or from the courts on when an IDGT note crosses the line into an equity interest. Thus, tax advisors have been left wondering how much seed money is truly required.

Another commonly overlooked risk with sales of closely-held business interests to an IDGT is that the IRS may, in a later estate tax return audit, allege that the sale price was insufficient (a "bargain sale"), resulting in an immediate constructive taxable gift from the seller to the IDGT trust beneficiaries in the year of the sale. That argument may be made, even with no realistic chance of prevailing, primarily to put extra pressure on the estate to settle its estate tax issues.[9]

Planning Tip: In LTR 9515039, the IRS ruled that a purchaser's guarantee would suffice in the context of a private annuity sale, provided that the guarantor had sufficient personal assets to make good on the guarantee. Consider using beneficiary guarantees in conjunction with a minimum 10% seed gift to best support the bona fide aspect of the sale.

Planning Tip #2: The IRS can be prevented from alleging in a later estate tax return audit that a "bargain sale" occurred in the year of the sale to the IDGT by filing an IRS Form 709 (federal gift tax return) reporting no gift for the year of the sale.

2. **Trust Income Tax Considerations.**

[8] See, e.g., "Using Beneficiary Guarantees in Defective Grantor Trusts," Milford B. Hatcher, Jr., and Edward M. Manigault, 92 JTAX 152 (March 2000).

[9] For example, incidental to the *Estate of Purdue* § 2036(a) issue, the IRS also asserted in the Tax Court litigation, 14 years after the fact, that the decedent made a year 2001 constructive bargain sale taxable gift to her children. The Service alleged that she did so by acquiescing to a non prorata distribution from her deceased husband's estate of an improperly valued minority LLC interest in satisfaction of their fractional beneficial estate share. Although the Service argument was frivolous (the valuation of that minority LLC interest was supported by an unchallenged independent appraisal), the estate net worth exceeded the $2,000,000 IRC § 2412 maximum necessary to be eligible for an award of its attorney fees incurred overcoming the meritless gift tax deficiency.

a. Beware of the 3.8% net investment income tax (NIIT). The net investment income tax (NIIT) is an additional 3.8% tax on individuals, estates, and trusts effective for tax years beginning on and after 1/1/13.[10] The NIIT is not an issue when an active business is sold by its owners, due to the material participation exception to NIIT.[11] However the NIIT is frequently an issue for income taxed to trusts because the trustees and beneficiaries do not satisfy any of the material participation tests.[12]

The use of trusts (as opposed to direct transfers) to hold active business assets for non-materially participating beneficiaries may provide a planning opportunity for avoiding the 3.8% NIIT tax. In *Frank Aragona Trust, et al. v. Commissioner*, 142 T.C. 165 (2014), the court held that the activities of three out of six co-trustees in the operation of an LLC (wholly owned by a trust) would be taken into account, and as a result, the trust satisfied the material participation test. The Tax Court did not, however, hold that all of the non-trustee fiduciaries, employees and agents could be considered in determining whether the trust materially participated, nor did it hold that the trustees' services to the

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[10] The 3.8% tax consists of three separate taxes (FICA, SECA, and NIIT) that are effectively 3.8%. They are collectively referred to in this article as the 3.8% NIIT taxes.

[11] Pursuant to temporary regulation §1.469-5T, a taxpayer materially participates in an activity in a tax year if any of the following are satisfied:

(1) The individual participates in the activity for more than 500 hours during such year.

(2) The individual's participation in the activity for the tax year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year.

(3) The individual participates in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year.

(4) The activity is a significant participation activity (participation of more than 100 hours but no more than 500 hours) for the tax year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.

(5) The individual materially participated in the activity for any five tax years (whether or not consecutive) during the ten tax years that immediately precede the tax year.

(6) The activity is a personal service activity (the fields of health, law, engineering, architecture, accounting, actuarial science or consulting, i.e. "professional services"), and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year.

(7) Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

[12] A common method of avoiding NIIT on undistributed trust income is to draft the governing document to be a grantor trust to the (active-owner) grantor. In the case of a grantor trust, each tax item included in computing taxable income of a grantor or another person under IRC § 671 is treated as if it had been received by, or paid directly to, the grantor or other person for NIIT purposes. See Reg. § 1.1411-3(b)(1)(v). Thus, if the grantor remains a material participant and is willing to remain liable for all trust income tax items, the NIIT can be avoided. This section of the materials assumes that the grantor either does not want grantor trust treatment, or grantor trust treatment to the grantor is unavailable (such as would be the case if the grantor is deceased).

business in other capacities (e.g., as employees) would be considered. Rather, the court found those determinations unnecessary since the trustees, acting in their fiduciary capacities as trustees, satisfied such test.

Although the IRS has not acquiesced to this decision, it provides support to the argument that if the trustees, in their fiduciary capacities, satisfy the material participation tests, so will the trust. However, be aware of (pre-*Aragona*) IRS technical advice memoranda 200733023 and 201317010, where the Service ruled that the appointment of an individual who is active in the business as a "special trustee" with only limited authority to act on behalf of the trust will not satisfy the material participation test.

> **Planning Tip**: Unfortunately, there appears to be no guidance as to whether all, a majority, or only one co-trustee must satisfy the material participation requirements in order to avoid the application of the 3.8% tax to the trust's income. While the Tax Court does not explicitly address this question, the Tax Court nevertheless found the Trust in *Aragona* Trust materially participated when only three of the six co-trustees (i.e., not a majority) were participating. Therefore, taxpayers may point to *Aragona Trust* as support where not all co-trustees are active in a trust's business. As a result, if a non-materially participating child (or other beneficiary) is designated as the trustee and beneficiary of a GST (or other) Trust, planners should consider whether appointing a co-Trustee who materially participates is effective to avoid the 3.8% NIIT tax.

b. <u>The Intentionally Defective Beneficiary Trust</u>. As discussed above, clients are often willing to establish trusts as grantor trusts so that the trust income tax liabilities are retained by the grantor. Doing so enables the trust assets to grow undiminished by income tax payments, and the tax payments by the grantor on behalf of the trust do not constitute additional (exemption-using) gifts to the trust. Under current law, non-grantor trusts generally pay much higher income taxes because the highest rate bracket of 37% applies to undistributed non-grantor trust income in excess of approximately $12,500, whereas such rate does not apply to individual income until it reaches $500,000. As a result, when clients wish to utilize trusts to accumulate income, far less income tax may result if the trust is a grantor trust for income tax purposes.

An IDGT is commonly established by reserving to the grantor powers under IRC § 675. Under § 675, a trust is characterized as a grantor trust whenever a non-adverse party[13] acting in a non-fiduciary capacity, and without the approval or consent of any person acting in a fiduciary capacity, has the power to enable the grantor to

[13]Code §672(a) provides that the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. Code §672(b) provides that the term "nonadverse party" means any person who is not an adverse party.

reacquire[14] the trust corpus[15] by substituting other property of equivalent value ("Substitution Power"),[16] or (2) the power to enable the "grantor" to borrow trust corpus or income, directly or indirectly, without adequate security ("Borrowing Power").[17] The IRC § 675 powers are generally favored because they confer grantor status for income tax purposes without causing inclusion of the trust assets in the grantor's estate.

Although IRS Private Letter Rulings are only binding on and for the benefit of the taxpayer requesting the ruling (and cannot therefore be cited as precedent), there nevertheless are many Private Letter Rulings generally confirming grantor trust status for income tax purposes where the Substitution Power and/or Borrowing Power were present. *See, e.g.,* PLR 199942017 (grantor had both substitution and borrowing powers). *See, e.g.,* PLRs 200845015, 9504024, 9437022, 9416009, 9352004, 9248016 (grantor had substitution power[18]); PLRs 200840025, 9645013, 9525032, 8708024 (grantor had borrowing power); PLRs 199942017, 9446008, 9403020 (grantor had both substitution and borrowing powers). PLRs 200010036, 199908002, 9810019, 9713017 and 9407014 (nonadverse party had the substitution power).

However, in many cases, having the trust income taxed to the grantor is not a feasible option, or is not available due to the grantor's death. In such cases, the trust may need to distribute out all trust income to enable income taxation at the (lower) individual rate brackets, or the trust may need to pay income taxes at the highest tax rate on a greater amount of the (non-grantor) trust income. The former option may not be in the best interests of the trust beneficiary, and/or may be contrary to the grantor's intent to accumulate income within the trust. The latter option is not ideal since it results in the highest income tax consequences.

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[14]Although the word "reacquire" may suggest that Grantor Trust status only results when the original trustors have the Substitution Powers, PLRs 199908002, 9810019 and 9713017 confirm that Substitution Powers granted to other persons (such as trust beneficiaries) can also result in Grantor Trust status.

[15]Code §675(2), and Code §675(4)(C) indicate that the form of the originally transferred assets may change or be altered without affecting grantor trust status, by their references to borrowing or reacquiring trust "corpus" rather than "the property originally transferred by the grantor." PLR 200842007 approved a Substitution Power enabling the grantor to "acquire ***any or all property constituting trust principal*** by substitution of other property of equivalent value…[emphasis added]" with respect to a trust where the trustees have broad powers to "invest, dispose of and otherwise deal with property in Trust, ***whether originally contributed to Trust, acquired by Trust or previously substituted into the Trust by Grantor***, without the approval or consent of any other person [emphasis added]."

[16] Code §675(4)(C).

[17] Code §675(2).

[18] The following Private Letter Rulings also confirm grantor trust status when a substitution power is present: 200910009, 200910008, 200729016, 200729015, 200729014, 200729013, 200729012, 200729011, 200729010, 200729008, 200729007, 200729006, 200729005, 200022048, 200022018, 200011012, 19942017, 19922007, 9719012, 9648045, 9645013, 9642039, 9616026, 9548013, 9525032, 9519007, 9505012, 9442012, 9440021, 9438025, 9437023, 9424032, 9403020, 9352017, and 9352007.

An alternate possibility is the intentionally defective beneficiary trust ("IDBT"). An IDBT is the functional equivalent to the IDGT, except the trust income is taxed to the beneficiary rather than to the grantor. In other words, it is a grantor trust *to the beneficiary*. Although a "grantor" of a trust established by a third party for the beneficiary's benefit includes any person who makes a gratuitous contribution to the trust,[19] it appears likely that a beneficiary may take the position that all trust income will be taxed to her or him individually due to the combination of IRC §§ 675 and 678. Under IRC § 678(a)(2), "a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which … such person has previously partially released … [a power to vest the corpus or the income therefrom in himself] … and after the release … retains such control as would, within the principals of sections 671 to 677 … subject a grantor of a trust to treatment as the owner thereof." In other words, if the beneficiary is granted a withdrawal right that is "partially released," and after such release the beneficiary continues to have a right under §§ 671 to 677 (e.g., the § 675(4) Substitution Power or § 675(2) Borrowing Power), the trust income is taxed to the beneficiary under 678(a)(2).

For example, in PLR 201216034, the current trust beneficiary (but no other person) had both a Substitution Power over 100% of the trust corpus and a cumulative power to withdraw from the trust corpus ("Withdrawal Power"), and the Withdrawal Power partially lapsed annually as to the value that did not exceed the greater of $5,000 or 5% of the value of the trust. In such case, the beneficiary was treated as the sole owner of the trust for federal income tax purposes.[20] Under the IRS's reasoning in PLR 201216034, if the trust document grants to the trust beneficiary (1) the Substitution Power and Borrowing Power over all of her or his trust assets, and (2) a second annual Withdrawal Power which can be exercised, in cash or in kind, out of any of the assets in that beneficiary's trust, then 100% of the assets of each trust are made subject to the powers granted to that trust's primary beneficiary, and all trust income should be taxable to the beneficiary.[21]

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[19] §1.671-2(e)(1) of the Income Tax Regulations provides that for purposes of subchapter J, a grantor includes *any* person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.

[20] PLR 201216034 provides: "Section 678(a) provides, in general, that a person other than the Grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a Grantor of a trust to treatment as the owner thereof… Based solely upon the facts submitted and the representations made, we conclude that, Primary Beneficiary will be treated as the owner of Trust under Section 678(a)(1) of that portion of Trust over which his withdrawal power has not lapsed. To the extent that Primary Beneficiary fails to exercise a withdrawal power and the power lapses, Primary Beneficiary will be treated as having released the power, while retaining a power of administration, exercisable in a non-fiduciary capacity, to acquire Trust corpus by substituting other property of an equivalent value."

[21] Although the PLR 201216034 beneficiary initially had no maximum dollar amount applicable to the power to withdraw the trust corpus, since no other person had the Substitution Power or Withdrawal Power over any portion of the trust corpus, there appears to be no reason why PLR 201216034 would be decided any differently even if that withdrawal power had been limited by a maximum dollar amount. Accordingly,

However, assets subject to a general power of appointment (*e.g.*, an unrestricted withdrawal right) are generally included in the taxable estate of the powerholder and are exposed to the claims of the powerholder's creditors. To limit the exposed amount, consider making the annual Withdrawal Power lapse at the end of each year (similar to the lapsing part of the withdrawal power in PLR 201216034), other than a relatively small amount (*e.g.*, $1,000).[22] That smaller amount of each such annual Withdrawal Power may accumulate and be withdrawn in future years (similar to the cumulative part of the withdrawal power in PLR 201216034).[23] Most importantly, no person other than the respective beneficiary has a Substitution Power, Borrowing Power or Withdrawal Power which would result in that person being another "owner" of the trust for income tax purposes (also similar to PLR 201216034).

Planning Tip: If the trust beneficiary is also a material participant in the business, implementing the IDBT income tax method may provide the best of all worlds: So long as the trust income is taxable to the beneficiary, the trustee material participation issues left open by *Aragona Trust* become irrelevant.

4. Mitigating Fiduciary Risk

The planning methods described above often take years (if not decades) of careful thought and planning on the part of clients and their attorneys. However, once implemented, the benefits of these trust and estate strategies can become threatened or undone by challenging beneficiaries and/or lax fiduciary oversight. Fiduciaries, such as

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planners should analyze whether the 678(a)(1) power can be limited to a smaller portion of the trust income (so long as the 678(a)(2) power is with respect to the entire trust).

[22] If the trust is drafted so that no lapse of the Withdrawal Power can exceed the "5,000 or 5%" rule of § 2514(e), there can be no present gift tax consequences to the beneficiary when part of the Withdrawal Power lapses, nor is any such lapse a "transfer" for purposes of Code § 2036 or § 2038 which would cause inclusion of the Trust in their taxable estate. However, any Withdrawal Power that has not lapsed by the beneficiary's respective death will be included in the taxable estate (for example, if the beneficiary lives another 60 years, this amount (if not withdrawn by her prior to death) would cause $60,000 to be included in her estate). Code § 2041 (b)(2); Reg. § 20.2041-3(d)(3).

[23] As noted above, for a beneficiary to be deemed the owner of a trust (for income tax purposes) under IRC § 678(a)(2), if such beneficiary's Withdrawal Power is "partially released," the beneficiary must retain a power over the trust that would render it a grantor trust with respect to the real grantor (if the real grantor had retained such power). It thus appears that if the power gradually lapses in its entirety (by $5,000 / 5% per year), IRC § 678 status is lost. However, PLR 200949012 indicates that this is not the case. The ruling apparently treats a "lapse" as a "release" so that even if the unilateral right to withdraw eventually disappears (by $5,000 / 5% per year), the lapse would be partial only because the general power to withdraw assets for the beneficiary's health, education, maintenance and support remains present. This general distribution power – if it had been retained by the grantor – would be a grantor trust trigger under IRC § 677. Thus, under IRC § 678, the beneficiary continued to be treated as the owner of the trust. That said, the "partial release" language of IRC § 678 leads us to believe that including a "true" partial release of the Withdrawal Power is the safer approach.

trustees and personal representatives, must meet significant legal duties and obligations to beneficiaries and may face liability for failure to meet those legally imposed duties. The following case studies exemplify three ways to engage in best practices as a fiduciary to mitigate fiduciary risk: (1) practice robust communication; (2) avoid self-dealing and commingling; and (3) manage trusts and estates efficiently and responsibly.

a. Use Robust Communication – *Gillespie v. Seattle-First Nat. Bank*

Gillespie v. Seattle-First National Bank exemplifies the importance of using robust and calculated communication to mitigate fiduciary risk.[24] In *Gillespie*, a family with limited financial investment experience relied on the advice of a bank trustee for a thirty-year period in which the bank invested and managed trust funds for the family's benefit. The bank communicated its investment decisions to the beneficiaries throughout the thirty-year period. However, the family was financially unsophisticated and did not fully comprehend the investment decisions nor the associated risks. The family understood that the trust incurred losses but did not understand the cause of the losses. The beneficiaries relied on the bank's expertise without seeking independent advice as to whether the investments recommended by the bank were appropriate. When the family lost their entire investment because of the bank's decisions, they sued the bank trustee for a breach of fiduciary duties, alleging mismanagement of the trust estate.

Gillespie demonstrates that merely communicating investment and management strategies to trust beneficiaries may be insufficient if the beneficiaries do not comprehend the investment decisions. The court held the bank trustee breached its fiduciary duties to the beneficiaries by communicating only a "temporary setback" in the trust investments and providing the beneficiaries with a "general awareness" of investment losses, when the losses were significant.

Gillespie also shows the importance of diligent communication for purposes of starting the statute of limitations. The statute of limitations for a breach of fiduciary duties claim begins to run when the beneficiaries learn of their potential claim. In *Gillespie*, the beneficiaries did not "learn" of their claim until they became aware that the "temporary setbacks" were in fact significant losses in trust funds, which occurred many years after the losses began.

Thus, *Gillespie* proves the importance of robust communication between a trustee and beneficiaries. The trustee must gage the degree of communication necessary based on the beneficiaries' level of sophistication and experience. If a trust is incurring losses, a trustee should communicate those losses and the associated risks to beneficiaries as soon as possible to both initiate the statute of limitations and provide the beneficiaries with complete understanding of their risks.

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[24] *Gillespie v. Seattle-First Nat. Bank*, 70 Wn. App. 150, 855 P.2d 680 (1993); *See also*, *Anderson v. Dussault*, 181 Wn.2d 360, 333 P.3d 395 (2014) (discussing the importance of fiduciary communication to a trust beneficiary to trigger the statute of limitations).

b. Avoid Self-Dealing and Commingling – *In re Estate of Jones*

In re Estate of Jones demonstrates the fiduciary risks associated with personal use of trust and estate property, self-dealing, and commingling of funds.[25] In *Jones*, a personal representative of an estate was removed for breaches of his fiduciary duties. Following his appointment as personal representative of the decedent's estate, the personal representative lived in the decedent's house rent-free, used the home to operate his business, and failed to pay the taxes, insurance, and utilities associated with the home. In addition, he undervalued the home when transferring it to himself and commingled his personal funds with the estate funds.

The *Jones* court held that an executor's rights in property are distinct from traditional property ownership: "Where a person's only right of possession of the property arises from his status as executor, he does not have a right to remain on and use the property.... if he chooses to use the house for his own benefit he must pay rent."[26] The court held that the personal representative in *Jones* breached his fiduciary duties and committed self-dealing by failing to pay rent while living in estate property, failing to pay necessary expenses to upkeep the property, and undervaluing the home when transferring it to himself. The Court held that a final accounting was necessary to determine whether the personal representative also breached his fiduciary duty by commingling his funds with estate funds. If the personal representative could show that all funds are accounted for and all discrepancies in the accounts were explainable, then no breach occurred from the commingling.

To reduce fiduciary risk in light of *Jones*, trustees and personal representatives should pay rent if using trust or estate property for their personal benefit. In addition, fiduciaries should use fair market values to value trust and estate property when making distributions, especially to oneself, to avoid any notion of self-dealing. Moreover, fiduciaries should maintain separate bank accounts to avoid any notion of commingling personal funds with trust and estate funds.

c. Manage Trust in and Efficient and Responsible Manner – *In re Estate of Wimberley*

In re Estate of Wimberley illustrates the risks associated with fiduciary mismanagement, particularly in the context of a family member serving as trustee or personal representative when family relationships are strained.[27] When a married couple died, their two sons fought over the assets in their parents' estates. One son was appointed as trustee of his parents' trust. The trustee son engaged in self-dealing by making distributions to himself from trust funds. He failed to provide accounting of trust assets to other beneficiaries, resulting in trust mismanagement. He was removed and

[25] *In re Estate of Jones*, 152 Wn.2d 1, 93 P.3d 147 (2004).

[26] *Id.* at 14.

[27] *In re Estate of Wimberly*, 186 Wn. App. 475, 349 P.3d 11 (2015).

replaced by a successor trustee, who petitioned for approval of an accounting showing that the trustee son over-distributed trust funds to himself.

The cost of resolving the issues in *Wimberley* was significant, largely because of the trustee son's mismanagement of the trust. A forensic accounting was completed to determine discrepancies in the trust administration and revealed that over $250,000 was misappropriated or missing. The court held that ordering the trustee son to pay for the successor trustee's litigation expenses was appropriate because "[the successor trustee] consistently informed [the trustee son] that his failure to respond with needed information would result in litigation...the administration of [the trust was] prolonged for three years by [the trustee son's] mismanagement and self-dealing with trust funds, and his unwillingness to cooperate with [the successor trustee's] subsequent management of the trust."[28]

Thus, to avoid the costs of litigation and potential forensic accountings, trustees and other fiduciaries should respond timely and accurately to requests for information. By maintaining detailed and accurate records of expenses, many of the issues raised in *Wimberley* can be avoided. In addition, individuals should consider hiring professional trustees to take the administrative burdens off family members, especially when family relationships are likely to cause strife between beneficiaries and appointed fiduciaries.

5. **<u>Conclusion:</u>**

The planning methods discussed in these materials demonstrate that, with timely planning, clients can utilize trusts to (1) transfer significant value to succeeding generations in a manner that substantially reduces the owners' taxable estates for estate tax purposes, (2) maximize the value of gift, estate and GSTT exemptions, and (3) leave the transferee trusts in the best income, estate and GSTT situations available under current law. Moreover, the decanting and directed trust statutes afford even greater flexibility for trustors and trustees to meet the changing needs of multi-generational beneficiaries. However, fiduciaries must take care to best protect both the carefully laid plans of the grantors, and themselves.

These materials do not constitute legal advice or create any attorney-client relationship between the author, MPBA, and the reader. If you have any questions, please contact Ryan Montgomery at (206) 682-7090 or rmontgomery@mpba.com.

[28] *Id.* at 512.