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## PLANNING POTPOURRI

Alternate Valuation: A taxable estate may qualify to value estate assets 6 months after death. With asset values declining this can be important. Consider making a protective Code Section 2032 election as a hedge against IRS valuation attacks. The executor can check the box on Form 706 indicating "Yes" for the alternate valuation election, and then write the words "protective", and file the 706 with regular values. Because of the economy some practitioners are making this procedure a regular practice. There does not seem to be any prohibition in the regulations against this. Caution: Using alternate valuation may change relative values of assets and help qualify the estate for other tax bennies, like the IRC Sec. 6166 estate tax deferral, or zap your ability to qualify. Thanks to Steven B. Gorin, Esq. of Thompson Coburn LLP, St. Louis, Missouri for this clever idea at the ABA RPTE Spring DC Meeting.

529 Plans; Wealthy taxpayers have always set up trusts for children, and in particular grandchildren to help pay for college. Now that those trust investments have been hammered, and wealthy families are feeling the pinch of recession, many are looking to invest the trust funds in 529 plans to eliminate the costs of maintaining trusts and/or to better qualify the grandchildren for financial aid since trust assets may be counted more heavily then are 529 assets. The trust itself may be able to transfer assets to a 529 plan. Another approach — the language of the trust may be broad enough to permit the funds to be distributed out of the trust to a 529 plan.

Love Life Insurance: We don't sell insurance so we can tell you with a straight face—when President Obama raises taxes on the wealthy the tax deferred growth inside that permanent insurance policy is going to look pretty appetizing (well, so long as the insurance company stays in business). Put that in the pot as you rethink insurance coverage in light of all the other changes.

NJ Tax Amnesty: Runs May 4 to June 15, 2009 and applies only to NJ tax liabilities for tax returns due on or after 1/1/02 and prior to 2/1/09. You can waive all penalties, referral cost fees, and 1/2 of the interest due as of 5/1/09, if you pay all tax due and 1/2 of the interest during the amnesty



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# PRACTICAL PLANNER

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## GRANTOR TRUSTS—ALL THAT GLITTERS ISN'T SIMPLE

**Summary: If a trust is treated as owned by the person setting it up ("grantor") for income tax purposes, good tax results follow. The grantor can pay income tax on trust earnings allowing tax free growth of trust assets outside the grantor's estate. The grantor can sell appreciated assets to the trust, without income tax consequences. This planning must be done with care to avoid the Scylla and Charybdis of the gift and estate tax. But how is such a tax elixir obtained? A common mechanism to achieve this is to permit substitution of non-trust property for trust property of equivalent value. The popularity of grantor trusts belies the complexity faced by those heading down the yellow brick road in search of grantor trust Oz.**

Code Section 675 – Income Tax Consequences of Power to Substitute. Code Section 675(4)(C) provides that the grantor is treated as the owner of any portion of a trust for which a power of administration is exercisable in a non-fiduciary capacity by any person, without the approval or consent of any person in a fiduciary capacity. "Power of administration" means any one or more of the following powers…(C) a power to reacquire the trust corpus by substituting other property of an equivalent value. Sounds simple. Just add the right lingo into a trust, like a grantor retained annuity trust (GRAT), or a defective grantor trust (IDGT) giving someone the right to substitute property in a non-fiduciary capacity. But there have been and remain lots of issues: Is the property held in a non-fiduciary capacity? This could turn on the facts in each case making a conclusion tough. So clearly, the grantor cannot be the trustee and hold this power. It is not clear that if the person given the power is the investment adviser, trust protector, etc. whether they could still hold this power in a non-fiduciary capacity. Caution might dictate not doing so.

Even if holding a power to substitute succeeds in characterizing the trust as a grantor trust for income tax purposes, does it taint the trust assets as includible in the grantor's estate? The conclusions that it didn't were often based on the case of *Jordahl v. Comr.*, but in that case the power was held in a fiduciary capacity. Apples and oranges. OK, so give your college buddy the power avoiding the issues of your holding the power as grantor creating estate inclusion. But how can he "reacquire" what he never owned to achieve the income tax status? But the statute says "any person." Not clear. The trustee must have a fiduciary duty to the beneficiaries, be held to a high standard of conduct, be required to administer the trust solely in the interest of the beneficiaries, act fairly, justly, honestly, in the utmost good faith and with sound judgment and prudence; be subject to a duty of impartiality; and take into account the interests of all beneficiaries.

Rev. Rul. 2008-22 – Estate Tax Issues of Power to Substitute. The IRS said that the power to substitute won't cause estate inclusion under IRC 2036 or 2038 if certain requirements are met. That's big. Follow the Ruling's recipe and win, but there are still lots of landmines. In the ruling taxpayer set up an irrevocable trust for descendants.

The grantor expressly cannot be trustee of the trust. The trust document provides that the grantor has the power, exercisable at any time, to acquire any property held in the trust by substituting other

*(Continued on page 2)*

## CHECKLIST: ALTERNATE VALUE

**Summary: When you die the estate tax is assessed on the value of your assets on the date of your death. In case you haven't noticed, asset values have been declining lately. If your estate were taxed on the date of death values, nine months later when the tax is paid, the value of the estate might have declined to the point where the tax is as much as the value of your assets. To minimize this harsh result the tax laws permit your estate to value assets at the date six months after your death if the values and resulting tax are lower. This is called the alternate valuation date ("AVD") and is contained in Code Section 2032.**

√Gee another tax rule. Do you care? Well, if you're an executor and don't make the election and should have, you could be held personally liable if the alternate valuation could lower taxes. Re Lohm Est., 269 A.2d 451 (Pa. 1970).

√ The election is made by the executor on the estate tax return and is irrevocable.

√ The election must apply to all estate assets, no partial application is permitted. Reg. Sec. 20.2032-1(b)(2).

*(Continued on page 3)*

# ...GRANTOR TRUSTS-ALL THAT GLITTERS ISN'T SIMPLE

*(Continued from page 1)*

property of equivalent value. This power is exercisable in a non-fiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. The grantor has to certify in writing that the substituted properties are of equivalent value. Under state law the fiduciary has the obligation to ensure that the properties are of equivalent value. If state law did not require this, will inclusion in the trust document suffice? This is the keystone of the Ruling – it is the fiduciary duty of the trustee that keeps the grantor's non-fiduciary power in check to avoid an adverse tax result. If the trust has two or more beneficiaries the trustee must have a duty to act impartially in investing and managing the trust assets, taking into account the differing interests of the beneficiaries. What happens if the assets include family business interests from which perquisites and salaries are paid? The trustee must prevent any shifting of benefits between the beneficiaries that could result from the substitution of property by the grantor. A common step in a GRAT is to "immunize" the GRAT after a run-up in asset values by substituting cash. Does immunization meet this criteria? The trustee must have the discretionary power to acquire, invest, reinvest, exchange, sell convey, control, divide, partition and manage trust property in accordance with the standards provided by law. Security GRATs are never really invested in accordance with the Prudent Investor Act. They are intentionally invested in non-diversified portfolios whose risk levels are substantially higher than the risk level for the family's overall portfolio. IDGTs often hold business and real estate interests. How will this Ruling be applied with a trust investment adviser serving, or if the trust has restrictions on selling a family business? While the trustee (or investment adviser) may prefer that trust investment provisions permit the holding of a non-diversified, highly volatile asset base, to confirm acceptability of the strategy used (i.e., to protect the trustee from a claim of improper investments), might such a provision conflict with the Rulings requirement of investment in accordance with "standards provided by local law"? The grantor cannot exercise the power in a manner that reduces the value of the trust property or increases the grantor's net worth. The nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust. The entire intent of a GRAT is to increase the benefits to the remainder beneficiaries. Does that violate this concept? Maybe not since the grantor's interests during the GRAT term is fixed.

<u>PLR 200846001 – Gift Tax Issues of Power to Substitute.</u> A common planning approach is to set up a 2 year GRAT which is a grantor trust. Proposals are pending to require a minimum 10 years for GRATs. After 2 years assets remaining in the trust can be distributed to the heirs, or held in further trust. The remainder trust, which follows the GRAT term, can be structured as a grantor trust so the grantor continues to pay income tax on the trust earnings, leveraging the value in that trust for the kids. This PLR (private letter rulings can only be relied upon by the taxpayer to whom issued) had a different approach then the above Revenue Ruling. Here's the facts Joe Friday. Wife set up a GRAT and named Husband trustee. A different approach was used to achieve grantor trust status during the GRAT term and after. The power to substitute was used only for gift tax purposes, not to achieve grantor trust status for income tax purposes. The trust document specified that the annuity amount could be paid to the Grantor from income or principal. This arguably made the GRAT a grantor trust during the GRAT term. The power to substitute assets was held in a fiduciary capacity which could not create grantor trust status under IRC Sec. 675 (4)(C) which requires the power be held as a non-fiduciary. The IRS held that the power to substitute shares of publicly traded company 1 for compa-

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# ...CHECKLIST: ALTERNATE VALUATION DATE

*(Continued from page 1)*

√ Assets which are distributed, sold, exchanged, or otherwise disposed of, before the AVD, 6 months after death, are valued as of the date they were distributed, sold, exchanged, or otherwise disposed of. A transaction which is a mere change in form is not considered a sale, exchange, etc. and won't affect the 6 month date. Reg. Sec. 20.2032-1(c).

√ Patents, life estates, remainders and reversions that whose value is affected by a mere lapse in time are valued as of the date of death, and adjustments are only made to the 6 month AVD to reflect differences in value that are not due to the mere lapse of time. Treas. Reg. Sec. 20.2032-1(f).

√ If the alternate valuation approach is used, the value of an asset on the alternate valuation date becomes the beneficiary's income tax basis for that asset. IRC Sec. 1014(a)(2). The estate tax savings from electing alternate valuation may be offset by an increased income tax liability when the inherited property is later disposed of. You'll have even more fun if the result of the election is to lower taxes for one heir while raising the overall tax costs for another. The Hatfield-McCoy feud began over a 2032 election!

√ Some estates have intentionally restructured assets after death to reduce their value, then elected to use the alternate valuation date to lower their estate tax. The IRS viewed that like taking your finger off a checker piece then trying to move it anyhow – not playing by the rules. So they wrote new Proposed Regulations Section 20.2032-1(f)(1) to prevent executors from taking actions that could lower the value of an estate asset and then electing alternate valuation. Specifically, the IRS tries to limit reductions in value to only those caused by market forces.

√ Choosing alternate valuation can affect the estate's qualification for special estate tax benefits that are based on certain assets exceeding specified percentage tests. If the relative value of different assets change post-death these benchmarks could be met or missed. These could include: IRC 303 redemption of stock to pay death taxes if the value of the stock exceeds 35% of the gross estate; IRC 2032A requires that 25% or more of the adjusted value of the gross estate must be qualifying real property interests; or IRC 6166 requires that business interests exceed 35% of the adjusted gross estate to pay the estate tax in installments.

√ The retitling of the decedent's IRA ("John Doe") to an inherited IRA ("John Doe, Deceased, fbo Jane Doe") shouldn't be a 2032 distribution so the IRA is valued at the 6 month date (if no sales of stock).

√ Prior to September 30 of the year after death (the beneficiary determination date), the beneficiaries who inherit the IRA can split the IRA into separate IRAs so that each of them can be a "designated beneficiary" of their own separate IRA and thus use their own life expectancy to calculate required minimum distributions (e.g. cousins with significant differences in age). The division of one IRA among named beneficiaries should not be a "disposition" so that the value should

# RECENT DEVELOPMENTS

Grantor Retained Interests: Proposed revisions to Reg. 20.2036-1 (found in REG -119532-08 ) provide a method to determine the portion of trust corpus includible in a deceased grantor's estate if the grantor reserves a graduated retained interest, which is a retained interest that increases annually during the term of the trust. The proposed method measures the amount of principal needed to generate the annuity payments that would have been due even after the decedent's death based on the interest rates at the date of death. This is done as if the decedent had survived and continued to receive the retained interest. The proposed regulations make other changes as well, including clarification of the includable amount if the decedent retained the right to receive an annuity or other payment, rather than income, after the death of the current recipient of that interest.

New York will tax non-residents on gains on sales of interest in entities that own real estate in NY starting May 7, 2009. <u>Example</u>: You live in New Jersey and own 40% of an LLC whose sole asset is a building in NY. If you sell your LLC interest for $1M and had a $600K basis you'll have to report $400,000 of gain to NY. <u>Caution</u>: Depending on how your home state taxes your gain, and what it does by way of a credit for taxes paid to NY, you could pay taxes in both states! Sing the jingle: "Double your pleasure Double your fun With Doubletax Doubletax…"<u>Complexity</u>: Ya need more rules to keep your CPA employed, so: ■ Interests in a partnership, LLC, S corporation, or a C corporation is treated as NY real estate if 50% or more of its assets are real estate located in NY and it has 100 or fewer owners. ■ So you get smart and transfer enough cash into the LLC the week before you sell the property so that the real estate constitutes only 49% of the assets and you avoid the tax. No so fast Slick. Only assets owned for 2 years