

By **Martin M. Shenkman**

Using Powers of **Appointment** in Trusts

Prepare clients for adverse changes affecting the estate tax

While we don't know the outcome of the upcoming election, practitioners should counsel clients to plan in advance of possible adverse changes affecting the estate tax. Some of these changes (originally proposed by Senator Bernie Sanders) could include: a reduction in the estate and generation-skipping transfer (GST) tax exemption to \$3.5 million, a reduction of the gift exemption to \$1 million, the emasculation of grantor-retained annuity trusts (GRATs), inclusion of grantor trust assets in a settlor's estate, capping the annual gift exclusion at \$20,000 per donor and more.¹ Presumptive Democratic Presidential Nominee Joe Biden has proposed a capital gains tax on death.²

Current Planning Environment

Several key factors characterize the current planning environment. Practitioners should consider these factors when they select and structure the planning techniques they use for clients. Fundamental to this planning is the use of powers of appointment (POAs). Current planning should consider the following goals and circumstances:

- Values have been reduced by stock market declines, the possibility (existence) of recession and the increased uncertainty as to how the post-coronavirus economy will fare. This suggests transferring assets with lower values, which the clients believe will appreciate.
- Interest rates are at historic lows. Family loans, note sale transactions and GRATs are techniques that ben-

efit from low interest rates.

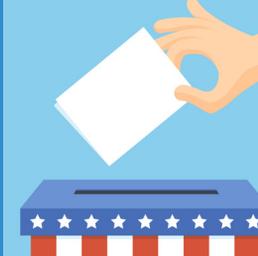
- The massive federal bailouts may result in tax increases on the wealthy, so that estate taxes may increase, and the current high temporary exemption might be reduced before it's scheduled to be reduced by half in 2026. So, the use of the exemption before laws become less favorable could be important for many clients.³ Implementing planning and, in particular, using the current high temporary exemptions before the laws may be changed following the election, is important for many clients.
- Asset protection could be even more important given the possibility of recession and the potential for increases in claims during these turbulent times. Some expect a wave of bankruptcies caused by the stay-at-home orders and economic upheaval. POAs can provide a means to permit enhanced asset protection while also permitting the client to retain some measure of access to the trust post-transfer.
- The most important consideration to the acceptability of a plan for many clients will be access to wealth post-transfer. The current economic worries, stock market decline and uncertainty increase the likelihood of clients insisting on access if they're going to transfer assets now. The use of POAs is fundamental to helping clients realize this objective.

Two Common Techniques

Two of the common techniques to consider are spousal lifetime access trusts (SLATs) for married couples and domestic asset protection trusts (DAPTs) for single clients or married clients who want more access than provided by SLATs. These trusts can facilitate using the exemption, or transferring discounted assets, before laws may become more restrictive after the election. While GRATs are an incredible opportunity in the current very low interest rate environment, they don't



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secure unused exemptions, nor do they provide significant asset protection. This is because, by definition, with a GRAT, the principal and a rate of return must be distributed back to the client as part of the required annuity payments. Wealthier clients who've used all their exemptions and believe that the possible asset protection disadvantages of GRATs, as contrasted with other techniques, are acceptable will find GRATs to be a favored tool.

SLATs

SLATs permit each spouse to be a beneficiary of the trust created by the other spouse and are a common planning technique for married clients. SLATs permit removing assets from a couple's estate, and from the reach of creditors, but with each as a beneficiary of the other spouse's trust, the couple can remain discretionary beneficiaries of both trusts, thus retaining limited access to all assets transferred. Each spouse creates a non-reciprocal trust for the other spouse. The theory and objective are that if one spouse creates a trust for the other, and vice versa, collectively both spouses, so long as both are alive and remain married, can benefit from potentially all of the assets that have been transferred out of their respective estates. Integral to differentiating each spouse's SLAT from the other is incorporating different POAs into each of the two trusts.⁴

SLATs can have more flexibility to assure the settlor access by incorporating a floating spouse clause that provides that anyone the settlor is married to will be a beneficiary. So, if the spouse who was alive when the SLAT was created dies or divorces, and the settlor remarries, then indirect access to SLAT assets may again be provided to the settlor through that new spouse as a beneficiary.

DAPTs and Their Variations

Some form of a DAPT may be a choice for clients who desire more access to their wealth levels than a SLAT might provide (and certainly for single clients without a spouse who could provide indirect access to a SLAT).

DAPTs permit access by naming the grantor as a beneficiary. For those domiciled in the 19 jurisdictions with enabling DAPT legislation, most commentators see no issue with the efficacy of DAPTs. For those resident in other non-DAPT jurisdictions, there's disagreement as to whether the creation of a DAPT in a DAPT jurisdiction will succeed.⁵ Some suggest that a DAPT

created by a resident of a non-DAPT jurisdiction may not succeed.⁶

Another variation is to have a time fuse on the period after which the settlor could be named as a beneficiary or after which the settlor might automatically become a beneficiary. For example, the settlor could be precluded from receiving distributions for 10 years and one day after the creation of the trust or after additions are made to the trust. This is to avoid the provisions of the Bankruptcy Protection Act,⁷ which permit the bankruptcy trustee to access assets of the self-settled trust or similar device for 10 years after transfers are made to it, in some cases.

Hybrid DAPTs

Concerns over the safety of DAPTs have given rise to variations of the DAPT technique that some commentators view as safer. With a hybrid DAPT, the settlor isn't named as a beneficiary of the trust initially. Rather an individual is granted, in a non-fiduciary capacity, a limited or special POA to add beneficiaries to the trust. While the settlor could be named as an individual who could be added, a more common approach is to create a class of potential beneficiaries, for example the descendants of the settlor's grandparents. In that way, the settlor could be added but isn't specified so it's less direct to hopefully deflect a challenge that there's an implied agreement to add the settlor. There's uncertainty about this technique, however.⁸

SPATs

An alternative approach to any type of self-settled trust is the special power of appointment trust (SPAT) that may permit access to trust assets but avoids characterization as a self-settled trust.⁹ In a SPAT, the settlor grants an individual, also acting in a non-fiduciary capacity, the power to direct the trustee to make distributions to the settlor. However, the settlor in no event should be permitted to be added back as a beneficiary, nor can the trustee make discretionary distributions to the settlor. With these limitations, the trust shouldn't be characterized as a self-settled trust, and it shouldn't be subject to the law that allows creditors access to such a trust.

Additional Special POAs

As noted above, access to assets transferred will be of paramount importance for many clients to plan in the current environment. Incorporating various types of



special powers into SLATs and DAPT variants can further facilitate achieving this goal. It will be imperative for most clients to preserve access to the assets transferred to irrevocable trusts, as many clients won't make the transfers if they can't be comfortable that they can have some access in some manner in future years. This is important in light of economic uncertainty, longevity and the need to finance retirement especially considering reduced retirement account values. Preserving access has several planning ramifications. For example, in a non-grantor trust, client access creates a host of issues that the practitioner will need to address. Also, if the settlor's spouse is named as a beneficiary, a non-adverse party will have to approve distributions if the trust is to retain non-grantor trust status.¹⁰

Power to Loan Trust Assets

In a grantor trust, the settlor could provide in the trust instrument a power, held by an individual in a non-fiduciary capacity, to loan trust assets to the settlor. This power is merely a special or limited POA. While this may create a debt due to the trust by the settlor, it's a potentially important means of preserving access to assets that the settlor may need at a future date for living or other expenses. While the loan provision has generally been viewed as a mechanism to create grantor trust status for the particular trust,¹¹ it can also be used, when non-grantor trust status is assured by other provisions, to provide an important means of providing access to trust assets to a settlor making a large gift. Even though the settlor will have a debt to repay the trust, with interest, it nonetheless provides an access to trust assets should the settlor need or want.

Power to Reimburse for Taxes

Another means of providing the settlor access to the trust is for the trust to incorporate a tax reimbursement provision, so long as permissible under applicable state law without enabling creditors of the settlor to thereby access the trust assets. In most instances, this will have to be a discretionary distribution decision made by the trustee. Such a power, perhaps, is a special or limited power held by the trustee in a fiduciary capacity. Practitioners shouldn't only consider this from the standpoint of providing the settlor another means of access to the trust assets. This won't cause estate tax inclusion of the trust in the settlor's estate.¹²

Substitution Power

A grantor's power to swap or substitute assets can't provide the grantor incremental value but may be useful to address concerns of the grantor after the trust is funded. The trust instrument can give the grantor a power to substitute trust property in a non-fiduciary capacity.

The trustee must determine that the properties acquired and substituted by the grantor are in fact of equivalent value. Finally, the trustee must determine that the power can't be exercised in a manner that would shift benefits among the beneficiaries of the trust. The trustee must have a fiduciary obligation to ensure that the grantor complies with the trust terms. The settlor's substitution power can't be exercised in a manner that can shift benefits among beneficiaries. If the requirements are complied with, the trust property won't be included in the grantor's estate under Internal Revenue Code Sections 2036 or 2038.¹³

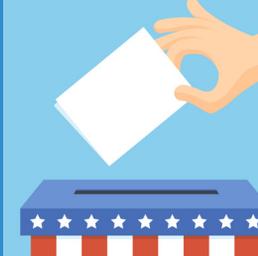
Trust-Owned Entities

The client may hold a special power to direct the trustee as to trust investments, for example, to hold private equity. If the client is contemplating the transfer of family business interests, or real estate entity interests, to an irrevocable trust, that transfer doesn't have to eliminate the client's ability to access assets held by the trust. For example, the client may be permitted to receive arm's-length and reasonable compensation from those transferred entities for services provided as a manager or in another appropriate capacity. Such payments might be more susceptible to challenge if the entity interests so transferred merely hold passive assets, such as marketable securities, which the client isn't actively managing. This may provide for some clients another means to access wealth transferred to a trust. Give consideration to having an analysis of reasonable compensation performed by an independent appraiser to corroborate any fees that are so paid.

Technique Combinations

Practitioners can cobble together the various techniques and special powers available to create a mix of rights and powers for each client. By aggregating different techniques for each spouse's trust for married clients, access under different conditions might provide more financial security. Also, differentiating the trusts using different special powers may further

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deflect a reciprocal trust challenge.

A broader perspective than merely defaulting to non-reciprocal SLATs for a married couple is to consider the use of DAPTs (or a variation) and not merely limit them to single clients. A DAPT can, for example, be used in combination with a SLAT. For example, one spouse could create a SLAT for the other, and the other spouse could create a DAPT, hybrid DAPT or SPAT that benefits both the other spouse as well as potentially himself. That difference between the SLAT and DAPT may be relevant to deflecting the reciprocal trust doctrine. It may also enhance access as contrasted to a more traditional reciprocal SLAT plan.

Planning Encouraged

In the current environment, clients are concerned about economic security, making many worried about transferring assets. However, the potential for increased taxes, especially following the elections, to pay for the government bailouts, and the risks of lawsuits and claims that may be accentuated by COVID-19 and the economic downturn, all encourage current planning. The creative use of special POAs in various trust structures can help clients achieve these apparently competing goals. 

Endnotes

1. For the 99.8 Percent Act, S. 309 116th Cong. (2019).
2. See www.cnbc.com/2020/03/13/this-is-how-joe-biden-will-tax-generational-wealth-transfer.html.

3. See *supra* note 1, which might serve as a blueprint for Democratic tax legislation.
4. *Estate of Herbert Levy*, T.C. Memo. 1983-453 (1983). See also Private Letter Ruling 9643013 (July 19, 1996).
5. See, for example, *In the Matter of the Cleopatra Cameron Gift Trust*, Dated May 26, 1998, and the *Cameron Family Exempt Gst Trust Fbo Cleopatra Cameron*, created under the *Cameron Family Trust*, dated Dec. 20, 1996, as amended, 2019 S.D. 35. The South Dakota Court didn't permit California to enforce a judgment against a South Dakota trust. However, the challenges in this case may not be over. Some commentators suggest that domestic asset protection trusts (DAPTs) created by residents of non-DAPT jurisdictions may succeed. See "Steve Oshins on the 20th Anniversary of Domestic Asset Protection Trusts," *LISI Asset Protection Planning Newsletter* #341 (April 3, 2017).
6. For example, the Uniform Voidable Transactions Act advocates in Comment 8 to Section 4 that any transfer to a DAPT is voidable if the transferor's home jurisdiction hasn't enacted DAPT legislation.
7. Internal Revenue Code Section 548(e).
8. *Matter of Ianotti v. Comm'r*, 725 N.Y.S.2d 866 (2001).
9. Abigail O'Connor, Mitchell Gans and Jonathan Blattmachr, "SPATs: A Flexible Asset Protection Alternative to DAPTs," 46 *Estate Planning* 3 (February 2019).
10. The individual holding the consent power must have a substantial interest adverse to the exercise of the power in favor of the decedent, his estate, his creditors or the creditors of his estate. Treasury Regulations Section 20.2041-3(c)(2).
11. Express loan provisions will cause grantor trust status, IRC Section 675(2). See PLR 9525032 (Dec. 13, 1999).
12. Revenue Ruling 2004-64.
13. Rev. Rul. 2008-22.

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