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CARE AND FEEDING OF YOUR IRREVOCABLE TRUSTS

Summary: Since 2012 and the threat of a reduced gift, estate and GST exemption, and especially during 2020-2022 when there were also concerns over harsh estate tax proposals, many taxpayers created irrevocable trusts and transferred substantial assets to those trusts. Many wealthy people create trusts to protect assets from claimants. Proper administration of those trusts is essential for those trusts to have any potential of achieving your goals. This article will summarize many of the common administrative issues that are often overlooked.

■ **Asset Location and Allocation**: Asset location refers to which assets are in which "bucket" such as tax deferred (e.g., IRA), taxable, irrevocable grantor trust, irrevocable non-grantor trust, etc. If you have created trusts the tax status (grantor, GST exempt, outside your estate or not) should be factored into the decisions as to which types of assets are in which bucket (asset location). Also, depending on the terms of trusts to which you made wealth transfers outside your estate you might need a more aggressive asset allocation to continue to meet financial targets. Your investment advisor should coordinate with your CPA and estate attorney and adjust periodically.

■ **Insurance**: If you've made large wealth transfers you should review all insurance coverage. Depending on the structure and distribution provisions in the trusts receiving the wealth transfers you may have gaps in your financial plan in the event of premature death, unanticipated disability or care costs. You should review all coverage and needs and determine if you should modify or increase each type of coverage. Your financial situation may be different after large wealth transfers and even if you had no need or wish for insurance before the transfers, it might be comforting now. Also, remember that insurance is not a buy and hold asset. Every insurance policy should be reviewed on a regular basis by an insurance expert. Policy performance, needs for coverage, the strength of the insurance carrier, all may change.

■ **Reporting**: The transfers made to your trust should be reported consistently everywhere. If you made a gift to an irrevocable trust subject to a valuation adjustment mechanism (limits the equity interests transferred if the IRS increases the gift value on audit) your personal financial statement, trust statements, income tax return, gift tax return, entity income tax return, etc. should all properly and consistently indicate the ownership interests. Many valuation adjustment mechanisms hinge on a transfer of a dollar figure of entity interests (e.g., $10 million of LLC interests) not a percentage (e.g., 50%). That dollar value interest is often not properly reflected by trustees, CPAs, etc. You should not expect the IRS or creditors to respect your planning if you yourself do not. Don't show trust assets on your personal balance sheet (e.g., the one you give to the bank who is making a loan to your family business). Not only might that be a fraud on the bank but it may contradict your position that the business interests transferred to the trust are outside of your estate for tax purposes.

■ **Fiduciaries and Powerholders**: Old style trusts often had just a trustee. Newfangled modern trusts might have any of the following flavors of trustees: administrative, distributions, insurance, investment, art, and other trustees as well. There may also be people that hold an array of different powers: powers of appointment, power to loan or to add a beneficiary, etc. There may be a trust protector as well. Any of the above positions might be a committee. All these folks need to know what their role is and it is advisable that they understand their roles and responsibilities. Too often these folks may not have even been informed that they have been named.

■ **Annual Review**: For complex irrevocable trust plans an annual review with key players and advisors all participating is pretty much an essential ingredient to keeping the components of the plan (assets, people, formalities)

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CHECKLIST: POWER

Summary: A Power of Attorney is a fundamental or core estate planning document that authorizes a designated person, called your agent, to handle certain tax, legal and financial matters. Every adult should have a current power of attorney. Below are some of the considerations when reviewing what you have.

√ **Document**: Do you know where the original power is? While many will accept electronic copies, it may not be sufficient in some instances, so you have to have the original.

√ **Agents**: Who did you name as agent to handle your financial situation? Are they still appropriate? Is your ex-brother-in-law still listed as the initial agent? Review the people listed and be sure that those are still the choices you would make. Have you named sufficient successor agents?

√ **Gifts**: Authorizing the agent to make gifts is considered a "hot" power and will not generally be inferred and must be expressly provided for in the document. Also, what was appropriate for a gift provision when you signed your power may not be appropriate now. For example, if the estate tax exemption was only $1 million years ago when you signed the power, and in 2023 it is close to $13 million perhaps gift provisions are no longer needed or appropriate. In contrast, if your estate is modest permitting an agent to

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N'Sync. Reality check – far too few folks with complex trusts do this. Big mistake. And now that this can all be coordinated with a web meeting so the cost and time to do this is really a fraction of what it used to be. The best part of an annual review is after a few review meetings you and all your advisers will be sure to understand the plan. The periodic meeting provides an opportunity to evaluate many of the formalities complex trust plans require. These are so nuanced that even sophisticated advisers often misconstrue what must be done.

■ Gift Tax Return: These are complicated and vital to the success of most plans. They really should be completed by a tax professional (CPA or attorney) that specializes in trust and estate planning work. A mere dilettante is not the right approach. Many gift tax returns list gifts in the wrong section of the form, fail to safely address allocation of GST exemption, and miss key disclosures required to toll the statute of limitations. If you don't meet the strict requirements of "adequate disclosure," a defined term in the tax Regs, the period of time during which the IRS can audit the return won't toll. That means they can audit the return forever.

■ Modifications: "Hey my trust is irrevocable, I can't change it." Well not quite. The law has evolved substantially. Although not so many years ago advisers would explain an irrevocable trust as one that "is carved in stone," that is just no longer the case. People holding powers of appointment provided in the trust might be able to exercise those powers in a way to modify the trust or appoint assets to a new trust. The trustee may be able to decant (merge) the existing trust into a new trust. A trust protector may hold powers that permit certain modifications to the trust. All those involved might be able to agree to a non-judicial modification of the trust by agreement. Finally, a court might be petitioned to interpret or modify the trust. The bottom line is that there may be many options to effectuate change of an otherwise irrevocable trust. Most trusts are not regularly evaluated to determine if a change is advisable or feasible, as if the old-style approach of viewing irrevocable trusts as immutable continues. That might not be prudent.

■ Banking: Keep it clean. An irrevocable trust should only pay for expenses that are the trust's expense. If you transferred significant assets to a trust and pay your lawyer and CPA for estate planning services, the trust should not pay an expense that is your personal expense. That goes for indirect payments as well. Say you transferred an interest in a family business to an irrevocable trust. If that business pays for your personal legal or accounting fees that may be equivalent to the trust itself paying a personal expense. That inappropriate payment can not only jeopardize the trust in your estate and asset protection plan, but may also jeopardize the integrity of the business entity as well enabling the IRS and creditors to pierce the entity. Never commingle trust and personal or business assets. Keep each "bucket" pristine as to only deposits and expenses belonging to that bucket. While all of this sounds simple, it is often mishandled and having your CPA regularly involved may provide a solution.

■ Administrative Formalities: Trusts come in lots of flavors and you should never make an assumption as to what is required. Best approach is to review the trust with your estate planner and other advisers and annotate it for how trust administration should generally work. The administrative provisions are often quite different than the provisions everyone focused on when planning the trust. If the trust is a so-called "directed" trust which has a person tell the trustee what investments to hold (or what distributions to make, etc.) then actions to be taken by the trustee may have to be preceded by the correct person providing a signed letter to the trustee directing them as to what to do. If you use an institutional trustee they may require a formal written request and documentation for their distribution committee to consider a distribution.

■ Is Your CFO an Estate Planning Attorney: Many people have an in-house CFO or even an entire family office. Be honest and realistic about what assistance they can provide in trust administration. Too often outside advisers are left out of the loop while internal personnel "handle" trust administration. Even a skilled CPA or corporate attorney in your family office may not have the requisite familiarity with the nuances of administering a complex trust plan. Consider having periodic meetings so in-house personnel can get the guidance they need. It is always much safer and less costly to handle matters correctly. PP

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gift all of your assets away may be useful for Medicaid planning. Is there one (or more) people you provide financial assistance to? If so a gift provision permitting gifts to them may be essential if that help is to continue if you are incapacitated. Should your agent be permitted to make large gifts to use up any remaining estate tax exemption you might have? That might make sense to provide flexibility for estate tax planning before the exemption is cut in half in 2026 but that could be an authorization to move almost $13 million in assets! So the decision is not standard and must be made to provide appropriate flexibility and appropriate safeguards.

√ Coordination: If you have a revocable trust has the planning and documentation of your revocable trust and power of attorney been coordinated? Did you coordinate the person named as a designated representative on long term care coverage, the emergency contact given to your broker, the person authorized to assist with your Social Security, etc. with the agent named in your power of attorney? What about people named as agents on bank or brokerage account forms?

√ Retirement assets, Life Insurance, etc.: How broad is the authorization given your agent to change beneficiary designations on retirement assets, life insurance and other assets? Is there a potential conflict between the agent named and other heirs? How broad or limited should that authority be? Have circumstances changed since you first signed the power document? With many significant changes to the tax rules affecting retirement plans in recent years (Secure Act, and various regulations interpreting it) it might be important to give an agent wide flexibility to update beneficiary designations. But the tricky part is when that authorization is too broad it might give an agent who has ulterior motives an opportunity for nefarious acts. Where to strike the balance is not simple.

√ State Law: If you have multiple homes which state law should apply? Might it be beneficial to complete a power of attorney on a statutory or standard form used in each state you have a residence? Can that be done without creating conflicts and coordination issues?

√ Businesses and Professional Practices: It may be advisable to have a separate power of attorney for certain business matters. Business planning and documents (shareholder agreements, operating agreements, partnership agreements, etc.) need to be coordinated with the provisions and agents in a power of attorney to address business matters. It might not matter who you name as your agent or what powers you give them as the documents governing the business may control who can act for you if you are incapacitated. When have those provisions last been reviewed? If you operate a solo professional practice the professional ethics may require that you have a separate practice power naming an appropriately licensed professional to act in the event you cannot. You might prohibit the agent under your general power from exercising authority over professional practice matters.

√ Indemnification: Should you include a provision indemnifying the agent? How far and broad should such a provision go? Some people may not serve without an indemnification but on the other hand you want someone given this broad power over your assets and more to be responsible.

√ Practical Steps: Does your agent know who your CPA and wealth adviser are? Do they know where your passwords and other account information is kept and how to access it? Be sure to organize all key info. PP

Recent Developments

Summary: There have been ongoing challenges by the IRS based on valuation issues. Several recent cases give the message that more attention and care should be given to valuation issues.

■ Be sure that if you have a valuation adjustment mechanism it references "gift tax value as finally determined." Creative writing efforts should be confined to your poetry class. Nelson v. Commissioner, 128 AFTR 2d 2021-6532 (5th Cir. Nov. 3, 2021), aff'g T.C. Memo. 2020-81.

■ Taxpayer valued an asset gifted based on an old appraisal that was done before 5 offers to buy the company were received. The IRS not only nixed the valuation but said that it would not respect the valuation adjustment mechanism permitted to the special trust, a GRAT, the gift was made to. CCA 202152018 Release Date: 12/30/2021. Be sure if you have an asset appraised disclose all relevant facts to the appraiser and perhaps the appraiser should disclose those facts in its report. Even if the harsh result of this CCA is overturned, it is a clear warning from the IRS not to use egregious knowingly wrong valuations and rely on a valuation adjustment mechanism to keep you out of tax hot water if you're audited.

■ Taxpayer was a key exec who knew the public company had offers to merge. He disregarded those circumstances and valued the stock at the mean between the high and low value for the day which is how the tax Regs say stock should be valued. The IRS objected but it appears that the case was settled. The IRS seems wrong on this one but notice the pattern of valuation challenges. Daniel R. Baty v. Comm'r, Docket No. 12216-21.

■ Taxpayers made a gift of life insurance and had a well-known appraisal firm value the policies which was done based on the secondary market for life insurance. But the tax Regs require use of the interpolated terminal reserve value plus unexpired premiums. Reg. § 25.2512-6(a). Dematteo v. Comm'r, Tax Ct. Dkt. No. 3634-21 (July 21, 2022). This is not a simple one. The Regs are old and don't contemplate the policy type involved. But the policy involved was also outside the parameters of the typical policies sold in the secondary market. Was that expressly addressed in the appraisal? Insurance valuations should probably include a Form 712 and an analysis of those numbers by an insurance expert. PP

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■ **Formula Defined Value Transfers**: This is a technique where you transfer by gift or sale a dollar value of interests (see lead article). When the gift tax statute of limitations runs the reporting of the asset should change. This should be 3 years after the filing of the gift tax return if adequate info was disclosed on the return. So, if you gifted or sold say $10M of LLC interests the trust, your financial statements, tax returns all should show that the trust owns $10M of LLC interests. Once the period for audit is over that reporting must change to show the now fixed percentage of interests in the LLC that the trust owns. It's important to show this respect for the formalities of the transaction if you want the IRS and creditors to be bound by it.

■ **Beneficiary Designations**: These should be updated for the significant changes made by the Secure Act which became effective in 2020. If you named trusts as beneficiaries of retirement plans it may be particularly important to reconsider this in light of the law changes. Talk to your advisor team and see what options you may now have. The stretch may be gone and trust beneficiaries may face harsher taxes unless properly planned for.

■ **How Might that Gift/Inheritance Affect your Kids/Heirs**: Estate planning too often focuses on getting the most chips to the next generation and not much on how to prepare the heirs for the largesse. Are you giving outright where no brakes can be applied or in trust where parameters can be established? Have you started to involve the potential heir in discussions with you and your advisers appropriate to their age and your circumstances? Prepping the kids for what is coming is a great way to increase the likelihood of wise use of the money and not undermining their becoming productive members of society.

■ **Secure Original Documents**: Your wills and other legal documents should best be kept in a fireproof safe at home since safe deposit boxes may be hard to access following an emergency (e.g. your disability) or death. But a mere safe is not enough to protect these vital documents. You can purchase for $20-30 a fireproof and waterproof document bag that is also heat insulated. Pop your docs into these before putting them in that safe to provide better protection from fire and water damage.

■ **Revocable Trust**: Do you have a rev trust and pour over will? It has become more common as people age to use a funded rev trust created with checks and balances (e.g. trust protector, perhaps institutional trustee, etc.) to protect you as you age. PP

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