Estate Planning
Practical Solutions to Common Issues

Why should I engage in planning now? Nothing is going to change, and the exemption is so high!

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Introduction and Overview

Practitioners are quite aware that the in 2026 the exemption will be reduced by half. Clients might be aware of the issue, but many have likely not focused on what it means to them. Many clients will assuredly wait until the last minute to do any planning. That is just human nature. If anything, given the costs of tax planning and how unpleasant it is to plan an estate in anticipation of death, those of our clients with the greatest need to address estate planning may be even more likely to put it off.

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Since the exemption was increased on January 1, 2018 by operation of the Reconciliation bill commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "TCJA"),[2] a common refrain from clients has echoed across the country:

"Why should I engage in planning now? Nothing is going to change, and the exemption is so high?"
"Why spend money on this now? Maybe the law won't change and I won't have to worry about it!"

On the one hand, clients may be finding comfort in the political landscape which makes it unlikely for major tax legislation before the 2024 elections. If the White House and control of the Senate shift back to the Republicans, with retention of Republican control of the House, perhaps the TCJA might be extended. In such a scenario, there is also a possibility that Republicans can garner the votes to repeal the estate tax entirely.

There certainly is a logic to that reasoning. However, this Is not likely the best answer.

If, as a result of the 2024 election, the Democrats are able to hold the Senate and the White House and reclaim a majority in the House, there could be a resurgence of some of the proposals that had been floating around in 2021 which would have the lifetime exemption reduced dramatically. Such a change in law could potentially be effective as of January 1, 2025.

On the other hand, if control of government remains split following the 2024 election, it is quite possible that gridlock in Washington will continue. In that case, the TCJA will operate to cut the lifetime exemption almost in half automatically, effective January 1, 2026.

TCJA offers clients many opportunities to plan their estates in a tax efficient way. However, the law may also cause inertia and create a challenge for practitioners to pull reticent clients out of their complacency. Though practitioners often prefer to start by thinking up planning opportunities and proposing them to clients, perhaps the better starting point for practitioners is to find a way to convince clients that planning should start soon.

We'll also present at the end of this outline a sample letter practitioners might use to motivate clients into planning mode so that practitioners can have a discussion.

Getting Clients to Step 1: Why Plan Now Instead of Waiting?

There are several critical reasons clients should plan now. Practitioners understand all of these points, but many clients do not. Even if clients theoretically understand the reasons to plan, they may not have focused on those reasons. Practitioners in all disciplines should educate clients as to the benefits of planning now. Wealth advisors, accountants, and tax preparers must play the prominent role since they might just be in the best position to have the initial client conversations about planning and guide clients to reach out to their estate planning attorney. Such advisors should facilitate the discussion to ensure that the attorney has the client's attention when discussing planning opportunities. Clients who need motivation to meet with their attorneys may not get there without prodding from their other advisors.

[2] The official name of the TCJA was "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," enacted as Public Law 115-97.

As with all collaborative efforts, advisors should be sure to be on the same page as to what types of planning could be valuable and how the client might benefit. By way of example, consider:

- Non-estate tax benefits of planning suggest that planning sooner rather than later may be prudent. Clients for whom estate taxes are not a motivator factor might need to be counseled on the **asset protection benefits** of creating irrevocable trusts. Such protections should be obtained before it is needed. Waiting too long (i.e. until a claim arises or until after marriage) may preclude future protective transfers. If the client waits to see what the tax environment might be in 2025, an intervening claim may resolve the decision for the client. Planning will simply have been too late. Given the litigious nature of society, asset protection planning likely could benefit most if not all clients, if appropriately designed for the risks the client faces.
- Carefully planned transfers to irrevocable trusts may afford one or more **income tax benefits**. If the use of the exemption, e.g., via a transfer to a completed gift trust, is combined with the use of a non-grantor (complex) trust, the client may begin saving state income taxes immediately. A client living in a high tax state, such as California or New York, could form a trust in a trust friendly jurisdiction like Nevada, Delaware, Alaska, etc. and potentially and immediately begin to avoid state income taxation.
- Any completed gift trust, whether characterized as grantor or non-grantor, might grant a senior family member a general power of appointment ("GPOA"). On the death of that senior family member, assets subject to the GPOA may be included in that family members estate and garner a step-up in income tax basis. If the client has an elderly or infirm family member, deferring this type of planning may waste a valuable basis step up opportunity. Thus, deferring planning until the reduction in the exemption in 2026 becomes, in the client's view, a certainty, may waste valuable income tax benefits. Why wait?
- The **step-transaction doctrine** gives advantage to planning earlier. Simply put, the more time between steps in the planning transactions, perhaps the less likely that the IRS will be able to successfully assert a step-transaction challenge. There are also important misconceptions about this doctrine, and apart from the Smaldino case,[3] the step-transaction doctrine seems to play second fiddle to the focus planners have given the reciprocal trust doctrine. This will be discussed in more detail below, not only from the planning perspective, but from the lens of what practitioners should explain to clients so that they better understand the benefits of planning sooner.
- The **reciprocal trust doctrine** can "un-cross" two trusts, such as spousal lifetime access trusts ("SLATs") deemed to be too similar. While similarity between two trusts would be a very subjective determination, and there is only limited law on the doctrine, practitioners often try to differentiate two trusts involved by drafting different provisions into each. There is a wide continuum of opinion on the timing of trusts as to the implication of the reciprocal trust doctrine. Nonetheless, it would seem safe to suggest that the more time between the creation of each trust involved, the better the defense against a reciprocal trust challenge. While some practitioners are not particularly concerned about the timing and choose to differentiate trusts in other ways, time is the friend of SLAT planning.
- Practitioners might wish to describe the logistics of last-minute planning to any client determined to wait until after the 2024 election or until just before TCJA sunsets on January 1, 2026. What might the planning environment be (think October 2012!) when changes to the law appear to be imminent? Such concerns make excessive deferral imprudent. Many estate planners will simply

[3] Smaldino v. Comr., T.C. Memo. 2021-127 (November 10, 2021).

be too busy with work when some clients finally get around to doing planning in late 2024 or 2025. Realistically, **deferring planning has limits**.

- Planning for something your client must do (e.g., life insurance) might set the foundation for more robust planning. If client already agrees to do such ILIT planning, why not enhance it with a more robust trust to which the client can transfer larger assets to use gift, and, if appropriate, Generation Skipping Transfer ("GST") tax exemption?

This is, in the words of the great Yoggi Berra, "Déjà vu all over again." Many clients who faced the reduction of the estate tax exemption issue in late 2012 may have gotten lucky when the exemption was not automatically reduced as the law had then provided. Clients playing estate tax roulette in 2025 may not win this time, particularly given the current political environment. Legislators on both sides of the issue seem to be stubbornly entrenched in their positions and unwilling to compromise with each other.

Right now, time is the planning client's friend. Based on the issues noted above, which will be explored in more detail below, that friendship may be fading.

Asset Protection Benefits

Liability Risks are Ubiquitous

Endeavoring to protect assets from malpractice claimants, creditors and predators, and other risks is a fundamental part of prudent financial and estate planning. The risks of being sued are substantial. While risks vary by occupation, lifestyle, etc., every client should take steps to protect themselves, their assets and their families. That is why so many buy large excess liability policies. It is why advisers caution everyone buying a rental property or starting a business to have an entity created to insulate personal assets.

Statistics corroborate the premise of the reason stated here that clients should plan sooner than later. "Nearly half of physicians 55 and older report having been sued compared with just 8 percent of doctors younger than 40." [4] "…50% of all civil lawsuits target small businesses annually. And 75% fear being targeted by a frivolous lawsuit."[5]

Every comprehensive financial plan should include a discussion about (if not a full review of) a client's insurance coverage. Similarly, every comprehensive financial or estate plan should evaluate the title to assets, and what might be done to those, to enhance protections.

Tax Planning for Exemption May Justify Asset Protection Planning

In general, it's best when asset protection planning is a by-product of planning for other reasons. Claimants may seek to dismantle planning on the grounds that it was motivated by a desire to keep assets out of their hands in order to argue that the plan is suspect. Even when clients had been unaware of a potential claim and the claim has not yet arisen at the time of planning, creditors could pierce the

[4] https://www.ama-assn.org/practice-management/sustainability/1-3-physicians-has-been-sued-age-55-1-2-hit-suit .
[5] https://www.simplybusiness.com/simply-u/articles/2022/07/how-to-protect-your-small-business-from-lawsuits/.

protective veil over a client's assets unless the planning was motivated by other factors. For clients like physicians or estate planning attorneys,[6] and others commonly subject to malpractice claims, impending tax changes which could cut exemptions in half may offer a substantial non-asset protection motivation to engage in planning.

Estate tax exemption reduction is looming right now. If the Republicans achieve unified government in 2024 and are able to make the TCJA permanent or eliminate the estate tax altogether, clients with potential liability exposure may no longer have the justification that they are planning for the estate tax exemption. In other words, future events could make it harder to uphold planning on the grounds that it was not done for the purpose of safeguarding assets from potential claimants. A client in this situation who waits could, therefore, miss an important opportunity afforded by the current state of the federal estate tax laws.

Plan While the Opportunity Is Available

For a transaction to withstand a challenge by a creditor, it should be viable and have economic substance. Corroborating this at the time of the transfer may serve to deflect a later challenge that the transfer was a fraudulent conveyance.[7]

Most clients typically expect that their net worth will continue to grow over time, at least until retirement. This expectation does not always materialize. Market value of investment assets does decline during some periods. Bad investments can be made. A health issue might develop that increases health care related expenses, perhaps even permanently. The client may purchase a large second (third, fourth, …) home that depletes investment assets and increases lifestyle expenses. A myriad of other possible future events may make today's forecast appear optimistic in retrospect.

Yes, in many cases net worth will increase, income will increase, and planning may be more beneficial at those levels, and relatively speaking, more affordable. But if the client could predict that rosy future, they would also be able to predict the timing and nature of any claim. They can't. So, the time to plan is as soon as it is feasible, which is often the present. For example, the Levine Court stated: "From the beginning, Larson and Levine's children made it clear to Swanson that Levine wanted enough money to maintain her lifestyle until her death. This meant that any estate planning needed to be done with Levine's excess capital—i.e., assets that she would not likely need during her lifetime." Planning while there can be that economic certainty of funding lifestyle expenses is important for planning to be respected as well as asset protection planning.[8]

Transfers Over Many Years May Be Safer

Those concerned about asset protection planning and who face ongoing risks of lawsuits might find it useful to make use of a "creeping" plan to transfer assets to irrevocable trusts. Such clients could create

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[6] According to the Ames & Gough LPLI 2022 Claims Survey, the largest number of malpractices claims stem from three key practice areas. At the top of that list is Trusts & Estates. The most common claimed legal malpractice error related to conflicts of interest. At least two of 11 insurers surveyed reporting the average cost to defend a claim exceeded $500,000. According to the ABA's 2020 Standing Committee on Lawyers' Professional Liability, which publishes a Profile of Legal Malpractice Claims study every four years, the percentage of claims involving payouts of $2 Million or more was substantially on the rise. See Ken Laino, "Lawyers Can Face Severe Consequences for Helping a Client With a Fraudulent Conveyance," Asset Protection Law Journal, May 28, 2014.

[7] *Jackson v. Calone*, No. 2:16-cv-00891-TLN-KJN (E.D. Cal. Sep. 30, 2019).

[8] Levine Est. v. Comr., 158 T.C. No. 2 (February 28, 2022).

a trust now and make ongoing gifts to the trust each year so that no one gift transfer is a very significant portion of the client's net worth. Any such "creeping" plan necessarily requires additional time for the plan to be fully effectuated.

Example: A client is concerned about lawsuits and would like to transfer her full exemption amount to a hybrid-DAPT. Assume her net worth is $20 million and she will continue to earn sufficient income for more than a decade to cover lifestyle expenses. She would like to transfer her entire exemption to the trust. Instead of transferring approximately $13 million in 2023, which would be about 65% OF her net worth, she creates the trust in 2023 and transfers $4 million. Then in 2024 she gifts another $5 million. Then in 2025 she gifts whatever remains of her then inflation adjusted exemption to the trust. While that approach will expose the later transfers to the risk of suit, spreading the transfers out over time might be viewed as a means to make each transfer less susceptible to attack as being a fraudulent conveyance as in any year she is transferring a smaller percentage of her wealth. If there is merit to this idea, starting the planning now, not deferring it, is essential to the plan.

Income Tax Benefits

Planning Distributions to Low Tax Beneficiaries

Clients \may be able to use non-grantor trusts as a vehicle to achieve income tax savings. If the non-grantor trust has a broad class of beneficiaries, the trustee can determine each year which of the beneficiaries is in the lowest tax bracket and then make distributions to that beneficiary. The distributing non-grantor trust will realize a deduction for distributions of its distributable net income ("DNI")[9] to the beneficiary in the amount of which the beneficiary is required to include in gross income. If the beneficiary is in a lower tax bracket, then the trust there will be an overall savings to the family because the trust will recognize a deduction for such distributions.[10] This savings may be compounded if the beneficiaries reside in states with lower or no income tax as compared to the trust. The trustee can plan distributions to even "fill up" the lower tax brackets of various beneficiaries spreading the income among them in the manner that is most optimal. The broader the class of beneficiaries, and the more actively those beneficiaries participate in the tax planning with the trustee, potentially the greater the income tax savings. Obviously, the non-tax considerations of such distributions must be considered. Funds distributed to a beneficiary may be reached by that beneficiary's creditors. If a recipient beneficiary is receiving government aid, the distribution could taint qualification for the payor program, and the desire of high tax beneficiaries for distributions might be considered. The latter might be addressed by the trust purchasing personal use assets to make available to such beneficiaries, tracking equalization distributions for those high bracket beneficiaries for a future date when perhaps they are in a lower bracket, etc.

Have Trust Make Charitable Gifts

Properly planned charitable distributions from trusts can provide income tax advantages. This will require advanced planning for the requirement that distributions must be from gross income, avoiding discharging a legal obligation (e.g., binding pledge) of the settlor (as in some trusts that might create an issue of estate inclusion), and other steps may be required. So, with planning and care, charitable gifts can offer income tax advantages. The charitable purpose must be specified in the governing instrument.

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[9] Defined in Code. Sec. 643(a).

[10] The deduction for a distribution of DNI allowed under Code Sec. 651 or 661.

This is known as the "governing instrument requirement." The IRS has taken the position that a charitable beneficiary cannot be added later through non-judicial modification or other change as that is not the original instrument. It may be feasible to still garner a charitable contribution deduction by having the trust invest in a partnership that makes charitable contributions which then flow back to the trust on Schedule K-1 from the partnership.

Taxable income of a non-grantor trust is determined in a manner like that of an individual taxpayer but is subject to several special rules. One of those is that a charitable contribution deduction is allowed under Code Sec. 642(c) in contrast to that for individuals. for its gross income paid for a charitable purpose. The trust's charitable contribution deduction reduces the trust's taxable income but also may reduce its DNI.

A significant advantage to making charitable contributions through trusts rather than personally is that the deduction is not subject to any percentage limitations.

In a recent private letter ruling[11] the IRS granted a trust an extension of time[12] to make an election to treat distributions of gross income made by the trust to one or more charitable organizations during the taxable year as if made in the preceding taxable year. In the PLR, the trust filed its federal income tax return on a calendar year basis and made distributions to one or more charitable organizations during the year after the year in which it wanted a deduction. The trust intended to have the contributions treated as though paid in the prior year as permitted under Code Sec. 642(c)(1) but, due to inadvertence, the trust's election was not timely filed.

<u>INGs May Save State Income Taxes of the Settlor</u>

Non-grantor trust status (e.g., so-called "ING Trusts," or variations like a spousal lifetime non-grantor trust or "SLANT") may also save the client current state income taxes. The environment for ING planning is getting more challenging. The IRS will no longer provide PLRs on INGs. New York has restricted the use of INGs for many years taxing incomplete non-grantor trusts as if they were grantor trusts whose income is reported on the grantor's state income tax return. California has pursued a similar strategy. Recent California tax legislation enacted similar provisions.[13] The income of an ING is included in gross income of a grantor of the ING, as if the ING were a grantor trust. The new California rules were retroactive to January 1, 2023.

Nonetheless, ING planning may be feasible in other states. A similar strategy with a common objective may still be feasible in New York and California, if a completed gift structure were used instead of an incomplete gift trust.

A common question with structuring non-grantor trusts is whether a spouse can be included as a beneficiary. While subject to some uncertainties, the prevailing wisdom is that a spouse could be named as a beneficiary of a trust intended to be non-grantor so long as any distributions to the spouse must be approved in advance by an adverse party. "For purposes of this subpart, the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the

[11] PLR-110205-23, May 16, 2023.
[12] Pursuant to Treas. Reg. § 301.9100-3 of the Procedure and Administration Regulations.
[13] S.B. 131, Cal. Rev. & Tax. Code Section 17082, July 10, 2023.

exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust."[14]

General Powers of Appointment May Provide a Basis step Up Saving Income Taxes

To the extent that a plan might be structured to permit appreciated assets to obtain an income tax basis step-up during the client's lifetime, the client may enjoy substantial income tax savings. A power of appointment ("POA") is a right, granted under a legal instrument such as a will or trust, by a person referred to as the "donor," to a person referred to as the "donee" or "powerholder," which empowers that powerholder to designate who should receive interests in certain property, called the appointive property subject to the POA. Code Sec. 2041 provides that the powerholder's gross estate will include all property over which powerholder has a GPOA at death. Upon these grounds, a client may wish to consider granting an elderly relative with a modest estate a GPOA over a trust holding appreciated property to garner a basis step up upon the death of the elderly relative. Many practitioners have touted the use of such "upstream planning" in order to salvage otherwise unusable federal estate tax exemptions that elderly or ill relatives of clients may have.

Apropos to our earlier discussion about the prudence of planning sooner rather than later, this upstream planning must be implemented before the GPOA-holder passes. Further, it would seem preferable to have the trust created well in advance of that relative passing so that the transaction has better optics. Also, creating the trust in advance can permit distributions from the trust to the elderly relative to support an argument that the power was not a mere naked power with no economic substance to such relative's interests in the trust.

Example: Parent has an estate of only $4 million. Wealthy child creates a trust with assets worth approximately $7.4 million, granting the parent a GPOA over the assets in the trust. The intent of the upstream plan is that parent's estate would include the assets in the trust, and those assets would garner an estate tax free adjustment (hopefully step-up) in income tax basis on the parent's death.

A GPOA should have safeguards to prevent unintended use by the power-holder to prevent waste of the trust's assets. It should also have safeguards in case the exempt amount declines before the power holder dies, either by operation of the TCJA sunset provisions or by a new law enacted in the interim.

By way of example, the GPOA could be crafted to require its exercise be conditioned upon the consent of a non-adverse party. As another approach, the POA could be crafted as a limited power of appointment (an "LPOA") and unrelated person who is not subordinate to the creator of the trust could have the power to convert the LPOA to a GPOA. If the exemption is reduced, upstream planning would be limited and for some, obviated. In such a case, practitioners might want to review the original planning to be certain that the estate inclusion in the upstream plan does not inadvertently trigger an unintended estate tax on the senior generation's death. While some upstream plans were likely crafted to only include in the senior generation's gross estate an amount that does not trigger an estate tax, the more prudent course of action would be to confirm that is in fact the case. Clients who only recently had planning updated to address the inclusion of GPOAs to a higher generation will likely be frustrated by the yo-yo tax law changes and ongoing planning updates.

[14] Code Sec. 672(a).

A GPOA can be created if any one of the four categories of appointees specified in the Code are permissible appointees. Further, there is no language that must be used to create a GPOA. Code Sec. 2041(b)(1) defines a "general power of appointment" as "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." It is not necessary for the power to be exercisable with respect to all four categories of potential beneficiaries. A power of appointment is a general power under section 2041(b)(1) if the donee of the power can appoint the property in favor of any one of those specified categories.[15]

The tax law provides specific exclusions from GPOA characterization:

1. IRC Sec. 2041 excludes from definition of a GPOA a POA where the powerholders authority is limited by an ascertainable standard, e.g., for health, education maintenance and support ("HEMS"). However, a GPOA that is limited to a HEMS standard may still be reachable by the powerholder's creditors, although some states have enacted legislation providing that a GPOA limited to HEMS is not reachable by the powerholder's creditors.

2. A POA that can only be exercised with the consent of the donor of the power is not a GPOA.

3. If the powerholder can only exercise the POA in conjunction with a person having an "adverse interest" in the property, then it is not a GPOA. The determination of who is adverse can be a gray area.

Planning with GPOAs is often intended to obtain a basis adjustment, hopefully a step-up in basis for appreciated property, on the death of the powerholder who held a GPOA over the property. The Code provides in part: "In the case of decedents dying after December 31, 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939. In such case, if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a)…"[16]

If the powerholder dies without exercising a GPOA the property subject to the power is included in the powerholder's gross estate and any such appreciated property will, in general, be subject to a step-up in basis. While most or perhaps all practitioners believe that a GPOA should automatically result in estate tax inclusion, there are some concerns. Must there be a real economic effect to the granting of the power independent of its desired tax results? Or will the use of a mere "naked GPOAs" suffice for that consequence? Limitations on the exercise of the GPOA, or even the impracticability of exercising the GPOA, may not alter the result that the property over which the power is exercisable will be included in the powerholder's gross estate. Thus, the mere existence of the GPOA will generally suffice to cause estate tax inclusion. In other words, the fact that the powerholder has no knowledge of the GPOA or is incapable of exercising the power at death (e.g., the powerholder is incapacitated), may not change the desired result of estate tax inclusion. While this is generally the accepted result, might there be an exception?

Step-Transaction Doctrine

[15] Jenkins v. United States [70-2 USTC ¶ 12,701], 428 F.2d 538, 544 (5th Cir. 1970).
[16] Code Section 1014(b)(9).

Introduction

The step-transaction doctrine is one of many tax constructs that might well undermine steps you might guide your client to take to plan their estate to reduce future estate taxes or to protect assets from a malpractice claim or other creditors. In the simplest of terms, the step-transaction doctrine might be applied to collapse many arguably separate steps of a plan into fewer steps and arrive at a different result than what you intended for your client's plan. The results can be devastating from a tax and/or legal perspective. The point of this discussion is that clients that begin planning for 2026 today, will have more time to pass between steps in a plan, more time and perhaps thus more opportunity to imbue each step of a plan with independent economic consequences, etc. That may all help deflect a step-transaction challenge. Clients who instead wait until the end of 2025 to plan will have little time to differentiate steps in a plan thereby making their steps riskier.

Example: Here's an example of a plan that illustrates the application of the step-transaction doctrine and might not be what your client should do. The wife is a surgeon, and she wants to both protect her assets from a malpractice claim and move them out of her estate before the estate tax exemption is reduced by half in 2026. Her husband is a schoolteacher and has few assets in his name. Wife gifts $5 million to husband. The following week the husband creates a trust to benefit his wife and all their descendants and transfers the same $5 million into that new trust. The step-transaction doctrine would likely be applied to this "plan" and unravel it. The wife will be treated as if she, not the husband, made the gift to the trust. That may place those back into her estate and make them reachable by her claimants in a malpractice suit. The "plan" was for naught.

Smaldino Case

A recent court case unraveled a plan based on this theory similar planning was successfully challenged by the IRS.[17] In Smaldino the husband gave the wife interests in a family limited liability company (LLC) which she purported transferred to a trust for the husband's children from a prior marriage the next day. The court found that it was really the husband that made the transfer to the trust, not the wife. The wife was merely a straw-person or intermediary to facilitate the transfer and she never really owned the interests involved.

Example: Wife is a surgeon, and she wants to both protect her assets from a malpractice claim and move them out of her estate before the estate tax exemption is reduced by half in 2026. Her husband is a schoolteacher and has few assets in his name. Wife gifts $6 million to husband in May 2023. The following day the husband deposited the gift into an account that he had had in his name along for many years. The husband hired a new investment advisor who creates a new financial plan, investment policy statement, and reallocates the asset allocation. The husband withdraws funds periodically from this new account and treats the funds as his own. More than six months later, in the new 2024 tax year, the husband hired an estate planning attorney who created a trust for wife and descendants pursuant to a plan he developed with the husband. The husband funded the initial $100,000 gift to the trust from funds he inherited many years ago. The husband then had his financial planner create new forecasts and determine through that analysis an amount of money that husband might reasonably gift to the new trust. The financial adviser's analysis suggests $5 million could be gifted and the following month the husband makes the gift.

[17] Smaldino v. Comr., T.C. Memo. 2021-127 (November 10, 2021).

What might have been done right in the second plan. While there is no assurance that the IRS or a creditor might try to pierce through the second scenario plan arguing that under the step-transaction theory the wife really funded the trust to benefit, herself. But there are some better arguments that the husband's funding of the trust was not part of the same integrated plan of the wife's gift to him. Some of the factors that might help support the plan might include:

- The husband treated the gifted funds as his own in many ways. He reallocated the investments, withdrew and used funds from the gifted money, and commingled the money with an old account of his own.
- The husband hired his own investment advisor to advise him on the funds and the nature of the funds changed dramatically from a cash gift to an investment portfolio.
- The amount the wife gave the husband did not correlate to the amount husband gave the trust.
- The husband did not merely just re-gift the funds wife gave, but he had an independent analysis completed to arrive at the amount that he might gift to a trust for his wife.
- About eight months passed from wife's gift to husband's funding the trust.
- The husband's gift was in a separate tax year from wife's gift.

No Bright Line Rules

Overall, there are better facts in the second example than in the first example (which might be viewed as problematic from a tax and legal perspective). Will these modifications suffice to avoid the application of the step-transaction doctrine to unravel the plan? Maybe. There are no definitive rules on what actions are enough to assuredly break the step-transaction doctrine.

Many plans have facts that are less compelling than the second example above. That doesn't mean that less favorable scenarios may not succeed either. For example, in 2020 and 2021 when most taxpayers and advisers feared imminent, significant and detrimental changes to the estate tax laws, many taxpayers implemented plans where time between steps was modest to nearly non-existent. Those plans were based on the premise that the government could change the tax laws any day so it might have been better to implement a plan as fast as possible, since any risk of a quickly done plan might outweigh the risk of not getting the planning completed before a change in the tax laws.

Is Six Days Enough Time Between Steps?

In the Holman tax case, the court found that holding stock for a mere six days, in one step along the planning path, was enough time for the tax plan to be respected.[18] In simplified terms the parents transferred Dell stock to a family limited partnership ("FLP"). About six days later they gifted part of the partnership interests to a trust and argued that the value of the FLP interests should be discounted from the value of the underlying stock value. The IRS sought to apply the step-transaction argument that the parents really made direct gifts of the Dell stock to their children's trust. This argument was based on the FLP not being real and rather just being a-waystation on the path from the parents to the trust so that not only would the FLP be ignored, but the reduction in value the parents claimed would be as well. If the gifts are considered indirect gifts of Dell stock, instead of gifts of FLP there could be no discount. The IRS reasoning in their attack was that the step-transaction doctrine provides that if a series of steps in a transaction are so integrated and interdependent, economic reality may be better reflected by collapsing the various steps into a single step. The court, in a resounding taxpayer victory, determined that during

[18] Thomas Holman, 130 TC No. 12, 5/27/08.

the six-day time period that the FLP held Dell stock created an economic risk that the value could change because publicly trading stock is volatile. While few if any tax experts might suggest that a six-day period is sufficient when you are planning a transaction, the lessons of the Hollman case are valuable.

Linton Case

The court in the Lint[19]on case found that the taxpayers crafted a scheme that consisted of pre-arranged parts of a single tax plan. The court found those steps were interdependent. The Court did not believe that the taxpayers would have undertaken the initial steps in the plan without the later and integrated acts. The Linton court did not find real economic risks of a change in asset values during the time between steps.[20]

Factors That Might Affect Applicability of the Step-Transaction Doctrine

If the steps in the plan have to "lien" on each other to stand, they are interdependent. In other words, would the client do step 3 if steps 2 and 5 were not also done? If the answer is no, then there might be an issue. This might be referred to as a "mutual interdependence test." To analyze a plan from this lens, consider each step that might be incorporated into the plan. Try to determine whether specific steps are meaningless unless all the other steps in the plan happen.

What would happen if the plan stopped at an interim step and further steps were not completed? So, if there are four steps in the plan, and you stopped the plan mid-stream at step 2, not getting to steps 3 or 4, what would happen? If the IRS shows that the various steps are pre-arranged parts of a single plan that are intended from the beginning to achieve a particular end result, those steps might be collapsed. Thus, this factor is referred to by some as the "end result test." Can you stop the plan at step 4 and skip steps 5 and 6? If you have contractual or other obligations to complete all 6 steps it might appear that you are locked into completing every step of the plan. Each step might thus be viewed as a fait accompli. So, if you have a binding commitment from the beginning of the plan to undertake each following step in the plan, all steps may be integrated. This type of challenge may be easier for the IRS to pursue if all the various steps in the plan occurred in close time proximity. This test is thus referred to by some as the "binding commitment test."

So**me Step-Transaction Planning Lessons**

The step transaction challenge might be an issue for many transactions. As general suggestions consider some of the following:

- The longer the time span between each step or phase of a plan, the more likely that each planning step may stand independently on its own. But time alone should not be the sole factor considered. Other factors might negate the application of this doctrine. So, endeavor to plan further than only considering time. This is directly key to the point of encouraging clients to proceed now with planning rather than defer it. The more calendar time that exists before the various transactions have to be completed, e.g., by January 1, 2026, when the exemption is cut in half, the more time that can be inserted in between each step of the plan bolstering this one of the factors that may negate a step-transaction challenge.
- Ideally there should be some, and if possible significant, economic implications to each step of the plan. If one spouse transfers assets to the other spouse, while the second spouse holds the

[19] Penrod v. Comr. 88 T.C. 1415 (1987).

[20] Linton v. US, 638 F. Supp. 2d, 1277 (W.D. Wash. 2009).

asset there should be a meaningful risk of economic consequences during that period of ownership. If interests in an LLC are transferred a distribution might be made from the entity while that recipient holds the interests, a new contract for the LLC business negotiated, an amended and restated operating agreement signed, etc.

- To the extent feasible each step in the plan should be able to serve as the final step of the plan. There should ideally be no requirement or even need to proceed to later steps.
- The recipient of a transfer should exercise control, to the extent feasible, over the asset received.
- Carefully adhere to all the legal formalities the plan would seem to suggest. For example, interests in an entity, such as an LLC, are transferred from one person to another, then to another entity and finally to a trust. The LLC should have a new operating agreement that could be amended and restated and signed at each transfer confirming the new owner after that step.
- The LLC, assuming that it is taxed as a partnership for income tax purposes, should issue a K-1 to each owner properly reflecting the number of days each owned an interest in that LLC during the year. If a donee of an interest only held that interest for a week it might be easier for the CPA to miss issuing the K-1 for that modest period (which should not be permitted). But if the donee held the interest for months, and received a distribution in that period, it is more likely that the reporting formalities won't be overlooked.
- Carefully adhere to all the tax formalities the plan would seem to suggest. Again, assume that interests in an entity, such as an LLC, are transferred from one person to another, then to another entity and finally to a trust.[21]

Reciprocal Trust Doctrine

Introduction

Spousal lifetime access trusts ("SLATs") may very well be the top planning tool for married couples to use their exemption. As we get closer to the 2026 reduction by half in the exemption amount practitioners will likely be deluged with SLAT plans.

Planning with SLATs could implicate the reciprocal trust doctrine, which could sometimes be applied by the courts to "uncross" the two trusts involved. In other words, where a husband created a trust for his wife and the wife created a nearly identical trust for her husband, the two trusts may be treated for tax purposes as though each spouse had created a trust for himself or herself. In a worst case scenario, such an "uncrossing" might result in trust assets being deemed included in the settlor's estate for estate tax purposes unless the trust instrument as interpreted under relevant state law would permit such trust to be treated as a statutory self-settled trust.

The seminal case on the reciprocal trust doctrine was the Supreme Court case of United States v. Grace.[22] In Grace, the decedent created a trust from which his wife received the income, the trustees had discretion to distribute principal to the wife, and the wife had a testamentary special power of appointment in favor of the husband and the couple's descendants. Only two weeks later, the wife created a mirror image trust. The Supreme Court held that the reciprocal trust doctrine applied since the

[21] Sorensen v. Commissioner, Tax Ct. Dkt. Nos. 24797-18, 24798-18, 20284-19, 20285-19 (decision entered Aug. 22, 2022).

[2222] 395 U.S. 316 (1969).

trusts were interrelated, “and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been if they had created trusts naming themselves as life beneficiaries.”

The *Grace* decision hinged on a key litmus test: are the parties in a different economic position following the transfer as they had been prior? Because the trusts at issue were identical, the *Grace* court did not set forth any bright-line test to help practitioners resolve what quantum of “differences” between two trusts are necessary to avoid application of the reciprocal trust doctrine and otherwise prove economic substance.

Clients who might benefit from a dual-SLAT strategy should likely start putting together their plan earlier in order to take advantage of the luxury of time. Waiting until the proverbial last minute could rob clients of the opportunity to space out their trusts and infuse more significant differences between SLATs. Planning that extends over time (i.e. 2023, 2024, and possibly, 2025) could allow advisors time to be thoughtful and strategic, so that economic substance to the transaction can be more obvious and easier to prove if challenged.

<u>Consider What Differences Might be Integrated into a Two Trust Plan</u>

- The trusts can be created at different times (although only one case mentioned timing differences and that was 15 months apart), with different assets and trustees, and with very different terms.
- Consider creating each SLAT in a different state. This is simpler and more efficient with document generation software. Local counsel should likely be consulted.
- In one trust, the beneficiary spouse can be entitled to distributions each year, have a lifetime broad special power of appointment, can change trustees (within Rev. Rul. 95-58 safe harbor), withdraw under an ascertainable standard (i.e. HEMS). In the other trust, the beneficiary spouse would have no entitlement to distributions (perhaps might not even be a current beneficiary), no power to change trustees, and no power of appointment, but could become eligible to receive a distributions only upon exercise by an adult child with the power to add beneficiaries.
- Engage the CPA and wealth advisors to determine the economic positions of each spouse following each transfer. Don’t put a husband and wife in the same economic position following the establishment of the two trusts.
- Ensure that the planning does not unnecessarily hinder either spouse’s need for access to assets by creating a cash flow analysis. For example, the husband could create a trust for the benefit of his wife and issue, and the wife could create a trust for the benefit of her issue, in which her husband isn’t a beneficiary. But is that agreeable from an economic perspective to the husband? What if the wife dies and he loses indirect access to the trust he created for the wife? Then the husband would have no access to the assets of either trust. Do the family financial forecasts support that?
- Perhaps a spouse could be a beneficiary of the trust he creates if the trust were formed in an asset protection jurisdiction such as Alaska, Delaware, Nevada or South Dakota, and the other spouse could create a trust of which she isn’t a beneficiary (that is, a trust that’s not a domestic asset protection trust).
- Use different distribution standards in each trust. For example, one trust could limit distributions to an ascertainable standard, while the other trust could be fully discretionary. However, limiting distributions to an ascertainable standard reduces flexibility, may prevent decanting and may expose the trust assets to a beneficiary’s creditors.

- Use different trustees or co-trustees. If each spouse is a trustee of the trust the other spouse creates, add another trustee to one or both trusts. If adding another trustee to each trust, consider adding a different trustee for each trust (i.e. by using different institutional trustees).
- Give one spouse a noncumulative "5 and 5" power, but not the other. This power permits the holder to withdraw up to the greater of $5,000 or 5 percent of the trust principal each year. The amount the powerholder could have withdrawn at the time of death is includible in his estate. However, the lapse of the power, not in excess of the greater of $5,000 or 5 percent of the trust assets each year, isn't considered a release of the power includible in the powerholder's estate or a taxable gift. However, this power may expose the assets of the trust to the powerholder's creditors.
- Give one spouse a special power of appointment, but not the other. However, the absence of a power of appointment reduces the flexibility of the trust.[23] Note that many practitioners suggest the existence of an SPOA in one trust but not the other would be insufficient on its own to deflect a reciprocal trust challenge. If the same trust had both a limited power of appointment and a 5 and 5 power, and the other SLAT had neither, would that suffice? Some practitioners say absolutely. Others say maybe, and still others might suggest more is needed.
- What if one trust gave one spouse the broadest possible special power of appointment and the other trust gave the other spouse a special power of appointment exercisable only in favor of a narrower class of permissible appointees, such as issue, or issue and their spouses.
- Give one spouse a power of appointment exercisable both during lifetime and by will and the other spouse a power of appointment exercisable only by will.
- In the case of insurance trusts, include a marital deduction savings clause in one trust, but not the other. A marital deduction savings clause provides that if any property is included in the grantor's estate because the grantor dies within three years after transferring a policy on his life to the trust, some or all the proceeds of the policy is held in a qualified terminable interest property trust or is payable to the surviving spouse outright. Alternatively, if each trust has a marital deduction savings clause, the provisions of the two could be different.
- Create different vesting provisions for each trust. For example, the two trusts could mandate distributions at different ages, or in a state that has repealed or allows a transferor to elect out of the rule against perpetuities, one trust could be a perpetual dynasty trust. However, mandating distributions severely reduces the flexibility of the trust, throws the trust assets into the beneficiary's estate for estate tax purposes and exposes the assets to the beneficiary's creditors and spouses.
- Instead of mandating distributions, give the beneficiaries control or a different degree of control, at different ages. For example, the ages at which each child can become a trustee, have the right to remove and replace his co-trustee, and have a special power of appointment could be different in each trust.
- Vary the beneficiaries. For example, one spouse could create a trust for the spouse and issue, and the other spouse could create a trust just for the issue. Note that if, for example, the husband creates a trust for his wife and their first child, and the wife creates a trust for her husband and their second child, the gifts could still be viewed as reciprocal. What if other family members were added to the class of beneficiaries of one trust but not the other? That might also be combined with GPOA planning to endeavor to achieve a basis step up.
- Create the trusts at different times. In Lueders' Estate v. Commissioner, a husband and wife each created a trust and gave the other the power to withdraw any or all the trust assets. Inasmuch as

[2323] PLR 9643013.

the trusts were created 15 months' apart, the Third Circuit, in applying Lehman, held that there was no consideration or quid pro quo for the transfers. However, it should be noted that Lueders preceded Grace, in which, while the trusts were created two weeks apart, the Supreme Court held that the motive for creating the trusts wasn't relevant. If the difference in time is a factor post-Grace, a short time might be sufficient considering Holman v. Comm'r, in which a gift of partnership interests six days after the formation of the partnership wasn't a step transaction. Practitioners should also bear in mind that if the same transaction includes funding an LLC, then making gifts to the trusts that are to qualify for fractional interest or other discounts, they will be dealing with the challenge of two dating issues: the difference between the trusts, and the maturation period of assets in the LLC prior to gift or sale. One national speaker stated emphatically that she would not create SLATs with less than a year of time between them. Really? In 2020 and 2021 when Democrat tax proposals would, if enacted, have changed estate planning as we know it, that could have assured that the client's plan would not have been completed. What is the basis in the law for 12 months? (Hint there is really none). Be careful about how you incorporate what you read and hear into your practice.

- Contribute different assets to each trust, either as to the nature or the value of the assets. However, if the purpose is to contribute equal amounts to each trust, it may not be feasible to contribute assets of different value, and in any event varying the value of the trust only serves to reduce the amount to which the reciprocal trust doctrine may apply. Contributing different assets may not negate the application of the reciprocal trust doctrine, since the assets in a trust may be susceptible to change over time. However, if one trust is funded with non-liquid assets, or assets subject to contractual restrictions on sale (e.g., operating agreement restrictions on transfer of interests in an LLC) that may be viewed as a more meaningful difference in assets that may not be susceptible to ready modification.

Spousal Lifetime Access Trusts ("SLATs"): Implications of Trust Differences to Blended Families

While so many practitioners focus on planning to deflect a reciprocal trust challenge, perhaps another aspect of this requires more attention. What might non-reciprocal differences mean in the real world?

The Differences between SLATs can be real! Consider the impact in a blended family, if there is a divorce, or when one spouse dies in a blended family or for when the surviving spouse remarries. The different provisions integrated into each trust to make them different from each other have real economic significance. Many of the differences may have a real impact on the financial security of each spouse. It might an issue for an intact marriage but in a blended family situation, it may be an even greater concern. With a greater potential for divorce, more stress in the marriage, different children or beneficiaries named, etc., the risks of the differences having an unintended and undesired consequence could be greater. The more detailed discussion following will help clarify this concern. The illustrations below should drive home the point that the differences that may be integrated into a non-reciprocal trust plan have real and substantial economic consequences. But that is the entire point, those differences may be what makes the plan sustainable against attacks by the IRS or creditors (although neither of those hoped for results are assured). So, the more substantive economic differences between the trusts, especially in a blended family, the greater the risk that one spouse may subvert the entire plan.

5 and 5 power in one trust and not the other.

A commonly used right or power in trust drafting is the so-called "5 and 5 Power." This gives a person the right to withdraw the greater of 5% of the trust corpus or $5,000, each year. This odd sounding right is based on tax laws that would cause any power that is a hair broader to cause all the trust assets over which a person holds a greater power to be included in the powerholder's estate. Another way to say it is that withdrawing not more than 5% of a trust's assets annually is the greatest power you can give someone and keep those assets outside the powerholder's estate. So, if husband's trust that he created for wife does not have that power, but wife's trust she created for husband does have that power, that might be a meaningful difference between the two trusts. That means wife would not have the right to pull out 5% of the assets from the trust she is beneficiary of. But the husband could pull out 5% of the assets from the trust he is beneficiary of every year. Say the trust husband can access has $10 million in assets. He can withdraw, no questions asked by anyone, 5% of that, or $500,000 a year, every year, year in and year out. The wife cannot withdraw any funds. That is unbalanced, but that is the point. That is a difference that has real economic consequences. What if there is stress in the marriage (seemingly likely in a blended family based on the stats), or the marriage even gets rocky? The husband keeps pulling out $500,000 every year and wife gets to pull out nothing. See the potential issue in every family, but especially in a blended family?

Including a limited power of appointment in one trust but not the other.

A power of appointment is a right given to someone under the terms of a trust to appoint or direct the trust assets to be distributed to whoever the powerholder chooses subject to the terms of the power. For example, client creates a SLAT, and in the trust gives their spouse the right to appoint trust assets (either during spouse's lifetime or at death under spouse's will, or both) to any person other than herself, her creditors, her estate, or creditors of her estate. That odd sounding formulation is, under the tax laws, the maximum right to appoint assets that can be given without causing assets to be included in the powerholder's estate. That is critical as key purposes of the SLAT is to keep assets out of the client's (and client's spouse's) estate, and out of the reach of creditors which often have similar rules. This right is referred to as a "broad limited power of appointment." That is a power granted under some SLAT plans to one spouse but not in the other trust to the other spouse. The goal of this is to endeavor to differentiate the trusts. But consider the impact. Husband has no power of appointment in this example under the trust wife created for him and descendants. But the wife has a broad limited power of appointment during her lifetime and/or at death under the trust the husband created for her. So, after the trusts are formed, the wife secretively goes to a new lawyer and signs a new will exercising that power of appointment, so all those trust assets pass only to her children from a prior marriage. No one may know of this until she dies, and that exercise may completely upend the intended dispositive scheme that the couple had agreed to.

Deferring Planning Has Limits

The logistics of what the environment will be late in 2025 (think October 2012!) make excessive deferral imprudent. Many estate planners will simply be too busy with work when some clients finally get around to doing planning in late 2025. Think back to the environment by late 2012. Many practitioners in all disciplines simply had to stop accepting new clients by August or September of 2012. Appraisers started at some point saying that they might provide a value figure but no reports until the next year. Yet later in 2012 many appraisers simply stopped taking new work. For those using institutional trustees, there was a point in the year at which different trust companies simply could no longer review, process and accept trusts.

Planning for Something You Must Do (e.g., Life Insurance) Might Set the Foundation for More Robust Planning

Some clients will engage in a plan or transaction that triggers the need for planning, and once the process is started, it may be more cost effective to complete a broader plan rather than to defer additional planning. For example, consider a client evaluating the purchase of a large life insurance policy for reasons that may be unrelated to estate tax planning, perhaps to increase coverage for their growing family. Practitioners could recommend creating a simple traditional irrevocable life insurance trust ("ILIT") to own the insurance policy and a nominal bank account, with the plan that such ILIT would be funded with annual gifts sufficient to pay premiums. However, a simple ILIT may prove to be short-sighted and miss an opportunity to create a more sophisticated vehicle that can be used for future planning. Even if the client chooses to defer funding, in whole or part, the incremental cost to the client and effort to create a more robust irrevocable trust plan may not be significant. In the long run, a more robust plan may serve the client better.

Example: Jane and John Smith are both physicians in their early 40s, with young children and $2 million of non-retirement savings. Jane's mother is in her 90s and not doing well. They help her out financially, sending a check every month. The Smiths are very concerned about professional malpractice risks. Their estate will likely grow in coming decades as their professional careers grow and mature. They each have inadequate life insurance to protect themselves or their children. The term coverage they have is owned by them personally. The couple has no concerns about estate taxes now but acknowledge that their estate might grow to a level where estate taxes become an issue for them.

Because the risk of an estate tax is so far into the future, the Smiths are not keen on spending much money on tax planning. However, because they are buying additional life insurance to protect their growing family, the Smiths understand that they need to create ILITs to hold the new policies. You use the opportunity to discuss with them the benefits of enhancing the ILITs with more robust and flexible trusts.

Under your guidance, Jane and John created two non-reciprocal SLATs, with provisions that enable the trusts to hold life insurance policies on the life of the settlor. The trusts are created in their home state to save money as compared to using a better state for asset protection purposes. However, you discuss with them that because of their significant worries over malpractice risks in the next few years as their incomes grow, they might wish to consider moving Jane's trust to Nevada and John's trust to Alaska since both states have advantageous asset protection statutes. In order to facilitate their opportunity to exercise this option, the SLATs name John's uncle as trust protector and given the right to move each trust to a new state, change the governing law for each trust, and appoint a new trustee.

Since one of the primary goals of the Smiths is to have sufficient assets in retirement, the SLATs are drafted with different provisions that could allow both the beneficiary-spouse and the settlor-spouse to access funds in the trust. The SLATs include loan provisions, tax reimbursement clauses, the ability to appoint charitable beneficiaries and other means of access.

Jane's trust has a hybrid DAPT provision and John's trust includes a SPAT (special power of appointment) provision. Those additional means of access, especially to address the risk of premature death, are greatly appreciated by the Smiths. They understand that these provisions cannot be used until the trusts are moved to better jurisdictions.

You collaborate with the Smiths' other advisors to prepare a cash flow analysis, financial forecast, insurance analysis and other due diligence ancillary steps to support the plan. Each SLAT includes a separate insurance trustee (Jane's cousin in her SLAT, and John's nephew in his) and insurance provisions. Each trust buys life insurance to create the plan that you determine protects all their interests.

You review and help each of Jane and John obtain more appropriate disability coverage than the meager policies provided at their practices. Jane gifts $500,000 to her SLAT. Several months later, John gifts $650,000 to his SLAT. They will each make gifts in each future year as their income rises and you help document that they can afford to do so. In the meantime, the cash contributed to each SLAT and any income earned thereon can be used to pay premiums on the life insurance policies owned by the trusts, thereby reducing the need to make annual exclusion gifts to either of the trusts.

Jane and John now have a valuable asset protection plan that will grow as their wealth grows. Even though their estate tax concerns were at best lukewarm, they appreciate that the wealth growing in their SLATs will be protected from estate taxation if they can grow their estates to that point (recognizing the risks of unknown future tax law changes).

Jane's mother is given a general power of appointment over each trust. On her passing, the investment assets will be included in Jane's mother's estate and get a basis adjustment (hopefully, a basis step up). That will eliminate all capital gains on any non-qualified plan investment portfolio held in the trusts. The income tax savings on Jane's mother's passing will be significant and should pay for the plan many times over.

Jane and John needed insurance trusts and a more robust life insurance plan and now they have that. But unlike their family and colleagues who complain about the complexity and hassle of annual gifts and those "Crummey" powers, Jane and John will never have to worry about annual hassles to fund their insurance trust as there is plenty of money in their SLATs to pay premiums. Jane and John had discussed setting up trusts for their children after they completed funding 529 plans. Now they don't have to do that.

Conclusion and Practitioner Action Step

Clients who need to plan for reducing exemptions upon the sunsetting of TCJA in 2026 – or, earlier by Congressional action – may be putting the matter off believing that they have lots of time. Clients are well aware of how frequently Congress has tinkered with the tax laws, particularly recently. It may be reasonable for clients to wonder why they should incur the costs and hassle of planning now if the game rules may be changed before 2026 arrives. However, members of the professional advisory team need to educate clients as to the advantages of more focused, deliberate planning over a longer period. This paper, and the sample client letter below, endeavor to help practitioners do just that.

Sample Client Letter Practitioners Might Use to Motivate Clients to Open a 2026 Planning Discussion

Dear Client:

As you may be aware, the current federal estate tax exemption is nearly $13 million, so that a couple may transfer almost $26 million worth of assets without incurring a tax cost. Those high *exemption amounts, while valuable for wealthy taxpayers, are so high that they have dissuaded many taxpayers from engaging in estate planning that could be very beneficial. That is for two reasons. First, estate planning should never only be about minimizing estate taxes, there are other valuable benefits that should be considered, even if your estate is substantially below the above figures. The second reason is that the above exemption amounts will be cut in half in 2026. Thus, while the tendency of many taxpayers is to "wait and see" what happens (wait until after the 2024 election, wait until late 2025 to see what the state of the law will be, etc.) that could be a costly mistake.*

For very wealthy taxpayers, planning whenever feasible should be pursued because Congress can be fickle, especially with tax legislation. So, for very wealthy taxpayers the advice to pursue planning diligently has not changed, but the lesson for "mere" wealthy taxpayers introduced below, may apply and be helpful to consider.

<u>Plan for Asset Protection Now</u>*: Estate planning should include addressing personal objectives such as planning for retirement and aging, structuring gifts and bequests to heirs to best help them, and not harm them, with the wealth transferred. Those objectives need to be addressed but are not necessarily relevant to more complex planning which many are putting off seeing what the law will be. An important planning goal for many is asset protection. That is structuring your assets so that if a malpractice or other claimant or creditors pursue your wealth, you will have barriers to endeavor to deflect them. A common asset protection technique is to create a corporation or limited liability company ("LLC") to hold a business venture or real estate property. In that way, a lawsuit against the business or rental property may not be able to reach your personal assets outside the entity. Another very common asset protection benefit is to transfer assets to irrevocable trusts designed to be protective. The latter planning is often the same planning used to safeguard estate tax exemption. Thus, pursuing asset protection may entail identical steps to estate tax planning. As you can never know when you might be sued, asset protection planning must be implemented before you need it. Thus, if malpractice claims or other lawsuits could jeopardize your wealth, you should pursue that planning immediately. Waiting could jeopardize your wealth. If you are going to pursue that planning, you should simultaneously incorporate estate planning benefits and considerations into the planning steps. So, don't wait to plan until 2025 when the potential for halving the estate tax exemption may be more certain. Plan now.*

<u>Plan for Income Tax Savings Now</u>*: Taxpayers are always seeking to find ways to reduce their income tax bill. Carefully planned transfers to irrevocable trusts may afford several ways to do just that. Those same irrevocable trust plans can also provide important estate tax planning benefits by locking in the exemption that might otherwise be cut in half in 2026. So, if you want income tax savings, why would you wait and lose years of tax benefits? If you are going to evaluate planning to use irrevocable trusts to save income taxes incorporate estate planning into whatever you do and do it now. There are several distinct ways you use your transfer of assets to irrevocable trusts to save income taxes (in addition to the estate planning benefits):*

- *Transfer assets to a non-grantor (complex) trust. That is the type of trust that pays its own income taxes. This could provide several immediate tax savings. First, if you live in a high tax state, such as California or New York, you could form the trust in a low or no tax jurisdiction like Nevada, Delaware, Alaska, etc. and immediately begin avoiding state income taxes in your home state. Secondly, if you name a broad class of beneficiaries the trustee can sprinkle or spray (distribute) income of the trust to whichever beneficiary has the lowest tax bracket. That can provide tax savings on a federal and state level, year after year. You might include charities as beneficiaries. Trusts can qualify for more favorable charitable contribution deductions then individual taxpayers can.*
- *If you transfer assets to a trust so that the assets are outside your estate, the trust can give an older family member who has modest net worth a right over those assets. This is called a general power of appointment ("GPOA"). On the death of that family member the assets over which they held the GPOA may be included in their estate and get a step-up in income tax basis. For example, you transfer stock you paid $10,000 for that is now worth $1 million to a trust for your spouse, children and elderly mother. The trust provides that your mother can appoint the trust assets to her creditors. She never does that. On her passing, the $1 million worth of stock is included in her estate. Because her assets are modest there is no estate tax. However, the assets still obtain a step-up in income tax basis to the market value of the stock. So, if you sell the stock afterwards, you will pay no capital gains. That could be $200,000 in income tax savings.*

Deferring income tax planning until the reduction in the exemption in 2026 becomes certain may waste valuable income tax benefits. Why wait?

***The Step-Transaction Doctrine Makes Planning Now Advantageous**: There are several tax principals, referred to as tax "doctrines" that may serve to unravel planning you might seek to do. Here's a simple and common example. A married couple wants to transfer assets to trusts to protect assets, obtain income tax benefits, or use exemption. Wife, a successful surgeon, is holding most family assets in her name. She transfers assets to husband, who a month later transfers those assets to a trust for the wife and children. The IRS may assert what is referred to as the "step-transaction doctrine" to collapse the steps in the plan. If successful, the planning would be treated as if the wife herself made the transfer to the trust and the purported transfer to the husband could be ignored. The results of that could be disastrous for the plan exposing assets to the wife's malpractice claimants and including the assets in her estate.*

Let's change the facts a bit. The wife gifts marketable securities to the husband in late 2023. The husband has their financial adviser prepare a new investment policy statement and reallocate the assets into a quite different asset allocation. He withdraws a portion of the funds to buy that Harley he always dreamt about. In 2025, a different tax year and more than 12 months after wife transferred assets to him, he transfers most of the assets (sans the Harley) to a trust for wife and children. Not only has husband demonstrated his control and use over the assets involved, but there is what some would argue is a lengthy period between the gift by wife to husband and his later transfer of those assets to a trust for the wife. Many experts would argue that the time (bolstered by the control) involved should deflect a challenge by a creditor of the wife's or the IRS *using the step-transaction doctrine. There seems to be enough independent economic events and time between the steps in the transactions. The take home point is that if you are going to plan time can be your friend bolstering the results you want, or it can be your enemy potentially undermining your hoped-for results by application of the step-transaction doctrine. So, why defer planning? Doing so might only increase the risks that the planning goals you have may not be realized.*

***<u>The Reciprocal Trust Doctrine Makes Planning Now Advantageous</u>**: Unfortunately, to understand the importance of timing to your planning you must tackle, at least in general terms, another tax doctrine.*

The reciprocal trust doctrine can be asserted by the IRS or a creditor to "un-cross" two trusts. That can unravel all your planning goals for the trusts. Here's a simple and common example. Husband is an attorney and wife is a physician. They are both concerned about asset protection planning from malpractice claims as well as general suits (e.g., a car accident, fall at their home, etc.). So, husband creates a trust for his wife and their children. Wife creates a similar trust for her husband and their children. They each gift substantial assets, consisting of interests in a valuable rental property LLC they owned, to the trust they created with the anticipation that the assets in the trusts will be protected from their claimants and creditors. Then the husband is sued. The claimant asserts that they should be able to access the assets in the trust the wife created for the husband under the reciprocal trust doctrine. The claimant argues that the trust husband and wife created for each other were so similar that there was no meaningful difference in the economic position of the husband from before the plan was created until after the plan was created.

Let's change the facts a bit. The wife creates her trust for husband and children in late 2023. She gifts both interests in the family real estate LLC, marketable securities and a life insurance policy on her life to the trust. The husband does nothing and has no plan. In 2025 the husband has their estate planner prepare a trust for wife, children and grandchildren. The trust has several significant differences from the trust the wife created more than a year and a half earlier. Husband gives wife a so-called "5 and 5 power" that gives her the right to withdraw the greater of $5,000 or 5% of the trust principal each year. The trust wife created for husband did not give him that right. Husband also gives wife a right to appoint trust assets among a class of family members. Wife's trust did not give that right to the husband. Also, the husband adds his mother as a beneficiary of the trust (perhaps as part of a plan to grant a general power of appointment to endeavor to obtain a basis step up). Not only does husband's trust have different assets and what many would argue are materially different rights, but there is what most would argue is a lengthy period between the creation and funding of the wife's trust and the creation and funding of the husband's trust. Many experts would argue that the time (bolstered by the different trust terms) should deflect a challenge by a creditor of the wife's or the IRS using the reciprocal trust doctrine. The take home point is that if you are going to plan time can be your friend bolstering the results you want, or it can be your enemy potentially undermining your hoped-for results by application of the reciprocal trust doctrine. So, why defer planning? Doing so might only increase the risks that the planning goals you have may not be realized. If you are going to pursue asset protection planning with irrevocable trusts as described above, why not integrate estate planning considerations into it as well?

<u>Last Minute May Not be Viable</u>*: You can wait until the last minute, say the end of 2025 to try to plan for the exemption that is to be reduced by half in 2026. While there may be some logic to it, it is not practical. In addition to the tax, asset protection and other reasons discussed above, planning just takes time. You will need a qualified appraisal of any business, real estate or other non-marketable assets you might wish to transfer. By mid-2025 appraisers may be so inundated with work that it may be difficult or impossible to hire one, or one may only be available at a bonus price because of the work demands. The same could well be the situation in hiring CPAs and attorneys. If you want to use an institutional trustee, which can be a significant benefit to bolster your planning, that takes time for any institution to review the trust and take actions. There have been similar situations in the past. In 2012 the estate tax exemption was $5 million and that was scheduled to decrease to $1 million in 2013. There was such a deluge of planning that many reputable firms in all the allied estate planning professions stopped taking clients in August or September. While that reduction did not materialize, there is no certainly that the 2026 reduction won't happen. So, carefully consider how long you can delay. There is one final point. Planning done with a reasonable time frame and at a reasonable pace will be more thoughtful, more careful, and easier for you to absorb and hence understand. Even if you can get your planning done at the last minute, do you want subpar planning done so quickly no one has time to evaluate and explain options?*

For many clients, but certainly not all, estate planning may make sense to begin now. For those that have already complete some measure of planning, reviewing and updating that planning is advisable. The inflation adjustments to the transfer tax exemption have added substantial increases and another is likely in 2024. Addressing the relevance of those increases to your planning, reviewing the operation and administration of your existing planning, is all advisable.

Please consider the above carefully. A review and update meeting can help us help you understand your options and the potential benefits of planning now.