

IRREVOCABLE TRUSTS: TERMINATE, DECANT OR MODIFY FOR BASIS STEP-UP?

PROCEED WITH CAUTION

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Should Existing Irrevocable Trust be Terminated?

ACTION MAY BE VALUABLE, BUT UNDERSTAND THE GOAL

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Do Your Client's Existing Irrevocable Trusts Work?

- Many taxpayers created irrevocable trusts and transferred significant assets to them to hopefully save estate tax. Following recent tax law changes does the existing trust plan really work? Should the trust be terminated?
- Assets in most irrevocable trusts won't receive a basis step up on your death, leaving the specter of substantial capital gains costs. "Basis step-up" is when on death the tax basis, which is used to calculate gain or loss on sale in each asset, is marked to market.
- The new \$15 million inflation-adjusted permanent exemption eliminates estate tax worries for most taxpayers (perhaps under 1,500 decedents a year!). That means that your irrevocable trusts may provide no estate tax savings, but they may prevent valuable income tax basis step up.
- There are approximately 2.7 million irrevocable trusts in existence. Many of these should be evaluated to determine whether and how they might be changed or even terminated to get assets back in your estate for basis step-up purposes
- **BOTTOM LINE:** In some but not all instances getting some but not necessarily all highly appreciated assets out of an irrevocable trust may be advantages. There are lots of different approaches to doing this, some of which may not require terminating or even modifying the trust.

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POLL QUESTION

Do you obtain a fully signed copy of every client trust you have an investment account for, and review it to determine what the income and estate tax status and distribution powers are:

- a) Yes and we review it with the client's attorney.
- b) Yes but we review it with a staff attorney in our firm.,
- c) Yes but we use FP Alpha, Vanilla or a similar service to review it.
- d) Sometimes, maybe, not sure.

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APPROACHES TO ADDRESS LACK OF BASIS STEP-UP

MANY OPTIONS OTHER THAN TERMINATING THE TRUST

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APPROACHES TO ADDRESS LACK OF BASIS STEP-UP

- **Modifying asset location decisions**. Are there steps the financial adviser alone can take to address the issue? Asset location refers to which buckets those different assets are placed in. Which assets, even assuming a constant asset allocation overall, are located in which buckets can have a substantial impact on whether or not there is a benefit to modifying, terminating, or distributing assets from an existing trust. For example, when the estate tax exemption was only \$1 million it may have been advisable to hold growth assets only in an irrevocable Credit Shelter Trust. In that way those assets would grow for the long term outside of the estate of the surviving spouse. But now, with a \$15 million permanent exemption there may be no concern about growing assets outside of the estate. So, in the current environment if a Credit Shelter Trust exists it may address the no basis step up issue by holding bonds in that irrevocable trust bucket.
- A grantor trust can **swap** highly appreciated assets in the trust other assets back into the settlor's estate. This may be a relatively simple and inexpensive process that can leave the trust intact.

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APPROACHES TO ADDRESS LACK OF BASIS STEP-UP

- **Distributing highly appreciated assets** out of the trust can put them into a beneficiary's estate for step up purposes. Carefully review the provisions in the trust (e.g., HEMS). This approach may leave the trust intact with all of its protections and other benefits. Confirm with the trust CPA any income tax consequences. This may be accomplished by the trustee with no change in legal documentation.
- **Changing the trustee**. Of a self-settled domestic asset protection trust ("DAPT") from an institution in a DAPT jurisdiction to you in a non-DAPT jurisdiction. That may cause estate inclusion. This is nuanced and technical get legal help to confirm it works.
- **Decanting** might effectuate the desired change or set up the trust so that the desired change can be made after the decanting. For example, powers of appointment may be able to be added so long as not violative of the intent of the existing trust. Trustee powers may be expanded or clarified to facilitate the desired plan. This is costly and complicated as it will require a new trust and a decanting agreement.
- A trust may contain **powers of appointment** may be permitted during lifetime. Have the power holder exercise that power in a manner that achieves the estate planning goal of a basis step up. This can range from simple (appointing assets to an elderly donee of the power) to complicated (appointing to a new trust that has to be created) depending on the circumstances.

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POLL QUESTION

Do you understand the important implications of powers of appointments your clients may have been given under irrevocable trusts others have created?

- a) Yes and we review it with the client's attorney.
- b) Yes but we review it within our firm.
- c) Sometimes, maybe, not sure.

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APPROACHES TO ADDRESS LACK OF BASIS STEP-UP

- **Trust protector** action may effectuate change depending on the powers given. Start by reading the powers given to the Trust Protector in the trust document.
- In a Special Power of Appointment Trust ("**SPAT**") provides a named person the power to direct the trustee to pay assets to the settlor of the trust. That may resolve the issue of basis inclusion by simply appointing those assets to the person desired.
- **Non-judicial modification agreement** ("NJMA") may be used to modify the trust. This must be done under state law so that how much can be changed will depend on the latitude provided under state law. State law may permit broader change if the settlor who created the trust is alive and agrees to the changes. Typically, all beneficiaries and trustees must consent to the modification or at least non-object. In some circumstances, almost any change desired can be made. That is very powerful. While this can be done without court approval, a NJMA may require a modification agreement, new trust and representation of various people by different attorneys.

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CIRCUMSTANCES TO EVALUATE BEFORE TERMINATING A TRUST

CONSIDERATIONS

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CIRCUMSTANCES TO EVALUATE BEFORE TERMINATING A TRUST

- **BOTTOM LINE** if the plan of action makes sense for the client to remove appreciated assets from a trust, **before** proceeding be sure to consider all the ripple effects to avoid problems. Some but not all of these follow:
- **Appreciation** in the trust currently.
- What **potential income tax cost** might the trust assets realistically face on a present value basis? Example, the trust may hold an interest in a family business that is intended to be passed on to many future generations. The PV of the tax due is probably 0. CRT? 1031?
- **Anticipated changes** may eliminate tax concern. Might current assets be sold or traded for other assets in the future? Example: appreciated growth stocks may have been held in a particular irrevocable trust for years, but the primary beneficiary, perhaps a surviving spouse, may now be retired and need to tap those assets so that they will be liquidated over time.
- **Tax law changes** will continue to occur. What if the exemption is reduced?
- **Residency may change**. Example: beneficiary may live in a state with no estate tax and move to a state with a state estate tax. Assets outside a trust may now trigger an estate tax.

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POLL QUESTION

Have you (or will you) discuss with clients who have irrevocable non-grantor trusts the state tax implications of their trusts?

- a) Yes and we review it with the client's CPA.
- b) Yes but we review it within our firm.,
- c) Sometimes, maybe, not sure.

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CIRCUMSTANCES TO EVALUATE BEFORE TERMINATING A TRUST

- Risks of lawsuits, divorce or claims destroying all the assets distributed out of a protective trust. This is a major issue and often warrants detailed discussions with all involved, lien and judgement searches and other steps.
- State laws may be relevant. A trust was created in one state but the beneficiary, such as the surviving spouse, has moved to another state. If you distribute assets out of the trust the new state laws will apply. This could be relevant to the safety of those assets, e.g. a new spouse's right of election.
- Family dynamics. If assets are distributed out of trust will the bad child harass mom for a gift or bigger inheritance? Take the time to discuss the "what ifs" with the clients before taking action. Have you met with all the players before? If not can you now?
- Basis step-up is not really correct. It's really a basis adjustment. The law provides that the cost basis of most assets the decedent owned at death is adjusted to the fair market value ("FMV") of those assets on the date of death. That adjustment is like the proverbial two-edged sword. If someone dies holding assets at a market downturn basis could be lower!

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POLL QUESTION

Do you generally as part of the estate planning process discuss risks of divorce, lawsuit and claims with clients and encourage them to review asset protection considerations:

- a) Yes and we review it with the client's attorney.
- b) Yes but we review it within our firm.,
- c) Sometimes, maybe, not sure.

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LIABILITY RISKS OF MODIFYING OR TERMINATING A TRUST

INFORM EVERYONE OF RISKS INVOLVED

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LIABILITY RISKS OF MODIFYING OR TERMINATING A TRUST

- **BOTTOM LINE:** You've come up with a plan, you've analyzed the circumstances and are ready to go. Before everyone jumps, evaluate the liability the decision might create for the trustee, and even you.
- Trustees and advisers engaging in any of the above techniques should evaluate the potential implications and what if any liability exposure the proposed steps may trigger.
- **Example:** Consider the view of the beneficiaries if assets in an old Credit Shelter Trust are distributed to their surviving parent as a beneficiary to gain a step up in tax basis on her death. Shortly after the distribution the surviving widow remarries and bequeaths the assets to her new husband, how will the children feel? They will have achieved the desired step up in income tax basis but lost their inheritance. Will the kids sue the trustee?
- Will having the children sign off approving the plan suffice to insulate the trustee and advisers from liability? Maybe. But if the attorney for the wife handled the planning and transaction, who represented the beneficiaries? If they did not have legal counsel might they argue in their suit against the trustee and advisers that they were misled? Caution is in order.

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POLLING QUESTION

Does your firm have policies to minimize risks to your firm when you address estate planning with your clients?

- a) Yes and we review issues with an attorney on staff or at a firm meeting.
- b) Yes but we rely on standard disclaimers to address all these risks and issues.
- c) Yes and as appropriate we will send a follow up letter confirming some of the risks we have warned the client about.
- d) Sometimes, maybe, not sure.

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MAKE A TRUST ACTION PLAN

CREATE A CHECKLIST OF DECISIONS AND STEPS

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MAKE A TRUST ACTION PLAN

- **BOTTOM LINE** You've decided on a plan, evaluated the circumstances and potential liability, before implementing create a checklist of the analysis, decision, options and steps to actually make the plan work. Circulate that checklist/summary to all advisers, then proceed. In the checklist indicate who will do what (your firm, trustee, lawyer, trust protector, CPA, etc.).
- Prepare a memorandum summarizing all relevant facts and options so everyone understands what is involved.
- That doesn't substitute for recommending that each retain their own legal adviser.
- Tailored actions may be best, e.g. dividing a trust and taking different actions as to each part may get a better result. For example, divide the trust and put the most appreciated assets in one trust and all other assets in the other. Take the actions to address basis step-up only with respect to the new trust that has the appreciated assets. Perhaps the other trust is left intact.
- In some cases, the simplest approach of just changing asset location decisions, or distributing some of the highest appreciated assets, may be all that is required.
- In some, perhaps many cases, when all the risks and implications are objectively evaluated staying the course with no restructuring or termination may be the preferable approach.

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CONCLUSION AND SUMMARY

WRAP UP

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Conclusion And Summary: Action Can Be Real Win for the Client Family....But Take Preliminary Steps

EVALUATE CIRCUMSTANCES

- What are the assets involved?
- How much tax might be saved?
- Risks of claims, divorce, etc.
- Consider all relevant circumstances.

EVALUATE PLANNING OPTIONS

- Can you just terminate the trust based on trust terms or state law? Should you?
- Should you divide the trust to address appreciated and non-appreciated (or special) assets?
- Will a non-judicial modification agreement resolve the issue (NJMA)?
- Can decanting help?
- Are there powers of appointments that might help?
- Consider all relevant planning approaches.

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