Harrison
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Gimme Shelter — Gifting in 2011 While Retaining Strings

In past columns, we have discussed the increase in the lifetime gifting amount to $5,000,000 for gifts during the years 2011 and 2012. [Insert cite from a couple of months ago.] This article examines an additional strategy that has become increasingly popular for gifts in the husband and wife scenario.

Prior to 2011, the extent of lifetime non-taxable gifts that could be made (in excess of the annual exclusion amount) was $1,000,000. A practical issue left unaddressed in the last 20 years — because it was not then in front of our clients — was whether parents would gift substantial amounts in excess of $1,000,000, if those gifts were non-taxable. The practicalities are now squarely in front of practitioners with the non taxable-gift limit expanded to $5,000,000.

In that setting, would a couple with an estate of say $10,000,000, gift $5,000,000 during life to the kids if they knew the estate tax-free amount was being reduced to $1,000,000? How about if the couple had an estate of $20,000,000? $50,000,000?

The answer is different depending on the analysis from a tax or non-tax perspective. From a tax perspective, the answer is "Yes, go ahead and make the gifts."

From a non-tax perspective, the answer that has arisen over the last six months is three fold:

"1. Yes, I know that these gifts should be made from a tax perspective; but

2. I don't want my kids to have access to those funds immediately; and

3. I may need the funds back to live on during my lifetime."

Statement 3 above is a new one as it relates to gifting strategy, and is endemic to the substantial increase in gifting credit that we now have. It can be addressed and planned around in the husband and wife scenario by creating the "Lifetime Credit Shelter Trust." An iteration to that strategy, creating tag along creditor shielded trusts for the children, will also effectively address the concern noted in 2 above. Here's how to create that trust.

Structuring of the Lifetime Credit Shelter Trust

The elements include the following:

The trust is irrevocable. Though it is possible to allow for the possibility of changed terms through a trust protector — an aggressive technique that is not without risk — the terms of the trust are unchangeable. As a result, the transfer of funds to the trust is a completed gift for gift tax purposes.

The beneficiaries are both the spouse and the children. In this regard, the trust is analogous to a spousal ILIT ("Irrevocable Life Insurance Trust"), though not funded with insurance. Instead, the trust is funded with up to $5,000,000 of assets contributed from the non beneficiary spouse. For example, the husband sets up this trust for his wife and children, and contributes $5,000,000 of husband's own property.

The gift must be from the non-beneficiary's separate property; in the example above, from the husband spouse, and not from a joint account, from community property, or from the beneficiary spouse. In this way, one spouse can contribute up to $5,000,000 to the trust. The gift and trust are excluded from the non-beneficiary spouse's gross estate.

The trust can also be excluded from the beneficiary spouse's estate, provided the beneficiary spouse has no general power of appointment. In this regard, the beneficiary spouse can be the trustee, and entitled to income or principal as needed by the beneficiary spouse for his or her health, support, or maintenance. If trustee, the beneficiary spouse cannot make a distribution for his or her best interests or other non-ascertainable standard. The ability to make a distribution pursuant to a non-ascertainable standard — for the beneficiary's best interest, for example — could be in the discretion of a third party (non beneficiary), as a co-trustee, without running afoul of this rule.

The beneficiary spouse can be given the power during life to appoint the property to the beneficiary's children. That power will not have adverse estate or gift tax consequences. If exercised, that power should not result in any taxable gift concerns.[1]

The beneficiaries during the life of the spouse could also be the children, entitled to discretionary distributions as the trustee determines. The trustee should be prohibited from making a distribution to the children or for the children that would discharge a support obligation of either parent.

At passing, the funds will pass free of estate tax to the children (or their descendants, on a *per stirpital* basis). The distribution to the children could be in further trust, with the children as their own trustee, to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility to the child in terms of access to the principal, with some protection against creditors, although not a complete insulation. For planning purposes, assume the client and planner has determined that a flexible creditor protection

[1] The IRS takes the position that the exercise of a limited power of appointment during life is a gift of the income interest in the property by the person exercising the power if the person exercising the power has a mandatory right to the income from the trust. *See* Reg. §§25.2514-3(b)(2), 25.2514-3(e). The Court of Claims held contrary to the IRS interpretation in *Self v. United States,* 142 F.Supp. 939 (Ct.Cl. 1956). This possible gift tax issue should be understood and discussed with the client before any lifetime power is exercised, especially because the IRS has announced that it will not follow *Self.* Rev. Rul. 79-327, 1979-2 C.B. 342.

trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?"[2] Each shift in adding more control to the beneficiary – as trustee, and then pursuant to an unascertainable standard — creates some decrease in creditor protection. How much will depend on evolving state law in this regard. And yet, this is the kind of decision that a client cannot be expected to make in an informed way. The practitioner, based on state law and knowledge of the client's family, has to recommend the format that should be used.

Practical Concerns

The desirous part of this strategy is that the parents give away property for gift and estate tax purposes while one parent still retains the right to access the property, if needed. Further, one of the parents can control the distributions to the children at least during the beneficiary spouse's life.

Concerns exist, premised on the strength of the marriage. If the marriage ends in divorce, that trust may be neither marital nor separate property. The trust property may be considered outside the property to be divided on divorce, and yet, the beneficiary spouse may still be in control of the property (as trustee and beneficiary).

Also, once the beneficiary spouse passes away, the grantor spouse can no longer access the funds, so the strategy is best structured to allow the longer expected lived spouse to be the beneficiary.

The Tax Effects of the Trust

The trust will be free of estate tax to the grantor spouse, and will be free of estate tax at the grantor's spouse's level as to funds that remain in the trust at the grantor's spouse's passing. The trust can be structured to be generation skipping as well, but from a practical perspective, this additional tax feature may not be desired. If one intent of the trust is that funds could become available to the spouse, then a distribution from the trust to the spouse, which will have already used the lifetime gifting credit as to that distribution, will now also waste the generation-skipping tax exemption used for the trust.

Having said that, the decision whether to make the trust a generation-skipping tax-exempt trust is a close call, and either structure works fine.

From an income tax perspective, this trust likely is a separate taxpayer, taxed as a complex trust for income tax purposes. If the goal is to make the trust a grantor trust for

[2] "Best interests" is a scary standard for trusts controlled by beneficiaries for tax purposes, but perhaps not for creditor protection purposes.

income tax purposes, that can certainly be drafted into the trust (with, for example, a substitution power, or the power in a non-adverse party to add additional beneficiaries).

Who Can Be Trustee

The beneficiary spouse — who does not contribute funds to the trust—can be a trustee, provided the standard for distribution is one related to health, support or maintenance. That standard prevents Code Sec. 2041 from equating that discretion to a general power of appointment.

If a broader standard is desired, one that includes "best interests" (essentially allowing the trustee to make a distribution whenever the trustee determines the beneficiary's life will be enhanced by the distribution), then a co-trustee can be part of the trust. That co-trustee's role will include determining whether that standard is met. In no event should the beneficiary spouse have the right to participate in decisions on whether to make a distribution for best interests; the document should expressly prohibit that spouse from participating in that decision.

Should Both Husband and Wife Create a Trust for One Another

On the surface, spouses may desire to create these types of trusts for one another, so called reciprocal trusts. Unfortunately, if reciprocal trusts are created, then pursuant to the *Grace* case reasoning, *U.S. v. Grace*, 395 U.S. 316 (1969), the IRS could ignore the separate existence of both trusts, and combine them together. The effect would be that each spouse created a trust for that spouse's benefit, thereby triggering estate tax inclusion under Code Sec. 2036(a) (1). It is possible that the trusts could be sufficiently different that the doctrine is inapplicable. However, in practice, we have recommended that only one spouse use the strategy (at least starting out in 2011), and most clients are comfortable having just one trust.

Then the question is whether that one spouse can use the other spouse's $5,000,000 gifting credit by the technique of gift splitting on a gift tax return. Gift splitting will not result in inclusion under Code Sec. 2036 (a) (1) provided the beneficiary spouse was not the owner of the property at the time of the gift.

Treating a transfer as a split gift, if effective, would allow $10,000,000 of property to be transferred to this kind of trust outside of the gift and estate tax regime. The concern is with Reg. §25.2513-1(b) (4), which provides that an interest can be split only if the value transferred to non-spousal beneficiaries is ascertainable. In the proposed structure, the spouse is a discretionary beneficiary, and that discretion on the surface makes the other beneficiaries' interests non-ascertainable.

For example, if $1,000,000 is transferred to the trust, and the trustee has discretion to make distributions for the spouse's health, support, maintenance or best interests, how much property of that $1,000,000 will be available for the children

beneficiaries? The answer: unknown. If the power is limited by an ascertainable standard, then certain rulings suggest that the gift is splittable.[3]

In practice, we have not had to consider the necessity of considering split gifting in most circumstances. Clients who have been happy with this strategy at $5,000,000, tend to be reluctant at $10,000,000. Though rationally the latter should be more attractive, clients often exhibit irrational economic attitudes towards our strategies. A reluctance to do the strategy at $10,000,000 demonstrates that irrationality.

Conclusion

The Lifetime Credit Shelter Trust, rarely used in the past, will be a favorite technique in the next two years for married clients to give away, but not quite give away, substantial portions of their $5 million gifting credit, to their kids outside of the estate and gift regime.

Unanswered Questions

1. Gift Splitting: Available orNot
2. Funding: Insurance: yes or no; how?
3. Annual exclusion going forward
4. Grantor trust status
5. Reciprocal Trusts

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[3] *See, e.g,* PLR 8044080, and Rev. Rul. 56-329, .