For Trusted Advisors
Summer 2015

Estate Planning

Trust Decanting

An irrevocable trust may no longer meet a beneficiary's needs either because of a change in circumstances of the beneficiary or changes in law. In such cases, trust "decanting" may be an option. Decanting involves the transfer of the assets of one trust into a new trust to be governed under the terms of the new trust. A trustee's authority to decant may be found in the trust document, a decanting statute or possibly at common law. Currently, 22 states have enacted decanting statutes.[1] These statutes bring greater certainty and protection to a trustee who might fear liability for decanting a trust.

In the absence of a decanting statute, decanting may still be permitted at common law, but the rules relating to decanting and the circumstances under which decanting may be available are murkier.

Changing beneficiaries.

Whether decanting may be an option under a decanting statute will depend on certain features of the original trust as well as the specific change desired. It is generally possible to remove one or more trust beneficiaries by decanting. Adding beneficiaries, however, is generally not permitted. While adding a new beneficiary to the trust may not be permitted, it may be possible to pass assets to persons who were not beneficiaries of the decanted trust by granting powers of appointment in the new trust. The extent to which powers of appointment may be granted to a beneficiary varies greatly by jurisdiction. For example, a number of jurisdictions expressly provide that the permissible appointees of a power of appointment need not be permissible beneficiaries of the decanted trust. New York, on the other hand, generally only permits the new trust to grant a power of appointment that is identical to the power of appointment that existed under the decanted trust, unless the power of appointment is granted to a beneficiary who might have received an outright distribution of principal.

In certain states, beneficiaries may be changed by accelerating the interest of a future interest beneficiary to that of a current interest beneficiary. Even in states where acceleration of a future interest is not expressly permitted, it may still be possible to accomplish in other ways, such as by removal of the current beneficiaries. A significant number of decanting statutes, however, do not address acceleration of a beneficiary's interest at all.

The trustee's distribution power.

Another trust feature that may play a role in whether decanting may be available is the degree of discretion that the trustee has in distributing trust principal. This consideration likely stems from the common law rationale that if a trustee's discretionary power permits the trustee to distribute property to or for the benefit of one or more current beneficiaries, then this power may be used to distribute property to a new trust for the benefit of such beneficiary. Therefore, where the trustee's authority to distribute to a beneficiary is limited in some way, the ability to decant may be limited as well. While states tend to permit decanting where the trustee has absolute discretion to distribute all principal and income, options for decanting may be more limited in cases where the trustee's ability to distribute is limited by an ascertainable standard, such as the health, education, maintenance and support of the beneficiary. Generally, the greater the degree of trustee discretion, the more flexibility exists in decanting.

Other considerations.

The validity of decanting may also depend on whether the beneficiary has a vested right to withdraw trust assets. While it may be permissible to decant to a new trust to eliminate some future right to withdraw property, decanting after the beneficiary acquired an absolute right to demand decanted assets may be more difficult. For example, in *Ferri v. Powell-Ferri* (2013 WL 5289955), the trust document gave the beneficiary the right to withdraw 75% of trust assets at age 43, and all trust assets at age 47. At the time the action was commenced the beneficiary had the right to withdraw 75% of the trust's assets. While the action was pending, the beneficiary became entitled to withdraw all of the trusts' assets. The new trust, however, only gave the beneficiary a limited lifetime power of appointment which he could not exercise in favor of his creditors or his spouse.

In an unpublished opinion, a Connecticut Superior Court, applying Massachusetts common law, noted that the distinction between decanting before and after the right to withdraw arose is "not insignificant" and held that the decanting could not stand.

Conclusion.

Decanting could be a good option for certain outdated trusts. The trust's features, as well as state law, will determine whether decanting is possible in a particular case. While some states have enacted decanting statutes, case law interpreting these statutes is scant. In other states without a decanting statute, the legal landscape for decanting may be even more uncertain.

1 AK, AZ, DE, FL, IL, IN, KY, MI, MO, NC, NH, NV, NY, OH, RI, SC, SD, TN, TX, VA, WI and WY.

Net Unrealized Appreciation (NUA) Strategy

A Net Unrealized Appreciation (NUA) strategy may allow a person who is retiring or changing jobs to convert some of their qualified plan distributions from ordinary income to capital gains.

Introduction.

If you retire or change jobs you can often roll over your qualified plan monies into another qualified plan or IRA. However, if a portion of your plan assets are held in highly appreciated employer company stock, it may be advantageous to use the Net Unrealized Appreciation (NUA) strategy.

"Net unrealized appreciation" is the excess of the fair market value of employer securities at the time of a lump sum distribution over the cost basis of the securities to a qualified plan trust. For NUA purposes, "employer securities" may include shares of a parent or subsidiary corporation.

NUA strategy.

The NUA strategy refers to the special tax treatment of company stock that is distributed from employer sponsored qualified plans.[1] With this strategy, you will immediately be taxed at ordinary income rates on the cost basis of the stock—not the current market value. Although you will be taxed on the cost basis, the NUA strategy permits you to hold the shares in a non-qualified account, and the gains are not taxed until the stock is sold. Therefore, some retiring participants may want to take a taxable, in-kind distribution of the company stock shares, and roll the remaining non-stock assets into an IRA.

If the price of the stock has appreciated considerably, this could be a significant advantage when the stock is eventually sold. The NUA (the difference between the cost basis and the current market value at time of distribution) generally qualifies for long-term capital gains treatment.[2]

If the same company stock were rolled over into an IRA, any future distribution from the IRA would be taxed at ordinary income tax rates rather than long-term capital gain rates.

In addition, since the stock no longer resides in a qualified retirement plan, the value of the stock is no longer subject to Required Minimum Distributions (RMDs). If the participant holds the NUA stock until death, the heirs may get a step-up in basis and the unrecognized gain may never be recognized.

For example, Katharine, age 60, purchased 1,000 shares of company stock within her retirement plan, at a cost of $20 per share. When she leaves the company, the stock is trading at $50 a share. Therefore:

- The current market value of the stock is $50,000 (1,000 x $50 a share).
- Her cost basis is $20,000 (1,000 x $20 a share), subject to ordinary income tax rates up to 39.6% upon distribution.
- The NUA is $30 a share ($50 minus $20 a share), or a total of $30,000, subject to capital gains rates of 15% or 20% when sold. The 3.8% net investment income tax (NIIT) may also apply.

While the tax savings under the NUA strategy are compelling, the strategy may not be appropriate for everyone.

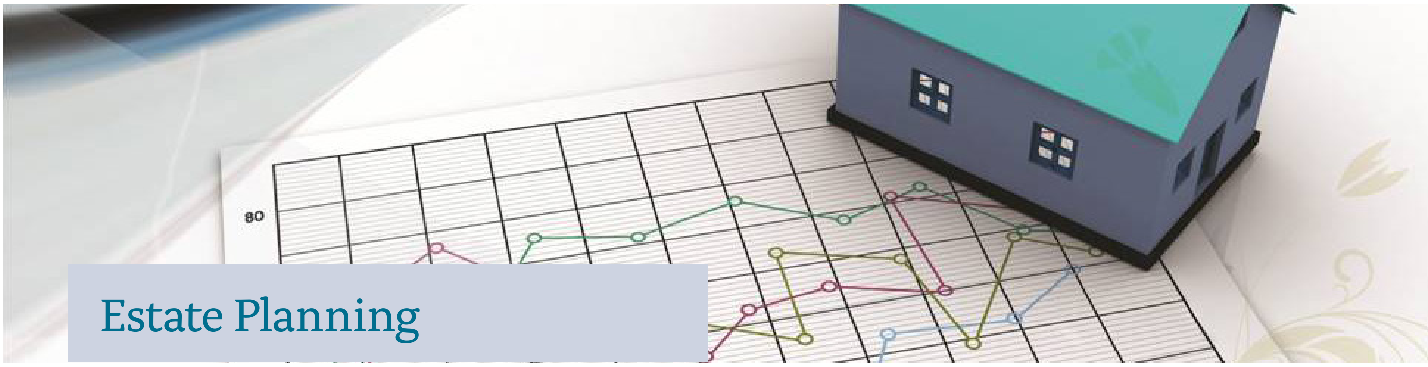
The NUA strategy works best when the following factors are present:

- The employer stock is highly appreciated.
- You can afford the tax liability on the ordinary income tax on the stock basis portion of your distribution.
- Your ordinary income tax rate is higher than your capital gains rate.

Other considerations.

- The distribution of the stock must generally be as a lump-sum distribution, as defined by the IRS.
- The stock must be distributed in-kind. The NUA strategy doesn't apply if the stock is liquidated and taken in cash.
- The NUA strategy doesn't apply if you roll the company stock into an IRA. If you have already rolled the stock into an IRA, the ability to apply the NUA strategy is generally lost.
- If you are under age 59½, a 10% early withdrawal penalty may apply to the cost basis of the in-kind stock distribution, if you do not qualify for an exception.

1 Only distributions from employer sponsored qualified plans can qualify for lump-sum distribution treatment, and thus for NUA treatment. Distributions from IRAs, SEP-IRAs and 403(b) plans are not eligible for NUA treatment.
2 Any additional gains after the distribution are subject to the short-term capital gains rate, if the sale is made within one year of the distribution.



Estate Planning

Unwinding pre-ATRA estate plans

Due to the increased estate and gift tax exemption made permanent by the American Taxpayer Relief Act of 2013 (ATRA), many people put estate planning into place that may no longer be relevant, or worse, may subject them to higher taxes than someone similarly situated who had done no planning at all.

With the unified estate and gift exemption at $5,000,000 ($5,430,000 in 2015) and portability allowing clients to carry forward any remaining estate tax exemption in a deceased spouse's estate, many taxpayers find themselves well planned for an estate tax they are no longer subject to, while cementing into place state estate tax and capital gains tax issues which they will encounter.

Therefore, it may be worthwhile to identify ways to "unwind" a complex estate plan as much as possible to favor inclusion of assets over exclusion and minimize capital gain and state estate tax posture as much as possible.

Potential remedies.

Avoid or reverse the discounting of assets: Avoiding valuation discounts for client owned assets, including unwinding or liquidating Family Limited Partnerships or reacquiring FLP interests so as to hold the underlying (and undiscountable) assets rather than the discounted entity.

Cause inclusion of assets in grantor/settlor's estate: People who transferred assets to a trust may now wish to have those assets included in their estate. Consider a common method for creating a "grantor" trust by including the ability of the Grantor to "swap" assets in that trust for assets of equivalent value. High growth or low basis assets can be reacquired in this fashion, pulling those assets back into the settlor's estate.

Cause inclusion in a beneficiary's estate: People typically pass assets in trust to beneficiaries for both tax and non-tax reasons, e.g., estate and generation skipping taxes versus creditor protection and financial immaturity of a beneficiary. When the potential tax savings outweigh the non-tax reasons for the trust's existence, it makes some sense to look at trust-held assets and determine how they might be held by the beneficiary outright rather than in trust, for example, decanting a trust into a new trust, granting the beneficiaries a "general power of appointment" over the trust assets, and thus causing inclusion in the beneficiary's estate.

Change ownership of spousal assets: Dealing with a rich spouse/poor spouse has long been a common planning technique, particularly in separate property states. The increased exemptions under ATRA only make this more valuable. One variation that may be useful is to consider having the spouse with the shorter life expectancy own the appreciated property. At the death of that spouse, those assets would receive a step up in basis and could be sold without incurring gain.

For those in community property states, it may be beneficial to partition assets and have the spouse with the longer life expectancy retain loss assets so as to avoid a "step down" to fair market value at the first death.

"Switch off" grantor trust status: Grantor trusts require that the grantor pay the trust's income taxes, because the trust's assets are deemed to be owned by the grantor. Because of ATRA's increased income tax rates, switching off grantor trust status may lower a family's overall income tax burden in some instances. Additionally, the grantor, relieved of the burden of paying the trust's income taxes, may retain more personal assets and invest in items which would receive a step up in basis at death. For grantors who have a "swap power" over trust assets (as mentioned previously), releasing that power may be all that is required.

Conclusion.

None of these ideas to unwind an obsolete estate plan are generic; they should be undertaken only with the advice and guidance of qualified legal and tax professionals. This article provides a few possible options and is not intended to be an exhaustive overview of options or solutions. Each of the techniques above may implicate not only estate and gift tax issues, but also income tax, fiduciary duty obligations, and the individual's estate planning documents, not to mention the various intricacies of state law with respect to any course of action.

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Taxation - Income, Estate and Gift

Trusts and avoiding passive activity loss rules

In a 2014 case,[1] the U.S. Tax Court ruled that in some instances a trust can "materially participate" in a trade or business, thus avoiding the "passive activity loss rules" which generally apply to certain investment activities.

Facts.

In 1979, Frank Aragona formed a trust with himself as the grantor and initial trustee, and his five children as beneficiaries.

When Frank died in 1981, he was succeeded by six trustees: his five children and one independent trustee.

The trust was the sole owner of an LLC consisting of rental real estate properties. As a result, the LLC was a disregarded entity for income tax purposes. Three of the children worked full time for the LLC.

For the tax years in question, the trust took the position that because the trustees met often about trust business and three of them worked full time in the real estate operations, the trust was entitled to treat certain losses as ordinary and also carry those back to previous tax years.

The tax court found that under these limited circumstances, the activities of the trustees could be used to determine whether or not the trust itself was "materially participating" in the business and in fact held that the Frank Aragona Trust was "materially participating" and not merely passively participating in the trust's real estate investments.

Why this matters.

Passive activity income presents two general issues. The first, encountered by the Aragona family, is that in general, the passive activity loss rules limit the amount of losses you can report on your income tax returns.

These rules were enacted to counter the tax shelter industry which was funneling enormous losses through to passive investors to shelter ordinary income. Passive losses are now generally only allowed against passive gains. If your passive losses exceed your passive gains, you may carry them forward to use against future passive gains.

Additionally, and of more recent interest, is the 3.8% Net Investment Income Tax (NIIT) that high income and high net worth clients are subject to as a result of their passive activity income.

This tax hits trusts particularly hard. A non-grantor trust with more than $12,300 in taxable income will find itself in the 39.6% bracket. Any undistributed net investment income will be subject to that additional 3.8% NIIT.

This ruling opens the door for certain taxpayers to have the advantages that trust ownership and active participation in the business provide.

Caveats and considerations.

For the near future, anyone wanting to take advantage of this ruling would be wise to hew closely to the facts of this case and the particular holding of the tax court:

- Three of the six trustees participated in the trust's real estate operations full time.
- The trust's real estate operations were substantial and it had practically no other operations.
- The trustees handled practically no other businesses on behalf of the trust.
- The trust had majority ownership of certain assets owned jointly with two of the trustees.

Many unanswered questions remain. For instance: How does this apply to minority interests in business entities or non real estate activities?

There is some indication that the U.S. Treasury Department is considering further guidance on the subject of material participation for trusts and estates.

As further guidance is provided, the contours of this valuable planning technique will be further revealed.

1 Frank Aragona Trust v. Commissioner, 142 T.C. 9 (2014)