Federal Regulations

Reg §20.2041-1. Powers of appointment; in general.


(a) Introduction. A decedent's gross estate includes under section 2041 the value of property in respect of which the decedent possessed, exercised, or released certain powers of appointment. This section contains rules of general application; §20.2041-2 contains rules specifically applicable to general powers of appointment created on or before October 21, 1942; and §20.2041-3 sets forth specific rules applicable to powers of appointment created after October 21, 1942.

(b) Definition of "power of appointment".

(1) In general. The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example, if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment. If the community property laws of a State confer upon the wife a power of testamentary disposition over property in which she does not have a vested interest she is considered as having a power of appointment. A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any
other person including himself, the decedent is considered as having a power of appointment. However, the decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal. Similarly, a power to amend only the administrative provisions of a trust instrument, which cannot substantially affect the beneficial enjoyment of the trust property or income, is not a power of appointment. The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment. Further, the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

(2) Relation to other sections. For purposes of §§20.2041-1 to 20.2041-3, the term "power of appointment" does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038. (See §§20.2036-1 to 20.2038-1.)

No provision of section 2041 or of §§20.2041-1 to 20.2041-3 is to be construed as in any way limiting the application of any other section of the Internal Revenue Code or of these regulations. The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includible in his gross estate to the extent it would be includible under section 2033 or some other provision of part III of subchapter A of chapter 11. For example, if a trust created by S provides for payment of the income to A for life with power in A to appoint the remainder by will and, in default of such appointment for payment of the income to A's widow, W, for her life and for payment of the remainder to A's estate, the value of A's interest in the remainder is includible in his gross estate under section 2033 regardless of its includibility under section 2041.

(3) Powers over a portion of property. If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest. For example, if a trust created by S provides for the payment of income to A for life, then to W for life, with power in A to appoint the remainder by will and in default of appointment for payment of the remainder to B or his estate, and if A dies before W, section 2041 applies only to the value of the remainder interest excluding W's life estate. If A dies after W, section 2041 would apply to the value of the entire property. If the power were only over one-half the remainder interest, section 2041 would apply only to one-half the value of the amounts described above.

(c) Definition of "general power of appointment".
(1) In general. The term "general power of appointment" as defined in section 2041(b)(1) means any power of appointment exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate, except (i) joint powers, to the extent provided in §§20.2041-2 and 20.2041-3, and (ii) certain powers limited by an ascertainable standard, to the extent provided in subparagraph (2) of this paragraph. A power of appointment exercisable to meet the estate tax, or any other taxes, debts, or charges which are enforceable against the estate, is included within the meaning of a power of appointment exercisable in favor of the decedent's estate, his creditors, or the creditors of his estate. A power of appointment exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors. However, for purposes of §§20.2041-1 to 20.2041-3, a power of appointment not otherwise considered to be a general power of appointment is not treated as a general power of appointment merely by reason of the fact that an appointee may, in fact, be a creditor of the decedent or his estate. A power of appointment is not a general power if by its terms it is either—(a) Exercisable only in favor of one or more designated persons or classes other than the decedent or his creditors, or the decedent's estate or the creditors of his estate, or (b) Expressly not exercisable in favor of the decedent or his creditors, or the decedent's estate or the creditors of his estate.

A decedent may have two powers under the same instrument, one of which is a general power of appointment and the other of which is not. For example, a beneficiary may have a power to withdraw trust corpus during his life, and a testamentary power to appoint the corpus among his descendants. The testamentary power is not a general power of appointment.

(2) Powers limited by an ascertainable standard. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort," "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses of invalidism."
determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

(3) Certain powers under wills of decedents dying between January 1 and April 2, 1948. Section 210 of the Technical Changes Act of 1953 provides that if a decedent died after December 31, 1947, but before April 3, 1948, certain property interests described therein may, if the decedent's surviving spouse so elects, be accorded special treatment in the determination of the marital deduction to be allowed the decedent's estate under the provisions of section 812(e) of the Internal Revenue Code of 1939. See §81.47a(h) of Regulations 105 (26 CFR (1939) 81.47a(h)). The section further provides that property affected by the election shall, for the purpose of inclusion in the surviving spouse's gross estate, be considered property with respect to which she has a general power of appointment. Therefore, notwithstanding any other provision of law or of §§20.2041-1 to 20.2041-3, if the present decedent (in her capacity as surviving spouse of a prior decedent) has made an election under section 210 of the Technical Changes Act of 1953, the property which was the subject of the election shall be considered as property with respect to which the present decedent has a general power of appointment created after October 21, 1942, exercisable by deed or will, to the extent it was treated as an interest passing to the surviving spouse and not passing to any other person for the purpose of the marital deduction in the prior decedent's estate.

(d) Definition of "exercise". Whether a power of appointment is in fact exercised may depend upon local law. For example, the residuary clause of a will may be considered under local law as an exercise of a testamentary power of appointment in the absence of evidence of a contrary intention drawn from the whole of the testator's will. However, regardless of local law, a power of appointment is considered as exercised for purposes of section 2041 even though the exercise is in favor of the taker in default of appointment, and irrespective of whether the appointed interest and the interest in default of appointment are identical or whether the appointee renounces any right to take under the appointment. A power of appointment is also considered as exercised even though the disposition cannot take effect until the occurrence of an event after the exercise takes place, if the exercise is irrevocable and, as of the time of the exercise, the condition was not impossible of occurrence. For example, if property is left in trust to A for life, with a power in B to appoint the remainder by will, and B dies before A, exercising his power by appointing the remainder to C if C survives A, B is considered to have exercised his power if C is living at B's death. On the other hand, a testamentary power of appointment is not considered as exercised if it is exercised subject to the occurrence during the decedent's life of an express or implied condition which did not in fact occur. Thus, if in the preceding example, C dies before B, B's power of appointment would not be considered to have been exercised. Similarly, if a trust provides for income to A for life, remainder as A
appoints by will, and A appoints a life estate in the property to B and does not otherwise exercise his power, but B dies before A, A's power is not considered to have been exercised.

(e) Time of creation of power. A power of appointment created by will is, in general, considered as created on the date of the testator's death. However, section 2041(b)(3) provides that a power of appointment created by a will executed on or before October 21, 1942, is considered a power created on or before that date if the testator dies before July 1, 1949, without having republished the will, by codicil or otherwise, after October 21, 1942. A power of appointment created by an inter vivos instrument is considered as created on the date the instrument takes effect. Such a power is not considered as created at some future date merely because it is not exercisable on the date the instrument takes effect, or because it is revocable, or because the identity of its holders is not ascertainable until after the date the instrument takes effect. However, if the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first. The application of this paragraph may be illustrated by the following examples:

Example (1). A created a revocable trust before October 22, 1942, providing for payment of income to B for life with remainder as B shall appoint by will. Even though A dies after October 21, 1942, without having exercised his power of revocation, B's power of appointment is considered a power created before October 22, 1942.

Example (2). C created an irrevocable inter vivos trust before October 22, 1942, naming T as trustee and providing for payment of income to D for life with remainder to E. T was given the power to pay corpus to D and the power to appoint a successor trustee. If T resigns after October 21, 1942, and appoints D as successor trustee, D is considered to have a power of appointment created before October 22, 1942.

Example (3). F created an irrevocable inter vivos trust before October 22, 1942, providing for payment of income to G for life with remainder as G shall appoint by will, but in default of appointment income to H for life with remainder as H shall appoint by will. If F died after October 21, 1942, without having exercised his power of appointment, H's power of appointment is considered a power created before October 22, 1942, even though it was only a contingent interest until G's death.

Example (4). If in example (3) above G had exercised his power of appointment by creating a similar power in J, J's power of appointment would be considered a power created after October 21, 1942.
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ESTATES, TRUSTS, & GIFTS

Portability or No: The Death of the Credit-Shelter Trust?

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The newest statutory choice in estate planning—the ability to elect to have a surviving spouse "inherit" the deceased spouse's unused estate tax exemption amount—was touted
as providing additional simplicity. The results are anything but simple, however.

Portability became effective for married persons dying after 2010, and was scheduled to be eliminated from the tax system at the end of 2012. As a result, many did not view portability as significant.\(^1\) Now, the American Taxpayer Relief Act of 2012 (P.L. 112-240, 1/2/13) (ATRA) has made portability permanent. Temporary Regulations issued in June 2012 clarified-in many instances, in favorable ways-the applicable rules.\(^2\)

It is important for estate planners to be thoroughly familiar with portability. Although touted as a simplification, portability will make planning more complex for many clients because it is yet another option that requires analysis to determine whether relying on it, or at least preparing an estate plan that makes relying on it possible, is beneficial.

**BACKGROUND**

Since 1948, spouses effectively have been able to share in each other's lifetime gift tax exemptions by electing, under the gift-splitting provisions, to treat each other's gifts during a calendar year (other than those to each other) as having been made one-half by each of them.\(^3\) For example, if the wife is wealthier than the husband and they wish to make a large gift to their children, the wife, using her assets, can make the gift. The husband, by consenting to split gifts for the year, can allow his exemption to shelter one-half the gifts while the wife's exemption would shelter the other half. Gift-splitting similarly permits married couples to share in the lifetime use of their GST exemptions.\(^4\)

In contrast, until 2011 no direct mechanism permitted a married couple to use each other's estate tax exemptions when the first spouse died or to preserve the deceased spouse's unused exemption until the survivor died. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 first adopted a regime, known as "portability," which essentially permits the first spouse to die (hereinafter, the "first decedent") to "port" or transfer over to the surviving spouse the unused estate tax exemption of the first decedent. The surviving spouse may then use that exemption, known as the "deceased spousal unused exemption" (DSUE), either to make gifts during lifetime or to transfer property at death. Portability thus allows the surviving spouse to "inherit" and use as his or her own the first decedent's unused
exemption amount.

In fact, portability may be viewed as a paradigm shift in estate planning for married couples. Although it was promoted as a way to simplify estate planning, it may make it more complex and even costly in some cases. Portability also creates significant planning opportunities, especially for the very wealthy but also for the "merely" affluent. Various aspects of portability will be discussed below, along with guidelines as to when reliance on it may or may not be appropriate. This article also will suggest techniques for preserving flexibility and discuss alternatives.

PORTABILITY DETAILS

Portability is available only for married couples. For example, if the gross estate of an unmarried decedent is less than his or her remaining estate tax exemption, the unused exemption cannot be preserved for the use of anyone else, such as the decedent's descendants. Likewise, even if an unmarried decedent's gross estate (reduced by deductions for debts and expenses of administration) exceeds his or her estate tax exemption, the exemption cannot be preserved if his or her estate passes in a form qualifying for the estate tax charitable deduction. Most unmarried individuals die with estates lower in value than their unused estate tax exemptions. To that extent, their exemptions are wasted.

In the case of a married decedent, however, under the portability provisions the unused exemption can be preserved for use by the surviving spouse. The opportunity to use portability arises in essentially one of two ways.

First, the value of a first decedent's gross estate, reduced by deductions for debts, funeral expenses and expenses of administering his or her estate, may not be large enough to use his or her estate tax exemption in full. In that event, the unused exemption can be preserved for the surviving spouse if the first decedent's executors make a portability election on a timely filed Form 706 ("United States Estate (and Generation-Skipping Transfer) Tax Return").

For example, the first decedent's gross estate (reduced by deductions for debts and administration expenses) may be only $1 million. His or her estate tax exemption this year would be $5,250,000. Even if no part of the first decedent's estate qualifies for the estate tax marital or charitable deduction (such as if the first decedent leaves the entire $1 million to his or her descendants), $4,250,000 of exemption is not used. Accordingly, the surviving spouse may "inherit" the unused exemption if the first decedent's executors make a timely portability election.
Hence, regardless of the estate plan used (including one that uses a credit-shelter trust), portability can preserve the unused estate tax exemption of a married decedent of relatively modest wealth. ⁶

The second way in which portability can be used is to have the first decedent's estate pass in a form qualifying for the estate tax marital deduction (or at least have a sufficient portion of it so pass as to reduce the first decedent's taxable estate to less than the unused estate tax exemption). ⁷ In that event, the marital deduction will reduce the first decedent's taxable estate to an amount that is less than his or her estate tax exemption amount. Nevertheless, by filing an estate tax return and making a timely portability election, the first decedent's executors can "port" the unused exemption to the surviving spouse. The first decedent's unused exemption is thereby preserved for use by the survivor.

ATRA clarified how the DSUE amount is calculated. The DSUE amount with respect to a surviving spouse of a decedent dying after 2010 will be equal to the lesser of (1) the basic exclusion amount or (2) the excess of (a) the applicable exclusion amount of the last such deceased spouse of such surviving spouse over

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(b) the amount with respect to which the tentative estate tax is determined on the estate of such deceased spouse. By defining the second limitation by reference to the applicable exclusion amount (rather than the "basic exclusion amount") of the last deceased spouse, ATRA conformed the statutory language to what the Treasury already stated it believed to be the legislative intent of the portability rules. ⁸

PORTABILITY ADVANTAGES

Eight distinct advantages to portability can be identified.

Simplicity. As mentioned above, an alleged advantage of relying on portability is simplicity, at least in the eyes of many married couples. They may perceive that, rather than being bequeathed to a credit-shelter trust ⁹ equal to the otherwise unused estate tax exemption of the first decedent, portability permits the first decedent's assets to be left outright to the surviving spouse.

Although the first decedent's entire estate in that case will qualify for the marital deduction (provided that the surviving spouse is a U.S. citizen ¹⁰), the first decedent's unused exemption still can be inherited by the surviving spouse. Hence, many taxpayers may assume that a simple "sweetheart" form of will (or will substitute, such as a revocable trust) can be used. ¹¹ As will be seen, however, it will often be preferable, at a minimum, for the first decedent's estate to pass to a "qualified terminable interest property" (QTIP) trust
that can qualify for the estate tax marital deduction to the extent that the first decedent's executors elect. 12

**Basis step-up.** A second advantage of portability is that the assets acquired from the first decedent generally will receive a new (or second) automatic change in basis under Section 1014 when the surviving spouse dies. 13 To the extent, however, the property inherited from the first decedent will be consumed during the survivor's lifetime, no "second" automatic change in basis will occur.

Although that might make the second automatic change in basis appear unimportant, neither the performance of the assets nor the timing of the survivor's death can be predicted with certainty. Therefore, a second change in basis always has the potential to reduce future income taxes. If an amount equal to the unused estate tax exemption of the first decedent is placed into a credit-shelter trust that will not be included in the estate of the surviving spouse, no automatic change of basis will occur on the death of the surviving spouse. 14

**IRD tax-efficiency.** A third advantage arises where the estate of the first decedent includes sufficiently large amounts of IRD property that the first decedent's unused estate tax exemption would have to be funded with IRD property. If a credit-shelter trust is funded with rights to IRD, income taxes on the IRD will erode the wealth that ultimately passes to the couple's descendants at the death of the surviving spouse, in effect wasting exemption on assets used to pay income taxes. The DSUE amount, by contrast, is fixed as of the first decedent's death, so long as the surviving spouse does not fail to use up the DSUE amount prior to remarrying and surviving a second spouse. 15

**Market declines.** A fourth advantage of portability is that the DSUE amount is not reduced if the assets inherited from the first decedent decline in value. If the first decedent creates a credit-shelter trust, partial relief against market declines can be obtained by making the alternate valuation election under Section 2032. With proper (albeit sometimes complex) planning, the alternate valuation election will permit the burden of market declines to be shifted to the marital share that ultimately will be included in the surviving spouse's gross estate. 16

The alternate valuation election, however, cannot protect a credit-shelter trust against market declines that occur more than six months after the first decedent's death. And the alternate valuation election is not available unless both the gross estate and the estate tax are reduced. 17 The DSUE amount, by contrast, is fixed as of the death of the first decedent.

**Lower state exemption amount.** A fifth advantage of portability arises where the first decedent's estate could be subject to a state estate tax and the state exemption amount differs from (usually, is smaller than)
the federal estate tax exemption. In order to avoid state estate tax when the first decedent dies, the first decedent may wish to limit the share of his or her estate that does not qualify for the marital deduction (such as any share passing to a credit-shelter trust) to the state death tax exemption amount. By leaving the balance of his or her estate to the survivor in a form that qualifies for the estate tax marital deduction, no state estate tax should arise at the first decedent's death. 18

Even if assets qualifying for the marital deduction are ultimately included in the survivor's gross estate, state death taxes on such assets will be avoided altogether if, for example, the surviving spouse moves to a state, such as Florida, that does not have a state death tax. Planners who "hardwire" a couple's documents so that state death taxes will have to be paid at the first decedent's death, therefore, may face criticism if it turns out that such taxes had been paid unnecessarily.

**Avoiding state death tax.** Sixth, even if the surviving spouse dies in a state with a state death tax, portability can still be used to avoid state death tax on the first decedent's full federal exemption amount. 19 A gift by the survivor of the DSUE amount to the couple's descendants (except, perhaps, a gift by a surviving spouse domiciled in Connecticut, which is the only state with a gift tax, or of real or tangible personal property situated in Connecticut) normally will remove the property transferred from the state death tax base.

Thus, if the first decedent's executors elect portability and the surviving spouse uses up the DSUE amount during lifetime, state death tax on the entire federal estate tax exemption amount of the first decedent can be avoided. Further, as discussed below, the surviving spouse can to a significant extent retain beneficial access to the property that he or she transfers by gift in order to use up the DSUE amount.

**Grantor trusts.** A seventh advantage of portability is that it creates a simple way to "supercharge" the first decedent's exemption amount. That is, as discussed below, the surviving spouse can use the DSUE amount to fund a grantor trust for descendants, of which he or she will be treated as the owner for income tax purposes. For reasons discussed later, a grantor trust for descendants is likely to be more efficient from an estate and gift tax perspective than a conventional testamentary credit-shelter trust. Hence, as will be seen, portability opens up additional estate tax planning opportunities, at least for the very wealthy.

**Avoidance of funding formulas.** A final advantage of portability is that it permits a couple to avoid using "optimum" or "reduce-to-zero" funding formulas. In general, such formulas limit the property passing from
the first decedent that qualifies for the marital deduction to the smallest possible amount that will not cause estate tax to be due at the first decedent's death. Although long seen as a virtually inevitable consequence of sound estate tax planning, "optimum" formulas always have had drawbacks. They include:

- **Complexity.** Reduce-to-zero funding formulas are complex both in the manner in which they are expressed and in their administration. Tax-driven formulas in particular are unavoidably tied to provisions of the Code, making for highly technical drafting.

- **Administrative complexity.** A reduce-to-zero funding formula essentially divides the first estate's estate into multiple shares. Those shares must be initially calculated based on the first decedent's remaining exemption amount. With some types of formulas, such as "fractional" formulas, the shares also are a function of the value of the assets of the first decedent's estate. The shares may thereafter need to be recalculated every time that the marital or nonmarital share is funded. In some instances, such as where the first decedent had used up most of his or her exemption amount via lifetime gifts, the administrative costs of a reduce-to-zero formula may even exceed the actual amount of the nonmarital share.

- **Dispositive uncertainty.** A reduce-to-zero funding formula leaves it to Congress (and, in some cases, state legislatures) to fill in the terms of the first decedent's dispositive plan. This may have unintended consequences. In 2010, for example, several states passed legislation to correct the unintended consequences of tax-driven formulas. Some have contended that it can be difficult to predict the actions of Congress. Especially where marital and nonmarital shares have different beneficiaries, it may not be wise to permit politicians to have a say in how the first decedent's assets will be disposed of.

- **Gain recognition on funding.** With some types of reduce-to-zero formula clauses, the funding of the marital or nonmarital share with appreciated assets will cause the first decedent's estate to recognize capital gain.

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With portability, the foregoing drawbacks of reduce-to-zero funding formulas can be avoided.

**APPARENT DISADVANTAGES OF PORTABILITY**

Portability is alleged to have several disadvantages, a half dozen of which are identified below.

**GST exemption.** One alleged disadvantage is that the unused GST exemption of the first decedent is not
portable and will be lost (wasted) to the extent not otherwise used by him or her. By contrast, if property equal to the unused GST exemption of the first decedent passes to a credit-shelter trust, the GST exemption can be allocated to the credit-shelter trust. A credit-shelter trust, however, absorbs estate tax exemption and thereby restricts or eliminates the ability to port the first decedent's unused exemption to the surviving spouse. 22

Creditors' claims. A second alleged disadvantage is that assets passing outright to the surviving spouse will be subject to the claims of creditors of the survivor, including any subsequent spouse if the surviving spouse remarries. Such a subsequent spouse may have claims against the survivor in the event of divorce or death. Even if the couple resides in a state that exempts inherited property from claims in divorce, the couple may move to a state, such as Connecticut, where all property owned by either spouse, regardless of how or when acquired, is subject to division in the event of divorce. 23

Moreover, the burden to prove the "pedigree" of property, so that it is a type not subject to division in the event of divorce, is on the spouse making that claim. In a long-term marriage, that burden may prove difficult to overcome. In addition, in virtually all non-community-property jurisdictions, a surviving spouse will have a claim to a portion of the estate of a deceased spouse, even with respect to property that would not be subject to division if the marriage had ended in divorce. 24 Hence, even if the spouses in the first marriage agree that their property should pass exclusively to the descendants of their marriage, the "inheritance" rights of a subsequent spouse may prevent that from occurring.

Of course, the survivor could enter a prenuptial agreement with the new spouse. But that may not occur, and such an agreement might be challenged. Suffice it to say that placing the property of the first decedent into trust is most likely the best means to preserve it to the exclusion of any subsequent spouse or other creditor of the survivor.

Improvvidence. A third apparent disadvantage of portability is that, if assets are left outright to the surviving spouse, he or she will not be protected from "unwise" financial decisions, such as to fulfill a request for funds made by a friend or relative. 25

Lack of indexing. A fourth apparent disadvantage is that, unlike one's own estate and gift tax exemption, the DSUE amount ported over to the survivor is not indexed for inflation. Property passing from the first decedent may grow by the time the survivor dies. If the growth occurs within a credit-shelter trust that uses up all of the first decedent's estate tax exemption, more property will be protected from estate tax than if the first decedent's estate tax exemption is instead ported to the surviving spouse.
One study estimated that if the survivor lives for 15 years after the death of the first decedent, the additional wealth in the credit-shelter trust may exceed the inherited shelter by more than $2 million. That study assumed the first decedent dies after five years and the survivor lives another 15 years. Federal income taxes on the credit-shelter trust were taken into account.

**Estate tax credits.** A fifth apparent disadvantage occurs when the first decedent’s estate would be entitled to one or more estate tax credits (other than the unified credit). These credits would be wasted if the estate of that spouse does not generate any "gross" federal estate tax against which a credit can be applied. There can be no gross estate tax, however, unless the entire estate tax exemption is used, which will prevent any portability election from being made. Even if the first decedent's estate would not appear to be entitled to a credit (other than the unified credit), a credit may arise before death, such as a prior transfer credit arising from an inheritance from someone else.

**Remarriage forfeiture.** A sixth apparent disadvantage is that if the surviving spouse remarries and survives a second spouse, the DSUE amount of the first spouse, if not previously used to make gifts, is forfeited.

**PORTABILITY AND CONVENTIONAL PLANNING**

Many of the apparent disadvantages of portability can be overcome with proper planning. For example, a portability election does not necessarily mean that the GST exemption of the first decedent will be "wasted."

As mentioned above, unused GST exemption of the first decedent is not portable and will be lost to the extent not used by him or her. Hence, an individual who desires to avoid tax with

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respect to grandchildren or more remote descendants should probably make it possible for unused GST exemption to be allocated at his or her death.

Using GST exemption may seem unimportant where it is highly probable that the value of any property passing to grandchildren will never exceed the estate tax exemption of the person from whom the grandchild receives the property (such as a parent who is the child of the spouse dying first). Of course, by the time the first decedent's assets wend their way to grandchildren, they may have appreciated in value. And the first decedent's children might well acquire additional wealth or the amount of estate tax exemption of the grandchild's parent might be reduced.
If the first decedent's assets pass at least in part to a conventional credit-shelter trust, his or her GST exemption could be allocated to the credit-shelter trust. A credit-shelter trust, however, will reduce (or eliminate) the DSUE amount. As an alternative, which also preserves the ability to elect portability, the estate of the first decedent may pass into a QTIP trust \(^{31}\) that, by election, can be made to qualify for the estate tax marital deduction and, by another election, \(^{32}\) can allow the unused GST exemption of the spouse dying first to be allocated to that trust.

Because the trust to which the GST exemption is allocated qualifies for the marital deduction, the estate tax exemption of the first decedent can be preserved and ported over to the survivor. Moreover, because the QTIP trust will be included in the gross estate of the surviving spouse, the automatic change in basis of the trust's assets will occur on the death of the survivor. The survivor, by directing the estate tax on the trust to be paid out of other assets, such as the residue of the survivor's probate estate, also can prevent the GST-exempt QTIP trust from being depleted by estate tax.

To be sure, the income from a QTIP trust must be paid to the surviving spouse, which erodes the amount that can pass free of GST tax. It may be better, in order to maximize the property protected from GST tax, to use a credit-shelter trust, especially one that has been "supercharged." \(^{33}\) Alternatively, the surviving spouse can cause the income of a reverse QTIP trust to be accumulated for the benefit of descendants if he or she uses up the DSUE amount (and/or his or her "basic" exemption amount) by making a gift of the income interest in the QTIP trust to a trust for descendants. Such a gift, as will be discussed, enables income to be accumulated for the benefit of the couple's descendants yet remains effectively exempt from GST tax.

Second, a portability election does not mean that a couple must forgo creditor protection for the surviving spouse or protection against unwise financial decisions. On the contrary, if the first decedent leaves his or her assets in a QTIP trust, the assets (other than any income distributed to the survivor) will be protected both from the survivor's creditors and from any poor financial decisions that he or she might make if the assets were held outright. Hence, if there is any concern about subsequent creditors of the surviving spouse or his or her ability to manage assets prudently, a QTIP trust seems a better choice than an outright disposition.

Third, portability planning does not mean that a couple cannot take advantage of estate tax credits. For example, the first decedent could leave all of his or her assets to a trust that can qualify as QTIP to the extent his or her executors elect. If a credit, such as a foreign death tax credit, might be available to the first decedent's estate, the first decedent's executors could then fail to make the QTIP election and thereby
generate a gross tax against which the credit can be applied. But if no credit (other than the unified credit) were available, the executors could make the QTIP and portability elections and thereby cause the first decedent's unused estate tax exemption to be inherited by the surviving spouse.

Portability planning is likewise compatible with generating a prior transfer tax credit for the estate of the surviving spouse: if the survivor dies soon after the first decedent or has a condition that may significantly reduce his or her life, the first decedent's executors can deliberately fail to make the QTIP election and thereby generate a potentially significant prior transfer credit for the survivor's estate.

Finally, a portability election does not mean that a couple loses the opportunity to cause returns on the DSUE amount to pass free of estate tax at the survivor's death. If the survivor uses the DSUE amount to make a gift to or for the benefit of descendants, returns on the property transferred by gift can pass to descendants free of estate tax (and, if GST exemption is allocated, also free of GST tax), just as if the property had passed from the first decedent to a credit-shelter trust. (Meanwhile, as noted, the first decedent's GST exemption is not lost so long as it is allocated to a reverse QTIP trust.)

The funding of a credit-shelter trust, by contrast, often will carry out taxable income from the first decedent's estate. The gift also can be "supercharged" if it is made to a trust that is treated as owned for income tax purposes by the surviving spouse. Moreover, as discussed in detail below, it is even possible for the surviving spouse to make a gift of the DSUE amount yet still (1) retain a beneficial interest in the property transferred by gift and (2) preserve the first decedent's GST exemption.

**REAL DISADVANTAGES OF PORTABILITY**

Even though many of the alleged disadvantages of portability can be overcome, real disadvantages remain. Ironically enough, one such disadvantage may be complexity: as is seen throughout this article, there are many advantages to portability, but often they can be achieved only through additional planning.

**Income tax consequences.** Another disadvantage is that, if the first decedent fails to create a credit-shelter trust, significant opportunities for income tax planning may be lost. In general, with a portability election, all of the income earned on the assets passing from the first decedent to the surviving spouse will be taxed to the survivor and/or any marital trust for her benefit. The income tax planning opportunities of a discretionary credit-shelter trust include the ability to shift the trust's income over to any
trust beneficiary, which may include descendants of the couple, and thereby reduce or eliminate federal, state and/or local income taxes that otherwise would be imposed.

On the other hand, trusts are subject to the highest tax brackets at much lower thresholds than individuals. In addition, the level at which a trust's net investment income is subject to the Medicare surtax on investment income is much lower than for individuals. As noted, however, a trustee may, through discretionary distributions to the beneficiaries, be able to minimize the trust's and the beneficiaries' overall income tax burden.

That will not be possible or desirable, however, in all cases. For example, if GST exemption is allocated to a credit-shelter trust, it may be preferable for income to be accumulated in the credit-shelter trust for the ultimate benefit of skip persons, even if distributions could reduce the combined income tax burden of the trust and the beneficiaries.

706 must be filed. A third potentially adverse effect of portability is that, to elect portability, an estate tax return must be filed even if the return is not due. That may increase the costs of administering the first decedent's estate. On the other hand, in some cases, the IRS permits executors who file an estate tax return solely for purposes of electing portability not to report the value of the assets qualifying for the marital deduction.

Further, estates often choose to file a return, even though none is required, in order to commence the running of the statute of limitations for assessment of tax. Another reason, independent of portability, to prepare an estate tax return is that a pro forma federal estate tax return may need to be filed with a state taxing authority even if no return is required to be filed with the IRS.

Finally, many of the costs associated with preparing an estate tax return, such as valuing assets to determine their basis for income tax purposes, may need to be incurred even if no return is filed. Thus, the marginal additional cost of completing an estate tax return may not be as great as anticipated.

Effect of inherited exemption. It also may be unwise to rely entirely on portability if the first decedent inherited exemption from a prior spouse but did not make sufficient adjusted taxable gifts to use the inherited exemption in full. For example, if the first decedent has used none of the first decedent's own exemption and has inherited $3 million of DSUE from a prior spouse and dies in 2013 when the "basic" exemption amount is $5.25 million, then, under Section 2010(c)(4)(A), the maximum amount of
exemption that the first decedent's surviving spouse could inherit from the first decedent is $5.25 million. The first decedent, therefore, to the extent that he or she does not use the exemption inherited from a prior spouse by making lifetime gifts, should consider creating a credit-shelter trust at least equal to the remaining unused DSUE from the prior spouse. 40

Second marriages. Finally, as discussed below, portability may not be appropriate for a subsequent marriage situation.

PORTABILITY AND THE SUBSEQUENT MARRIAGE

The marital deduction for QTIP trusts was to some extent inspired by the fact that many Americans die in second or subsequent marriages with descendants from a prior union. Often, even in a subsequent marriage, the spouses will desire to provide for each other to the maximum extent possible and to postpone estate tax until the survivor dies. Before 1982, the ultimate disposition of property that qualified for the marital deduction in the estate of the first decedent was generally left to the discretion of the survivor. Since the enactment of the QTIP provisions, however, the first decedent has been able to have property passing at his or her death qualify for the marital deduction yet still control where the property goes when the surviving spouse dies. 41

Of course, in lieu of a QTIP trust, the spouses may promise that the survivor will leave equal shares of their combined wealth to the spouses' respective descendants. Sadly, such promises are not always kept, although they might be made enforceable with a marital agreement. If the survivor seeks to disregard the wishes of the first decedent, the first decedent's descendants may effectively be disinherited, in whole or in part, and considerable litigation may ensue after the survivor's death. 42

A similar conflict between the surviving spouse and the first decedent's descendants may arise if the first decedent's estate passes to a QTIP trust and the DSUE amount is ported to the surviving spouse. The surviving spouse in that case may decide to use the DSUE amount (as well as his or her own "basic" exemption amount) to protect transfers to his or her own descendants to the exclusion of the first decedent's. Meanwhile, the QTIP trust will be included in the estate of the surviving spouse under Section 2044. Section 2207A essentially provides that the increase in estate tax attributable to the inclusion of a QTIP trust in the survivor's gross estate must be paid out of the QTIP trust, unless the surviving spouse provides otherwise. Thus, even though the surviving spouse may not be able to divert the assets in the QTIP trust, he or she can still deny the remainder beneficiaries any benefit of the first decedent's estate tax
exemption.

Some might claim that any transfer to the surviving spouse could be conditioned on the survivor’s agreeing to pay estate taxes at the survivor’s death from other assets so that the DSUE amount will shelter the QTIP trust except to the extent used to make gifts in favor of the descendants of the first decedent. At a minimum, however, the imposition of such a condition would no doubt complicate the estate planning documents. The condition may also be difficult to enforce and there may be questions of whether such an agreement could cause gift, estate, or income tax issues to arise.\(^4\)

Moreover, the surviving spouse may not retain the DSUE if he or she remarries. In that event, the DSUE amount inherited from the first decedent will be lost if the second spouse predeceases the surviving spouse. (The surviving spouse might then acquire a new DSUE amount from the subsequent spouse, but only if the subsequent spouse does not use his or her own exemption, and his or her executors make the portability election.) Therefore, to ensure that the DSUE amount from the first decedent is actually used, the surviving spouse must use it before the subsequent spouse dies. If the survivor has descendants from a prior marriage, he or she may resist using the DSUE in favor of the first decedent’s family. The survivor might just prefer to let the DSUE amount expire when the subsequent spouse dies.

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For these reasons, using portability in a second or subsequent marriage likely is not a good choice. Rather, if the first decedent wishes to benefit the surviving spouse and ensure that his or her estate exemption is used for the benefit of his or her own descendants, a traditional credit-shelter trust should be considered.

**WHERE PORTABILITY MAY BE APPROPRIATE**

Although portability may not be appropriate in second or subsequent marriage situations, it may be appropriate in other situations.

Small first estate. Probably the most common circumstance where portability will be used is where the first decedent’s estate is too small to absorb his or her remaining estate tax exemption. In that instance,\(^4\) the only reason, it seems, for not electing portability is the cost of filing an estate tax return if none otherwise was due.

For example, if a married New Yorker dies without a will and no descendants, the whole of his or her estate will pass to the surviving spouse.\(^4\) It is likely, in that case, that the surviving spouse will become the
administrator of the estate of the first decedent. He or she can then decide whether to incur the cost of filing a return and electing portability. 46

A similar result may occur where all assets of the first decedent pass automatically to the survivor, such as where the spouses' property is held jointly with rights of survivorship or where the survivor is the successor owner of the first decedent's property (such as under the beneficiary designation of a qualified retirement plan, IRA, or life insurance). If a Form 706 return is filed and portability elected, the IRS may audit the return at any time for purposes of determining the DSUE amount, even after the period to assess estate tax has expired. Hence, the survivor's use of the DSUE amount at any time after the first decedent's death may effectively cause an audit of the first decedent's estate tax return. 47

**Very wealthy clients.** A second circumstance where portability may be appropriate is where a couple is extremely wealthy. In lieu of a conventional credit-shelter trust, the first decedent's unused exemption amount can be ported to the surviving spouse, who can then fund a grantor trust for the benefit of descendants. (To avoid wasting the first decedent's GST exemption, a "reverse" QTIP trust should be created for the surviving spouse under the first decedent's will or will substitute. The grantor trust for descendants should then be funded with assets other than those that pass to the reverse QTIP trust.) The grantor trust can then earn returns free of income tax during the surviving spouse's lifetime, even as the surviving spouse's estate is depleted by the income tax liability. 48

Over the survivor's remaining lifetime, the income tax liability on a grantor trust funded initially with, for example, $5.25 million (the maximum DSUE amount that currently can be ported to a surviving spouse) may be very significant. Indeed, it may be that the major downside of having the surviving spouse fund a grantor trust with the DSUE inherited from the first decedent is that the plan is "too" efficient, in that it will deplete the survivor's resources too rapidly. For all but the very wealthiest couples, therefore, it will be important to take steps, such as enabling grantor trust status to be "turned off," to ensure that a portability plan will not result in more wealth-shifting than he or she can afford. Nevertheless, it seems that a far more significant wealth shift would occur if the surviving spouse, prior to the first decedent's death, funded a grantor trust using both spouses' shelters and both spouses' GST exemption. Of course this would require "knowing" who will be the survivor.

**Flexibility regarding stepped-up basis.** A third instance where portability is appropriate arises where a couple is unsure whether, at the death of the surviving spouse, the benefits of a second change in basis will outweigh the benefits of permitting assets to pass free of estate tax. Such a couple may wish to preserve as much flexibility as possible. As discussed below, portability is itself an important flexibility tool, as the
surviving spouse can choose to use the DSUE amount at any time after the first decedent's death.

Further, through the use of QTIP trusts, it is possible for the surviving spouse to convert a marital trust that will be included in the surviving spouse's gross estate (and qualify for a change of income tax basis) into the equivalent of a credit-shelter trust that will not be so included (but will pass free of estate tax at the survivor's death). There will not be any loss of the first decedent's GST exemption, if allocated to the QTIP trust. A portability election combined with QTIP trusts thus enables a couple to decide at any time after the first decedent's death when the first decedent's exemption amount should be used.

**State death tax planning.** A fourth situation favoring portability occurs where the first decedent dies in a state whose estate tax exemption amount is lower than the federal estate tax exemption amount. In that case, as discussed previously, state death tax on the difference between the two exemption amounts can be deferred by leaving assets to the survivor in a form that qualifies for the marital deduction.

By not paying state death taxes at the first decedent's death, a couple ultimately may avoid such taxes altogether if, for example, the surviving

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spouse moves to a state that does not have a state death tax. Even if the surviving spouse does not relocate to such a state, state death taxes on the first decedent's federal estate tax exemption amount still can be avoided if the surviving spouse makes lifetime gifts equal to the DSUE. If the gifts are made to a self-settled trust or by an assignment of the income interests in one or more QTIP trusts, the survivor (as will be discussed below) need not lose all beneficial access to the assets transferred by gift.

**Small nonmarital share.** A fifth situation favoring portability occurs where the nonmarital share otherwise would be relatively small. For example, suppose that the first decedent made $900,000 of adjusted taxable gifts and dies domiciled in New York. If he or she creates a credit-shelter trust at death equal to the largest amount that can pass free of both federal and state estate tax, the credit-shelter trust's share of the estate will be at most $100,000. Creating such a small credit-shelter trust may not be worth the administrative costs.

For example, if the credit-shelter bequest is defined as a fractional share of the first decedent's estate, it may not be practicable or desirable to transfer a pro rata share of each asset of the first decedent's estate to the marital and nonmarital shares. Consequently all assets of the first decedent's estate may have to be revalued so that the shares can be properly funded. Rather than incur the cost of revaluing all assets, it may
be easier and more efficient to make a portability election and have the surviving spouse use the DSUE to make a gift of the credit-shelter amount.

**IRD assets.** A sixth case where portability may be preferred occurs where the first decedent cannot use his or her estate tax exemption amount without funding the nonmarital share at least in part with the right to IRD. As discussed previously, the income tax liability on IRD will erode the net wealth that can pass free of estate tax at the survivor’s death. Unless the credit-shelter trust can earn sufficient returns during the survivor’s lifetime to overcome the inherent income tax liability on IRD, porting the first decedent’s unused estate tax exemption amount to the surviving spouse may protect more of the couple’s wealth from estate tax at the survivor’s death. Whether this is true will depend on the life expectancy of the surviving spouse and the anticipated expenditure of the inherited assets during the surviving spouse’s lifetime.

**Older, childless couples.** A seventh example of where portability may be appropriate arises where a couple is likely to be beyond childbearing or adopting age and have no descendants. The couple may decide that they have little desire to save estate taxes and therefore will be content to leave all assets of the first decedent to the survivor. Especially if an estate tax return is required to be filed at the first decedent’s death, the first decedent’s executors may decide that there is no downside in making the portability election, even if the surviving spouse is not very interested in saving estate taxes.

Perhaps a final circumstance where portability may make sense is where the couple does not have children and it is very unlikely that the survivor will bear or adopt a child. That probability no doubt is much lower if the survivor’s chances of remarrying are low.50 Nothing is certain, however, so it may still be wise to include in the couple’s plans techniques, including the portability-related techniques discussed herein, that enable the first decedent’s unused exemption to shield property against tax at the survivor’s death.

**Summary.** Practitioners probably can expect to discuss with many married couples, especially those whose combined wealth will fall well below the amount of two estate tax exemptions, whether they should use a credit-shelter trust or rely on portability. It is probably reasonable to conclude that portability may or may not prove to be a wise choice. It may be better not to “hardwire” into a couple’s documents a plan that will force them either to use portability or reject it. Maintaining flexibility in an estate plan usually is wise and may be especially wise in managing the choice between relying on portability or not.

**DISCLAIMERS AND PORTABILITY**

One option that provides flexibility is to leave the entire estate of the first decedent to the survivor and, to the
extent appropriate for any reason, have the surviving spouse disclaim. The disclaimed property could then pass under the terms of the first decedent’s will into (for example) a credit-shelter trust for the survivor and, perhaps, the descendants of the couple.

Alternatively, for additional flexibility, the property disclaimed could first pass into a QTIP trust that can qualify for the marital deduction to the extent the first decedent’s executors elect. If the surviving spouse also disclaims his or her interest in the QTIP trust, the disclaimed property could then pass into a traditional credit-shelter trust. Such “cascading” disclaimers might provide great flexibility. It may be foolhardy, however, to rely on the surviving spouse to disclaim.

PARTIAL QTIP ELECTIONS

Another technique for preserving flexibility is to have the first decedent’s assets pass directly to a QTIP trust. The first decedent’s executors may then elect to qualify all, part, or none of the trust for the marital deduction. The determination of the extent of the marital deduction also will determine the extent to which first decedent’s estate tax exemption is used up at his or her death, which in turn determines how much unused exemption can be ported to the surviving spouse. Thus, if a six-month extension of time to file the first decedent’s estate tax return is obtained, the first decedent’s executors will have 15 months to decide the extent to which it is better to cause a portion of the first decedent’s estate to pass outside of the survivor’s gross estate or instead to be included in the survivor’s gross estate so that the assets (other than IRD) may qualify for a second change in basis.

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One downside of this type of planning is that the first decedent’s executors only have the limited period in which to make or not make a QTIP election. An additional downside of a partial QTIP election is that income from the portion that does not qualify for the marital deduction must (because the trust was designed to qualify for the marital deduction) be paid over to the surviving spouse, which increases the value of the surviving spouse’s property that potentially will be subject to estate tax.

CLAYTON QTIPs

Another important flexibility technique is known as a Clayton QTIP. The QTIP Regulations allow an estate tax marital deduction for property passing into a trust designed to qualify as QTIP, even if the will provides
that the property will pass in a form not qualifying for the marital deduction to the extent the executor does not make the QTIP election. 54

For example, if the executors fail to make the QTIP election, the property that otherwise would be held in a QTIP trust might pass instead to a discretionary credit-shelter trust. Unlike the case of property passing to a credit-shelter trust by reason of a disclaimer by the surviving spouse, with Clayton provisions the surviving spouse may control the benefits of the property in the nonmarital deduction trust. Nevertheless, the surviving spouse should not be the executor empowered to make (and not make) the election to have the property qualify for the marital deduction, as she or he may be deemed to make a gift to the extent the marital deduction is not elected. 55

Clayton QTIPs may provide great flexibility in determining the extent to which portability should be used. (One drawback, however, is that Clayton provisions may, depending on the terms of the trust for which the executors did not make the QTIP election, prevent the first decedent's executors, if they deemed it appropriate, from causing estate tax to be payable at the first decedent's death in a way that will enable the surviving spouse's estate to obtain a prior transfer tax credit under Section 2013.)

PORTABILITY ELECTION AS THE ULTIMATE FLEXIBILITY TECHNIQUE

As discussed above, disclaimers, partial QTIP elections, and Clayton provisions all can be used to defer the decision whether to use up the first decedent's exemption amount. A disadvantage of those techniques, however, is that they force a decision to be made relatively soon after the first decedent's death:

- A qualified disclaimer must be made by the surviving spouse within nine months of the first decedent's death. 56
- A QTIP election (or non-election) must be made on the first decedent's estate tax return, which is generally due nine months after the decedent's death (unless an extension is obtained). 57
- Similarly, the portability election must be made on a timely filed estate tax return. 58

If portability is elected, however, the surviving spouse is not forever "stuck" with an inheritance from the first decedent that will be included in the survivor's gross estate. On the contrary, as discussed, the surviving spouse may at any time after the first decedent's death choose to use up the DSUE amount by making lifetime gifts. As with a credit-shelter trust, such gifts can cause future returns on the first decedent's
exemption amount to pass free of both federal and state estate tax at the surviving spouse’s death. Further, if the gifts are made to a grantor trust, the surviving spouse, by substituting low-basis for high-basis assets, can achieve the equivalent of a second change in basis of the assets transferred to the trust. In this way, portability itself preserves flexibility: whereas a decision to use up the first decedent’s exemption via a credit-shelter trust is irreversible, the DSUE amount can be put to work at any time between the deaths of the two spouses.

Gifts that use up a surviving spouse’s DSUE amount may be perceived to have at least two drawbacks. First, to prevent gifts that use up the DSUE amount from being included in the surviving spouse’s gross estate at death, the surviving spouse must generally relinquish beneficial access to the gifts. Second, the first decedent’s GST exemption generally cannot be allocated to the surviving spouse’s gift of the DSUE amount.

Those drawbacks, however, can be overcome with proper planning. For example, rather than make a gift of conventional assets, such as cash or securities, the surviving spouse can make a gift of an income interest in one or more QTIP trusts created by the first decedent. 59 A gift of the income interest will cause the surviving spouse to be deemed to have transferred principal under Section 2519. Thus, if the surviving spouse has $5 million of DSUE and is the beneficiary of a QTIP trust worth $5 million, a gift of the income interest will cause the surviving spouse to have made gifts of both income and principal, i.e., the entire $5 million. 60 Thereafter, it seems that the surviving spouse may, without significant risk of gross estate inclusion, continue to receive principal of the QTIP trust in the discretion of an independent trustee. 61 Both future income and appreciation, in other words, can pass free of both federal and state estate tax at the surviving spouse’s death, even though the surviving spouse retains the ability to receive distributions of principal.

Meanwhile, if the first decedent’s GST exemption was allocated to the QTIP trust, it appears the trust will remain wholly exempt from GST tax, both as to principal 62 and as to the income that remains in the QTIP trust prior to distribution, 63 even after the surviving spouse’s gift of income and deemed gift of principal. To put it another way, a gift of a reverse QTIP trust, even though it is made by the surviving spouse, can be shielded by the first decedent’s GST exemption. In effect, a gift of an income interest in a reverse QTIP trust achieves an artificial form of portability of the first decedent’s GST exemption.

To summarize, if the portability election is made and the first decedent’s estate passes to one or more QTIP
trusts, the surviving spouse can, at any time after the first decedent's death, choose to cause the first
decedent's unused estate and GST tax exemptions to be held for the surviving spouse's benefit in a trust
that is similar to a credit-shelter trust, in that (1) income can be accumulated during the surviving spouse's
life, (2) distributions may be made to the surviving spouse in the discretion of an independent trustee, (3)
the trust property will not be included in the surviving spouse's gross estate, and (4) the first decedent's
GST exemption will make the trust effectively exempt from GST tax.

The reverse, as discussed, is not true: once a credit-shelter trust is created, even if the assets are
distributed to the surviving spouse so that they will be included in his or her gross estate, the surviving
spouse would not have a restored DSUE amount. By contrast, if the surviving spouse makes a taxable gift
of the DSUE amount that is included in the surviving spouse's gross estate, the DSUE amount would be
restored for use at death.

PORTABILITY, QTIP TRUSTS, AND REV. PROC. 2001-38

It seems that if portability is desired, using a QTIP trust may be a better choice than an outright distribution
to the surviving spouse. A question arises as to the effect of an unnecessary QTIP election, meaning one
not needed to reduce the estate tax to zero.

In Rev. Proc. 2001-38, 2001-1 CB 1335, the IRS ruled that the estate of the surviving spouse may apply to
"reverse" or "undo" a QTIP election made by the first decedent's executors, provided that the election was
unnecessary. As has been observed, undoing a prior QTIP election under Rev. Proc. 2001-38 prevents the
trust property from being included in the survivor's gross estate and thereby may enable the couple to avoid
state death tax on the first decedent's entire federal exemption amount. 64

For example, suppose the first decedent was domiciled in New York and directed that the amount by which
his or her federal estate tax exemption exceeded the New York exemption (limited to $1 million) should
pass into a separate QTIP trust (the "Excess Exemption QTIP Trust"). If the first decedent's executors
elected for that trust to qualify for the federal estate tax marital deduction, the Excess Exemption QTIP Trust
also would qualify for the New York marital deduction. At the survivor's death, his or her executors could
then apply to "undo" the QTIP election, which effectively would remove the Excess Exemption QTIP Trust
from the survivor's gross estate for both federal and New York estate tax purposes.

Prior to Rev. Proc. 2001-38, the first decedent faced a dilemma: (1) pay more New York estate tax when he
or she dies or (2) cause an increase in the gross estate of the surviving spouse because the full federal
estate tax exemption was not used. Portability now provides another way to avoid that same dilemma. A married New Yorker (if he or she has not made adjusted taxable gifts) may provide that only $1 million of his or her estate will not qualify for the estate tax marital deduction. Consequently, neither New York nor federal estate tax will be due. Thereafter, even if the surviving spouse remains domiciled in New York, New York estate tax can be avoided if the surviving spouse makes gifts that use up the DSUE amount.

Structuring the estate plan to use the separate Excess Exemption QTIP Trust makes it possible to rely on either portability or Rev. Proc. 2001-38 in order to avoid state estate tax on the difference between the federal and state exemption amounts. If an Excess Exemption QTIP Trust is created, the first decedent’s executor may elect to have the Excess Exemption QTIP Trust qualify for the marital deduction. With that election made, either (1) the surviving spouse (or his or her estate) may invoke

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Rev. Proc. 2001-38, if appropriate, when the surviving spouse dies and/or (2) the first decedent’s executors may make the portability election. Indeed, in theory, there could even be a double federal estate tax benefit: If the surviving spouse uses up the DSUE amount as well as his or her “basic” exemption amount and the QTIP election with respect to the Excess Exemption QTIP Trust is undone, the couple will be able to use the equivalent of three exemption amounts.

Nevertheless, it is likely (if not certain) that the IRS will rule either that (1) the Revenue Procedure may not be used if portability has been elected or (2) the inherited exemption will be disallowed if the Revenue Procedure is invoked. Of course, if the surviving spouse used the inherited exemption during lifetime, its use could not be effectively disallowed at the survivor’s death unless there was a “recapture” for estate tax purposes of the exemption so used during lifetime. It seems most likely that the IRS will simply deny the use of the Revenue Procedure if portability has applied during lifetime.

In deciding whether to use portability or Rev. Proc. 2001-38, practitioners need to take two additional considerations into account. First, if the Revenue Procedure is invoked, all appreciation of the Excess Exemption QTIP trust property between the deaths of the first decedent and the survivor will be excluded from the survivor’s gross estate. In contrast, if a portability election is made, such appreciation will be included in the survivor’s gross estate unless the surviving spouse makes gifts that use up the DSUE amount.

Second, if a couple relies on portability, the property inherited by the surviving spouse, including the Excess Exemption QTIP Trust, will receive an automatic change in income tax basis when the surviving spouse
dies. If the Revenue Procedure is invoked, by contrast, the basis of the Excess Exemption QTIP Trust will not be adjusted at the survivor's death.

Some have questioned whether a couple may intentionally plan to use Rev. Proc. 2001-38. It has been suggested that the Revenue Procedure may be invoked only if the estate of the surviving spouse establishes that making an unnecessary QTIP election was "inadvertent" and not done to enhance planning opportunities. There is no such limitation in the Revenue Procedure. Of course, the IRS could attempt to foreclose its use other than where the taxpayer can establish that the unnecessary election was inadvertent. In any event, as discussed, if the first decedent's estate passes to a QTIP trust and the QTIP election is made, both options would appear to be available: the first decedent's executors could either elect portability or instead not elect portability but rely on Rev. Proc. 2001-38 when the survivor dies. ⁶⁶

**GRANTOR TRUST STATUS AND PORTABILITY**

Grantor trusts are among the most powerful estate planning tools. Among other things, the grantor is liable for the income tax on the trust's income yet is not treated as making a gift by, in effect, paying the tax on the trust's behalf. ⁶⁶ To the extent the estate of the first decedent passes outright to the surviving spouse, the survivor can transfer those assets to a trust that is a grantor trust with respect to the survivor and use the inherited DSUE to protect the trust from gift tax. In addition, although this trust presumably will be structured not to be included in the gross estate of the surviving spouse, the survivor, prior to death, could substitute high-basis assets of his or her own for lower-basis assets of the trust and thereby obtain, in essence, a tax-free change in basis. ⁶⁷

A potential drawback of making a lifetime gift to a trust is that the survivor would lose access to the trust property unless the survivor is a beneficiary. A trust the survivor creates or settles for himself or herself (a "self-settled trust") will be included in his or her gross estate (thereby eliminating

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any benefit of grantor trust status) if he or she is entitled to the income, ⁶⁸ he or she retains the power to control the beneficial enjoyment of the trust property, ⁶⁹ or his or her creditors can attach the assets of the trust. ⁷⁰

Even if the grantor is a discretionary beneficiary, however, the property should not be so included if none of those "strings" exist. ⁷¹ That said, the survivor would have less access to and control over a self-settled trust
than a "standard" credit-shelter trust. In addition, a self-settled trust that is not included in the survivor's gross estate likely must be created under the laws of a limited number of jurisdictions.

Accordingly, the couple must balance whether transferring the DSUE amount to a grantor trust so it will grow free of income tax is sufficiently compelling to reduce the interest and control that the surviving spouse otherwise could have. They also must decide how confident they are that a self-settled trust created by the survivor will not be included in his or her gross estate at death. Finally, the couple should keep in mind that a credit-shelter trust created by the first decedent for the benefit of the surviving spouse probably could provide complete asset protection and other benefits of trust ownership.

Having the survivor create a grantor trust for descendants using the DSUE amount inherited from the first decedent probably should be considered only by couples with substantial wealth. And, if the couple is wealthy, it perhaps would be better for the survivor to use his or her own wealth to create a grantor trust rather than use the property inherited from the deceased spouse. At a minimum, if the first decedent's GST exemption has been allocated to a "reverse" QTIP trust, the assets of that trust should not be distributed to the surviving spouse, as the distribution would waste the first decedent's GST exemption.

For the most part, it is not possible for the first decedent's unused GST exemption to be allocated to a grantor trust that the surviving spouse creates for descendants. If the surviving spouse uses the DSUE amount by making a gift to a grantor trust of the income interest in a reverse QTIP trust, the income (when thereafter paid over to the grantor trust) probably would not continue to be shielded from GST tax by the first decedent's GST exemption. On the other hand, the principal of the reverse QTIP trust will continue to be shielded from GST tax. Nevertheless, although it appears that the income of the QTIP trust can be assigned to a grantor trust with respect to the surviving spouse, it would be difficult to cause the principal to be treated as owned by the surviving spouse for income tax purposes.

An alternative that may be safer than having the surviving spouse create a self-settled trust is to use a supercharged credit shelter trustSM. Such a trust also is a grantor trust with respect to the surviving spouse and may equal the unused estate tax exemption of the first spouse to die. Moreover, it is perhaps less likely that the IRS would contend that the supercharged trust is included in the estate of the surviving spouse than it would with respect to a self-settled trust.

Furthermore, the supercharged trust may permit the survivor to have greater interest and control than he or she could or should have over a grantor trust that the survivor could create after the death of the first
decedent, using the DSUE amount inherited by the survivor. Supercharged credit shelter trusts \textsuperscript{SM} also may provide greater opportunities for a change in basis of all the couple’s property when the first spouse dies, by making each trust revocable by the spouse who created it until it is certain which spouse will die first.

What the foregoing discussion of grantor trusts demonstrates is that planning to have the surviving spouse create a grantor trust is complicated. Certainly, it runs counter to the simplicity that was supposed to be the hallmark of portability. It likely should be considered only for families of substantial means. An impecunious surviving spouse likely could not afford to pay additional income tax generated from a grantor trust where the survivor will not be entitled to at least an amount equal to the income tax generated from the grantor trust. \textsuperscript{74}

**DIRECTION FOR OR AGAINST PORTABILITY**

As mentioned above, the executor of the first decedent’s will is empowered to make the portability election or not to make it. In some cases, an executor may refuse to make the election because of the additional cost of filing an estate tax return or from spite or other reasons. It is difficult to know if using portability will be wise or unwise. Directing that the election must be made or cannot be made may not be appropriate unless the surviving spouse will be named the executor and is viewed as likely to make the wisest decision whether to implement portability. \textsuperscript{76}

If a married person does not want a portability election, he or she can

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dispose of his or her estate in a manner that will use up his or her estate tax exemption. Of course, if the first decedent does not have adequate wealth to use his or her exemption, then an estate tax return presumably would not be required to be filed. It seems that the cost of filing, even if the return is not required to be filed, should be deductible for estate or income tax purposes, as the expenses seem to be ordinary and necessary costs of administering the decedent’s estate. \textsuperscript{76}

If the executor refuses to file the return or make the election for an insufficient reason, the surviving spouse may have recourse to the court having jurisdiction over the estate. The court might order the executor to file the return and make the election, or appoint the equivalent of a special executor who would be authorized to file the return and make the election. \textsuperscript{77}

It might be possible for the first decedent to direct that the executor must elect portability if the surviving
spouse so directs. It also seems that he or she could direct that the election will be made only if the survivor "pays" for the cost of filing the return (if not otherwise required to be filed) and making the election. Assuming the cost is an estate-tax-deductible expense, the taxable estate will not increase: although charging the expense to property otherwise passing to the surviving spouse would reduce the estate tax marital deduction, there presumably would be an offsetting estate tax administration expense deduction for the cost incurred in filing the return.

If the estate of the surviving spouse is so small that virtually nothing passes to the surviving spouse who wants to inherit the DSUE amount, perhaps a direction in the will that the survivor must pay for the cost of filing the return and making the election would not seem to generate taxable income to the estate. Presumably, the expense would be an administrative expense deductible for income tax purposes.

CONCLUSION

Portability can be an important tool for a married couple. It may be commonly used where the first decedent dies without a will or without having engaged in significant planning or where the estate of the first decedent is so small that the whole exemption of that spouse cannot be used. Portability also may provide some simplification for couples without significant wealth. Even couples of modest wealth, however, should consider having the first decedent leave his or her estate in QTIP trusts rather than outright to the surviving spouse. Yet that complicates rather than simplifies estate planning and administration.

At the other extreme, portability opens up significant planning opportunities for very wealthy couples. Such couples should consider relying on portability and having the surviving spouse make a gift of the DSUE amount to a grantor trust for descendants.

For couples who are "merely affluent," several factors may favor the use of portability (e.g., an automatic change in basis at death) but others at least at first appear to militate against it (e.g., potential loss of GST exemption of the first decedent). Many of the alleged shortcomings of portability, however (e.g., loss of the use of the GST exemption and creditor protection), can be overcome by using a QTIP trust. Portability combined with the use of QTIP trusts also can be used to save state death taxes.

Perhaps the most important lesson of portability is that a couple should preserve as much flexibility as possible and for as long as possible. Disclaimers, partial QTIP elections, and Clayton provisions provide substantial flexibility, although, as discussed, there will be only a limited period after the first decedent's death in which to employ these techniques. Further, a Clayton "election" probably should be made by an
independent executor.

Finally, the portability election itself creates significant flexibility, insofar as it gives the surviving spouse the choice for the balance of his or her lifetime either to use or not use the DSUE amount. If the surviving spouse is given the power to assign the income interests in one or more QTIP trusts to or for the benefit of descendants, he or she can in essence convert them at any time, including those that are GST exempt, into the equivalent of a credit-shelter trust. That creates, perhaps, the ultimate in portability planning flexibility.

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There were exceptions. See, e.g., Bramwell, "How to Use Portability to Avoid (Not Just Defer) State Death Taxes," LiSI Estate Planning Newsletter #1991 (7/24/12); ABA Real Property Trust & Estate Law Section's Estate and Gift Tax Committee, "Portability-Part One," available at www.americanbar.org/content/dam/aba/events/real_property_trust_estate/heckerling/2012/heckerling_report_2012_portability_part_one.authcheckdam.pdf.

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Section 2652(a)(2); Reg. 26.2652-1(a)(4). Once the "unlimited" gift tax marital deduction came into effect in 1982, one spouse could give property to the other without gift tax and the recipient spouse could make a gift of the property as a gift from him or her without the necessity of gift splitting; see Section 2523(a). Under current rules, however, a spouse may not use the gift tax marital deduction in making gifts to his or her spouse who is not a U.S. citizen; see Section 2523(i).
Freid, "Estate and Gift Rules: Some Clarity for Now," New York Times, 2/12/11 ("the new 'portability' feature that Congress added to simplify estate planning for married couples").

6

There is no true estate tax exemption. Rather, the exemption is essentially the amount of taxable estate a decedent may have that does not generate estate tax by reason of the unified or applicable credit allowed under Section 2010. Section 2010(c) uses the phrase "applicable exclusion amount" and not "estate tax exemption."

7

The unused estate tax exemption of the spouse dying first also can be preserved for the survivor by having the estate of the first spouse to die qualify for the estate tax charitable deduction under Section 2055(a). Even if the first decedent has substantial charitable intent, that likely would be suboptimal from a tax perspective. Rather than bequeathing the estate of the first decedent to charity, the estate could pass to the surviving spouse in a form qualifying for the marital deduction and the survivor could thereafter transfer it to charity. In both cases, there is no estate tax and the exemption is preserved. But in the second case (where the estate passes to the surviving spouse and the survivor transfers the property to charity), the survivor would be entitled to an income tax charitable deduction as well.

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See Section 2010(c)(4); Temp. Reg. 20.2010-2T(c)(1). See also Zaritsky and Zeydel, supra note 2.

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The trust is structured so that, even though the surviving spouse may benefit from the trust property, it will be sheltered from estate tax when the survivor dies, and is equal to the unused estate tax credit allowed under Section 2010.

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If the survivor is not a U.S. citizen, the marital deduction will be allowed only if the assets pass into qualified domestic trust (QDOT) described in Section 2056A; see Section 2056(d).
Other ways to have the entire estate of the spouse dying first pass outright to the surviving spouse are by operation of law if property is titled jointly between the spouses with a right of survivorship, under beneficiary designation forms applicable to some assets (such as an IRA or a life insurance policy) by which the successor is designated on a form, or through a "payable on death" account where the surviving spouse succeeds directly to the ownership of the asset.

See Section 2056(b)(7).

Not all assets included in the gross estate of an individual receive the automatic change in basis (often called the "income-tax-free step-up in basis"). For example, it does not apply to the right to income in respect of a decedent (IRD) described in Section 691; see Section 1014(c). In any event, there also could be a reduction in basis if the property declines in value by the time of the death of the surviving spouse.

A type of simulated change in basis, as will be discussed in the text, below, may be achieved by using a "supercharged credit shelter trust SM."


See Section 2032(c).

For more on this type of planning, see Bramwell, supra note 1.

The need for recalculation is most obvious when a "fractional" formula is used but is in fact present even where the marital or nonmarital share is defined as a pecuniary, preresiduary gift, as "separate shares" must then be calculated (and/or recalculated on a partial distribution) for income tax purposes. See Regs. 1.663(c)-2(b)(1) and 1.663(c)-5, Example 6.

See, e.g., N.Y.E.P.T.L. section 2-1.13.

The unused estate tax exemption may be greater than, the same as, or smaller than the unused GST exemption. See the discussion in Blattmachr, Gans, Zaritsky, and Zeydel, "Congress Finally Gives Us a Permanent Estate Tax," 118 JTAX 75 (February 2013).


See, e.g., Fla. Stat. section 732.201 et seq.


See Gassman, Crotty, Buschart, and Moody, "The $28,000,000 Mistake: Underestimating the Value of a Bypass Trust and Overestimating the Value of Spousal Estate Tax Exclusion Portability," LISI Estate Planning Newsletter #2061 (2/7/13), suggesting it could be much more where a credit-shelter trust is invested in Dow Jones Industrial Average securities.

For example, a decedent's estate may be entitled to a prior transfer credit under Section 2013 or a foreign tax credit under Section 2015.


From time to time, the federal estate tax exemption has declined. See www.irs.gov/pub/irs-soi/ninetyestate.pdf.

See Section 2056(b)(7).
See Section 2652(a). The election under this section is called the "reverse" QTIP election.

See Gans, Blattmachr, and Zeydel, "Supercharged Credit Shelter TrustSM," 21 Probate & Property 52 (July/August 2007).

Section 1(e).


Under Section 6018, an estate tax return must be filed if the gross estate of a U.S. citizen or domiciliary exceeds (1) the applicable exclusion amount (estate tax exemption) over (2) the sum of adjusted taxable gifts made after 1976 and the amount allowed as the "old" gift tax exemption under old Section 2521 between 9/8/76 and 12/31/76.


An adjusted taxable gift is a gift made after 1976 that is not included in the decedent's gross estate; see Section 2001(b).

As discussed in the next part of this article, a spouse who inherited estate tax exemption from a prior spouse is at risk of losing the DSUE amount if he or she survives a subsequent spouse. Under a special rule in Temp. Reg. 20.2010-3T(b), however, the DSUE amount from the prior spouse may be "locked in" with taxable gifts made prior to the subsequent spouse's death. A surviving spouse who inherits exemption and remarries, therefore, should consider making taxable gifts before the second spouse dies. A discussion of the many techniques for making taxable gifts in this circumstance is beyond the scope of this article.


Among other issues, it is unclear how the preservation of the DSUE amount would occur if the surviving spouse made taxable gifts. The DSUE amount is used before the survivor's own exemption is used and use of gift tax exemptions is not optional—they are used whenever taxable gifts are made. It could even be that the survivor is treated as having made an inadvertent gift. See, e.g., CCA 201208026.

It is understood that most adults (55%) in the U.S. do not have wills. See wiki.answers.com/Q/What_percentage_of_people_in_the_US_die_without_a_Will.

N.Y.E.P.T.L. section 4-1.1(a)(2).

This may not create any additional burden when compared to filing to elect portability, because if no return is filed the IRS could audit the estate and assess tax at any time. If no estate tax return is filed, however, the probability of an audit is likely to be very small in most cases.


New York's estate tax is equal to the lesser of (1) the tentative state death tax credit that would be calculated under Section 2011(b) and (2) the federal estate tax that would be due (under laws enacted through 7/22/98) if the exemption amount were $1 million. With $900,000 of adjusted taxable gifts and an exemption amount of only $1 million, a taxable estate of greater than $100,000 would generate a federal estate tax. Likewise, a tentative state death credit begins to be generated at taxable estates greater than $100,000.

"[R]emarriage rates among older widowers are fairly low, and even lower among older widows." See en.wikipedia.org/wiki/Remarriage#Remarriage_following_widowhood.

As Professor Jeffrey Pennell has observed, among the world's greatest lies are: (1) "The check is in the mail"; (2) "I'm from the government and I want to help you"; and (3) "Of course I'll disclaim if it will save taxes." Pennell, 843 T.M. (BNA), *Estate Tax Marital Deduction*, fn. 42.

Reg. 20.2056(b)-7(b)(2).


Section 2518(b)(2).

Section 6075(a).


This type of planning is explained in further detail in "Bramwell & Kanaga on PLR 201243004," LISI Estate Planning Newsletter #2040 (12/20/12); Bramwell, *supra* note 1; and Bramwell and Kanaga, "The Section 2519 Portability Solution," Trusts & Estates (June 2012). See also Bramwell, "Using Section 2519 to
The example assumes that the surviving spouse does not have a power over the trust, such as a special power of appointment, that may cause the deemed gift of principal to be incomplete for gift tax purposes; see Reg. 25.2511-2(b). In addition, a deemed transfer under Section 2519 is a transfer for purposes of Section 2036; see Reg. 25.2519-1(a). Thus, the surviving spouse should not have any power that would cause gross estate inclusion under either Section 2036(a)(1) or (2). For example, the surviving spouse should not have a power to make principal distributions (even if limited to an ascertainable standard) over the QTIP trust principal.

For further discussion of this point, see Bramwell and Kanaga, LISI Estate Planning Newsletter #2040, supra note 59, and the authorities cited therein.


Reg. 26.2652-1(a)(5), Example 4. It would seem, however, that the gift by the surviving spouse of the income interest, perhaps to a new trust, would not be sheltered by the principle that a Section 2519 transfer does not change the identity of the transferor for GST purposes. Section 2519, by its terms, addresses only the deemed gift of the corpus; see Reg. 25.2519-1(c). The gift of the income interest is taxable under Section 2511, and is therefore an independent gift by the surviving spouse that would, to retain its GST-exempt status, appear to require an allocation of GST exemption by the surviving spouse. Assuming the QTIP trust permits distributions of corpus to the surviving spouse, valuation of the income interest seems to be covered by Rev. Rul. 75-550, 1975-2 CB 357 (indicating that the value of an income interest is affected by anticipated distributions of corpus). Accordingly, caution would appear to dictate making an allocation of the surviving spouse's GST exemption to the recipient trust that acquires the gift of the income interest. If such an allocation is unnecessary, Reg. 26.2632-1(b)(4)(i) would render it void ("Except as provided in §26.2642-3 (relating to charitable lead annuity trusts), an allocation of GST exemption to a trust
is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust"). On the death of the surviving spouse, the income interest expires, and Example 4 supports the conclusion that the "unpaid income" remaining in the QTIP trust that would have funded the now-expired income interest are sheltered by the first decedent's GST exemption allocation. For example, suppose the surviving spouse assigns the income interest to a new trust and the income interest at the time of the assignment has an FMV of $1 million. The following year the surviving spouse dies and only $25,000 of income has been earned and paid to the new trust. It seems that the balance of the $1 million that would have funded the income interest had the surviving spouse lived out her life expectancy (which balance remains in the QTIP trust) continues to be sheltered by the first decedent's GST exemption.

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This is discussed more fully in Gans and Blattmachr, "Decoupling, Portability and Rev. Proc. 2001-38," LISI Estate Planning Newsletter #1965 (5/21/12).

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As explained in the article cited in note 33, supra, it may be better to secure a change in basis for the assets in the QTIP trust than to have them excluded from the gross estate of the survivor.

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See Section 2036(a)(1).
See Sections 2036(a)(2) and 2038.


See, e.g., Ltr. Rul. 200944002; Estate of German, 55 AFTR 2d 85-1577, 7 Cl Ct 641 (Clis. Ct., 1985).


See note 33, supra.

Rev. Rul. 2004-64, supra note 48, held that the grantor trust would be included in the gross estate of the grantor for federal estate tax purposes if the grantor was entitled to payments from the trust to "cover" the income tax on the trust's income attributed to the grantor under the grantor trust rules, or if the trustee was authorized but not required to reimburse the grantor for those income taxes where applicable state law allowed the grantor's creditors access to the trust on account of the reimbursement authority, or where there was an implied understanding that the trustee would reimburse the grantor.

Although a strong case can be made that an executor is empowered by federal law to make or not make the election, challenges to making federal tax elections have been made under state law. See, e.g., Matter of Schuman, N. Y. L. J. 12/23/09 (Surr. Ct. N.Y. County) (denying a petition by trustees of a QTIP trust to compel the decedent's preliminary executor to make an election to defer payment of estate tax under Section 6166). Even if the executor is not inhibited in making the election under state law, the executor might be sued for waste by incurring the cost of filing the return. It may be appropriate, therefore, expressly
to authorize the executor to do so.

See Section 2053 and Reg. 1.212-1(i).

§ 2056 Bequests, etc., to surviving spouse.

\[ N \] (a) FTC Estate PPC WG&L Treatises **Allowance of marital deduction.**

For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

\[ N \] (b) Estate PPC WG&L Treatises **Limitation in the case of life estate or other terminable interest.**

\[ N \] (1) FTC Estate WG&L Treatises **General rule.**

Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail, no deduction shall be allowed under this section with respect to such interest—

\[ N \] (A) FTC Estate WG&L Treatises if an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse); and

\[ N \] (B) FTC Estate WG&L Treatises if by reason of such passing such person (or his heirs or assigns) may possess or enjoy any part of such property after such termination or failure of the interest so passing to the surviving spouse;

and no deduction shall be allowed with respect to such interest (even if such deduction is not disallowed under subparagraphs (A) and (B))—

\[ N \] (C) FTC Estate WG&L Treatises if such interest is to be acquired for the surviving spouse, pursuant to directions of the decedent, by his executor or by the trustee of a trust.
For purposes of this paragraph, an interest shall not be considered as an interest which will terminate or fail merely because it is the ownership of a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity for life or for a term.

\[ w_3^{(2)} \text{ FTC Estate \ WD&L Treatises Interest in unidentified assets.} \]

Where the assets (included in the decedent's gross estate) out of which, or the proceeds of which, an interest passing to the surviving spouse may be satisfied include a particular asset or assets with respect to which no deduction would be allowed if such asset or assets passed from the decedent to such spouse, then the value of such interest passing to such spouse shall, for purposes of subsection (a), be reduced by the aggregate value of such particular assets.

\[ w_3^{(3)} \text{ FTC Estate \ PPP WD&L Treatises Interest of spouse conditional on survival for limited period.} \]

For purposes of this subsection, an interest passing to the surviving spouse shall not be considered as an interest which will terminate or fail on the death of such spouse if—

\[ w_3^{(A)} \text{ FTC Estate \ WD&L Treatises such death will cause a termination or failure of such interest only if it occurs within a period not exceeding 6 months after the decedent's death, or only if it occurs as a result of a common disaster resulting in the death of the decedent and the surviving spouse, or only if it occurs in the case of either such event; and} \]

\[ w_3^{(B)} \text{ FTC Estate \ WD&L Treatises such termination or failure does not in fact occur.} \]

\[ w_3^{(4)} \text{ FTC Estate \ PPP WD&L Treatises Valuation of interest passing to surviving spouse.} \]

In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—

\[ w_3^{(A)} \text{ FTC Estate \ WD&L Treatises there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession,} \]

https://checkpoint.riag.com/app/view/docText?usid=6a9a2y105807&DdocID=i0fc5c6e419d... 1/12/2015
legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and

\[ \frac{w_{20}}{w_{20}} \text{ FTC Estate WG\&L Treatises} \]  

where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

\[ \frac{w_{20}}{w_{20}} \text{ FTC Estate PPC WG\&L Treatises} \]  

Life estate with power of appointment in surviving spouse.

In the case of an interest in property passing from the decedent, if his surviving spouse is entitled for life to all the income from the entire interest, or all the income from a specific portion thereof, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire interest, or such specific portion (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the interest, or such specific portion, to any person other than the surviving spouse—

\[ \frac{w_{20}}{w_{20}} \text{ FTC Estate PPC WG\&L Treatises} \]  

the interest or such portion thereof so passing shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and

\[ \frac{w_{20}}{w_{20}} \text{ FTC Estate PPC WG\&L Treatises} \]  

no part of the interest so passing shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse.

This paragraph shall apply only if such power in the surviving spouse to appoint the entire interest, or such specific portion thereof, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

\[ \frac{w_{20}}{w_{20}} \text{ FTC Estate PPC WG\&L Treatises} \]  

Life insurance or annuity payments with power of appointment in surviving spouse.

In the case of an interest in property passing from the decedent consisting of proceeds under a life insurance, endowment, or annuity contract, if under the
terms of the contract such proceeds are payable in installments or are held by the insurer subject to an agreement to pay interest thereon (whether the proceeds, on the termination of any interest payments, are payable in a lump sum or in annual or more frequent installments), and such installment or interest payments are payable annually or at more frequent intervals, commencing not later than 13 months after the decedent's death, and all amounts, or a specific portion of all such amounts, payable during the life of the surviving spouse are payable only to such spouse, and such spouse has the power to appoint all amounts, or such specific portion, payable under such contract (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), with no power in any other person to appoint such amounts to any person other than the surviving spouse—

\[\text{(A) such amounts shall, for purposes of subsection (a), be considered as passing to the surviving spouse, and}\]

\[\text{(B) no part of such amounts shall, for purposes of paragraph (1)(A), be considered as passing to any person other than the surviving spouse.}\]

This paragraph shall apply only if, under the terms of the contract, such power in the surviving spouse to appoint such amounts, whether exercisable by will or during life, is exercisable by such spouse alone and in all events.

\[\text{Election with respect to life estate for surviving spouse.}\]

\[\text{(A) In general. In the case of qualified terminable interest property—}\]

\[\text{(I) for purposes of subsection (a), such property shall be treated as passing to the surviving spouse, and}\]

\[\text{(II) for purposes of paragraph (1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse.}\]

\[\text{(B) Qualified terminable interest property defined. For purposes of this paragraph—}\]
In general. The term "qualified terminable interest property" means property—

**(I)** FTC Estate WG&L Treatises which passes from the decedent,

**(II)** FTC Estate WG&L Treatises in which the surviving spouse has a qualifying income interest for life, and

**(III)** FTC Estate WG&L Treatises to which an election under this paragraph applies.

**(ii)** FTC Estate WG&L Treatises Qualifying income interest for life. The surviving spouse has a qualifying income interest for life if—

**(I)** FTC Estate WG&L Treatises the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and

**(II)** FTC Estate WG&L Treatises no person has a power to appoint any part of the property to any person other than the surviving spouse.

**Subclause (II)** shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

**(iii)** FTC Estate WG&L Treatises Property includes interest therein. The term "property" includes an interest in property.

**(iv)** FTC Estate WG&L Treatises Specific portion treated as separate property. A specific portion of property shall be treated as separate property.

**(v)** FTC Estate WG&L Treatises Election. An election under this paragraph with respect to any property shall be made by the executor
on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable.

Treatment of survivor annuities. In the case of an annuity included in the gross estate of the decedent under section 2039 (or, in the case of an interest in an annuity arising under the community property laws of a State, included in the gross estate of the decedent under section 2033) where only the surviving spouse has the right to receive payments before the death of such surviving spouse—

(i) the interest of such surviving spouse shall be treated as a qualifying income interest for life, and

(ii) the executor shall be treated as having made an election under this subsection with respect to such annuity unless the executor otherwise elects on the return of tax imposed by section 2001.

An election under clause (ii), once made, shall be irrevocable.

Special rule for charitable remainder trusts.

In general. If the surviving spouse of the decedent is the only beneficiary of a qualified charitable remainder trust who is not a charitable beneficiary nor an ESOP beneficiary, paragraph (1) shall not apply to any interest in such trust which passes or has passed from the decedent to such surviving spouse.

Definitions. For purposes of subparagraph (A)—

Charitable beneficiary. The term "charitable beneficiary" means any beneficiary which is an organization described in section 170(c).

ESOP beneficiary. The term "ESOP beneficiary" means any beneficiary which is an employee stock ownership plan (as defined in section 4975(e)(7)) that holds a...
remainder interest in qualified employer securities (as defined in section 664(g)(4)) to be transferred to such plan in a qualified gratuitous transfer (as defined in section 664(g)(1)).

Qualified charitable remainder trust. The term "qualified charitable remainder trust" means a charitable remainder annuity trust or charitable remainder unitrust (described in section 664).

Denial of double deduction.

Nothing in this section or any other provision of this chapter shall allow the value of any interest in property to be deducted under this chapter more than once with respect to the same decedent.

Specific portion.

For purposes of paragraphs (5), (6), and (7)(B)(iv), the term "specific portion" only includes a portion determined on a fractional or percentage basis.

Definition.

For purposes of this section, an interest in property shall be considered as passing from the decedent to any person if and only if—

1. such interest is bequeathed or devised to such person by the decedent;

2. such interest is inherited by such person from the decedent;

3. such interest is the dower or curtesy interest (or statutory interest in lieu thereof) of such person as surviving spouse of the decedent;

4. such interest has been transferred to such person by the decedent at any time;

5. such interest was, at the time of the decedent's death, held by such person and the decedent (or by them and any other person) in joint ownership with right of survivorship;
(6) W

G&L Treatises the decedent had a power (either alone or in conjunction with any person) to appoint such interest and if he appoints or has appointed such interest to such person, or if such person takes such interest in default on the release or nonexercise of such power; or

(7) FTC Estate W

G&L Treatises such interest consists of proceeds of insurance on the life of the decedent receivable by such person.

Except as provided in paragraph (5) or (6) of subsection (b), where at the time of the decedent's death it is not possible to ascertain the particular person or persons to whom an interest in property may pass from the decedent, such interest shall, for purposes of subparagraphs (A) and (B) of subsection (b)(1), be considered as passing from the decedent to a person other than the surviving spouse.

(d) FTC Estate W

G&L Treatises Disallowance of marital deduction where surviving spouse not United States citizen.

(1) Estate PPC W

G&L Treatises In general.

Except as provided in paragraph (2), if the surviving spouse of the decedent is not a citizen of the United States—

(A) FTC Estate W

G&L Treatises no deduction shall be allowed under subsection (a), and

(B) FTC Estate W

G&L Treatises section 2040(b) shall not apply.

(2) PPC W

G&L Treatises Marital deduction allowed for certain transfers in trust.

(A) FTC Estate W

G&L Treatises In general. Paragraph (1) shall not apply to any property passing to the surviving spouse in a qualified domestic trust.

(B) FTC Estate W

G&L Treatises Special rule. If any property passes from the decedent to the surviving spouse of the decedent, for purposes of subparagraph (A), such property shall be treated as passing to such spouse in a qualified domestic trust if—
the Federal estate tax paid (or treated as paid under section 2056A(b)(7)) by the
first decedent with respect to such property shall be allowed as a credit under
section 2013 to the estate of such surviving spouse and the amount of such
credit shall be determined under such section without regard to when the first
decedent died and without regard to subsection (d)(3) of such section.

Paragraph (1) shall not apply if—

the surviving spouse of the decedent
becomes a citizen of the United States before the day on which the return of
the tax imposed by this chapter is made, and

such spouse was a resident of the United
States at all times after the date of the death of the decedent and before
becoming a citizen of the United States.
Reformations permitted.

In general, in the case of any property with respect to which a deduction would be allowable under subsection (a) but for this subsection, the determination of whether a trust is a qualified domestic trust shall be made—

(i) as of the date on which the return of the tax imposed by this chapter is made, or

(ii) if a judicial proceeding is commenced on or before the due date (determined with regard to extensions) for filing such return to change such trust into a trust which is a qualified domestic trust, as of the time when the changes pursuant to such proceeding are made.

Statute of limitations. If a judicial proceeding described in subparagraph (A)(ii) is commenced with respect to any trust, the period for assessing any deficiency of tax attributable to any failure of such trust to be a qualified domestic trust shall not expire before the date 1 year after the date on which the Secretary is notified that the trust has been changed pursuant to such judicial proceeding or that such proceeding has been terminated.
characteristics of the territory are a consideration for the department under sec. 66.016, Stats.

Here the record shows the territory had a total area of approximately 12.5 square miles, including about 4.2 square miles of land. The trial court was correct in finding the 4 square mile minimum area requirement was met.

By the Court.—Order affirmed.

IN MATTER OF ESTATE OF BARR, Deceased: STATE, Appellant, v. BARR, and another, Respondents.

(Also reported in 233 N.W.2d 901.)

1. Taxation §554—Inheritance tax—trust instrument—distribution of income to granter’s widow according to specific directions—transfer as falling within statute imposing tax. Trust whereunder, upon death of granter, income was to be distributed to granter’s widow according to specific directions, fell within type of transfer defined by statute imposing tax when transfer is made without adequate and full consideration in money or money’s worth and is intended to take effect in possession or enjoyment at or after death of transferor (Stats §72.12).

2. Trusts §554—Construction of trusts—effectuating subjective intent of settlor. In construing trusts, both testamentary and inter vivos, language thereof should be construed so as to give effect to subjective intent of settlor.


Where there is no ambiguity inherent in trust document, subjective intent of settlor may be ascertained from language of trust document itself, considered in light of circumstances surrounding its drafting.

* See Callaghan’s Wisconsin Digest, same topic and section number.

4. Trusts §554—Construction of trusts—title to assets vested in trustees—mitigation against finding of absolute fee in settlor’s widow. Fact that title to trust assets was vested by settlor in trustees and not in settlor’s widow mitigated, in itself, strongly against finding of absolute fee in widow.

5. Taxation §554—Inheritance tax—trust instrument—distribution of income to granter’s widow according to specific direction—other provisions—construction for tax purposes as not having transferred absolute fee to widow. Trust whereunder, upon death of granter, income was to be distributed to granter’s widow according to specific directions, and provision was made for distribution of remaining principal and undistributed income, if any, to certain beneficiaries, would be construed, for purposes of inheritance taxation, not to have transferred an absolute fee to widow.

APPEAL from a judgment of the county court of Racine county: GILBERT N. GERAGHTY, County Judge. Affirmed.

The State of Wisconsin appeals from a judgment which determined the inheritance tax in the matter of the estate of Harry G. Barr, deceased.

For the appellant the cause was argued by E. Weston Wood, assistant attorney general, with whom on the brief was Bronson C. La Follette, attorney general.

For the respondents there was a brief by Foley & Capwell, S. C. and oral argument by John W. Foley, all of Racine.

CONNOR T. HANSEN, J. The single issue presented in this case is whether the trial court correctly determined that under the provisions of the trust document, the distributive share transferred to the widow was a life estate.

On July 7, 1972, Harry G. Barr (hereinafter grantor or settlor) established a revocable trust. Constance B. Barr, his wife (hereinafter widow), was to become a

* See Callaghan’s Wisconsin Digest, same topic and section number.
beneficiary under the terms of the trust. She and the First National Bank and Trust Company of Racine (hereinafter jointly referred to as respondents) were named as co-trustees. In pertinent part, the trust instrument provided:

"SECOND. A. Upon the death of the Grantor the Trustees shall pay and apply such amount or amounts of income and principal (even to the extent of all) as my Trustees may deem appropriate for the support, welfare and maintenance of my wife, Constance B. Barr. Said income and principal shall be distributed in such amounts as my Trustees deem proper, and my Trustees may disregard to the extent they deem appropriate other resources that she may have or the duty of any other person to provide for her, but my Trustees shall wholly disregard the interests of subsequent beneficiaries.

'B. Upon the death of my wife, Constance B. Barr, my Trustees shall transfer, assign and distribute the then remaining principal and undistributed income, if any, to my son, James C. Barr. If my son, James C. Barr should not survive the time set for distribution hereunder, I then direct that all of the rest, residue and remainder of the Trust Estate shall be distributed as follows:

'1. One-third (1/3) shall be transferred, assigned and distributed to my daughter-in-law, Geraldine Barr.

'2. Two-thirds (2/3) shall be transferred, assigned and distributed to the then-living descendants of my said son in equal shares, per stirpes.

'THIRD. In the event that my wife, Constance B. Barr, or her guardian if she should become incompetent or disabled, believes that the amount distributed to her by my Trustees is inappropriate for her welfare, support and maintenance when considered in connection with the financial condition of the Trust, and her needs and circumstances, I then direct that my said wife or her said guardian may, at any time, petition a court having jurisdiction over the Trust for a determination of what amount is appropriate to be paid to her out of the principal and income under the terms of the Trust. My Trustees shall, in no event, be held liable on account of the distributions that they have made to her or her guardian from

principal or income prior to a determination of an amount by the court."

The grantor died on May 1, 1974, without having revoked the trust. Surviving him were his widow and one son, James C. Barr. The respondents, as trustees, caused to be filed with the Wisconsin Department of Revenue an inheritance tax return for the estate of the settlor. The full value of the trust assets appears to have been $72,481.91. The actual valuation of the trust assets is not contested. The inheritance tax return reported the distributive share of the widow to be a life estate interest in the trust assets valued at $26,862.68, and the distributive share of the son to be the remainder interest valued at $45,619.23. The respondents determined that the total inheritance tax due was $3,290.73, and tendered that amount to the department of revenue.

The department of revenue informed the respondents that it interpreted the pertinent trust provisions to require that the entire trust estate should be taxed to the widow as the primary beneficiary. The department of revenue recomputed the total tax due as $4,102.99 and requested the payment of $712.26 as the difference between that amount and the amount previously tendered.

The respondents then filed a petition for a determination of inheritance tax pursuant to sec. 72.30 (4), Stats., seeking to settle the disagreement between the parties as to whether the value of the whole trust estate or only the value of a life estate therein should be taxed to the widow.

Following a hearing, the trial court made and filed its findings of fact and conclusions of law. The trial court concluded as a matter of law that the facts and language of the trust document did not justify a determination that the widow was receiving an absolute fee in the trust assets. Judgment was entered accordingly in which it was ordered and adjudged:
In Matter of Estate of Barr, 78 Wis. 2d 254.

"That Constance B. Barr, widow of Harry G. Barr has received only a life estate under the Harry G. Barr Revocable Trust, and said widow may not be taxed under the Wisconsin Inheritance Tax on more than a life interest in the corpus of said trust as it was constituted as of the date of the death of Harry G. Barr."

[1]

The parties do not dispute the fact that a transfer such as would trigger the imposition of the tax has occurred in this case. The revocable trust established by the settlor, the income of which was to be distributed to the widow according to specific directions subsequent to the settlor’s death, falls within the type of transfer defined by sec. 72.12(4)(b), Stats. The parties further do not dispute the relationship existing between the settlor and the beneficiaries. The controversy is based upon a determination of the nature of the interests which were transferred to the widow and son upon the death of the settlor.

It is not contended that any ambiguity exists in the provisions of the trust document or in the trust document when viewed as a whole. The trial court found no ambiguity. We likewise conclude that the trust document is not ambiguous.

[2, 3]

This court has held that in construing trusts, both testamentary and inter vivos, the language thereof should be construed so as to give effect to the subjective intent of the settlor. In re Fortwin Trust, 57 Wis.2d 184, 188, 203 N.W.2d 711 (1973); In re Bowler Trust, 56 Wis.2d 171, 176, 177, 201 N.W.2d 573 (1972); Estate of Gehl, 39 Wis.2d 206, 211, 159 N.W.2d 72 (1967); Welch v. Welch, 235 Wis. 282, 290, 223 N.W. 150 (1933); Luecke v. Thiers, 238 Wis. 451, 458, 211 N.W. 188 (1927). Where there is no ambiguity inherent in the trust document, that intention may be ascertained from the language of the trust document itself, considered in light of the circumstances surrounding its drafting.

Tomow v. N. & E. Isaacson & Associates, Inc., 60 Wis.2d 1, 24, 203 N.W.2d 824 (1973); In re Fortwin Trust, supra, 188; Estate of Breese, 7 Wis.2d 422, 426, 96 N.W.2d 712 (1959).

Thus, a determination of the interests transferred to the widow and son is dependent upon the clear meaning of the trust document.

[4]

The appellant contends that the widow received an absolute fee in the trust assets because the trustees could, in their discretion, transfer portions of the principal to her. There is a possibility that portions of the principal, and indeed the whole of the principal could be transferred to the widow. The fact remains, however, that title to the trust assets was vested by the settlor in the trustees and not in the widow. See: In re Mueller Travel Agency, Inc., 56 Wis.2d 207, 201 N.W.2d 589 (1972).

That in itself strongly mitigates against a finding of an absolute fee in the widow.

The trustees could transfer portions of the principal to the widow only if they determined in their discretion that such amounts were appropriate for the support, welfare and maintenance of the widow during her lifetime. The decision lay with the trustees and not with the widow.

The appellant concedes that in view of the provisions of sec. 701.19, Stats., the widow, although a trustee, could not participate in any decision by the trustees whether to make a distribution of principal or income to her. The fact that the trustees were empowered to disregard the interests of the remainderer in making the determination to distribute portions of the principal to the widow does not lessen the fact that such distribution lay solely within their discretion. Nor does it lessen the fact that the trustees were not required at any time to transfer the entire trust assets to the widow.

Moreover, the content of the quoted THIRD provision of the trust document, enabling the widow to resort to
court intervention in the event that she believed that amounts distributed to her were inappropriate, is merely a recitation of an already existing right of the widow to challenge what she may believe is an abuse of the discretion vested in the trustees. That provision does not relieve the trustees of their discretionary power and vest control of the trust assets in either the widow or the court. It merely makes the exercise of their discretion subject, as it is in any event, to court review.

If the settlor had intended to transfer an absolute fee in the trust assets to his widow, he could have and no doubt would have done so directly, without resorting to vesting title to the trust assets in the trustees. Had the settlor intended the above result there would have been little if any need for this trust. Moreover, there would have been no need to designate a remainderman to take the residue. The further fact that the settlor did not indicate that the trust assets were to be transferred to the widow at a certain time or upon a certain happening, irrespective of the trustee's discretion, reflects an intent to create merely a life estate in the widow.

In II Scott on Trusts (3d ed.), sec. 128.4, pp. 1018, 1019, it is stated:

"§128.4. Trusts for support. Where by the terms of the trust it is provided that the trustee shall pay to or apply for a beneficiary only so much of the income and principal or either as may be necessary for the support of the beneficiary, the extent of the interest of the beneficiary depends upon the manifestation of intention by the settlor. The court will not interfere to control the discretion of the trustee as long as he acts within the bounds of a reasonable judgment in the exercise of his discretion, but the court will interfere when he exceeds those bounds. As to the amount which the trustee may or should expend for the support of the beneficiary, much depends upon the circumstances. In the first place, the will may indicate the character of the support to be given, as for example where the settlor specifies that the support shall be good or comfortable or generous. Much depends, of course, on the size of the trust estate, on the condition in life of the beneficiary, on the extent of the discretion conferred upon the trustee."

See also: Restatement, Trusts, 2d, sec. 128, pp. 276-280.

In the case before us, the record reflects that the widow was seventy-six years of age and in good health at the time of the settlor's death, and that she was the beneficiary of a revocable trust which she had established on July 7, 1972. Her trust was valued at approximately $120,000 on December 31, 1974. No principal from the trust created by the settlor had been paid to Mrs. Barr up to the date of the death of the settlor.

[5] Under the facts of this case we conclude that the language of the trust document indicates that the settlor intended to insure an appropriate amount of support for his widow during her lifetime. Whether the income alone would be sufficient to meet the needs of the widow, or whether the principal would have to be invaded, were decisions left to the discretion of the trustees, and decisions over which the widow had no control. It is clear that the settlor intended that any remaining assets and undistributed income were to pass to the designated remainderman. The widow had no measure of control to direct the passage of assets upon her death. The widow had no absolute right to the assets. The whole plan of the trust reflects the fact that the settlor intended that the widow receive nothing more than a life estate in the trust. There was no transfer of an absolute fee to the widow.

We do not deem it necessary to discuss in detail the financial status of the widow independent of the trust. What in fact may or may not occur in the future in regard to principal distribution has no bearing on ascertaining the subjective intent of the settlor as to the interest in his estate transferred to his widow.
Also, we are not impressed by the argument of the appellant that there is no method of determining the widow's interest in the estate unless the tax is imposed upon the full value of the trust. The trial court accepted the respondents' valuation of the trust assets. The correctness of the figures used by respondents in determining the tax are not in dispute. We are of the opinion that sec. 72.28(1)(c), Stats., provides a method for the valuation of the widow's limited estate and the son's future estate. Since the mathematical result of the use of this method is not challenged, we need address the issue no further.

By the Court.—Judgment affirmed.

1 Sec. 72.28(1)(c), Stats., governs the valuation of future or limited estates:
(c) Future or limited estates. 1. Method of valuation. a. Determination of the value of every future or limited estate, income, interest or annuity dependent upon any life or lives in being shall be based on tables designated by the department. These tables shall be those used by the internal revenue service for like computations.
b. If valuation cannot be established under subd. 1.a, the commissioner of insurance, upon application of the department or county court, shall determine the value. The commissioner's report shall be presumptive evidence that his method of computation is correct.
§ 1014 Basis of property acquired from a decedent.

Wax (a) FTC Estate Pen & Ben Analysis PPC WG&L Treatises In general.

Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—

Wax (1) FTC Estate WG&L Treatises the fair market value of the property at the date of the decedent's death,

Wax (2) FTC Estate PPC WG&L Treatises in the case of an election under section 2032, its value at the applicable valuation date prescribed by such section,

Wax (3) FTC Estate WG&L Treatises in the case of an election under section 2032A, its value determined under such section, or

Wax (4) FTC Estate New Law Analysis PPC WG&L Treatises to the extent of the applicability of the exclusion described in section 2031(c), the basis in the hands of the decedent.

Wax (b) FTC Estate PPC WG&L Treatises Property acquired from the decedent.

For purposes of subsection (a), the following property shall be considered to have been acquired from or to have passed from the decedent:

Wax (1) FTC Estate WG&L Treatises Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;

Wax (2) FTC Estate WG&L Treatises Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;
In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;

Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;

In the case of decedents dying after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, if the property consists of stock or securities of a foreign corporation, which with respect to its taxable year next preceding the date of the decedent's death was, under the law applicable to such year, a foreign personal holding company. In such case, the basis shall be the fair market value of such property at the date of the decedent's death or the basis in the hands of the decedent, whichever is lower;

In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939;

Repealed.

Repealed.

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) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent. Such basis shall be applicable to the property commencing on the death of the decedent. This paragraph shall not apply to—

(A) FTC Estate WG&L Treatises annuities described in section 72;

(B) FTC Estate property to which paragraph (5) would apply if the property had been acquired by bequest; and

(C) FTC Estate WG&L Treatises property described in any other paragraph of this subsection.

Property includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed). In any such case, the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).

Property representing income in respect of a decedent.

This section shall not apply to property which constitutes a right to receive an item of income in respect of a decedent under section 691.

Special rule with respect to DISC stock.

If stock owned by a decedent in a DISC or former DISC (as defined in section 992(a)) acquires a new basis under subsection (a), such basis (determined before the application of this subsection) shall be reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date. In computing the gain the decedent would have had if he had lived and sold the stock, his basis shall be determined without regard to the last sentence of section 996(e)(2) (relating to reductions of basis of DISC stock). For purposes of this subsection, the
estate tax valuation date is the date of the decedent's death or, in the case of an election under section 2032, the applicable valuation date prescribed by that section.

Appreciated property acquired by decedent by gift within 1 year of death.

In general.

In the case of a decedent dying after December 31, 1981, if—

Appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death, and

such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor),

the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

Definitions.

For purposes of paragraph (1)—

Appreciated property. The term "appreciated property" means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.

Treatment of certain property sold by estate. In the case of any appreciated property described in subparagraph (A) of paragraph (1) sold by the estate of the decedent or by a trust of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.
Rev. Rul. 66-283, 1966-2 CB 297, IRC Sec(s). 1014

Headnote:

Rev. Rul. 66-283, 1966-2 CB 297 -- IRC Sec. 1014 (Also Sections §2033, §2036, §
2038, §20.2033-1, §20.2036-1, §20.2038-1.)

Reference(s): Code Sec. 1014; Reg § 1.1014-2

A husband and wife transferred their California community property to a revocable trust, reserving to themselves a life income interest therein. Upon the death of one of the spouses, one-half of the value of the community interest in the property held in the trust is includible under §§2033, 2036(a)(1) and 2038(a)(1) of the Internal Revenue Code of 1954 in determining the value of the decedent's gross estate. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under §section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and its basis is determined in accordance with the provisions of § section 1014(a) of the Code.

Full Text:

Advice has been requested with respect to the application of §section 1014(b)(6) of the Internal Revenue Code of 1954 to the income tax basis of a surviving spouse's one-half interest in California community property which has been transferred to a revocable trust.

$H$ and $W$ are husband and wife and domiciliaries of the State of California. Under California community property law a husband and wife may by agreement characterize their property as community or separate. Section 158 of the California Civil Code; Mears v. Mears (1960) 4 Cal. Rptr. 618; Tomaier v. Tomaier (1944) 146 P. 2d 905. Under California law, community property may also be held by a trustee without losing its character as such. Berniker v. Berniker (1947) 182 P. 2d 557. In 1958 $H$ and $W$ executed a revocable trust and transferred to it certain property held by them as community property under the laws of California. The trust instrument provides that the property transferred to the trust shall retain its character as community property. Under the terms of the trust, $H$ and $W$, as long as both
are alive, may at any time alter, amend or revoke the trust in whole or in part, provided that any part of the trust estate so withdrawn shall be transferred to H and W as community property. The net income from the trust is community property, and is to be paid to or applied for the benefit of the grantors.

Upon the death of either H or W, the trust estate is to be divided into two equal shares, each to be held and administered as a separate trust. One share is to consist of the community interest of H, and the other of the community interest of W. During the lifetime of the survivor, the trustee is to pay to the survivor all of the net income from his or her share, and to pay to the survivor and another designated beneficiary the net income from the decedent’s share. The trust consisting of the community interest of the decedent is to be irrevocable, but the trust consisting of the survivor’s community interest may be altered, amended, or revoked by the survivor at any time.<Page 298>

One of the spouses died in 1965. As of the date of the decedent’s death, the trust had not been altered, amended or revoked.

Section 1014(b)(6) of the Code provides, in pertinent part, that in the case of decedents dying after December 31, 1947, property which represents the surviving spouse’s one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, is considered, for purposes of section 1014(a) of the Code, to have been acquired from or to have passed from the decedent if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent’s gross estate under chapter 11 of subtitle B (sec. 2001 and following, relating to estate tax).

Section 676(a) of the Code, dealing with power to revoke, treats the grantor as the owner of any portion of a trust where he has at any time the power to vest in himself title to such portion. Section 671 of the Code provides, generally, that where the grantor is treated as the owner of any portion of a trust under subpart E (sec. 671 and following), part I, subchapter J, chapter 1 of the Code, the items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust shall be included in computing the taxable income and credits of the grantor.

For purposes of section 1014(b)(6) of the Code, H and W are considered as continuing to own the property transferred by them to the revocable trust as their community property.
Under section 2033 of the Code the value of the gross estate includes the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a)(1) of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death the possession or enjoyment of, or the right to the income from, the property.

Section 2038(a)(1) of the Code provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time after June 22, 1936, made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death.

In this case, one-half of the value of the community interest in the property held in the revocable trust is includible under sections 2033, 2036(a)(1), and 2038(a)(1) of the Code in determining the value of the gross estate of the first spouse to die, because both spouses had retained for their lives the right to the income from the community property held in the trust and possessed at the date of the decedent spouse's death a power to alter, amend or revoke the trust. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and, accordingly, its basis is determined under the provisions of section 1014(a) of the Code.
Syllabus

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued.
The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader.

SUPREME COURT OF THE UNITED STATES

Syllabus

UNITED STATES v. WINDSOR, EXECUTOR OF THE ESTATE OF SPYER, ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT


The State of New York recognizes the marriage of New York residents Edith Windsor and Thea Spyer, who wed in Ontario, Canada, in 2007. When Spyer died in 2009, she left her entire estate to Windsor. Windsor sought to claim the federal estate tax exemption for surviving spouses, but was barred from doing so by §3 of the federal Defense of Marriage Act (DOMA), which amended the Dictionary Act—a law providing rules of construction for over 1,000 federal laws and the whole realm of federal regulations—to define “marriage” and “spouse” as excluding same-sex partners. Windsor paid $363,053 in estate taxes and sought a refund, which the Internal Revenue Service denied. Windsor brought this refund suit, contending that DOMA violates the principles of equal protection incorporated in the Fifth Amendment. While the suit was pending, the Attorney General notified the Speaker of the House of Representatives that the Department of Justice would no longer defend §3’s constitutionality. In response, the Bipartisan Legal Advisory Group (BLAG) of the House of Representatives voted to intervene in the litigation to defend §3’s constitutionality. The District Court permitted the intervention. On the merits, the court ruled against the United States, finding §3 unconstitutional and ordering the Treasury to refund Windsor’s tax with interest. The Second Circuit affirmed. The United States has not complied with the judgment.

Held:

1. This Court has jurisdiction to consider the merits of the case. This case clearly presented a concrete disagreement between opposing parties that was suitable for judicial resolution in the District Court, but the Executive’s decision not to defend §3’s constitutionali-
ty in court while continuing to deny refunds and assess deficiencies introduces a complication. Given the Government's concession, amicus contends, once the District Court ordered the refund, the case should have ended and the appeal been dismissed. But this argument elides the distinction between Article III's jurisdictional requirements and the prudential limits on its exercise, which are "essentially matters of judicial self-governance." *Warth v. Seldin*, 422 U.S. 490, 500. Here, the United States retains a stake sufficient to support Article III jurisdiction on appeal and in this Court. The refund it was ordered to pay Windsor is "a real and immediate economic injury," *Hin v. Freedom From Religion Foundation, Inc.*, 551 U.S. 587, 599, even if the Executive disagrees with §3 of DOMA. Windsor's ongoing claim for funds that the United States refuses to pay thus establishes a controversy sufficient for Article III jurisdiction. Cf. *INS v. Chadha*, 462 U.S. 919.

Prudential considerations, however, demand that there be "concrete adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult constitutional questions." *Baker v. Carr*, 369 U. S. 186, 204. Unlike Article III requirements—which must be satisfied by the parties before judicial consideration is appropriate—prudential factors that counsel against hearing this case are subject to "countervailing considerations [that] may outweigh the concerns underlying the usual reluctance to exert judicial power." *Warth*, supra, at 500–501. One such consideration is the extent to which adversarial presentation of the issues is ensured by the participation of amici curiae prepared to defend with vigor the legislative act's constitutionality. See *Chadha*, supra, at 940. Here, BLAG's substantial adversarial argument for §3's constitutionality satisfies prudential concerns that otherwise might counsel against hearing an appeal from a decision with which the principal parties agree. This conclusion does not mean that it is appropriate for the Executive as a routine exercise to challenge statutes in court instead of making the case to Congress for amendment or repeal. But this case is not routine, and BLAG's capable defense ensures that the prudential issues do not cloud the merits question, which is of immediate importance to the Federal Government and to hundreds of thousands of persons. Pp. 5–13.

2. DOMA is unconstitutional as a deprivation of the equal liberty of persons that is protected by the Fifth Amendment. Pp. 13–26.

(a) By history and tradition the definition and regulation of marriage has been treated as being within the authority and realm of the separate States. Congress has enacted discrete statutes to regulate the meaning of marriage in order to further federal policy, but DOMA, with a directive applicable to over 1,000 federal statutes and
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the whole realm of federal regulations, has a far greater reach. Its operation is also directed to a class of persons that the laws of New York, and of 11 other States, have sought to protect. Assessing the validity of that intervention requires discussing the historical and traditional extent of state power and authority over marriage.

Subject to certain constitutional guarantees, see, e.g., Loving v. Virginia, 388 U. S. 1, “regulation of domestic relations” is “an area that has long been regarded as a virtually exclusive province of the States,” Sosna v. Iowa, 419 U. S. 393, 404. The significance of state responsibilities for the definition and regulation of marriage dates to the Nation’s beginning; for “when the Constitution was adopted the common understanding was that the domestic relations of husband and wife and parent and child were matters reserved to the States,” Ohio ex rel. Popovici v. Agler, 280 U. S. 379, 383–384. Marriage laws may vary from State to State, but they are consistent within each State.

DOMA rejects this long-established precept. The State’s decision to give this class of persons the right to marry conferred upon them a dignity and status of immense import. But the Federal Government uses the state-defined class for the opposite purpose—to impose restrictions and disabilities. The question is whether the resulting injury and indignity is a deprivation of an essential part of the liberty protected by the Fifth Amendment, since what New York treats as alike the federal law deems unlike by a law designed to injure the same class the State seeks to protect. New York’s actions were a proper exercise of its sovereign authority. They reflect both the community’s considered perspective on the historical roots of the institution of marriage and its evolving understanding of the meaning of equality. Pp. 13–20.

(b) By seeking to injure the very class New York seeks to protect, DOMA violates basic due process and equal protection principles applicable to the Federal Government. The Constitution’s guarantee of equality “must at the very least mean that a bare congressional desire to harm a politically unpopular group cannot” justify disparate treatment of that group. Department of Agriculture v. Moreno, 413 U. S. 528, 534–535. DOMA cannot survive under these principles. Its unusual deviation from the tradition of recognizing and accepting state definitions of marriage operates to deprive same-sex couples of the benefits and responsibilities that come with federal recognition of their marriages. This is strong evidence of a law having the purpose and effect of disapproval of a class recognized and protected by state law. DOMA’s avowed purpose and practical effect are to impose a disadvantage, a separate status, and so a stigma upon all who enter into same-sex marriages made lawful by the unquestioned authority
of the States.

DOMA’s history of enactment and its own text demonstrate that interference with the equal dignity of same-sex marriages, conferred by the States in the exercise of their sovereign power, was more than an incidental effect of the federal statute. It was its essence. BLAG’s arguments are just as candid about the congressional purpose. DOMA’s operation in practice confirms this purpose. It frustrates New York’s objective of eliminating inequality by writing inequality into the entire United States Code.

DOMA’s principal effect is to identify and make unequal a subset of state-sanctioned marriages. It contrives to deprive some couples married under the laws of their State, but not others, of both rights and responsibilities, creating two contradictory marriage regimes within the same State. It also forces same-sex couples to live as married for the purpose of state law but unmarried for the purpose of federal law, thus diminishing the stability and predictability of basic personal relations the State has found it proper to acknowledge and protect. Pp. 20–26.

699 F. 3d 169, affirmed.

KENNEDY, J., delivered the opinion of the Court, in which GINSBURG, BREYER, SOTOMAYOR, and KAGAN, JJ., joined. ROBERTS, C. J., filed a dissenting opinion. SCALIA, J., filed a dissenting opinion, in which THOMAS, J., joined, and in which ROBERTS, C. J., joined as to Part I. ALITO, J., filed a dissenting opinion, in which THOMAS, J., joined as to Parts II and III.
Cite as: 570 U. S. ____ (2013)

Opinion of the Court

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SUPREME COURT OF THE UNITED STATES

No. 12–307

UNITED STATES, PETITIONER v. EDITH SCHLAIN WINDSOR, IN HER CAPACITY AS EXECUTOR OF THE ESTATE OF THEA CLARA SPYER, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

[June 26, 2013]

JUSTICE KENNEDY delivered the opinion of the Court.

Two women then resident in New York were married in a lawful ceremony in Ontario, Canada, in 2007. Edith Windsor and Thea Spyer returned to their home in New York City. When Spyer died in 2009, she left her entire estate to Windsor. Windsor sought to claim the estate tax exemption for surviving spouses. She was barred from doing so, however, by a federal law, the Defense of Marriage Act, which excludes a same-sex partner from the definition of “spouse” as that term is used in federal statutes. Windsor paid the taxes but filed suit to challenge the constitutionality of this provision. The United States District Court and the Court of Appeals ruled that this portion of the statute is unconstitutional and ordered the United States to pay Windsor a refund. This Court granted certiorari and now affirms the judgment in Windsor’s favor.

I

In 1996, as some States were beginning to consider the concept of same-sex marriage, see, e.g., Baehr v. Lewin, 74
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Haw. 530, 852 P. 2d 44 (1993), and before any State had acted to permit it, Congress enacted the Defense of Marriage Act (DOMA), 110 Stat. 2419. DOMA contains two operative sections: Section 2, which has not been challenged here, allows States to refuse to recognize same-sex marriages performed under the laws of other States. See 28 U. S. C. §1738C.

Section 3 is at issue here. It amends the Dictionary Act in Title 1, §7, of the United States Code to provide a federal definition of "marriage" and "spouse." Section 3 of DOMA provides as follows:

"In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife." 1 U. S. C. §7.

The definitional provision does not by its terms forbid States from enacting laws permitting same-sex marriages or civil unions or providing state benefits to residents in that status. The enactment's comprehensive definition of marriage for purposes of all federal statutes and other regulations or directives covered by its terms, however, does control over 1,000 federal laws in which marital or spousal status is addressed as a matter of federal law. See GAO, D. Shah, Defense of Marriage Act: Update to Prior Report 1 (GAO–04–353R, 2004).

Edith Windsor and Thea Spyer met in New York City in 1963 and began a long-term relationship. Windsor and Spyer registered as domestic partners when New York City gave that right to same-sex couples in 1993. Concerned about Spyer's health, the couple made the 2007 trip to Canada for their marriage, but they continued to reside
in New York City. The State of New York deems their Ontario marriage to be a valid one. See 699 F.3d 169, 177–178 (CA2 2012).

Spyer died in February 2009, and left her entire estate to Windsor. Because DOMA denies federal recognition to same-sex spouses, Windsor did not qualify for the marital exemption from the federal estate tax, which excludes from taxation “any interest in property which passes or has passed from the decedent to his surviving spouse.” 26 U. S. C. §2056(a). Windsor paid $363,053 in estate taxes and sought a refund. The Internal Revenue Service denied the refund, concluding that, under DOMA, Windsor was not a “surviving spouse.” Windsor commenced this refund suit in the United States District Court for the Southern District of New York. She contended that DOMA violates the guarantee of equal protection, as applied to the Federal Government through the Fifth Amendment.

While the tax refund suit was pending, the Attorney General of the United States notified the Speaker of the House of Representatives, pursuant to 28 U. S. C. §530D, that the Department of Justice would no longer defend the constitutionality of DOMA’s §3. Noting that “the Department has previously defended DOMA against ... challenges involving legally married same-sex couples,” App. 184, the Attorney General informed Congress that “the President has concluded that given a number of factors, including a documented history of discrimination, classifications based on sexual orientation should be subject to a heightened standard of scrutiny.” Id., at 191. The Department of Justice has submitted many §530D letters over the years refusing to defend laws it deems unconstitutional, when, for instance, a federal court has rejected the Government’s defense of a statute and has issued a judgment against it. This case is unusual, however, because the §530D letter was not preceded by an adverse
judgment. The letter instead reflected the Executive's own conclusion, relying on a definition still being debated and considered in the courts, that heightened equal protection scrutiny should apply to laws that classify on the basis of sexual orientation.

Although "the President . . . instructed the Department not to defend the statute in Windsor," he also decided "that Section 3 will continue to be enforced by the Executive Branch" and that the United States had an "interest in providing Congress a full and fair opportunity to participate in the litigation of those cases." Id., at 191–193. The stated rationale for this dual-track procedure (determination of unconstitutionality coupled with ongoing enforcement) was to "recogniz[e] the judiciary as the final arbiter of the constitutional claims raised." Id., at 192.

In response to the notice from the Attorney General, the Bipartisan Legal Advisory Group (BLAG) of the House of Representatives voted to intervene in the litigation to defend the constitutionality of §3 of DOMA. The Department of Justice did not oppose limited intervention by BLAG. The District Court denied BLAG's motion to enter the suit as of right, on the rationale that the United States already was represented by the Department of Justice.

The District Court, however, did grant intervention by BLAG as an interested party. See Fed. Rule Civ. Proc. 24(a)(2).

On the merits of the tax refund suit, the District Court ruled against the United States. It held that §3 of DOMA is unconstitutional and ordered the Treasury to refund the tax with interest. Both the Justice Department and BLAG filed notices of appeal, and the Solicitor General filed a petition for certiorari before judgment. Before this Court acted on the petition, the Court of Appeals for the Second Circuit affirmed the District Court's judgment. It applied heightened scrutiny to classifications based on sexual orientation, as both the Department and Windsor had
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urged. The United States has not complied with the judgment. Windsor has not received her refund, and the Executive Branch continues to enforce §3 of DOMA.

In granting certiorari on the question of the constitutionality of §3 of DOMA, the Court requested argument on two additional questions: whether the United States' agreement with Windsor's legal position precludes further review and whether BLAG has standing to appeal the case. All parties agree that the Court has jurisdiction to decide this case; and, with the case in that framework, the Court appointed Professor Vicki Jackson as amicus curiae to argue the position that the Court lacks jurisdiction to hear the dispute. 568 U.S. ___ (2012). She has ably discharged her duties.

In an unrelated case, the United States Court of Appeals for the First Circuit has also held §3 of DOMA to be unconstitutional. A petition for certiorari has been filed in that case. Pet. for Cert. in Bipartisan Legal Advisory Group v. Gill, O. T. 2012, No. 12–13.

II

It is appropriate to begin by addressing whether either the Government or BLAG, or both of them, were entitled to appeal to the Court of Appeals and later to seek certiorari and appear as parties here.

There is no dispute that when this case was in the District Court it presented a concrete disagreement between opposing parties, a dispute suitable for judicial resolution. “[A] taxpayer has standing to challenge the collection of a specific tax assessment as unconstitutional; being forced to pay such a tax causes a real and immediate economic injury to the individual taxpayer.” Hein v. Freedom From Religion Foundation, Inc., 551 U. S. 587, 599 (2007) (plurality opinion) (emphasis deleted). Windsor suffered a redressable injury when she was required to pay estate taxes from which, in her view, she was exempt
but for the alleged invalidity of §3 of DOMA.

The decision of the Executive not to defend the constitutionality of §3 in court while continuing to deny refunds and to assess deficiencies does introduce a complication. Even though the Executive's current position was announced before the District Court entered its judgment, the Government's agreement with Windsor's position would not have deprived the District Court of jurisdiction to entertain and resolve the refund suit; for her injury (failure to obtain a refund allegedly required by law) was concrete, persisting, and unredressed. The Government's position—agreeing with Windsor's legal contention but refusing to give it effect—meant that there was a justiciable controversy between the parties, despite what the claimant would find to be an inconsistency in that stance. Windsor, the Government, BLAG, and the amicus appear to agree upon that point. The disagreement is over the standing of the parties, or aspiring parties, to take an appeal in the Court of Appeals and to appear as parties in further proceedings in this Court.

The amicus' position is that, given the Government's concession that §3 is unconstitutional, once the District Court ordered the refund the case should have ended; and the amicus argues the Court of Appeals should have dismissed the appeal. The amicus submits that once the President agreed with Windsor's legal position and the District Court issued its judgment, the parties were no longer adverse. From this standpoint the United States was a prevailing party below, just as Windsor was. Accordingly, the amicus reasons, it is inappropriate for this Court to grant certiorari and proceed to rule on the merits; for the United States seeks no redress from the judgment entered against it.

This position, however, elides the distinction between two principles: the jurisdictional requirements of Article III and the prudential limits on its exercise. See Warth v.
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The requirements of Article III standing are familiar:

“First, the plaintiff must have suffered an ‘injury in fact’—an invasion of a legally protected interest which is (a) concrete and particularized, and (b) ‘actual or imminent, not “conjectural or hypothetical.”’ Second, there must be a causal connection between the injury and the conduct complained of—the injury has to be ‘fairly . . . trace[able] to the challenged action of the defendant, and not . . . th[e] result [of] the independent action of some third party not before the court.’ Third, it must be ‘likely,’ as opposed to merely ‘speculative,’ that the injury will be ‘redressed by a favorable decision.’” Lujan, supra, at 560–561 (footnote and citations omitted).

Rules of prudential standing, by contrast, are more flexible “rule[s] . . . of federal appellate practice,” Deposit Guaranty Nat. Bank v. Roper, 445 U. S. 326, 333 (1980), designed to protect the courts from “decid[ing] abstract questions of wide public significance even [when] other governmental institutions may be more competent to address the questions and even though judicial intervention may be unnecessary to protect individual rights.” Warth, supra, at 500.

In this case the United States retains a stake sufficient to support Article III jurisdiction on appeal and in pro-
ceedings before this Court. The judgment in question orders the United States to pay Windsor the refund she seeks. An order directing the Treasury to pay money is "a real and immediate economic injury," *Hein*, 551 U.S., at 599, indeed as real and immediate as an order directing an individual to pay a tax. That the Executive may welcome this order to pay the refund if it is accompanied by the constitutional ruling it wants does not eliminate the injury to the national Treasury if payment is made, or to the taxpayer if it is not. The judgment orders the United States to pay money that it would not disburse but for the court's order. The Government of the United States has a valid legal argument that it is injured even if the Executive disagrees with §3 of DOMA, which results in Windsor's liability for the tax. Windsor's ongoing claim for funds that the United States refuses to pay thus establishes a controversy sufficient for Article III jurisdiction. It would be a different case if the Executive had taken the further step of paying Windsor the refund to which she was entitled under the District Court's ruling.

This Court confronted a comparable case in *INS v. Chadha*, 462 U.S. 919 (1983). A statute by its terms allowed one House of Congress to order the Immigration and Naturalization Service (INS) to deport the respondent Chadha. There, as here, the Executive determined that the statute was unconstitutional, and "the INS presented the Executive's views on the constitutionality of the House action to the Court of Appeals." *Id.*, at 930. The INS, however, continued to abide by the statute, and "the INS brief to the Court of Appeals did not alter the agency's decision to comply with the House action ordering deportation of Chadha." *Ibid*. This Court held "that the INS was sufficiently aggrieved by the Court of Appeals decision prohibiting it from taking action it would otherwise take," *ibid.*, regardless of whether the agency welcomed the judgment. The necessity of a "case or controversy" to
satisfy Article III was defined as a requirement that the Court's "decision will have real meaning: if we rule for Chadha, he will not be deported; if we uphold [the statute], the INS will execute its order and deport him." *Id.*, at 939–940 (quoting Chadha v. INS, 634 F. 2d 408, 419 (CA9 1980)). This conclusion was not dictum. It was a necessary predicate to the Court's holding that "prior to Congress' intervention, there was adequate Art. III adverseness." 462 U.S., at 939. The holdings of cases are instructive, and the words of Chadha make clear its holding that the refusal of the Executive to provide the relief sought suffices to preserve a justiciable dispute as required by Article III. In short, even where "the Government largely agree[s] with the opposing party on the merits of the controversy," there is sufficient adverseness and an "adequate basis for jurisdiction in the fact that the Government intended to enforce the challenged law against that party." *Id.*, at 940, n. 12.

It is true that "[a] party who receives all that he has sought generally is not aggrieved by the judgment affording the relief and cannot appeal from it." *Roper, supra*, at 333, see also *Camreta v. Greene*, 563 U. S. ---- (slip op., at 8) ("As a matter of practice and prudence, we have generally declined to consider cases at the request of a prevailing party, even when the Constitution allowed us to do so"). But this rule "does not have its source in the jurisdictional limitations of Art. III. In an appropriate case, appeal may be permitted . . . at the behest of the party who has prevailed on the merits, so long as that party retains a stake in the appeal satisfying the requirements of Art. III." *Roper, supra*, at 333–334.

While these principles suffice to show that this case presents a justiciable controversy under Article III, the prudential problems inherent in the Executive's unusual position require some further discussion. The Executive's agreement with Windsor's legal argument raises the risk
that instead of a "real, earnest and vital controversy," the Court faces a "friendly, non-adversary, proceeding... [in which] a party beaten in the legislature [seeks to] transfer to the courts an inquiry as to the constitutionality of the legislative act." Ashwander v. TVA, 297 U.S. 288, 346 (1936) (Brandeis, J., concurring) (quoting Chicago & Grand Trunk R. Co. v. Wellman, 143 U.S. 339, 345 (1892)). Even when Article III permits the exercise of federal jurisdiction, prudential considerations demand that the Court insist upon "that concrete adverseness which sharpens the presentation of issues upon which the court so largely depends for illumination of difficult constitutional questions." Baker v. Carr, 369 U.S. 186, 204 (1962).

There are, of course, reasons to hear a case and issue a ruling even when one party is reluctant to prevail in its position. Unlike Article III requirements—which must be satisfied by the parties before judicial consideration is appropriate—the relevant prudential factors that counsel against hearing this case are subject to "countervailing considerations [that] may outweigh the concerns underlying the usual reluctance to exert judicial power." Warth, 422 U.S., at 500–501. One consideration is the extent to which adversarial presentation of the issues is assured by the participation of amici curiae prepared to defend with vigor the constitutionality of the legislative act. With respect to this prudential aspect of standing as well, the Chadha Court encountered a similar situation. It noted that "there may be prudential, as opposed to Art. III, concerns about sanctioning the adjudication of [this case] in the absence of any participant supporting the validity of [the statute]. The Court of Appeals properly dispelled any such concerns by inviting and accepting briefs from both Houses of Congress." 462 U.S., at 940. Chadha was not an anomaly in this respect. The Court adopts the practice of entertaining arguments made by an amicus when the
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Solicitor General confesses error with respect to a judgment below, even if the confession is in effect an admission that an Act of Congress is unconstitutional. See, e.g., Dickerson v. United States, 530 U. S. 428 (2000).

In the case now before the Court the attorneys for BLAG present a substantial argument for the constitutionality of §3 of DOMA. BLAG’s sharp adversarial presentation of the issues satisfies the prudential concerns that otherwise might counsel against hearing an appeal from a decision with which the principal parties agree. Were this Court to hold that prudential rules require it to dismiss the case, and, in consequence, that the Court of Appeals erred in failing to dismiss it as well, extensive litigation would ensue. The district courts in 94 districts throughout the Nation would be without precedential guidance not only in tax refund suits but also in cases involving the whole of DOMA’s sweep involving over 1,000 federal statutes and a myriad of federal regulations. For instance, the opinion of the Court of Appeals for the First Circuit, addressing the validity of DOMA in a case involving regulations of the Department of Health and Human Services, likely would be vacated with instructions to dismiss, its ruling and guidance also then erased. See Massachusetts v. United States Dept. of Health and Human Servs., 682 F. 3d 1 (CA1 2012). Rights and privileges of hundreds of thousands of persons would be adversely affected, pending a case in which all prudential concerns about justiciability are absent. That numerical prediction may not be certain, but it is certain that the cost in judicial resources and expense of litigation for all persons adversely affected would be immense. True, the very extent of DOMA’s mandate means that at some point a case likely would arise without the prudential concerns raised here; but the costs, uncertainties, and alleged harm and injuries likely would continue for a time measured in years before the issue is resolved. In these unusual and urgent circum-
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stances, the very term "prudential" counsels that it is a proper exercise of the Court's responsibility to take jurisdiction. For these reasons, the prudential and Article III requirements are met here; and, as a consequence, the Court need not decide whether BLAG would have standing to challenge the District Court's ruling and its affirmance in the Court of Appeals on BLAG's own authority.

The Court's conclusion that this petition may be heard on the merits does not imply that no difficulties would ensue if this were a common practice in ordinary cases. The Executive's failure to defend the constitutionality of an Act of Congress based on a constitutional theory not yet established in judicial decisions has created a procedural dilemma. On the one hand, as noted, the Government's agreement with Windsor raises questions about the propriety of entertaining a suit in which it seeks affirmance of an order invalidating a federal law and ordering the United States to pay money. On the other hand, if the Executive's agreement with a plaintiff that a law is unconstitutional is enough to preclude judicial review, then the Supreme Court's primary role in determining the constitutionality of a law that has inflicted real injury on a plaintiff who has brought a justiciable legal claim would become only secondary to the President's. This would undermine the clear dictate of the separation-of-powers principle that "when an Act of Congress is alleged to conflict with the Constitution, [it is emphatically the province and duty of the judicial department to say what the law is.]" Zivotofskiy v. Clinton, 566 U. S. ___, ___ (2012) (slip op., at 7) (quoting Marbury v. Madison, 1 Cranch 137, 177 (1803)). Similarly, with respect to the legislative power, when Congress has passed a statute and a President has signed it, it poses grave challenges to the separation of powers for the Executive at a particular moment to be able to nullify Congress' enactment solely on its own initiative and without any determination from the Court.
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The Court's jurisdictional holding, it must be underscored, does not mean the arguments for dismissing this dispute on prudential grounds lack substance. Yet the difficulty the Executive faces should be acknowledged. When the Executive makes a principled determination that a statute is unconstitutional, it faces a difficult choice. Still, there is no suggestion here that it is appropriate for the Executive as a matter of course to challenge statutes in the judicial forum rather than making the case to Congress for their amendment or repeal. The integrity of the political process would be at risk if difficult constitutional issues were simply referred to the Court as a routine exercise. But this case is not routine. And the capable defense of the law by BLAG ensures that these prudential issues do not cloud the merits question, which is one of immediate importance to the Federal Government and to hundreds of thousands of persons. These circumstances support the Court's decision to proceed to the merits.

III

When at first Windsor and Spyer longed to marry, neither New York nor any other State granted them that right. After waiting some years, in 2007 they traveled to Ontario to be married there. It seems fair to conclude that, until recent years, many citizens had not even considered the possibility that two persons of the same sex might aspire to occupy the same status and dignity as that of a man and woman in lawful marriage. For marriage between a man and a woman no doubt had been thought of by most people as essential to the very definition of that term and to its role and function throughout the history of civilization. That belief, for many who long have held it, became even more urgent, more cherished when challenged. For others, however, came the beginnings of a new perspective, a new insight. Accordingly some States
concluded that same-sex marriage ought to be given recognition and validity in the law for those same-sex couples who wish to define themselves by their commitment to each other. The limitation of lawful marriage to heterosexual couples, which for centuries had been deemed both necessary and fundamental, came to be seen in New York and certain other States as an unjust exclusion.

Slowly at first and then in rapid course, the laws of New York came to acknowledge the urgency of this issue for same-sex couples who wanted to affirm their commitment to one another before their children, their family, their friends, and their community. And so New York recognized same-sex marriages performed elsewhere; and then it later amended its own marriage laws to permit same-sex marriage. New York, in common with, as of this writing, 11 other States and the District of Columbia, decided that same-sex couples should have the right to marry and so live with pride in themselves and their union and in a status of equality with all other married persons. After a statewide deliberative process that enabled its citizens to discuss and weigh arguments for and against same-sex marriage, New York acted to enlarge the definition of marriage to correct what its citizens and elected representatives perceived to be an injustice that they had not earlier known or understood. See Marriage Equality Act, 2011 N.Y. Laws 749 (codified at N.Y. Dom. Rel. Law Ann. §§10–a, 10–b, 13 (West 2013)).

Against this background of lawful same-sex marriage in some States, the design, purpose, and effect of DOMA should be considered as the beginning point in deciding whether it is valid under the Constitution. By history and tradition the definition and regulation of marriage, as will be discussed in more detail, has been treated as being within the authority and realm of the separate States. Yet it is further established that Congress, in enacting dis-
crete statutes, can make determinations that bear on marital rights and privileges. Just this Term the Court upheld the authority of the Congress to pre-empt state laws, allowing a former spouse to retain life insurance proceeds under a federal program that gave her priority, because of formal beneficiary designation rules, over the wife by a second marriage who survived the husband. *Hillman v. Miretta*, 569 U. S. ___ (2013); see also *Ridgway v. Ridgway*, 454 U. S. 46 (1981); *Wissner v. Wissner*, 338 U. S. 655 (1950). This is one example of the general principle that when the Federal Government acts in the exercise of its own proper authority, it has a wide choice of the mechanisms and means to adopt. See *McCulloch v. Maryland*, 4 Wheat. 316, 421 (1819). Congress has the power both to ensure efficiency in the administration of its programs and to choose what larger goals and policies to pursue.

Other precedents involving congressional statutes which affect marriages and family status further illustrate this point. In addressing the interaction of state domestic relations and federal immigration law Congress determined that marriages “entered into for the purpose of procuring an alien’s admission [to the United States] as an immigrant” will not qualify the noncitizen for that status, even if the noncitizen’s marriage is valid and proper for state-law purposes. 8 U. S. C. §1186a(b)(1) (2006 ed. and Supp. V). And in establishing income-based criteria for Social Security benefits, Congress decided that although state law would determine in general who qualifies as an applicant’s spouse, common-law marriages also should be recognized, regardless of any particular State’s view on these relationships. 42 U. S. C. §1382c(d)(2).

Though these discrete examples establish the constitutionality of limited federal laws that regulate the meaning of marriage in order to further federal policy, DOMA has a far greater reach; for it enacts a directive applicable to

In order to assess the validity of that intervention it is necessary to discuss the extent of the state power and authority over marriage as a matter of history and tradition. State laws defining and regulating marriage, of course, must respect the constitutional rights of persons, see, e.g., Loving v. Virginia, 388 U. S. 1 (1967); but, subject to those guarantees, “regulation of domestic relations” is “an area that has long been regarded as a virtually exclusive province of the States.” Sosna v. Iowa, 419 U. S. 393,
404 (1975).

The recognition of civil marriages is central to state domestic relations law applicable to its residents and citizens. See Williams v. North Carolina, 317 U. S. 287, 298 (1942) ("Each state as a sovereign has a rightful and legitimate concern in the marital status of persons domiciled within its borders"); The definition of marriage is the foundation of the State’s broader authority to regulate the subject of domestic relations with respect to the “[p]rotection of offspring, property interests, and the enforcement of marital responsibilities.” Ibid. “[T]he states, at the time of the adoption of the Constitution, possessed full power over the subject of marriage and divorce . . . [and] the Constitution delegated no authority to the Government of the United States on the subject of marriage and divorce.” Haddock v. Haddock, 201 U. S. 562, 575 (1906); see also In re Burrus, 136 U. S. 586, 593–594 (1890) (“The whole subject of the domestic relations of husband and wife, parent and child, belongs to the laws of the States and not to the laws of the United States”).

Consistent with this allocation of authority, the Federal Government, through our history, has deferred to state-law policy decisions with respect to domestic relations. In De Sylva v. Ballentine, 351 U. S. 570 (1956), for example, the Court held that, “[t]o decide who is the widow or widower of a deceased author, or who are his executors or next of kin,” under the Copyright Act “requires a reference to the law of the State which created those legal relationships” because “there is no federal law of domestic relations.” Id., at 580. In order to respect this principle, the federal courts, as a general rule, do not adjudicate issues of marital status even when there might otherwise be a basis for federal jurisdiction. See Ankenbrandt v. Richards, 504 U. S. 689, 703 (1992). Federal courts will not hear divorce and custody cases even if they arise in diversity because of “the virtually exclusive primacy . . . of the
States in the regulation of domestic relations." Id., at 714 (Blackmun, J., concurring in judgment).

The significance of state responsibilities for the definition and regulation of marriage dates to the Nation's beginning; for "when the Constitution was adopted the common understanding was that the domestic relations of husband and wife and parent and child were matters reserved to the States." *Ohio ex rel. Popovici v. Agler*, 280 U. S. 379, 383–384 (1930). Marriage laws vary in some respects from State to State. For example, the required minimum age is 16 in Vermont, but only 13 in New Hampshire. Compare Vt. Stat. Ann., Tit. 18, §5142 (2012), with N. H. Rev. Stat. Ann. §457:4 (West Supp. 2012). Likewise the permissible degree of consanguinity can vary (most States permit first cousins to marry, but a handful—such as Iowa and Washington, see Iowa Code §595.19 (2009); Wash. Rev. Code §26.04.020 (2012)—prohibit the practice). But these rules are in every event consistent within each State.

Against this background DOMA rejects the long-established precept that the incidents, benefits, and obligations of marriage are uniform for all married couples within each State, though they may vary, subject to constitutional guarantees, from one State to the next. Despite these considerations, it is unnecessary to decide whether this federal intrusion on state power is a violation of the Constitution because it disrupts the federal balance. The State's power in defining the marital relation is of central relevance in this case quite apart from principles of federalism. Here the State's decision to give this class of persons the right to marry conferred upon them a dignity and status of immense import. When the State used its historic and essential authority to define the marital relation in this way, its role and its power in making the decision enhanced the recognition, dignity, and protection of the class in their own community. DOMA, because of

The Federal Government uses this state-defined class for the opposite purpose—to impose restrictions and disabilities. That result requires this Court now to address whether the resulting injury and indignity is a deprivation of an essential part of the liberty protected by the Fifth Amendment. What the State of New York treats as alike the federal law deems unlike by a law designed to injure the same class the State seeks to protect.

In acting first to recognize and then to allow same-sex marriages, New York was responding "to the initiative of those who [sought] a voice in shaping the destiny of their own times." *Bond v. United States*, 564 U. S. ___ (2011) (slip op., at 9). These actions were without doubt a proper exercise of its sovereign authority within our federal system, all in the way that the Framers of the Constitution intended. The dynamics of state government in the federal system are to allow the formation of consensus respecting the way the members of a discrete community treat each other in their daily contact and constant interaction with each other.

The States' interest in defining and regulating the marital relation, subject to constitutional guarantees, stems from the understanding that marriage is more than a routine classification for purposes of certain statutory benefits. Private, consensual sexual intimacy between two adult persons of the same sex may not be punished by the State, and it can form "but one element in a personal bond that is more enduring." *Lawrence v. Texas*, 539 U. S. 558, 567 (2003). By its recognition of the validity of same-sex
marriages performed in other jurisdictions and then by authorizing same-sex unions and same-sex marriages, New York sought to give further protection and dignity to that bond. For same-sex couples who wished to be married, the State acted to give their lawful conduct a lawful status. This status is a far-reaching legal acknowledgment of the intimate relationship between two people, a relationship deemed by the State worthy of dignity in the community equal with all other marriages. It reflects both the community's considered perspective on the historical roots of the institution of marriage and its evolving understanding of the meaning of equality.

IV

DOMA seeks to injure the very class New York seeks to protect. By doing so it violates basic due process and equal protection principles applicable to the Federal Government. See U.S. Const., Amdt. 5; Bolling v. Sharpe, 347 U.S. 497 (1954). The Constitution's guarantee of equality "must at the very least mean that a bare congressional desire to harm a politically unpopular group cannot" justify disparate treatment of that group. Department of Agriculture v. Moreno, 413 U.S. 528, 534–535 (1973). In determining whether a law is motivated by an improper animus or purpose, "[d]iscriminations of an unusual character" especially require careful consideration. Supra, at 19 (quoting Romer, supra, at 633). DOMA cannot survive under these principles. The responsibility of the States for the regulation of domestic relations is an important indicator of the substantial societal impact the State's classifications have in the daily lives and customs of its people. DOMA's unusual deviation from the usual tradition of recognizing and accepting state definitions of marriage here operates to deprive same-sex couples of the benefits and responsibilities that come with the federal recognition of their marriages. This is strong evidence of a
law having the purpose and effect of disapproval of that class. The avowed purpose and practical effect of the law here in question are to impose a disadvantage, a separate status, and so a stigma upon all who enter into same-sex marriages made lawful by the unquestioned authority of the States.

The history of DOMA’s enactment and its own text demonstrate that interference with the equal dignity of same-sex marriages, a dignity conferred by the States in the exercise of their sovereign power, was more than an incidental effect of the federal statute. It was its essence. The House Report announced its conclusion that “it is both appropriate and necessary for Congress to do what it can to defend the institution of traditional heterosexual marriage. . . . H. R. 3396 is appropriately entitled the ‘Defense of Marriage Act.’ The effort to redefine ‘marriage’ to extend to homosexual couples is a truly radical proposal that would fundamentally alter the institution of marriage.” H.R. Rep. No. 104–664, pp. 12–13 (1996). The House concluded that DOMA expresses “both moral disapproval of homosexuality, and a moral conviction that heterosexuality better comports with traditional (especially Judeo-Christian) morality.” Id., at 16 (footnote deleted). The stated purpose of the law was to promote an “interest in protecting the traditional moral teachings reflected in heterosexual-only marriage laws.” Ibid. Were there any doubt of this far-reaching purpose, the title of the Act confirms it: The Defense of Marriage.

The arguments put forward by BLAG are just as candid about the congressional purpose to influence or interfere with state sovereign choices about who may be married. As the title and dynamics of the bill indicate, its purpose is to discourage enactment of state same-sex marriage laws and to restrict the freedom and choice of couples married under those laws if they are enacted. The congressional goal was “to put a thumb on the scales and influence a
state's decision as to how to shape its own marriage laws."
Massachusetts, 682 F. 3d, at 12–13. The Act's demonstrated purpose is to ensure that if any State decides to recognize same-sex marriages, those unions will be treated as second-class marriages for purposes of federal law. This raises a most serious question under the Constitution’s Fifth Amendment.

DOMA's operation in practice confirms this purpose. When New York adopted a law to permit same-sex marriage, it sought to eliminate inequality; but DOMA frustrates that objective through a system-wide enactment with no identified connection to any particular area of federal law. DOMA writes inequality into the entire United States Code. The particular case at hand concerns the estate tax, but DOMA is more than a simple determination of what should or should not be allowed as an estate tax refund. Among the over 1,000 statutes and numerous federal regulations that DOMA controls are laws pertaining to Social Security, housing, taxes, criminal sanctions, copyright, and veterans' benefits.

DOMA's principal effect is to identify a subset of state-sanctioned marriages and make them unequal. The principal purpose is to impose inequality, not for other reasons like governmental efficiency. Responsibilities, as well as rights, enhance the dignity and integrity of the person. And DOMA contrives to deprive some couples married under the laws of their State, but not other couples, of both rights and responsibilities. By creating two contradictory marriage regimes within the same State, DOMA forces same-sex couples to live as married for the purpose of state law but unmarried for the purpose of federal law, thus diminishing the stability and predictability of basic personal relations the State has found it proper to acknowledge and protect. By this dynamic DOMA undermines both the public and private significance of state-sanctioned same-sex marriages; for it tells those couples,
and all the world, that their otherwise valid marriages are unworthy of federal recognition. This places same-sex couples in an unstable position of being in a second-tier marriage. The differentiation demeans the couple, whose moral and sexual choices the Constitution protects, see Lawrence, 539 U. S. 558, and whose relationship the State has sought to dignify. And it humiliates tens of thousands of children now being raised by same-sex couples. The law in question makes it even more difficult for the children to understand the integrity and closeness of their own family and its concord with other families in their community and in their daily lives.


For certain married couples, DOMA’s unequal effects are even more serious. The federal penal code makes it a crime to “assail[t], kidna[p], or murde[r] ... a member of the immediate family” of “a United States official, a United States judge, [or] a Federal law enforcement officer,” 18 U. S. C. §115(a)(1)(A), with the intent to influence or retaliate against that official, §115(a)(1). Although a “spouse” qualifies as a member of the officer’s “immediate
family,’” §115(c)(2), DOMA makes this protection inapplicable to same-sex spouses.


DOMA divests married same-sex couples of the duties and responsibilities that are an essential part of married life and that they in most cases would be honored to accept were DOMA not in force. For instance, because it is expected that spouses will support each other as they pursue educational opportunities, federal law takes into consideration a spouse’s income in calculating a student’s federal financial aid eligibility. See 20 U. S. C. §1097nn(b). Same-sex married couples are exempt from this requirement. The same is true with respect to federal ethics rules. Federal executive and agency officials are prohibited from “participat[ing] personally and substantially” in matters as to which they or their spouses have a financial interest. 18 U. S. C. §208(a). A similar statute prohibits Senators, Senate employees, and their spouses from accepting high-value gifts from certain sources, see 2 U. S. C. §31–2(a)(1), and another mandates detailed financial disclosures by numerous high-ranking officials and their spouses. See 5 U. S. C. App. §§102(a), (e). Under DOMA, however, these Government-integrity rules do not apply to same-sex spouses.
Opinion of the Court

* * *

The power the Constitution grants it also restrains. And though Congress has great authority to design laws to fit its own conception of sound national policy, it cannot deny the liberty protected by the Due Process Clause of the Fifth Amendment.

What has been explained to this point should more than suffice to establish that the principal purpose and the necessary effect of this law are to demean those persons who are in a lawful same-sex marriage. This requires the Court to hold, as it now does, that DOMA is unconstitutional as a deprivation of the liberty of the person protected by the Fifth Amendment of the Constitution.

The liberty protected by the Fifth Amendment's Due Process Clause contains within it the prohibition against denying to any person the equal protection of the laws. See Bolling, 347 U. S., at 499–500; Adarand Constructors, Inc. v. Peña, 515 U. S. 200, 217–218 (1995). While the Fifth Amendment itself withdraws from Government the power to degrade or demean in the way this law does, the equal protection guarantee of the Fourteenth Amendment makes that Fifth Amendment right all the more specific and all the better understood and preserved.

The class to which DOMA directs its restrictions and restraints are those persons who are joined in same-sex marriages made lawful by the State. DOMA singles out a class of persons deemed by a State entitled to recognition and protection to enhance their own liberty. It imposes a disability on the class by refusing to acknowledge a status the State finds to be dignified and proper. DOMA instructs all federal officials, and indeed all persons with whom same-sex couples interact, including their own children, that their marriage is less worthy than the marriages of others. The federal statute is invalid, for no legitimate purpose overcomes the purpose and effect to disparage and to injure those whom the State, by its mar-
riage laws, sought to protect in personhood and dignity. By seeking to displace this protection and treating those persons as living in marriages less respected than others, the federal statute is in violation of the Fifth Amendment. This opinion and its holding are confined to those lawful marriages.

The judgment of the Court of Appeals for the Second Circuit is affirmed.

It is so ordered.
BROKEN TRUSTS

Repairing Broken Trusts and Other Fallen Estate Plans

When trusts no longer suit their intended purposes, practitioners need to explore available remedies while being mindful of family dynamics and the potential tax consequences of change.

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"Forever is a very long time Peter," wrote J.M. Barrie in Peter Pan. Over the long term—or even in a short time—trusts may break and estate plans may fall for a variety of reasons, including the following:

- **Incomplete information.** The plan is defective from the beginning because the planner was unsuccessful in obtaining the client's true financial picture, goals, or family circumstances. The plan fails to address crucial information regarding assets, family disagreements, children out of wedlock, or expected inheritances. Undisclosed community property or nonprobate assets—assets that have a beneficiary designation such as life insurance or retirement benefits, property held by the entireties or jointly with right of survivorship, and payable-on-death and transfer-on-death securities accounts or certificates of deposit—may not match up with the plan.

- **Circumstances change.** A once-successful plan no longer meets the needs of the beneficiaries in the way the client intended. Children grow up, become financially independent, and wish to forgo an expected inheritance in favor of their children. Beneficiaries may develop drug or alcohol problems, experience marital problems or creditor issues, or suffer debilitating injuries or diseases for which government assistance would be available but for the beneficiaries’ interests in the trust. The centerpiece of the estate plan, the family business, succeeds wildly or fails. Insurance no longer suits the purposes for which it was purchased. The economy rockets and crashes.

- **Tax laws change.** Gift, estate, and generation-skipping transfer (GST) tax exemption amounts have risen dramatically and continue to rise, creating unintended results or trusts that are no longer
necessary. Income taxes may now be a more important factor than the transfer taxes the plan sought so earnestly to avoid. Portability is now permanent. The credit shelter trust, until very recently a common estate planning technique for a moderately wealthy client, may no longer be needed given high trust income tax rates and lack of basis adjustment for assets remaining in the trust at the second spouse's death.

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- *Families expand and contract.* The plan does not contemplate a death out of the expected order or increases in longevity, the variety of relationships, changing societal norms, or advances in reproductive technology. The family becomes more fragmented and geographically distant with the passing of each generation. Divorce, remarriage, and blended families produce unique challenges and restless beneficiaries.

And, of course, everyone makes mistakes. The trust omits a critical clause, contains a limited power of appointment where a general one was needed (or vice versa), fails to obtain a charitable or marital deduction, or proves to be an impermissible shareholder of a Subchapter S corporation.

This article provides a suggested methodology when evaluating an irrevocable trust that does not fulfill the settlor's wishes or fails to provide the needed flexibility for a change in circumstances. Remedies are available even if the trust creator has died or did not retain or give to a third party the power to modify the trust. The author recommends tailoring a remedy after a three-step inquiry:

1. Examining the trust instrument or will.
2. Discerning the available remedies under applicable (or available) law.
3. Researching the likely tax consequences from either keeping the plan as is or implementing the desired change using one or more of the available remedies.

Critical to this analysis is an understanding of the family dynamics: Is this a close-knit family where the beneficiaries are willing to cooperate and consents to change will be easy to obtain? Or are ill-feelings, distrust, and conflict so pronounced that any remedy will more closely resemble a settlement of protracted litigation than a revised plan drawn solely from the settlor’s intended objectives? Frequently, the optimal tax or legal remedy is not available or is unworkable in the real-world workings of the family.

**Examining the trust instrument or will**

The first inquiry in reviewing a broken estate plan is whether the problematic language occurs in a will, a trust, or both. Historically, courts were reluctant to rewrite the terms of a will where the language was unambiguous. Courts refused to allow disappointed beneficiaries to contradict the plain terms of a will. Courts prohibited the beneficiaries from introducing evidence (referred to as *extrinsic* or *parol* evidence) as to what the maker of the will truly intended to happen.

By contrast, many modern remedies for fixing trusts contemplate that evidence of the trust creator’s intent is relevant in determining whether the remedy is available. These remedies are also typically available for trusts created by will.

**Example.** Bill wishes to update his will, intending to leave his house to his niece Nancy. The attorney copies Bill’s previous will from when Bill was still married. The attorney fails to update the appropriate provision, so the new will Bill signs leaves the house to his ex-wife, Barbara. After Bill’s death, Nancy sues his estate,
worrying to introduce the evidence of "a hundred witnesses" that Bill intended to leave the house to her. Under the traditional rule, the court would give the house to Barbara and refuse to allow Nancy to offer her evidence, saying that if the language of the will is unambiguous, the court will not allow evidence of Bill's (or his attorney's) mistake.

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If, however, Bill were to have put the house in a trust and mistakenly left the house to Barbara when he meant Nancy, a court may allow Nancy to introduce evidence of the mistake using one of the remedies discussed below.

Discerning the available remedies

The second step in reviewing the will or trust is determining whether the document itself authorizes a remedy that may be helpful, such as giving the trustee authority to consolidate or divide trusts; decant the existing, problematic trust into a new one; or move the place of administration of the trust to a friendly jurisdiction. If the document does not authorize a useful remedy, then the next step is to consider what remedies are available under applicable law.

Remedies under the UTC

The Uniform Trust Code (UTC), adopted in 29 states and the District of Columbia (see Exhibit 1 for a complete list of these jurisdictions), provides helpful tools in remedying broken trusts. These include reformation, several provisions on modification, and division and consolidation. Some of these remedies may be obtained in the trustee's discretion or with the consent of the trustee and the beneficiaries; others may be exercised only on approval of a court. Even if not all of the UTC remedies are available in a particular jurisdiction, with a little creativity, practitioners often are able to remedy the problem using the tools that are available.

Exhibit 1. Uniform Trust Code Jurisdictions

The following jurisdictions have adopted the Uniform Trust Code:

1. Alabama.
2. Arizona.
3. Arkansas.
5. Florida.
8. Maine
10. Massachusetts.
12. Mississippi.
The person desiring to remedy a trust must satisfy up to three constituencies:

- Other interested parties, such as the trustee or beneficiaries, whose consent may be required.\(^3\)
- The court, in a judicial remedy, which typically has great discretion whether to grant the relief sought.
- The IRS, which in determining whether to recognize the remedy will look at the procedures followed in making its determination as to whether the parties and any court complied with the IRS's reading of applicable state law.

Preparation, compliance with procedural requirements, and satisfaction of the elements of any remedy are critical. For those remedies requiring judicial approval, success at the lower court is paramount as the appellate standard for review may be abuse of discretion. This would make it extremely difficult to overturn an adverse ruling. In addition, winning at the trial court is not enough: The practitioner should prepare for trial as if the IRS were sitting behind the bench as a second judge. The IRS will likely make its own assessment of whether the petitioner satisfied the state law requirements and met any applicable burdens of proof in determining whether to respect the state court proceedings. Complying with statutory obligations, making sure all qualified beneficiaries are served, and guardians ad litem appointed as necessary are all critical.

State law governs the determination of property rights established by a trust and the procedures to amend or modify those rights; whether the modification will be respected by the IRS is a matter of federal law.\(^4\) The cases and letter rulings differ depending on what the proponent is trying to accomplish with the modification. As is discussed below, the IRS is not generally bound by the state court's determination. Particularly after a taxable event, the completed transaction rule provides that a modification will be less likely to be recognized for tax purposes.\(^5\)
Reformation. UTC section 415 provides that a "court may reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence what the settlor's intention was and that the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement." Reformation is available for noncharitable and charitable trusts.

Reformation can be a powerful and helpful tool. Reformation contemplates a mistake in the making of the trust, which if corrected should relate back to the creation of the trust. Because of this relationship back, reformation may be the remedy most likely to be given retroactive treatment by the IRS. 6

Reformation may be available where the proponent has sufficient evidence of a mistake (such as a drafting error on the part of the attorney or a failure to meet technical requirements of the Internal Revenue Code). 7 The principal hurdle to a reformation proceeding is being able to establish to the court's satisfaction "clear and convincing evidence" of the settlor's true intent, particularly if the settlor is no longer living. The clear and convincing standard may be simply stated as "much more likely than not" or "substantially more likely than not." In contrast, other remedies may use a lower "preponderance of the evidence" standard, which is essentially a "more likely than not" or "just over 50%" standard.

Modification. In addition to reformation, the UTC contains four different modification provisions that may be helpful in amending an otherwise unchangeable trust to address problems: 8

- Modification by consent (section 411).
- Modification because of unanticipated circumstances (section 412).
- Cy pres (section 413).
- Modification to achieve the settlor's tax objectives (section 416).

UTC section 412 and its charitable counterpart section 413 are modern expressions of long-standing equitable remedies. Section 412 provides:

The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. To the extent practicable, the modification must be made in accordance with the settlor's probable intention.

Section 412 arose out of the common law concept of equitable deviation. Equitable deviation recognizes that unanticipated circumstances might warrant a deviation from the language of the trust, which may include the court's removing a prohibition on the sale of certain trust assets or other restrictive condition. Had the settlor been able to anticipate circumstances as they unfolded, the settlor would have supported a change to the trust or written the trust differently to accommodate those circumstances. Section 413 incorporates the similar remedy of cy pres, available for charitable trusts if a particular charitable purpose "becomes unlawful, impracticable, impossible to achieve, or wasteful."

Perhaps the most novel modification provisions in the UTC are the modification-by-consent provisions in section 411 and the modification to achieve tax objectives in section 416.

Section 411 permits modification upon consent of the settlor and all beneficiaries, even if the modification is inconsistent with a material purpose of the trust. 9 Section 416 provides for modification to achieve the
settlor's tax objectives, which the court may give retroactive effect. Again, the state's court's conferring retroactive effect to the remedy may not be respected for estate planning purposes.

Division and consolidation. UTC section 417 permits division and consolidation of trusts as follows:

After notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.

Division may be appropriate for dividing an existing "pot" trust into separate trusts or for segregating generation-skipping trusts into trusts with an inclusion ratio of one or zero. Consolidation may be helpful where combining two trusts would facilitate administration.

Consolidation may be employed creatively to replicate decanting discussed below: Faced with a trust that failed to include the desired

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provisions, the settlor or another party might create and fund a new trust with the desired provisions; the trustee may later merge the old trust into the new, with the new trust (and new provisions) being the surviving trust in the consolidation.

Changing the situs of a trust. If applicable law proves too restrictive for the remedy sought, consider whether the home, or situs, of the trust can be moved to a state with more favorable remedies.

UTC section 108(b) imposes on the trustee "a continuing duty to administer the trust at a place appropriate to its purposes, its administration, and the interests of the beneficiaries." Section 108(c) provides, "Without precluding the right of the court to order, approve, or disapprove a transfer, the trustee, in furtherance of the duty prescribed by subsection (b), may transfer the trust's principal place of administration to another State or to a jurisdiction outside of the United States."

The procedural requirements for moving the trust are contained in UTC section 108(d).

Some states have statutes expressly authorizing the trustee to move the place of administration and law of the trust. Moving the trust to the welcoming arms of a friendly host state may allow the party seeking relief to use the new state's law in obtaining a desired remedy.

Under the reasoning of the Peierls cases in Delaware, the party seeking relief may be able to move the trust situs to Delaware even if the trust agreement specifies that the laws of the original jurisdiction apply. The technical requirements can be complex and should be examined carefully in consultation with experienced counsel. Essentially, the process involves appointing a Delaware trustee or co-trustee who later brings an action in Delaware Chancery Court to petition under Delaware law for the relief sought, whether modification, decanting, or another remedy.

Non-UTC remedies

As discussed above, the practitioner has a wide array of tools under the UTC, some of which may be exercised only with court approval, but others upon consent of the interested parties or in the trustee's discretion. Still, sometimes a UTC or applicable state law remedy is not available to fix a trust gone bad. Practitioners are not limited to remedies expressly authorized by the statutes of their state. Depending on the
language of the trust agreement and the creativity of the planner, the following may be worthy of consideration.

Decanting. Frequently, older trusts contain undesired provisions that are unchangeable by the terms of the trust. Decanting is the process by which the assets in the trust with the undesired provisions are poured into a new trust or trusts with more favorable provisions. Decanting originated as a common-law equitable remedy under a line of cases that began most prominently in Florida with *Phipps v. Palm Beach Trust Co.*. The theory behind the *Phipps* case is that the power of a trustee to transfer a greater interest (such as a transfer outright to the beneficiary) includes the power to transfer a lesser interest (that is, in further trust for the beneficiary).

Some states have adopted decanting statutes with varying requirements. The National Conference of Commissioners on Uniform State Laws is considering a uniform decanting statute, which may be a separate act, part of the UTC or both.

The tax implications surrounding decanting are complex and include issues of income, gift, estate, and generation-skipping transfer taxes. In 2011, the IRS issued Notice 2011-101 seeking comment on the income, gift, estate, and generation-skipping transfer tax consequences of decanting.

While these issues are under study, the IRS will not issue private letter rulings with respect to such transfers that result in a change in beneficial interests. The Notice states that the IRS generally will continue to issue letter rulings with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period; however, as a practical matter, no new letter rulings appear to have been issued on decanting since the Notice.

If considering decanting in a state without a decanting statute, first look at whether the trust document contains language that may be read expressely or impliedly to authorize decanting. See Illustration 1 below for the power of common law decanting.

Disclaimers. Disclaimers can be a powerful tool in altering an estate plan. Sometimes called renunciations, disclaimers allow a party who has not accepted the benefits of the trust or gift to renounce the trust or gift so that it passes to another. If the disclaimer is qualified, the party making the disclaimer (the disclaimant) is not considered to have made a taxable gift or otherwise have acquired an interest in the property.

Unlike some of the other statutory remedies discussed in this article, disclaimers may be used by beneficiaries of wills and of trusts, regardless of whether the language in the document is ambiguous. Disclaimers are governed primarily by Internal Revenue Code Section 2518 and associated regulations. Many states also have disclaimer statutes. The federal statute and regulations should be consulted together with the applicable state statute for compliance.

Properly and timely executed disclaimers may be used in a host of situations, such as to prevent beneficiaries who should not or do not wish to receive money outright to receive it in trust, prevent trusts that do not maximize GST exemption (that is, tainting a GST-exempt trust or a trust with an inclusion ratio of zero by the addition of non-GST exempt funds) and otherwise divert funds from a bad end to a good one. A full discussion of the use and requirements for effecting a qualified disclaimer is beyond the scope of this article.
If disclaimer planning is desired, however, note that a strict deadline is imposed by the federal and state statutes, as well as delivery requirements.

An additional requirement is that the one making the disclaimer have no input as to the passing of the disclaimed interest, so frequently the practitioner must look carefully at the will or trust provisions as well as the law of intestacy to determine where the disclaimed interest will end up. Be very careful if the disclaimer is initiated to waive benefits in an effort to qualify (or maintain the qualification of) a beneficiary for Medicaid purposes; it may disqualify the one making the disclaimer from receiving Medicaid benefits.  

Defensive planning. Sometimes the advisor does not have the luxury of using a statutorily authorized or recognized common law remedy to address the problem. Instead, the best the advisor can hope for is to press ahead while seeking to limit the liability of the executor or trustee as much as possible. This planning begins by looking at the duties owed by the fiduciary (such as the trustee’s duties of prudent administration, 22 loyalty, 23 and impartiality 24) and breaches thereof 25 and the common defenses available to an executor or trustee. Common legal and equitable defenses include the beneficiary’s consent, release, ratification, 26 unclean hands, laches, and running of the statute of limitations. 27 The planner then seeks to establish as many defenses as possible. 28

Under this approach, to the extent feasible, one seeks releases and indemnities from all concerned, documents the consent and ratification of the proposed course of action, and obtains the signatory’s waiver of, and estoppel from raising, future claims. In addition, some states provide a shorter statute of limitations if the fiduciary furnishes the interested parties with a written report. 29

**Tax consequences of change**

Even if a state law remedy is available, will the IRS respect the proposed fix? Even if the IRS respects it, will the IRS do so retroactively? A complete discussion of the IRS’s treatment of state-law authorized modifications and reformations is beyond the scope of this article. 30 However, a few observations may be in order.

**Gleaning IRS intent.** With the exception of some reported cases 31 and some statutory 32 and regulatory guidance, 33 much of the expression of the Service’s intent in this area is contained in private letter rulings, which cannot be used or cited as precedent. 34

**State court ruling not binding.** A state court authorizing a modification or reformation does not automatically bind the Service. The Service is not shy about reviewing a state law decision and finding the ruling does not conform to the Service’s reading of the state law.

The leading case is *Estate of Bosch*, 35 in which the U.S. Supreme Court held that the Service is not necessarily bound by the ruling of a state court as to an underlying issue of state law when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the
state trial court’s determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court. 33

Will IRS recognize? Whether the IRS will respect the modification may depend on the reason for the modification. Was it to amend but ensure that the trust continues to have an inclusion ratio of zero for GST purposes? 37 Qualify the trust as a holder of Subchapter S stock? 38 Amend a defective charitable trust to ensure that the trust qualifies for the charitable deduction? 39 The IRS seems to be liberal in these areas, less so in the recognition of an amendment intended to qualify a trust for the marital deduction. 40

Retroactivity elusive. Generally speaking, the Service is reluctant to grant retroactivity to a state court decision. As one commentator states, “unless the reformation is based on mistake or ambiguity, it may not be recognized retroactively.” 41 Once the taxable event has occurred, the IRS may not give retroactive treatment under the completed transaction doctrine. 42 For example, if an asset becomes included in an estate (such as that of a surviving spouse), the Service is sometimes reluctant to permit a retroactive fix that purports to take the asset out of the estate.

In Ltr. Rul. 201243001, the Service refused to grant retroactive effect to a state court reformation of an irrevocable trust. The decedent and his spouse had created a trust for their benefit during their lives. Upon the death of the second-to-die spouse, the son’s interest would pass outright to the son unless he executed a qualified disclaimer, in which case the son’s interest would pass to an irrevocable trust for the benefit of the son and his descendants. The son failed to execute a qualified disclaimer within nine months following the death of the second spouse.

The son successfully petitioned for reformation of the trust under state law so that the son’s interest would not pass outright to him, but would pass directly to the irrevocable trust as if he had signed the disclaimer. The ruling at the state court level was conditioned on the son’s obtaining a favorable private letter ruling.

The Service refused to recognize the effectiveness of the state court ruling. The IRS cited the Bosch decision, among other federal court decisions, as support for the federal government’s failure to be bound by decisions of a lower state court. The Service looked at the state’s reformation statute and absence of the state’s highest court to rule on the statute. Like UTC section 415, the state statute required clear and convincing evidence of the settlor’s unilateral mistake to reform the trust. The Service concluded that, “[b]ased upon the facts submitted (including the affidavit and attached letter) and the representations made ..., the reformation of [the trust] is not consistent with applicable State law, as applied by the highest court of State. Accordingly, we conclude that the reformation of [the trust] will not be recognized retroactively for gift, estate, or GST tax purposes.”

The Service noted:

As a general rule, a state court reformation of a trust instrument has retroactive effect as between the parties to the instrument, but not as to third parties who previously acquired rights under the instrument. Generally, retroactive changes to the legal effects of a transaction through judicial nullification of a transfer or judicial reformation of a document do not have retroactive effect for federal tax purposes.

In Van Den Wymelenberg, the taxpayer executed a trust agreement that was intended to achieve a gift tax exemption under § 2503(c). However, the agreement did not empower the trustee to invade corpus to meet the needs of the beneficiaries or allow the beneficiaries to dispose of their interests by will. The gifts did not qualify under the annual gift exclusion of § 2503. The taxpayer changed the trust agreement to correct the error but did not obtain a court
order to make the correction retroactive for state law purposes. The Service refused to apply the
correction retroactively. The Seventh Circuit opined that even if the amendment properly
expressed the original intent and the error was due to inadvertence, tax consequences should be
determined by the terms of the initial agreement. The court’s concern was that a different
conclusion would provide an opportunity for “collusive” state court actions having the sole
purpose of reducing federal tax liabilities. Further, the court stated that

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federal tax liabilities would remain unsettled for years after their enactment if state courts and
private persons were empowered to retroactively affect the tax consequences of completed
transactions and completed tax years. [Citations omitted and emphasis added.]

**Tax ramifications.** Be mindful of estate, gift, and GST tax ramifications. Be particularly careful with
beneficiary consents to the proposed transaction, which may be a taxable gift. For example, if a beneficiary
consents to decrease its beneficial interest in trust as part of a judicial modification action, has the
beneficiary just made a taxable gift under Section 2511(a), \(^43\) which reaches indirect as well as direct
transfers?

**GST tax planning.** Be particularly careful when modifying trusts that predate the GST tax \(^44\) or are intended
to use GST exemption. In Ltr. Rul. 201210008, the Service recognized a post-death reformation and
modification of a residuary trust designed for GST planning. The attorney who prepared the trust stated that
he made a scrivener’s error in permitting distributions under the trust to be made by the surviving spouse as
co-trustee without regard to an ascertainable standard. \(^45\) To correct the scrivener’s error, the trustee of the
trust successfully obtained a state court order reforming and modifying the trust.

The Service found that the modification did not provide the surviving spouse with a general power of
appointment over the trust’s assets, nor constitute a gift under Section 2514. Further, on the surviving
spouse’s death, the trust’s assets would not be includable in the surviving spouse’s gross estate.

In Ltr. Rul. 200936023, the Service considered a modification to a GST-exempt trust sought by a grantor, his
son, and his son’s children requiring beneficiaries to enter into premarital agreements to continue as eligible
beneficiaries. The Service found the proposed modification did not result in the loss of the trust’s GST-
exempt status, nor constitute a gift by son or son’s children. The clause that was inserted provided:

No child of the beneficiary shall receive (or continue to receive) any distribution of principal or
income from the trust if prior to entering into marriage or any legally recognized union he or she
does not execute a valid premarital agreement under the relevant state’s law declaring that the
trust property is and shall remain his or her separate property. If a child of the beneficiary enters
into any marriage without having executed such a premarital agreement protecting the trust
property (which premarital agreement shall remain effective during the marriage), he or she
shall, as of the date of the marriage, be deemed to have predeceased the beneficiary and this
Trust shall be read accordingly. The purpose of this provision is to preserve and protect the trust
property for the benefit of the beneficiary’s children.

**Apply for letter ruling.** If the area is one in which the Service will issue private letter rulings, consider
whether the state court petition for modification or reformation can be made contingent on receiving a
favorable ruling from the Service. \(^46\)

https://checkpoint.riag.com/app/view/toolItem?usid=6a9a2v105807&feature=checkpoint 1/12/2015
Trust distribution standard. What about distributions a trustee makes to himself or herself as beneficiary where the trust document omits any ascertainable standard? Will the trust need to be amended to provide an ascertainable standard to avoid undesired gift and estate tax consequences?

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Where the trust permits the trustees to make distributions to himself or herself, UTC section 814 implies an ascertainable standard, even if the trust document is silent as to any standard or limitation as to distributions to the trustee as beneficiary. This allows the trustee to meet an exception under Section 2514(c)(1), which defines a general power of appointment as follows:

For purposes of this section, the term "general power of appointment" means a power which is exercisable in favor of the individual possessing the power (hereafter in this subsection referred to as the "possessor"), his estate, his creditors, or the creditors of his estate; except that—

(1) A power to consume, invade, or appropriate property for the benefit of the possessor which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the possessor shall not be deemed a general power of appointment.

Without the statutory inference, a general power of appointment over the trust assets could create estate tax inclusion of the trust in the trustee's estate or unwanted gift tax results.

Illustrations

To see how the various tools discussed above might be used to remedy planning that no longer fulfills its purpose, consider the following illustrations:

Illustration 1. Use of decanting to add beneficiaries as trustees, update trust provisions, and preserve GST exemption—Morse v. Kraft. 47

As noted above, decanting started as a common-law remedy. Even if the state law governing the trust does not have a statute authorizing decanting, decanting may still be available. The recent Kraft case in Massachusetts illustrates the power of decanting in a state that does not have a decanting statute.

In the Kraft case, Robert Kraft (the owner of the New England Patriots) created a trust with separate shares for each son (the 1982 trust). Because the sons were relatively young, the trust provisions required a disinterested trustee to make distribution decisions. After the sons had become responsible adults and the trustee was about to retire, the trustee petitioned the court to affirm his ability to decant the separate shares into a new trust (the 2012 trust) that would allow the sons to make distributions to themselves subject to an ascertainable standard. The 2012 trust also updated many of the administrative provisions from the 1982 trust. The Kraft trustee relied on language in the trust agreement allowing him to make distributions for the benefit of the sons.

Interestingly, the 1982 trust predated the GST tax. Part of the relief requested was a ruling that decanting was authorized without court approval and thus would fit within the safe harbor established in the GST regulations for exempt trusts. 48

The trustee obtained the assent of each of the sons to the modification. The trustee also offered affidavits of settlor Robert Kraft, his attorney, and the trustee that the settlor intended that the trustee be empowered to make distributions in further trust.
The Supreme Judicial Court of Massachusetts relied on seminal cases in Florida, Iowa, and New Jersey authorizing common law decanting. The court also looked to the Restatement, which permits the introduction of extrinsic evidence to demonstrate the settlor's intent.

The court held that the trustee was authorized to decant the 1982 trust into the 2012 trust and that the transfer qualified for the GST exemption in that neither court approval nor beneficiary assent was required. This was all because of the four little words "for the benefit of."48

Another recent case illustrates the power of decanting, this time saving a beneficiary's entitlement to government benefits. In Matter of Kroll,50 a New York Surrogate's Court recognized decanting of a trust under New York's decanting statute into a special needs trust where the beneficiary suffered from several disabilities (arising after the date of the initial trust) and received Medicaid and SSI benefits. Prior to the beneficiary's 21st birthday, payments of principal and interest were discretionary. Once the beneficiary turned 21, however, the beneficiary would have been entitled to quarterly distributions of income and outright distributions of trust principal at ages 25, 30, and 35, with the ability to demand all of the trust principal at age 21. These payments would have disqualified the beneficiary for Medicaid and other governmental benefits. Over the objections of the New York State Attorney General's Office, the court permitted the existing trust to be decanted into a special needs trust, finding it to be a third-party, rather than self-settled special needs trust, with no requirement for a payback provision.


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Second marriages often result in tension between the surviving spouse and the decedent’s children from a previous relationship when the surviving spouse is the beneficiary of a QTIP trust established by the decedent. Children are not keen on waiting for the surviving spouse to pass away before receiving their inheritance and do not like the QTIP requirement that all income be distributed to the spouse for life. A planning opportunity arises where the funds in the QTIP trust, together with the surviving spouse's other resources, are more than sufficient to meet the surviving spouse's needs.

In Ltr. Rul. 201426016, the trustees of the surviving spouse's QTIP trust proposed to divide the trust into three trusts—Trust 1, Trust 2, and Trust 3—each with the same provisions as the original trust. After the division, Trust 2 would be converted into a total return unitrust; Trust 3 would be terminated, its assets distributed to the remainder beneficiaries, and the beneficiaries would pay any gift tax resulting from the termination.

The Service found as follows:

- The division does not disqualify the trusts from being QTIP trusts.
- The division of the trusts and the conversion of Trust 2 to a total return unitrust was not a gift either by the surviving spouse or the remainder beneficiaries.
- A gift does result with the termination of Trust 3, the value of which under Section 2519 consists of the fair market value of the assets transferred less the qualifying interest, plus the value of the qualifying interest under Section 2511, less the gift tax paid by the recipients.
- No gain or loss on division/termination.
- Following the termination of Trust 3, the value of the assets previously held in Trust 3 will not be includable in the surviving spouse's estate.
What were the goals here? Apparently, the planning sought to accomplish the following:

(1) Get the decedent's children some of the trust assets now without subjecting the whole trust to tax under Sections 2519 and 2511.

(2) By using Trust 2, provide that the excess of any income over the unitrust amount (3%-5%) is saved for the children rather than having to be distributed to the surviving spouse under the QTIP rules.

Illustration 3. Saving the S election for shares too long in a non-electing trust.

S corporations may have only a certain number and certain types of shareholders.\(^1\) Only certain types of trusts such as qualified Subchapter S trusts (QSSTs) and electing small business trusts (ESBTs) are eligible shareholders in an S corporation.\(^2\)

When someone dies, his or her probate estate remains an eligible shareholder for the duration of the administration of the estate without the need for any specific action by the executor; once the stock is transferred to a trust, however, the trustee has two years from the date the stock is transferred to either get the stock out of trust or make an election if the trust qualifies.

When it comes to S corporation relief, the Service is liberal—the taxpayer may seek late election relief under Rev. Proc. 2013-30,\(^3\) which includes a flowchart for determining whether the Procedure is available. If the taxpayer does not meet the requirements of the Procedure, a letter ruling is required for relief.

In Ltr. Rul. 201426018, a shareholder of a Subchapter S corporation died. His shares were distributed to a trust. Two years passed and the trust failed to make a timely QSST election. The Service found that the termination was inadvertent for purposes of Section 1362(f), and the S election will continue as if no termination had occurred.

Conclusion

In the course of advising clients, estate planners are likely to come across trust and estate plans that fail to fulfill their intended purposes. Perhaps circumstances have changed over time while the trust provisions remained stable, or maybe the trust document was flawed when originally drafted. In any event, a variety of techniques are available that may be effective in correcting those trust shortcomings. When identifying strategies to follow, practitioners should be sure to review state laws as well as federal tax statutes to ensure that their fixes do not create unintended problems of their own. By applying the same creativity planners bring to the initial plan design, planners often can find a remedy to address seemingly intractable situations.

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2. The UTC modification remedies typically include the ability to terminate the trust in addition to provisions focused solely on trust termination.
For charitable trusts, the State Attorney General and Department of Revenue also may be interested parties.

UTC section 416 comment.


Kasner, Strauss, and Strauss, Post Mortem Tax Planning (Thomson Reuters / WG&L), Chapter 17; McCaffrey and Heller, supra note 5; Ltr. Rul. 201214022 (retroactive reformation recognized to convert general power of appointment in residual trust to limited one). As a practical matter, private letter rulings may use the terms reformation and modification interchangeably. Just because the proponent is successful in a "reformation" action does not guarantee retroactive treatment by the IRS. See Ltr. Rul. 201243001.

The UTC also includes a separate modification provision to achieve the tax purposes of the settlor. UTC section 416 (2010).

While sections 412 and 416 are available for noncharitable and charitable trusts, section 411 is available only for noncharitable trusts and section 413 is available only for charitable trusts.

UTC section 411 contains optional language, and enactment differs by jurisdiction. The UTC provides as an option that a court will approve the modification if the court finds that the settlor and all beneficiaries consent to the modification. A further option in section 411(e) grants the court power to modify the trust even if all of the beneficiaries have not consented if the court is satisfied that “(1) if all of the beneficiaries had consented the trust could have been modified ... under this section; and (2) the interests of a beneficiary who does not consent will be adequately protected.”


In the Matter of Peierls Family Inter Vivos Trusts, 77 A3d 249 (Del. 10/4/2013); In the Matter of Peierls

For example, if a court in the original home state may be considered to have “primary supervision” over the trust at issue, this may necessitate getting an order from that court terminating such supervision before the Delaware Chancery Court will exercise jurisdiction. See Gordon and Hayward, supra note 11.

196 So. 299 (Fla., 1940); see also In re Estate of Spencer, 232 NW2d 491 (Iowa, 1975); Wiedenmayer v. Johnson, 254 A2d 534 (N.J. Super., 1969); Regents v. Trust Co., 198 SE 345 (1938).


2011-52 IRB 932.

The IRS included decanting in its 2011-2012 Priority Guidance Plan. Since then, the IRS dropped decanting from its Priority Guidance Plan. The opening language to the Priority Guidance Plan states that the Plan includes projects that the Service intends to work on in the coming year, but without any committed deadlines. Colloquially, the Priority Guidance Plan is thought to include projects that the Service plans to complete within the year of the plan. The initial version of the 2014-2015 Priority Guidance Plan, released 8/26/2014, does not reference decanting.


For guides on complying with Section 2518, see Bittker and Lokken: Federal Taxation of Income, Estates, and Gifts (Thomson Reuters / WG&L) ¶121.7; Stephens, Maxfield, Lind, Calfee, and Smith, Federal Estate and Gift Taxation (Thomson Reuters / WG&L) ¶ 10.07. For a thorough discussion on the uses of disclaimers, see Westfall and Mair, Estate Planning Law and Taxation (Thomson Reuters / WG&L) ¶15.08[4]; Becker, Shirley, “Practical Disclaimer Planning,” presented at Southeast Region Fall Meeting, American College of Trust and Estate Counsel (2003) (available from ACTEC website or author).


UTC section 804 (2010).

UTC section 802 (2010).

UTC section 803 (2010).

UTC section 1001 (2010).

UTC section 1009 (2010).

UTC section 1005 (2010).


Id.
For additional information, see Kasner, Strauss, and Strauss, supra note 6, Chapter 17; McCaffrey and Heller, supra note 5.


See, e.g., Section 2055(e)(3) with respect to a "qualified reformation" to receive a charitable deduction for a defective split-interest trust, such as a charitable remainder trust.

See, e.g., Reg. 26.2601-1(b)(4)(i), which provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a GST-exempt trust will not cause the trust to lose its exempt status. The regulation states specifically that the rules apply to only whether a trust will lose its exempt status, not whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary or results in the realization of capital gain.

Section 6110(k)(3).

Note 31, supra.

Ltr. Rul. 201210008.

Ltr. Rul. 201418001.

Ltr. Ruls. 201425018 and 9823032.

Ltr. Rul. 201125007.

See, e.g., Estate of Bosch, supra note 31; Estate of Rapp, supra note 31.
Kasner, Strauss, and Strauss, supra note 6; Ltr. Rul. 200318064 (state-law reformation of irrevocable trust to include settlor's after-born children recognized as retroactive; agreement between settlor and special representatives agreeing to reformation on behalf of settlor's minor children was not gift for purposes of Section 2511(a)).

McCaffrey and Heller, supra note 5.

Section 2511(a); Regs. 25.2511-1(c)(1) and (h), Example 8; compare Ltr. Rul. 200318064 (state-law reformation of irrevocable trust to include settlor's after-born children recognized as retroactive; agreement between settlor and special representatives agreeing to reformation on behalf of settlor's minor children did not constitute gift for purposes of Section 2511(a)) with Ltr. Rul. 200917004 (amendment to generation-skipping trust to include legally adopted children as issue and descendants under trust did not affect GST tax-exempt status of the trust, but by adding adopted children and grandchildren, the naturally born children and grandchildren have made a taxable gift for purposes of Section 2501); Stephens, Maxfield, Lind, Calfee, Smith, supra note 20, ¶10.10 n. 13 and 14.

Under Section 433(b)(2)(A) and Reg. 26.2601(b)(1)(l), the GST tax does not apply to a transfer under a trust that was irrevocable on 9/25/1985, provided no additions (actual or constructive) were made to the trust after that date.

Consider whether UTC section 814, discussed below, could have been read to imply such a standard.

See, e.g., Ltr. Ruls. 201125007 and 200818002.

992 NE2d 1021 (Mass., 2013).


In a ruling after Kraft, a Connecticut Superior Court applying Massachusetts law found that a trustee's power to segregate funds for later distribution to a beneficiary did not include the power to decant the trust into a new one and avoid the beneficiary's vested rights to demand outright distribution of the trust when he attained certain ages. The case arose in a divorce context with the wife challenging the decanting as an invalid attempt to protect the beneficiary's interest from division. Ferri v. Powell-Ferri, 20134 Conn. Super. LEXIS 1938 (2013).
Estate Planning for a Family with a Special Needs Child

By Sebastian V. Grassi Jr.

This article is a general overview of issues that a lawyer may need to address when preparing an estate plan for a family with a special needs child.

For purposes of this article, “special needs child” refers to a child who, at birth or because of a subsequent illness or injury, is mentally, physically, or emotionally disabled, and because of the severity of the disability is, or may be, eligible for means-tested government benefits. "Means-tested" government benefits are public programs with limitations on the amount of income and assets/resources a recipient can own. Such programs include Supplemental Security Income and Medicaid.

Typical special needs children include those born with cerebral palsy, autism, Fragile X syndrome, Down syndrome, mental impairment, and so on. See Thomas D. Begley Jr. & Angela E. Canellos, Special Needs Trust Handbook (2009); chapter 17 of Lawrence A. Frolik & Melissa C. Brown, Advising the Elderly or Disabled Client (2d ed. supp. 2008); and Sterling L. Ross Jr., The Special Needs Trust: A New Wrinkle No More, 36th Heckerling Inst. on Est. Plan. ch. 16 (Jan. 2002), at 15-i, for detailed information on special needs planning.

Overview of Critical Government Benefit Programs

The most important means-tested government benefit programs concerning a special needs child are:

- Supplemental Security Income (SSI), 42 U.S.C. § 1381 et seq., 20 C.F.R. Part 416, which provides a minimum level of monthly income to aged, blind, and disabled individuals who meet certain eligibility requirements and are indigent. In most states, the receipt of SSI benefits automatically entitles or includes the receipt of Medicaid benefits. The two benefits are linked together. If the special needs child loses his or her SSI benefits, the child may also lose his or her Medicaid benefits.
- Medicaid, 42 U.S.C. § 1396 et seq., 40 C.F.R. Parts 430, 431, and 435, which is a medical payment program (and not a health insurance program) for the aged, blind, and disabled who meet certain eligibility requirements and are indigent. In addition to paying for medical services, Medicaid pays for a host of ancillary services that are essential for a special needs child, such as personal care attendants, housing, and so on. Consequently, preserving the special needs child’s Medicaid eligibility is typically of paramount concern.

Special Needs Challenges and Responses

In addition to the usual hurdles that parents face when preparing an estate plan (for example, who should be the guardian, trustee, executor, and so on), the parents of a special needs child are faced with five unique estate planning challenges:

1. how to provide for all of their loved ones without jeopardizing the special needs child’s current (or potential) eligibility for means-tested government benefits such as SSI and Medicaid;
2. how to design an estate plan that supplements the special needs child’s means-tested government benefits and enhances the quality of the special needs child’s life;
3. how to treat the other children equitably while providing for the special needs child;
4. how to make sure sufficient funds are available at a parent’s death to care for the special needs child; and
5. how to provide for the proper supervision, management, and distribution of an inheritance for the special needs child through a third-party created and funded special needs trust (SNT).

Of these five unique estate planning challenges, items (4) and (5) typically prove to be the most difficult to implement. This is especially true if most of the parents’ estate is composed of retirement benefits, if there is no trustee in the parents’/special needs child’s vicinity who is experienced in administering SNTs, or if there is an experienced trustee.
available (typically a corporate trustee) but its minimum fee is too high relative to the proposed size of the SNT.

Practice Point: In the client estate planning questionnaire/intake form, ask if any family members are disabled, incapacitated, or have special needs.

At a minimum, the parents of a special needs child should typically have the following five estate planning documents prepared:

1. A last will and testament.
2. A general durable power of attorney for financial affairs (GDPA). The parent’s GDPA should permit the agent to make discretionary nonsupport distributions to or for the benefit of the special needs child and to establish a third-party created and funded SNT for the benefit of the special needs child.
3. A durable medical power of attorney.
4. A revocable living trust. During a parent’s period of incapacity, the parent’s revocable living trust should contain language that permits the trustee to make discretionary nonsupport distributions to or for the benefit of the special needs child. On the parent’s death, the special needs child’s inheritance should be distributed to a third-party created and funded SNT previously established by the parent.
5. A third-party created and funded SNT, which is discussed below.

Five estate planning options are available to parents concerning their special needs child:

1. Distributing assets outright to the special needs child (not recommended because the assets may disqualify the child from receiving means-tested government benefits);
2. Disinheriting the special needs child (generally not recommended because the child will have no “safety net” if government benefits are subsequently reduced or eliminated);
3. Leaving property to another family member with the “understanding” that the property will be used for the benefit of the special needs child (generally not recommended because the arrangement is not legally enforceable and the sibling’s creditors (including a potential ex-spouse) may be able to seize the assets);
4. Establishing a third-party discretionary support trust for the special needs child (generally not recommended because the trust will, in many states, disqualify the child from receiving means-tested government benefits); and
5. Establishing a third-party created and funded SNT for the special needs child (highly recommended because the trust will not disqualify the child from receiving means-tested government benefits).

The Third-Party Created and Funded Special Needs Trust

Of these five options, practitioners generally prefer that parents establish an inter-vivos stand-alone, third-party created and funded SNT. An alternative to a stand-alone, third-party created and funded SNT is to have the parents’ last will and testament or their revocable living trust contain third-party created and funded SNT provisions.

An SNT established by and wholly funded with the assets of someone other than the special needs child (or the special needs child’s spouse) is considered to be a “third-party” trust. Under existing applicable law, assets contained in a properly drafted and administered third-party created and funded SNT are not considered to be “available” to the special needs child for determining the child’s (financial) eligibility for means-tested government benefits, such as SSI and Medicaid, and there is no requirement that Medicaid be repaid from the third-party created and funded SNT when the special needs child dies or if the trust terminates during the special needs child’s lifetime.

A typical third-party created and funded SNT is one established by the parents or grandparents of the special needs child that is funded with the parents’ or grandparents’ assets (and not with the assets of the special needs child) and such trust is not created under 22 U.S.C. § 1396p(c)(2)(B)(iii) to make the trustmaker (for example, the parent or grandparent) eligible for Medicaid paid nursing home care. A trust established with the special needs child’s assets (such as an inheritance, gift, bequest, alimony, or lawsuit settlement received by or payable to the special needs child) is considered to be a “first-party” or “self-settled” trust. First-party special needs trusts are discussed below.

Caution: Never, ever include a Medicaid payback provision in a third-party created and funded SNT. This point cannot be overemphasized.

Practice Point: If an irrevocable inter-vivos third-party created and funded SNT is established by the parents or grandparents, the parents’ (or grandparents’) wills should specify the
source for the payment of any death taxes attributable to the trust if any part of the third-party created and funded SNT is includable in the parents' (or grandparents') gross estate. Should the death taxes be apportioned against the third-party created and funded SNT, or against the residue of the parents' (or grandparents') estate?

Trustee Selection

Because the trustee of a third-party created and funded SNT is given complete discretion in making distributions to or for the benefit of the special needs child, who should serve as the trustee of a third-party created and funded SNT is important. The selection of the trustee involves many considerations, including the trustee's ability to understand and respond to the needs of the special needs child; the trustee's knowledge of government benefit programs and the effect that trust distributions will have on the special needs child's government benefits; the trustee's health, integrity, reliability, and financial acumen; the trustee's potential for a conflict of interest if the trustee is a current or remainder beneficiary of the trust; and the potential for adverse income and transfer tax consequences if a family member serves as a trustee and is also a current or remainder beneficiary of the trust.

Caution: Because of SSI and Medicaid rules and for various tax reasons, neither the special needs child nor his or her spouse should serve as trustee of either a third-party or first-party SNT.

A Maximum Flexibility

Because a third-party created and funded SNT is a discretionary non-support trust with spendthrift provisions (a very important element under common law and the Uniform Trust Code (UTC)—see UTC §§ 501 and 502), the trustee has maximum flexibility to meet the beneficiary's needs and maintain the beneficiary's eligibility for government benefits, all of which underscores the need to select the right person to serve as trustee.

As previously mentioned, such a trust, if properly drafted and administered, does not disqualify a special needs child from receiving means-tested government benefits. A third-party created and funded SNT is well suited to deal with possible changes in the amount of government benefits that may be available in the future because of changes in SSI or Medicaid funding, budget cuts, eligibility requirements, and so on.

The principal purpose of a third-party created and funded SNT is to provide an inheritance for the special needs child without risking the loss of important means-tested government benefits such as SSI, Medicaid, and so on.

Even if the special needs child does not receive means-tested government benefits such as SSI or Medicaid and instead receives entitlement-based government benefits such as Social Security Disability Income and Medicare, a third-party created and funded SNT will always protect the special needs child from his or her inabilities, disabilities, predators, and creditors. A third-party created and funded SNT can, at the same time, be both flexible and protective.

Contingent Provisions

Anyone can become a special needs child (or severely disabled) in just a matter of seconds. An auto accident or sporting injury can change a person's life forever. To plan for the possibility that a child (or beneficiary under a trust or will) becomes severely disabled at a later date, a testator/trustmaker should include a provision in the governing instrument that permits the fiduciary to establish a third-party created and funded SNT and fund the trust with the property that would otherwise be paid outright to the (now) severely disabled beneficiary. See sample drafting language on the following page.

Coordination with Other Relatives' Estate Plans

The principal purpose of a third-party created and funded SNT is to provide an inheritance for the special needs child without risking the loss of important means-tested government benefits such as SSI, Medicaid, and so on. Consequently, it is important that grandparents and other relatives (including the siblings of the special needs child) do not leave an inheritance outright to a special needs loved one.

Fortunately a parent's stand-alone inter-vivos third-party created and funded SNT can be structured to receive gifts, bequests, and inheritances from grandparents (and other relatives/friends) for the benefit of the special needs child. This avoids the grandparents (or other relatives/friends) having to prepare a separate third-party created and funded SNT.

Review of All the Parents' Assets

A corollary to the need to coordinate a special needs child's inheritance with other relatives is the need to review all possible ways a special needs child could receive property, an inheritance, or a gift. For example, the following common assets and applicable beneficiary designations should be reviewed to make sure they will not be paid (or given) directly to the special needs child:

- IRA, 401(k), and other retirement benefits, see section 6.3.11 of Natalie B. Choate, Life and Death Planning for Retirement Benefits (6th ed. 2006), www.ataxplan.com;
Sample (contingency) language for inclusion in a relative’s trust or will [use “Executor”] in the event a beneficiary subsequently becomes disabled and needs public assistance benefits. The author makes no warranties or representations concerning the tax implications or efficacy of the sample language.

Power to Establish a Special Needs Trust, and to Amend or Reform a Trust. If an individual beneficiary-devisesee has applied for or is receiving government assistance that is based on financial eligibility requirements, or if Trustee [Executor] reasonably anticipates that a beneficiary-devisesee may need such government assistance in the foreseeable future, Trustee [Executor] may in its sole, absolute and uncontrolled discretion withhold the trust [estate] property otherwise distributable to such beneficiary-devisesee and establish a third-party created and funded discretionary non-support spendthrift special needs trust; or if that is not possible or practicable, establish by court order a first-party (i.e., a self-settled) discretionary non-support spendthrift special needs trust (such as a self-settled special needs trust permitted under 42 U.S.C. 1396p(d)(4)(A) or 42 U.S.C. 1396p(d)(4)(C)). Trustee [Executor] shall then fund the special needs trust with the property that would otherwise be distributed to the beneficiary-devisesee. In establishing a special needs trust, Trustee [Executor] may select a trustee and successor trustees (other than the beneficiary-devisesee or the beneficiary-devisessee’s spouse), establish accounting requirements, and shall include all provisions determined to be reasonable and necessary by Trustee [Executor] after consultation with a qualified attorney. It is my intent that any special needs trust established pursuant to this provision be drafted and administered so as to provide the maximum benefit to the beneficiary-devisesee and that the assets of the special needs trust not be available to the beneficiary-devisesee for determining the beneficiary-devisesee’s income or assets under rules by which any government agency determines eligibility for need-based services or financial services (such as SSI and Medicaid). To the extent required by law, the special needs trust shall be for the sole benefit of the beneficiary-devisesee during his or her lifetime. To the extent not prohibited by law, distributions from the special needs trust shall be made in the sole, absolute, and uncontrolled discretion of the special needs trustee to or for the benefit of the beneficiary-devisesee. In making such distributions, the special needs trustee shall consider the effect such distributions may have on the beneficiary-devisessee’s said government assistance benefits. The special needs trust (or joint agreement as concerns a special needs trust established pursuant to 42 U.S.C. 1396p(d)(4)(C)) shall provide (to the extent possible) that upon the beneficiary-devisesee’s death and after all proper reimbursements and payment of expenses have been made (to the extent such reimbursements and payment of expenses are required by law), the special needs trustee shall distribute the remaining trust property (if any) to such of my descendants (other than the beneficiary-devisesee, the beneficiary-devisesee’s estate or the creditors of either) as the beneficiary-devisesee shall appoint by the beneficiary-devisesee’s last will and testament that makes specific reference to this testamentary limited power of appointment. Any unappointed trust property shall be distributed to the then living descendants of the beneficiary-devisesee, by right of representation, or if there are no then living descendants of the beneficiary-devisesee, the unappointed trust property shall instead be distributed: (i) to my descendants by right of representation, or (ii) to such remainder beneficiaries as may be determined by a court of competent jurisdiction at the time of Trustee’s [Executor’s] establishment of the special needs trust. Trustee [Executor] shall neither possess nor exercise its authority hereunder in a manner that would impair or prevent a beneficiary’s unexercised right of withdrawal that has not yet lapsed, or prevent an existing bequest from qualifying for the marital or charitable deduction, or impair the status or qualification of a trust that holds shares of stock in a Subchapter S corporation, or prevent a trust from qualifying as a Look-Through Trust with a Designated Beneficiary (or Beneficiaries).

After my death, Trustee [Executor] may obtain an order from a court of competent jurisdiction to amend or reform any trust (or any trust created or to be created) under this instrument to the minimum extent necessary to comply with my intent and to comply with applicable federal and state laws or regulations, including those pertaining to special needs trusts. Trustee’s [Executor’s] authority hereunder is to be exercised only in fiduciary capacity and may not be used to enlarge or shift any beneficial interest except as an incidental consequence of the discharge of fiduciary duties, and in no event shall any amendment or reformation increase the class of beneficiaries. No Trustee [Executor] (or court) shall have the power to amend or reform this instrument in a manner that would thwart my intent, impair or prevent a beneficiary’s unexercised right of withdrawal that has not yet lapsed, or prevent an existing bequest from qualifying for the marital or charitable deduction, or impair the status or qualification of a trust that holds shares of stock in a Subchapter S corporation, or prevent a trust from qualifying as a Look-Through Trust with a Designated Beneficiary (or Beneficiaries). In no event shall this power of amendment or reformation be construed or exercised in a manner so as to bestow upon Trustee [Executor] a general power of appointment (as that term is defined under the Internal Revenue Code).
• life insurance (including employer-provided life insurance) benefits;
• accidental death and travel insurance benefits provided through credit cards when a person purchases a plane ticket, and so on, using that credit card;
• annuities;
• savings bonds;
• any property not subject to the parents’ will or trust;
• UGMA or UTMA accounts;
• “transfer on death” (TOD), “pay on death” (POD), “in trust for” (ITF) designations on accounts, savings bonds, or securities;
• inheritances, gifts, or bequests through another person’s will or trust (if not paid to a third-party created and funded SNT);
• deeds;
• joint accounts;
• jointly owned property, including jointly owned real estate;
• final paycheck (including unused vacation and sick pay);
• collectibles, antiques, and family heirlooms;
• personal injury and wrongful death proceeds payable to a deceased parent’s estate; and
• homestead laws that give the surviving spouse a life estate and the minor children a vested remainder interest (as does Florida law in certain instances).

Caution: This list is not exhaustive.

**Managing Assets Already Owned by a Special Needs Child**

If a special needs child who is disabled (as defined by Social Security under 42 U.S.C. § 1382c(a)(3)) has received (or has a vested noncontingent right to receive) an inheritance, gift, bequest, lawsuit award or settlement, child support, alimony, or divorce property settlement, the special needs child’s receipt of these assets can result in the disqualification of means-tested government benefits such as SSI and Medicaid. See Thomas D. Begley Jr. & Andrew H. Hook, Using Self-Settled Special Needs Trusts to Facilitate

**Matrimonial Settlements, 34 Est. Plan. 42 (Apr. 2007).**

To preserve these government benefits, the special needs child’s disqualifying assets should be converted into exempt (or noncountable) assets or be transferred to a first-party self-settled SNT that is government approved.

**The (d)(4)(A) SNT**

The first type of safe harbor first-party self-settled SNT is an inter-vivos irrevocable trust established under 42 U.S.C. § 1396p(d)(4)(A), commonly referred to as a “(d)(4)(A) SNT” or a “(d)(4) (A) Medicaid payback trust.” A (d)(4)(A) SNT is best suited for a significant amount of resources that can sustain a professional trustee’s minimum fee schedule. Generally, a corporate fiduciary requires the trust to contain at least $100,000 in marketable assets. By statute, a (d)(4)(A) SNT must contain a Medicaid payback provision on the death of the special needs child (or in some instances, if the trust terminates during the lifetime of the special needs child)—hence the name, “Medicaid payback trust.”

*Practice Point:* As previously mentioned, a third-party created and funded SNT is not required to contain a Medicaid payback provision and should never contain a Medicaid payback provision.

**The (d)(4)(C) SNT**

The second type of safe harbor first-party self-settled SNT is an inter-vivos “pooled account trust” established under 42 U.S.C. § 1396p(d)(4)(C), commonly referred to as a “(d)(4)(C) SNT” or a “(d)(4)(C) pooled account trust.” A (d)(4)(C) SNT is administered by a nonprofit charitable association, which also acts as the trustee. The special needs child’s disqualifying assets are transferred into the master trust, and a separate trust account (also known as a “sub-trust account”) is established by the nonprofit charitable association for the sole benefit of the special needs child. For purposes of investment and management of funds, however, the master trust pools all the separate trust accounts—hence the name, “pooled account trust.” A (d)(4)(C) pooled account trust is best suited for the situation in which the amount of non-exempt assets owned by the special needs child is not large enough to justify the cost of establishing and administering a (d)(4)(A) SNT or when the parents or child want to ultimately benefit the mission of the nonprofit association on the death of the special needs child.

*Practice Point:* Not all states have (d)(4)(C) pooled account trusts.

The transfer of a special needs child’s assets to a properly drafted and administered OBRA ‘93 SNT does not penalize the special needs child for purposes of qualifying for means-tested government benefits.

**OBRA 1993 Special Needs Trusts**

Collectively, (d)(4)(A) SNTs and (d)(4)(C) SNTs are referred to as “OBRA 1993 special needs trusts” (“OBRA ‘93 SNTs”) in reference to the law (the Omnibus Budget Reconciliation Act of 1993) that established the use of these trusts to preserve Medicaid eligibility, which was subsequently clarified in the Foster Care Independence Act of 1999, 42 U.S.C. § 1382b, to preserve SSI eligibility. See 42 U.S.C. § 1382b(e)(5), which
authorizes the use of (d)(4)(A) and (d)(4)(C) SNTs to preserve SSI benefits for a special needs child.

The transfer of a special needs child’s assets to a properly drafted and administered OBRA ’93 SNT does not penalize the special needs child for purposes of qualifying for means-tested government benefits, and the child’s assets held in a properly drafted and administered OBRA ’93 SNT are not considered to be “available” to the special needs child for determining the child’s financial eligibility for means-tested government benefits.

Practice Point: To avoid the special needs child making a completed gift to the OBRA ’93 trust remainder beneficiaries on funding the trust, the special needs child should be granted a testamentary limited power of appointment over the trust assets. Treas. Reg. § 25.2511-2(c).

Medical Treatment and the Adult Special Needs Child

Under the privacy rules of the federal Health Insurance Portability and Accountability Act (HIPAA), 42 U.S.C. § 1320d, 45 C.F.R. Parts 160–164, which went into effect in April 2003, medical personnel (such as doctors and hospitals) are not allowed to talk freely about a patient’s medical condition, and they can be fined or jailed for dissemination of any private health information without the patient’s consent. This applies to all patients over the age of 18, including patients with special needs. Although the HIPAA privacy rules are well-intentioned, they can have horrendous implications for the medical care of an adult special needs child if he or she is unable to give informed consent and knowingly participate in his or her own medical treatment.

If an adult special needs child lacks the ability to make informed medical or mental health decisions or to give consent to the release of confidential medical information, parents should consider these options:

- if the special needs child is mentally competent under applicable state law, have an estate planning attorney prepare a durable medical power of attorney that includes HIPAA release information and names each parent as a “personal representative” under the HIPAA rules so that the parent can legally request and receive confidential medical information; or
- if the special needs child is mentally incompetent, obtain a guardianship over the special needs child for medical treatment purposes.

Once the child becomes an adult, a parent’s right to know, monitor, advocate, and intercede in the special needs child’s affairs may be limited or prohibited absent the child’s consent, a court order (such as a guardianship), or a GDPA.

Assisting the Adult Special Needs Child in Financial, Educational, and Daily Living Matters

General Durable Power of Attorney

If an adult special needs child is mentally competent under applicable state law, he or she should have a GDPA prepared by an estate planning attorney. The GDPA for the special needs child should authorize the child’s agent to transfer the child’s assets into a first-party SNT.

Practice Point: Under federal law, a GDPA cannot be used by the special needs child’s agent to establish a (d)(4)(A) SNT for the benefit of the special needs child; however, an agent under a GDPA can transfer the special needs child’s assets into an existing (d) (4)(A) SNT. An agent under a GDPA, however, can execute a joinder agreement for a (d)(4)(C) pooled account trust and transfer the child’s assets into the (d)(4)(C) pooled account trust. See Andrew H. Hook, 859 T.M., Durable Powers of Attorney, for a discussion of GDPA’s and sample forms.

Once the child becomes an adult, a parent’s right to know, monitor, advocate, and intercede in the special needs child’s affairs may be limited or prohibited absent the child’s consent, a court order (such as a guardianship), or a GDPA. A GDPA will permit the person named as the power of attorney to assist the special needs child in his or her financial affairs. The GDPA is highly recommended because it is the least costly and least intrusive method for assisting the adult child in his or her nonmedical affairs. When the special needs child dies, the authority given the person named as power of attorney under the GDPA automatically expires.

Parent as Representative Payee

In addition, a parent may become the “representative payee” of the special needs child’s SSI, SSDI, and Social Security benefits, thus avoiding a court-appointed “guardian of the estate” or conservatorship. 20 C.F.R. Parts 404.2001–404.2065. A representative payee is the SSA’s version of a
Durable Power of Attorney for Education Matters

If an adult special needs child is mentally competent under applicable state law, he or she also should have a durable power of attorney for education matters prepared. Such a document can name the parents as the child’s agent and advocate concerning educational matters. Assisting the child in education-related matters once the child turns 18 is especially important if the child is intimidated by authority figures, such as teachers and school administrators, and needs a third party to advocate on the child’s behalf. In most instances, the parents are the natural and preferred choice to serve as the child’s advocate. See Judith C. Saltzman & Barbara S. Hughes, Planning with Special Needs Youth upon Reaching Majority: Education and Other Powers of Attorney, 1 NAELA J. 41 (2005).

Conclusion

Estate planning for the special needs family is the first of many steps that needs to be taken by parents in their journey of caring for all their loved ones. Financial planning, retirement planning, housing issues, caretakers, personal assistants, advocates, and so on, also need to be considered, especially as pertains to a special needs child. Estate planning is a starting point, not the end all. Competent legal counsel along with other professionals can guide the parents along the way. “It takes a team to plan for a special needs child.” See Abraham J. Perlstein, Comprehensive Future Care Planning for Disabled Beneficiaries, 27 Est. Plan. 358 (Oct. 2000).
Estate Planning and Retirement Benefits

An Approach Toward Simplification, Part 1

By Edward V. Atnally

Much has been said and written about the use of retirement plan benefits in the estate planning process, but little has been done to simplify the concepts and procedures involved. This article is designed to help practitioners provide guidance to their clients when dealing with retirement plans in estates of all sizes and complexities.

Part I of this article reviews the steps to be taken in smaller estates when there is no need for a trust arrangement and in more complex estates in which trusts are useful to provide for beneficiaries with special needs. Part II, which will appear in the September/October issue, will review the steps to be taken when credit shelter and marital deduction trusts are desirable to reduce estate taxes. The planner's goal is to avoid the payment of unnecessary estate taxes and especially income taxes by "spreading out" retirement plan distributions and related tax liabilities thereby enhancing the value of assets eventually passing to the plan beneficiaries.

Planning for Smaller Estates—Special Needs Trusts

Retirement planning for estates has been described by some individuals as a "morass" or "quagmire," but it remains increasingly important as 401k plans, individual retirement accounts (IRAs), and other retirement plans become significant parts of

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Using a Crummey Trust to Preserve Gift Tax Exclusion

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Editor: Albert B. Ellentuck, Esq.

A gift qualifies for the annual gift tax exclusion ($14,000 for 2014) only if the transfer is of a present interest in the property. A present interest is defined as an unrestricted right to the immediate use, possession, or enjoyment of the property or the income from it. This present interest requirement often prevents a gift to a trust from qualifying for the annual gift tax exclusion if the trust accumulates income and defers the distribution of principal.

A favorite tool of practitioners is the Crummey trust. It satisfies the present interest requirement while allowing the donor to avoid the requirement of the Sec. 2503(c) trust that all income and principal be distributed to the beneficiary at age 21 and the requirement of the Sec. 2503(b) trust that all income be distributed currently. It was named after a 1968 decision by the Ninth Circuit Court of Appeals that was subsequently accepted by the IRS in Rev. Rul. 73-405 (Crummey, 397 F.2d 82 (9th Cir. 1968)).

In the typical Crummey trust, a periodic contribution of assets to the trust is accompanied by an immediate withdrawal power that gives the beneficiary the right to withdraw the contribution for a limited time. However, the expectation of the donor is that the power to withdraw will not be exercised (although there should be no express agreement to this effect). The beneficiary's limited withdrawal right (a Crummey power) causes the gift to the trust to be a gift of a present interest that can be sheltered by the annual gift tax exclusion. It is the presence of a legal right, not the likelihood of its exercise, that is the determining factor.

In Letter Ruling 199912016, the IRS considered four factors in determining whether a beneficiary's withdrawal (Crummey) right qualified gifts to a trust as present interest gifts:

1. The trust is required to give the beneficiary reasonable notice in which to exercise the withdrawal right;

2. The beneficiary is given adequate time following notice in which to exercise the withdrawal right;

3. Upon exercising the withdrawal right, the beneficiary will have the immediate and unrestricted right to an amount equal to the amount contributed to the trust; and

4. There is no understanding or agreement, expressed or implied, that the withdrawal will not be
Withdrawal Right

The trust’s beneficiary must be given actual notice of the withdrawal right along with a reasonable period to exercise it, generally considered to be 30 days or longer. The IRS has privately ruled that without a current notice that a gift is being transferred to the trust, it is not possible for a donee to have the real and immediate benefit of the gift (Technical Advice Memorandum 9532001). The authors recommend the notification be written; also, a written acknowledgment should be received from the beneficiary or the beneficiary’s representative. The trust instrument may limit the withdrawal right to the amount of the annual gift tax exclusion or the fair market value of the property contributed to the trust, whichever is less.

The IRS has long been concerned about trust arrangements that give individuals Crummey withdrawal rights but no other economic interest in the income or principal of the trust (sometimes referred to as "naked" Crummey powers). The IRS holds that the beneficiaries of a Crummey trust must have an actual economic interest in the trust property for the present interest requirement to be satisfied (Letter Ruling 9045002). In other words, the beneficiaries should have a vested right to principal or income for the annual exclusion to apply.

The IRS was dealt a major defeat on this issue in 1991 when the Tax Court ruled that the controlling factor in the present interest requirement was not the likelihood of the beneficiaries’ exercising their withdrawal power, but whether the beneficiaries had the power to make the withdrawals (Estate of Cristofani, 97 T.C. 74 (1991), acq. 1992-1 C.B. 1, acq. 1996-2 C.B. 1). Although the IRS acquiesced in the Cristofani decision, it also issued an action on decision (AOD), which indicates it will continue to litigate in situations where the annual withdrawal power is granted to persons who do not have income or vested remainder interests in the trust other than the withdrawal power (AOD 1992-09).

In an unusual move, the IRS issued a second AOD (1996-10) on the Cristofani decision five years after the event. In addition to repeating the rationale of the earlier AOD, the second one states that the IRS will challenge Crummey powers if the withdrawal rights have no real substance, regardless of the power holders’ other interests in the trusts. Specifically, the IRS Chief Counsel stated that if there is evidence of an agreement between the donor and the power holder that the withdrawal right would not be exercised, or if the exercise of the right would result in adverse consequences to the holder, the withdrawal right will not be considered a bona fide gift of a present interest. Simultaneously with the release of AOD 1996-10, the IRS issued Letter Ruling 9628004, in which it denied annual exclusions on transfers to trusts, based in part on its finding that the donor and beneficiaries had a "prearranged understanding" that the beneficiaries would not exercise their rights of withdrawal.

Caution: As a result of Letter Ruling 9628004 and AOD 1996-10, practitioners should be aware that the IRS will continue to look very carefully at the substance behind Crummey power holders’ rights and the vested interest that a power holder has in the trust. The practitioner should assume that an annual gift tax exclusion will probably not be allowed for a power holder who has no interest in a trust other than withdrawal rights. In addition, the IRS will likely challenge exclusions for powers held by contingent
beneficiaries. While the IRS acknowledges that in Cristofani not all of the power holders for whom a gift tax exclusion was allowed by the court had an income or vested remainder interest in the trust (although those that did not were contingent beneficiaries), it does warn that it will continue to deny exclusions for Crummey power holders where the withdrawal rights have no substance, regardless of the beneficiaries' economic interest in the trust.

Lapse of Withdrawal Right

When the income beneficiary and the remainderman are different individuals, a hidden gift tax trap awaits the Crummey power holder. If the power holder (i.e., the individual who has the power to withdraw the contribution from the trust for a limited period) allows the power to lapse at the end of the specified period, he or she has in effect made a transfer of a future interest in the property to the remainderman. If the power holder or his or her estate is the remainderman, no transfer has occurred, because he or she would simply be making a transfer to himself or herself. Where the power holder and the remainderman are different individuals, the lapse of the power may be a taxable gift from the income beneficiary to the remainderman under the power-of-appointment rules.

To avoid this unexpected gift from the income beneficiary to the remainderman, the Crummey power may be limited to a level that does not exceed the allowable lapsing right gift tax exemption (i.e., the "five and five" limitation, where withdrawals cannot exceed $5,000 or 5% of the trust's assets, if greater). However, this limitation may not allow for full use of the annual gift tax exclusion. Alternatively, the power holder could be given a testamentary power of appointment over the property, which would cause the trust property to be included in the beneficiary's estate. The obvious solution is to make the Crummey power holder the trust's sole beneficiary.

Income Tax Considerations

Under Sec. 678(a), a person other than the grantor will be treated as the owner of any portion of a trust over which he has a power to vest trust income or corpus in himself. Therefore, until a Crummey power is exercised or allowed to lapse, the power holder is treated as the owner of any income attributable to contributions made to the trust that are subject to the power. Such income is reported directly to the power holder under the grantor trust reporting rules. If the power holder (beneficiary) allows the withdrawal power to lapse, but retains an interest in the trust property (the usual case), the beneficiary will continue to be treated as the owner of that portion of the trust (Sec. 677 via Sec. 678(a)(2); Letter Ruling 200022035).

To the extent that trust income is taxed to a trust beneficiary under the age of 18, or if the child is age 18 or a full-time student age 19—23 who has earned income equal to less than 50% of his or her support, the kiddie tax rules will apply. To minimize the income tax effects, the trustee could be authorized to invest in non-income-producing property, such as growth stocks, or in tax-exempt bonds.

Other Considerations

Other types of trusts may contain a Crummey power; that is, the beneficiary (child) is granted the power to withdraw a specific amount of income or principal annually. This power may qualify gifts to the trust for the annual gift tax exclusion, even though the withdrawals may not actually occur. Also, Crummey
clauses can be structured to permit multiple beneficiaries to invade the trust.

Parents may prefer a Crummey trust over a Sec. 2503(c) trust to gain more certainty over the termination of the trust. Assets in a Sec. 2503(c) trust generally must be distributed when the child reaches age 21, unless he or she elects to let the trust continue. This distribution requirement does not apply to a Crummey trust, which can, by its terms, extend termination well past age 21.

To summarize, a Crummey trust can affect the clients' income, estate, and gift tax planning. Therefore, careful consideration should be given to the tax and trust rules before setting up a Crummey trust.

This case study has been adapted from PPC's Guide to Tax Planning for High Income Individuals, 15th edition, by Anthony J. DeChellis and Patrick L. Young, published by Thomson Reuters/Tax & Accounting, Carrollton, Texas, 2014 (800-431-9025); tax.thomsonreuters.com.

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Gather Useful Crumbs of Knowledge About Crummey Powers

Time-limited withdrawal rights can ensure gifts to a trust are present interests that qualify for the gift tax annual exclusion—but the planning considerations do not end there.

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Granting beneficiaries of an irrevocable trust a right of withdrawal over contributions ("Crummey powers") in order to secure the benefits of the gift tax annual exclusion (maximum exclusion amount of $14,000 in 2013, increased from $13,000 in 2012) is a basic tool in every estate planner's toolbox. Many implications of granting Crummey powers are, however, often overlooked or misunderstood by estate planners and their clients.

Lapsing withdrawal powers

While Crummey ¹ was not the first case in which withdrawal powers were used to create a present interest for gifts made in trust, ² it was the first case that limited the withdrawal rights of the beneficiaries of an irrevocable trust to the annual exclusion amount, and provided that the withdrawal right would lapse at the end of the year in which the gift was made if not exercised. The IRS in Crummey did not actually take issue with the impact of such withdrawal powers in creating a present interest if the beneficiary was a competent adult. Rather, with regard to the minor beneficiaries of the trust, the IRS took the position it had earlier published in Rev. Rul. 54-91 ³ that a transfer to an otherwise discretionary trust for a minor beneficiary is a gift of a future interest regardless of the existence of a withdrawal...
power if there is no legally appointed guardian to demand immediate distribution for that minor beneficiary.

The court in *Crummey*, however, not only confirmed the effectiveness of immediate and temporary withdrawal rights in creating a present interest for a gift in trust. It also held that, so long as a minor beneficiary has the absolute legal right to withdraw a gift to a trust, the fact that there is no appointed guardian to act for the minor beneficiary does not cause the gift to be a gift of a future interest.

Five years later, in *Rev. Rul. 73-405*, the IRS revoked *Rev. Rul. 54-91*. Instead, it took the new position that, so long as there is no legal impediment under state or local law with regard to the appointment of a guardian for a minor beneficiary, the fact that a guardian has not been so appointed at the time of a gift to a trust with a *Crummey* power does not result in a gift of a future interest.

### *Crummey* powers and the GST tax annual exclusion

The generation-skipping transfer (GST) tax annual exclusion is available for direct skips so long as the transfer qualifies for the gift tax annual exclusion under

[pg. 4]

**Section 2503(b).** However, the availability of the GST tax annual exclusion for a direct skip into a trust for the benefit of a skip person is substantially more limited than is the gift tax annual exclusion. Specifically, in order for a gift in trust to qualify for the GST tax annual exclusion, the transfer must qualify for the gift tax annual exclusion and satisfy two additional requirements:

1. During that beneficiary's lifetime, no part of the trust principal or income may be distributed to or for the benefit of any person other than the beneficiary holding the *Crummey* power.
2. If that beneficiary dies before the trust terminates or is otherwise fully distributed to the beneficiary, the remaining assets of the trust must be includable in the deceased beneficiary's taxable estate.

Therefore, use of the GST tax annual exclusion is not appropriate if the goal of the donor is to create a dynasty trust that can pass from generation to generation without the imposition of estate or GST tax.
Gift splitting and Crummey powers

Section 2513 provides that spouses may elect to treat gifts made by either of them as being made one-half by each spouse—even when the property is entirely the separate property of one of them. A gift cannot be split, however, if the value of the gift is not ascertainable. The wrinkle in combining gift splitting with Crummey powers stems from the manner in which the election to split gifts is made and the lapse of time between the gift giving and the election being made and becoming irrevocable.

Imagine a typical Crummey power which gives beneficiaries the ability, within 30 days after the contribution, to withdraw the amount of the contribution that qualifies for the gift tax annual exclusion. The non-donor spouse will not have given his or her consent until the gift tax return is filed in the following year (and the election, if made on a return filed before April 15, does not become irrevocable until that date). How will the trustee and beneficiary know what portion of the contribution is covered by the non-donor spouse's annual exclusion until the non-donor spouse gives his or her consent?

Drafting around this issue carries some traps that need to be considered. If the donor were to condition the beneficiary's withdrawal right on his or her spouse's consent to split the gift, the beneficiary's interest is no longer a present interest, but rather, is contingent on some future event (the spouse's election or non-election). The IRS has ruled that if a Crummey power is so limited, the value of the withdrawal right is unascertainable and the annual exclusion does not apply. 9

Taxpayers have options, however, to avoid this result:

(1) Each spouse may actually contribute half of each gift to the trust, either by creating sufficient community property from one spouse's separate property before making the gift if the couple lives in a community property state, or by making gifts equally from each spouse's separate property, in which case gift splitting is unnecessary.

(2) Provide either in the trust instrument or in the instrument of transfer that, if the donor is married, the amount available for withdrawal is determined as if all gifts were split between the donor and his or her spouse, regardless of whether the gift-splitting election is actually made.

While the non-donor spouse is the transferor for gift and GST tax purposes when a gift-splitting election is made, the non-donor spouse is not the transferor for estate tax purposes, and, more specifically, for purposes of the reinclusion of trust assets in the donor's estate
under Sections 2036 through 2038. As a result, gifts to an irrevocable trust can be split even if the non-donor spouse is a beneficiary of the trust. However, to split gifts to such a trust, the non-donor spouse's interest in the trust and in the gifted property must be ascertainable and severable from the other beneficiaries' interests. In that case, the non-donor spouse is considered a transferor for gift tax purposes only with regard to the portion of the gift over which he or she has no beneficial interest.

How this rule is actually applied, however, is a bit unclear as the IRS has come to different conclusions

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under similar facts. Nevertheless, split-gift treatment should be allowed for any portion of the trust that is not reachable by the spouse, and the value of the gift is discounted by any withdrawal right the spouse may possess.

**Example.** A trust grants a spouse a $5,000 withdrawal power and grants each of two children a $14,000 withdrawal power. Thereafter the donor spouse makes a $33,000 contribution to the trust. The spouse's $5,000 withdrawal right may not be split, but the remaining $28,000 may be split—resulting in the non-donor spouse making a $14,000 annual exclusion gift, and the donor spouse making a $19,000 gift.

**Gift tax consequences**

A Crummey power is a power held by a trust beneficiary to withdraw trust assets that is not limited by an ascertainable standard related to the beneficiary's health, maintenance, support, or education. As a result, a Crummey power is a general power of appointment within the meaning of Section 2041, the release or lapse of which is a gift to the trust by the releasor. The gift by the releasor is a gift of a future interest to the other trust beneficiaries and, therefore, the gift tax annual exclusion does not apply. Absent an exception to this gift tax treatment, the releasor must file a gift tax return to report the release, thereby consuming a portion of the releasor's gift tax applicable exclusion or even resulting in the payment of gift tax if the releasor has fully used his or her applicable exclusion.

"Five or five" withdrawal rights. Under Section 2514(e), the release of a general power of appointment that does not exceed the greater of $5,000 or 5% of the aggregate value (at the time of lapse) of the trust assets subject to the power (the "five or five" amount) is disregarded for gift tax purposes. Therefore, if a beneficiary's Crummey withdrawal right is
limited to the five or five amount, the lapse of the power would not result in gift tax consequences to the beneficiary.

Five or five powers are restrictive in that the $5,000 limit cannot be replicated among multiple trusts. On the other hand, the 5% limitation is calculated on the aggregate value of all trusts to which the limit applies. 15

Example. A beneficiary has the power to withdraw $28,000 from the corpus of one trust arising from gifts made to the trust by two donors, and the power lapses on 6/1/2013 when the trust corpus is worth $300,000. The same beneficiary has a second noncumulative power to withdraw $28,000 from the corpus of the same trust arising from gifts made to the trust by two different donors; this power lapses on 12/1/2013. The value of the trust corpus has appreciated to $400,000 as of that date. The maximum trust assets subject to the beneficiary's withdrawal power at the time of any lapse during the calendar year would be $400,000, and the beneficiary's five or five amount for the year would be $20,000 (5% × $400,000). The remaining $36,000 ($28,000 + $28,000 - $20,000) subject to the beneficiary's withdrawal power in that calendar year would be a gift to the trust by the beneficiary. 16

Example. A beneficiary has the power to withdraw $28,000 from the corpus of one trust, and the power lapses on 6/1/2013 when the trust corpus is worth $300,000. The same beneficiary has a second power to withdraw $28,000 from the corpus of a different trust; this power lapses on 12/1/2013 when the value of the trust corpus is $400,000. The maximum amount of trust assets subject to the beneficiary's withdrawal power for the year would be $35,000 (5% × $700,000). The remaining $21,000 ($28,000 + $28,000 - $35,000) subject to the beneficiary's withdrawal powers in that calendar year would be a gift to the trusts by the beneficiary. 17

Despite the limitations of a five or five power, restricting Crummey withdrawal powers to the five or five amount should always be considered, particularly if the value of the trust assets is likely to be sufficient to allow full use, or nearly full use, of the gift tax annual exclusion amount for all donors. For example, if a married couple is funding a trust for the collective benefit of children and grandchildren, so long as the value of the trust assets is at least $560,000, the full annual exclusion amount for both spouses can be used for each of the trust beneficiaries even though the Crummey powers are limited to the five or five amount.

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Hanging powers. Limiting Crummey powers to the five or five amount may not be practical if the full annual exclusion amount is required to accomplish the donor’s objectives (such as to fund premiums on a life insurance policy) and the value of the trust is not sufficient for the 5% limitation to support full use of the gift tax annual exclusion. In that case, adverse gift tax consequences to the beneficiary might be deferred or even avoided entirely by providing under the trust instrument that (1) the withdrawal right will lapse in any calendar year only up to the five or five amount, and (2) the balance will remain subject to the beneficiary’s right of withdrawal until, if ever, the assets of the trust have appreciated sufficiently to allow the unexercised power to lapse under the five or five rule (a “hanging power”).

Such a hanging power is particularly useful if the assets of the trust are expected to spring in value in the future. For example, if a trust holds a life insurance policy, on the payment of the policy proceeds to the trust when the insured dies, the value of the trust assets should be sufficient to “lapse out” the hanging powers. Importantly, if the beneficiaries holding hanging powers and the ultimate beneficiaries of a trust are not the same, then division and distribution of the trust should be delayed sufficiently for all hanging powers to lapse out (or the trust should prohibit distribution of any amounts subject to unapsed withdrawal rights). Otherwise, the nonbeneficiary power holders will make a gift of their unapsed withdrawal powers to the ultimate beneficiaries.

Hanging powers have several potential disadvantages, including estate and GST tax consequences, which are discussed below. There is also the practical disadvantage associated with the fact that a hanging power can be exercised at any time by the trust beneficiary. This needs to be explained to the settlor of the trust. To limit the risks to the trust in this regard, once the normal period for the lapse of the Crummey power has expired (such as 30 or 60 days), it should be permissible for the trust instrument to provide that the hanging power may be exercised only with the consent of a non-adverse party. Note that even if the consent of a non-adverse party is required to exercise a hanging power, the assets subject to that power could remain subject to creditors’ claims.

Creating an incomplete gift. If a beneficiary holding a Crummey power is the sole beneficiary of the trust and if the trust property is payable to his or her estate if he or she dies before receiving full distribution of the trust assets, the lapse of the beneficiary’s Crummey power is an incomplete gift. Further, if a beneficiary holding a Crummey power also holds a general power of appointment over the trust, the lapse of the Crummey power is an incomplete gift.
Another option to avoid adverse gift tax consequences for a beneficiary on the lapse of his or her Crummey power would be to provide the beneficiary a testamentary special power of appointment over the portion of the trust funded with his or her lapsed withdrawal right (or the portion exceeding the five or five power). Because the beneficiary maintains "dominion and control" over the disposition of the assets he or she has "gifted" to the trust as the consequence of the lapse, the gift is incomplete. If the trust property is ultimately distributed to the beneficiary during his or her lifetime, the gift will never be complete. This strategy works well in only separate share trusts, however, and is not a particularly workable option when there are multiple trust beneficiaries with withdrawal rights over a single trust fund.

**Estate tax consequences**

A Crummey power is a general power of appointment. Thus, if a beneficiary dies holding an unsapped Crummey power, including a hanging power, the unsapped power is includable in his or her taxable estate. If, however, all of a beneficiary's Crummey powers lapsed prior to his or her death, and if the lapse of the Crummey power in any given year never exceeded the five or five amount, no portion of the trust assets is includable in the beneficiary's estate solely by virtue of the lapsed withdrawal power.

Where the gift tax consequences of a lapsed Crummey power are deferred by virtue of a testamentary power of appointment, however, whether general or special, the estate tax consequences are far more complicated. In such circumstances, estate tax inclusion results either under Section 2036(a) if the beneficiary retained an economic interest in the trust property funded with his or her lapsed withdrawal right, or under Section 2038 due to the beneficiary's retention of control over the use and enjoyment of the trust property until his or her death. Under these provisions, the fraction of the value of the trust property funded by the lapsed withdrawal right in excess of the five or five amount, determined as of the date of the beneficiary's death (i.e., factoring in appreciation and depreciation in trust property), are includable in the beneficiary's estate for estate tax purposes, not just the value of the lapsed withdrawal amounts. This can be a particularly troublesome calculation, if, for example, a trust holds a life insurance policy, the proceeds of which were received before the beneficiary died, or if the trust invested the gifted property in assets that substantially appreciated in value before the beneficiary died.
GST tax implications of beneficiary holding a *Crummey* power

Because (1) the GST tax is imposed on certain transfers to skip persons, and (2) the definitions of "skip persons" and "non-skip persons" are defined by reference to the transferor, a transferor needs to be identified for every transfer to ascertain the GST tax implications of that transfer. The identity of the transferor is also critical in determining who can or should apply GST tax exemption to a particular transfer.

A "transferor" for GST tax purposes includes any individual who transfers property in a manner that is subject to estate or gift tax. If multiple individuals have been subject to estate or gift tax on the transfer of a particular property, the individual with respect to whom the transferred property was most recently subject to estate or gift taxation is the transferor. Thus, an intervening event that subjects an individual other than the original transferor to taxation under any other principles of estate or gift taxation changes the identity of the transferor for GST tax purposes. A *Crummey* power may be considered such an intervening event, the effect of which depends on the extent of the withdrawal power.

**Five or five power.** To the extent that a beneficiary holds a five or five power, a lapse of that power will not change the transferor, as the lapse of a five or five power does not result in a transfer for gift tax purposes. However, if the beneficiary dies before the power lapses, the property subject to the power would be included in the beneficiary's gross estate and subject to estate tax. This would make the beneficiary the transferor of such property at the beneficiary's death for GST tax purposes. This possibility may be mitigated by limiting the withdrawal power to 30 days.

**Hanging power.** A beneficiary holding a withdrawal power in excess of a five or five power is treated as the transferor of the excess amount to the extent the power lapses and the lapse is a completed transfer. If, however, there is no lapse of the power because the power "hangs," the beneficiary would not be subject to gift taxation, and the grantor would remain the sole transferor for GST tax purposes. If the beneficiary dies while a withdrawal power in excess of the five or five amount is still hanging, the property subject to the power is included in the beneficiary's gross estate and subject to estate tax. The beneficiary would then become the transferor of the amount in excess of the five or five amount for GST tax purposes.
To maintain GST tax exempt status for the trust, if that is desired, the beneficiary’s GST tax exemption must be applied to the formerly hanging power. Because the grantor remains the transferor for GST tax purposes of the previously lapsed five or five amount (as well as any other portion of the trust that was not subject to a withdrawal right), the trust has two transferors for GST tax purposes. Each portion is treated as a separate trust for GST tax purposes.  

**Lapsing power in excess of five or five power.** Alternatively, if a power to withdraw an amount in excess of the five or five amount lapses and the lapse is a completed transfer, the beneficiary becomes the transferor of this amount for GST tax purposes. To maintain GST tax exempt status for the trust, if that is desired, the beneficiary’s GST tax exemption must be applied to the lapsed withdrawal power in excess of the five or five amount. Each portion is treated as a separate trust for GST tax purposes. Similarly, if the beneficiary dies while holding a withdrawal power in excess of a five or five power, the subject property, including the five or five amount if it has not yet lapsed, is included in the beneficiary’s gross estate for estate tax purposes. In each case, because the grantor remains the transferor for GST tax purposes of the previously lapsed five or five amounts (as well as any other portion of the trust that was not subject to a withdrawal right), the trust has two transferors for GST tax purposes.

**Estate tax inclusion period.** An important part of GST tax planning relates to the allocation of GST tax exemption to transfers that are subject to, or will be subject to, GST tax. Even where the transferor is properly ascertained, the GST tax exemption cannot be allocated until the close of the estate tax inclusion period (ETIP) with respect to that transferor. The ETIP is the period during which the value of the transferred property would be includable in the gross estate of the transferor or the spouse of the transferor.

Because the ETIP includes the period during which the value of transferred property would be includable in the gross estate of the spouse of the transferor, a Crummey power held by the spouse of a transferor could prevent the transferor from allocating GST tax exemption until the lapse of the power. However, an exception to the ETIP rule is available if the spouse of the transferor holds a withdrawal power no greater than the five or five amount and such withdrawal power terminates no later than 60 days after the transfer to the trust. Because
the withdrawal power must terminate within 60 days, the spouse of the transferor cannot hold a hanging power without running afoul of the ETIP rule.

To the extent that a beneficiary holds a Crummey power in excess of a five or five power, or permits a Crummey power in excess of a five or five power to lapse, that beneficiary is the transferor of the amount in excess of the five or five amount for GST tax purposes. Accordingly, if the trust is a dynasty or multi-generational trust, both the original grantor (to the extent of the five or five amount) and the beneficiary (for the amount in excess of the five or five amount) must allocate GST tax exemption to their respective transfers. However, as a power to withdraw in excess of a five or five power results in inclusion under Section 2041 (a)(2), the beneficiary is unable to allocate GST tax exemption until death because of the ETIP rule.

**Income tax implications**

A beneficiary's withdrawal power is a power exercisable solely by that person to vest the corpus or income to oneself, as described in Section 678(a)(1). 40 Section 678(a)(2) makes clear that a beneficiary is treated as an owner of the trust for income tax purposes if the beneficiary releases a power exercisable solely by that person to vest the corpus or income to himself or herself (i.e., a withdrawal power) to the extent the beneficiary would be an owner under Sections 671 through 677. It is less clear whether a "lapse" is a "release" for purposes of Section 678(a)(2). The IRS has treated a lapse of a withdrawal power as a release for such purposes in a private letter ruling. 41 Presumably the position of the IRS stems from the language of Sections 2041(b)(2) and 2514(b), which expressly provide that the "lapse" of a general power of appointment is a release of that power for estate and gift tax purposes. Unlike Sections 2041 and 2514, however, Section 678 does not carve out a de minimis exception. In other words, there is no analog to the five or five amount for purposes of Section 678.

If a beneficiary is treated as an owner of a trust under Section 678, the beneficiary includes in his or her taxable income and credits, a pro rata portion of the trust's income, deductions, and credits. The portion allocated to the beneficiary's taxable income and credits is equal to a fraction, the numerator of which is the amount subject to withdrawal and the denominator of which is the fair market value of the trust property at the date the withdrawal becomes effective. 42 Further, as most withdrawal powers exist for a limited period (e.g., 30 days), the fraction allocating the income, deductions, and credits of the trust is further reduced by the portion of the year during which the withdrawal power was not effective. 43
If the original grantor is the owner of the trust under the grantor trust rules, a beneficiary holding a Crummey power generally is not subject to the grantor trust rules (i.e., Section 678). Section 678(b) provides that a person is not treated as the owner under Section 678 (a) in regard to a power over income if the original grantor is already treated as the owner of the trust under the grantor trust rules. Although this rule appears to be of limited applicability at first glance, as a Crummey power is a withdrawal power over corpus, the congressional committee report indicates that the exception applies to the grantor's power over both income and corpus. The IRS has consistently ruled accordingly in various private letter rulings.

Several rulings do rely on Reg. 1.671-2(b), which provides for purposes of the grantor trust rules, the word “income” refers to taxable income and not trust or fiduciary accounting income. (Contrast this with Reg. 1.643(b)-1, which provides that “income” refers to trust or fiduciary accounting income unless modified with the words “taxable,” “distributable net,” “gross,” or “undistributed net income.”) This Regulation further provides that for such purposes, it is immaterial whether the income involved is income or corpus for trust accounting purposes. If “income,” as it is referred to in Section 678(b), means both items of income allocable to principal and those allocable to income, the rulings would seem to be consistent with both the congressional intent and regulatory authority.

A question that arises in Crummey trusts that are structured as grantor trusts is whether the death of the original grantor opens the door to Section 678. Neither Section 678 nor its attendant regulations specify whether Section 678(b) continues to prevent a Crummey beneficiary or holder of a withdrawal power from becoming an owner of the trust after the death of the original grantor. Historically, the IRS has held that a Crummey beneficiary or holder of a withdrawal power would become an owner of the trust at the death of the grantor even if the grantor was originally treated as the owner of the trust under the grantor trust rules. However, in Ltr. Rul. 9321050, the IRS concluded that the death of the original grantor of a grantor trust did not make a beneficiary holding a withdrawal power an owner of the trust even though the beneficiary held a withdrawal power after the death of the original grantor. Interestingly, in that private letter ruling, the IRS specifically references an earlier private letter ruling, Ltr. Rul. 9026036 (as opposed to a general statement reversing its position), and expressly reverses its previous position with respect to this particular issue in that ruling. Presumably, a trust that ceases to be treated as a grantor trust with respect to the grantor (e.g. on the grantor’s death) is treated as a separate taxpayer for income tax.
purposes, and any *Crummey* beneficiaries or holders of a withdrawal power are not treated as the owner of the income of the trust for federal income tax purposes.

**Annual exclusion gifts to trusts lacking *Crummey* powers.** Occasionally, practitioners are presented with existing irrevocable trusts that either lack *Crummey* powers or have *Crummey* provisions that limit the withdrawal power to $10,000. In both situations, the full gift tax annual exclusion could be secured if the instrument of transfer directs the trustee to give one or more trust beneficiaries an immediate right of withdrawal over the gift and specifies the terms of the withdrawal right. 47

The inherent disadvantage of relying on the use of instructions in the instrument of transfer to create *Crummey* powers is that these instructions must be provided each time a gift is made to the trust and cannot be provided after the gift is made. Further, if the instructions are not sufficiently specific with regard to who is to possess the withdrawal power or fails to address other material terms of the withdrawal right (such as the amount), the IRS may not accept the external instructions as sufficient to create a present interest. 48

Because donors might fail to consult with their attorneys before making a gift to a trust, a more fail-safe option might therefore be to create a new irrevocable trust (a "pass-through trust") that contains the necessary withdrawal powers. Such a trust would provide that any gifts to the trust that are not withdrawn within the specified time frame (such as 30 days from receipt by the beneficiaries of notice of the gift and their withdrawal rights) will be distributed to the existing trust (the "target trust"). This will ensure that any gifts are immediately subject to a right of withdrawal and will therefore qualify as gifts of a present interest, just as if the *Crummey* powers in the pass-through trust had been included in the target trust.

**Limiting existing withdrawal powers with external instructions**

If a *trust* contains *Crummey* powers and there is reason either to restrict the beneficiaries who are provided withdrawal rights or to limit the amounts subject to such withdrawal rights, the restrictions can be imposed in the instrument of transfer. The IRS has ruled privately that including a provision in a trust agreement that authorizes a donor to impose such restrictions at the time of the transfer is not a retained power over the gifted property for purposes of *Section 2036* or *2038*. 49 The IRS has also provided technical advice that such a power is not a retention of control over the beneficial enjoyment over gifted property for purposes of causing trust income or corpus to be owned by the donor for...
income tax purpose pursuant to Section 674(a). ^50

**Boilerplate overriding Crummey powers**

Merely including withdrawal powers in a trust instrument does not always ensure that a gift to a trust qualifies as a gift of a present interest for purposes of the gift tax annual exclusion. To qualify for the annual exclusion, the amount subject to the *Crummey* power must be ascertainable. That amount is not ascertainable, for example, if value subject to an un glimpsed *Crummey* power is not excluded from the application of the following provisions:

- “Boilerplate” provisions in the trust instrument give the trustee the discretion to retain or redirect assets otherwise distributable to a minor or incompetent beneficiary.
- A provision permitting the trustee to distribute trust property subject to an un glimpsed *Crummey* power to another trust beneficiary.
- A provision permitting another trust beneficiary to hold a power of appointment over assets subject to an un glimpsed *Crummey* power.
- A provision in the trust instrument giving the trustee the discretion to withhold distributions to a beneficiary holding a *Crummey* power (such as in the context of substance abuse or the existence of creditor’s claims). ^51

In addition, the gift to the trust could be a gift of a future interest notwithstanding the existence of *Crummey* powers in the trust instrument if the trust instrument requires a beneficiary to take certain actions in advance of a trust distribution or withdrawal. A requirement in the trust that a married beneficiary have a premarital agreement or separate property trust in place in order to receive trust distributions would trigger this future interest situation if those actions were not taken before the gift was made. In contrast, if the terms of the trust instrument apply such provisions to gifted property only *after* the lapse of the *Crummey* power, then present interest status is preserved. The amount subject to the right of withdrawal is ascertainable, and the annual exclusion should apply. ^52

**Premium payments to irrevocable life insurance trusts**

Special issues arise in the context of irrevocable life insurance trusts with *Crummey* powers. For example, a cash gift to a trust may be used to make premium payments before a
Crummey power has lapsed under the terms of the trust agreement. A gift may also be made of the insurance policy itself, or of a premium payment made directly by the donor to the insurance company.

Reg. 25.2503-3(c), Example 6 provides that premium payments to the carrier by the insured on a policy owned by another is a present interest gift. The regulations do not, however, address the consequences of a policy potentially being worth less than the Crummey power after the premium payment has been made, such as in the case of group-term policies. Further, in a 1950 case, the Tax Court held that a gift of a fractional interest in a life insurance policy is not a gift of a present interest if multiple owners must consent to the exercise of incidents of ownership over the policy.53 Therefore, in the context of irrevocable life insurance trusts, conservative practitioners should consider strategies to ensure that gifts to the trust subject to Crummey withdrawal rights qualify for the gift tax annual exclusion. For instance, the trustee may hold the money contributed to the trust until lapse of the withdrawal power after notice to beneficiaries, and then pay the premium, or the trustee may simply maintain a side fund at all times sufficient to satisfy any withdrawal rights that arise from premium payments.

The IRS has, nevertheless, sanctioned a trustee’s ability to distribute fractional interests in insurance policies as sufficient to satisfy a Crummey withdrawal right.54 Even in situations involving group-term policies, the IRS has ruled that the annual exclusion applies where the beneficiary could withdraw the policy in kind under a Crummey power.55 The IRS has ruled that the power to withdraw cash or other assets included in a trust with a group-term policy qualifies for the annual exclusion.56 This implies that, so long as the trustee can surrender or distribute the policy to the Crummey power holder, or the trust

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has other assets to satisfy the Crummey power, premium payments directly to the carrier qualify for the annual exclusion even if the policy value is less than the premium, although this is not specifically discussed in any of the rulings.57

Crummey powers held by contingent beneficiaries

In the 1991 case of Cristofani58 the Tax Court addressed the question of whether a Crummey power held by contingent beneficiaries (in that case, five grandchildren who would receive nothing from the trust if their parents survived their grandmother) would be respected for purposes of the gift tax annual exclusion. Importantly, it was stipulated that there was no
agreement or understanding that these rights would not be exercised. Under these facts, the Tax Court, citing Crummey, rejected any test for a present interest based on the likelihood that beneficiaries would actually receive present enjoyment of the trust property or that a demand right would actually be exercised. Nor, stated the Tax Court, should the test be whether a beneficiary with a withdrawal power has a vested present interest in the trust or a contingent remainder interest. Rather, the test should simply be whether the beneficiary had an enforceable right to demand payment from the trustee that the trustee would be unable legally to resist.

Despite the fairly resounding taxpayer victory in Cristofani, not long after the Tax Court issued its opinion, the Service issued AOD 1992-09 in which it stated its intention to continue to litigate cases involving abuses of Crummey powers, particularly if the cases have facts more egregious than those in Cristofani and the cases arise outside of the Ninth Circuit. The IRS subsequently published Ltr. Rul. 9628004, in which it acknowledged the holding in Cristofani and stated that its position generally is not to contest Crummey powers held by current income and vested remainder beneficiaries. However, the IRS stated that, where withdrawal rights are held by discretionary beneficiaries or beneficiaries with remote contingent interests in the trust, their failure to exercise their withdrawal rights, which is contrary to their economic interests, must indicate a prearranged plan not to exercise those rights. Consequently, the Service in Ltr. Rul. 9628004 disallowed 13 annual gift tax exclusions that were attributable to unexercised Crummey powers held by remote contingent beneficiaries or by individuals who had no other interest in the trusts in question other than their withdrawal rights. 69

Again, however, when this issue came up in a litigated case, this time from the Third Circuit, the IRS was unsuccessful. In Kohlsaat, 60 a decedent's two children and 16 contingent remainder beneficiaries (consisting of grandchildren, great-grandchildren, and certain in-laws), all held Crummey withdrawal powers over the trust. All of the beneficiaries were timely notified of their withdrawal rights, but none were exercised. The IRS argued that the only rational explanation for the failure of the 16 contingent beneficiaries to exercise their withdrawal powers was an implied agreement that they would not do so.

The Tax Court in Kohlsaat disagreed with the IRS that there was an implied agreement, noting that at trial other credible reasons were offered for why the contingent beneficiaries did not exercise their withdrawal rights. As a result, annual exclusions were allowed with respect to the Crummey powers held by all 16 contingent beneficiaries.
In one rare and unique Tax Court case, the IRS did secure a minor victory on the issue of implied agreements with regard to Crummey powers. In Trotter, an elderly grandmother made a gift of her condominium to a trust for the benefit of her grandchildren. The grandmother, who was suffering from recurring cancer when she created the trust, continued to live in the condominium. In lieu of paying rent, she paid utilities, insurance, and taxes. On her death, the IRS included the residence in her estate under Section 2036(a)(1). Accepting the position of the Service, the Tax Court noted that, not only did the facts presented suggest there was an implied agreement between the grandmother and her grandchildren that she would have the right to continued rent-free occupancy of the condominium for her lifetime (this alone would have been sufficient for estate tax inclusion), but there was also an implied agreement that the grandchildren would not exercise their Crummey withdrawal rights.

Stories have been circulating among practitioners since the Trotter case that the IRS is not beyond deposing trust beneficiaries after the death of the settlor of a Crummey trust to ask them, under oath, whether they had any agreement with the decedent that they would not exercise their withdrawal rights and whether they were threatened with penalties, such as disinheritance, if they did exercise those rights. It is therefore extremely important that this not be the message conveyed to the beneficiaries, whether direct or implied.

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**Notice and “mechanics” of Crummey powers**

The Service’s position is that the beneficiary of an irrevocable trust must have actual notice of his or her right of withdrawal for a gift to the trust to qualify for the annual exclusion. The theory behind this requirement is that without actual notice, the beneficiary’s demand right is illusory. This requirement can certainly be satisfied by providing the beneficiary with written notice, which thereby imparts actual notice on the beneficiary. To provide maximum evidentiary effect, a Crummey Letter should include:

1. A statement that a gift was made to the trust for the benefit of the beneficiary.
2. The amount of the gift subject to the beneficiary’s demand right.
3. The demand right exercise period.
4. A request that the beneficiary notify the trustee if the beneficiary wishes to exercise the demand right.
The *Crummey* Letter may also include an attached acknowledgment with instructions that the beneficiary sign and return the acknowledgement, in order to provide documentation of the beneficiary's receipt of the notice.

Where written notice is not provided, the actual notice requirement can still be satisfied by showing the beneficiary had actual knowledge of the demand right. However, in the absence of written notice, the taxpayer bears the burden of proof of demonstrating the beneficiary's actual knowledge of the demand right. This burden may prove difficult.

In one case, the Tax Court determined that a beneficiary had satisfied its burden with regard to actual knowledge of the demand right, where the beneficiary was provided with verbal notice. Similarly, the IRS may find that the actual notice requirement is satisfied where the facts and circumstances demonstrate that the beneficiary possessed actual knowledge. For example, the IRS allowed an annual exclusion where the beneficiaries were minors and their guardian, who was serving as trustee, did not provide herself with written notice. Likewise, where the beneficiary was the spouse of the grantor and also served as trustee, no written notice was required because the IRS found that the beneficiary had actual knowledge of her demand right.

In certain cases, the IRS has permitted a single written notice provided in year one to be actual notice for subsequent years when written notice is not provided. However, these cases have been limited to scenarios typically involving annual contributions to an irrevocable life insurance trust that were made on the same day of the year and in the same amounts in order to cover annual premium payments. Although prior scenarios have been limited to life insurance trusts, a parallel argument could be made to support actual notice, where a single notice is provided for an annual recurring payment made to any type of irrevocable trust.

A beneficiary who has been provided with written notice of a demand right, and waives the right to future written notifications, may have actual knowledge of the demand right; however the IRS has specifically disapproved such an approach to establish actual notice. For example, in *TAM 9532001*, where the beneficiaries were provided with notice of their demand right on initial contributions to the trust and then subsequently waived their right to be notified of future contributions, the IRS found that the future contributions were not gifts of a present interest as the beneficiaries did not have actual notice of those contributions. Specifically, the IRS stated that a gift is not a transfer of a present interest unless the beneficiary has current notice of the gift; without such notice, a beneficiary cannot have “a real and immediate benefit of the gift.”
Even where a beneficiary has actual notice of a demand right, the IRS also requires that the beneficiary of an irrevocable trust have a reasonable opportunity to exercise the demand right in order for the gift to qualify for the annual exclusion. The IRS has not specifically stated what is a reasonable exercise period. However, several private letter rulings have held that a beneficiary had a reasonable opportunity to exercise a demand right where a beneficiary was afforded at least a 30-day exercise period. Conversely, where the beneficiary was afforded only three days to exercise a demand right, the IRS determined that the right was illusory and disallowed the annual exclusion.

On the other hand, in Cristofani, the beneficiaries were afforded only a 15-day exercise period, and the court found that the transfer qualified for the annual exclusion. The length of the exercise period, however, was not specifically challenged by the IRS in Cristofani. Thus, until a shorter exercise period is specifically approved, a beneficiary should be afforded at least 30 days to exercise a demand right.

It is also important to make sure that the exercise period begins immediately on the date of the transfer, rather than on the date of notice, even if notice is not simultaneously provided, as any delay in

the beneficiary's ability to exercise the demand right might create a future interest, thereby disqualifying the transfer from the benefit of the annual exclusion. So long as the demand right is immediately exeriscible, the lapse of the exercise period may be based on either the date of the transfer or the date the notice is provided, as the IRS has approved both methods. However, if lapse of the exercise period is based on the date of the transfer and notice is not simultaneously provided, the exercise period should be made sufficiently long enough to ensure that the beneficiary has at least 30 days to exercise the demand right after receiving notice.

Also, the exercise period should not be contradicted by the terms of the trust. Some trust agreements provide that demand rights automatically lapse on December 31 of each year, regardless of when the contribution is made. In such a case, the terms of the trust may result in a curtailed exercise period of less than 30 days for transfers made after December 1. The better approach is to provide a 30-day exercise period, even if a demand right carries over into the next year, as it is immaterial if the time period in which a beneficiary may exercise a demand right ends in a different calendar year.
Despite the position of the Service and the resulting “best practices” outlined about, in the 2011 case of *Turner*, the Tax Court sustained the decedent’s claimed annual exclusions even though some or even all of the beneficiaries of a trust may not have known they had the right to demand withdrawals. The court stated that the lack of knowledge of the right of withdrawal did not affect a beneficiary’s legal right to withdraw. Consequently, all is not necessarily lost if notice is not provided, and the gift tax exclusion may be available.

**Notice to minor and incompetent beneficiaries**

In the *Crummey* case itself, the court stated that it was highly unlikely that a guardian would be appointed to make the withdrawal or that the minor beneficiaries knew or would ever know about the gifts to the trust that gave rise to the withdrawal rights. Under the trust document and local law, however, the minors had the right to demand withdrawal of gifted assets up to the annual exclusion amount. Thus, the court found the gifts to the trust to be gifts of a present interest. The IRS acquiesced to this holding in *Rev. Rul. 73-405*.

Although minors clearly can hold valid *Crummey* powers, some practitioners remain concerned as to who should be provided notice and the right to act on behalf of a minor beneficiary. There is authority for the premise that a gift to a *Crummey* trust for the benefit of a minor beneficiary is a gift of a present interest even though the parent with the authority to act for the minor is the donor. However, no rulings or cases specifically address whether a donor acting for a minor beneficiary could be a retention of the ability to direct the disposition of the gift, thereby risking the estate tax inclusion of the gifted assets in the donor’s estate under Section 2036 or 2038 (which would also trigger a three-year look back under Section 2035).

To avoid this risk, the trust agreement might provide that the withdrawal rights must be exercised by a parent acting for the minor who is not the donor. However, this might not be practical if both parents are donors or if the donor and the child’s other parent are estranged and the donor does not want the other parent having any rights over or even any knowledge of the existence of the trust. To address this concern, the trust instrument might provide that the trustee has the power to designate an adult to receive notice on the part of the minor and to exercise the minor’s rights of withdrawal.

Of course, when a minor beneficiary attains the age of majority under state law, that beneficiary should be provided notice like any other beneficiary and the right to exercise his or her own right of withdrawal. If the trust instrument provides its own definition of “minor” and
"adult" beneficiaries that differs from state law, it would be advisable to exclude that definition in the context of when a beneficiary is considered to be an adult for purposes of exercising a Crummey power.

The same principles that permit a minor beneficiary to possess a Crummey power should also apply to beneficiaries who are legally incompetent adults. If, however, the trust contains special needs provisions for an incompetent adult that would limit the beneficiary's withdrawal rights in order to preserve public benefits, then the withdrawal right is not a gift of a present interest. Importantly, the existence of Crummey powers in a special needs trust almost certainly is a resource that must be considered in determining whether the beneficiary qualifies for needs-based public benefits. In addition, the lapse of a Crummey power held by the beneficiary of a special needs trust could convert a third-party special needs trust to a self-settled special needs trust, which, among other negative consequences, could permit the state providing benefits to seek recovery from the assets.

remaining in the trust at the beneficiary's death. Therefore, a trust that is intended to be a special needs trust should not incorporate Crummey powers that are exercisable by the beneficiary whose benefits are being preserved.

Asset protection considerations

Under traditional common law, assets subject to a power of withdrawal by a beneficiary are not subject to the claims of the beneficiary's creditors or his estate. Additionally, the donee's creditors cannot compel the donee to exercise the power of withdrawal, nor can the creditors acquire the power. However, under the UTC and Restatement Third, during the period that a power of withdrawal may be exercised, the assets subject to withdrawal are subject to the claims of the beneficiary's creditors, the same as the beneficiary's other assets. If the beneficiary retains the withdrawal power until death, the property subject to the power may be liable for claims against the beneficiary's estate. For withdrawal powers limited either in time or amount, such as a right to withdraw a $13,000 annual exclusion contribution within 30 days, the UTC limits the creditor to the $13,000 contribution and requires the creditor to take action before the expiration of the 30-day period. Because no statutes correspond to the UTC and Restatement Third under California law, for example, it is unclear whether assets subject to a Crummey withdrawal right and hanging powers would be subject to the claims of a Crummey power holder's creditors.
Generally, if a trust instrument includes a spendthrift clause, a beneficiary's interest under the trust may not be restrained. However, where the settlor is a beneficiary of a trust he or she created, any spendthrift clause in the trust instrument is invalid against the settlor’s transferees or creditors. Consider also state law. For instance, although no California court has ruled specifically on the issue, Crummey trusts do not appear to be exempt from California’s prohibition against self-settled spendthrift trusts set forth in California Probate Code §15304. Consequently, the creditors of a Crummey power holder could arguably reach any assets within a trust that were subject to the Crummey withdrawal power even after it expires by a lapse, release, or waiver.

For states that follow the UTC, trust property that was previously subject to a beneficiary's withdrawal right that has lapsed, released, or been waived is subject to the claims of the beneficiary's creditors only to the extent that the value of the property subject to the power when the stated time frame expires exceeds the greater of:

1. The five or five amount.
2. The gift tax annual exclusion amount.

Example. A trust holds $25,000 and the beneficiary has the right to withdraw $15,000 of that amount for 30 days, after which time the withdrawal right lapses. The beneficiary does not exercise the withdrawal power, and the 30-day withdrawal period ends. The five or five amount is $5,000, because 5% of $25,000 is only $1,250. The gift tax annual exclusion amount is $14,000. Therefore the greater of: (1) the five or five amount, and (2) the gift tax annual exclusion amount is the gift tax exclusion amount ($14,000). After the expiration of the 30-day withdrawal period, $1,000 of the trust property ($15,000 minus $14,000) will continue to be subject to the beneficiary's creditors.

In light of the foregoing concerns, the trust instrument should be drafted to allow the donor to exclude a beneficiary who has current creditor or spousal problems from withdrawing trust assets. Otherwise, the creditor or spouse may be able to obtain a court order compelling the beneficiary to exercise such powers and make the trust funds available for division in a divorce, bankruptcy, or other similar action. Unfortunately, this restriction may preclude the use of a Crummey withdrawal power to create a present interest in the trust assets and qualify gifts in trust for the gift tax annual exclusion.

When the beneficiary's time frame for exercising a withdrawal power expires by a lapse, release, or waiver, the property formerly subject to the Crummey power may be subject to the beneficiary's creditors. It is reasonable to give a Crummey withdrawal power to a beneficiary
who has no current problems, because such withdrawal powers exist only briefly as to any particular gift. The donor can cease making transfers to the trust if the beneficiary's financial or marital situation worsens to the point at which the creditor or divorcing spouse is seeking assets on which to make a claim. Furthermore, the donor may wish to retain an express power to terminate the operation of the withdrawal power as to future contributions.

1 22 AFTR 2d 6023 397 F2d 82 68-2 USTC ¶12541 (CA-9, 1968).

2 See Kieckhefer, 40 AFTR 661 189 F2d 118 51-1 USTC ¶10812 (CA-7, 1951); Gilmore, 45 AFTR 1605 213 F2d 520 54-1 USTC ¶10948 (CA-6, 1954); Baker, 50 AFTR 1 236 F2d 317 56-2 USTC ¶11636 (CA-4, 1956); Trust No. 3, 7 AFTR 2d 347 285 F2d 102 61-1 USTC ¶9151 (CA-7, 1960).

3 1954-1 CB 207.


5 Sections 2642(c)(1) and (c)(3)(A).

6 Section 2642(c)(3)(A).

7 Section 2642(c)(2)(A).

8 Section 2642(c)(2)(B).

9 Ltr. Rul. 8022048.

10 See Ltr. Rul. 200130030.

11 Ltr. Rul. 200616022.

12 Section 2513(a)(1) (limiting split-gift treatment to transfers to third parties).

13 Compare Ltr. Ruls. 200616022 and 200422051 (ignoring Crummey withdrawal rights held by third parties in analyzing the non-donor spouse's interest in the trust) with Ltr. Rul. 200130030 (ruling that the third parties' withdrawal rights trumped the non-donor spouse's discretionary interest in the trust).

14 Section 2514(b).

Id.

Id. See also GCM 3937 and Ltr. Rul. 9030005.

Rev. Rul. 82-156, 1982-2 CB 216; Section 2041(b)(1)(c).

Ltr. Rul. 8142061.

Ltr. Ruls. 8517052, 8545076, and 8142061.

Reg. 25.2511-2(b). See also Ltr. Rul. 8229097.

Section 2041(a)(2).

Section 2041(b)(2).

Reg. 20.2041(d)(4); see also Ltr. Rul. 200022035.

Section 2613(a).

Section 2613(b).

Sections 2631(a) and 2632(a).

Section 2652(a)(1).


Reg. 26.2652-1(a)(5), Example 5 and Section 2514(e).

Section 2041(a).


Section 2654(b)(1) and Reg. 26.2654-1(a)(2)(i).

Id.

Section 2654(b)(1) and Reg. 26.2654-1(a)(2)(i).

Section 2041(a).
Section 2642(f).
Reg. 26.2632-1(c)(2).
Rev. Rul. 81-6, 1981-1 CB 385.
Letter Ruls. 200022035, 8517052, and 8142061. In Letter Rul. 8839008, the IRS ruled a right over corpus can affect income, so that a right over either corpus or income falls within Section 678(b).
Reg. 1.671-3(a)(3).
Letter Rul. 8142061.
Letter Ruls. 200730011, 200603040, and 9309023.
Letter Ruls. 9034004 and 9026036.
See TAM 8445004 (direction of donor making a gift to an irrevocable trust was effective to increase the withdrawal amount from $5,000, as provided in the trust instrument, to $10,000).
See TAM 9532001 (annual gift tax exclusion not allowed where letter to trustee accompanying the initial gift did not create a present interest in subsequent gifts.).
Letter Rul. 9030005.
TAM 8901004.
TAM 8107009 (unlimited power of invasion or diversion, which makes it impossible to value an interest, prevents any exclusion from being claimed against a gift of the interest even though it is a present interest); see also Letter Rul. 8103074.
Letter Ruls. 8213074 and 8121051; TAM 8107009.
Skouras, 14 TC 523 (1950), aff'd 40 AFTR 491 188 F2d 831 51-1 USTC ¶10805 (CA-2, 1951) (limitations imposed on a donee's rights to dispose of, or otherwise deal
with, an insurance policy will convert the gift of such a policy into a gift of a future interest).

54 Ltr. Ruls. 8044080 (whole life policies), 7935091 (term insurance), and 8051128 (split-dollar insurance).

55 See Ltr. Ruls. 8006109, 8021058, and 8111123.

56 See Ltr. Ruls. 8103074, 8006109, and 8111123.

57 See also Estate of Turner TC Memo 2011-209 RIA TC Memo ¶|2011-209 102 CCH TCM 214 (payment of a life insurance premium directly to the carrier qualifies for the annual exclusion as an indirect gift of a present interest to the trust beneficiaries).


59 See also AOD 1996-010.

60 TC Memo 1997-212 RIA TC Memo ¶|97212 73 CCH TCM 2732 .

61 TC Memo 2001-250 RIA TC Memo ¶|2001-250 82 CCH TCM 633 .


63 Ltr. Ruls. 8008040, 8022048, and 9030005.

64 Estate of Holland, TC Memo 1997-302 RIA TC Memo ¶|97302 73 CCH TCM 3236 .

65 Ltr. Rul. 9030005.

66 Ltr. Rul. 8008040.

67 Ltr. Ruls. 8121069 and 8133070.


69 Ltr. Ruls. 200130030, 200123034, 200011054, 199912016, and 9311021.


71 Ltr. Rul. 8433024.

72 Ltr. Ruls. 8008040, 8103074, and 8051128.


75 See also Naumoff, TC Memo 1983-435 PH TCM ¶83435 46 CCH TCM 852.

76 1973-2 CB 321.

77 See Ltr. Rul. 8008040. See also Estate of Holland, TC Memo 1997-302 RIA TC Memo ¶97302 73 CCH TCM 3236

78 See Perkins, 27 TC 601 (1956). See also Ltr. Ruls. 8229097, 8024084, and 8022048.

79 Restatement (Second) of Property: Donative Transfers, section 13.2, noting that some state statutes provide an exception to this rule.

80 Scott on Trusts, at section 147.3. See, also, University Nat'l Bank v. Rhoadarmer, 827 P2d 561 (Colo., 1991), cert. den. 1992 Colo. LEXIS 269 (Colo., 3/23/1992) (debtor's unexercised right to withdraw up to $5,000 from a trust was not a property right that was subject to garnishment).

81 See comment to UTC section 505; and Restatement Third, section 56, comment b.

82 Id.

83 See Comment to UTC section 505.


86 UTC section 505(b)(2). See also Restatement Third, section 56, Reporter's Note to comment b (citing UTC section 505(b)(2)).
SUPREME COURT OF WISCONSIN

CASE NO.: 2003AP40

COMPLETE TITLE:
Susan Hatleberg, Plaintiff-Respondent,

REVIEW OF A DECISION OF THE COURT OF APPEALS 2004 WI App 48
Reported at: 271 Wis. 2d 225, 678 N.W.2d 302 (Ct. App. 2004-Published)

OPINION FILED: July 7, 2005
SUBMITTED ON BRIEFS: January 7, 2005
ORAL ARGUMENT:

SOURCE OF APPEAL:
COURT: Circuit
COUNTY: Eau Claire
JUDGE: Eugene D. Harrington

JUSTICES:
CONCURRED:
DISSENTED:
NOT
PARTICIPATING:

ATTORNEYS:
For the defendants-appellants-petitioners there were briefs by Dennis M. Sullivan, Stephanie Finn and Herrick & Hart, S.C., Eau Claire, and oral argument by Dennis M. Sullivan.

For the plaintiff-respondent there was a brief by Paul J. Gossens and Paul J. Gossens, S.C., Wauwatosa, and oral argument by Paul J. Gossens.
An amicus curiae brief was filed by John E. Knight, James E. Bartzen, Kirsten E. Spira and Boardman, Suhr, Curry & Field LLP, Madison, on behalf of the Wisconsin Bankers Association.

2005 WI 109

NOTICE
This opinion is subject to further editing and modification. The final version will appear in the bound volume of the official reports.

No. 2003AP40
(L.C. No. 00 CV 261)

STATE OF WISCONSIN

Susan Hatleberg,

Plaintiff-Respondent,

v.

Norwest Bank Wisconsin, n/k/a Wells Fargo Bank,

Defendants-Appellants-Petitioners.

FILED

JUL 7, 2005

Cornelia G. Clark
Clerk of Supreme Court

REVIEW of a decision of the Court of Appeals. Affirmed and cause remanded.

¶1 DAVID T. PROSSER, J. This is a review of a published decision of the court of appeals, Hatleberg v. Norwest Bank Wisconsin, 2004 WI App 48, 271 Wis. 2d 225, 678 N.W.2d 302. The court of appeals affirmed a judgment of the circuit court for Eau Claire County, Eugene Harrington, Judge, holding Norwest Bank (now known as and hereinafter referred to as Wells Fargo Bank) liable for breach of fiduciary duty in its capacity as trustee of an irrevocable

trust set up by Susan Hatleberg's mother, Phyllis Erickson. Wells Fargo appeals, and we affirm on different grounds.

§2 In this case, during its tenure as trustee, Wells Fargo became aware of a defect in a trust that it had not drafted. It did not reveal that defect to the grantor, Erickson. After Erickson's death, the trust was subject to increased tax liability due to the drafting defect. Hatleberg sued Wells Fargo on behalf of Erickson's estate, alleging several theories of liability. The circuit court concluded that Wells Fargo breached a duty to Erickson, and the court of appeals affirmed.

§3 We reach the following conclusions: First, on the facts of this case, Wells Fargo had no duty to review the Erickson trust to ensure its effectiveness as an instrument to avoid estate taxes. The pertinent facts are that the trust instrument did not assign this responsibility to the trustee and the trustee did not draft the trust. Second, inasmuch as Erickson's estate suffered no physical harm, Wells Fargo was not subject to "Good Samaritan" liability under § 323 of the Restatement (Second) of Torts. Third, Wells Fargo negligently breached a duty to Erickson by continuing to advise her to contribute money to the trust to save estate taxes after it realized the trust was defective. Therefore, we affirm the decision of the court of appeals on different grounds and remand to the circuit court to allow it to determine whether there ought to be any adjustment in damages.

I. FACTS AND PROCEDURAL POSTURE

§4 The Eau Claire bank now known as Wells Fargo has been called several names. In 1984 it was known as American National Bank
and Trust Company. At some point in 1984, Ted Erickson, Phyllis Erickson's husband, met with Dale Sevig, American National's "Vice President and Senior Trust Officer," about estate planning possibilities.[1] On September 6, 1984, Sevig wrote a follow-up letter to Ted Erickson, expressing Sevig's interest in "hopefully help[ing] you with your estate and investment planning." Sevig attached extensive documentation and a suggested estate plan for the Ericksons.

¶5 Unfortunately, Mr. Erickson died in March 1985. On March 27, 1985, Sevig wrote another letter, this one to Mrs. Erickson, expressing condolences and soliciting her business: "[I]t will be quite easy to set up a trust account so we can help you on bill paying and watching your investments, plus whatever else needs to be done on your financial matters." Sevig's handwritten note on the letter indicates that he called Mrs. Erickson about the letter on April 8, 1985.[2] Eventually, she agreed to set up a revocable trust, with the bank serving as trustee. Sevig set up the revocable trust and handled many of Erickson's finances through it.[3] The revocable trust is not at issue in this case.

¶6 Sevig also recommended that Erickson set up an irrevocable trust to reduce her estate taxes by taking advantage of the gift tax exemption.[4] He offered to refer her to an attorney he believed to be an expert in estate planning who would draft the irrevocable trust. Erickson decided that she would set up an irrevocable trust, but she wanted her neighbor, Attorney Richard Duplessie, to draft the trust instrument. By his own admission, Duplessie was not an expert in estate planning; nevertheless,
Erickson insisted that he draft the trust. Duplessie agreed to do so, essentially copying the instrument from a form book. Duplessie testified that Erickson intended the trust to provide a way for her to reduce her estate taxes.

¶7 The parties agree that the trust was defective because it did not contain "Crummey provisions."[5] These provisions take their name from the Ninth Circuit's decision in Crummey v. Commissioner of Internal Revenue, 397 F.2d 82 (9th Cir. 1968). Crummey provisions give the trust beneficiaries a present interest in the trust, thereby bringing the trust corpus within the gift exception to the federal income tax, and removing it from the estate. Id. at 83-84. Because the beneficiaries gain a present interest, the funds are not considered part of the estate, and are not taxed upon distribution. See Mark Bradley et al., Eckhardt's Workbook for Wisconsin Estate Planners, § 8.246 at 85-86 (4th ed. 2003). In effect, the provisions require the trustee to notify the trust beneficiaries that they have some form of present interest in the trust funds. See id. If the beneficiaries are not given a present interest, the trust deposits do not qualify as gifts and therefore are not immune from federal taxation.

¶8 Initially, this error went unnoticed. In 1985 Erickson began to make deposits of $40,000 ($10,000 for each of four family members) annually into the irrevocable trust, and continued to do so for 11 years.

¶9 In 1988 Sevig noticed the absence of Crummey provisions in the trust during the bank's annual review of the trust provisions. He immediately notified Duplessie via a handwritten note, and attached suggested Crummey provisions that would "solve the
gift tax exclusion problem." Until that time, Duplessie had never heard of Crumney provisions. Duplessie received the communication but informed Sevig that he believed the trust was adequate as written. Duplessie also thought Sevig's concern was irrelevant as it was too late to add the Crumney provisions. He "assumed that [because this was an irrevocable trust], that meant you couldn't amend it." Duplessie also (erroneously) believed the trust was "completely funded"; i.e., he believed Erickson would not make any further contributions to the trust principal. The trust was never amended.

§10 Duplessie and Sevig independently admitted that neither one of them informed Erickson of the concerns about her trust. On the contrary, Sevig advised Erickson to continue to make trust contributions, which she did. Sevig stated: "I reviewed your trust for gifts made in 1990 and 1991 as follows: 1. $10,000.00 to Susan on 12-11-90. You can do so again in 1991 for the $10,000.00 annual exclusion. . . . Again, for estate tax purposes, it makes sense to do the gifts." (Emphasis added.) Hatleberg testified that Sevig told Erickson "there [were] absolutely no problems, everything was fine. She had nothing to worry about." In 1995 Sevig advised Erickson that "I think you can afford another round of gifts for the grandchildren."

§11 Erickson continued to make gifts each year through tax year 1996. She deposited a total of $440,000 in the trust over the 11-year period between 1985 and 1996. She died in November 1998. Upon her death, Sevig wrote to her probate attorney: "The lack of [ ] 'Crumney' provision[s] concerns one for her taxable estate." When the estate filed its tax return, it had to recapture the $440,000 in
gifts and pay $173,644.00 in additional estate taxes. Hatleberg, who described herself as "stunned" at that development, called Sevig to demand an explanation; Sevig replied, "I prefer not to answer that question with you because I may have to face you in a court some day." When later questioned about what he meant by that, Sevig said, "We can smell these things."

¶12 On April 17, 2000, Hatleberg sued Wells Fargo and Duplessie, alleging negligence. Duplessie reached a $173,000 settlement with the estate and has been dismissed from the lawsuit. The remaining parties tried the case without a jury on July 23 and 24, 2002.

¶13 The circuit court rendered its decision on August 22, 2002. The court made extensive factual findings, of which the following are excerpts:

Finding No. 1: "Crucial to [Sevig's] advice was the tax savings that could be achieved for federal estate taxes."

Finding No. 4: "[T]he reduction of the estate tax liability was one of the essential purposes for the trust."

Finding No. 16: "Mr. Sevig and others at [Wells Fargo] discovered the fundamental flaw in the irrevocable trust in 1988. . . . [N]either Sevig nor any other representative of [Wells Fargo] did anything to alert Mrs. Erickson or her beneficiaries about the trust document flaws."

¶14 Later in its oral decision, the court added, "suffice it to say the primary purpose for the trust was to reduce the Ericksons' estate tax." The court concluded that Wells Fargo "had a duty to Phyllis Erickson and her beneficiaries to furnish complete and accurate information concerning the trust." The court held that Wells Fargo breached that duty, and that damages of $300,933.00 would make the estate whole. It concluded that Wells Fargo was entitled to an offset of approximately $173,000 due to the Duplessie settlement,
and therefore owed the estate $127,993.00. Wells Fargo moved for reconsideration, asking, among other things, for the court to make findings assessing the comparative negligence of the parties. The court granted the motion and held that Wells Fargo was 60 percent liable and Duplessie was 40 percent liable. Accordingly, the court increased Wells Fargo's liability to $182,359.31. Wells Fargo appealed, and the court of appeals affirmed. We granted Wells Fargo's petition for review.

II. STANDARD OF REVIEW

¶15 Whether negligence exists is a mixed question of fact and law. Rockweit v. Senecal, 197 Wis. 2d 409, 423, 541 N.W.2d 742 (1995). "Whether certain events occurred are questions of historic fact to be determined by the circuit court." Jorgensen v. Water Works, Inc., 2001 WI App 135, ¶8, 246 Wis. 2d 614, 630 N.W.2d 230. "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses." Wis. Stat. § 805.17(2) (2001-02).[6] On the other hand, the existence and scope of a duty of care is a pure question of law, which this court reviews de novo. Stephenson v. Universal Metrics, Inc., 2002 WI 30, ¶15, 251 Wis. 2d 171, 641 N.W.2d 158. Whether the facts as found show that the defendant violated a particular duty is also a question of law. Jorgensen, 246 Wis. 2d 614, ¶8.

¶16 In reviewing the court's award of damages, an appellate court may not substitute its judgment for the fact finder's. Teff v. Unity Health Plans Ins. Corp., 2003 WI App 115, ¶41, 265 Wis. 2d 703, 666 N.W.2d 38. Rather, we simply determine whether the award falls
within reasonable limits, viewing the evidence in the light most favorable to the award. Id.

III. NEGLIGENCE

¶17 In this case, it is undisputed that Wells Fargo, in its capacity as trustee, paid asset manager, and (arguably) financial planner, owed certain duties to Erickson. Indeed, in Wisconsin, "'[e]veryone owes to the world at large the duty of refraining from those acts that may unreasonably threaten the safety of others.'" Alvarado v. Sersch, 2003 WI 55, ¶13, 262 Wis. 2d 74, 662 N.W.2d 350 (citing Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 103 (N.Y. 1928) (Andrews, J., dissenting)). In other words, "'[e]very person has a duty to use ordinary care in all of his or her activities, and a person is negligent when that person fails to exercise ordinary care." Alvarado, 262 Wis. 2d 74, ¶14.

¶18 We must decide the scope of Wells Fargo's duties to Erickson. We have organized our analysis into three categories: (1) Duties arising in Wells Fargo's undisputed capacity as trustee; (2) Duties arising in Wells Fargo's disputed capacity as financial planner or advisor; and (3) Duty to avoid negligently providing inaccurate information. We address each in turn. Ultimately, we conclude that Wells Fargo violated a duty arising in its capacity as a financial advisor to avoid providing false information to Erickson.

A. Duties Arising in Wells Fargo's Capacity as Trustee

¶19 The parties, and the court of appeals, focused their analyses on Wells Fargo's duties as a trustee. As the court of appeals correctly noted, generally a trustee's duties are explicitly defined in the trust instrument. Hatleberg, 271 Wis. 2d 225, ¶10; see also McGeoch Building Co. v. Dick & Reuteman Co., 253 Wis. 166, 175,
33 N.W.2d 252 (1948) ("[T]he instrument creating the trust . . . is to be looked to for stipulations fixing the obligations of the parties"); Saros v. Carlson, 244 Wis. 84, 88, 11 N.W.2d 676 (1943) ("It is a trustee's paramount duty to . . . comply with the terms of the trust.").

¶20 However, the duties of a trustee go beyond the four corners of the trust document. For example, a trustee has the duty to be "vigilant" in guarding the trust's assets. In re Revocable Trust of McCoy, 142 Wis. 2d 750, 756, 419 N.W.2d 301 (Ct. App. 1987). The trustee must "warn [the grantor] regarding easily identifiable impediments or pitfalls" that would thwart the grantor's intent. Id. at 757. This court has recognized the trustee's duty to "disclos[e] relevant information." Hammes v. First Nat'l Bank & Trust Co., 79 Wis. 2d 355, 368, 255 N.W.2d 555 (1977).

¶21 This court has also held that trustees are fiduciaries, and as such, have a duty to employ "diligence, prudence, and absolute fidelity" in managing a trust. Sensenbrenner v. Sensenbrenner, 76 Wis. 2d 625, 635, 252 N.W.2d 47 (1977). Wisconsin has enacted the Uniform Fiduciaries Act, which explicitly defines "fiduciary" to include "a trustee under any trust . . . or any other person acting in a fiduciary capacity for any person, trust, or estate." Wis. Stat. § 112.01(1)(b).

¶22 With these background principles in mind, we turn to the parties' arguments.

¶23 Hatleberg raises three arguments that Wells Fargo breached a duty in its capacity as Erickson's trustee. First, she argues that Wells Fargo, as trustee, had a duty to review the trust to ensure that it worked for its intended purpose. Second, Hatleberg
believes that a duty of notification arose when Wells Fargo discovered the deficiency in the trust. Third, she alleges that Wells Fargo violated its fiduciary duty as trustee.

\(\text{¶24} \) Hatleberg first argues that because Wells Fargo held itself out as possessing special expertise in trust planning and management, it owed Erickson a duty to review the trust to ensure that it would perform its intended purpose. The court of appeals did not directly decide this question; it "disagree[d]" with Wells Fargo's contention that it had no duty to examine the document for accuracy. Hatleberg, 271 Wis. 2d 225, ¶10, but later noted that "Wells Fargo may have originally had no duty to review the trust for accuracy . . . ." Id., ¶15. Ultimately, it appears the court "[a]ssume[d] without deciding that Wells Fargo had no duty originally, [but] it created the duty itself." Id., ¶10.

\(\text{¶25} \) Here, the trust instrument contained no language requiring the trustee to review it for effectiveness. In view of the fact that Wells Fargo did not draft the trust, we have serious reservations about Hatleberg's invitation to impose liability for failing to ensure that the trust worked for its intended tax avoidance purpose. In this case, Wells Fargo was involved in Erickson's estate and financial planning from the beginning, and had at the very least a general idea as to her intentions. Some trustees, however, might not be aware of the ultimate purposes of particular trusts. Their activities might be limited to safeguarding a trust's assets and distributing the assets to the beneficiaries. We are reluctant to impose liability on a trustee for not discovering and correcting a defect in a trust resulting from negligence by an unaffiliated drafter, unless that responsibility was assumed by
contract. We therefore decline to impose a general duty to review a trust document drafted by another and draw legal conclusions as to its effectiveness.

¶26 We turn now to Hatleberg's second argument. The parties, and the court of appeals, focused on Hatleberg's contention that when Wells Fargo discovered that the trust was defective, it should have notified her. Hatleberg relies on the Restatement (Second) of Torts § 323, commonly known as the "Good Samaritan" provision. It provides:

One who undertakes, gratuitously or for consideration, to render services to another which he should recognize as necessary for the protection of the other's person or things, is subject to liability to the other for physical harm resulting from his failure to exercise reasonable care to perform his undertaking, if

(a) his failure to exercise such care increases the risk of such harm, or

(b) the harm is suffered because of the other's reliance upon the undertaking.

Restatement (Second) of Torts § 323 (1976) (emphasis added).

¶27 On its face, this provision requires that the plaintiff suffered "physical harm" to her person or property.hatleberg argues that Erickson's estate "suffered real physical harm by having its assets reduced." The court of appeals appears to have accepted Hatleberg's argument, but did not specifically cite the Restatement; instead, it relied on Nischke v. Farmers & Merchants Bank & Trust, 187 Wis. 2d 96, 522 N.W.2d 542 (Ct. App. 1994). In turn, the Nischke court directly relied on the Restatement. It stated: "Wisconsin has long recognized that liability may be imposed on one who, having no duty to act, gratuitously undertakes to act and does so
negligently." Id. at 113. Nischke then cited and quoted the Restatement.

¶28 In Nischke, the "physical harm" to be remedied was soil and water contamination caused by a leaking underground gasoline storage tank. 187 Wis. 2d at 102. Here, the only harm is the reduction of the estate's assets. Despite the voluminous number of cases applying this section of the Restatement, we have found no cases—and Hatleberg has not cited any—holding that purely economic harm satisfies the "physical harm" requirement. On the contrary, the authority is unanimous: the Good Samaritan provision of the Restatement does not apply to "economic harm arising out of an alleged abuse of a contractual relationship." Love v. United States, 915 F.2d 1242, 1248 (9th Cir. 1990); see also Jones & Laughlin Steel Corp. v. Johns-Manville Sales Corp., 626 F.2d 280, 287-88 (3d Cir. 1980) ("Neither the rule nor its accompanying commentary and illustrations extends liability for negligence to encompass economic losses"); Oregon Laborers-Employers Health & Welfare Trust v. Philip Morris, Inc., 17 F. Supp. 2d 1170, 1183 (D. Or. 1998) ("[P]hysical harm is a requisite element of a claim for breach of an assumed duty"); Nat'l Crane Corp. v. Ohio Steel Tube Co., 332 N.W.2d 39, 43 (Neb. 1983); Carlotti v. Employees of Gen. Elec. Fed. Credit Union No. 1161, 717 A.2d 564, 566-67 (Pa. Super. Ct. 1998). We discern no justification to depart here from the established interpretation. Purely financial harm does not equal physical harm. We decline to extend the Good Samaritan rule to nonphysical harm, and withdraw any language to the contrary in the court of appeals' opinion.

¶29 Finally, in her third argument, Hatleberg alleges that, as the trustee, Wells Fargo acted as a fiduciary, and had a duty to
provide Erickson with information relevant to trust administration—specifically, its knowledge that the trust was defective due to the lack of Crummey provisions.

¶30 Wells Fargo disputes that it had any such duty, but argues that even if it did have a duty to disclose the information about the lack of Crummey provisions, it adequately satisfied its obligation by disclosing the information to the trust drafter, Attorney Duplessie. Wells Fargo argues that Duplessie was Erickson's agent for purposes of the irrevocable trust. The parties dispute the facts relating to Duplessie's status (or lack thereof) as Erickson's agent. The circuit court made no factual findings about Duplessie's post-drafting relationship with Erickson. As a matter of course, this court is not qualified to make findings of fact. See Wurtz v. Fleischman, 97 Wis. 2d 100, 108, 293 N.W.2d 155 (1980). Accordingly, we could remand for further factual findings. However, in light of our conclusion in Part III.C., infra, we need not decide whether the notice to Duplessie satisfied Wells Fargo's fiduciary duty to "disclose relevant information." Therefore, the need for a remand on those grounds is obviated.

B. Duties Arising in Wells Fargo's Capacity as Financial Advisor

¶31 Hatleberg argues that Wells Fargo held itself out as an expert in financial planning, and that it committed professional negligence by failing to inform her of the problems with the trust. As a threshold matter, Wells Fargo disputes the contention that it was Erickson's "financial planner," alleging instead that it was only her "investment planner." On the facts here, we fail to see how the label pinned on the bank would include or exclude the bank from concern about the tax consequences flowing from its management
of Erickson's money. The facts show that, by his own admission, Wells Fargo's employee, Sevig, deliberately solicited Erickson's business and extensively managed her financial affairs. Indeed, Wells Fargo's own expert admitted at trial that if he had been on the receiving end of Sevig's solicitations, he would have concluded that Wells Fargo wanted to be his "investment planner."

§32 Whether Wells Fargo styles itself an "investment planner," "financial planner," or "financial advisor," it bears responsibility for its actions. A fiduciary duty may arise in these circumstances. See Merrill Lynch v. Boeck, 127 Wis. 2d 127, 136, 377 N.W.2d 605 (1985) ("A fiduciary relationship arises from a formal commitment to act for the benefit of another . . . or from special circumstances from which the law will assume an obligation to act for another's benefit."). In determining whether a fiduciary relationship has arisen, courts consider a variety of factors, including whether there is dependence and inequality based on weakness of age or mental strength, lack of business intelligence, inferior knowledge of facts involved, or other conditions giving one side an advantage over the other. Prod. Credit Ass'n of Lancaster v. Croft, 143 Wis. 2d 746, 755-56, 423 N.W.2d 544 (Ct. App. 1988). Wells Fargo admitted at oral argument that it owed a fiduciary duty to Erickson, and that that duty required it to furnish complete and accurate information to the grantor. Again, however, it argues that it satisfied the duty to Erickson by notifying Duplessie of the problem. For the same reason discussed above, we decline to determine whether notice to Duplessie satisfied Wells Fargo's obligation to Erickson to disclose information about the defect.
Instead, we turn to Hatleberg's final argument, which definitively settles this case.

C. Duty to Avoid Negligently Providing Information

Even if we accept, arguendo, Wells Fargo’s arguments that its notice to Duplessie constituted notice to Erickson, we still must address the fact that Sevig continued to advise Erickson to contribute money to the trust to save estate taxes after he knew the trust was defective.


Wells Fargo admitted at oral argument that it had a professional duty to furnish complete and accurate information to Erickson. We need not go that far. This is not a "duty to disclose" case.[7]

In this case, despite its knowledge of the problem with the trust, Wells Fargo assured Erickson that "she had nothing to worry about," and that "for estate tax purposes, it makes sense to do the gifts." These assertions are not disputed. Thus, we decide only whether, by affirmatively making such statements to Erickson, Wells Fargo breached a duty. We conclude that it did.

Wisconsin has adopted Restatement (Second) of Torts § 552. See Citizens State Bank v. Timm, Schmidt & Co., 113
Wis. 2d 376, 385-86, 335 N.W.2d 361 (1983); Milwaukee Partners, 169 Wis. 2d at 362-63. That section provides in relevant part:

§ 552. Information Negligently Supplied for the Guidance of Others.

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

¶39 We conclude that all the elements listed in § 552 are present here. Wells Fargo made false statements to Erickson by telling her that "for estate tax purposes, it makes sense to do the gifts" and that there were "no problems" with her trust after it knew of the Crummey problem. Wells Fargo made the statements in the course of its business. Wells Fargo intended to guide Erickson's business practices ("it makes sense to do the gifts"). Wells Fargo had a pecuniary interest in the transactions, as it received a fee for serving as the trustee. Erickson relied on Wells Fargo's statements and suffered pecuniary loss in the amount of more than $173,000 in taxes. Accordingly, Wells Fargo had—and breached—a duty under § 552.

¶40 Similarly, we have no difficulty concluding that Wells Fargo's statements to Erickson are negligent misrepresentations under Wisconsin common law. The tort of negligent misrepresentation has four elements. Gorton v. Am. Cyanamid Co., 194 Wis. 2d 203, 223, 533 N.W.2d 746 (1995). They are:

(1) a duty of care or voluntary assumption of a duty on the part of the defendant; (2) a breach of that duty, i.e., failure to exercise ordinary care in making the representation or in ascertaining the facts; (3) a causal
link between the conduct and the injury; and (4) actual loss or damage as a result of the injury. 

Id.; see also Wis JI—Civil 2403.

¶41 Wells Fargo's conduct satisfies all these elements. We have already discussed Wells Fargo's potential duty under various theories: its duty as trustee, its duty as financial planner or advisor, and its duty under the Restatement (Second) of Torts to avoid negligent misrepresentations. Under any of these theories, Wells Fargo had a duty to ensure that the information it actually provided to Erickson was correct. Wells Fargo breached that duty by failing to exercise ordinary care; it told Erickson to continue contributing to the trust even though it knew the trust was defective for her objective. Finally, both the causal link and resulting injury are clear; Erickson's estate paid increased taxes due to Wells Fargo's failure to inform her of the deficiencies. Had it told her of the problem, she could have remedied it in part by giving the beneficiaries a present interest in future gifts or by setting up a new trust.

¶42 As a matter of law, we conclude that, because Wells Fargo held itself out as an expert in managing Erickson's finances, it had a duty to avoid providing false information to its client. It breached that duty, and we therefore affirm the court of appeals.

¶43 Our holding should not be interpreted as encouraging trustees and financial professionals to remain silent rather than risk providing false information to their clients. As we have recognized, trustees have a duty to disclose "relevant information." Hammes, 79 Wis. 2d at 368.

IV. DAMAGES
¶44 As we have noted, the circuit court apportioned the damages, finding Wells Fargo 60 percent liable and Duplessie 40 percent liable. Wells Fargo does not challenge that finding on appeal, and we do not disturb it. However, our holding in this case is that Wells Fargo's liability does not date back to its original receipt of the trust document in 1985, but began when it first negligently misrepresented to Erickson that she should continue making contributions to the trust. This occurred in 1988, three years after the trust's creation. In light of this change from the circuit court's and court of appeals' holdings in this case, we remand this case to the circuit court to allow it to determine whether there ought to be any adjustment in damages.

V. CONCLUSION

¶45 In summary, we reach the following conclusions: First, on the facts of this case, Wells Fargo had no duty to review the trust to ensure its effectiveness as an instrument to avoid estate taxes. Second, inasmuch as Erickson's estate suffered no physical harm, Wells Fargo was not subject to "Good Samaritan" liability under the Restatement (Second) of Torts. Third, Wells Fargo negligently breached a duty to Erickson by continuing to advise her to contribute money to the trust to save estate taxes after it realized the trust was defective. Therefore, we ultimately affirm the decision of the court of appeals. We remand to the circuit court to allow it to determine whether there ought to be any adjustment of damages, consistent with our holding.

By the Court.—The decision of the court of appeals is affirmed and the cause is remanded.
[1] Sevig stated that one of his roles at the bank was to "solicit ... business if possible for the bank."

[2] Wells Fargo's expert admitted that if he had received the letters Sevig sent Erickson, "it would be fair to conclude that the bank is saying 'We have special knowledge to be your estate and investment planner."

[3] Despite his repeated contacts with the Ericksons, Sevig claimed that he never held himself out as a financial planner. However, he also testified that he was "probably" Phyllis Erickson's "sole financial advisor." Sevig also stated that the bank's job with respect to Erickson was "investment management ... where we could suggest various courses of investments for her and carry those out." In her revocable trust, Erickson gave the bank the right to "invest, reinvest, [and] maintain" her investments at the bank's "sole discretion." As Sevig summarized it, "She just plain gave us the right to manage her portfolio as we deemed fit for her."

[4] See 26 U.S.C. § 2503(b) (2000) ("In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first $10,000 of such gifts to such person shall not ... be included in the total amount of gifts made during such year.").

[5] Wells Fargo asserted at oral argument that this is technically incorrect. Counsel stated that the trust need not contain explicit Crumley provisions so long as the beneficiaries are somehow notified of their present interest. For our purposes, the distinction is not relevant because neither action was taken here.

[6] All references to the Wisconsin Statutes are to the 2001-02 edition unless otherwise indicated.

[7] In general, "silence, a failure to disclose a fact, is not an intentional misrepresentation unless the seller has a duty to disclose."  Ollerman v. D'Rourke Co., 94 Wis. 2d 17, 26, 288 N.W.2d 95 (1980); see also Tietsworth v. Harley-Davidson, Inc., 2004 WI 32, ¶¶12, 14, 270 Wis. 2d 146, 677 N.W.2d 233.
Indeed, it is not impossible to view the bank's representations to Erickson as intentional misrepresentations.