

The ESTATE Defective Trust
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For decades estate planning has largely been about the avoidance of a confiscatory federal transfer tax. The changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)¹ significantly decrease the number of taxpayers subject to a federal estate tax. By one estimate, in 2006 (when the federal estate tax unified credit exemption equivalent is \$2.0 million per taxpayer), less than one percent of all decedent estates will owe a federal estate tax.² For the vast majority of taxpayers, estate planning will no longer be driven by the avoidance of a confiscatory federal transfer tax. Instead, personal and family concerns and other tax issues (e.g., state inheritance taxes and income taxes) will drive the estate planning process for most clients.

Because the basic purposes of income taxes and transfer taxes differ, the rules governing the income taxation of trusts, grantors and beneficiaries differ marketability from the rules governing the transfer taxation of trusts, grantors and beneficiaries. This gap creates creative planning opportunities.

For years planners have used the gap to create "Income Defective Trusts"³ that provide significant transfer estate tax benefits to their clients. When an Income Defective Trust is used, the grantor⁴ remains taxable on the income earned by the trust pursuant to the grantor trust income tax rules of Code section 671-679.⁵ However, the transfer to the trust is a completed gift for gift tax purposes and the assets of the trust are not included in the grantor's federal taxable estate.

Virtually the entire discussion of defective trusts has been about the use of Income Defective

1 Pub. L. 107-16, 107th Cong., 1st Sess. (2001), 115 Stat. 38.

2 See: John Godfrey, "US Senate Endorses Plan to Speed Cut of Estate Tax," Wall Street Journal, March 21, 2003.

3 John B. Huffaker and Edward Kessell, "How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts," Estate Planning, April 2004; George L. Cushing, "Planning with Intentional Grantor Trusts," ALI-ABA Sophisticated Estate Planning Techniques, Boston, September 17, 1992; Randall W. Roth, "The Intentional Use of Tax Defective Trusts," 1992 U. Miami Inst. Est. Plan. section 400; Howard M. Zaritsky, Tax Planning for Family Wealth Transfers, WG&L 1991, section 3.02.; Federal Income Taxation of Estates and Trusts, (WG&L) section 7.03[3]; AIs Income Tax Payment by Grantor Owner of a Subpart E Trust a Taxable Gift, @ Journal of Taxation, April 1995; Irizarry-Diaz, "How Defective is Your Trust? Suggestions on Structuring an Intentionally Defective Grantor Trust," 41 Tax. Mgmt. Memo. No 13, 231 (6/19/2000).

4 Pursuant to IRC section 678, a third party who has certain powers over the trust may be taxable on the trust's income. See: Richard A. Oshins and Noel C. Ice, "The Inheritors Trust Preserves Wealth as Well as Flexibility," Estate Planning Journal (October 2003); Richard A. Oshins and Noel C. Ice, "The Inheritors Trust the Art of Properly Inheriting Property," Estate Planning Journal (September 2003).

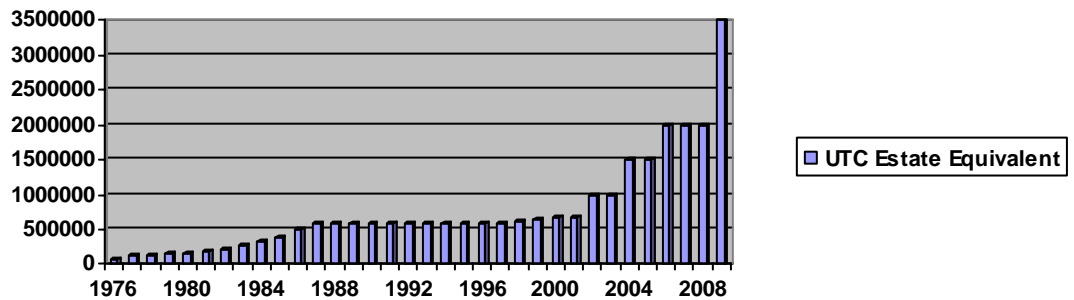
5 For more information on the income tax intricacies of grantor trusts see: Grantor Trusts: Sections 671-679. BNA Portfolio 452; Zaritsky and Lane, Federal Income Taxation of Estates and Trusts, (WG&L), section 7.01.

Trusts. However, with the recent increases in the unified credit (and the increases still to come), the gap between the income tax and transfer tax rules may create planning opportunities for Estate Defective Trusts. Such trusts are purposely created to have the trust income taxable to the trust or its beneficiaries, but to have the trust assets remain in the grantor’s taxable estate. Ironically, an Income Defective Trust is primarily an estate tax planning tool, while the Estate Defective Trust is primarily an Income Tax Planning tool.

This article will discuss some of the major tax, legal and planning issues surrounding Estate Defective Trusts.

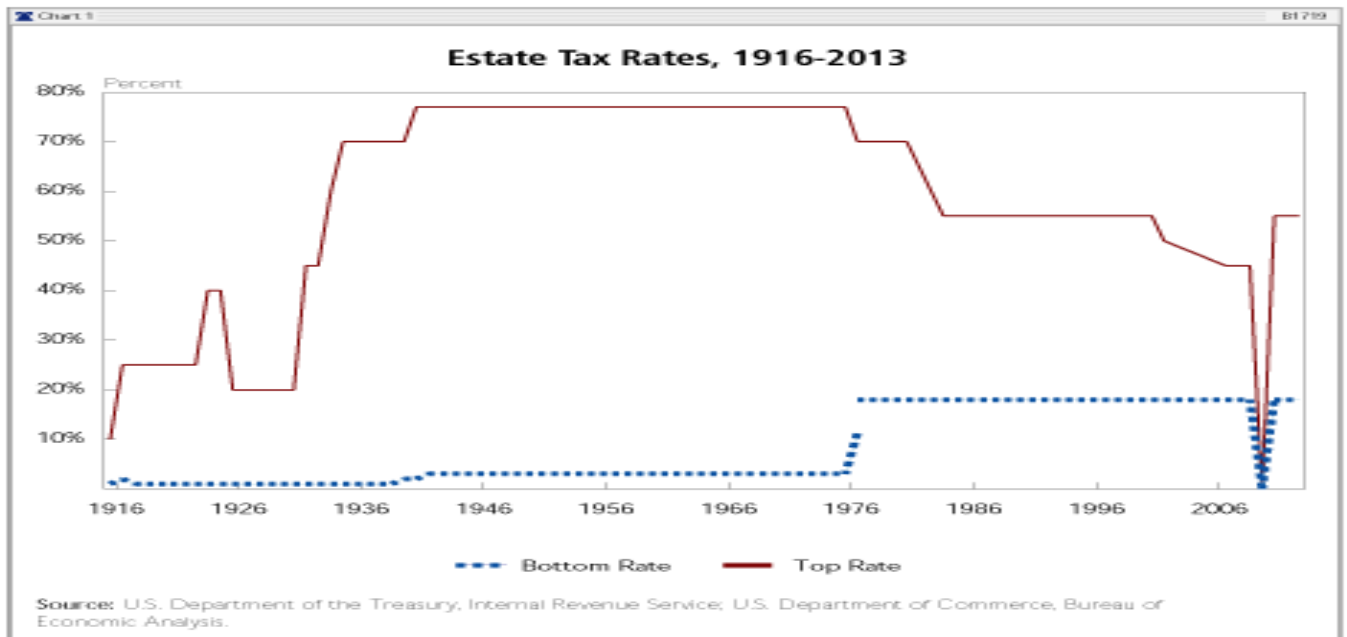
History of the Transfer Tax Exemption and Tax Rates

In order to understand why the avoidance of federal transfer taxes has historically been so paramount, it is necessary to understand the history of the federal transfer tax exemption. In 1976, the amount a decedent could pass tax-free to descendants was only \$60,000. By 1981 it had increased to \$175,000. These relatively small exemption amounts meant that much of the middle class was subject to an estate tax. In the 1980s, President Reagan effectively took the middle class out of the transfer tax system by proposing the adoption of a series of reforms, including an unlimited marital deduction and a phased-in unified tax credit equivalent to a \$600,000 exemption. As the result of legislation in 1997, the exemption was to have increased to \$1.0 million by 2006.



Not only has there been a significant decrease in the estate tax exemption, but the federal estate tax rate has also gone down.⁶ Even those taxpayers who are subject to a federal transfer tax, pay a lower portion of their estate to the federal government.

⁶ Chart from an article on the Heritage Foundation website by Gary Robbins, entitled “Estate Taxes: An Historical Perspective, found at www.heritage.org/Research/Taxes/bg1719.cfm.



As shown below, EGTRRA provided for even higher tax-free transfers and repeal of the estate tax in 2010. While repeal of the estate tax is unlikely, significant estate tax exemptions will probably remain for the foreseeable future, reducing the federal transfer tax confiscation many clients expected.

<u>Transfer Tax Exemption Amounts</u> (pursuant to the 2001 Tax Act)			
	<u>Gift Tax</u>	<u>Estate Tax</u>	<u>Generation Skipping</u>
2001	\$675,000	\$675,000	\$1.06M
2002-2003	\$1.0M	\$1.0M	\$1.06M
2004-2005	\$1.0M	\$1.5M	\$1.5M
2006-2008	\$1.0M	\$2.0M	\$2.0M
2009	\$1.0M	\$3.5M	\$3.5M
2010	\$1.0M	Tax Eliminated	Tax Eliminated
2011	\$1.0M	\$1.0M	\$1.06M, plus inflation increase

Note: Under the 2001 Tax Act, the entire bill is revoked in 2011, unless Congress reenacts its provisions. Thus, in 2011, the law before the 2001 Tax Bill may automatically be reenacted.

Assuming the exemption levels created by EGTRRA remain in place (or grow), the federal estate tax structure will have minimal impact on most Americans. Currently, roughly 2% of all estates are taxable, and if the \$3.5 million unified credit is in place in 2009, it is expected that less than 0.3% of all estates will pay an estate tax.⁷

⁷ See: John Godfrey, "US Senate Endorses Plan to Speed Cut of Estate Tax," Wall Street Journal, March 21, 2003.

As a result of these higher exemption amounts, most Americans will not be subject to a federal estate tax liability, assuming they do basic planning such as equalizing their estates and providing for unified credit trusts at the death of the first-to-die spouse. Many estates will be below the exemption amount of one individual and, therefore, equalization and the unified credit trusts may not be a federal tax necessity. With the vast majority of estates not being subject to a federal transfer tax, tax planning for most Americans will shift from a focus on federal transfer tax avoidance to a focus on income tax avoidance.

Advantages of the Defective Estate Trust

The Estate Defective Trust (“EDT”) offers a number of planning opportunities for planners and their clients, including:

Income Taxation. Until March 2, 1986,⁸ grantors could place assets in trust for a period of not less than ten years and have the income taxable to the trust beneficiaries, even when there was a reversionary interest to the grantor after the ten years. In 1986, Congress effectively eliminated the so called “Clifford Trust.”⁹ Under the current rules, in order for the grantor to avoid being taxed on the trust’s income, the reversionary interest to the grantor cannot exceed five percent of the trust. Using the 10% valuation tables, this means the term of the trust must be at least 32 years.

The EDT permits a grantor to have the trust income allocated to either the trust or its beneficiaries. Unlike an Income Defective Trust, the EDT can effectively permit a grantor to use the lower income tax brackets of the trust beneficiaries to reduce the overall taxes of the family.

Planning Example: Assume a client has a grandchild in college, the client owns a low basis asset which generates an annual income stream of \$40,000. The client is in an effective income tax bracket of 40%, while the grandchild is in an effective tax bracket of 15%. Using an EDT, the family saves \$10,000 in annual income taxes,¹⁰ while the low basis asset remains in the client’s estate for federal estate tax purposes, allowing a step up in basis at the grantor’s death.

Two benefits can result from this income reallocation: First, the income beneficiaries may be in a lower tax bracket than the grantor of the trust. Second, because the income is not payable to the grantor, the after tax proceeds from the income are not includable in the grantor’s estate reducing the possibility that the grantor may be subject to either state or federal transfer taxes.

Planning Example: Assume in the above example that the client dies in 20 years. Assuming an annual six percent return, the annual after-tax income (even at a 40% income tax rate)

8 See: The Tax Reform Act of 1986 (Pub.L. No. 99-514, section 1401(a), 100 Stat. 2085, as amended by the Technical and Miscellaneous Revenue Act of 1988 (Pub.L. 100-647, section 1014(a)(1), 102 Stat. 3342).

9 See: Helvering v. Clifford, 309 US 331 (1940).

10 If the client/grantor was paying social security or self-employment taxes (e.g., by being the general partner of a family limited partnership) on the income stream, the savings would be even more significant.

could create an additional estate value of over \$685,000 at the grantor's death.

One of the decisions clients will need to make in the potential creation of trusts is the decision of whether the grantor or the trust beneficiaries should be the ones taxable on the income of the trust. Based upon a recent revenue ruling¹¹ which found that the payment by a grantor of an Income Defective Trust was not an additional gift to the trust, clients who desire to deplete their estate (i.e. generally those with a taxable estate) should consider Income Defective Trusts. Clients who want to use the lower income tax brackets of their heirs should consider either an Irrevocable Non-Defective Trusts or, if the basis or non-tax issues are important, an EDT may be more effective.

Basis Issues. The use an EDT can fix many of the basis issues in a client's estate. Basis issues may come in many forms. For example:

- Appreciated Assets. Many clients have appreciated assets in their taxable estate. If the client gifts the asset to heirs, the donor's low basis in the asset will pass to the donee, effectively reducing the value of the gift by the inherent income tax cost. If the asset is held until death, the asset will step up to its fair market value.¹²
- Higher Valuations. With higher estate tax unified credit and a step-up in basis to a fair market value being provided at the time of the death, there may see a reversal in asset valuation. For years much of the estate tax conflict with the Internal Revenue Service has been to deny their argument that the estate was worth more than the client indicated. With the higher exemptions, clients may want to drive up the value of the assets of the estate in order to get a higher step-up in basis and thereby reduce the future ordinary income (e.g. depreciation of depreciable assets) or capital gains (e.g. upon the sale of the asset).
- Insufficient Information. In many cases, the client lacks sufficient information to properly compute the basis which might be transferred to a donee if the asset is gifted. For example, assume an eighty year old grandfather wanted to gift a family farm to his children. In many cases, determining the donor's basis can be an insurmountable task. Assuming a non-taxable estate, the retention of the asset in the taxable estate of the grantor cleanses most questions about basis because of the new step-up in basis that occurs at death.
- Depreciation Recapture. An asset may be subject to depreciation recapture. If the asset is gifted, the donee may be responsible for the tax payment associated with the depreciation recapture. If the asset remains in the client's taxable estate until death, the depreciation recapture can disappear when the basis steps up to fair market value. Not only does the depreciation recapture disappear, but the inheritors also have a new basis and can start depreciating the asset again using a new, higher basis.

Keeping the asset in the current owner's name can resolve many of a client's basis issues. However, there remain significant, non-estate tax reasons to make gifts to family. Where the client wants to make a transfer of the asset during life (e.g., to allocate income to heirs, provide for financial or education help or for other non-tax reasons), the EDT can offer the opportunity of a transfer which does not create basis problems.

¹¹ Revenue Ruling 2004-64, 2004-27 IRB 7.

¹² IRC section 1014.

Planning Example: EDT may be used as part of a plan to pass low basis assets to a chronically ill or terminally ill family member. The basis step-up may be restricted by the rules which provide that if “*appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent’s death, and such property is acquired from the decedent (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property ... shall be the adjusted basis of such property... immediately before the death of the decedent.*”¹³. However, there may be ways to avoid the one year rule:

- The donor could gift the asset to a trust, provide an income right to the terminally ill family member and give the family member a testamentary power of appointment. Arguably, because the inclusion in the deceased family member’s estate is due to the testamentary power of appointment, not the gift, the one year rule will not apply.¹⁴
- In the alternative, assume a client’s wife is terminal, but owns no assets. The donor could transfer \$1,000,000 in low basis assets to the spouse, who creates an EDT which will hold the assets for the benefit of the original donor. It is unclear whether IRC section 1014(e) applies to bequests to trusts for the benefit of an original donor. However, to reduce the argument that 1014(e) is being violated, the EDT might permit discretionary distributions of income and principal among a group of beneficiaries, not just the husband. It might also be worthwhile that the husband not be a trustee.
- In the foregoing example, another alternative might be available. If the wife dies within one year, the donor/spouse can disclaim his interest in the EDT and the assets should step-up to their fair market value, saving taxes for the beneficiary-children. If the wife survives the transfer by one year, the step-up occurs and the disclaimer is unnecessary (i.e., the husband can remain a beneficiary of the trust). In any case, the family saves up to \$200,000 in capital gains taxes when the assets are sold.¹⁵

Future Appreciation. The EDT also provides the ability to grow the value of the assets after the creation of the trust and receive a step-up in basis at the donor’s later death.

Planning Example: Assume a client has an asset which is currently worth \$200,000 with a \$10,000 basis. The asset is expected to grow at a rate of 5% per year while generating an annual income stream of \$30,000 per year. The client places the \$200,000 asset in an EDT and dies 20 years later. Over the term of the trust prior to his death, \$600,000 in income has been moved to the children who pay the related income tax at a potentially lower rate than the grantor. Second, in 20 years the value of the assets placed in the EDT is over \$677,000. When the EDT assets step-up to a fair market value (assuming a 25% state and federal capital gain bracket), the post-death sale of the assets would save almost \$170,000.

Non-Tax Opportunities. Many client estate planning decisions have been dictated by the

¹³ IRC section 1014(e).

¹⁴ But Letter Ruling 200101021 where the IRS took a contrary view. But see O’Sullivan and Weaver, “The Internal Revenue Service’s Position as to Joint Trusts and Section 1014(e),” 1 Est. Tax Plan. Advisor 14 (March 2002).

¹⁵ i.e., \$1,000,000 times a 20% capital gains tax.

requirements of the avoidance of a federal estate tax. For example, a grantor to a trust could not retain a power of appointment to reconfigure the trust at some later date without the trust assets remaining in the grantor's taxable estate. However, because the vast majority of estates will not be taxable, the dictation of terms created by the federal estate tax will no longer apply to the vast majority of estates. Instead planners should examine the income tax implications of trusts and draft language to minimize the income tax exposures, not the estate tax exposures.

Planning Example: Assume a client creates an irrevocable trust naming his three children as beneficiaries. The client's children have not shown themselves to be financially responsible and the client wants to retain some ability to reconfigure the assets among the beneficiaries or give the assets to charity in the future. A retained testamentary general or special power of appointment over the EDT will result in the inclusion of the trust assets in the grantor's estate.¹⁶ However, a testamentary power of appointment does not result in the trust being treated as a grantor trust for income tax purposes if the trust income cannot be accumulated without the consent of an adverse party.¹⁷ Therefore, the income of the trust would be taxable to the recipient beneficiaries, the EDT assets would be includable in the grantor's estate at the time of his death permitting a step-up in basis, and the grantor retains a power over the EDT to satisfy his personal concerns about his children.

Planning Example: In the foregoing example, the EDT grantor could also retain the right to invade the principal of the trust for any income beneficiary for any reason (i.e., without regard to any formula or ascertainable standard) if the beneficiary's share of the trust is charged with the distribution and the beneficiary's income is reduced accordingly. Thus, the EDT grantor could retain the power during life to accelerate the corpus distribution for any beneficiary.

Such acceleration and the placement of the distributed assets outside the control of the grantor would result in an interesting tax issue. For gift tax purposes, the gift to the trust was a completed gift.¹⁸ What is the transfer tax impact of the early distribution to the trust beneficiary? It would not appear to be a gift, because the gift was already complete. However, if the decedent dies within three years of relinquishing the power, section 2038 might apply and the corpus distribution might be includable in the taxable estate of the grantor.

Thus, the Estate Defective Trust not only provides the income tax benefit of a step-up in basis at the time of the donor's death, it may also overturn many of the limitations that have

¹⁶ IRS section 2036 provides that a retained "right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income there from" will result in the inclusion in the grantor's estate.

¹⁷ IRC section 674(b)(3).

¹⁸ See Treasury Regulation 25.2511-2(d).

restricted a grantor's lifetime authority over a trust. Many of the owners which were given up to avoid a federal transfer tax may now be available to EDT grantors.

Other Reasons. Like many other trusts, the EDT can be created to provide other benefits to the grantor and his or her heirs, including:

- Asset Protection. The trust can be created to provide asset protection to the grantor and the grantor's heirs.

Planning Example: A client is concerned about protecting her assets. Unfortunately, the assets which the client is willing to give up have a low basis. The client could create an EDT naming a spouse as primary beneficiary. As long as the spouse is alive and the couple remain married, the client receives an indirect benefit from the asset, which will remain in his taxable estate, but be beyond the call of his creditors.¹⁹

- Avoidance of Probate Issues. To the extent that the grantor places assets in the EDT prior to his death, probate of those assets is not necessary. This may provide a number of other benefits, including reducing executors fees, avoiding probate delays, eliminating elective shares and reducing the chance of will contests.
- Secrecy. In many cases a client wants to make sure that their disposition decisions are not reflected in public records. By placing assets in the EDT, the client can effectively remove how assets are being passed from the scrutiny of other parties.

Planning Example: Assume a client does not want people to know what he does for the benefit of estranged family members or ex-wives. Assuming the estate is not taxable, the use of an EDT could provide a mechanism for transferring low basis assets to unacceptable family members without disclosure to all of the family members. If a federal estate tax return is not due, there may be no documents which disclose the existence of the trust and unless the trustee or the beneficiary makes this disclosure, the veil of secrecy remains.

Creating an Estate Defective Trust

In planning the Estate Defective Trust, the planner must precisely navigate the differences in these separate areas of tax law.

Federal Estate Taxes. Federal estate tax law generally provide that donor must include in his or her taxable estate transfers for less than full and adequate consideration over which the grantor retained too much direct dominion or control.

Income Tax Differences. There are a number of material differences between the income tax rules and the estate rules governing grantor trusts, including:

¹⁹ For two interesting articles on this concept see: Timothy P. O'Sullivan and Stewart T. Weaver, "Using Two Trusts with Reciprocal Spousal Powers of Appointment," Estate Planning (June 2003) and Dennis M. Sandoval, "Drafting Trusts for Maximum Protection from Creditors," Estate Planning (June 2003).

- In a number of instances, the grantor trust income tax rules provide that the powers provided to a spouse or to a related or subordinate party results in taxation of the trust income to the grantor. There are no similar provisions in the transfer tax rules. Inclusion is generally dependent upon the power retained by the donor, not the powers granted to other parties.
- The grantor trust income tax rules generally provide that if a grantor's retained power is restricted by the approval of an adverse party, the power in the grantor to control the trust will not result in the trust income being taxed to the grantor. However, there is no similar transfer tax rule. The existence of an adverse party's approval will not result in "cleansing" of the retained power in the grantor.²⁰

Gift Tax Differences. When planning the EDT, the planner must make sure that the transfer to the trust is not treated as a completed gift.²¹ While planners have long recognized that there are significant differences between the transfer tax and income tax rules, there has been less understanding that a gift to a trust may be complete, but the assets of the trust may still be taxed in the donor's estate in certain instances.

Thus, if the planner is not careful, the transfer to the EDT could be treated as a completed gift for federal gift tax purposes (i.e., using portions of the client's available unified credit exemption) while remaining taxable in the grantor's estate. Because of the differences between the estate and gift tax rules, double taxation is possible.²²

The question evolves around "What degree of control does the donor have to retain to render the gift incomplete." The regulations provide that a completed gift occurs when a donor has "...*no power to change its disposition, whether for his own benefit or for the benefit of another...*"²³ There are instances in which a transfer to a trust will be deemed complete for federal gift tax purposes, but the assets will remain taxable in the grantor's estate. For example, assume a client creates a trust and retains the right to revoke the trust with the approval of an adverse party. For income tax purposes, the trust is not a grantor trust. For gift tax purposes, the trust is a completed gift. However, the retained power will result in the trust assets being taxable in the donor's taxable estate.

Planning with Estate Defective Trusts

There are a number of ways to create EDTs, including:²⁴

²⁰ See: Treasury Regulation 20.2036-1(b)(3) and 20.2038-1(a)(3).

²¹ Perhaps the best discussion of the completed gift issue which the author has found is Stephens, Maxfield, Lind and Calfee, Federal Estate and Gift Taxation (WG&L), section 10.01. The authors note: "This is a good place to abandon expressly any hope that the estate tax and the gift tax rules on completeness are nicely parallel."

²² Id at section 10.01[10][e]. See also, Estate of Alexander vs. Commissioner, 81 T.C. 757 (1983), aff'd in unpublished opinion (4th Cir. 1985).

²³ Treasury Regulation 25.2511-2 (b).

²⁴ This list is not intended to cover every possible approach to creating an EDT.

- Powers of Appointment. A grantor creates a trust and retains a testamentary power of appointment over an irrevocable trust's assets. Sections 2041 and 2038 provides that a grantor's retention of a testamentary power of appointment over assets of an irrevocable trust results in the inclusion of the value of the trust assets at the grantor's death.

Section 673(b)(3)²⁵ provides that a grantor's power that is exercisable only by will does not cause the trust to be treated as a grantor trust for income tax purposes. However, either the trust must not permit accumulation of income or must provide that income can only be accumulated with permission of an adverse party.

For gift tax purposes, the transfer to the trust would appear to be incomplete because the grantor has retained the ability to change the beneficial corpus interests of any beneficiary. However, because the grantor could not change the income rights during his life, it can be argued that the income interests are a completed gift.

- Power to Distribute Corpus. A grantor retains a power as a non-fiduciary to distribute the corpus of the trust. Section 2038(a) provides that any power to appoint the corpus of the trust results in inclusion of the trust assets in the grantor's estate. However, if the power is pursuant to a fiduciary power limited by a fixed and ascertainable standard, inclusion will not occur. A grantor having the right to exercise such power as a non-trustee will cause the inclusion of the trust assets in the grantor's estate.

Section 674(b)(5) provides that the retained power to distribute the trust corpus does not result in income taxation to the grantor, if either of the following conditions occur: First, the distribution is pursuant to a "reasonably definite standard" which is "clearly measurable." Note that this standard would seem to vary from the ascertainable standard language of IRC section 2514 and 2041. Second, the beneficiary's share of the trust must be reduced by the distribution, with a concomitant reduction in the beneficiary's income benefits.

For gift tax purposes, the ability of a grantor in a non-fiduciary capacity to change who will receive beneficial rights from the trust would appear to create an incomplete gift.

- Power to Withhold Income. A grantor creates an irrevocable trust and retains the right to accumulate income otherwise payable to any beneficiary and add the income to the trust principal. The trust provides that all principal is distributed equally to the named beneficiaries upon the termination of the trust. The ability of a grantor to accumulate income and add it to principal would appear to retain such dominion and principal in the donor as to result in inclusion in the donor's estate.²⁶

IRC section 674(b)(6) provides that income accumulation is permitted (without creating a grantor trust for income tax purposes) as long as the accumulated income is payable to the beneficiary, his or her estate or to appointees pursuant to a power of appointment.²⁷

²⁵ See also Treasury Regulation 1.674(b)-1(b)(3).

²⁶ IRC Section 2036.

²⁷ See also the second exception in IRC section 674(b)(6).

For gift tax purposes, the right to delay a distribution of income should not result in the transfer being treated as an incomplete gift. All the grantor can do is delay the distribution of income. He cannot take the right to receive income away.

- Power To Withhold Income During Disability or Under Age 21. A grantor retains the right to withhold income from any beneficiary when the beneficiary is under age 21 or is under legal disability. The grantor's ability to withhold income would result in the trust assets being included in the grantor's estate pursuant to section 2036.

IRS section 674(b)(7) provides that a grantor's power to withhold income from a beneficiary who is under age 21 or is under a legal disability does not create a grantor trust for income tax purposes. Effectively the section permits the grantor to withhold income, add the accumulated income to principal and then pass the principal to other remainder beneficiaries.

For gift tax purposes, the transfer to the trust would be treated as a completed gift.²⁸

Disadvantages of the Defective Estate Trust

But the Estate Defective Trust does carry significant risks, including the following:

Potential Federal Estate Taxation. An EDT is normally created on the assumption that the grantor will not have a federal taxable estate. Inheritances, unexpected growth in the estate or other factors could increase the size of the estate. Moreover, the exemptions which are currently available could be decreased by a future Congress.

To some degree, this fundamental uncertainty can be handled if the client and the advisor continue to monitor the client's particular facts and state and federal transfer tax law. If the assumptions which were made in the creation of the trust turn out to be invalid, the client could consider renouncing those powers over the trust which resulted in the inclusion of the trust assets in the grantor's estate. However, if the donor dies within three years of the relinquishment of the power, section 2038 might still include the EDT trust assets in the grantor's estate.

Gift Taxes. As previously discussed, the differences between the gift tax rules and estate tax rules can create conflicts between the two transfers tax systems.

Documentation. If the estate is below the unified credit exemption amount, a federal estate tax return is generally not due.²⁹ This raises the obvious need for clients to properly document the value of the assets in the EDT as of the date of death of the grantor. This documentation will be essential to assuring that the step-up in basis of the EDT assets actually occurs. Therefore, it is an absolute necessity that any unmarketable EDT assets which are included in the taxable estate be properly appraised at the time of the death of the grantor. The trust should probably include language

²⁸ See Treasury Regulation 25.2511-2(d).

²⁹ IRC section 6018.

requiring the trustees to obtain such an appraisal at the time of the grantor=s death.

State Transfer Taxes. Even though there will be substantial reductions in federal transfer taxes, state death taxes will offset at least part of the reduction. As a part of EGTRRA, Congress replaced the state death tax credit with an federal estate tax deduction. Thirty-eight states use the federal credit as their state estate tax. These states are revising their statutes to impose new state inheritance taxes. Some states will ignore the higher federal exemption amounts, creating a state death tax when no federal estate tax is due.

Like the federal government did in 1924, more states will adopt a state gift tax to stop the loss of transfer tax revenue through lifetime gifts.³⁰ The issue of complete or incomplete gifting will be even more important in those states which impose a state gift tax, particularly when (unlike the federal estate tax) there is no federal deduction for state gift taxes.

For a majority of Americans, the continuing increases in the estate tax unified credit exemption amount will continue to diminish federal transfer tax avoidance as a core goal of estate planning. Increasingly, other tax planning and personal planning issues are rising to the fore.

The Estate Defective Trust adds one more tool to the arsenal of planning tools. Like the Income Defective Trust, the Estate Defective Trust will not work for every client, but for those clients who fit its criteria, it can be an excellent part of their plan.

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³⁰ As of December 31, 2003, only Connecticut, Louisiana, North Carolina, Tennessee, and Puerto Rico have a state gift tax.