

# Trust and Estate Planning Strategies for Challenging Economic Times

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1

2

## Trust and Estate Planning Toolbox

- 1. Estate tax focused tools**
- 2. Income tax focused tools**
- 3. Trust modification tools to account for changed circumstances**



2

## 2021: A Year of Uncertainty

- **Various proposals impacting the Estate Tax:**
  - Eliminate cost basis step-up at death
  - Accelerate the Estate Tax “sunset”
  - Eliminate “Grantor Trust” planning
  - Eliminate valuation discounts on gifts of passive real estate entities
  
- **But, the proposals never became law**
  
- **The proposals may be a preview of future Estate Tax focused legislation**



3

## 2022: Continued Uncertainty

- **Rising inflation**
  - DOL reported in October that CPI rose 7.7% over prior 12 months
  - Gasoline 18% higher than last year
  
- **Impending recession**
  - GDP declined in first half of 2022
  - Stock market down (S&P 500 down 17.36% YTD)
  - Fed tightening monetary policy
  - Higher interest rates (Average 30-year mortgage 7.32%)
  
- **Labor issues**
  
- **Geopolitical conflict**
  
- **No Congressional action to change Federal Estate Tax**



4

## 2023 and beyond...

- **2023:**
  - Annual Exclusion: \$17,000
  - Federal Gift and Estate Tax Exemption: \$12.92 million (\$860,000 increase from 2022)
  - Spousal portability remains
    - Plus: Estates can now request late portability election relief for 5 years (Rev. Proc. 2022-32)
- **2026:**
  - The 2017 Tax Cuts & Jobs Act expires on December 31, 2025
  - Federal Gift & Estate Tax exemptions will drop back down to \$5 million, indexed for inflation (unless Congress takes action before then)



5

## Window of Opportunity for Substantial Gifting Between Now and 2026

- More time to make “use it or lose it” gifting decisions
- Making large gifts now won’t harm estates after 2025 84 Fed. Reg. 64,995, (Nov. 26, 2019)
- Risks to further delaying gifts:
  - Asset appreciation between now and the date of the gift (future gift of appreciated asset uses more exemption than a gift now)
  - Congress could act sooner to reduce exemptions or prohibit common gifting strategies (Grantor Trusts, discount rules)



6

## Gifts Must Be Substantial

- Ms. Doe makes a gift of \$2 million in 2022 (when the exemption amount is \$12.06 million) but later passes away in 2026 when the exemption is \$6 million. So, Ms. Doe's applicable exclusion amount is \$4 million (the prior gift reduces exemption).
  - \$21 million estate
  - Less: \$4 million rem. exemption
  - \$17 million
  - x 40%
  - \$6.8 million of estate tax
- **Important:** To take full advantage of tax savings, gifts must exceed what the exemption will be reduced to!



7

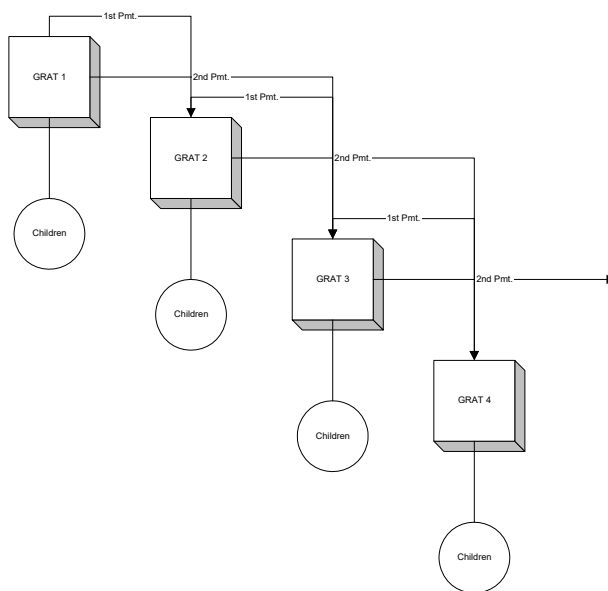
## Estate Tax Focused Gifting in a “Down” Market

- Take advantage of market declines by making gifts of assets likely to appreciate in the future
  - Marketable securities are generally down right now
  - Volatility may dampen value of closely-held businesses and real estate markets
- Consider Grantor Retained Annuity Trusts (GRATs)
  - Transfer of high-yielding and rapidly appreciating asset
  - Grantor retains a fixed annuity interest
  - Future growth removed from gross estate
  - Consider short-term rolling GRATs, particularly when markets are down



8

## Rolling GRATs



9

## Estate Tax Focused Gifting Techniques

- **Gift to an Intentionally Defective Grantor Trust (IDGT)**
  - Assets likely to appreciate
  - Future growth removed from gross estate
  - Grantor pays the income tax
- **Sale to an IDGT**
  - Not a taxable sale
  - Freezes value
- **Spousal Lifetime Access Trust (SLAT)**
  - Get future growth of asset out of Grantor's estate
  - Preserve income stream for spouse
- **"Wait and See" Disclaimer Trust**
  - Transfer to short-term marital trust for spouse; if no disclaimer then hand the gift back to the spouse; if disclaims, then held in trust for spouse
  - Provides flexibility to decide whether to make the gift or not



10

## Primary Approaches in Earlier Planning – Estate Tax Focused

- Maximize use of Estate and Gift Tax Exemptions
- Maximize Marital Deduction Planning
- Aggressive Lower Valuations
- Use of Lifetime Planning/Charitable Giving/Second to Die Life Insurance



11

## New Planning Approaches – Income Tax Focused

- Estate and Gift Tax is not relevant in decision making for most people
- Income Taxes can be substantially more costly (particularly for estates and trusts)
- Shift in focus:
  - Focus is on income tax, particularly tax basis planning
  - Carryover basis vs. step-up basis



12

## Carryover Basis - Lifetime Transfers

(carryover basis exceptions/modifications)

- **Basis of gifted property is lower of carryover basis or FMV of asset**
- **Gifted “Loss Property”**
  - If basis is greater than FMV, then basis for determining loss is the lower FMV (if later sold between basis and FMV, then neither gain nor loss is realized)
- **Spousal and Divorce Transfers**
  - “Lower of” rule doesn’t apply



13

## Lifetime Transfers (continued)

(carryover basis exceptions/modifications)

- **Liability in Excess of Basis**
  - General rule is current taxable income to transferor to the extent of the difference between the basis and applicable debt
- **Basis Adjustment for Taxable Gifts**
  - Increase in basis for gift tax paid
- **Sale to A Related Party**
  - Recognized loss on sales to a related party are denied (IRC Sec. 267)
- **Installment Sales to Family Members**
- **Unknown Gift Bases**



14

## Basis Step-Up – Testamentary Transfers

(step-up basis exceptions/modifications)

- **Income in respect of a decedent (“IRD”)**
  - No step up for IRD items
- **Partnerships/LLCs**
  - Tax basis of 751 “hot asset” held in a partnership is not changed
- **S Corp IRD**
  - If S stock is inherited, then the IRD rules apply; S corp stock basis must be reduced by the IRD items attributable to the decedent
- **Employer Stock**
  - Employer stock distributed from a qualified plan doesn’t get a step up
- **Alternative Valuation**
  - Basis is FMV at the earlier of the date of distribution or 6-month alternative valuation date



15

## Testamentary Transfers (continued)

(step-up basis exceptions/modifications)

- **Special Use Valuation**
  - Basis is the special use value
- **Conservation Easements**
  - Tax basis is the decedent’s basis
- **Jointly Owned Assets**
  - Rules depend on when death occurred and identity of beneficiary
- **Gifted Appreciated Property (One Year Rule)**
  - No step up if receive gifted property back from decedent within 1 year of gift
- **DISC Stock**
  - Basis adjusted for unrealized dividends in the entity
- **Uniform Basis Rules**
  - Basis of inherited asset is the same whether in the hands of the executor, trustee, beneficiary, heir, etc.



16



## Assets/Situations to Consider Basis Planning

- **Attractive for Basis Adjustments at Death**
  - **Highly Appreciating Property**
  - **Very Low Basis Property**
  
- **Less attractive for Basis Adjustments at Death**
  - **High Basis Property**
  - **Loss Property**
  - **Assets not entitled to a basis step-up, like IRA's and qualified plans**



17

## Highest to Least Benefit from Step Up

- Creator Owned IP
- Negative Basis Commercial Real Property
- Community Property
- Investor/Collector Owned Art, Gold and Other Collectibles
- Low Basis Stock or Other Low-Basis Capital Assets/Highly appreciating
- Roth IRA Assets
- High Basis Stock
- Fixed Income Assets
- Cash
- Stock and Other Capital Assets with Unrealized Loss
- Variable Annuities
- Traditional IRA and Qualified Plan Assets



18

## Strategies for Obtaining Basis Step Up

- Hold Asset Until Death
- “Re-gifting”
- Argue that IRS Arguments for Inclusion Apply
- Distribute Assets to Beneficiary
- Use of General Powers of Appointment
  - GPOA causes estate inclusion
  - Full GPOA v. Formula GPOA
  - Revisit old plans?



19

## Trust Modifications to Account for Changed Circumstances

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|---|--|
| <ul style="list-style-type: none"> <li>▪ Extend the trust term</li> <li>▪ Converting a support trust into a discretionary trust</li> <li>▪ Fixing drafting errors or resolving ambiguity</li> <li>▪ Moving the trust to a state with more favorable laws</li> </ul> | <ul style="list-style-type: none"> <li>▪ Adjusting powers of appointment</li> <li>▪ Changing trustee provisions</li> <li>▪ Combining or separating trusts</li> <li>▪ Drafting a special needs trust</li> <li>▪ Qualifying the trust to hold Sub S stock</li> </ul> |
|---|--|

20

## Scenario #1 – Trust Decanting

- Irrevocable Trust established as a family trust 20 years ago for the lifetime benefit of wife, and trust property is not includible in wife's estate
- Assets have appreciated significantly in value over 20 years
- When the trust was established, the family was worried about estate tax exposure when exemptions were much lower (\$1,000,000 in 2002 vs. \$12,060,000 in 2022)
- 20 years later, with increased exemptions and mom's balance sheet, estate tax isn't a concern, but the kids are concerned about income taxes since they will receive the trust property with a low cost basis
- Option:
  - Judicial modification due to changed circumstances
  - *Alternative:* Use trust decanting to grant mom a testamentary general power of appointment to cause inclusion in mom's estate, resulting the trust property receiving a cost basis-step up at mom's death

21

## Trust Decanting

- **Overview:**
  - The Trustee uses its distributive authority to move assets to a new trust, with different terms
  - Doesn't require consent or court approval
  - Requires 60 days notice to qualified beneficiaries
- **Most common uses:**
  - Postponing non-vested distributions
  - Modifying of adding powers of appointment
  - Altering successor trustee provisions



22

## Trust Decanting

- **Limitations on Changes to Dispositive Terms:**
  - **Cannot add beneficiaries**
  - **Cannot accelerate a beneficiary's interest**
  - **Dispositive terms of the new trust must adhere to specific requirements**
    - Ascertainable standard must be maintained
    - Cannot reduce a fixed income, annuity or unitrust interest (that has come into effect)



23

## Trust Decanting

- **Second Trust May:**
  - **Grant new power of appointment**
    - Note: permissible appointees may include persons not beneficiaries of the original trust
  - **Retain, Modify or Omit a power of appointment**
- **Concerns regarding fiduciary liability**
  - **Trustee's exercise of discretionary power to distribute trust property**
  - **Failure to decant does not give rise to fiduciary liability**



24

## Scenario #2 - Nonjudicial Settlement Agreement

- Irrevocable Trust established in 1999
- Grantor is deceased
- Trustee dies in 2022 and failed to exercise Trustee's power to appoint successor Trustee
- Trusteeship is vacant
- Options:
  - Court action to appoint successor, or
  - Nonjudicial settlement agreement to address Trustee succession, administrative powers, and trustee compensation

25

## Modification by Nonjudicial Settlement Agreement

- Primarily for administrative matters where all "interested persons" are willing to sign
- Not substantive or dispositive issues
- Change cannot violate a "material purpose"
- Statute: NCGS § 36C-1-111
- Examples:
  - 1. Approve trustee reports
  - 2. Direct the trustee to perform or refrain from an administrative act
  - 3. Resignation, appointment, compensation
  - 4. Transfer place of administration
  - 5. Address liability for other items in the list

26

## Scenario #3 - Nonjudicial Modification by Consent

- Irrevocable Life Insurance Trust established in 1988
- Grantor is living
- Trust document requires a Corporate Trustee, but Corporate Trustee wants to resign
- Grantor and all beneficiaries are “okay” with an individual serving as Trustee
- Options:
  - Nonjudicial Settlement Agreement is not available because requiring a corporate trustee was a “material purpose” of the trust
  - Alternative: nonjudicial modification by consent of grantor and all beneficiaries
    - Remove requirement of a corporate trustee, and
    - Change administrative provisions regarding trustee appointment

27

## Nonjudicial Modification by Consent

- Modification of Irrevocable Trusts NCGS § 36C-4-411(a)
  - Requires consent of the settlor and beneficiaries
  - Permitted even if the proposed change is inconsistent with a material purpose of the trust
  - Does not require court approval (but may seek)
  - All beneficiaries (not just “qualified”)



28

## Nonjudicial Modification by Trustee

- **Modification of Uneconomic Trusts NCGS § 36C-4-414(a)**
  - No court required
  - If trust property is under \$50K and trustee determines value of trust property is insufficient to justify costs of administration
  - Beneficiary consent not required, but requires notice to qualified beneficiaries



29

## Scenario #4 - Judicial Modification by Consent

- Irrevocable Trust for the lifetime benefit of a beneficiary, remainder to step-family
- Grantor is deceased
- When the trust was established, income beneficiary had money management issues
- 25 years later, income beneficiary is 65, and circumstances have changed for the better, but needs money now instead of income over time
- Income beneficiary and remaindermen agree on an actuarial payout of their respective interests and want to terminate the trust early
- Option:
  - Judicial modification by consent of all beneficiaries, but the court must determine the reason for the modification substantially outweighs the interest in accomplishing the material purpose of the trust

30

## Judicial Modification by Consent

- **Compelled modification by consent of all beneficiaries (NCGS § 36C-4-411(b))**
  - “Material purpose”
  
- **Requested modification by consent of all beneficiaries (NCGS § 36C-4-411(c))**
  - “Substantially outweigh trust’s material purpose”



31

## Judicial Modification

- **Modification without consent of beneficiaries (NCGS § 36C-4-411(d))**
  - Adequate protection for nonconsenting beneficiaries
  
- **Other circumstances:**
  - Unanticipated circumstances (NCGS § 36C-4-412)
  - Correct drafting errors (NCGS § 36C-4-415)
  - Achieve settlor’s tax objectives (NCGS § 36C-4-416)



32



## Scenario #5 - Judicial Modification of Charitable Trust

- Irrevocable Charitable Remainder Trust
- Charitable beneficiary is no longer in existence and the trust doesn't provide for a back-up charitable beneficiary
- Option:
  - Judicial modification to direct the trust property to another charitable organization consistent

33

## Judicial Modification of Charitable Trusts

- **Modification of Charitable Trusts NCGS § 36C-4-413**
  - Cy pres
  - Becomes unlawful, impracticable, impossible to achieve, or wasteful
  - Modify or terminate in a manner consistent with the settlor's charitable purposes
- Any court action related to a charitable trust requires notice and full disclosure to the NC Attorney General's office in advance of the court filing



34

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