# ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

2021 YEAR END

## PLANNING THOUGHTS

### The emergence of directed trusts

Over the last decade, trust administration has undergone a transformative evolution. A trust instrument of a *directed trust* includes provisions that allow for an adviser, co-trustee, or other fiduciary to direct the trustee to exercise a variety of ministerial and discretionary responsibilities. These may include investment decisions pertaining to all or a portion of the assets, tax reporting, distributions, transfer of trust situs, amendments to the trust instrument, and how and when beneficiaries receive notice and information. In other words, a directed trust is a trust in which some of the duties traditionally held by a trustee are held by a separate adviser.

#### Divided responsibilities

This evolution in trust law was both necessary and long overdue. By dividing the duties, the grantor is able to use separate specialized advisers to administer the trust. Settlors today often use common law trusts as complicated wealth transfer vehicles with specific objectives that can involve closely held entities, start-up companies, concentrated positions, real estate, art, or other unique assets. Because of the historic development of the law of common law trusts and a trustee's general fiduciary duties that impose a duty of care and a duty to diversify, a set of prudent investor or prudent person rules can come in direct conflict with holding such specialized assets. The settlor might even live in a jurisdiction in which such duties are not waivable. Settlors have used common law trusts to achieve unique investment, tax, and dispositive objectives that can conflict with traditional fiduciary limitations and pose unacceptable risks, particularly for corporate fiduciaries. Settlors are now seeking to accomplish these same goals by bifurcating the responsibilities from the rest of the traditional trust administration functions and giving them to a separate adviser.

A directed trust is not merely a delegation of duties among fiduciaries. In order to effectively bifurcate responsibilities, the settlor will need to ensure that: (1) the governing instrument of the directed trust is properly drafted, (2) the jurisdiction selected as the situs of the trust has a strong directed trust statute, and (3) the trustee is familiar with how to administer a directed trust. A well-drafted governing instrument of a directed trust will effectively bifurcate the directed function between two (or more) fiduciaries and eliminate the trustee, who is acting solely at direction, from the decision-making and monitoring of directed decisions.

#### Purposes

Why would anyone want a directed trust? Isn't this just used to protect the trustee? The general answer is simple: the settlor, beneficiaries, or trustee want a directed trust in those circumstances where they want someone other than the trustee to possess responsibilities and liabilities traditionally associated with the trustee function. If the settlor chooses to have a directed trust, then the settlor will want the trustee to be excluded from that area of decision-making. The settlor will not want the trustee to be second-guessing or interfering with the investment decisions. Likewise, the trustee will also want to ensure that those responsibilities are truly bifurcated, so that the trustee is not exposed to unexpected fiduciary risk.

The most common use of a directed trust is a structure that utilizes an investment advisor. The investment advisor directs the trustee with respect to all or some subset of investment decisions. Often, a settlor wishes to create a trust that holds special assets, such as a concentrated position in the stock of a family-controlled business, a limited liability company (LLC), real estate, or stock that will soon be sold in an initial public offering.

Settlors and beneficiaries may have specific preferences about how the trust assets should be invested and managed, or they may contemplate a specific transaction in the foreseeable

future. The prudent investor rules requiring diversification, and rules prohibiting self-dealing may put pressure on a trustee, or indeed require a trustee, to abandon these objectives.

Alternatively, the beneficiaries may have a special relationship with a local investment manager that has an office close to their residence and is better equipped to manage the family's investment needs in the trust. Here, the settlor can retain the power to manage the trust investments by serving as the investment adviser and directing the trustee.

The investment responsibilities and liabilities can be assigned to an investment adviser, named in the trust instrument, and the trust instrument can require the trustee to act solely upon that investment adviser's direction. Without the benefit of a directed trust statute, in many instances the trustee wouldn't be prudent in holding the concentrated position, so the trustee wouldn't be able to meet the settlor's needs. An investment adviser could have responsibility for directing the trustee with respect to all of the trust assets, some portion of the trust assets, or specific assets (sometimes referred to as "Special Holdings" or "Special Assets"). Often, the investment adviser will be responsible for directing the valuation of assets subject to direction, particularly for assets that are not readily valued on a public exchange.

### Distributions

Another common use for directed trusts is where a distribution adviser directs the trustee with respect to distribution powers.

Settlors often want the responsibility for making trust distributions to belong to individuals who are close to the family and have personal knowledge of the beneficiaries' needs. This may be particularly desirable where a beneficiary has special needs or where the trust instrument includes lifestyle incentives or prohibitions that require personal knowledge and impose commitments of time and attention. In addition, under the federal income tax grantor trust rules, beneficiaries with interests substantially adverse to the grantor may need to direct the trustee to make distributions to prevent the trust from being treated as a grantor trust. Other possible areas for trustee direction include limiting a trustee's duty to inform beneficiaries, tax return preparation and reporting, amendments to the trust agreement, change of situs, and change of governing law.

## CASES AND RULINGS

### An heir who accept benefits from an estate may not later challenge the will.

#### Estate of Johnson, 64 Tex. Sup. Ct. J. 1160 (Tex. 2021)

Dempsey's will made several specific bequests and divided his residuary estate among his three daughters, Lisa, Tia, and Carla. Tia also was specifically left a mutual fund worth $143,229 and half of a bank account. Lisa was named executor of the estate.

Dempsey died in August 2017. Lisa began the probate of Dempsey's will in October that year, and she distributed the mutual fund to Tia in December. In February 2018 Tia brought a lawsuit alleging that Dempsey's will was tainted by undue influence or a lack of testamentary capacity. She argued that the will should be set aside, which would result in an intestacy. In that case, she would inherit 1/3 of the $1.4 million estate (the value of the other specific bequests is not provided in the opinion).

Lisa moved to dismiss on the grounds that Tia had no standing to attack the will, as she had already accepted benefits under it. The trial court agreed. Tia appealed, on the basis that she would receive a far larger inheritance should her suit be successful. Because Lisa did not offer evidence to rebut that assertion, the appellate court reversed.

The Supreme Court of Texas now reverses the appellate court decision, holding that her acceptance of benefits barred Tia's attempt to overturn the will. Tia did not return the mutual fund to the estate. "Equity does not permit the beneficiary of a will to grasp benefits under the will with one hand while attempting to nullify it with the other."

Tia accepted the mutual fund voluntarily. The court recognized that the beneficiary's acceptance of benefits must be voluntary so that "an opportunistic executor [cannot] offensively deny a would-be will contestant's claim by partially distributing the estate to an unwitting beneficiary to avoid a will contest."

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### A small drafting error spoils an attempted defined value clause.

#### Nelson v. Comm'r, T.C. Memo 2020-81, aff'd No. 20-61068 (CA-5, Nov. 3, 2021)

On January 1, 2004, Parents decided to make gifts of LLC units to each of their four children. The gifts were defined so as to use up Parents' $1 million federal gift tax exemption and the $11,000 annual gift tax exclusion available in that year. The LLC was valued by an independent appraiser, and an appropriate percentage of membership units was found to satisfy the dollar value of the intended transfer. Upon audit, the IRS increased the value of the membership units by roughly 30%, triggering a gift tax liability.

The change in value did not change the value of the gift, the Tax Court held. The reallocation of LLC interests is not the same

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as returning a portion of the gift to the donor, so this defined value clause was not a "tax savings" clause, bringing it outside the reach of *Proctor*. The Court specifically noted the absence of charitable organizations as parties to the transaction [*Wandry v. Commissioner,* T.C. Memo. 2012-88].

Now a similar case has been decided with the opposite outcome. Mr. and Mrs. Nelson were the general partners of an LLC whose subsidiaries were in oil field service and a Caterpillar dealer in Oklahoma and West Texas. On December 31, 2008, Mrs. Nelson made a gift in trust of her "right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment." On January 1, 2009, she sold $20 million worth of the limited partnership interest to the same trust, taking back a promissory note paying 2.06% interest.

The independent appraiser was hired, and it was determined that to reach the identified gift value, exactly 6.1466275% of the LLC was the amount transferred. Upon audit, the IRS concluded that the appraiser had undervalued the company, and that 6.1466275% came to much more than $2 million. The Tax Court agreed, the increased value of the gift was taxable. The difference between Wandry and Nelson outcomes was ten magic words, missing from the Nelson defined value transfer: "as finally determined for federal estate and gift tax purposes."

The Fifth Circuit Court of Appeals has now affirmed the Tax Court's decision.

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## IRS sets closing letter fees for estates.

### T.D. 9957; 86 F.R. 53539-53542; 2021-41 IRB 452

Despite the fact that fewer and fewer estates are subject to the federal estate tax as the exemption equivalent has grown, the number of Forms 706 filed every year has exploded. Most are nontaxable returns; they have been filed solely to claim the Decease Spouse's Unused Exemption Amount, which will be lost if the Form is not filed.

Faced with this administrative burden that generated no revenue, the IRS announced in June 2015 that it would no longer routinely provide estate tax closing letters. That did not stop estate administrators from needing the letters, however, and they continued to request them.

In December 2020, the IRS proposed new regulations in this area to speed the process of getting an estate tax closing letter. The regulations included a $67 fee to obtain a closing letter. Final regulations were issued on September 27, 2021, and the fee went live on October 28, 2021. To obtain a closing letter now, one goes to pay.gov and searches for "estate tax" or "closing letter," then selects "Estate Tax Closing Letter User Fee" from the results.

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## Whistleblower dies, claim survives.

### Joseph Insinga v. Commissioner, 157 T.C. No. 8

In 2007, when he was an employee of the Dutch bank Rabobank Group, Joseph Insinga filed a report with the IRS Whistleblower Office. He alleged that billions of dollars from U.S. companies were being inappropriately sheltered from taxation at the bank. Insinga provided the IRS with internal audit reports to demonstrate the claims. Five years went by with no word on what reward he might receive for blowing the whistle. In 2012, Insinga filed a Tax Court petition to get the IRS to give him an answer.

In 2013 the answer finally came, and it was a denial that Insinga was due any reward at all for the information he provided. There were no collected proceeds on which to base the reward, according to the Service. A new lawsuit was filed challenging that determination, and years of discovery followed. Insinga died in March 2021. His estate moved to substitute itself as the petitioner, and the IRS did not oppose the motion.

However, an agreement by the parties does not confer jurisdiction, and the Tax Court took up the question, which was one of first impression.

The Court held that based on the common law rule that rights of action under federal statutes survive a plaintiff's death if the statute is remedial, not penal, Insinga's case can go forward. The fact that the reward is proportional to the recovery supports that conclusion, the Court ruled.

## WASHINGTON TALK

**Higher federal transfer tax numbers for 2022.** The exemption equivalent for the unified credit for estate and gift taxes goes to $12,060,000, and the annual gift tax exclusion is bumped up to $16,000.

**Before the Build Back Better Act (BBBA) was substantially rewritten,** the Congressional Research Service published a summary of the estate and trust provisions of the earlier bill. The report remains useful, because these provisions could reappear

in 2022 bills as "pay-fors"

- *Reduction in half of the unified estate and gift tax credit.* Because this change is already scheduled for 2026, it would have had an effect in only four calendar years. Reduction of the credit would have raised $54.3 billion.
- *Increase in dollar limits on special use valuation.* Under current law a farm may be valued for its agricultural use for the estate tax, rather than a much higher value it might have for nonagricultural development. Heirs must continue to farm the property for ten years. The maximum value reduction allowed in 2021 is $1.19 million. The BBBA would have boosted the maximum to $11.7 million, at a revenue cost of $300 million over ten years.
- *Minority discounts.* The BBBA would have disallowed discounts for cash or readily marketable securities owned by a private corporation or partnership. This change was estimated to raise $19.9 billion over ten years.
- *Grantor trusts.* Under the BBBA, exchanges between a grantor and a grantor trust would be treated as a recognition event for capital gains. The trust would be included in the grantor's estate, and distributions from the trust to the beneficiaries would be treated as taxable gifts by the grantor. These changes were projected to raise $7.9 billion over ten years.

**A Prince-ly settlement.** The March 2022 trial concerning the estate tax obligations of Prince's estate has been cancelled, as the estate and the IRS have reached a settlement. Initially the executor of the estate had reported its value to be $82 million, and the IRS countered with taxable value of $163 million. Terms of the settlement were not announced.

**Important reminder to non-itemizers.** In early November the IRS reminded the 90% of taxpayers who do not itemize their deductions that they still have access to an above-the-line deduction for charitable gifts in 2021. The extra deduction was created by the CARES Act in 2020 and extended to the 2021 tax year by the Taxpayer Certainty and Disaster Relief Act of 2020—enacted last December. Single taxpayers are permitted a deduction of up to $300, marrieds filing jointly up to $600—for cash gifts to qualified charities [*IR-2021-190*].

When the standard deduction was doubled with TCJA 2017, making itemizing unnecessary for the large majority of taxpayers, there was a fear that the loss of the tax benefit might reduce American generosity. That does not appear to have happened. According to Giving USA, charitable giving by individuals rose by 2.2% in 2020, reaching $324.1 billion. That was the year of the economic hardships of the pandemic, but those who could still opened their wallets wide.

**The release of the "Pandora Papers"** has stimulated an interest at the House Ways and Means Committee in the taxation of trusts. The Pandora Papers purport to document how the wealthy have been able to hide their wealth from government authorities, sometimes using the USA as a tax haven. Interestingly, to date no Americans have been publicly identified in the Papers. There has been no allegation of a loss of revenue to the IRS.

Nevertheless, the Joint Committee on Taxation prepared "Present Law and Background on the Federal Taxation of Domestic Trusts" [JCX-49-21] for a December hearing of the Ways and Means Oversight Subcommittee. Key observations:

- intentionally defective grantor trusts are being used as "estate freezing" strategies;
- grantor-retained annuity trusts have been used to successfully reduce estate and gift tax obligations;
- the generation-skipping transfer tax may be avoided when the GSTT exemption is applied to a perpetual dynasty trust.

The Report also provides data on the income taxation of trusts and estates, as well as the reporting requirements of domestic trusts.


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