

OBIT Power: The One Clause You Need (or Need to Add) in Every Irrevocable Trust

The mindset of estate planners has long been to vigorously guard against any estate tax inclusion. In 2013, Congress's decision to make the $5 million federal estate tax exemption both permanent and portable between spouses rendered such purpose largely moot for all but a tiny percentage of Americans. Moreover, the federal estate tax exemption for 2018 through 2025 has doubled again, to $11,180,000 per person, or $22,360,000 per married couple, indexed for inflation, so that the percentage of Americans exposed to federal estate tax is minuscule indeed.

"A greater power than we can contradict hath thwarted our intent."

— *Wm Shakespeare,* Romeo and Juliet*, Act V, sc. 3, l. 153*

Now, the goal of overall tax avoidance or reduction may more often be accomplished by deliberately causing a trust estate to be included in as many beneficiaries' taxable estates as possible. Such inclusion causes the income tax basis of includible assets to be "stepped up" to the fair market value as of the date of death of the beneficiary, effectively causing forgiveness of built-in capital gain[1] upon each beneficiary's death.[2] The successor owner of such assets (or the continuing trust) after basis step-up can immediately sell the assets without capital gain. Even later sales measure gain only from the date of death forward, saving income tax (assuming 2018 rates) at 0 percent, 15 percent or 25 percent capital gain tax rates, depending on the type of taxpayer and the income level.

Of course, deliberately causing inclusion in a decedent's estate to avoid capital gain at 0 percent, 15 percent or 25 percent would be foolish if the decedent's estate were so large that such includible assets on the date of death would end up being subject to tax (assuming 2018 rates) at the estate tax rate of 40 percent. Accordingly, the trick is to cause only so much of the trust assets to be includible in a decedent's estate as would not be subject to estate tax, *i.e.*, use a formula clause.[3] If the amount made includible is less than all the trust assets, then it would be best to include low-basis assets first, with the greatest amount of gain to be forgiven.

Here is a sample form[4] [shown on page 30], the inclusion of which is deemed by some to create an "Optimal Basis Increase Trust," or OBIT, with its deft allusion.

Does an OBIT clause potentially cause unwanted estate taxes? No, because the formula causes inclusion only up to the maximum amount where no estate tax is incurred.

Could this same result be obtained instead by giving the Trustee (or perhaps a Trust Protector) a power to grant a beneficiary a general power of appointment if the Trustee deems it advisable? Yes, except that the person holding the power might not grant it when needed. Moreover, a general power granted by a Trustee might turn out to be too broad and cause unwanted estate tax inclusion if the estate ended up being subject to actual estate taxation; hence the wisdom of a formulaic approach.

When should an OBIT clause not be included in a trust? When you can't trust the beneficiary. Including the trust assets

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Where There's a Will

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in a decedent beneficiary's estate requires giving the beneficiary a general power of appointment, exercisable by last will and testament, to control the disposition of the assets over which the power is given. A foolish or perverse beneficiary could appoint it to anyone, including persons of whom the Trustor would not have approved and potentially cut off future generations of the Trustor's descendants from any further benefit from the Trust. One risk mitigation strategy is to provide that the exercise of the general power of appointment must be with the consent of another person in order to be effective. Such person might be the Trustee, or a Trust Protector, or a family friend, upon whom the Trustor relies to refuse consent when there is any attempted inappropriate exercise of the power.[7] Another risk management strategy is to limit the class of permissible appointees to creditors of the decedent beneficiary.[8] The mere existence of the general power of appointment is sufficient to create the step-up in basis, even if its exercise is thwarted by a third party's lack of consent to the manner of exercise or is limited to a class consisting only of creditors.

What about pre-existing irrevocable trusts that do not have this language, such as all those credit shelter trusts created on the death of the first spouse to die? Aren't they irrevocable and unamendable? Well, yes, at least by the Trustor. One of the hallmarks of modern trust law, as expressed in Tennessee's version of the Uniform Trust Code, is the flexibility permitted in modifying existing irrevocable trusts.[9] Thus, even for existing trusts, there may well be a way to make any irrevocable trust an OBIT trust.[10]

Given the potential benefit, perhaps the standard of estate planning practice should be to include an OBIT clause in every irrevocable trust, unless there is a specific reason not to do so. ⚖

SAMPLE FORM

Including this is deemed by some to create an "Optimal Basis Increase Trust," or OBIT.

Death of Beneficiary. Upon the death of Beneficiary, the Trustee shall distribute the trust estate as follows:

(1) General Power. To or for the benefit of any one or more persons, including Beneficiary, Beneficiary's estate, and creditors of Beneficiary and of Beneficiary's estate, on such terms as Beneficiary may appoint by will making specific reference to this power of appointment, exercisable alone and in all events, but only as to a fractional portion of the trust estate equal to the maximum fraction, valued as finally determined for federal estate tax purposes, that will not cause or increase federal estate taxes in Beneficiary's estate. The Trustee may rely upon an instrument admitted to probate in any jurisdiction as the will of the deceased Beneficiary or may assume that Beneficiary died intestate if the Trustee has no notice of a will within three months after Beneficiary's death. This general power of appointment:

(a) shall apply only to assets (i) whose fair market value (as finally determined for federal estate tax purposes) exceeds the trust's income tax basis in the asset, and (ii) that are eligible for an adjustment to basis under IRC §1014;[5] and

(b) shall apply to such assets, up to the full fractional amount determined herein, in order from lowest to the highest ratio of income tax basis to fair market value (as finally determined for federal estate tax purposes).

Notwithstanding anything herein to the contrary, to the extent this testamentary general power of appointment would under applicable law at such time expose the assets of the trust to the claims of the creditors of Beneficiary as holder of the power, even though the power was not exercised in favor of creditors, then the power shall be limited in favor a class of permissible appointees consisting of the Beneficiary's descendants or the Grantor's descendants.[6]

(2) Default Distribution. To the extent not effectively appointed under subparagraph (1) above, then to [default disposition]

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Notes

1. IRC §1014(a)(1) and (b)(9).

2. The benefit of capital gain forgiveness on the death of any trust beneficiary suggests that parents, grandparents and other higher-generation beneficiaries should be included as legitimate discretionary beneficiaries and given general powers of appointment in order to maximize the number of basis step-up opportunities.

3. The IRS has approved of formula general powers of appointment based on the remaining estate tax exclusion of the decedent's spouse or of a child. See PLR 200403094, PLR 200604028, and PLR 9527024. Similar formula structures have been approved in the context of disclaimers and partial QTIP elections. See Treas. Reg. §25.2518-3(d), Ex. 20, Treas. Reg. §25.2523(f)-1(b)(3), and Treas.

Reg. 20.2056(b)-7(b), examples 7 and 8.

4. The author makes no warranty that this form accomplishes any or all tax or other desired benefits and offers this form solely for attorneys to consider. For other sample forms, see Franklin & Law, "Clinical Trials With Portability," *48th Annual Heckerling Institute on Estate Planning*, Jan. 15, 2014, media.straffordpub.com/products/portability-in-estate-planning-alternative-strategy-for-maximizing-tax-benefits-2014-10-14/reference-materials.pdf (starts at page 29). See also Morrow, "The Optimal Basis Increase and Income Tax Efficiency Trust," http://ssrn.com/abstract=2436964.

An OBIT is an "Optimal Basis Increase Trust"

5. Note that the formula does not give a general power of appointment over assets that are not eligible for basis step-up, such as income in respect of a decedent (IRD), or to assets that have depreciated in value, where inclusion would cause a "step-down" in the basis.

6. Traditionally, the existence of a general power of appointment has not by itself allowed creditors to reach the assets over which the powerholder held the power. However, both Restatement (Third) of Property and the Uniform Power of Appointment Act take the position that property subject to an exercisable general power of appointment may be reached by the powerholder's creditors. See Restatement (Third) of Property (Wills & Donative Transfers) § 22.3, Comment c. (2011) (adopting the position articulated in Restatement (Third) of Trusts § 56 (2003) and Restatement (Second) of Property (Donative Transfers), §13.2, §13.4, §13.5 (1986)); Uniform Powers of Appointment Act, Article 5 § 501(d)(2), § 502(a)(2) (2013). While Tennessee law does not adopt these positions, the applicable law of creditor's rights upon a trust beneficiary's death may be the law of the beneficiary's domicile, so the proposed form attempts to limit the application of any such law.

7. The person whose consent to approve the exercise of a general power of appointment must not have a substantial interest in the property subject to the power, adverse to exercise of the power in favor of the decedent, or else the power is not a general power of appointment. IRC §2041(b)(1)(C)(ii).

8. Creating a general power of appointment by limiting the class of permissible appointees to creditors of the decedent beneficiary has potential risk of manipulation by the powerholder. A holder of such power could in theory borrow $100 from a friend, evidenced by a promissory note, making his friend a legitimate creditor. Then the powerholder by his will could appoint the entire trust estate to his friend. No known statute or case law limits the power to appoint to a creditor to the amount of the actual obligation to the creditor.

9. The four primary methods by which existing irrevocable non-charitable trusts can be modified to some extent are the following:

(1) *Nonjudicial Settlement Agreement. Tenn. Code. Ann.* §35-15-111 allows the Trustee and all Qualified Beneficiaries, as defined in the statute, without court approval, to agree to certain largely non-substantive changes in the document. Some might well argue that this statute would not allow a substantive modification, such as adding a general power of appointment, except as an interpretation of existing trust language.

(2) *Modification When the Trustor Is Still Alive. Tenn. Code Ann.* §35-15-411(a) allows the Trustee, when the Trustor is still alive, without court approval, to modify an irrevocable Trust, with the consent of all Qualified Beneficiaries, so long as the Trustor is given notice and does not object.

(3) *Modification When the Trustor Is Deceased. Tenn. Code Ann.* §35-15-411(b) allows the Trustee, when the Trustor is deceased, to seek a Court Order to modify the Trust, with the consent of all Qualified Beneficiaries, so long as the Court finds that the modification is not inconsistent with a material purpose of the trust.

(4) *Decanting. Tenn. Code Ann.* §35-15-816(b)(27) provides that if certain conditions are met, a Trustee may exercise his discretion to make distributions to beneficiaries by distributing trust assets to a different trust for such beneficiaries, in this case a trust that contains an OBIT clause, even if it is the trustee himself who creates the new trust.

10. An alternative to modifying an irrevocable trust to add an OBIT clause is for the Trustee simply to exercise discretion under the terms of the governing instrument (if available) and distribute the assets outright to the beneficiary. This assumes the Trustee believes the trust no longer serves any material purpose, tax or non-tax. This would terminate the trust to the extent of the distribution and obtain the step-up in basis at the beneficiary's death. Of course, this alternative creates risk that (1) the beneficiary might be a spendthrift, or (2) the beneficiary's estate might become a taxable estate before death, or (3) the beneficiary's will leaves his or her estate in a manner antithetical to the Trustor's purposes for having created the trust.

