Advanced Estate Tax Planning

April 2018

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Mr. Parthemer is a Managing Director and Senior Fiduciary Counsel for Bessemer Trust, responsible for working with clients and their advisors to develop practical and efficient wealth transfer plans and for guiding the firm on fiduciary issues. He joined Bessemer, an exclusive wealth management firm, in 2004 after private law practice in Pennsylvania and Florida, most recently as a Trust and Estate partner with Duane Morris LLP. He also spent several years at PricewaterhouseCoopers and was involved in private businesses.

Mr. Parthemer is a nationally recognized speaker and frequently published author. He is an ACTEC Fellow, and is in leadership of the Real Property Trust and Estate Section of the American Bar Association, the Florida Bankers Association (Board Member; Past Chair Legislation Committee) and the Florida and Pennsylvania Bar Associations. He is an Associate Editor and Columnist for the Journal of Financial Service Professionals, member of Synergy Summit (Past President), the Palm Beach County Estate Planning Council (Board Member), and the Palm Beach Tax Institute. He was awarded the 2014 Article of the Year from the American Bar Association's Probate & Property magazine and named the Florida Bankers Association 2015-2016 Banker of the Year.

He frequently is faculty for the University of Miami's prestigious Heckerling Institute, was an Adjunct Professor, Widener University School of Law, and guest lectures at the Dickinson School of Law and the University of Miami School of Law's LLM program. He has been quoted in the Wall Street Journal, Barron's, NY Times and MONEY Magazine, and has been honored by Best Lawyers in America with their Lifetime Achievement Award.

He earned a J.D. from The Dickinson School of Law, B.A. and B.S. degrees in philosophy and government from Franklin and Marshall College, conferred status of an Accredited Estate Planner, and completed MBA Phase I curriculum.

"The avoidance of taxes is the only intellectual pursuit that still carries any reward."

- John Maynard Keynes

Approaching Advanced Planning

Advanced estate tax planning comes down to understanding the clients estate plan – who gets how much and in what way – and then implementing efficiencies.

Most estate tax planning strategies can be lumped into these categories:

1. Use exclusions and deductions.
2. Leverage exclusions.
3. Make zero-gift transfers.
4. IRAs and life insurance.

<u>Holistic approach required:</u> Always consider other relevant factors, such as income taxes, tax basis management, and creditor and spendthrift behavior protection.

“Tax Cut and Jobs Act”

Significant changes – and most since 1986.

TCJA is not the official title. The title was deemed “extraneous” (one of 3 determined by Senate parliamentarian, forcing a House revote).

Official title:

> “To provide for reconciliation pursuant to Titles II and IV of the concurrent resolution on the budget for fiscal year 2018.”

“Tax Cut and Jobs Act”

All but one transfer tax change is temporary, most expire after 2025.

Only permanent change – use of Chained CPI. This index contemplates a dynamic consumer who will consider less expensive alternatives to rising commodity prices (thus increases slower).

Key change – increase in basic exclusion amounts for gift/estate and GST to $10 million from $5 million, indexed.

For 2018, the index increased to $11,180,000 per person.

Thoughts on Taxation

"I like to pay taxes. It is purchasing civilization."

- Oliver Wendell Holmes

"I am proud to be paying taxes in the United States. The only thing is, I could be just as proud for half of the money."

- Arthur Godfrey

"Tax Cut and Jobs Act"

A few changes that may impact wealth planning clients –

1. Alimony deductibility changed for 2019 and beyond.
2. Section 682 repealed (big deal for estate planners).
3. Recharacterization of Roths eliminated for conversions after 2017.
4. 691(c) not repealed. This is important for IRA beneficiaries, though of less value because fewer taxable estates and more needed to "overtake" higher standard deduction and fewer allowed itemized deductions.
5. 199A is a complex new provision creating a 20% deduction on income from certain pass-through entities.

TCJA Estate Planning Paradigm

The "new" paradigm separates clients by net worth into 4 categories:

1. Under $5.5 million – traditional estate planning; basis management.
2. $5.5 - $11 million – flexibility; basis management.
3. $11 - $22 million – use exclusions before sunset (retain potential benefit); flexibility; basis management.
4. Over $22 million – sophisticated tax planning; use enhanced GST; leverage exemptions.

Couples with less than $5.5 million

- Traditional estate (not estate tax) planning.
- Basis is key, so outright to spouse (or marital trust) to ensure step-up occurs at both deaths.
- Elect portability? (maybe in some circumstances just in case).

Couples with $5.5 - $11 million

- Traditional estate planning, with hedge for estate tax planning.
- Outright to spouse (or marital trust) to ensure step-up at both deaths.
- Use disclaimer to absorb exclusion at first death, add sprinkle power in favor of spouse to bypass trust, make the trust QTIPable, or elect portability.
- Add flexibility to position for basis step-up at second death.
- Manage asset selection for those that won’t receive second step-up.

Couples with $11 - $22 million

- Same as couples with $5.5 - $11 million, plus:
- Use exclusion at during life with strategies that permit benefit to senior generation (e.g., SLAT).
- Use balance of GST at first death.
- If DSUE ported, promptly use to mitigate risk of survivor dying after exemption has sunset back to $5MM (indexed), or the survivor remarries and second spouse predeceases.

Not as easy as it sounds to use exclusions because they are so large that using the enhanced amounts mean significant transfers, which may cause financial strain (real or perceived).

Couples with more than $22 million

- Traditional estate tax planning inside estate tax planning.
- Use gift/estate and GST exclusions during life.
- Leverage exclusions via discounts.
- Employ non (or limited) gift taxable transfers such as GRATs.
- If DSUE ported, promptly use to mitigate risk of survivor dying after exclusion has sunset back to $5MM (indexed), or death of next spouse if survivor remarries.
- Add flexibility to position for basis step-up at second death.
- Manage asset selection for those that won't receive second step-up.
- Embed flexibility to enable future management of amount (if any) to be included in survivor's estate.
- Consider up (or side) stream gifts to use exemption of family members that otherwise may be wasted (e.g., perfectly poor parent). Or, sell to a trust that provides a GPOA to such family member.

6 Popular Gifts with (Temporarily) Increased Exclusions

1. Forgive loans to children and others.
2. Equalize prior gifts to children and grandchildren.
3. “Pre-fund” ILITs (assuming level of insurance remains appropriate).
4. Roll-out of life insurance split dollar structures.
5. Convert/decant/modify GST non-exempt trusts to exempt.
6. Fund grantor trusts, preferably GST exempt dynasty trusts.

Gifts with “Retained” Benefits

1. Spousal Lifetime Access Trusts (i.e., SLATs).
2. Non-reciprocal trusts.
3. Self-settled trusts in DAPT jurisdictions.
4. Creating residential co-tenancy with spouse (or trust).
5. Preferred partnership freeze.
6. Management fees.
7. Inter vivos QTIPable trust.
8. Retained income gift trust.

Non-gifts with "Retained" Benefits

1. Sale for a note or annuity.
2. Grantor borrows cash from a trust.
3. Grantor borrows assets previously transferred into a grantor trust (a/k/a Reverse Grantor Trust).

Embedding Flexibility in Trusts

1. Liberal use of Limited Powers of Appointment.
2. Broad discretionary distribution power vested in an independent trustee.
3. Substitution power (and actually swap high basis assets for low basis ones).
4. Appoint an independent Trust Protector and authorize to:
    a. Modify trust.
    b. Terminate trust.
    c. Confer a General Power of Appointment (don’t use trustee).
    d. Add the donor as beneficiary, if established in a DAPT jurisdiction.
    e. Debate - will granting a testamentary LPOA to donor will trigger 2038?
5. Include a formulaic GPOA.
6. Tee up the Delaware Tax Trap – in most states, the exercise must grant a presently exercisable GPOA (not a Section 2041 requirement, but due to state law).

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1. Deductions and Exclusions

Deductions and Exclusions.

Two most frequently used deductions:

1. Marital.
2. Charitable.

Exclusions to be considered:

1. Annual exclusion from gift tax. §2503(b). Must be a present interest.
2. Annual exclusion from gst tax (more restrictive if in trust - income only can be distributed to beneficiary and must be includible in bene's estate). §2642(c).
3. Health and education exclusion from both. §2503(e); §2642(c)(3)(B) – have lead to the use of HEETs (Health and Education Exclusion Trusts).
4. Estate, gift and GST basic exclusion amounts.

Observations about *Crummey* Powers

Some lessons since 1968:

- IRS still fussing over them.
- Make the withdrawal right apply to all gifts, direct and indirect.
- Initiate from the date of the gift, irrespective of whether notice is given.
- Allow the trustee to satisfy the right out of any property.
- Have the right apply only to taxable gifts, not all additions.
- Empower a donor to modify, negate or toggle on the power.
- Proposal to create $50,000 annual exclusion without the need for a withdrawal right - tabled.

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Taxable Gifts

- Before 2001, taxable gifts were an effective wealth planning strategy due to their tax exclusive nature.
- Since then, taxable gifts have been the exception due to potential for death to occur during a year of estate tax repeal.
- If gift tax may survives any estate tax reform, perhaps due to protective nature re income tax.

Benefits of Taxable Gifts

For every $100 transferred, how much do the beneficiaries receive?

Transfer tax rate	Effective gift tax rate	Net to estate heirs	Net to gift donees	Benefit of gift
55%	35.48%	$45	$64.52	43%
45%	31.03%	$55	$68.97	25%
40%	28.57%	$60	$71.43	19%

- Potential benefit from different tax computation (gift tax exclusive; estate tax inclusive).
- Gifting removes future appreciation from the estate tax, but loses basis step-up.
- Using grantor trusts enables shift of income tax to the donor, reducing the remaining estate while protecting all of the yield on the gifted assets (and with swap power, engage in basis management).
- However, if the donor dies within three years after the gift, the gift tax paid is brought back into his or her estate for federal (but not state) estate tax purposes.

Net Gifts

- Formula: $\frac{\text{Tentative Tax}}{1 + \text{Rate of Tax}}$

- Example: $1,000,000 gift in 2018: 400,000/(1 + .4), or **$285,714** (effective tax rate of 28.57%).
- Potential psychological advantages to net gifts - donor write a check to the IRS and donee may be less unwilling, having just received the gift.
- For income tax purposes, a net gift is treated as a part sale, so the donee gets basis enhancements for the gift tax paid.
  - However, if the gift tax exceeds the donor's basis in the assets, he or she must recognize capital gain. Exception: no gain if donee is a grantor trust.
- Written agreement is prudent to evidence required donee obligation.
- Net-net gift – when donee also assumes responsibility for estate tax if donor dies within three years.

Financed Net Gifts

1. Donor makes a net gift.
2. Donee agrees to pay the tax.
3. Donor later lends to donee the funds to pay the gift tax (can bear interest at the relevant AFR).

- Similar elements to a Sale to Grantor Trust, but is:
  - Simpler.
  - Has much less debt.
  - Probably less exposure to estate tax inclusion.
- Provides donee cash to pay the tax (important if gift is of illiquid or discounted assets).
- Absent a discount, this is simply packaging a gift and a loan into one transaction, with the benefits of both:
  - Gift element has lower effective transfer tax rate.
  - Loan element benefits the next generation if investment return exceeds the loan interest rate.

Portability

Unused DSUE can be ported to a surviving spouse. Thus, a decision must be made on whether to use a credit shelter trust or rely on portability.

Considerations include:

1. DSUE is not indexed.
2. Cannot port GST.
3. Expectation of behavior during “over-life” (if survivor remarries and the new spouse dies before survivor uses ported exclusion, it will be lost).
4. Nature of assets (e.g., IRA).

Consensus that DSUE will not be trimmed if surviving spouse dies after sunset of Tax Cut and Jobs Act.

2. Leverage Exclusions

Leverage Exclusions

Typically by reducing the value of the asset via structures such as:

1. Fractional interest ownership. Example – when funding a QPRT, consider funding partial interests into separate QPRTs.
2. Split interest transfers, including charitable lead and remainder trusts.
3. Shift capital gains within other tax strategies.
4. 2704 proposed Regs officially pulled, so seek up to three potential discounts based on
   - A. Nature of asset (e.g., private equity - lock-up/capital calls).
   - B. Lack of marketability.
   - C. Minority interests.

Caution: When using a family limited partnership or limited liability company, be wary of *Estate of Powell v. Commissioner*, 148 T.C. 18 (May 18, 2017).

Charitable Remainder Annuity Trust Funded with $5MM; 6% Growth.

March 2017

Mrs. Client
Age 75

- Transfers $5MM to CRAT.
- Added benefit if asset qualifies for a valuation discount.

Charitable Remainder Trust*

- Used lifetime annuity.
- Remainder, if any, paid to charity.

Mrs. Client

Estimated $2,750,000

- Donor receives $250,000 annuity annuity for life.

Charity

Estimated $5,750,000

- Received after death of donor.

	NO CRAT	CRAT
Sons**	$5,694,000	$1,650,000
IRS (Estate Tax)	$3,796,000	$1,100,000
Charity	$0	$5,750,000
Income Tax Deduction	$0	$2,716,000

*Can be any period of up to 20 years or lifetime of one or two persons, and can be annuity or unitrust.
**After 40% estate tax.

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10-Year* Charitable Lead Annuity Trust Funded with $5MM; 6% Growth.

May 2016

Mr. or Mrs. Client

- Transfers $5MM to CLAT.
- Added benefit if asset qualifies for a valuation discount.

Client Family Charitable Lead Annuity Trust

- 10-year annual payments to charity.
- Remainder, if any, paid to or for family.
- “Zeroed-out” for estate and gift taxation.

	NO CLAT	CLAT
Sons**	$4,321,259	$1,693,598
IRS (Estate Tax)	$2,880,839	$0
Charity	$0	$5,508,500
Income Tax Deduction (optional)***	$0	$5,000,000

Charity

Estimated $5,508,500

- Receives $550,850 annually for 10 years.

Children

Estimated $1,693,598

- After 10 years, entire balance to Sons outright or in trust.
- Can be GST exempt.

*Can be any period of up to 20 years, or for lifetime.
**Can be into trust, including a GST exempt trust, providing additional estate tax savings.
***Deduction in first year if a grantor trust CLAT is established, but election will cause future earnings to be taxed to donor.

20-Year* Charitable Lead Annuity Trust Funded with $5MM; 6% Growth.

May 2016

Mr. or Mrs. Client

- Transfers $5MM to CLAT.
- Added benefit if asset qualifies for a valuation discount.

Client Family Charitable Lead Annuity Trust

- 20-year annual payments to charity.
- Remainder, if any, paid to or for family.
- "Zeroed-out" for estate and gift taxation.

Charity

Estimated $5,999,000

- Receives $299,950 annually for 20 years.

Children

Estimated $5,001,839

- After 20 years, entire balance to Sons outright or in trust.
- Can be GST exempt.

	NO CLAT	CLAT
Sons**	$6,600,503	$5,001,839
IRS (Estate Tax)	$4,400,336	$0
Charity	$0	$5,999,000
Income Tax Deduction (optional)***	$0	$5,000,000

*Can be any period of up to 20 years, or for lifetime.
**Can be into trust, including a GST exempt trust, providing additional estate tax savings.
***Deduction in first year if a grantor trust CLAT is established, but election will cause future earnings to be taxed to donor.

6 Capital Gains/Net Investment Income Tax Planning Strategies

A. Shifting Strategies

1. <u>643 Regs</u> – tax capital gains to trust beneficiaries or Grantors (NINGs and DINGs; what about FLINGs?). See PLR 201642019 and for background, LR 201514006-8.

2. <u>In-kind Distributions</u> – could trigger built-in gains, but then carried out as “actually distributed?”

3. <u>Flow Through Entity</u> – To tax to beneficiary, sell inside entity; to tax to trust, distribute to trust and then sell.

B. Minimization Strategies

1. <u>Reduce Passive Income</u> via Investment Allocation (Municipal Bonds, Annuities, PPLI, deferred income accounts, convert to non-passive via material participation TAM 201317010).

2. <u>Charitable Contribution Sourcing</u> – 170 vs. 642(c).

3. <u>Defer</u> - Installment Sales, 1031 Exchanges, Charitable Remainder Trusts – and return of the NIMCRUT.

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By income, we mean…

- For most purposes, the term “income” (when not modified by some other term, such as gross, taxable, or distributable net) means fiduciary accounting income as determined under state law. §643(b).

- However, the term “income” means taxable income for grantor trust purposes. Treas. Reg. §1.671-2(b) (penultimate sentence).

- Fiduciary accounting income, taxable income, and DNI for a year may all be different, and they may be higher or lower than the others, depending on the circumstances.

Computing DNI

DNI of a trust or estate is its taxable income, with several modifications.

- The distribution deduction is not allowed. §643(a).
- The deduction in lieu of the personal exemption is not allowed.
- For simple trusts (but not complex trusts), exclude extraordinary dividends or taxable stock dividends that are allocable to corpus. §643(a)(4).
- Add back the amount of any tax-exempt interest, reduced by expenses directly associated with tax-exempt income, and reduced by a proportionate part of indirect expenses (apportioned between tax-exempt and taxable income). §643(a)(5).
- Capital gains are generally excluded.
- The character of income is generally preserved.
- Tier rules are distinctions in §661(a)(1)-(2) for amounts of income required to be distributed currently (first tier) and amounts properly paid, accredited, or required to be distributed (second tier). Amounts to charity are "in-between" Tiers 1 and 2.

Capital Gains

- Capital gains ordinarily are excluded from DNI. Treas. Reg. §1.643(a)-3(a).

- Net short term capital gain from a mutual fund is treated as fiduciary income under the Uniform Principal and Income Act. Florida deviates and treats short and long-term capital gains as allocable to principal. F.S. §738.401(3)(d). But still DNI because short term gains treated as dividends for Federal income tax purposes.

- Given increased rates and Section 1411 tax, may want to shift taxation.

- Under the regs, capital gains will be included in DNI if they are designated:

   1. Pursuant to the terms of the governing instrument and applicable law, or

   2. Pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law).

Capital Gains – 3 Ways to Include in DNI

Treas. Reg. §1.643(a)-3(b):

1. Allocated to income per trustee discretion (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to §1.643(a)-3(b)).

2. Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary.

3. Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is, or is required to be, distributed.

Minimization Strategy: Charitable Deduction Planning

- Trust charitable deductions (§642(c)) reduce AGI because they are "above-the-line" and thus reduce NII dollar-for-dollar.
- Individual charitable deductions (§170) do not reduce MAGI because they are "below-the-line" and thus do not reduce NII at all.

Married Individual IRC §170 Deduction		**Trust - IRC §642(c) Deduction**	
Wage Income	$ 260,000	Interest Income	$ 100,000
Interest Income	$ 100,000	Dividend Income	$ 50,000
Dividend Income	$ 50,000	AGI	$ 150,000
MAGI	$ 410,000	Less: Charitable Deduction	$ 150,000
Less: Threshold Exemption	($ 250,000)	AGI	$ 0
Subtotal	$ 160,000	NII Tax at 3.8%	$ 0
Lesser of (1) excess of MAGI over Threshold and (2) NII	**$ 150,000**		
NII Tax at 3.8%	$ 5,700	*Non-Grantor Charitable Lead Trust*	

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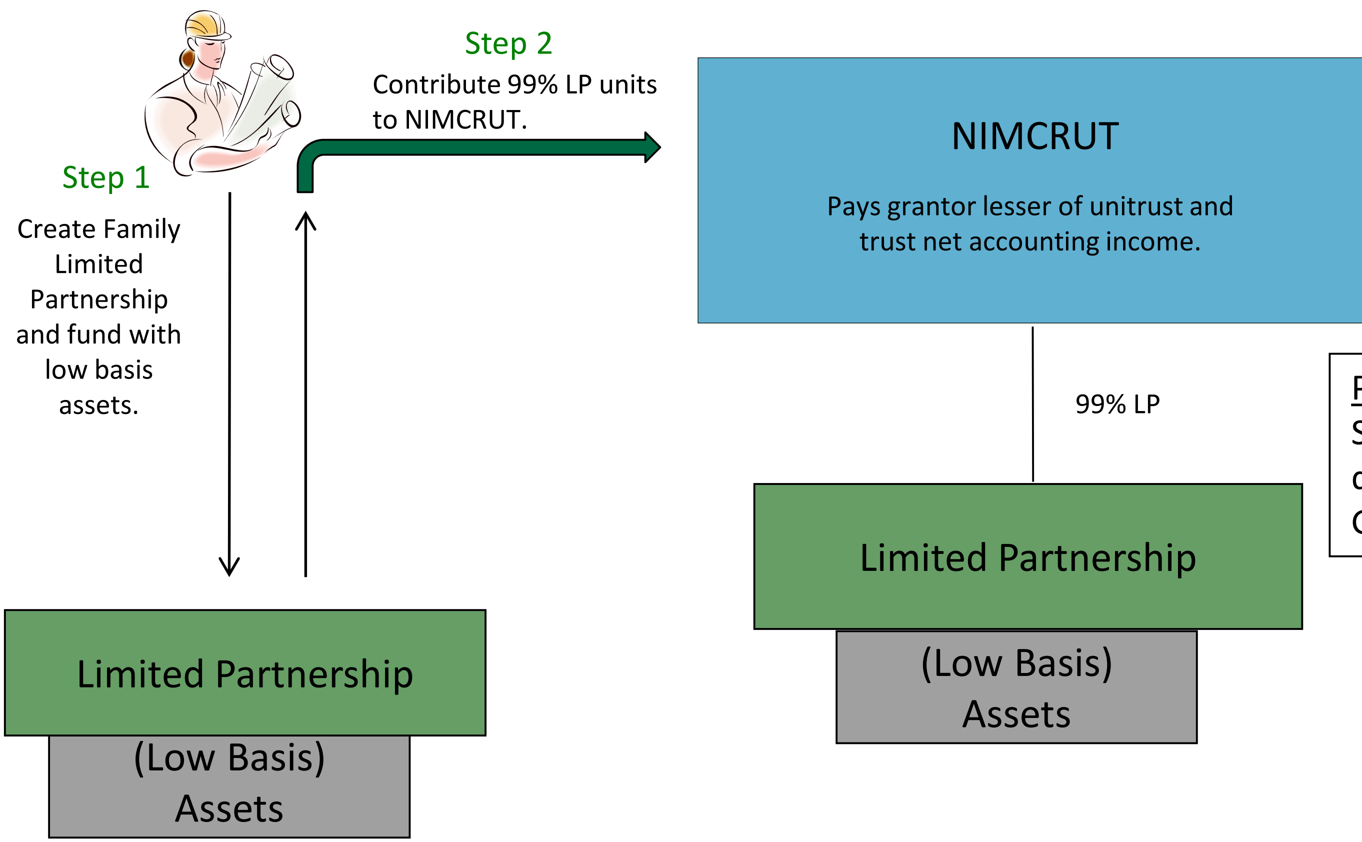
Going One More Step: FLP in a NIMCRUT

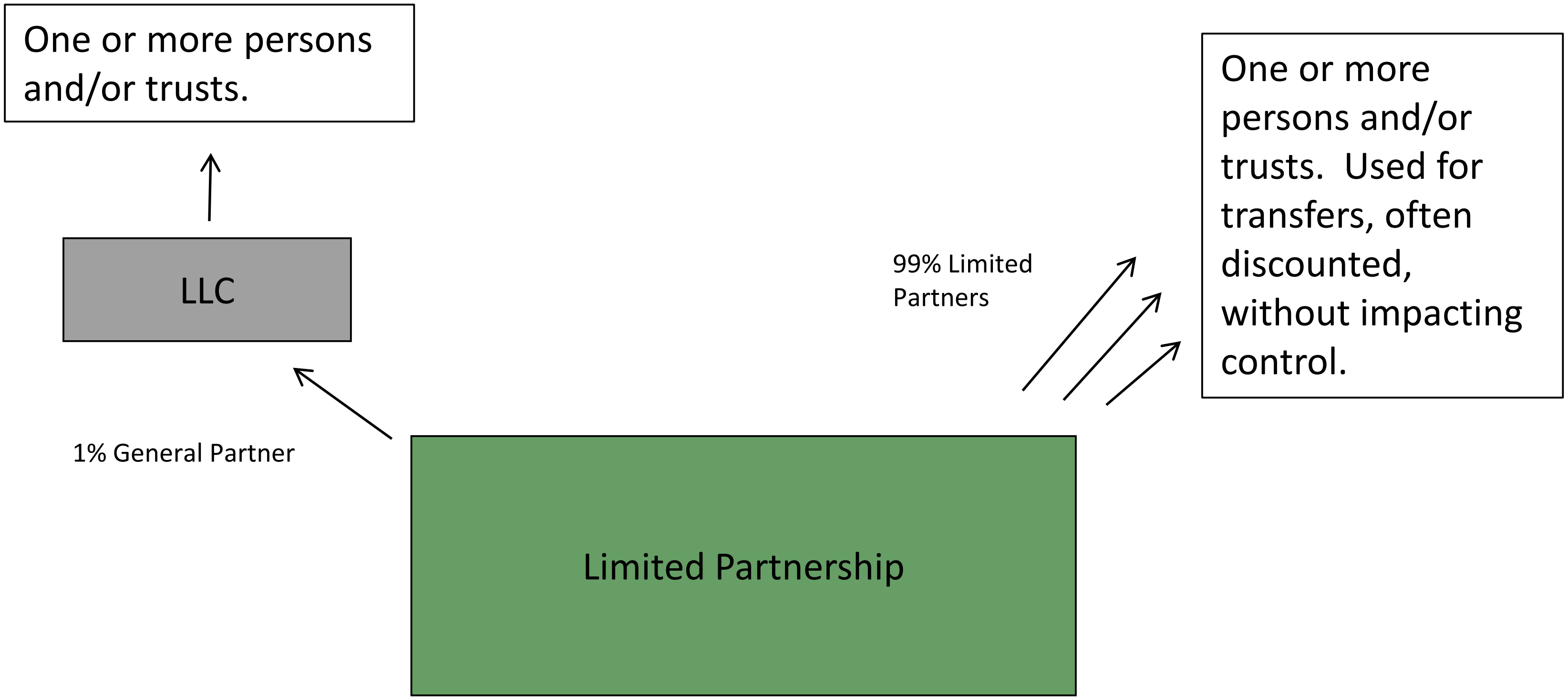


<u>Planning Pointer</u>
Structure to eliminate self-dealing, including separate GP and trustee.

By reinvesting earnings within the partnership, the NIMCRUT would have no “income” to distribute. For tax purposes, 99% of the income is reported by the NIMCRUT a tax exempt entity…creating a deferral until the partnership makes a distribution.

Warning: this strategy has been on the IRS “no ruling” list for over 10 years.

Typical Basic Family Limited Partnership



3. Zero-gift Transfers

Zero-Gift Transfers

After exemption is used, wealth transfer still can be positioned through:

1. GRATs.
2. Sales.
3. Family loans.
4. Grantor trusts.

GRAT Basics, Path Dependency, and Four Creative GRAT Strategies

Nearly zeroed-out Grantor Retained Annuity Trust

Step 1

Returned to Grantor
$2,062,049

Initial GRAT Funding
$2,000,000

Step 2
Annuity***
Year 1: $937,295
Year 2: $1,124,754

Step 3
Remainder after 2 years:
$197,798
(no gift tax)

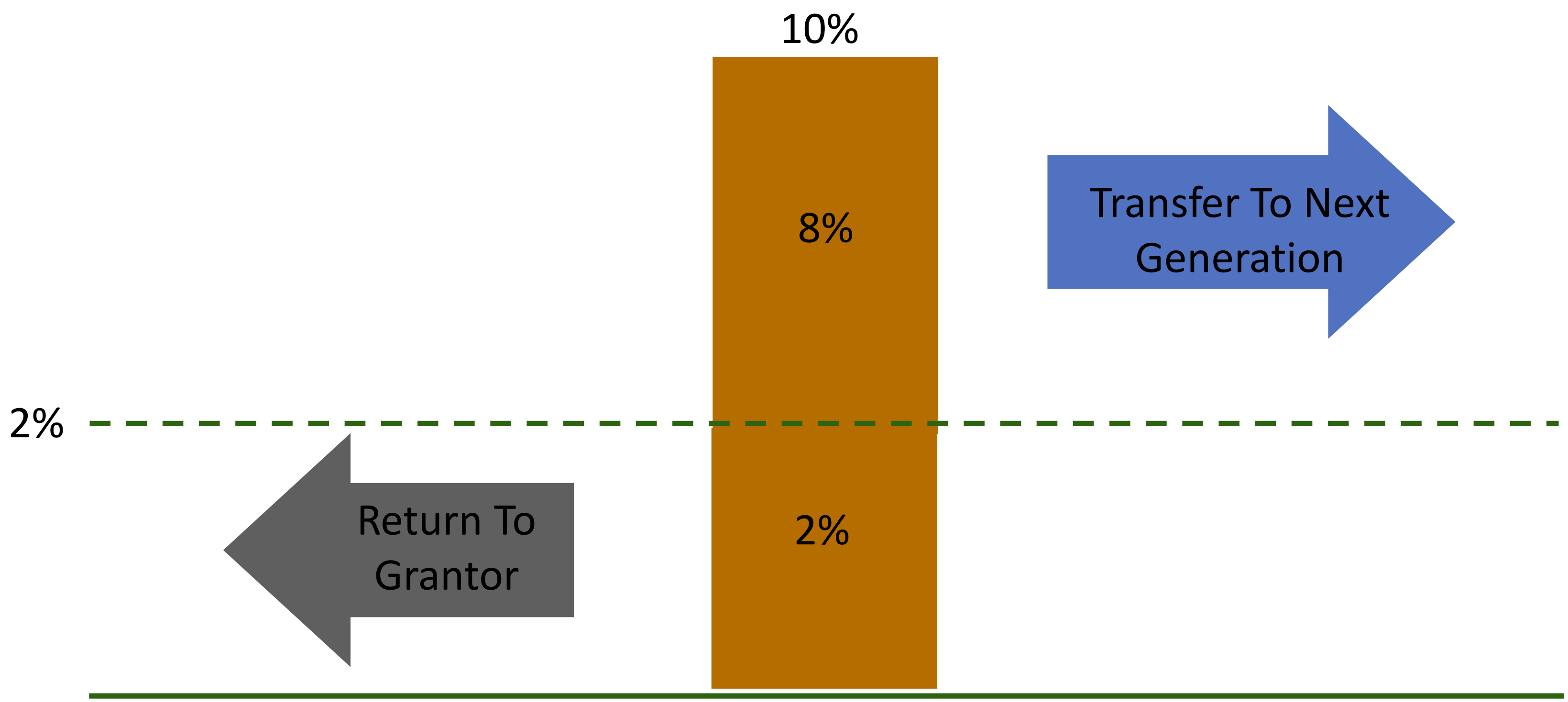
Amount transferred	$2,000,000
Value of annuity	$1,999,999 *
Value of remainder (Gift)	$1

(Grantor) Trust for Children
$197,798

* Assumes §7520 rate of 2.00 %.
** Assumes trust assets grow at 8%.
*** Assumes 20% increase in annuity annually.

Often, Focus Is Only on Return

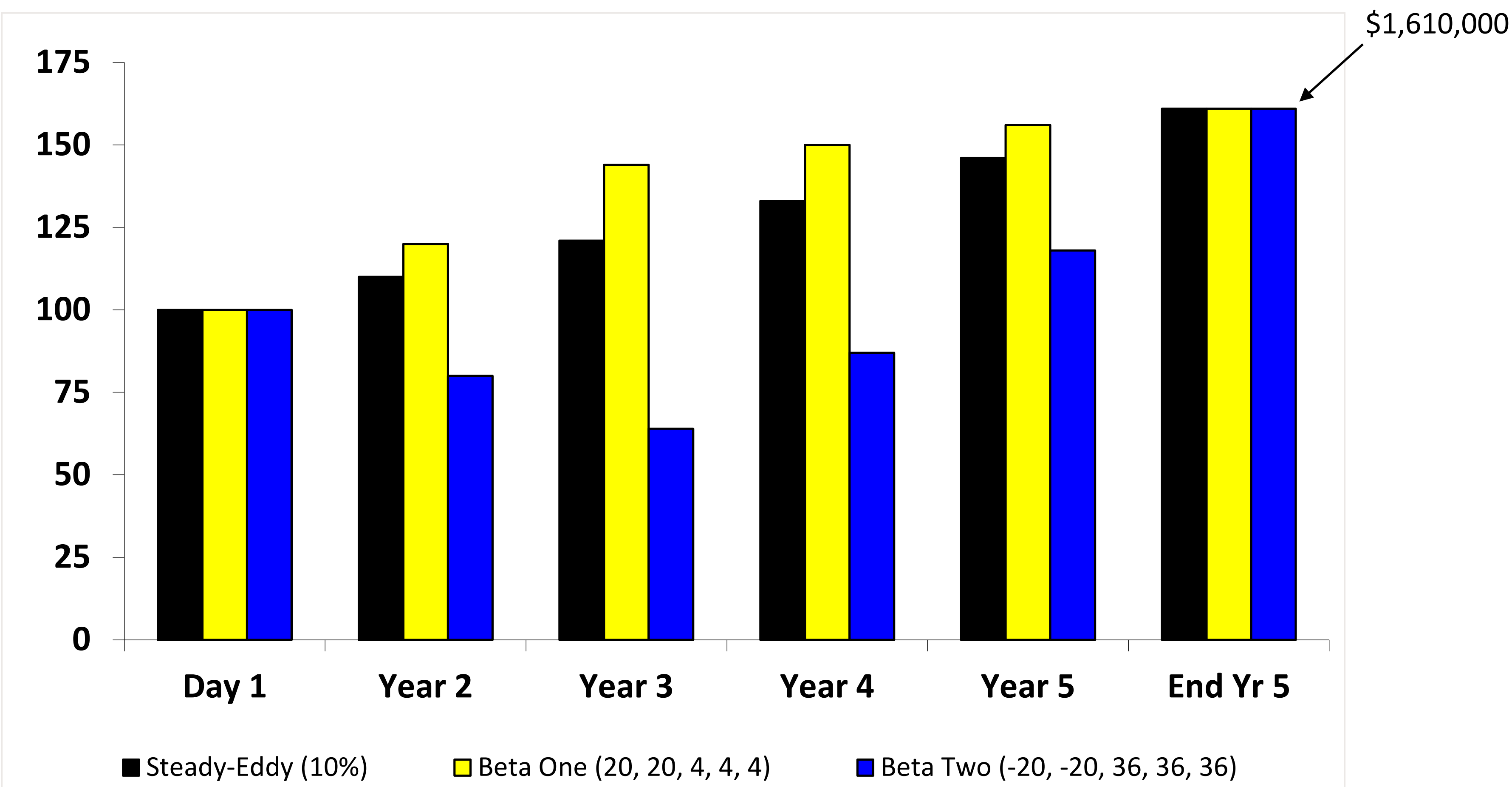
"Hypothetical" One-year 2% GRAT with 10% Return*



*The hypothetical examples included in this presentation are for illustration only.

Portfolio GRAT: Flat versus Increasing Annuity — Impact of Path Dependency

Three sample growth patterns of $1,000,000 investments



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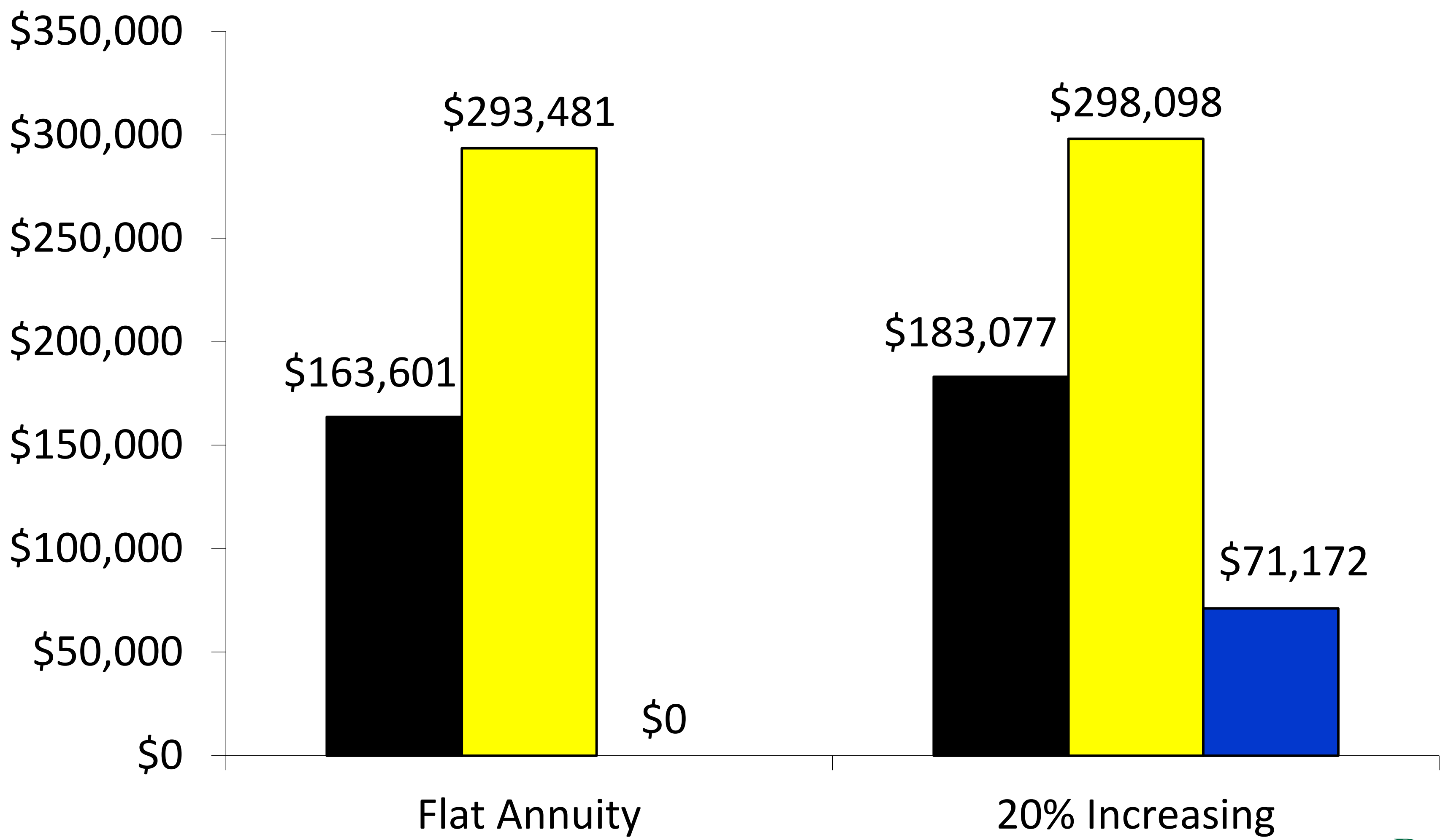
Path Dependency: Increasing Annuity Creates Benefit

5 year GRAT Results



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1. Leveraged Mixed Asset GRATs

- Fund GRAT with discounted asset, hard-to-value asset, illiquid or alternative assets. Add fixed income portfolio.
- Use fixed income to fund annuity first.
  - ✓ Gives time for other assets to percolate.
  - ✓ Creates arbitrage between annuity based on partial discount yet paid in non-discounted assets.
  - ✓ May reduce number of valuation appraisals.
- To ease timing on funding and ease on transfer throughout, drop hard-to-transfer assets (e.g., private equity) into an LLC.

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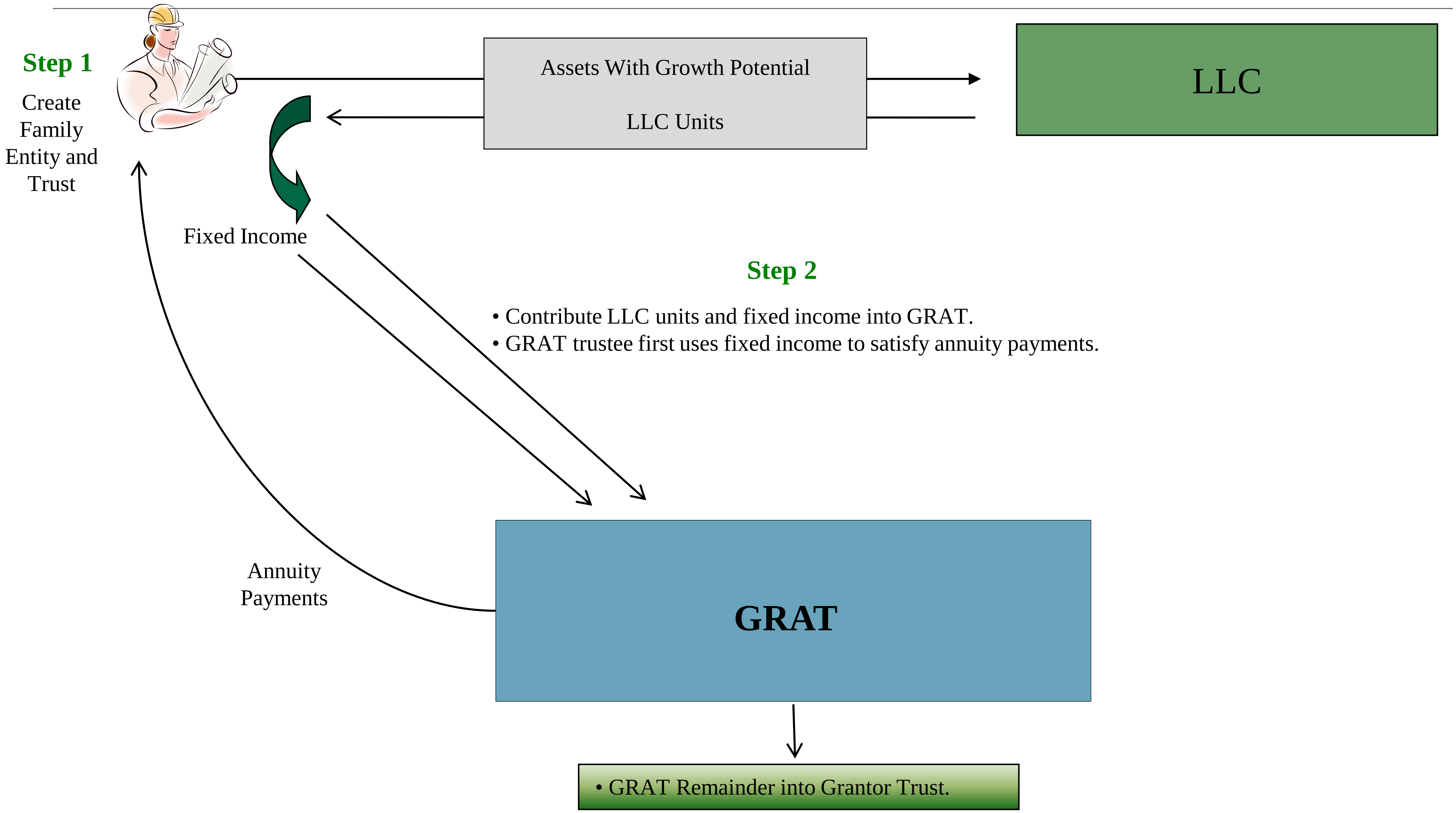
Leveraged Mixed Asset GRAT



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5 Year GRAT with 50% Private Equity and 50% Fixed Income

July 2013 7520 Rate	1.40%	
Fixed Income/Yield	$ 1,000,000	3.00%
Private Equity/Growth	$ 1,000,000*	20.00%

* For illustrations purposes, assumes no valuation discount.

2. Portfolio GRATs: Separate GRATs for Correlated or Concentrated Positions

Diversification:

- ✓ Prudent under Modern Portfolio Theory, but
- ✓ Anathema to a Portfolio GRAT!

Portfolio GRAT: Asset Selection Not Enough

	Return	Ending Value	
1,000,000 @ $50 Company A	+20%	$60	$6,000,000
1,000,000 @ $50 Company B	-20%	$40	$4,000,000
			$10,000,000
Minimum annuity to grantor*			($10,140,000)
Amount transferred to next generation			– 0 –

* Assumes a 1.4% §7520 rate and for illustration and emphasis purposes only, a fictitious one year GRAT term.

Split Uncorrelated Assets into Separate GRATs

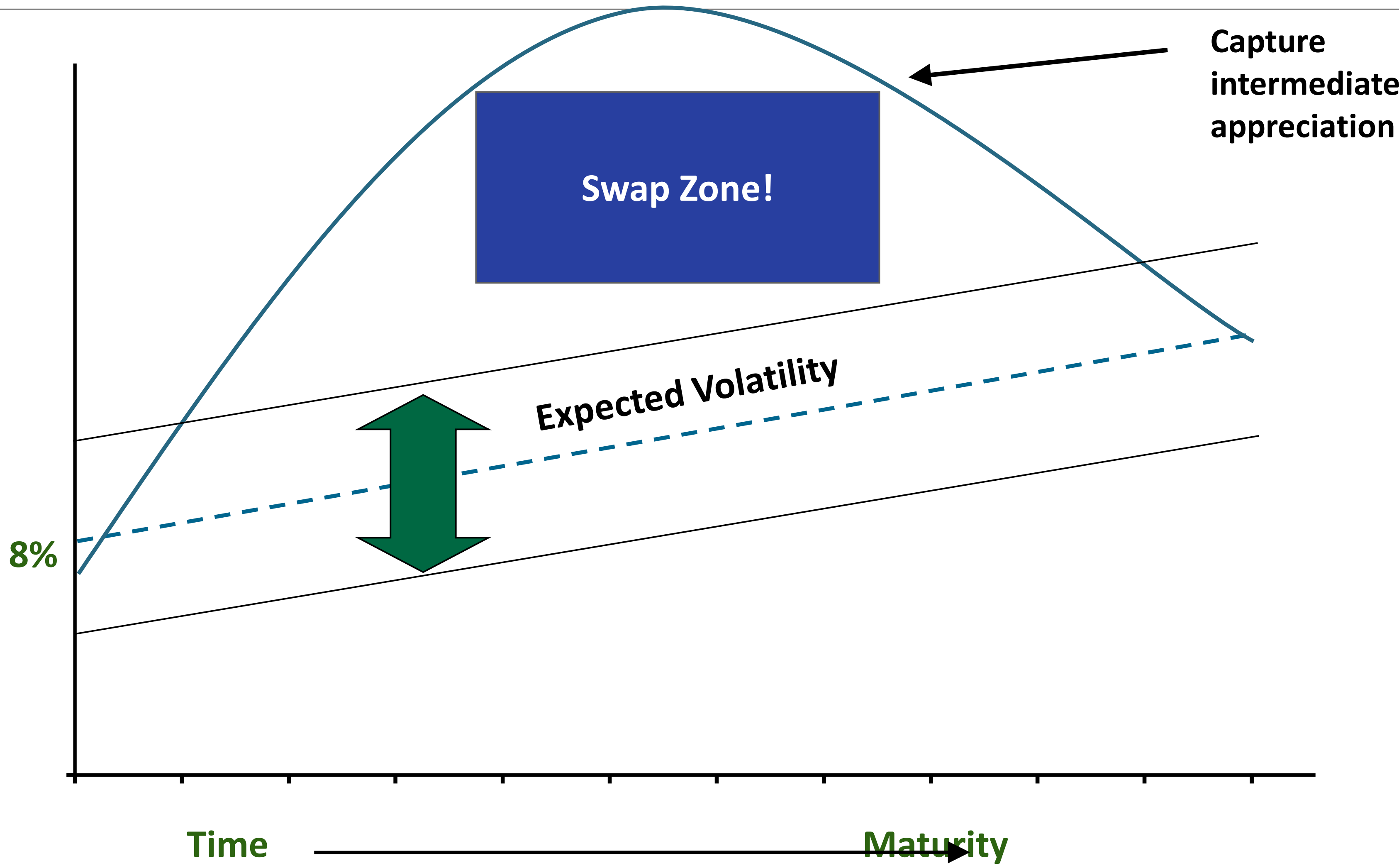
GRAT 1:	Return	Ending Value		
Company A	+20%	$60		$6,000,000
			Minimum annuity to grantor*	$5,070,000
			Amount transferred	$930,000
GRAT 2:				
Company B	-20%	$40		$4,000,000
			Minimum annuity to grantor*	$5,070,000
			Amount transferred	– 0 –
			Total Transferred	**$930,000**

* Assumes a 1.4% §7520 rate and for illustration and emphasis purposes only, a fictitious one year GRAT term.

3. Portfolio GRATs: Use Substitution Power to Manage Performance

- Resulting raw volatility creates likelihood of greater swings
- Focus on swings; not just return over term
- Tactically deploy substitution power to:
  - ✓ Lock-in Winners
  - ✓ Re-GRAT Losers

Portfolio GRAT: Active Management via Substitution Power



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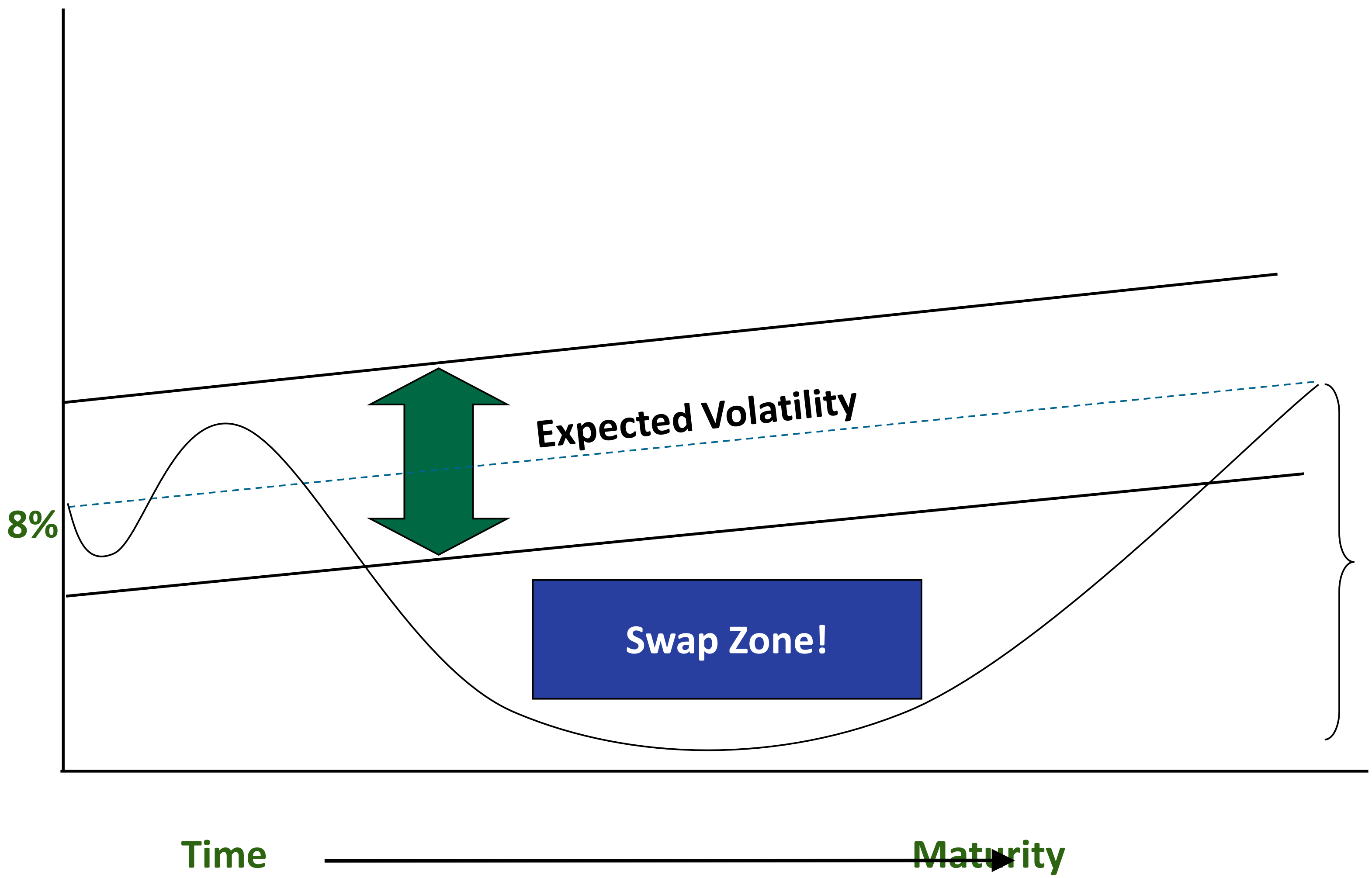
Portfolio GRAT: Active Management via Substitution Power



4. "Shelf" GRATs

Four Risks to a Rolling GRAT Program:

1. Donor dies.
2. Assets decline in value.
3. 7520 rises dramatically.
4. Law change prohibits new short term GRATs.

Shelf GRATS can mitigate risks 3 and 4.

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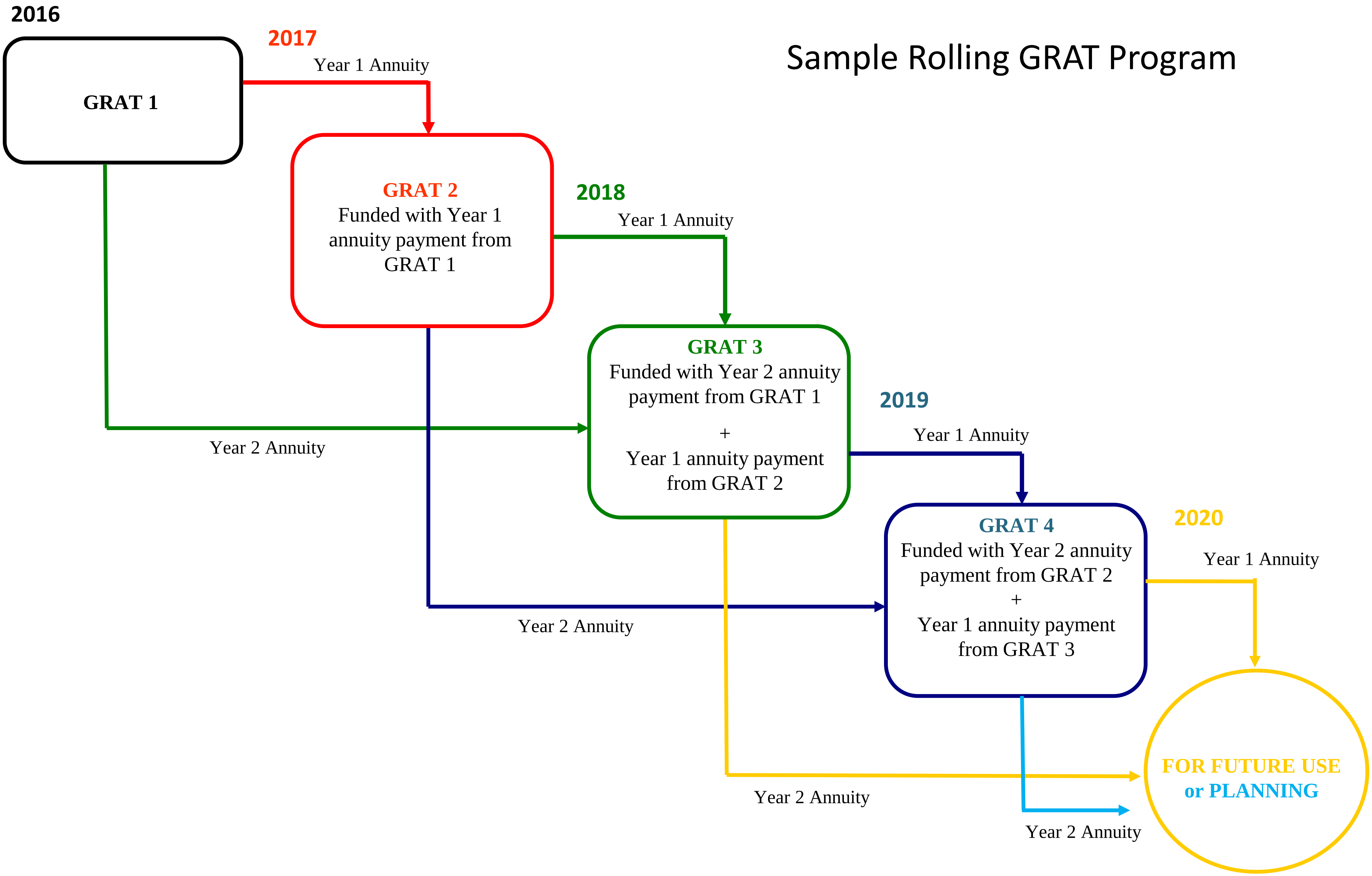
“Shelf” GRATs Steps

Steps:

1. Create inventory of mid and longer term GRATs.
2. Fund currently with low volatile assets.
3. Set on “shelf” (but pay annuities).
4. Swap in volatile assets to activate.

Sample Rolling GRAT Program



The Need to Super Size Shelf GRATs

7520 Rate	**2.00%**
Annuity Growth	**20%**

	10	**9**	**8**	**7**	**6**	**5**	**4**	**3**	**2**
1	4.41%	5.43%	6.74%	8.49%	10.90%	14.36%	19.66%	28.65%	46.86%
2	5.29%	6.51%	8.09%	10.19%	13.08%	17.23%	23.59%	34.38%	56.24%
3	6.35%	7.81%	9.71%	12.23%	15.70%	20.67%	28.31%	41.25%	
4	7.62%	9.38%	11.65%	14.68%	18.83%	24.81%	33.97%		
5	9.15%	11.25%	13.98%	17.61%	22.60%	29.77%			
6	10.98%	13.50%	16.78%	21.13%	27.12%				
7	13.18%	16.20%	20.13%	25.36%					
8	15.81%	19.44%	24.16%						
9	18.97%	23.33%							
10	22.77%								

<u>Example 6 year Shelf GRAT</u>	Principal returned	Principal remainin g
After 2 years:	23.98%	76.02%
After 4 years:	58.51%	41.49%

GRAT Tidbits

Here are four quick thoughts on GRAT structuring:

1. Use a separate document for the remainder interest.
2. Receptacle should be a grantor trust – additional benefit of income tax “burn” plus enable basis management (many GRATs distribute low basis assets).
3. Trusts should be for children only and not per stirpes. Couple with a Will “offset” to address GST ETIP issue.
4. Omit spendthrift clause to provide flexibility.

Cryptocurrency = Property IR-2014-36

General Rules for Property Transactions Apply.

- Over the past year, Bitcoin (one form of cryptocurrency) has ranged from a high of almost $20,000 to a low of $

- This fluctuation creates estate tax planning opportunities, *e.g.,* GRATs.

- Characterization as property may lead to capital gain if value has increased when currency used to purchase goods or services (or ordinary income if owner is a virtual currency “miner” or dealer).

- “Silver” lining??? *State of Florida v. Espinoza*, Case # F14-2923 (Criminal Division), July 22, 2016. Use of Bitcoin is a defense to a felony charge of money laundering under F.S. §896.101.

Leveraged Sale to Dynastic Grantor Trust

Step 1

Create Family Entity and Trust

Assets With Growth Potential

LLC Units

LLC

Step 3

- Parent sells entity interest to Trust, often discounted.
- Sale does not current generate capital gains.
- Trust pays with a Note, typically interest only.

Step 2

"Seed Gift" to Trust

- Fund trust with gift (10%? of purchase price) and/or obtain beneficiary guarantee.
- Can allocate GST exemption to gift.

Dynasty Grantor Trust

- Can be GST Exempt.
- Parent can remain taxable on all income, thereby making an indirect gift to beneficiaries.

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Sale SCIN/GRAT? (Self Canceling Installment Notes) Proceed with Caution - CA 201330033; *Estate of Davidson*

- IRS assessment $2.6 billion.
- Stipulated decision July 2015: $320,523,233.
- Basic facts:
  - Age 86; Life expectancy 5.8 years under 7520 table.
  - IRS expert: 2.5 years.
  - Four medical consultants (two IRS; two taxpayer) all said greater than 50% probability of living more than one year (hence, not terminal).
  - Large stock sales in Jan. 2009 for 5-year SCINs.
    - Some with principal premium (88%).
    - Some with interest rate premium (13% above 7520 rate).
  - Died two months after sales; no Note payments.
- IRS position announced in 2013 in Chief Counsel Advice 2013220022 – use medical history on date of gift, not 7520 mortality tables (i.e., willing-buyer/willing-seller).
- Settlement likely has a chilling effect on use of SCINs.
- $500MM malpractice suit versus tax advisor who “pitched” concept (dismissal based on contractual shortening of SOL on appeal).

Family Loan - Bond Portfolio Arbitrage

Promissory Note

Lend Cash (for Bonds)

Better not to lend directly:
- Interest income to Mom would be taxable.
- Mom loses the non-taxable gift benefit of paying tax on the taxable bond income, if any.

(Grantor)
Trust for Daughter

Grantor Trust

- Solves income tax issues.
- Enables consideration of taxable bonds.

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Bond Portfolio Arbitrage - Example

Promissory Note

Lend Cash (for Bonds)

Rule: For each 1% of interest above the loan rate, the trust receives $100,000/year per $10M.

Example: $20M loan; bonds yield 3% net of fees.

Trust receives:

- ✓ $458,000 per year (net of Note interest July 2016 ST AFR .71%).
- ✓ $1,374,000 3-year Wealth Transfer (assuming stable bond value).
- ✓ No Gift or GST tax.

(Grantor)
Trust for Daughter

…or for Grandchildren!

Leveraged Sale – Deeper Issue

- ✓ Take advantage of discounts, if possible.
- ✓ If accruing interest, watch out for OID rules unless meet exception.

<u>Optimal Term for Note – short, mid or long?</u>

- ➢ Quantitative analytics reflects with balanced growth portfolio, long term Notes typically overcome higher interest rate “hurdle” by 15th year.

A Grantor Trust Analysis for - John Smith
30 yr Note vs 9 yr Note

Year		Trust with 30 yr Note - Net Median		Trust with 9 yr Note - Net Median		Benefit / (Cost) of 30 yr Note
2012	1	$	11,462,548	$	11,776,548	$	(314,000)
2013	2	$	13,107,374	$	13,762,995	$	(655,620)
2014	3	$	14,710,572	$	15,710,872	$	(1,000,300)
2015	4	$	16,432,874	$	17,835,175	$	(1,402,301)
2016	5	$	18,137,942	$	19,948,468	$	(1,810,525)
2017	6	$	19,894,677	$	22,143,869	$	(2,249,193)
2018	7	$	22,093,825	$	24,839,268	$	(2,745,443)
2019	8	$	24,183,713	$	27,423,751	$	(3,240,038)
2020	9	$	26,806,540	$	30,559,942	$	(3,753,402)
2021	10	$	29,043,563	$	32,496,361	$	(3,452,798)
2022	11	$	31,975,161	$	34,973,303	$	(2,998,143)
2023	12	$	34,597,133	$	36,790,989	$	(2,193,856)
2024	13	$	37,810,199	$	39,313,171	$	(1,502,972)
2025	14	$	41,279,611	$	42,122,224	$	(842,614)
2026	**15**	**$**	**44,640,345**	**$**	**44,564,058**	**$**	**76,287**
2027	16	$	48,766,081	$	47,745,744	$	1,020,337
2028	17	$	53,460,705	$	50,864,997	$	2,595,708
2029	18	$	57,861,301	$	54,088,023	$	3,773,278
2030	19	$	62,251,039	$	57,405,209	$	4,845,830
2031	20	$	66,908,565	$	61,408,752	$	5,499,813
2032	21	$	72,710,352	$	66,002,118	$	6,708,234
2033	22	$	78,306,904	$	70,050,727	$	8,256,177
2034	23	$	83,755,864	$	74,836,048	$	8,919,815
2035	24	$	89,605,476	$	78,508,617	$	11,096,859
2036	25	$	98,062,750	$	84,393,554	$	13,669,196
2037	26	$	104,510,564	$	89,868,213	$	14,642,351
2038	27	$	111,737,361	$	96,929,759	$	14,807,602
2039	28	$	121,435,687	$	103,431,914	$	18,003,772
2040	29	$	128,906,263	$	110,994,345	$	17,911,918
2041	30	$	138,599,276	$	117,450,029	$	21,149,247

The year in which the value of the grantor trust with the 30 yr note will surpass the value of the grantor trust with the 9 yr note

Long term overcomes higher interest

18% Benefit!

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Refinance Family Loan:
Consider the Term – Short, Mid or Long?

§1274(d) (AFR) with annual compounding:

Duration:	Less than 3 Years	3 to 9 Years	More Than 9 Years
March 2018	1.96%	2.57%	2.88%
April 2017	1.11%	2.12%	2.82%

Relationship between Fed Funds rate and AFR/7520 rate?

Refinancing: It is about more than cash flow; it is about wealth transfer!

	Date	AFR	Annual Interest
$20,000,000 9 yr. Note	May 2010	2.87%	$574,000
$20,000,000 3 yr Note	March 2012	.19%	($38,000)

Reduction $536,000

Power of Compounding: At 5%, a value doubles every 14.21 years.

After 99.47 years (7 compounds) $68,608,000

After 358 years (25.19 compounds) $17,985,175,552,000

Grantor Trusts: My, how times have changed…

- IRC Subchapter J, Subpart E historically was to punish taxpayers.
- Perceived abuse - multiple trusts established to create separate taxpayers to take advantage of the bottom tax brackets.
- So, rules crafted generally to push income out to settlor of a grantor trust and to beneficiaries of a nongrantor trust and taxed at higher marginal rate.
- Because of the current compressed tax brackets for trusts, these rules are now generally favorable to taxpayers.

Grantor Trusts - Where in the Code are we?

- Subpart E of Subchapter J includes §§671-679, which provide exceptions to the general rule of §641 taxing income of a trust to the trust or its beneficiaries.
- The income, deductions, and credits of a grantor trust are reportable on the grantor's individual income tax return. §671.
- The statute does not specifically refer to gains or losses, and whether the grantor can claim losses is not totally clear. Losses are considered along with gains in determining the trust's "income" but that does not necessarily mean the grantor would be treated as the owner of excess losses. *See* Treas. Reg. 1.671-3(a)(1).

Grantor Trusts – Useful for…

- Estate “freeze” planning.
  - ✓ No capital gain or loss recognized on sales between trust and grantor. Rev. Rul. 85-13.
- Estate “burn” planning.
  - ✓ Rev. Rul. 2004-64 provides that grantor’s payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries.
  - ✓ Rev. Rul. 2004-64 also provides that a mandatory tax reimbursement clause would not gift consequences, but would cause full value of the Trust’s assets to be included in the grantor’s gross estate under §2036(a)(1).
- Grantor trusts (as to both income and corpus) can be S corporation shareholders. §1361(c)(2)(A)(i).
- The §121 gain exclusion for the sale of a principal residence applies if the residence is owned by the resident’s grantor trust. Rev. Rul. 85-45.
- For net investment income tax purposes, the grantor’s threshold applies, and material participation (for purposes of the material participation in active business exception) is based on participation by the grantor.

Overview of the Six Grantor Trust Triggers

1. §673–Right of Reversion. Reversionary interest at the time the trust is created exceeds 5% of the trust's value (assuming the maximum exercise of discretion in favor of the grantor).

2. §674–Power to Control Beneficial Enjoyment. Grantor or nonadverse party has control over distributions. Exceptions to the general rule are in §674(b).

3. §675–Administrative Powers. Depending on the specific power, a trigger if held by (1) the grantor or a nonadverse party, or (2) any person in a nonfiduciary capacity.

4. §676–Power to Revoke. Grantor or nonadverse party has power to revest title in the grantor.

5. §677–Income for Benefit of Grantor. When income, without the approval or consent of any adverse party, *is*, or in the discretion of the grantor or nonadverse party, *may be* (1) distributed or accumulated for future distribution to grantor or grantor's spouse, or (2) applied to the payment of premiums for life insurance policies on grantor or grantor's spouse.

6. §678–Person Other Than Grantor Treated as Substantial Owner. When a person other than the grantor has sole power to vest the corpus or the income in the power holder.

Section 675(4) – The Golden Trigger

- Section 675(4) lists several general powers of administration, which, if exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment.
- One of those powers, listed in § 675(4)(C), is "a power to reacquire the trust corpus by substituting other property of an equivalent value."
- Even though §675(4)(C) refers to a power to reacquire "trust corpus," this power causes the grantor to be treated as the owner of trust corpus and income (including ordinary income not allocable to corpus). Treas. Reg. § 1.671-3(b)(3).
- The determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration." Treas. Reg. §1.675-1(b)(4).

Section 675(4)(C) – Helpful Revenue Rulings

- Revenue Ruling 2008-22, 2008-16 IRB 796, provides that a grantor non-fiduciary substitution generally will *not* trigger estate inclusion under §§2036 or 2038 if:
  1. Trustee ensures equivalent value, and
  2. Trustee ensures not shifting of benefits.
     - A substitution power cannot be exercised in a manner that can shift benefits if:

(a) the trustee has both the power to reinvest the trust corpus AND a duty of impartiality with respect to the trust beneficiaries *[state law would generally impose both of these duties unless the trust instrument negates them],* or

(b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, e.g., a unitrust, discretionary principal and income distribution trust.

- Rev. Rul. 2011-28 is a follow-up to Revenue Ruling 2008-22 and clarifies that a nonfiduciary substitution power generally will not trigger estate inclusion with respect to life insurance under §2042.
- Uncertainty regarding controlled corporation stock (though no §2038 analog to 2036(b)(2)).

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Section 675(4)(C) – Who Should Not Hold Substitution Power

- *Trustee* should not hold power because grantor trust status depends upon the power being held in a “nonfiduciary” capacity. Similarly, a trustee’s approval or consent should not be required (or else the requirement in the initial sentence of §675(4) will not be satisfied.)

- *Adverse party* (e.g., a beneficiary) probably should not. Even though several clauses of §675 require that a power be exercisable by a nonadverse party (§675(1) & (2)), §675(4), which deals with general powers of administration, merely refers to powers held “by any person” without requiring that the power be held by a nonadverse party. However, Regulation §1.675-1(b)(4) refers to powers of administration held in a nonfiduciary capacity “by any nonadverse party.” Despite the clear contradiction, the regulation might be upheld under the broad deference standard for upholding regulations.

Section 672

<u>Adverse party under §672(a)</u>:

- Has a substantial beneficial interest in the trust (at least 5%) which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.

- Has a general power of appointment over the trust property.

<u>Related or subordinate party §672(c)</u>:

- A nonadverse party who is—
  - The grantor's spouse if living with the grantor.
  - The grantor's father, mother, issue, brother or sister.
  - An employee of the grantor.
  - A corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control.
  - A subordinate employee of a corporation in which the grantor is an executive.

Section 675(4)(C) – Who (Perhaps) Can Hold Substitution Power

- Giving a third party a substitution power could be very desirable because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power) but clearly does not give the donor any power that would risk estate inclusion for estate tax purposes.

- The statute and regulations would both literally suggest that the power of substitution can be held by a third party. However, the statute refers to the power to "reacquire" trust corpus by substituting other property of equivalent value. A very literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to <u>re</u>acquire the property.

- Rev. Proc. 2007-45 provides a form for a grantor trust CLAT, and it uses a third party substitution power to cause grantor trust status. Similarly, Rev. Proc. 2008-45 uses the same approach for the sample inter vivos CLUT grantor trust form.

- Several private letter rulings have held (apparently incorrectly and inadvertently) that a trust with a third party substitution power was a grantor trust as to the holder of the substitution power, e.g., PLRs 201216034, 9311021.

Grantor Trust – Income Tax Reimbursement Power

A negative attribute is the estate tax inclusion caused by the grantor having a right to reimbursement for income tax incurred from a grantor trust. Rev Rul 2004-64.

- Specifically negate it, so there is no confusion.
- What about trustee discretion to reimburse?

1. Technically, permitted under the Rev Ruling.
2. Caution: the Ruling further states that the discretionary benefit is not, in and of itself, an inclusion trigger under §2036(a)(1), but it further states that coupled with other facts and circumstances, it could be.
3. Example: an "arrangement" or "understanding" between the grantor and trustee as to when the trustee will exercise such discretion (FLP "implied understanding" analogy).
4. Example: if the grantor has the power to name him or herself as successor trustee.
5. If the discretion to reimburse would expose the trust property to grantor's creditors – remember, it might be okay in the original state, but the grantor may move to another jurisdiction.

Grantor Trust – The "Off" Switch

With high estate tax exemptions, increased capital gains tax rates and the effect of the "burn" of grantor trust status, it is imperative to have the ability to terminate.

1. Typically done by terminating the circumstance causing the grantor trust status, such as by releasing the right to substitute assets.
2. Some practitioners doubt that there is an implicit ability to terminate, so in the trigger provision, consider specifically authorizing termination.
3. Some also feel it should not be held by the grantor, but a fiduciary concern if vested in the trustee.
4. Treasury official commentary: grantor may have power to turn on, or off, but not both.

Whoever is for higher taxes, feel free to pay higher taxes.

- Adam Carolla

4. Unique Assets
(IRAs and Life Insurance)

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IRA Planning Idea #1 – Conversion into Correlated Roths

Converting a Traditional IRA into a Roth generates a current income tax liability.

It was possible to recharacterize before filing the return for the year of conversion (i.e., no later than October 15th of following year).

Why recharacterize?

- Income tax reform and tax rates decrease more than assets increase.
- Assets lose value.

New Tax Act eliminates recharacterization for conversions after 2017; however, they can be done in 2018 for 2017 conversions. This elimination is not scheduled to sunset.

Conversion into Correlated Roths

Axiom: Successful investing comes down to one primary factor – choosing the right mix of assets to own.

Planning Strategy: Convert into multiple Roths using correlated or concentrated allocations within the silo Roths. Diversification is preserved on whole, but recharacterization may be done on a selected basis if, as commonly happens, some assets classes grow while others diminish. Note: new Tax Act permanently eliminates recharacterization for conversions after 2017.

Idea Planning Idea #2 – Convert to Generate Estate Deduction

If conversion occurs in last year of life, the income tax liability can be an estate tax deduction (Schedule K). See 20.2053-6(f).

IRA Planning Idea #3 – Don’t Forget IRC 691(c)

If estate tax is paid on IRD, a deduction can be claimed on the income tax return that reports the IRD. The deduction is available as a miscellaneous deduction, but is not subject to the 2% AGI floor.

The deduction is calculated by recomputing Form 706 without IRD, then subtracting this number from the original estate tax due. The difference is the estate tax on IRD and the amount of the total deduction.

The IRD recipient's portion of the deductible tax must then be determined by:

- Dividing the value of the IRD included in the beneficiary's income by the total value of the IRD included in the decedent's estate (**not** reduced by DRD), then
- Multiplying this fraction by the total estate tax deduction.

Although 691(c) was not disallowed by the new Tax Act, its benefit may be lessened by (a) fewer estates will be taxable, and (b) elimination of other deductions/increase in standard deduction (so more of the deduction absorbed to “make-up” difference).

IRA Planning Idea #4: Traditional IRAs to Charity

When contemplating funding of a client's, first consider funding charitable bequests with Traditional IRAs to avoid estate and income taxation.

IRA Planning Idea #5: Trusts as Beneficiaries

For numerous reasons, clients may desire a trust to be the beneficiary an IRA. Some planners think this is not possible, but it is.

Selecting a trust does add complication and the need for careful drafting. Failure to properly craft the trust will result a beneficiary that is not a "designated beneficiary" thereby limiting deferral to a maximum of 5 years. Trusts that qualify are commonly referred to as "see-through" trust.

The 5 requirements are:

1. Valid trust.
2. Irrevocable (or become irrevocable at owner's death.
3. Identifiable beneficiaries.
4. Beneficiaries themselves are designated beneficiaries (not an estate or charity).
5. Copy of trust provided to IRA administrator by October 31 following year of death.

Conduit versus Accumulation See-Through Trusts

Among other decisions, one must determine whether a conduit or accumulation see-through trust is preferred.

Conduit: Passes all distributions from the IRA through to beneficiaries.

Accumulation: Permits some of IRA distribution to be retained and added to principal.

Historical analysis pivots on trade-off between trust benefits and income tax efficiency.

Case Study

Basic Facts:

- ✓ Surviving spouse received terminal diagnosis.
- ✓ $3.5MM Traditional IRA and significant other assets.
- ✓ No charitable intent.
- ➢ Solution – converted to multiple Roths, GST allocated and stretched over life of 35 year-old grandchild.

Result:

- ❖ **Slight ($234,000) benefit at normal life expectancy (ignoring diagnosis)**
- ❖ **Substantial ($32,900,000) benefit by death of grandchild.**

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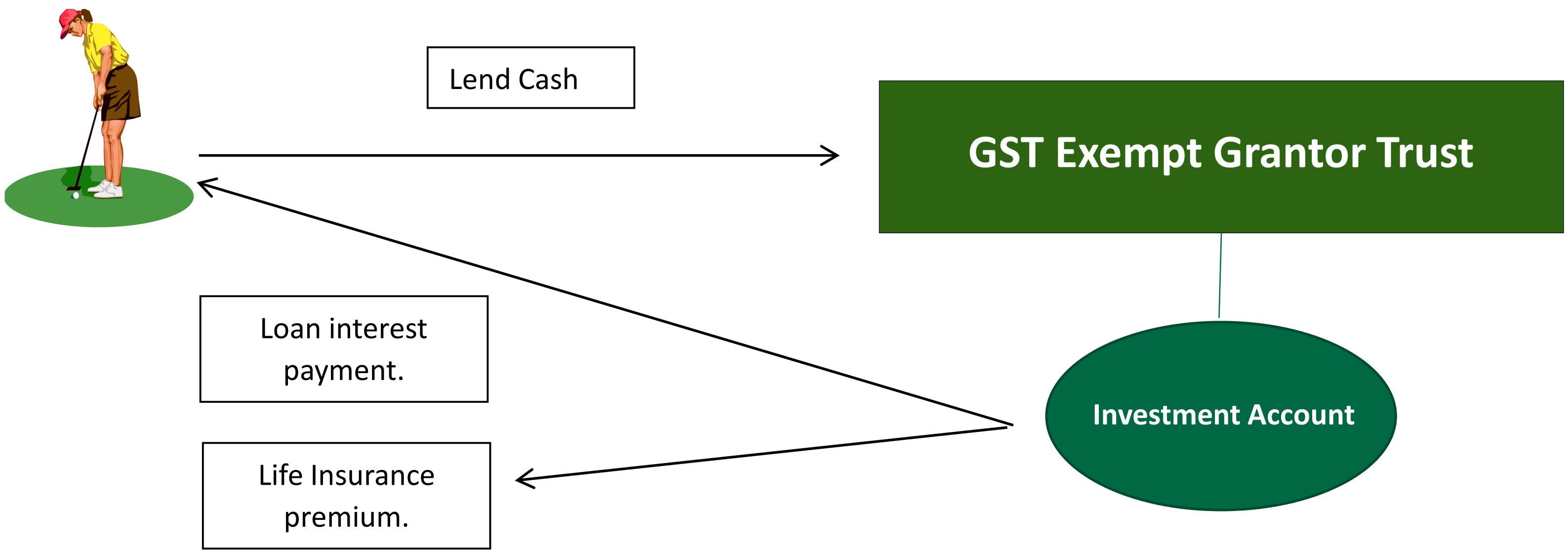
Life Insurance

<u>5 Basics to Govern Insurance Planning:</u>

1. Understand need/desire for life insurance.
2. Run the numbers on amount needed to accomplish the goal.
3. Discern right type (term, convertible, universal, variable, whole and private placement, or a blend) to achieve the goal.
4. Properly structure ownership options to minimize tax or help pay premiums.
5. Explore financing:
   a. Annual exclusion gifts; larger gifts using exemption.
   b. Owned by trust with income producing assets.
   c. Split dollar.
   d. Premium finance – bank sourced or private.
   e. Bond financing.

Family Loan/Portfolio Arbitrage Insurance Twist



- Trust pays note interest and uses “excess” return to purchase a policy engineered to be paid up before mid-term note is due
- Results in the arbitrage paying for a policy and leaving corpus available to pay note.
- Example:
  - $10MM loan at 1.45% mid-term AFR
  - Assuming investments generate a 5% return, providing “excess” of 3.55%, or $355,000 per year.
  - This funds a $20MM death benefit for two 55-year olds or $12.5MM for two 65-year olds.
  - At the end of 9 years, policy is “paid-up” and trust repays note.

Insurance on Pensioners

Step 2:

Economic Benefit Split Dollar

GST Exempt ILIT

Step 1:
Loan

Bank

Step 3:
PPLI with pension fund.

- Multiple life insurance on numerous pensioners.
- Pension fund gets death benefit in excess of economic benefit.
- Example:
  - Client contributes $5MM of own funds & $45MM of borrowed funds.
  - Funds purchase $300,000 death benefit policies for $50,000 each on 2,000 pensioners.
  - When a pensioner dies, proceeds split. If “day 2”, ILIT gets $50,000 (assuming no growth) and pension fund nets $250,000. Over time, EB grows and net to pension fund shrinks.
  - Funds grow income tax free and are return to ILIT income tax free over a statistically predictable “bell curve” time frame.

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Intergenerational Insurance

Step 2:

Typically, an economic benefit split dollar with collateral assignment - some using a “restrictive” loan regime.

GST Exempt ILIT

Step 1:
Loan
(optional)

Bank

Step 4:

• Right to repayment transferred by gift or sale.

• Discount claimed on likelihood of extended period before repayment (because insured is younger generation).

Step 3:
Insurance on child or grandchild.

GST Exempt Family Trust

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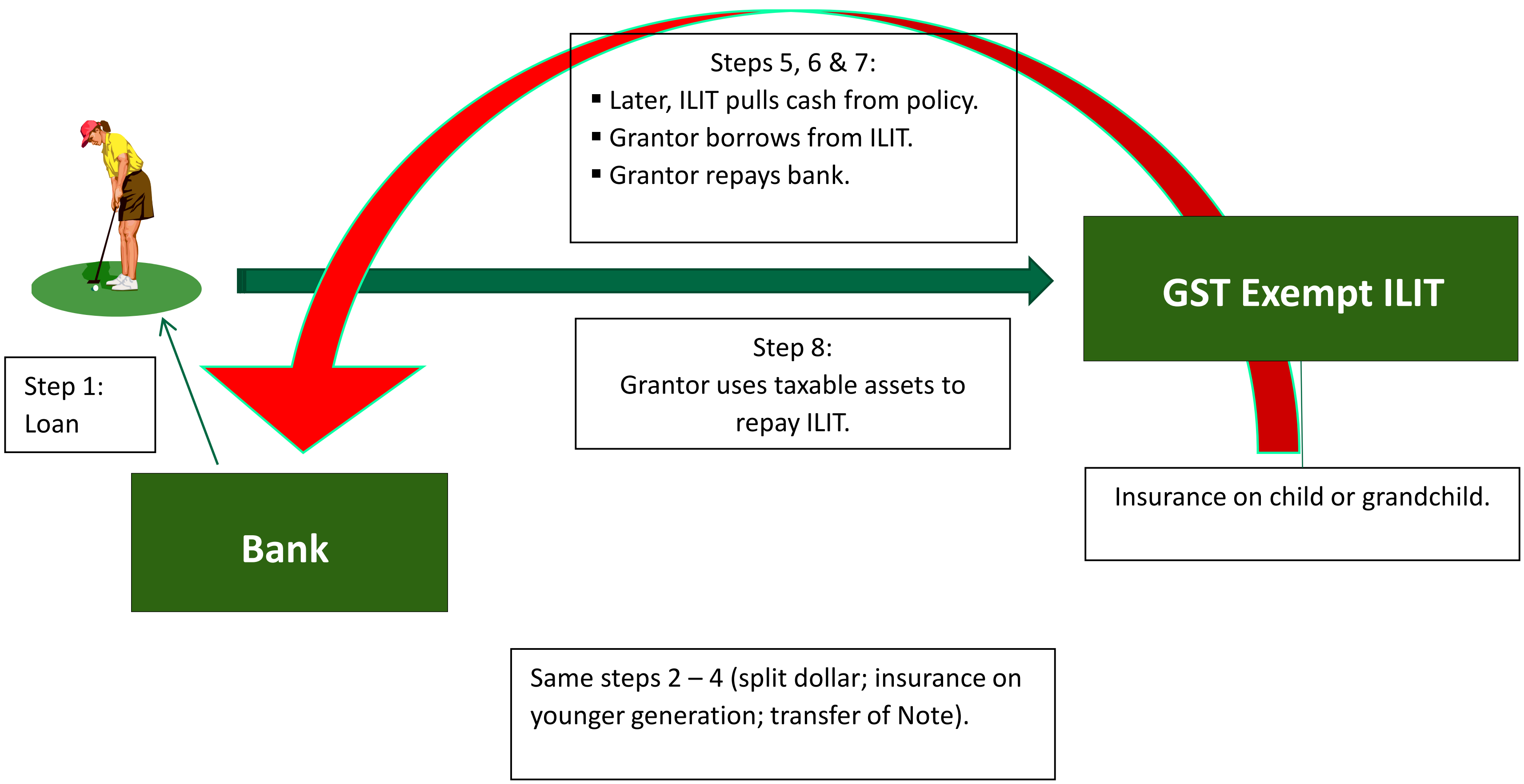
Intergenerational Insurance – Plus Estate Depletion



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Miscellany Final Thoughts

GST Savings GPOA

Pre-EGTRRA was always better to include in an estate in lieu of triggering GST due to marginal brackets and state death tax credit. These are no longer, plus new basis planning concerns.

Three options to an automatic GST savings GPOA:

1. Require consent from a non-adverse third party to the exercise. §2041(b)(1)(C).
2. Provide for a formulaic power, contingent on estate inclusion resulting in a lower aggregate tax (or other tax benefit), and limited only to that portion that will result in the lower tax.
3. Empower someone with authority to confer a GPOA on a beneficiary, such as:
   - Trustee (can be awkward - if conferred and exercised, assets may be taken away from other beneficiaries; if not conferred, may result in a tax liability).
   - Trust Protector.
   - Third party.
   - Solution: consider exculpatory language, required beneficiary consent, or making the power only available in response to a beneficiary's request.

➢ Drafting Pointer: Consider restricting GPOA to minimize risk assets leave family. GPOA even if only to creditors of holder's estate. LR8836023.

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The "Delaware" Tax Trap – IRC 2041(a)(3)

A taxable gift or inclusion in a beneficiary's estate can occur if:

1. A beneficiary exercises a power of appointment in further trust,
2. The new trust empowers its beneficiary with a power of appointment, and
3. The exercise of the power can postpone the vesting of the trust property without regard to the date of the creation of the first power.

Commentary: Could be triggered by decanting, but typically surfaces in the exercise under the beneficiary's Will.

"I always want to say to people who want to be rich and famous: 'try being rich first.' See if that doesn't cover most of it. There's not much downside to being rich, other than paying taxes and having your relatives ask you for money. But when you become famous, you end up with a 24-hour job."

- Bill Murray

Do you have a Living Will?

"Yes, absolutely, no question, pull the plug!

Then, immediately put it back in to see if I restart."

- Bill Murray

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