The Estate Planner

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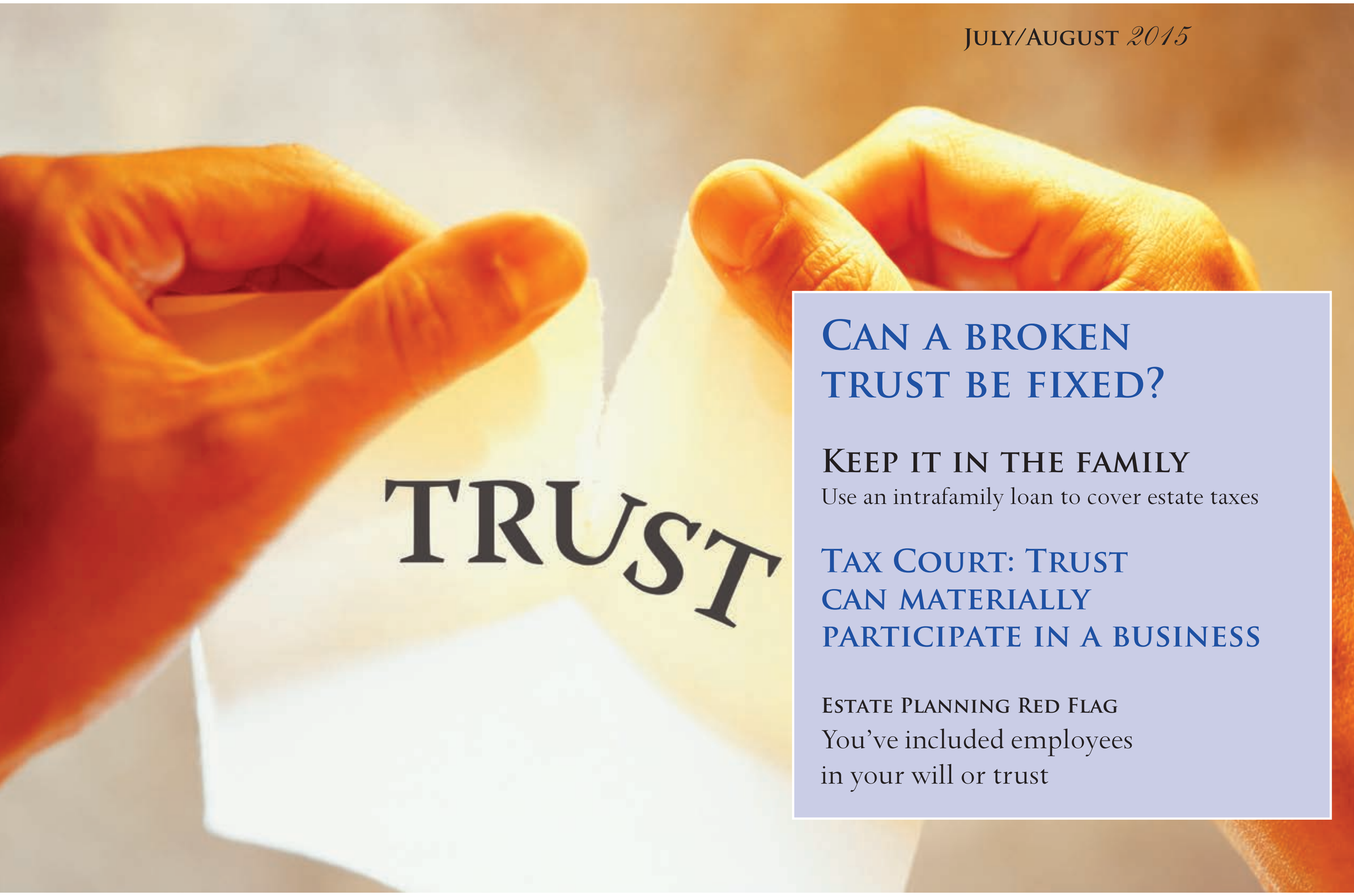

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Can a broken trust be fixed?

An irrevocable trust has long been a key component of many estate plans. But what if it no longer serves your purposes? Is it too late to change it? Depending on applicable state law, you may have several options for fixing a "broken" trust.

How trusts break

There are several reasons a trust can break, including:

Changing circumstances. A trust that works just fine when it's established may no longer achieve its original goals if your family circumstances change. If you divorce, for example, a trust for the benefit of your spouse may no longer be desirable. If your children grow up to be financially independent, they may prefer that you leave your wealth to *their* children. Or perhaps you prefer not to share your wealth with a beneficiary who has developed a drug or alcohol problem or has proven to be profligate.

New tax laws. Many trusts were created when gift, estate and generation-skipping transfer (GST) tax exemption amounts were relatively low. Today, however, the exemptions have risen to $5.43 million, so trusts designed to minimize gift, estate and GST taxes may no longer be necessary. And with transfer taxes out of the picture, the higher income taxes often associated with these trusts — previously overshadowed by transfer tax concerns — become a more important factor.

Mistakes. Potential errors include naming the wrong beneficiary, omitting a critical clause from the trust document, including a clause that's inconsistent with your intent, and failing to allocate your GST tax exemption properly.

If you have one or more trusts in need of repair, you may have several remedies at your disposal.

These are just a few examples of the many ways you might end up with a trust that fails to achieve your estate planning objectives.

How to fix them

If you have one or more trusts in need of repair, you may have several remedies at your disposal, depending on applicable law in the state where you live and, if different, in the state where the trust is located. Potential remedies include:

Reformation. The Uniform Trust Code (UTC), adopted in more than half the states, provides several remedies for broken trusts. Non-UTC states may provide similar remedies. Reformation allows you to ask a court to rewrite a trust's terms to conform with the grantor's intent. This remedy is available if the trust's original terms were based on a legal or factual mistake.

Modification. This remedy may be available, also through court proceedings, if unanticipated circumstances require changes in order to achieve the trust's purposes. Some states permit modification — even if it's inconsistent with the trust's purposes — with the consent of the grantor and all the beneficiaries.

Division/consolidation. The UTC also permits a trustee to divide a trust into two or more trusts, or to consolidate two or more trusts, under certain circumstances. For example, if a trust is only partially exempt from GST taxes, it might be appropriate to divide it into two trusts — one fully exempt and one nonexempt — and use the exempt trust to benefit grandchildren or for other generation-skipping gifts.

Relocation. In some cases, it may be possible to fix a broken trust by changing its situs — that is, by moving it to a jurisdiction whose laws are more favorable. The UTC may allow a trustee to relocate a trust to an appropriate jurisdiction if doing so would be in the beneficiaries' best interests.

Decanting. Many states have decanting laws, which allow a trustee, according to his or her distribution powers, to "pour" funds from one trust into another with different terms and even in a different location. Depending on your circumstances and applicable state law, decanting may allow a trustee to correct errors, take advantage of new tax laws or another state's asset protection laws, add or eliminate beneficiaries, extend the trust term, and make other changes, often without court approval.

Consult your advisor

The rules regarding modification of irrevocable trusts are complex and vary dramatically from state to state. And there are risks associated with revising or moving a trust, including uncertainty over how the IRS will view the changes. (See "Beware of federal tax consequences" at right.) Before you make any changes, it's critical to consult your advisor to discuss the potential benefits and risks. ✤

Beware of federal tax consequences

One risk associated with making changes to a trust — particularly those designed to take advantage of tax benefits — is uncertainty over how the IRS will view these changes. For one thing, state court rulings aren't necessarily binding on the IRS, so the IRS may reach its own conclusions about whether a reformation or modification of a trust is effective for federal tax purposes and whether it should apply retroactively.

Also, in some cases, certain changes may have their own tax consequences. In a 2011 notice, the IRS sought public comment on the tax implications of decanting a trust. Among the issues raised were whether:

1. A beneficiary whose interest is reduced has made a taxable gift,
2. Including a decanting power in a trust jeopardizes its qualification for the marital deduction or requires it to be treated as a grantor trust,
3. Decanting triggers generation-skipping transfer tax liability, or
4. Decanting results in taxable gain or other income tax consequences to the trust or its beneficiaries.

Unfortunately, as of this writing, the IRS hasn't yet provided any guidance on these issues.

Keep it in the family

Use an intrafamily loan to cover estate taxes

An intrafamily loan is one option if an estate doesn’t have the liquidity to pay estate taxes or other expenses. While a life insurance policy can be used to cover these costs, a benefit of using an intrafamily loan is that, if it’s properly structured, the estate can deduct the full amount of interest upfront. Doing so reduces the estate’s size and, thus, its estate tax liability.

Deducting the interest

An estate can deduct interest if it’s a permitted expense under local probate law, actually and necessarily incurred in administration of the estate, and ascertainable with reasonable certainty, and will be paid. Under probate law in most jurisdictions, interest is a permitted expense. And, generally, interest on a loan used to avoid a forced sale or liquidation is considered “actually and necessarily incurred.”

To ensure that interest is “ascertainable with reasonable certainty,” the loan terms shouldn’t allow prepayment and should provide that, in the event of default, all interest for the remainder of the loan’s term will be accelerated.

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the IRS or a court would likely conclude that future interest isn’t ascertainable with reasonable certainty and would disallow the upfront deduction. Instead, the estate would deduct interest as it’s accrued and recalculate its estate tax liability in future years.

The requirement that interest “will be paid” generally isn’t an issue, unless there’s some reason to believe that the estate won’t be able to generate sufficient income to cover the interest payments.

Ensuring the loan is bona fide

For the interest to be deductible, the loan also must be bona fide. A loan from a bank or other financial institution shouldn’t have any trouble meeting this standard.

But if the loan is from a related party, such as a family-controlled trust or corporation, the IRS may question whether the transaction is bona fide.

So the parties should take steps to demonstrate that the transaction is a true loan.

Among other things, they should set a reasonable interest rate (based on current IRS rates), execute a promissory note, provide for collateral or other security to ensure the loan is repaid, pay the interest payments in a timely manner, and otherwise treat the loan as an arm's-length transaction. It's critical that the loan's terms be reasonable and that the parties be able to demonstrate a "genuine intention to create a debt with a reasonable expectation of repayment."

Tax Court weighs in

In *Estate of Duncan*, the U.S. Tax Court affirmed the continued viability of this strategy. In that case, the deceased's revocable trust, which held illiquid oil and gas interests, paid estate taxes with a 15-year loan from an irrevocable trust established by the deceased's father.

The court allowed the interest deduction, even though the two trusts had the same trustees and beneficiaries. The trustees' fiduciary duties under state law obligated them to maintain the trusts' individuality and to respect the terms of the loan. They weren't, as the IRS suggested, "free to shuffle money between these 'trusts' as they please."

Footing the tax bill

If your estate is large and consists primarily of real estate, closely held business interests or other illiquid assets, your heirs may encounter difficulty paying estate taxes and other expenses after your death. An intrafamily loan may be an option for them to cover these costs. ✤

Tax Court: Trust can materially participate in a business

In a landmark 2014 case, the U.S. Tax Court opened the door to significant tax savings for certain trusts. In *Frank Aragona Trust v. Commissioner*, the court held that a trust can materially participate in a trade or business and even qualify as a "real estate professional."

Why does it matter?

Investors in passive activities are at a disadvantage. The passive activity loss (PAL) rules prohibit them from offsetting passive losses against nonpassive income, such as wages and investment income. In addition, high-income taxpayers are subject to a 3.8% net investment income tax (NIIT) on the lesser of their net investment income, including income from passive activities, or the amount by which their modified adjusted gross income exceeds the applicable threshold. The MAGI threshold is \$200,000 per year (\$250,000 for married filing jointly and \$125,000 for married filing separately).

Passive activities include:

- Trade or business activities in which a taxpayer doesn't materially participate, and
- Rental real estate activities, regardless of the level of participation, unless the taxpayer is a qualified real estate professional.

Non-real estate professionals who materially participate may deduct up to $25,000 in rental real estate losses, depending on their income.

Material participation means participation on a "regular, continuous and substantial" basis. The tax regulations provide several objective tests for determining whether a taxpayer materially participates in an activity.

For example, participation for 500 or more hours during a tax year is deemed to be material. Generally, to qualify as a real estate professional, you must 1) spend more than half of your working hours on real estate businesses in which you materially participate, and 2) spend at least 750 hours during a tax year on such real estate businesses.

The impact of the PAL rules and the NIIT on trusts is particularly harsh. A nongrantor trust is taxed at the highest rate (currently 39.6%) after its taxable income exceeds a low threshold ($12,300 for 2015). In addition, a trust's undistributed net investment income is subject to the 3.8% NIIT to the extent that its adjusted gross income exceeds the same threshold.

A trust that owns real estate or other passive business interests enjoys significant tax advantages if it's deemed to materially participate.

How can a trust materially participate?

A trust that owns real estate or other passive business interests enjoys significant tax advantages if it's deemed to materially participate and, in the case of rental real estate, if it qualifies as a real estate professional. For years, the IRS has taken the position

that a trust can do neither of these things, but in *Aragona* the Tax Court rejected this position.

Aragona involved a trust with six trustees — one independent trustee plus the deceased grantor's five children. Among the trust's assets was a wholly owned limited liability company (LLC) that managed most of the trust's rental real estate. Three of the five children worked for the LLC full time.

The IRS argued that the trust couldn't offset its rental real estate losses against its income from nonrental real estate activities, because 1) a trust can't perform personal services or materially participate, and 2) even if it can, services the trustees performed as employees shouldn't count toward the material participation or real estate professional requirements.

The court held that a trust *can* materially participate and qualify as a real estate professional based on the activities of its trustees, including the activities of trustees who are also LLC employees. The trustees were legally obligated to act in the beneficiaries' best interests, the court explained, and they "are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust."

The court didn't reach the question of whether the activities of the trust's nontrustee employees should be considered.

Evaluate your trusts

The court's ruling in *Aragona* was based on the specific facts of that case. It remains to be seen whether trusts will enjoy the same tax benefits under different circumstances. For example, it's possible that a trust may be deemed to materially participate in a business based on the activities of its nontrustee employees. Also, the court in *Aragona* emphasized that the trust held majority interests in all of the family's real estate businesses. It's uncertain whether the outcome would be different for a trust holding minority interests.

If your estate plan includes trusts that own real estate or other passive business interests, find out whether they might qualify as material participants or real estate professionals. If they don't, consider naming one or more active participants in these businesses as trustees. And be sure to document the trustees' involvement with these businesses to support your tax position. ✤

Estate Planning Red Flag

You've included employees in your will or trust

If you're an employer, you may think of your employees as family. But if you plan to provide for employees in your estate plan, watch out for unintended tax consequences.

Generally, money or other property received by gift or inheritance is excluded from the recipient's income for federal tax purposes. But there's an exception for gifts or bequests to employees: Under Internal Revenue Code Section 102(c), the exclusion doesn't apply to "any amount transferred by or for an employer to, or for the benefit of, an employee."

Certain gifts to employees aren't taxable, including "de minimis" fringe benefits, employee achievement awards and qualified disaster relief payments. Otherwise, the IRS generally views transfers to employees as "supplemental wages" subject to income and payroll taxes.

Despite Sec. 102(c), it may be possible to make a gift to an employee that avoids income taxes. According to the U.S. Supreme Court, such a gift must be made under a "detached and disinterested generosity" or "out of affection, respect, admiration, charity or like impulses." In contrast, if a gift is intended to reward an employee for past performance or serve as an incentive for future performance, it's considered compensation and is subject to income and payroll taxes. Unfortunately, the intent behind a gift can be difficult to prove.

Keep in mind that treating a gift or bequest as compensation isn't necessarily a bad thing. In some cases, the income and payroll taxes may be less severe than the gift, estate and generation-skipping transfer taxes that otherwise would apply. And you can always "gross up" the transferred amount to ensure that the recipient has enough cash to pay the taxes.

The Florida Revised Limited Liability Company Act

The use of limited liability companies ("LLC") in the United States has grown exponentially over the past three decades. This is because LLCs offer many favorable attributes, including limited personal liability, limited remedies available to creditors, and flexible management options. LLCs are often used in estate and asset protection planning because of the ability to tailor the LLC to protect assets both within and without the LLC while also providing the members with various options with regard to its operation.

LLCs came about in the late 1970s as a statutory creation. The idea was to bring about a business entity that combined the best attributes of corporations and partnerships. As such, LLC members had limited liability typical of shareholders in a corporation with the freedoms and benefits of general partnerships. In 1997, and after years of adverse rulings, the IRS ultimately allowed LLCs to opt for favorable partnership tax treatment, which is commonly known as pass-through taxation.

Fast forward to 2015 and we find that LLCs in Florida continue to evolve. Florida recently passed the Florida Revised Limited Liability Company Act ("the Act"). The Act replaces Florida's prior LLC law, and, as of January 1, 2015, applies to every Florida LLC whether it was formed under the revised Act or the former.

The new Act provides the default rules for LLCs. For this reason, it is crucial to have a well drafted operating agreement between the members and the company. If you are forming an LLC or have one that was formed under the prior Act, you should have the operating agreement reviewed to determine if it meets the needs and expectations of the company and members alike. If you do not have one at all, you should certainly speak to an attorney to discuss whether the default rules will have adverse consequences to the company and its members.

For example, Florida law provides that LLCs can be "member-managed" or "manager-managed," but an LLC is member-managed by default. The prior Act used the term "managing member," but the new law does not. Thus, any LLC predating the Act which currently uses the term "managing member" is deemed a member-managed LLC. So what, right? Well, the distinction may be important in an LLC where not all members are authorized to bind the LLC. In a member-managed LLC, every member has the apparent authority to bind the LLC. This is particularly important where the "manager" of the LLC does not own a membership interest.

Oftentimes the members want to restrict the admission of new members. The new law uses the term "transferable interest" rather than "interest" under the prior Act. The difference is important because giving someone a transferable interest confers only the right to distributions, but a membership interest carries with it voting rights, management rights (in a member-managed LLC) and any other rights provided to members under the company's operating agreement. Regardless, the operating agreement should set forth how the transfer of an interest occurs and how the transferee (the recipient) becomes a member.

LLCs also offer good protection in the event that an individual member of a multi-member LLC is sued and a judgment is obtained by a creditor. A creditor's sole remedy is to obtain a charging lien. This allows the creditor to attach only to distributions made from LLC, but it cannot take the interest. If distributions are not made, then the creditor generally gets nothing. Once again, this can be addressed in a carefully drafted operating agreement.

LLCs are great vehicles for the operation of businesses and ownership of assets. As previously stated, they are often integrated as part of a thorough estate and asset protection plan. Like most other things, however, good planning is integral to the proper implementation and operation of the LLC. Accordingly, speak to an attorney who is familiar with Florida's LLC Act to determine what suits your specific needs.