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WHEN WILL MODIFICATIONS OF A BY-PASS TRUST BE RESPECTED FOR BASIS STEP-UP

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[1] The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association. Although the author might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, the author has not been specifically engaged by a client to participate on this project.

EXECUTIVE SUMMARY

The Tax Cuts and Jobs Act ("Act"), increased the basic exclusion amount under IRC section 2010(c)(3) from 5 million to 10 million indexed for inflation after 2011. The Act is scheduled to sunset reducing the exclusion amount to 6 million in 2026. Hence, the exclusion amount is far greater than it ever was historically or was anticipated to be. Portability is also now available which no longer necessitates the use of a By-pass trust ("B trust") on the first death to utilize the first spouse's exclusion amount.

Due to the higher exemption amounts and portability, most clients no longer need a B trust to avoid estate tax on the second spouse's death. Assets in the B trust do not receive a step-up in basis on the second spouse's death. The B trust also increases administrative costs. Hence, practitioners often propose termination of the B trust, if it is anticipated that no estate tax will be due.

There are various methods used to terminate or modify a B trust, but which of these will be respected by the IRS. Presumably the terminated assets will be included in the surviving spouse's estate for estate tax purposes but is a step-up conditioned on the method of termination or modification?

A distribution agreement, executed by the trustee and all beneficiaries, is often used, to terminate and transfer assets to the surviving spouse. These agreements are also often used to modify trusts in settlements. But, California law arguably requires court approval to terminate an irrevocable trust. Since there will be inclusion in the surviving spouse's estate, and estate tax, if the surviving spouse's assets exceed the exclusion amount on death, is a step-up achieved? Because of this uncertainty, many practitioners terminate only with court approval. Other court modifications are also used to achieve a step-up, such as adding a general power of appointment to the B Trust by court order. Since a court order terminating or modifying a B Trust is binding under California law, a step-up should result.

Regardless of the method used, because of the uncertainty, it would be beneficial to have guidance to confirm any assets in the B Trust included in the surviving spouse's estate on death for estate tax purposes result in a step-up in basis. Specifically, which modification techniques achieve a step-up in basis on the assets previously held in the B trust on the surviving spouse's death and which, if any, of these methods do not achieve this result.

I. BACKGROUND

A. Portability

The ability to port the unified credit between married persons was originally enacted for only two years by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRUIRJCA"). It was effective January 1, 2011 and the provisions of TRUIRJCA were set to expire on December 31, 2012, until President Obama signed the American Taxpayer Relief Act of 2012 ("2012 Act") into law on January 2, 2013. The 2012 Act made portability a permanent option for married couples. When a decedent is survived by a spouse, assuming death on or after January 1, 2011, the amount of the unified credit available to that decedent's surviving spouse's estate for gift and estate tax purposes, includes any unused credit amount of the predeceased spouse, assuming a proper and timely portability election is made.

Upon an individual's death, the decedent's remaining lifetime exclusion amount is utilized to reduce that deceased person's taxable estate. The lifetime exclusion amount for gifts and transfers on death is adjusted each year for inflation. For 2019, the exclusion amount is $11,400,000. This means, for married couples, on or after January 1, 2011, any amount of the lifetime exclusion left unused on the death of the first spouse ("deceased spouse") can be transferred or ported to the surviving spouse. Accordingly, the surviving spouse is then left with the deceased spouse's unused exemption ("DSUE") in addition to his or her own lifetime exclusion amount.

The primary purpose of estate tax portability is to simplify the ability to use the first spouse's lifetime credit amount, including without the requirement of using trusts to hold the deceased spouse's remaining exclusion amount. Prior to portability, utilizing the deceased spouse's exclusion amount required drafting and administering a B Trust. Also, utilization of the exclusion amount was more complicated with transfers of certain assets, such as retirement benefits. Thus, the portability provisions alone, have reduced the need for many spouses to form and fund a B Trust on the first spouse's death, for estate tax purposes.

B. The Unified Credit Under The Tax Cuts and Jobs Act of 2017

Formally called "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," the Tax Cuts and Jobs Act ("Act") represents the most dramatic overhaul to the nation's tax law since the Tax Reform Act of 1986. In terms of estate and gift tax, the Act provides taxpayers the ability to increase gifts, during both life and for bequests on death without gift or estate tax, by doubling the exemption amount. Specifically, the new provisions under the Act increase the basic exclusion amount provided in Section 2010(c)(3) from $5 million to $10 million indexed for inflation occurring after 2011. The indexed amount for 2019 is $11.40 million. Under the Act, the transfer tax provisions relative to estate and gift tax are only effective for eight years (from January 1, 2018 to December 31, 2025), in the absence of congressional action.[2] After 2025, these new provisions sunset and beginning in 2026, the prior law returns. Even if a sunset occurs, the exclusion amount will return to 5 million, but when indexed will likely be 6 million. Thus, with lifetime exclusion amounts of somewhere between 6 million and 11 million or more, this alleviates the need for most spouse's to form a B trust to capture the deceased spouse's lifetime credit amount.

C. The Effect of Portability and the Increased Lifetime Exclusion Amounts

Fast forward to the last few years and dealing with these changes. Coupling the portability provisions with the larger lifetime exclusion amounts, has caused a paradigm shift in drafting as there is often no longer a need to draft estate plans with B Trusts. Today, there is much more of a focus on income tax planning and achieving a step-up in basis on both the first and second death. Prior to the enactment of portability, forming a B trust on the first spouse's was necessary or the first spouse's exclusion amount was lost forever. This trust also allowed the assets funded within such a trust, to grow estate tax free, to further minimize estate taxes on the surviving spouse's death.

Hence, many clients today, no longer need a B trust to avoid estate tax on the second death. And, having a B trust causes an increase in administrative fees and costs and time and energy to administer these trusts

[2] This was done to satisfy the "Byrd rule" so the Act would pass with merely a majority vote in the Senate (as opposed to the usually requisite 60 votes to close debate on the Senate floor). *See* Section 310 of the Congressional Budget Act of 1974 (P.L. 93-344, as amended)

properly on an annual basis. Plus, there will be no step-up in basis achieved on any appreciating assets held in the B Trust on the second spouse's death. So, many practitioners have proposed to many of their clients, who will likely never owe estate tax, that the B trust be terminated or modified. The benefits of termination and/or modification include reducing the time and expense of administering these trusts and the hope of receiving a step-up in basis in the surviving spouse's estate on any appreciating assets in the B Trust on the second death.

II. WHERE CALIFORNIA LAW ALLOWS TERMINATION AND/OR MODIFICATION BECAUSE FEDERAL LAW MUST RESPECT STATE LAW - A STEP UP IN BASIS SHOULD OCCUR ON ANY ASSETS ORIGINALLY IN THE B TRUST IF THEY ARE INCLUDED IN THE SURVIVING SPOUSE'S TAXABLE ESTATE ON THE SURVIVING SPOUSE'S DEATH

As discussed above, many practitioners are recommending to surviving spouse's that are beneficiaries of a B trust that this trust be modified or terminated to achieve a step-up in basis. The typical modification of the B Trust to achieve this result would be to add a general power of appointment so that the assets are then included in the surviving spouse's estate on his or her death. The other technique utilized is to simply terminate the B Trust and transfer these assets to the surviving spouse so that any assets in the B Trust are included in the surviving spouse estate on his or her death. Because under both of these techniques, the assets are included in the surviving spouse's estate then a step up in basis should be achieved under IRC Section 1014.

A. Basis Under Federal Law

Under I.R.C. §1014(a)(1), the basis of property received from a decedent's estate, if not sold, exchanged, or disposed of before the decedent's death, is the fair market value of the property at the time of the decedent's death. The following property shall be considered to have been acquired from or to have passed from the decedent: any property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent) (I.R.C. § 1014(b)(1)). For the purposes of determining what property is given a stepped-up basis, the test is generally whether the property was included in the gross estate of the decedent. The court in *Connecticut National Bank v. U.S.*, 937 F.2d 90, 93 (1991) held that the first decedent's estate (husband) was entitled to a step-up in basis for property acquired from the second

decedent's estate (wife) because the husband's estate never possessed real ownership in the martial trust property, the wife's estate did, and the husband only managed or held the marital trust on behalf of the beneficiaries. Because the beneficiaries and the surviving spouse agreed earlier to place the terminated "bypass trust" property/assets in the surviving spouse's estate, the property that the beneficiaries ultimately receive from the surviving spouse's estate met I.R.C. § 1014's criteria for a step up in basis.

B. Federal Law Looks to State Law

In *Commissioner v. Bosch's Estate*, 387 U.S. 456 (1976), the Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or federal agency in a federal estate tax controversy. The Court held that a federal court or agency must follow the state law announced by the highest court of the State and if there is no decision by the highest State court then the federal court or agency must apply what it finds to be the state law after giving "proper regard" to relevant rulings of other courts of the State. In this respect, the Court noted that the federal court or agency may be said to be, in effect, sitting as a state court.

In Rev. Rul. 73-142, a decedent created an irrevocable trust for his wife and children and retained the right to remove and replace the trustee. The trust language contained no limitation on appointing himself. A state trial court decree interpreted the removal power as being only exercisable once and not allowing the decedent to appoint himself. After the decree, the decedent removed the trustee and appointed another third party trustee. The Ruling notes that the decision appeared to be contrary to decisions of the highest court in the state. The Ruling cites Bosch and states that the Service is not bound by a state trial court property interest determination and that Bosch requires the state law as announced by the highest state court to be followed and if there is no decision of the highest court, the federal courts must apply what if finds the state law to be, after giving proper regard to decisions of other courts of the state. Notwithstanding the decision being apparently contrary to decisions of the highest state court, the Ruling notes that Bosch does not make a trial court decree that is inconsistent with a higher court ruling, to be void between the parties, and that if the parties time for appeal has expired then that the decree is conclusive as to the parties. The Ruling concludes that the rights and powers that would have caused estate tax inclusion were cut off prior to the decedent's death. The Ruling notes that unlike Bosch, the decree

in this case was handed down before the trustor's death, the event giving rise to the tax.

In Rev. Rul. 93-79, a trust did not qualify to own S corporation stock. As a result, the beneficiaries of the trust executed an agreement reforming the trust instrument's terms so that it was qualified to own S corporation stock and a state court issued an order ruling that the trust was retroactively reformed as of the date the S corporation election was filed. Citing numerous cases, the Ruling notes that retroactive changes of the legal effects of a transaction through judicial reformation of a document do not have retroactive effect for federal tax purposes. However, the Ruling notes that while not recognized retroactively, the trust reformation will be recognized prospectively.

Federal authority is not bound by intermediate state appellate court or state trial level court decisions where the state's highest court has not spoken on the point. The state's highest court is the best authority on its own law. If there is no decision by the state's highest court, then federal authorities must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State. *C.I.R. v. Bosch's Estate*, 387 U.S. 456, 465-466 (1967).

C. California Law

Both of these techniques, modification and termination, should result in a step-up in basis as long as state law is adhered to. There are several provisions under California law that allow for modification or termination of a B Trust after the death of one of the Trustor's. For example, Ca Probate Code Section 15402(a) can be used if all beneficiaries consent. The beneficiaries must also show that the reason for modifying the trust outweighs continuance of the trust terms. Courts routinely grant modifications or terminations of the B Trust under this provision as the petitioners argue that there is no estate tax reason to continue the trust, and the cost and expense of administering the B Trust will be eliminated upon termination, thus providing savings to the beneficiaries. They also argue that termination or modification will allow the assets in the B Trust to receive a step-up in basis on the surviving spouse's death which is beneficial to the remainder beneficiaries. Further, there can be significant income tax savings in a B Trust with a HEMS standard, providing only discretionary income. In this case the highest ordinary income tax rate will be reached, as well as the 3.8% NITT, on net income in the trust at $12,500.

If all of the beneficiaries do not consent, then Ca Probate Code Section 15404 can be utilized but this provision requires court approval to modify, including a trust termination. Additionally, Ca Probate Code Section 15409 allows modification of a trust for change of circumstances. This petition can be brought by a trustee or beneficiary. It is customary for courts to allow either modification to add an GPOA or to terminate, because circumstances have changed. Arguments for change of circumstances include those outlined above; reducing fees and costs, achieving a step-up in basis on the second death since there are longer estate tax considerations, and potential income tax savings.

The circumstances are slightly different when using beneficiary agreements under common law and not obtaining a court order. The general rule is that all parties in interest may terminate an irrevocable trust. *Helvering v. Helmholz*, 296 U.S. 93, 97 (1935). If all the beneficiaries of an irrevocable trust consent, and none of them is under an incapacity, they can compel the termination of the trust. *Rust v. Rust*, 176 F.2d 66, 67 (1949). Many courts have stated that whether there is only one beneficiary, or several, and they are all of one mind, and he or they are not under any disability, the specific performance of the trust may be arrested, and the trust may be modified or extinguished without court approval any by agreement among all of the beneficiaries. (*Eakle v. Ingram,* 142 Cal. 15, 16 (1904); *Fletcher v. Los Angeles Trust & Sav. Bank*, 182 Cal. 177, 179 (1920); *Bixby v. California*, 33 Cal.2d 495, 497 (1949); *Heifetz v. Bank of America Nat. Trust & Sav. Ass'n*, 147 Cal.App. 2d 776, 785 (1957)).

Under the above authority, California law clearly allows modification or terminations under a variety of circumstances. These include various methods under the Probate Code assuming the requirements of the specific statute are met: agreement by the beneficiaries without court approval or court approval of such modification or termination. Common law also supports a modification or termination by an agreement if signed by all beneficiaries.

Cases have held, an agreement to modify or terminate a trust will be respected by the federal courts. In *C.I.R. v. Bosch's Estate*, the Supreme Court ruled that federal courts look to the state's highest court in deciding issues related to state law. State trial court and appellate court decisions are accounted for, but are not controlling. *C.I.R. v. Bosch's Estate*, 387 U.S. 456, 465 (1967). And in fact, the California Supreme Court has spoken on and

approved of termination or modification of a trust by agreement. *Eakle v. Ingram* (142 Cal. 15, 16 (1904); *Fletcher v. Los Angeles Trust & Sav. Bank* (182 Cal. 177, 179 (1920); *Bixby v. California*, (33 Cal.2d 495, 497 (1949). Therefore, an agreement to modify or terminate a trust will be respected by federal courts. And if the particular trust modification is allowable under California law, and there are no decisions of California's highest court or rulings of any other State court construing the statute to prohibit a modification on similar facts, from the date of such modification, the trust modification should be respected. Thus, if the modification is accomplished by court order or under common law, then IRS should respect the modification or termination prospectively.

III. CONCLUSION

It is the author's belief that because a trust modification and/or termination is allowable under California law by obtaining a court order under the Probate code or utilizing an agreement under common law, and there are no decisions of California's highest court or rulings of any other State court construing the statute to prohibit a modification and/or termination on similar facts, from the date of such modification and/or termination prospectively, this should be respected. Thus, on the death of the surviving spouse, a step-up in basis should occur on any assets previously in the B Trust if treated as being held in the surviving spouse's estate foe estate tax inclusion purposes. Note however, once the B Trust is modified or terminated, the bell cannot be un-rung, and if estate tax is later determined to be due, the B Trust cannot miraculously spring back into life.