CURRENT FARM ESTATE PLANNING STRATEGIES:

Cultivating Multi-Generation Opportunities

A Non-Comprehensive Collection of Things to Think About While Planning, Structuring and Administering a Long Term Family Plan

Prepared For:

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CURRENT FARM ESTATE PLANNING STRATEGIES: Cultivating Multi-Generation Opportunities

A Non-Comprehensive Collection of Things to Think About While Planning, Constructing, and Administering a Long Term Family Plan

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I. INTRODUCTION

The purpose of this paper is to review some current farm estate planning features in a way that will be particularly useful to the active farmer and his or her advisers. There will be a focus on family farm businesses, federal and Illinois transfer tax, business succession, asset protection, trusts, trustees, and some practical administrative techniques.

"Estate planning" is not what it used to be. Breakthroughs in medical science, breakdowns in economic and social conditions, a growing litigiousness, and new principles of social justice have combined to dramatically skew our sense of the future. Surviving spouses are surviving longer. Adult children are finding themselves at financial risk long beyond the point of expected self-sufficiency. Fewer of the children's first marriages survive, and what constitutes a lawful marriage today and next year is different from what it was just a short time back. Fewer grandchildren are being born, and more children are being adopted – often by non-traditional households. One descendant may be wealthy, another incompetent; one may be a spendthrift, another sworn to public service, and who is to know one from the other when all are mere infants at the moment when the

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plan is prepared? These factors, and others, have come to confound familiar presumptions for the preservation, management, disposition and use of the family wealth.

Moreover, every man and woman engaged in farming is more than aware of the contractions within the agricultural industry; of the mind-numbing run-up in productive land values (with no relief from price volatility); and, most telling in the long run, the demographic reality that fewer active farmers are farming more and more of these high-priced acres, fewer family members are staying connected with the land, yet all family members want their "fair share" of the family wealth once the preceding generation leaves the scene.

Coupled with these concerns is a growing appetite for effective asset protection procedures that provide a reasonable degree of protection and predictable access if not control. Several states have enacted self-settled asset protection trust statutes (frequently referred to as "domestic asset protection trusts" or "DAPTs"). But these statutes vary upon their schemes and requirements, are not always user friendly in terms of cost and application, and the relative effectiveness of these new laws is largely untested. Will an Illinois creditor be barred by a Wyoming barrier? Maybe, but maybe not.

All told this economic and cultural turmoil is prompting a lot of new and not necessarily traditional estate planning thinking around the kitchen table, a process exacerbated in Illinois by dreadfully complicated – and inconsistent – federal and state gift and estate tax rules that have recalibrated the transfer tax calculus. As a result, each farm professional *cum* landlord now requires an even greater grasp of the rudiments of the estate and gift tax laws, the lawful techniques available to reduce the burden of transfer tax and other risks of loss, the non-tax issues relating to the disposition of assets and the protection of intended beneficiaries, and the legal structures best suited for current and future asset administration.

This is not a simple assignment. Estate planning is among the most complex fields of law, combining, as it does, so many different legal, tax, family, and other practical considerations. Popular misconceptions are rife, and technical errors seem almost unavoidable. The best any farm professional should expect is to stay currently informed of the general principles and trends in order to spot issues that may be of interest or impact. By staying generally informed, and having a sense of when to call in more specialized assistance where appropriate, the intellectually agile agrarian might

stand a chance at balancing these new planning challenges to his or her cumulative advantage.

The following materials have been prepared with this purpose in mind: to assist generally with general issues. This paper is not intended to be a comprehensive treatment of any of the selected topics that follow, and many important features have necessarily been capsulized or avoided altogether. Thus, while every effort has been made to assure the reasonable accuracy of the analysis and suggestions included in these materials, your author cannot assume responsibility for the contents beyond their use as a general teaching and reference guide. Any farm professional who is engaged in the estate planning process must independently verify the accuracy and applicability of the law to each particular circumstance, and satisfy himself or herself as to the federal and state tax consequences that may occur.

II. THE ESTATE PLANNING PROCESS

Estate planning begins with the certainty that our tenure in this world is limited, and that our loved ones, and our possessions, will still be here when we are gone. It is in the face of that certainty that we plan for the intelligent disposition of our property for the benefit of those we care most about, and to assure that our desires will be accomplished with a structural minimum of fuss, expense, and taxes.

The process begins by thinking, and gathering information. The usual considerations will include:

* Identifying assets (with special attention to how title to each asset is held), and estimating current and potential value
* Establishing beneficial objectives, by considering the needs and expectations of:
    * Spouses
    * Children (including children with special circumstances, such as disability, or who may or may not be interested in continuing to farm the family farm land)
    * Charities
    * Other valued persons, including dependent relatives, or perhaps an existing farm tenant
* Planning to minimize taxes, including:
    * estate and gift taxes ("transfer" taxes);
    * generation-skipping taxes; and,
    * income taxes,

  (and sometimes the transfer tax planning and income tax planning are in direct conflict)
* Planning to protect assets from current or potential claims of the beneficiaries' creditors, tax authorities, public aid, or estranged spouses in the event of the divorce
* Balancing the advantages or disadvantages of inter vivos (lifetime) gifts against testamentary (at death) dispositions
* Choosing appropriate business and estate planning vehicles for holding, transferring, and administering assets, including:
* Partnerships, including general partnerships, where all partners have equivalent control and responsibility, and limited partnerships, where different roles, responsibilities and liabilities are applied to the general and limited partners
* Corporations, including regular "C" corporations, which have a separate tax destiny, and "SubChapter S" corporations, which provide for the flow-through of significant tax events to their shareholders
* Limited Liability Companies, a hybrid business form that shares many features of both

corporate and partnership forms and which are increasingly popular

* Land trusts, an Illinois common-law creation now codified into statute that provides for the centralized ownership of land while facilitating convenient fractional transfers of interests
* Traditional trusts, including trusts created under a will (a "testamentary trust"); revocable trusts created during the owner's lifetime and becoming irrevocable at death (so-called "living trusts"); and, occasionally, irrevocable lifetime trusts that provide for the permanent transfer of property during the owner's lifetime
* Choosing a representative to carry out the owner's wishes when he or she is gone, or disabled, including all the criteria to be considered in choosing a family member, a corporate fiduciary, and/or an outside adviser like the farm manager
* Choosing a responsible adult to serve as guardian for minor children, or for a disabled adult

On the basis of this personal inventory and thinking the estate plan itself is then composed to provide for:

* Lifetime gifts, if any
* Post-death administration, including appointment of the executor, trustee, and/or guardian, and careful recitals of their respective duties, authorities and restrictions
* Payment and apportionment of debts, expenses and taxes
* Implementation of personal and tax objectives
* Distribution of the property; and/or
* The continued administration of the property through the trusts or other entities previously formed by or for the benefit of the decedent

The appropriate legal documents will then be prepared to give effect to these considered conclusions. Generally, these will include:

* A Will, necessary even when a living trust is selected as the primary estate planning

vehicle

* Frequently, one or more different trust arrangements
* Entity management plans, as required by the various entities, with supporting buy/sell agreements to facilitate economic continuity in the event that one or another key player is lost
* Title transfers for lifetime gifts, such as deeds, assignments or bills of sale
* Beneficiary designations for the owner's life insurance and retirement plans (as a matter of contract law, those benefits are not normally governed by the Will or living trust unless special provision is made for that purpose)
* One or more powers of attorney, for health care and for property, whereby the individual may appoint another to act in his or her name in the event of catastrophe, absence, or disability

In addition, there may be a separate marital agreement, to define certain interests in the event, say, of second marriages with children from a prior marriage, and maybe one or more contract arrangements for immediate transfers on death, such as joint tenancy, transfer-on-death ("T.O.D.") or payable-on-death ("P.O.D.") accounts.

The myriad of deferred benefit/retirement plans also require special attention, as in so many cases they represent the lion's share of some individuals' wealth.

There is, of course, no set combination of documents that will apply to all individuals. Instead, the legal instruments will be a function of what the individual chooses to do, and the correct application of the governing legal and tax principles.

That is the estate planner's art.

Estate plans should be considered or reviewed whenever a major milestone of life is reached, including:

* Adulthood
* Marriage, or divorce

* Birth of a child or grandchild
* Significant changes in wealth accumulation, or types of assets
* Changes in employment, or business ventures
* Advancing age, or retirement
* Significant changes in tax laws and laws regulating the administration of estates and trusts

In no other area of the law does sound, intelligent planning serve better to prevent unfortunate consequences -- and to reduce costs -- than in the area of estate planning. Absent a carefully considered estate plan the surviving family members will have to cope with the statutory scheme for the distribution of property, and almost certainly additional expense will be incurred to sort things out after the fact.

III. SELECT GIFT, ESTATE, AND GENERATION SKIPPING TRANSFER TAX CONSIDERATIONS

No complex estate planning strategies can be discussed without reference to the federal and state transfer tax context:

A. The Unified Transfer Tax System

Since 1977, the federal gift and estate tax systems[2] have been combined to reduce the differences between life time transfers and the transfer of property at death. This approach was disrupted in 2010 as the final phases of the 2001[3] tax act took effect (in anticipation of sunsetting the

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[2] Internal Revenue Code Chapters 12 (Sections 2501 to 2524) and 11 (Sections 2001 to 2210), respectively.

[3] The "Economic Growth and Tax Relief Reconciliation Act" of 2001 ("EGTRRA")

transfer tax *in toto* on December 31, 2010), but then were restored at almost the last minute by the *2010* tax act[4]. These 2010 extensions were in turn extended and reformed by the American Taxpayer Relief Act of 2012, or "ATRA 2012".

Here is the general framework:

1. All taxable lifetime gifts (gifts other than to spouses, charities, or in excess of annual gift tax exclusions) <u>and</u> any assets remaining in the individual's estate at death, are aggregated and subjected to the unified tax rate schedule with a single unified "applicable credit amount"
2. The unified credit is a *credit* against the calculated tax due, *not* a deduction to compute the amount subject to tax.
   * All or part of the tax credit is first applied to offset gift tax on lifetime transfers; what's left applies against estate tax due on transfers at death
   * Effect of the unified system is to pile the value of each current set of gifts onto the value of all prior taxable transfers made at any time Credit is then allowed against the total tax due according to the amount of unified tax credit available during the most recent year of transfer (or death) in order to calculate the tax that must be paid on that most recent transfer
   * Makes the estate tax computation at death fully derivative from all prior gift tax computations.
3. The amount of unified credit thus defines "the applicable exclusion amount", or the value that can pass free from federal transfer tax

The ATRA 2012 tax law updated this framework with new realities that appear to be here for a while:

1. The "applicable exclusion amount" now has two parts:
   * the "basic exclusion amount", which started at $ 5,000,000, but is adjusted for

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[4] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010").

inflation and for 2014 is $ 5,340,000[5]; and,

* in the case of surviving spouse, the new, portable, “deceased spousal unused exclusion amount”[6]

2. For 2014, the unified credit is $2,081,800, producing a base exclusion amount of $ 5,340,000.00.
3. The Chapter 13 generation-skipping transfer tax exemption amount is also indexed for inflation, and for 2014 is also $5,340,000. This reflects an attempt to coordinate GST planning and estate tax planning and compliance, but as we will see it doesn’t always work out that way
4. The estate, gift and GST tax rate is now a uniform 40% [7]

The essential if often-overlooked tax purpose and regimen remains unchanged: Much like our Illinois retail sales tax system, which taxes sales, our federal estate tax system taxes *transfers* of property, not its use. Once the transferred property has been subjected to this gift/estate tax equation it will not be subject to transfer tax again unless or until:

* It has vested (or deemed to have vested, as with a general power of appointment[8]) in another owner; and,
* That new owner transfers the property to or for the benefit of someone else.
* *Until both events occur* the property is "sheltered" by the tax payments/tax credits of the last-taxed transferor
* This ability to "shelter" property, by making it available (outright, or in trust) for the tax

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[5] Code Section 2010(c)(2) and (3)

[6] Code Section 2010(c)(2) and (4)

[7] Code Section 2001. Up from the 2010 compromise of 35%.

[8] Code Sections 2041 and 2514

free use by others, defines the theory and practice of "credit shelter" – critical for crafting tax efficient estate plan.

1. The Unlimited Marital Deduction

Since 1981, the federal transfer tax law treats husbands and wives as one economic unit.[9]

* This represents a key Congressional policy decision that no transfer tax need be imposed upon gifts or bequests between spouses
* Thus, the first spouse may leave an unlimited amount to the surviving spouse, and so long as technical requirements for the marital deduction are observed there will be no tax assessed at first spouse's death.
* However, marital property not consumed during the survivor's lifetime will be subject to the tax calculus upon the second spouse's death.

This makes the term "deduction" something of a misnomer; rather, it best considered a marital"deferral" of tax until both members of the marital team are gone. This contrasts with the unified credit/applicable exclusion amount that represents a pure reduction of the combined tax burden.

The marital deduction applies to outright transfers, including joint tenancies, POD/TOD, also gifts in qualifying trusts, including estate trusts and general power of appointment trusts under Code Section 2056(b)(5).

2. Qualified Terminable Interest Property Trusts

Unquestionably the most versatile marital deduction option is the always popular/increasingly essential (see the Illinois estate tax discussion below) qualified terminable interest property ("QTIP") marital deduction trust[10]. Available since January, 1982, QTIP is the result of determined lawyers manipulating Section 2056 in order to benefit from the marital deduction while preserving ultimate dispositive control in the first deceased spouse's.

* Before QTIP, property in which the surviving spouse received a life interest, with

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[9] Code Section 2056 and 2523

[10] Code Sections 2056(b)(7) (for estate tax) and 2523(f) (for gift tax)

remainder in others, would qualify for the marital deduction only if the surviving spouse had the sole, unrestricted general power to appoint the property either to herself or her estate[11]

* *With* QTIP, all that is now required to secure the marital deduction for the estate of the first spouse to die is:
    * The trust property must have passed from the decedent/donor spouse
    * The surviving spouse must:
        * be a U.S. citizen;
        * receive all of the income from the property at least annually; and,
        * no person may have the power to appoint any of the trust property to anyone other than the surviving spouse during his or her lifetime; and
* An election to qualify *any part or all* of the transfer must be made on a timely filed gift or estate tax return[12]

Subject to these requirements the remainder of the QTIP trust can fall in according to the prescriptions of the first to die.

Two features make QTIP trusts immensely flexible:

* First, the election to treat the trust as marital deduction property is *optional*. While other marital deduction plans automatically pass as part of the marital deduction (and risk over-funding), a QTIP qualifying trust can be used to fund the credit sheltered "family trust" so long as and to the extent that the QTIP election is not made.
* Second, the election may apply to only a part of the trust, meaning the decedent's executor or personal representative's proper formula election can "zero out" the taxable estate by electing only so much marital deduction as is actually needed and leave the

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[11] Code Sections 2056(b)(5)(b)(5); Treas. Reg. 20.2056(b)-5.

[12] Treasury Reg. 20.2056(b)-7(b)(2).

balance to be sheltered by the unified credit then available[13]

In addition:

- * QTIPS provide an important adjustment mechanism for Illinois estates in excess of $4,000,000
- * A "reverse" QTIP election is available to avoid GST problems with prior marital deductions, which is not available for other marital deduction methods[14]

In thus making only a partial election on the appropriate gift or estate tax return, the marital deduction and credit shelter portions can be calculated to a statistical certainty. This approach has the charm of simplicity and is attractive in those situations where the family is determined that the surviving spouse should have the benefit of all of the family wealth until the death of the survivor before any descendants step up to take an interest.

3. Portability: The Deceased Spousal Unused Exclusion Amount

The Tax Reform Act of 2010 introduced estate tax portability between spouses, and ATRA 2012 revised and cemented it into our thinking.

- * Portability was created as a relief provision for married taxpayers who did not have the foresight to establish marital deduction/credit shelter estate plans before the death of the first to die
- * Code Section 2010(c) allows a surviving spouse to take and employ the unused exclusion amount of a predeceased spouse who died after December 31, 2010.
- * Redefines the estate tax exclusion (*not* the marital deduction) for surviving spouses. The applicable exclusion amount for the surviving spouse is now defined as:
  - * That spouse's own "basic exclusion amount"
  - * PLUS, the *last* deceased spouse's unused exclusion amount, (the

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[13] Treasury Reg. 20.2056(b)-7(b)(2). Any partial election must be on a fractional basis, which "may be defined by formula". The resulting division of the trust must also be on fractional basis, but "the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust."20.2056(b)-7(b)(2)(ii)

[14] Code Section 2652(a)(3)

"DSUEA"[15]

* PLUS, the unused exclusion amount of *any other* deceased spouse to the extent the surviving spouse applied that exclusion amount to one or more taxable gifts

* The predeceased spouse's exclusion is available to the survivor for both gift and estate tax purposes, BUT:
    * Portability is not available for Chapter 13 GST calculations; if GST exemption of first spouse is not allocated, it is lost
    * Portability is only a *federal* tax concept. There is no portability of the Illinois estate tax exemption
* For multiple marrieds, the DSUEA can only be absorbed from the "last predeceased spouse"; in other words, the DSUE amount of multiple predeceased spouses cannot be aggregated, nor can the survivor choose the DSUEA of the richest predeceased spouse
    * If the widow/widower remarries and dies before his/her second spouse, the second spouse cannot use any of the widow/widower's unused exclusion amount attributable to his/her first spouse to die
    * Does this become a question of family law? Should a widowed client not remarry if the "new" spouse has a lower DSUEA than the previous (now deceased) spouse?
* A timely filed federal estate tax return is required to preserve the DSUEA
    * The first spouse's executor must timely file the federal tax return
    * Requires an affirmative election, even if no return would otherwise be due
    * That return may also be needed to preserve first spouse's GST exemption for

[15] Temporary Treasury Reg. 20.2010-1T attempts to define the DSUE amount as the lesser of "(i) the basic exclusion amount in effect in the year of the death of the decedent; or (ii) the excess of (A) the decedent's applicable exclusion amount; over (B) the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1)." Several subsequent treasury notices indicate that they are still struggling with this definition.

which portability does not apply

* For Illinois marrieds whose *combined* wealth exceeds $ 4,000,000, this provides no relief. Traditional credit shelter trust planning will still be required

On balance, portability creates an important post-mortem relief opportunity, but hardly a panacea, and in some respects just complicates things.

4. The Annual Gift Tax Exclusion

Code Section 2503(b) allows every individual to make tax free gifts of present interests in property up to but not exceeding $14,000 per year to as many people as he or she wishes.[16] Husbands and wives may join to give $28,000 to a single individual so long as they both file and sign the proper elective gift tax return. A validly completed gift, even one made within three years prior to death, will generally not be included in the donor's gross estate for federal estate tax purposes.

The annual exclusion amount is not considered part of the lifetime applicable exclusion amounts discussed above; it is an *extra* allowance which, when carefully considered, can provide immense opportunity for strategic lifetime wealth transfers for those who are prepared (financially and psychologically) to live without some of their accumulated assets:

> **Consider a farm family consisting of: husband and wife, who own land, equipment, cash, securities and retirement funds totaling $15,000,000; three children, all of whom are happily married, and one of whom plans to take over the farm operation; and six grandchildren, two to each child. The parents may make annual exclusion gifts of $28,000 to each child, each child's spouse, and each grandchild, meaning that $336,000 can be passed to the next generation(s) each year, all without using any of either parent's unified credit/applicable exclusion amount. The gifts may consist of cash, equipment, land, or any combination that is consistent with their overall dispositive plan.**

Planning for lifetime exclusion gifts is a highly developed field. Frequent strategies include:

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[16] Since 1997, the annual exclusion amount -- then $10,000, but now $14,000 -- is adjusted for inflation. The base for adjustment is the Consumer Price Index for 1997, and the adjustments are limited to $1,000 multiples. Note that Code Section 2503(c) also provides that direct payments for tuition or medical care are also excluded; however, this provision is narrowly construed, and gifts into a trust that would later make such payments do not qualify for the exclusion.

* Outright gifts of cash or valuable property, with no restrictions -- usually suitable for adults or mature minors
* Outright gifts to minors, where the minor's actual benefit and/or control is deferred until reaching the age of 21. (Special rules for these minors' gifts can be found under Code Section 2503(c) and the Illinois Uniform Transfers to Minors Act)
* Present gifts to irrevocable trusts, including irrevocable life insurance trusts ("ILITS") and so-called "Crummey" trusts

Aggressive lifetime planning can be of immense benefit to families with significant farm holdings, and when carefully prepared such plans can work like a charm. But, like so-many innovative tax strategies, there is more to the process than first meets the eye: Many different tax preference rules can collide in the process, often with unexpected and highly unfortunate results. For example, while the annual exclusion amount is also available to shelter some generation skipping gifts, the GST treatment is *far more restricted* than the Section 2503(b) gift tax exclusion.[17]

a. Lifetime Transfers and Tax Exclusive Gifts

For those who can afford it, the lifetime transfer of property is the most efficient use of the unified credit/applicable exclusion amount (and the generation skipping transfer tax exemption, discussed later) because:

* the post-transfer appreciation in value attributable to the gifted property will grow tax-free outside the donor's estate; and,
* if any gift tax (or GST tax) is payable (that is, if the gift exceeds the applicable

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[17] Gift tax excludible gifts into trust will not qualify for this GST exclusion unless: (i) during the beneficiary's life no portion of the trust corpus may pass to anyone other than the beneficiary; *and,* (ii) if the trust does not terminate until the beneficiary's death the trust corpus must be includible in the beneficiary's Chapter 11 taxable estate. Code Section 2642(c)(1); Treas. Reg. 26.2642-1(c)(3). To shelter most gifts in trust a portion of the grantor's GST exemption will need be allocated on a timely filed gift tax return. Failure to do so can result in the entire trust having an inclusion ratio of zero upon termination/distribution, producing a massive GST tax due. FOR PRACTICAL PURPOSES, PLEASE NOTE: The 2642(c) exception will never apply to a gift to a trust that is not a "Skip Person", *i.e.*, a trust where all current and potential beneficiaries are deemed to be at least two generations younger than the transferor. This is a frequent source of practitioner confusion and error.

exclusion amount, or the GST exemption amount, one or both) the tax paid is also removed from the donor's estate on a *tax exclusive basis*.

A "tax exclusive" gift is a gift where the tax is paid by the donor/transferor only on the amount actually received by the donee, and the tax paid is not considered part of the taxable transfer.

* Gift taxes paid under Section 2501, and GST taxes payable on certain direct skips, are tax exclusive.
* Estate taxes, however, and most GST taxes payable other than on select direct skips, are "tax inclusive", meaning that the money needed to pay the estate tax on the legacy is necessarily includible in the tax base, causing substantially more tax to fall due.[18]

Assume Parent A has used all of her annual exclusion gifts and unified credit/applicable exclusion amount, and the 40% federal transfer tax rate applies. Assume further that A chooses to make an inter vivos gift of $500,000 to her son, S. The gift tax will be calculated only upon the $500,000 gift. A will pay the tax of $200,000 and S will receive the entire $500,000 gift. The total cost to A is $700,000.

Assume the same facts as above, except Parent A leaves S $500,000 as a specific (unsheltered)bequest under her will. As a tax inclusive transfer, A's personal representative will be responsible for paying the tax out of taxable estate assets. To fund the specific bequest, the Estate will need $833,333 in cash to: (i) fund the gift with $500,000 of principal; plus, (ii) $333,333 total estate tax due on the testamentary gift.

Experience shows that only the most far sighted or most affluent of clients will be inclined to

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18 As a "tax inclusive" testamentary gift, the money needed to pay the estate tax on the legacy is necessarily includible in the tax base. This requires an interdependent computation between the value of the legacy and the value of the total tax payments needed to pay tax on the tax on the tax (etc.) on the legacy, based upon the applicable transfer tax rate. For planning purposes the following formula can be used: Gift value, divided by the product of (1 - the estate tax rate). For example, a $500,000 legacy at the top estate tax rate can be roughly calculated as $500,000 ÷ [1 - .40 = .60], or $833,333; $500,000 of gift and $333,333 of tax. A similar calculation can be used for the tax inclusive GST events.

Because of this steep advantage, the *gift causa mortis* rules will require that A's estate recapture the gift tax paid (but not the gift) on any taxable transfers occurring within the three year period prior to death. *See,* Code Section 2035(c). This also affects the Illinois estate tax calculation.

make substantial taxable lifetime gifts, and thereby take advantage of the commensurate tax savings. However, there is a growing awareness of the benefits of such transfers, and a corresponding growth in the sophistication of lifetime transfer techniques.[19]

b. *Crummey* Trusts

The planning for deferred benefit gifts is complicated by the Code requirement that only present interest gifts qualify for the Section 2503(b) annual exclusion; future interest gifts, those that by their express terms cannot be taken and consumed by the donee immediately, are fully taxable gifts that necessarily use some of the available unified credit. Parents and grandparents often want to use their annual exclusion rights to pass funds to minor children, but prefer that control or benefit be deferred until maturity.

Among the ways devised to get around the present interest restriction is to give the beneficiary -- either an adult, or a minor acting through his parent or guardian -- a right of withdrawal limited by a relatively short period of time. When the withdrawal right lapses, only that portion of the funding in excess of $5,000 (or 5% of the value of the gift, whichever is larger) is treated as a taxable gift by the beneficiary to the trust remainderman. When the gift is in excess of $5,000, as many are, the withdrawal right for the excess may be crafted so as to be suspended, or "hang" until future years when its lapse will fall under the “5 and 5" shelter.[20]

These arrangements are frequently referred to as "Crummey" trusts[21], and are now widely employed for a host of estate planning purposes. They are especially popular for irrevocable life insurance trusts, where the present annual exclusion gifts can combine with the later policy payouts to leverage immense wealth transfer at significant estate tax and GST tax savings. For farm families

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[19] In addition to sanguine tax planning, inter vivos transfers have an inherent asset protection component as well: valid gifts that do not run afoul of the fraudulent transfer rules are perfectly effective for removing assets beyond the reach of prospective creditors.

[20] The difference between the $14,000 annual exclusion amount under Code Section 2503(b), and the $5,000 non-taxable lapse shelter afforded by the general power of appointment rules under Code Sections 2514 and 2041, is highly technical but of immense practical importance, especially when planning for multi-generational gifts. Proposals to increase the power of appointment limit to equal the gift tax exclusion amount -- which would have simplified a lot of estate planning -- died in the ATRA 2012 negotiations.

[21] Named after the famous tax court case, *Crummey v. Commissioner*, 397 F 2d. 82, 68-2 USTC ¶12, 541, 22 AFTR 2d 6023 (CA-9, 1968).

with substantial land, and minimal interest in life insurance, some practitioners (including your author) favor funding similarly structured irrevocable trusts with cash or other property -- or *fractional pieces* of property, such as LLC or partnership or land trust interests.

The *Crummey* case, of course, stands for the proposition that the present interest gift tax requirement of Code Section 2503(b) is fully satisfied with an actual, if brief, "unrestricted right to the immediate use, possession, or enjoyment of property" transferred in trust. Treas. Reg. 25.2503-3(a) and (b). That that right may promptly lapse by its terms, and by design, is the whole point of the *Crummey* case and its progeny, and the technique is now well refined:

* Some valuable property -- frequently cash, but not always -- is transferred by a donor to the trustee of an irrevocable inter vivos trust.
* That trust agreement will provide that some beneficiary (or beneficiar<u>ies</u>) shall have the immediate and unrestricted right to withdraw some or all of the property from the trust, but only for a limited period of time -- usually, 30 days.[22]
* When the stated withdrawal period ends, or lapses, it then falls to the Trustee to administer that property according to the terms of trust.

The specific provisions can vary widely, reflecting each donor's purpose, circumstances, and imagination, but generally the trust will provide for deferring the beneficiary's ultimate benefit until some future event, such as the beneficiary's majority, or the death of the insured(s). For farm planning, the trust provisions will frequently include detailed management provisions, including restraints on the sale of land, and perhaps preferred farm tenancy rights for the descendant who intends to continue farming the land – all much like the farm operating provisions discussed later.

Usually these transfers will involve taking maximum use of the donor's annual exclusion potential, as a means of transferring value in a manner wholly insulated from the donors' own ultimate

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[22] How long that period for withdrawal should be is the subject of some debate. Interestingly, in the Crummey case itself, no notice was given at all. Since Crummey, the Internal Revenue Service has acquiesced to many of the key components of this stratagem but insists that the donee must receive some reasonable notice if the withdrawal right is not to be deemed illusory. Rev. Rul. 81-7, 1981-1 C.B. 474; Rev. Rul. 83-108, 1983-2 C.B. 167. Notice need not be in writing (although proof of notice, and receipt, is a good idea), and there is no stock "reasonable" time, although allowing less than 15 days is asking for it. *See, Cristofani v. Commissioner,* 97 T.C. 74.

gift or estate tax equation. However, in light of the advantages of shifting potential appreciation to the next generation(s) as early as possible, there is significant incentive to fund these trusts with more than just the annual exclusion amounts. Properly structured these *Crummey* trust arrangements can work like a charm, but great care is required to consider and provide for the confluence of conflicting tax rules. For example:

* **The annual gift tax exclusion under Code Section 2503(b).** So long as the transfer qualifies as a present interest, any number of benefactors may contribute up to $14,000 annually, on behalf of each withdrawal right holder, without gift tax treatment. Typically, an affluent husband and wife will want to place their combined maximum of $28,000 for each intended beneficiary.

* **The annual GST non-taxable transfer exclusion under Code Section 2642(c).** The GST annual exemption rule is much more narrow than the Section 2503(b) exclusion, meaning that plans for the benefit of children can be much more flexible than plans involving grandchildren as current <u>or</u> future interest takers.

  It is not uncommon to create a Crummey-style trust that uses little or none of the donors' applicable exclusion amount yet requires a significant part of the donors' GST exemption. An unexpected consequence of those GST allocations is to "decouple" the transferor's *estate tax* applicable exclusion amount from his/her remaining GST exemption amount.

* **The "5 and 5" general power of appointment exclusion.** A Crummey withdrawal right is nothing more or less than a general power of appointment over the contributed property. Code Section 2042(b) provides that the lapse of a general power shall be treated as a taxable release of the power. Taxability is avoided only when the lapsing power is limited to the right to withdraw no more than the greater of $5,000 and 5% of the corpus annually.

The divergence in benefit and impact, in each case, requires the most careful study of the client's tax equation and donative purposes. Like every estate planning project the best approach will depend upon each client's priorities and circumstances. There is no stock answer or formula around this conundrum. However, your author has frequently used irrevocable trusts that mirror the precise administrative provisions of the farm owners' own dispositive trusts -- with the ultimate intention that the two sets of trusts will one day merge -- for the purpose of assuring funding to discharge transfer tax while keeping coveted family land under family control.

B. The Federal Generation Skipping Transfer Tax

Recall that the basic gift/estate tax scheme taxes the *transfer* of property but not its use. Once launched and taxed, property had traditionally been left free from further tax until it vested and was transferred again. Mere termination of each intervening limited interest was effectively ignored.

In an ideal situation, where the opportunity exists to counsel multiple generations of the same family, we could do our clients proud by providing that each maturing generation devise all property into trust with limited powers to invade and appoint. By avoiding vesting (and subsequent taxable transfers) we could provide for virtually unfettered access, dominion and direction over the trust property -- asset protected and transfer tax free -- for generations, limited only by the rule against perpetuities.

Alas, Congress has effectively limited this discretion with the generation skipping transfer tax provisions of Chapter 13 of the Internal Revenue Code (Code Sections 2601 - 2663.)

* Since 1986 Congress has concluded that these suspended untaxed transfers were unfair, and that s*ome* tax should be imposed on the property at least once per generation
* Chapter 13 GST theory is deceivingly simple:

> ***Except as exempted*, property not subject to either gift or estate tax in each successive generation must face its own, separate GST tax at top estate tax rate**

Of course the GST tax is much more complicated in practice. It builds on the existing gift and estate tax system, but adds new and confusing concepts:

* "Generation-skipping transfer", defined as:
    * a transfer of property
    * that is subject to either gift or estate tax at the time of transfer
    * to or for the benefit of someone who is (or is deemed to be) two or more generations younger than the person charged with the tax; and,
    * without a second gift or estate tax being assessed on the property along the way

* Can be a “direct skip”, a “taxable distribution” or a “taxable termination”[23]

In GST jargon the donor of that property is called the "Transferor", a technical term that applies to:

* the person charged with transmitting the property, directly or indirectly,
* in a way that will (or might) avoid estate tax in the next generation.

This generally will include:

* the owner of the property (whether as decedent or inter vivos donor);
* the surviving spouse beneficiary of a marital deduction trust taxable in the surviving spouse's estate; or,
* the holder of a taxable general power of appointment over the property.

All GST analysis returns, eventually, to the question: "Who is – or who will be – the Transferor?" The answer will almost always be found by focusing on where the gift and estate tax burden last fell, or will next fall.

The GST tax exemption is the key to GST planning:

* Integral to all GST planning is the individual exemption from the GST tax allowed by Code Section 2631(a)
* For 2014 that exemption is equal to $5,340,000[24] worth of combined generation

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[23] More GST definitions include a tax scheme imposed at a flat **"applicable rate"** to the **"taxable amount"** of the generation-skipping transfer; the applicable rate is the maximum federal estate tax rate (now, 40%) unless some part of the transferor's **"GST exemption"** is involved, in which case an **"inclusion ratio"** is calculated to dilute the tax rate percentage.

In addition to the “Transferor”, other key players include: a “skip person” [which is either a natural person or a trust; Code Section 2613(a)(1); Treas. Reg. 26.2612-1(d)], and a “non-skip person” [defined by default as anyone/thing who is not a Skip Person. Code Section 2613(b)].

[24] **Section 2631. GST exemption.**

(a) General rule
For purposes of determining the inclusion ratio, every individual shall be allowed a GST exemption amount which may be allocated by such individual (or his executor) to any property with respect to which such individual is the transferor.

(b) Allocations irrevocable
Any allocation under subsection (a), once made, shall be irrevocable.

(c) GST exemption amount

skipping transfers made at any time during the Transferor's lifetime or at death

- * The exemption may be allocated to any property with respect to which any individual is the "Transferor"
- * Once allocated, exemption value is elastic, matching all increases or decreases in the trust value, in much the same fashion as a single generation credit shelter trust
- * A wholly exempt trust (one with an "inclusion ratio" of zero)[25] will never be exposed to GST tax, no matter how large it grows before termination/distribution
- * Exemption is indefinite so long as the trust property maintains its tax nexus with the original Transferor. General principle is same as the "credit shelter" trust; however –
- * If exempt trust property is somehow taxed to a beneficiary under Chapter 11 or 12 (as will occur with a general power of appointment), that just-taxed beneficiary will step into the box as the new Transferor and the prior exemption will vanish. That is <u>not</u> a good thing.

The GST tax regime is comprehensive, complicated, and riddled with hazards. Unintended GST events can result from any number of traditional estate planning techniques, triggering hefty unexpected tax. Any attorney preparing a multi-generation trust has no choice but to grasp the law's fundamentals or refer the project to someone who does.

C. The Illinois Transfer Tax System

> For purposes of subsection (a), the GST exemption amount for any calendar year shall be equal to the basic exclusion amount under section 2010(c) for such calendar year.

As part of the 2012 "American Taxpayer Relief Act" (Pub.L. 112-240), subparagraph (c) was amended to tie the GST exemption amount to the "basic exclusion amount" (formerly, the "applicable exclusion amount") used for determining the unified gift and estate tax credit for any given year. Section 2010(c) is indexed for inflation, as now is the GST exemption amount: for 2014, the basic exclusion amount/GST exemption amount is $ 5,340,000.00. This has helped uncomplicate things a bit.

[25] The "Applicable Rate", the "Inclusion Ratio", and the "Applicable Fraction" are all defined by the amount of allocated GST exemption. An Inclusion Ratio of "0" means a tax rate of "0" on all subsequent Taxable Terminations and Taxable Distributions regardless of the property value distributed. Thus, when the value of property passing in trust exceeds the amount of available exemption, it is best to plan for two trusts -- one with an Inclusion Ratio of "0", the other with an Inclusion Ratio of "1" -- than to have a single trust with an Inclusion Ratio somewhere in between.

Effective January 1, 2011, Illinois re-instated its estate tax[26]

* Allows maximum state death tax "exclusion amount of only . . . $4,000,000"[27] In many estates, the Illinois estate tax will be greater than the federal estate tax
* Applies to every Illinois citizen, and to non-citizens who own "property" – in most cases, *real* property – situated in Illinois[28]
* Substantially similar to the 2009 law; creates havoc with a lot of existing A-B/credit shelter estate plans: An existing credit-shelter-lead formula trust, geared to shelter the maximum federal basic exemption amount of $5,340,000.00, with sprinkle family benefits, will trigger Illinois tax of $382,857.00[29]

However, Illinois also restored its own version of the QTIP rule from 2009 as well (35 ILCS 405/2(b-1):

> **(b-1) The person required to file the Illinois return may elect on a timely filed Illinois return a marital deduction for qualified terminable interest property under Section 2056(b)(7) of the Internal Revenue Code for purposes of the Illinois estate tax that is separate and independent of any qualified terminable interest property election for federal estate tax purposes. For purposes of the Illinois estate tax, the inclusion of property in the gross estate of a surviving spouse is the same as under Section 2044 of the Internal Revenue Code. In the case of any trust for which a State or federal qualified terminable interest property election is made, the trustee may not retain non-income producing assets for more than a reasonable amount of time without the consent of the surviving spouse.**

* Effect is to lead away from two-trust plans to *three*-trust plans:

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[26] Illinois Public Act 096-1496, the "Taxpayer Accountability and Budget Stabilization Act", amending the Illinois Estate and Generation Skipping Transfer Tax Act [35 ILCS 405/1 - 18].

[27] 35 ILCS 405/2(b). Was $2,000,000; increased to $4,000,000.00 for persons dying after January 1, 2013. No further increases are scheduled under existing law.

[28] 35 ILCS 405/3(a)

[29] The tax calculation depends on an interrelated formula that the Attorney General has simplified with its on-line calculator. For that tool and other important compliance information regarding the Illinois Form 700 go to www.illinoisattorneygeneral.gov/publications/calculator

a. Trust No. 1: The first $ 4,000,000

* May be *either* traditional family/sprinkle trust or non-elected marital QTIP
* Trust is credit sheltered for both federal and Illinois.
* GST exempt; limited powers of appointment appropriate

b. Trust No. 2: The next $ 1,340,000[30]

* QTIP qualified
* No election for federal, but elected for Illinois.
* Trust is credit sheltered for federal; marital deduction for Illinois
* GST exempt; limited powers of appointment appropriate

c. Trust No. 3: The balance

* QTIP qualified
* Elected for both federal and Illinois
* Marital deduction for both federal and Illinois
* GST non-exempt; limited *and general* testamentary powers of appointment appropriate

* In those instances where portability is elected without QTIP treatment, there may be need for a *fourth* Illinois trust for the unprotected DSUEA excess

Note that Illinois does not have a gift tax.

* Distinguishes Illinois planning from federal planning, and in some cases encourages inter vivos gifts.
    * However, lifetime gifts are included when calculation the limitation on the tax computed under the tax tables.

[30] Since this excess amount is inflation indexed, and therefore indeterminable at the outset, Trust No. 2 *must* be defined by formula, either in the governing instrument or by partial election on the estate tax return(s)

* Inter vivos gifts will reduce but not eliminate the Illinois estate tax[31]

Administratively the Illinois estate tax is tied to the federal estate tax law unless otherwise stated.

* Illinois Form 700 requires preparation of a complete 706
* Due dates and extensions of time are the same as the federal return
* Illinois recognizes federal Section 2032A special use valuation

The application of the tax varies necessarily between Illinois residents and non-residents:

* For Illinois residents, all transferred property has an Illinois situs, except real or tangible personal property physically situated in another state
* For *non-residents*, only real estate and tangible personal property physically situated in Illinois have an Illinois situs[32]

For non-residents, converting Illinois real estate into non-tangible personal property situated in a more transfer tax friendly jurisdiction can make a lot of sense.

* Illinois law treats interests in Illinois land trusts as personal property, but not all states share this view
* Properly structured partnerships, LLCs or corporations can do the trick, but be careful with single member LLCs

In considering older instruments you will find a lot of formula allocations that will be difficult to interpret, referring to the "state death tax credit" that no longer has any significance for federal estate tax purposes but which has great significance for Illinois estate tax purposes. Moreover, some of these instruments will require credit shelter transfers (in trust or outright) that are funded at the maximum federal exclusion amount, which do not qualify for QTIP treatment, and in application do not provide the desired degree of support for the surviving spouse. These will require some post-mortem reform, such as reformation or disclaimer.

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[31] Lifetime gifts can help, but unlike transfers at death lifetime gifts do not get a step up in basis, so income tax planning joins the matrix

[32] 35 ILCS 405/13(C)

D. Valuation Principles and Discount Theory

If estate planning is largely dependent upon transfer tax analysis, that analysis in turn is absolutely dependent upon a sound appreciation of how the taxable values are calculated and reported. This is especially important for small businesses and farm operations where transferring the business intact can require the very closest shaving of the calculator's pencil.

In general, if a gift is made of property, the value of that property on the date of the gift is considered the amount of the taxable gift. The value of the property is the price at which the property would change hands between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Determining this value is a question of fact, and a sound valuation is based upon a consideration of all relevant facts and elements of value, although the weight to be accorded each element of value depends upon the facts peculiar to each case.

In valuing gifts of interests in a business, the cited relevant factors include, but are not limited to:

* the fair appraised value of all the underlying assets of the business
* the demonstrated earning capacity of the business
* goodwill
* the economic outlook of the particular industry
* the degree of control of the business represented by each separate transfer of ownership interest (without aggregation or family attribution)
* the value ascribed by the market place to the sale and purchase of similar interests in similar businesses.[33]

In applying the valuation factors certain adjustments, or "discounts", to gross appraised value

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33 *See generally*, Treas. Reg. §§ 25.2512-1, 25.2512-2, and 25.2512-3; *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996); Rev. Rul. 93-12, 1993-1 C.B. 202; Technical Advice Memorandum 9449001 (March 11, 1994).

are recognized by the courts to reflect particular economic and management realities such as:

- * the **minority interest/lack of control** represented by each separate transfer of ownership interest, and the presence or absence of enforceable liquidation rights in the donee after the gift transfer
- * the **lack of marketability** of the ownership interest in the absence of a recognized market for such interests
- * the presence or absence of **enforceable fiduciary duties** under state law in favor of other persons having a present or future interest in the business entity as a whole[34]

The recognized types of adjustments are not mutually exclusive; each is to be considered and applied independently of the others where warranted. Although many of the same factors may support both an adjustment for minority interest/lack of control, *and* the lack of marketability of the ownership interest, the two "are conceptually different, and an award of the latter does not preclude application of the former." [35]

As more and more farm operations have evolved from sole proprietorships to more intricate business organizations the methods for valuing closely held entities has grown to become one of the most important subjects in estate planning. While a sole proprietorship, or the unrestricted fee ownership of farm land, may be comparatively easy to value, it is a far different question when the underlying assets are owned by an entity -- a limited partnership, a corporation, a limited liability

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See generally, *Estate of McCormick v. Commissioner*, 70 T.C.M. (CCH) 318, (1995); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of Frank v. Commissioner*, 69 T.C.M. (CCH) 2255, (1995); *Mandelbaum v. Commissioner*, 69 T.C.M. (CCH) 2852 (1995) affd. without published opinion 91 F.3d 124 (3d Cir. 1996); *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990); *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983). However, as to some transfers of interests in business entities among family members, certain restrictions on rights of liquidation that might otherwise support a discount adjustment must be disregarded if the restriction is "more restrictive than the limitations that would apply under the State law applicable to the entity in the absence of the restriction." Treas. Reg. § 25.2704-2(b). Internal Revenue Code Section 2704(b).

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Estate of Wheeler v. United States, (U.S.D.C. - W.D. Tex. 96-1 USTC P 60,226; 1996 WL 266420 at p. 2 [not reported in F.Supp.]. Cf., *Estate of McCormick v. Commissioner*, supra, "Marketability discounts may apply in addition to a minority or lack of control discount where the interest under consideration is illiquid." 70 T.C.M. (CCH) 318 at ___ .

company, a land trust or even a traditional trust with limited ownership interests -- which in turn is owned by (or exists for the benefit of) a number of different owners who are bound by restrictions and restraints which purposely limit control and impair transfers. In that instance, the above-mentioned modifying factors should be considered in calculating the actual taxable value attributable to those fractional owners.

The courts have consistently acknowledged that the fair market value of a minority interest in an enterprise is less than the corresponding percentage in the whole, primarily because the minority owner lacks the capability to control management, business strategy or policy, the acquisition or disposition of assets, or the liquidation, sale, recapitalization or reorganization of the venture.

A similar -- but vitally distinct -- analysis also applies in considering the fair market value of the beneficial interests in light of their limited marketability. In the *Mandelbaum* decision, Circuit Judge Laro identified ten specific "elements of value", generally applied by investors, that impact upon the marketability, or lack of marketability, of any particular investment interest:

"(1) The value of the subject corporation's privately traded securities vis-a-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation's public and private stock);

"(2) an analysis of the subject corporation's financial statements;

"(3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends;

"(4) the [business] nature of the corporation, its history, its position in the industry, and its economic outlook;

"(5) the corporation's management;

"(6) the degree of control transferred with the block of stock to be valued;

"(7) any restriction on the transferability of the corporation's stock;

"(8) the period of time for which an investor must hold the subject stock to realize a sufficient profit;

"(9) the corporation's redemption policy; and

"(10) the cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting,

and underwriting fees."[36]

Judge Laro went on to concede that "the valuation of property is an inexact science." Calculating adjustments to the appraised value of underlying assets is always a question of opinion shaded by established precedents and arguments over the weight to be applied to any one or another set of pertinent factors. Still, when the *Mandelbaum* factors are compared to the realities of the property transferred, a close, skilled evaluation should sustain a gift base valuation significantly less than the total represented by the sum of the parts.

All of these valuation principles should be considered when crafting partial ownership gifts of farm-related assets.

E. Section 2032A Special Use Valuation.

Internal Revenue Code Section 2032A offers an important estate tax break for active farm families. The effect of Section 2032A is to reduce the estate tax value of qualified farm land from its full fair market value to its "special use value" by using a formula that combines property taxes, prevailing fair market cash rents, and the effective rate for new Federal Farm Credit System loans as published by the Internal Revenue Service.[37]

The qualifying standards are specific, narrow and strict. A*ll* of the following requirements must be satisfied:

- Decedent must have been a U.S. citizen
- Subject land must be located in the United States
- Family must have used that exact land (not replacement §1031 land) for farming (which is a "qualified use") for five out of the last eight years before death, or retirement, or disability

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[36] *Mandelbaum v. Commissioner*, 69 T.C.M. (CCH) 2852 at 2864.

[37] Treas. Reg. § 20.2032A-4; *See* Rev. Rul. 2013-39 for 2013 rates, and Rev. Rul. 2014-21 for 2014 rates.

* Decedent, or a "member of the family"[38] must have "materially participated" in the farming for a period of five years out of eight before death [39]
* Total farm assets (real or personal property used in farming, at full fair market value less debts and mortgages) must constitute at least 50% of the decedent's total gross estate for federal estate tax purposes
* Farm real estate (at full fair market value less secured debt) must constitute at least 25% of the decedent's total gross estate for federal estate tax purposes
* The real estate for which Section 2032A value is elected must pass from the decedent to a qualified heir; i.e., a "member of the family"
* The qualified heirs must continue to operate the property for a qualified use -- production risk farming -- for a period of ten years following the decedent's death
* The 2032A valuation must be properly elected on the estate tax Form 706, Schedule A-

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38 Code Section 2032A(e)(2). A member of the family includes includes: ancestors; spouses; lineal descendants of the decedent, his or her spouse, or the decedent's parent (thus, nephews and nieces are qualified heirs, but cousins are not!); a spouse of any lineal descendant of the decedent, his or her spouse, or the decedent's parent; a trust, provided that only qualified heirs receive the present interest in the trust.

39 "Material Participation" is defined by cross reference to the net earnings tests applicable for self-employment tax purposes; *See* Code Sections 2032A(e)(6) and 1042(a)(1). Note that "material participation" is a nebulous term of art, for which the regulations offer the following guidance:

> "No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. At a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation. With farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the participating decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material. **Retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must personally materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.**"
> Treas. Reg. § 20.2032A-3(e)(2).

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* All "qualified heirs" who receive any present or future interest in the property valued under Section 2032A must sign an agreement agreeing to the 2032A terms, and accepting personal liability for recapture tax if qualified use fails during the ten year period following death

If ALL of the foregoing requirements can be satisfied, then the personal representative may report the value of the subject land for federal estate tax purposes according to a special formula based upon a fraction where:

* the *numerator* is the five year average annual gross cash rental for comparable local properties, LESS the five year average annual real estate taxes on the comparable properties, and
* the *denominator* is the average annual effective interest rate charged on new Federal Farm Credit System loans.

For example:

Assume 2013 Illinois Decedent T satisfies all of the 2032A criteria, and died owning 650 acres of debt-free qualified real property having a fair market value of $12,500 per acre. Comparable cash rents in the vicinity of the land average $325/acre; the average property taxes on the comparable tracts average $30/acre; and, the applicable Farm Credit Bank (AgriBank, FCB) System interest rate for 2013 is 5.03%. T's personal representative may elect to value the qualifying farmland according to the following formula:

$$\frac{\$325 - 30 = \$295}{.0503} = \$5{,}865\text{/acre special use value}$$[40]

Unfortunately, there is a $1,070,000 cap[41] in total value reduction allowed under Section 2032A

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[40] Note that the lower the interest rate denominator, the less benefit afforded by the election. Had the interest rate been 6.03% the 2032A value would have been less than $4,900 per acre.

[41] Indexed for inflation. See, Rev. Proc. 2013-35 for the 2014 ceiling of $ 1,090,000.

for 2013. To determine the maximum amount of land to which the reduction may apply, the personal representative must compare the total fair market value of the decedent's land (in this example, $12,500/acre) against the calculated special use value ($5,865/acre), and then divide the result -- $6,635 -- into the $1,070,000 maximum reduction ceiling. $1,070,000 ÷ $5,865 =182, meaning that in this example the personal representative may elect to apply Section 2032A to a maximum of only 182 acres. The remaining 468 acres are not eligible for Section 2032A treatment, and must be reported at their full fair market value.

It is important to note that Section 2032A does not represent a tax *deduction*, or an *exclusion* of fair market value from the decedent's taxable estate; the statutory formula includes no reference to the actual market price of the qualifying land. Instead, the Section 2032A special use valuation method is based upon Congress' almost unique tax policy decision, codified by this fictional formula, that qualifying farm land is more fairly valued in accordance with the predictable rate of return that similarly valued assets could earn if they were not dedicated to continued family farm use. In the preceding example, the net cash income of $295/acre from $12,500/acre land reflects an actual rate of return of 2.36%, while the same net income earned from $5,865/acre special use value produces a formulaic rate of return of 5.02%.

The Internal Revenue Service had long held the position that cash leases of specially valued land following the death of the decedent is not a qualified use because the heirs no longer bear the production risk. Several court cases have upheld this position. In 1997 an important technical relief provision was added to Section 2032A to reverse this position, in part, by providing that a cash lease *from the surviving spouse or a lineal descendant to another lineal descendant* who continues to operate the farm in an otherwise qualifying fashion will not be deemed a recapture event[42]. This provision applies retroactively to cash leases entered into after December 31, 1976, and eliminates a major tax trap that had haunted extended family farm operations from the inception.

Two last points:

* 2032A values also apply to GST and Illinois estate tax calculations, multiplying its

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[42] Code Section 2032A(c)(7)(E)

value when suitable; and,

* elected real estate takes a tax cost basis equal to the reduced valuation for Code Section 2014 purposes. That may or may not be a step-up.

F. Powers of Appointment

Powers or appointment have been declared to be “the most efficient dispositive device that the ingenuity of Anglo-American lawyers has ever worked out"[43], and after years of study your author agrees with that characterization.

The deferred power to appoint one or more interests in property [or power(s) over property] means the deferred power *to decide* – or better yet, to postpone decisions -- until that distant generational moment when guess work and estimation have ripened into certainty. No other estate planning device affords such exceptional flexibility.

Careful, knowledgeable, grafting of the law and practice of powers of appointment onto the law of trusts and business organizations creates almost unlimited multi-generational farm estate planning opportunities.

1. The Common Law Concept and Property Law Principles

Illinois does not (yet) have a comprehensive powers of appointment statute[44] so, at least for now, the Illinois property law rules remain pretty much defined by a common law tradition that pre-dates the Republic.

For property law purposes a power of appointment can be defined as the power to direct the disposition or use of property *that belongs to someone else*:

That is an essential characteristic:

A power of appointment over property is *not* an ownership interest in the property.

Rather, the power to appoint is *a designation of authority* over the property, created or

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[43] Leach, Barton “Powers of Appointment” 24 A.B.A.J. 807 (1938)

[44] The National Conference of Commissioners on Uniform State Laws has approved and recommended for enactment in all States a Uniform Powers of Appointment Act.

conferred by its owner

- usually by delegation to another person, but
- sometimes reserved by the owner,
- as a component of the transfer of the appointive property from that owner to a new owner.

A power of appointment can *only* be created by that original owner; the creation is a function of the exercise of his or her ownership prerogatives. This remains true even in those circumstances when an initial power is subsequently exercised to create a *successor or concurrent* power in another holder: The authority, and therefore ultimate title, still flows from that original owner/creator/donor.

- In this sense the power of appointment is akin to a type of agency, under which the benefit flows from the owner (the "donor" of the power) to the ultimate taker (the "permissible appointee") directly, and not from the power "holder", who by his or her exercise merely facilitates the passing
- For so long as the power to appoint is in place, and until the passage of indefeasible ownership is actually completed – either from the holder to the appointee, or by lapse or release or default, a process which may be deferred for generations:
  - ALL subsequent titles to the property will remain indeterminate as a function of the intervening potential contingency
  - No interest in property that is subject to that power can fully vest until the power is exercised, or released, or it lapses upon its terms

The power to appoint an interest in property is an inherently elective authority, and therefore a fully discretionary authority. The pure power holder has no obligation to exercise in favor of the permissible appointees, which distinguishes the power holder from the mere trustee:

- A trustee, even one vested with unlimited discretion, administers upon enforceable interests created by the trust settlor
- The holder of the power of appointment, in contrast, has the discretionary authority to create, or to avoid the creation of, interests *ab initio*, albeit always in the original owner/donor's name and behalf.

* Another key notion:

  A trustee is a fiduciary. The pure power holder is not.[45]

If the holder (or successor holder) elects not to exercise the power, the authority "lapses", and the property interest passes to a "taker in default of appointment".

Every competently written power of appointment provides for who or what takes in the event of default of appointment.

* Unless otherwise addressed, there will be confusion. For example, does release, lapse or default:
  * Create a reversionary interest in the donor or his/her successors?
  * Vest title in the power holder, or in the class of permissible appointees?
  * Is there a difference if it is a general or nongeneral power at play?
  * Confusion is bad

In creating a power of appointment the owner/donor is limited only by the extent of his/her ownership, his/her imagination and willingness to delegate, the objects of his/her bounty, and any applicable rule against perpetuities.[46] A power may be:

* Given to another (the "donee") or retained by the original owner (sometimes called the "donor/donee")
* Require irrevocable exercise (presumed) or allow an exercise to be in part or in whole,

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[45] But in some jurisdictions, under some facts, there are occasions where a power of appointment that runs with the office of trustee can be merged into the fiduciary obligations *See, e.g.,* RESTATEMENT (THIRD) OF TRUSTS, § 50, general comment *a* (2003). This may require an additional tier of drafting to prevent that merger.

The distinction between a trust and a power of appointment is a predictably litigated sore point when the drafting is less than precise, or when a permissible appointee finds himself to be an excluded "disappointee". See, *In re Estate of Schaaf*, 19 Ill. App. 3d 662, 312 N.E. 2d 348 (4th Dist. - 1974) and *In re Estate of Reiman*, 115 Ill. App. 3d 879, 450 N.E. 2d 928 (4th Dist. - 1983).]

[46]

The rule against perpetuities is still the general rule of law in Illinois, despite 1997 amendments that provide for "qualified perpetual trusts"; 765 ILCS 305/1-6. *See*, *Martin v. Prairie Rod and Gun Club*, 39 Ill. App. 3d 33, 348 N.E. 2d 306 (3d Dist. - 1976); but see, *Deiss v. Deiss*, 180 Ill. App. 3d 600, 536 N.E. 2d 120 (4th Dist. - 1989); *First Nat'l. Bank of Joliet v. Hampson*, 88 Ill. App. 3d 1057, 410 N.E. 2d 1109 (3d. Dist. - 1980) [prudent savings clause preserves botched termination provision].)

or allow an exercise to be revoked upon the holder's design

* Presently exercisable, or subject to any number of conditions precedent, such as time, death, survivorship, another person's consent, an ascertainable standard, the rising of the moon, or the Cubs winning the pennant
* Held by one or more successive or concurrent holders, with identical or different authorities
* Exercisable to create successor powers, or barred from doing so
* Limited to a class of appointees, or selective appointive property, or unlimited altogether
* Exclusionary or inclusive among the members of a class of appointees
* Included not only in trusts, and as components of deeds, but also membership interests in an LLC, or closely held corporations, or even promissory notes

For property law (meaning creditors rights and asset protection) purposes, a general power of appointment has traditionally been a wholly unlimited power that could benefit anything or anyone in any way or any time, including the power holder.

* Since a power of appointment, general or otherwise, is not an ownership interest in property, it made little real difference whether the holder could benefit himself/herself, or his/her estate, or the creditors of either
* That traditional protection of property subject to a general power is eroding, and there is a growing sense of distinction between a "general" power of appointment and a "nongeneral" power of appointment for property.[47]

A power of appointment is now considered "general" to the extent that the power can be exercised to benefit the holder/donee – either directly, or indirectly on behalf of his/her creditors or estate, or the creditors of his/her estate, irrespective of whether the power is also exercisable in favor of others.

* Property that is subject to a presently exercisable general power of appointment is

[47] This distinction has some similarities with, and some important differences from the *tax* treatment of general and nongeneral powers.

construed to be the practical equivalent of an ownership interest in enough respects as to be vulnerable to the claims of the holder's creditors

* Conversely a "nongeneral" power of appointment (also referred to as a "limited" or "special" power of appointment) is expressly *not* presently exercisable for the benefit of the holder/donee, his/her estate or the creditors of either and correspondingly insulated from the holder's exposures

Do not confuse the status of a "holder" of a power of appointment – general or non-general – with the status of being a permissible appointee. The owner of property may give that property to another, in trust or otherwise, subject to either a general or nongeneral power of appointment *by which the donor is a permissible appointee.* This is neither a retained interest for tax purposes, nor is it a property interest subject to the donor's claims.

Grasping the difference between a general and nongeneral power of appointment, and the parallel distinction between being a holder of a power and being a permissible appointee of a power, is the most important first step in understanding and implementing powers of appointment.

2. The Tax Principles: Background and Philosophy

The artificial power of appointment tax rules represent Congress's response to a series of United States Supreme Court cases which ruled, quite conclusively, that even the broadest of general powers is not an "interest" in property within the scope of Internal Revenue Code Section 2033[48] (thereby avoiding the value of the appointable property from inclusion in the holder's taxable estate) nor is the exercise of a power a "transfer of property" by the holder on which the gift tax can be imposed under Code Section 2501.[49]

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[48] Code Section 2033 provides:

Property in which the decedent had an interest. The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

[49] Code Section 2501(a)(1) prrovides:

(a) Taxable transfers.
(1) General rule. A tax, computed as provided in Section 2502, is hereby imposed for

Following these decisions Congress overhauled the tax treatment of powers of appointment to create the legislative fiction, embodied by current Code Sections 2514 and 2041, that certain powers over property -- those which fall into the tortured definition of a tax "general power of appointment" -- are to be construed as the taxable equivalent of ownership, and the property subject to the general power shall be taxed accordingly:

* Under the resulting Internal Revenue Code Section 2514, the lifetime exercise, lapse or release of a tax general power of appointment will be treated as a taxable gift/transfer by the holder much like a gift under Section 2501; and,
* Under Code Section 2041, if a holder dies possessed of a general power of appointment, or in his or her lifetime exercises a general power of appointment in a manner that violates the retained interest rules under Code Sections 2035-2038, the value of the subject property will be included in the holder's federal gross estate, more or less as the equivalent of a Section 2033 interest.

Tax general powers are systematically addressed below, but the most important point should be made now: **relatively few powers will trigger taxability.**

While the tax rules are quite full of twists and turns, there is a remarkable philosophical consistency woven into the fabric. It is clearly possible to forecast, with substantial certainty, whether a power to appoint or withdraw property will be taxed as *de facto* ownership, or exempted as a non-taxable discretionary feature.

a. Retained Interests Distinguished

The complicated transfer tax treatment of powers of appointment results largely from a recognition by Congress that there is a proper distinction between:

* the interests or benefits in property *retained* by the owner (generally covered by Code

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each calendar year on the transfer of property by gift during such calendar year by any individual, resident or nonresident. (Emphasis added.)

Sections 2035-38);[50] and,

* any powers *over* that property that its owner might *delegate* to another

Since the owner/grantor has unrestricted control over the terms of his or her gifts, the lifetime transfer rules adopt a presumption that a decision to not "cut the strings" reflects an intended bargain, whereby taxability of the property is the price exchanged for the retained benefit to the donor.

In contrast, the donee/holder of a power of appointment neither creates nor defines his or her authority. The power holder is merely the nominee of the owner's discretion, and generally powerless to control the scope of that authority or its implications on his or her own tax burden.

The power of appointment tax rules reflect this key distinction, and in their crazy-quilt fashion represent a key tax policy determination:

Powers given to others must rise to a more significant degree of control if they are to be taxed in the holder as the equivalent of an ownership interest.[51]

The property law treatment of powers of appointment depends largely upon the distinction

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[50] Federal estate tax will be imposed on the value of property transferred by the decedent in his/her lifetime when these gifts are deemed to be in anticipation of death or to have afforded the decedent any continuing benefit from or control over the property after the gift. The precise circumstances of these lifetime transfer rules are detailed in Code Sections 2035, 2036, 2037 and 2038. Complex provisions in their own right, and generally beyond the scope of this article, they bear mentioning first as evidence of Congress' determination that gifts with strings are incomplete gifts (hence their moniker, the "string sections"). Secondly, the gift tax treatment of powers of appointment refers to all four as measuring standards.

Section 2035 refers to gifts of certain types of property made within three years of the death of the decedent, including life insurance and the property interests described in Sections 2036-2038 and 2042.

Section 2036, "Transfers with retained life estate" requires that the decedent's gross estate include the value of all property in which she has retained the possession, enjoyment or right to income, or the right to designate who shall have its benefit.

Section 2037, "Transfers taking effect at death" requires that the decedent's gross estate include the value of all property conditionally transferred prior to death where: (i) possession or enjoyment of the gift depends on surviving the grantor; and (ii) the grantor has retained a reversionary interest in the property which exceeds 5% of the value of such property.

Section 2038, "Revocable transfers" requires that the value of the gross estate include the value of all property where the decedent has retained the power over the property to "alter, amend, revoke, or terminate" the transfer, and that power is not restricted by a restraining standard.

[51] This distinction between "reserved" powers and delegated powers is meticulously addressed in Treas. Reg. 25.2541-1(b)(2) and 20.2041-1(b)(2): "the term 'power of appointment' does not include powers reserved by a [decedent/donor] to himself". That power is includible in her or his estate or gifts "to the extent it would be includible under Section[s][2033] 2511 or other provisions of the Internal Revenue Code."

between *non-ownership authorities* that are delegated, and *ownership rights* that are either: (i) retained by the owner after a partial gift or transfer, such as a gift with retained life estate; or, (ii) conveyed to a trustee with administrative instructions.

Powers that fall short of this threshold, such as the nongeneral (or, "special" or "limited") power of appointment, so useful in actual practice, will *not* be subject to taxation.

b. An Analytical Approach

The tax general power of appointment is an elusive creature in the sense it can emerge unexpectedly, but face to face it is far less fearsome than first thought. Its general definition, softened by exceptions, reduce it to a relatively narrow and predictable beast identifiable from the following approach:

First: Does the authority over the property exist as a matter of delegation, or by reservation? If the power to consume, invade, alter, amend or distribute belongs to the original owner it is *not* a tax power of appointment.[52]

Second: If the authority is in a donee/holder, does that holder have any current or permissibly appointable interest in the subject property? A disinterested trustee, acting strictly in a fiduciary capacity, to whom no benefit or interest can pass (nor be directed for his or her benefit, including the benefit of someone to whom the trustee owes a legal obligation of support[53]) will not have a general power of appointment

Third: If presented with an interested party/holder, when was the power created? Powers created or deemed created on or before October 21, 1942 (a "pre-1942 power") are treated more generously than those created after October 21, 1942 (a "post-1942 power")

Fourth: Does the holder have the power to distribute *to herself, her creditors, her estate or the creditors of her estate*? That is, does the holder's authority fall within the general power of appointment definitions set forth in Code Sections 2041(b)(1) and 2514(c) and their respective Regulations?

Finally: If confronted with a definitive general power, does it fall within one of the

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[52] *Id.*

[53] Expressly including the benefit of someone to whom the trustee owes a legal obligation of support. Treas. Regs. 25.2514-1(c) and 20.2041-1(c).

prescribed exceptions? Is it: (1) limited by an "ascertainable standard" or a "joint exercise" requirement; or, (2) muted by a non-cumulative "5 and 5" power?

After cataloguing the pedigree in this fashion, one may then determine the transfer tax consequences of the power's exercise, release, lapse, or disclaimer, or its mere possession by the holder at death.

c. General Power Defined

Internal Revenue Code Sections 2514(c) and 2041(b)(1) adopt an identical definition of a tax general power of appointment:

> **The term "general power of appointment" means a power which is exercisable in favor of the decedent [possessor], his estate, his creditors, *or* the creditors of his estate.**

Catch the crucial, particular, disjunctive form "or" in that definition: The unrestricted authority to appoint to any one of the four -- the holder, the holder's estate, the holder's creditors **or** the creditors of the holder's estate -- will be sufficient to constitute a tax general power of appointment.[54] Conversely, a power of appointment shall *not* be considered a general power if by its terms it is either:

* Exercisable only in favor of one or more designated persons or classes *other than* the possessor/decedent or her creditors, or the possessor's/decedent's estate or the creditors of her estate; or
* Expressly *not* exercisable in favor of the decedent/possessor or his creditors, or the decedent's/possessor's estate or the creditors of his estate.[55]

These definitions track the tax philosophy:

* If the holder has enough control to direct the property to his or her particular benefit, which clearly includes his or her creditors, then for gift or estate tax purposes the holder will be considered the actual owner of the property.
* If the holder lacks that degree of discretion, and the individual pecuniary interest is

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[54] Treas. Reg. 25.2514-1(b) and 20.2041-1(b).

[55] *Id.* Note that for this purpose the disjunctive "or" means that none of the four may be permissible appointees.

insulated from benefitting from the property in question, then the holder cannot be fairly treated as though he or she were the effective owner of the subject property.

d. Exceptions to the Rule

The broad provisions that define the general power of appointment are immediately followed by two exceptions to the tax treatment, both of which emerge from the parallel principle that even authority to benefit the holder directly will be exempted from tax if that power is significantly restrained.

(1) The Ascertainable Standard. By far the most important practical protection from taxability is afforded by Code Sections 2514(c)(1) and 2041(b)(1)(A), which insulate any general power to appoint if that "power to consume, invade, or appropriate property...is limited by an *ascertainable standard* relating to the health, education, support, or maintenance" of the holder or decedent. Examples of ascertainable standards are set forth in Treas. Reg. 25.2514-1(c)(2) and 20.2041-1(c)(2), and include the following specific qualifiers:

* "support"
* "support in reasonable comfort"
* "maintenance and health in reasonable comfort"
* "support in his accustomed manner of living"
* "education, including college and professional education"
* "health"
* "medical, dental, hospital and nursing expenses and expenses of invalidism"

These standards are in fact more generous and less restrictive than may first appear in cold black print:

* **The terms "support" and "maintenance" are "not limited to the bare necessities of life," and**
* **"[I]t is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised."** [56]

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[56] *Id.*

Properly worded, the power to invade and distribute trust property (whether income, or income and principal) is wholly justified to provide all accustomed costs of maintenance including, for example: all the costs of housing, taxes, utilities, insurance, education, transportation, food, clothing, medical care, and such -- in turn freeing the beneficiary's own resources for extras; *i.e.* for her own "happiness" or “best interests”, or gifts to other natural objects of the beneficiary’s bounty.

The ascertainable standard exception offers substantial protection from unwanted (and unintended) tax burdens yet preserves tremendous opportunity for distribution, especially where the trustee has a current or potential beneficial interest in the trust property.

Indeed, there is sound reason for including the ascertainable standard restraint on every distributive power held by an interested trustee unless it is intended that the property fall within the holder's tax orbit.

The result will put little practical restraint on the beneficiary's access, and may well save someone from an unexpectedly bad construction.

(2) Joint Powers. The second exception to what would otherwise be a taxable general power applies when that power may be exercised "only in conjunction with another person" who

* is the creator/donor of the power; or
* someone other than the creator/donor who has both a *substantial* and *adverse* interest in the property subject to the power. Code Sections 2514(c)(3)(A) and (B) and2041(b)(1)(C)(i) and (ii).[57]

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[57] Again, look to the tax theory behind this exception: With respect to the first exception, the donor's reservation of control will bring the value of the property into the donor's own tax package under Sections 2036 or 2038, thus diverting the burden from the encumbered holder. There can be no "general" power in fact if it is so clearly restricted by the donor's veto.

The second exception restrains the holder's exercise by the zero-sum principal that what serves the benefit of one detracts from the benefit of the other. An interest is substantial "if its value in relation to the total value of the property subject to the power is not insignificant." Treas. Regs. 20.2041-3(c)(2) and 25.2514-3(b)(2). An interest is "adverse" if the co-holder has a present *or future* opportunity to obtain a personal benefit from the property subject to the joint power. *Id.*

A taker in default of appointment clearly has an adverse interest, as does a successor to the unexercised power after the holder's death. But a co-holder has no adverse interest merely because of joint empowerment, or because he or she may be a *permissible* appointee. *Id.* And a mere co-trustee is not

e. Impact and Consequences

Once faced by a tax general power, loose from the leash of restrictions and exceptions, there is no choice but to address the resulting impact upon the *holder's* gift and estate tax burden. This treatment depends upon whether the power is: (i) exercised; (ii) released; (iii) lapsed; (iv) disclaimed; or (v) merely in the holder's possession at the time of his or her death.

(1) Exercise. This one is simple: The exercise of a general power of appointment is deemed to be a transfer of the property by the holder of the power. Internal Revenue Code Section 2514(a) and (b). Or, put simply: exercise equals ownership.

That construct is the heart of the legislative fiction that the general power holder, with all the self-benefitting discretion that that term implies, is deemed to be the owner of the subject property:

* If the power is exercised by the holder in his or her lifetime, and as a result the subject property passes in a fashion contemplated by Code Section 2511, then gift tax analysis will apply[58].
* If the power is exercised at death, the value of the subject property is included in the decedent's estate under Code Section 2011[59].

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treated as having an interest in the property, adverse or substantial, notwithstanding that legal title may be vested in the co-trustee, and notwithstanding its enforceable fiduciary duty to protect the best interests of the remaindermen. *Estate of Towle v. Commissioner,* 54 TC 368 (1970); Rev. Rul. 79-63, 1979-1 CB 302. That common law standard is specifically ignored, This distinction between "reserved" powers and delegated powers is meticulously addressed in Treas. Reg. 25.2541-1(b)(2) and 20.2041-1(b)(2): "the term 'power of appointment' does not include powers reserved by a [decedent/donor] to himself". That power is includible in her or his estate or gifts "to the extent it would be includible under Section[s][2033] 2511 or other provisions of the Internal Revenue Code."

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Of course, not every transfer constitutes a taxable gift, and Code Section 2514 must be analyzed in coordination with the remaining gift tax principles of Section 2511. For example, if the exercise of the general power is made in a fashion reserving to the holder dominion and control over the disposition of the property, the transfer is incomplete. Or, if the holder exercises the general power in favor of herself, there is no taxable gift because one cannot make gifts to oneself. If the power is exercised irrevocably but for consideration received, the taxable value is reduced by the value of the consideration. Finally, if the power is exercised only at death, the transfer is subject to estate tax rules not gift tax rules; the gift tax applies only to inter vivos transfers.

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For both gift and estate tax purposes, exercise is broadly construed. Whether the power has in fact been validly exercised may be determined by local law (as can result from an over-broad residuary clause

(2) Release. By definition the release of a post-1942 general power is treated as the equivalent of the exercise of that power in favor of the taker in default.[60]The tax consequences are equivalent as well; that is, whether the release causes gift (inter vivos) or estate (testamentary) tax, liability depends upon the application of the same gift tax, retained interest, or estate tax rules just mentioned above.

(3) Disclaimer Distinguished. A "qualified disclaimer" of a general power is not treated as the exercise, release or lapse of the power, and the disclaimer option may be the reluctant holder's best defense. The disclaimer rules[61] apply to all taxable transfers in property including specifically powers with respect to property, even though the power is extinguished as a result.

To qualify, the disclaimer must:

* be in writing and signed by the holder;
* refer specifically to the power or property being disclaimed;
* contain the holder's irrevocable and unqualified refusal to accept the power;
* be delivered to the donor or the donor's legal representative not later than nine months after the taxable transfer is made (or nine months after the day on which the holder attains age 21); and,
* the disclaimant may not have accepted the power or exercised any of its prerogatives.[62]

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in a will) but regardless of local law the power will be treated as exercised even if the result is the same as a default in appointment, or the appointee renounces any right to take under the appointment, or the disposition cannot take effect until some condition subsequent. All that is required is that the exercise be "irrevocable and, as of the time of the exercise, the condition was not impossible of occurrence."

In each case the *basis* of the property over which the general power is exercised (or deemed exercised, as results from a release or possession at death) will generally be the same as if the property were owned outright by the holder. If passing by lifetime exercise, the appointee or taker in default takes the donor's basis. If the value of the property is pulled into the holder's estate, however, the appointee or other successor in interest generally will receive the holder's final estate tax basis. Code Section 1014.

[60] Code Sections 2514(b) and 2041(a)(2); Treas. Regs. 25.2514-3(c)(1) and (4), and 20.2041-3(a) and (d).

[61] Code §2518 and Treas. Regs. 25.2518-2, -3. *See also*, 755 ILCS 5/2-7 and 765 ILCS 25/1.

[62]

See, Hirsch, *The Problem of the Insolvent Heir*, 74 Cornell L. Rev. 587 (1989) for an influential if controversial analogy between property law disclaimers and general powers of appointment, and *Drye v. United States*, 528 U.S. 49, 145 L.Ed.2d 466, 120 S.Ct. 474 (1999) where, in a disclaimer context, Professor Hirsch's theories were given great credence by a unanimous Supreme Court.

The qualified disclaimer principles are brought into the power of appointment regulations by an express reference,[63] while powers over property are likewise specifically addressed among the disclaimer rules.[64]

(4) Lapse and the "5 and 5" Exception. The lapse of a power of appointment created after October 21, 1942, is considered a release of the power; meaning, in effect, that a lapse shall be treated the same as an exercise.[65]

The theory for treating lapse as equivalent to exercise continues to follow the tax philosophy: by foregoing the benefits that would inure upon exercising the power, the holder has facilitated a valuable transfer of the appointable (or, withdrawable) portion to benefit the remainderman. Accordingly:

* For gift tax purposes an inter vivos lapse will be treated as a completed taxable transfer/gift;[66] and,
* For estate tax purposes, the value of the subject property will be included in the holder's estate if the holder retains some interest in or over the lapsed property sufficient to invoke tax treatment within the principles of our now-familiar Code Sections 2036-2038

Fortunately, Sections 2041 and 2514 both create a vital exception to this general treatment for lapsed powers: Tax treatment shall apply

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[63] Treas. Reg. 25.2514-3(c)(5) and (6).

[64] Treas. Reg. 25.2518-2(e)(1)(ii), 25.2518-2(e)(5), Examples (11) – (12); 25.2518-3(a)(iii), and 25.2518-3(d), Examples (9) and (21). These provisions make it clear that a power over the property may be disclaimed as to all or a portion of the property, but only on condition that any power or interest retained over or in that portion of the property is limited by an ascertainable standard.

[65] Code Sections 2514(e) and 2041(b)(2). Again, the lapse of a pre-1942 general power is of no consequence.

[66] And not necessarily an excludable gift for the purposes of Code Section 2503(b), which of course depends upon the lapse creating a transfer of a *present* interest.

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n value, at the time of such lapse, t

he **greater** of . . . :

(A) **$5,000**, or

(B) **5 percent** of the aggregate value [of the property].

This exception offers obvious advantages for gift tax purposes, but the estate tax treatment is a little trickier, since each lapse of a power over property valued in excess of the $5,000/5% limit, in a trust in which the holder has the continuing right to benefit, carries the retained-benefit burden of Sections 2036 and 2038. This can result in later estate tax that is in addition to current gift tax on the value of the excess, and is also in addition to the estate tax on the property that remains subject to the power at death.[67]

(5) Possession at Death. The possession of a general power created after 1942, regardless of exercise, or even the ability to exercise the power, is treated as the equivalent of

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[67] This exception to the lapse rule applies only to lapse during lifetime. The failure to exercise a non-cumulative power in lifetime results in the holder holding the power at death, and the value of the property subject to the power is included in her gross estate under Section 2041.

ownership of the property subjecting the value of the property to the holder's estate tax calculation. It is important to remember that the exercise, release or lapse of the general power of appointment is a gift tax transfer, and the value of the subject property is only brought back into the estate if there is a retained interest. Exercise, release or lapse in a fashion sufficient to remove the power holder's retained interest or power over the property will not subject the property to taxation in the decedent's estate. Under those circumstances, taxability is imposed strictly as a function of possession at death..

f. Exceptions Highlighted

The several exceptions to treatment of otherwise taxable general powers of appointment amount in the aggregate to a remarkably generous dispositive arrangement that still avoids transfer tax treatment. Consider the utility where the trust beneficiary (or interested trustee) may:

* Have access to all of the principal or income necessary for his or her health, maintenance, education and support, without being limited to the bare necessities of life, and without the requirement that he/she exhaust her other resources first;
* Withdraw an additional amount equal to the greater of $5,000 or 5% of the corpus annually; and,
* Possess the testamentary nongeneral power to direct the property to any person other than herself, her creditors, her estate, or the creditors of her estate, without exposing the holder's estate to taxation, or endangering the marital deduction. For non-marital deduction trusts the interested trustee/holder can even have an immediate, exclusionary, inter vivos nongeneral power to re-direct the property to any person other than herself, her creditors, her estate, or the creditors of her estate, (but in that case there may be gift tax consequences.)

On balance, the availability of these withdrawal and directive options makes it clear that nongeneral powers can be used to great advantage while avoiding unwanted general power tax treatment.

g. Income Tax Considerations

The grantor trust rules (generally, Code Sections 671 - 677) and Code Section 678 and its Regulations can create an income tax nightmare for beneficiaries holding a power of withdrawal

which they allow to lapse.[68] During the withdrawal period the power holder is deemed to be the owner of the subject portion available for withdrawal, and is to taxed on trust income attributable to that portion. The formula for calculating this deemed income (and pro rated share of deductions and credits) is generally set forth in the Regulations.[69] Where the beneficiary is to receive all of the income of the trust -- such as in the typical QTIP trust -- it would seem that the deemed income earned should be subsumed into the actual annual distributions, but for trusts which provide only discretionary income distributions the 5 and 5 option can cause tortuous calculations, and taxation to the beneficiary for funds not actually received.

h. The Generation Skipping Transfer Tax Connection

As discussed earlier, the Chapter 13 GST tax was built upon the existing gift and estate tax rules. In an ideal situation, where the opportunity exists to counsel multiple generations of the same family, we could do our clients proud by providing that each maturing generation devise all property into trust with limited powers to invade and appoint. By avoiding the general power traps discussed above we could provide for virtually unfettered access, dominion and direction over the trust property -- asset protected and transfer tax free -- for generations, limited only by the rule against perpetuities.

Integral to all GST planning is the individual exemption from the GST tax allowed by Code Section 2631(a). Chapter 13 has resulted in extravagant planning both to properly preserve the GST exemption amount in each spouse and to avoid undesirable transfers for the estate in excess of

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[68] **Section 678. Person other than grantor treated as substantial owner.**

(a) General rule.
A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release of modification retains such control as would, with the principles of sections 671 to 677 inclusive, subject to grantor of a trust to treatment as the owner thereof.

[69] Treas. Reg. 1.671 - 3.

this threshold. This is a complicated topic itself but the role of powers of appointment within multi-generational planning requires at least this much highlighting:

* **First,** the general tax policy of estate and gift taxation with respect to general and nongeneral powers of appointment is carried over into the Chapter 13 treatment. A person who holds a presently exercisable general power of appointment over trust income or principal has a Chapter 13 interest, while a person holding only a nongeneral power has no such interest. Code Section 2652(c)(1)(A). So, in the case of a classic GST exemption trust, general powers should be avoided throughout if the desired result of avoiding taxation in successor estates is to be preserved.
* **Second,** in planning for trusts *not* sheltered by the exemption, powers may be structured to include technical general powers of appointment causing inclusion in non-skip persons, on the presumption that regular estate tax rates are preferable to the punitive maximum rate imposed upon non-exempt trusts with inclusion ratio of "one". Remember that if a technical general power is needed, but a limited discretion *in fact* is desired, authority in the successor generation may be limited to the power to appoint to the creditors of the holder's estate, supplemented with a nongeneral power to appoint to certain classes of beneficiaries, descendants or gift-over charities. Another alternative is to make the exercise of the general power subject to the consent of a person who has neither a substantial nor adverse interest in the trust estate. See, Code Sections 2514(c)(3)(A) and (B) and 2041(b)(1)(C)(i) and (ii).
* **Third,** Code Sections 2514(d) and 2041(a)(3) impose a transfer tax on the exercise of a nongeneral power of appointment used to create a successor nongeneral power, "which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power"; that is, beyond the applicable rule against perpetuities. Since Illinois, along with an increasing number of states, allows an "opt out" from the rule against perpetuities under the

"Qualified Perpetual Trust" provisions of 765 ILCS 305/3(a-5), the unthinking exercise of a nongeneral power could cost the GST exemption of a previously exempt trust. Treas. Reg. 26.2601-1(b)(v)(B) similarly provides that the release, exercise or lapse of a nongeneral power of appointment is not treated as a constructive addition to a trust if such power of appointment is created in a GST-exempt irrevocable trust and a power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period beyond the perpetuities period applicable to the original trust (with a safe harbor 90-year perpetuities period). In practice, if the trust remains subject to the common law rule, then this trap is avoided; however, if the opt out to form a qualified perpetual trust is selected, then a savings clause prohibiting the exercise of a nongeneral power that would trigger Sections 2514(d) and 2041(a)(3) should be included in the trust terms.

G. Working the Transfer Tax System

The transfer tax planning component of estate planning is sometimes referred to as the "tail that wags the dog". Tax thinking should not be as important as it is, given all the other things our clients want to think about and do, but the fact remains that the less money that goes for taxes means that much more is available for the grantor's beneficence.

Generally speaking there is a three step approach:

* First, take maximum advantage of the unified credit/applicable exclusion amount:
    * The federal amount, including DSUEA; and
    * The much smaller, more troublesome Illinois amount
* Then, apply marital deduction matrix, if suitable
* Then, the GST structure

All three require strict attention to planning, asset allocation, and drafting, to achieve the various balance points, and avoid over funding either the credit shelter trust(s), or the marital trust(s).

Formula language is unavoidable. Rarely do we know, at the date of preparing an estate plan:

* Which spouse will die first, or when
* How much property value, if any, will pass by contract (like pension plans) or by joint ownership, or
* The total value of the first spouse's estate

There are two principal funding formulas for separating assets between the credit shelter portion(s) and the marital portion(s):

* A "pecuniary formula" is based on a specific dollar amount:
  * "to the trustee of the Family Trust the largest pecuniary amount as finally determined for federal estate tax purposes that results in the lowest possible total of: (i) federal estate taxes; and (ii) state death taxes, that are payable from all sources as a result of Grantor's death, ..."
  * "to the trustee of the Marital Trust "the smallest pecuniary amount as finally determined for federal estate tax purposes, if any, which if allowed as a federal [Illinois] estate tax marital deduction for federal [Illinois] estate tax purposes would result in the lowest possible total of: (i) federal estate taxes; and (ii) state death taxes, that are payable from all sources as a result of Grantor's death, ..."
* A "fractional share formula" is based on a fractional share of the total, with defined numerator and denominator:
  * "to the trustee of the Family Trust a fraction of the net estate, the numerator of which shall be the remaining applicable exclusion amount, and the denominator of which shall be the value of the net trust estate as finally determined for federal transfer tax purposes."
  * "to the trustee of the Marital Trust a fraction of the net estate, the numerator of which shall be the smallest amount, if any, which if allowed as a federal [Illinois] estate tax marital deduction for federal [Illinois] estate tax purposes would result in the lowest possible total of: (i) federal estate taxes; and (ii) state

death taxes, that are payable from all sources as a result of Grantor's death, and the denominator of which shall be the value of the net trust estate as finally determined for federal transfer tax purposes."

* Both pecuniary and fractional share formulas can be written to define either the marital or the credit shelter first, with the residue of the estate passing to the other
    * Pecuniary (or, fractional) *credit shelter* lead, followed by a residuary marital bequest
    * Pecuniary (or, fractional) *marital* lead, followed by a residuary credit shelter bequest
    * Each of the four produces vastly different results from the others.
* There are advantages and disadvantages to each approach. More complicated than it looks, with potential for very nasty surprises flowing from circumstances occurring after death but before division, distribution and funding
    * Pecuniary gifts skew benefit/harm from increases or decreases in value after death but before distribution; can either help or hurt the residuary taker, and distributions of appreciated property in kind can trigger capital gain to the distributing master trust or probate estate
    * Funding a pecuniary gift with IRD assets (such as deferred benefit plans) can trigger immediate recognition of taxable income
    * Fractional gifts allow administrative costs and taxes to be shared proportionately, and generally no capital gains are recognized on distribution if distributed pro rate in kind or "pick and choose" language is included in the trust agreement, but can be more difficult to administer once funded

The point to be remembered is that each approach has different consequences for different classes of beneficiaries, and there is no safe, standard, one-size-fits most approach: * F
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* But, where there may be a second spouse, and prior court orders, and nuptial agreements, or more than one group of descendants from blended families, then gauging which approach works best for which class of beneficiaries can be a hard nut to crack
* Similarly, different assets – cash; farmland; small businesses with buy/sell arrangements; disproportionately funded deferred benefit plans – can call for radically different funding theories, in each case calling for some real thought and study, and often some very intense (and not always wanted) consultations with the client

Another option, favored by many practitioners (including this author), is to eschew the credit shelter/marital deduction planning altogether in favor of a single QTIP trust. * Allocati ons and fraction a l division s are reserved f o r Schedul es M

[70] For example, the "pecuniary marital lead, date of funding valuation" formula works best for capturing all of the Section 2032A deduction for the credit shelter trust.

and R of the federal estate tax return and the separate QTIP schedule attached to Illinois Form 700[71]

* Single QTIP approach is made even more attractive by the new Illinois estate tax law, with its own QTIP allowance

GST planning the proceeds after the unified credit/marital deduction provisions have been settled, by adding a second structural overlay for allocating the GST exemption amount

* GST exemption planning is aimed at keeping the property insulated *after* it has been plotted through that first transfer tax thicket

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71 By making only a partial election on the appropriate federal or state estate tax return, the marital deduction and credit shelter portions can be calculated post-mortem to a statistical certainty. This approach has the charm of simplicity and is attractive in those situations where both clients are determined that the surviving spouse should have the benefit of all of the family wealth until the death of the survivor before any descendants step up to take an interest. Moreover, while the single QTIP trust is not the preferred formula for maximizing the benefit available from special use valuation under Section 2032A *for credit shelter purposes*, it is still possible to use the "pecuniary GST Non-exempt lead, date of allocation funding formula" in the trust agreement to move all of the 2032A benefit into the GST exempt portion. Indeed, the QTIP format for the residuary marital trust is almost mandatory for effective generation skipping transfer tax planning. This approach is adopted under

* Extrapolates upon the first set of formulas and administrative provisions to provide for both:
    * An additional GST tax framework, distinguishing the GST exempt and non-exempt funds; <u>and</u>
    * Highly targeted and flexible trust administration provisions meant to withstand multiple generations of changed circumstances

Although wildly different from the unified gift and estate tax scheme of Chapters 11 and 12, the Chapter 13 GST tax is still an extension of the existing transfer tax system; it cannot, and does not, exist without several shared points of reference. The most important of these is the segue between the familiar unified credit/marital deduction provisions, on the one hand, and the individual GST exemption on the other. The result is the transfer of the property, in trust, to distant descendants without exposing it to estate tax or GST tax during the intervening beneficial use.

III. SETTING THE TABLE: The Non-Tax Features

A. Trust Basics

It is almost impossible to discuss modern farm estate planning without reference to trusts. So here are some basics and some considerations:

A trust is a defined legal relationship by which property is held by the legal owner for the benefit of another person. **The keystone of trust law is that ownership and benefit are separated into distinct roles with different identities, rights and privileges.** This is true even when the person holding the office of trustee is also the beneficiary:

* which *can* be done;
* is *frequently* done; but
* *must be done most carefully*

The general principles – of creation, funding, administration by one for the benefit of another – are inherited from the English common law and the equity jurisdiction of the chancery courts.

Although the subject of various statutory regulatory schemes, such as the Illinois Trusts and Trustees Act[72], strong equitable principles still apply, together with some of the archaic nomenclature.

- A **Settlor** (or grantor, or donor; or frequently, a testator) creates the trust, defines its terms, and for the most part is responsible for its funding, one way or another
- The **Trustee**, whether one or more, takes *legal* title to the property and administers upon it according to the terms of the Settlor's gift
- The **Beneficiary** (again, whether one or more, concurrent or successive) benefits from:
  - the Settlor's terms of gift, however broad or narrow,
  - as administered by the Trustee

These terms need to be set forth with specificity, which almost always requires a written instrument of some type – such as a Will containing trust provisions (a *testamentary* trust), or a separate trust agreement between the Settlor and the Trustee, or occasionally but less frequently a deed transferring real estate with trust terms included.[73]

Trusts are as elastic as the imagination, and for making dispositions of property there is probably no tool more versatile.

- a trust can be created for any purpose that is not illegal or contrary to public policy
- the duties of the trustee are what the creator of the trust chooses to impose
- the interests of the beneficiaries are such as the creator may choose to confer

Trust law allows the craftsman almost a blank slate. Within the broad outlines of fiduciary responsibility and accountable benefit trusts are remarkably nimble and fit as implements of wealth management and transfer; to effect family settlements, to separate the benefits of ownership from the burdens and discretions of management, and to create any number of different forms of concurrent and consecutive beneficial interests, with or without specific regard to the myriad of income and

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[72] 760 ILCS 5/1 - 15/17

[73] Excluding for these purposes alternative, narrowly defined and applied trust vehicles, such as the equitable remedies of constructive trusts or resulting trusts; voting trusts; investment trusts; retirement trusts; land trusts, and so on .

transfer tax applications.

A carefully drafted trust, which incorporates deferred future decision authority pursuant to the power of appointment rules, can be a very useful instrument.

B. Structuring the Beneficial Interests and Fiduciary Appointments

Naturally, the more you know about the client and his/her business, the more effective the planning. Overkill is not required, but the attorney *must* have a firm understanding of the family, the financial context, and the beneficial objectives to be addressed, while always being willing to shift strategies in accordance with the client's own peculiar family sociology. Some key family matters to consider include:

* The age; mental, physical and emotional health; and overall competence of the client, while looking for signals of disproportionate/undue influence
* Spouses – past, current, potential future, and domestic partners
* Personal residence and domicile
* ALL descendants/children, including "his, hers and ours"; also, *in vitro* and posthumous
    * Special needs/special skills/business succession players
    * Disabilities, current or future; conflicts of interests
    * Behavioral/legal/insolvency problems; citizenship and marital status
    * Estrangements
    * Minors and their guardians, especially hostile guardians

* The relative degree of cooperation among all the players, and means to anticipate, deflect, or neutralize trouble

Similar attention, of course, must apply to the client's business and personal assets, liabilities and existing tax context. Intricate business, financial, and tax issues usually means complicated trust planning:

* Obvious, traditional assets, such as businesses, land, equipment, cash, securities,

retirement funds, life insurance, contract payments receivable; but also,

* Non-traditional assets, such as intellectual property, choses in action, out of state property, digital assets, frozen genetic material, prior inheritances, limited and general powers of appointment, and any existing trust interests[74]
* Direct and contingent debts, including support orders, nuptial agreements, buy-sell agreements, prior court orders, pending or potential litigation; be alert to fraudulent transfer issues[75]
* Previous gifts, application of unified credit, and GST exemption allocation; balancing the advantages or disadvantages of inter vivos gifts against testamentary dispositions

Where do the client's hopes and dreams lie, and how can you as the attorney facilitate them?

Frequently if not quite always we find that the client and his family is for the most part functional, and endorse the personal and financial advantages offered by long-term trusts in order to:

* Assure the predictable flow of all trust income for select family members, including surviving spouses, descendants, and options for descendants' spouses, according to the client's own sense of need and priorities
* Provide for the temperate distribution and/or use of principal according to definable standards
* Protecting an"active" farmer child's right to farm ground while preserving the other, non-farming descendants' right to the landlord's share of the income.
* Applying the suitable tax formulas to assure the best advantage of marital deduction, credit shelter and GST exemption amounts, and preserving the Section 2032A Special Use Valuation option <u>if</u> the family qualifies <u>and</u> desires to accept the long term restrictions on use and transfer
* Insulating the trust property from the claims and demands of predators

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[74] More than once your author has drafted current estate planning to pass into existing trusts created by the client's parents.

[75] The Illinois Uniform Fraudulent Transfer Act (740 ILCS 160/1 - 12).

Planning prudently, with the right blend of precision, discretion, and flexibility in order to minimize risks, while preserving benefit, access, and control in each immediately successive generation, and without undue taxation, can include procedures that:

* Names spouses/children as Trustees or Co-Trustees, or each child as Trustee or Co-Trustee of his or her own sub-divided trust
* Allows an interested Trustee/beneficiary access to principal for health, education, maintenance and support (the "ascertainable standard" safe harbor afforded under Internal Revenue Code Sections 2041 and 2514)
* Gives each child/beneficiary a *limited* power of appointment to end the trust or continue it on – or to redirect it – as he or she thinks best. This option extends planning discretion to each successor generation and preserves priceless flexibility; however, this flexibility can also be limited by terms restricting the class of permissible appointees and other terms of appointment

The net effect is to give each tier of beneficiaries -- spouses, then children, appointees and/or grandchildren -- substantially all of the practical benefit of outright ownership without the tax burdens or risks of loss. Since no beneficiary is an outright owner, the trust res generally cannot be reached by the beneficiary's personal creditors, including personal nuptial and tax obligations. Conceptually, the trust can endure indefinitely; however, even if the trust does not qualify as a perpetual interest trust[76], it may endure for "lives in being plus 21 years", which under existing facts should be sufficient

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[76] 765 ILCS 305/3(a-5). A simple opt-out from the RAP will do, if desired:

This trust is a Qualified Perpetual Trust as defined and provided by 765 ILCS 305/3(a-5), and by these specific terms the rule against perpetuities does not apply. No Trustee's power to sell trust property shall be construed to the contrary.

However, that opt-out *could* cost the GST exemption of a previously exempt trust. Treas. Reg. 26.2601-1(b)(v)(B) provides that the release, exercise or lapse of a non-general power of appointment is not treated as a constructive addition to a trust if such power of appointment is created in a gst-exempt irrevocable trust and a power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period beyond the perpetuities period applicable to the original trust (with a safe harbor 90-year perpetuities period). This rule appears to preclude the exercise of a power of appointment to create a dynasty trust without busting the GST exemption of the trust.

to cover two, three, four or more generations after the creator's death -- an ample term. It is your author's experience that once these advantages are explained and considered, the children are often the most enthusiastic advocates of the plan.

Selecting the trustee is key, and deserves a protracted word. The right trustee can occasionally salvage a bad plan, but a bad trustee can wreck the best of thinking and drafting. Sometimes it is a good idea to appoint a professional corporate fiduciary; equally often it is better to name a family member – sometimes an "interested" family member; sometimes a "disinterested" family member; and, sometimes it is a good idea to name both as co-fiduciaries with carefully defined and allocated responsibilities and authorities.

The traditional corporate trust department of 25 years ago bears little resemblance to its modern counterpart, and concurrent with that evolution we have found ourselves employing more and more non-professionals -- especially, family members -- as "boss" of the entrusted family venture. Practically every trust officer wants to do a good, conscientious job; to be responsive to his/her beneficiaries; to be professional, impartial, thoughtful and effective. But trust officers are not free agents: they work for the trust department, which in turn is a division of some other financial services enterprise, which exists to make money for its owners/stockholders (and those owners can change quickly and unpredictably.)

Making money for the owners is not always consistent with providing the hands-on service that was the hallmark of the loss-leading trust departments of yore – and few will argue that the trend is to provide more wealth management (i.e., investment and financial services) than beneficiary services, or that the standard of training and experience is shifting away from the law and in favor of business and accounting backgrounds. In some of the more drastic cases, the trust departments have become aggressive profit centers where fewer and fewer services are being performed by fewer and fewer people with less and lesser training – while charging the highest fees the market will bear and the courts will allow.

Contrast that with our increasingly better-informed and more highly-educated client base.

These new folks -- the Gen-Xers and Millenials who often are the ultimate objects of our clients' bounty -- are inculcated to believe in themselves and their inherent abilities, and fluent in research methods that some of us find a little astonishing. These client/beneficiaries want to be in charge; they do not want to pay for services and information that should be "for free"; and, they expect us to structure the family succession plan accordingly.

So, in the first case, you have traditional trust departments, with their steadiness, continuity, training and resources, that:

* Don't die or divorce or disappear
* Don't steal the money, or lose the assets
* Have experience and skills
* Are "disinterested" -- which can be very important for tax thinking
* Have access to outside advisers, including legal counsel, who can help implement and interpret in the face of changing circumstances, and manage or defuse disputes, and
* Generally administer the trust in a competent, professional way.

There will never be a shortage of need for those virtues. There will always be complex situations and family dynamics that require them; and, even in the most tightly structured family plans, there will almost always be a role for a corporate trustee somewhere in the equation.

In contrast, you can have family members running their own show, who:

* Frequently die, divorce, suffer physical or mental disability, or sometimes just disappear -- and rarely at a convenient moment
* Statistically, a few will steal or lose something sooner or later
* Often lack necessary experience, skills – and all-too-often, good sense
* Are far from "disinterested" -- which means that, in addition to being willing to occasionally indulge in retribution and other mischief, they are at risk of countless tax potholes
* May or may not choose to consult business, financial, or legal counsel when prudent or necessary (they cost money), and
* May or may not administer the fiefdom competently or wisely.

Drafting for the corporate fiduciary is by far the easier. There are far fewer tax traps and they will even give you their preferred forms[77]. So, in the absence of institutional strength and tax insulation, the drafting in favor of the family fiduciary requires all that more thought, to provide:

* Guidance and advice on what to do when – largely in the form of clearly worded mandates, supplemented by equally precise precatory explanations and statements of purpose and desires
* Insulation from unwanted tax events, which means among other things the very careful observation of the power of appointment principles
* Conflict management, including defining what is and is not a conflict of interest; who gets the ultimate benefit and makes the ultimate decisions among competing authorities and interest holders; addressing unmet expectations; mediation, as a means of conflict avoidance; arbitration and litigation, as a means of conflict resolution; and, the consequences of intransigence
* Reformation in the event of radically changed circumstances.

Here is one way to incorporate some of these Trustee succession and other thoughts:

ARTICLE THREE: Trustees and Succession.

A. For so long as either Grantor or Grantor's spouse, MARY NEWLIN, is living:

1. Grantor shall serve as sole Trustee until her death, resignation, or "disability" (as that term is hereinafter defined).

2. When Grantor ceases to serve then Grantor's spouse, MARY NEWLIN, shall succeed him as Trustee.

3. At such time as both the Grantor and Grantor's spouse should for any reason cease to serve as Trustee, and unless otherwise appointed by the Grantor pursuant to her power to amend this instrument, the successor Trustee shall then be:

FIRST: Such one or more person(s) or entities qualified to administer trusts as the Grantor's spouse may appoint by

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77 Which almost never include provisions for removal and replacement.

a signed written instrument (including a Will) specifically referring to this limited power of appointment; and,

SECOND: **In default of the foregoing, then Grantor's sons, LOGAN NEWLIN and LARRY NEWLIN, or the survivor of them shall succeed as Co-Trustees or sole Trustee; and,**

THIRD: **In the event all three of Grantor's Spouse and Grantor's sons should for any reason cease to serve as Trustee, the successor Trustee shall then be such one or more person(s) or entities qualified to administer trusts as the last of them to serve as sole Trustee may appoint by a signed instrument (including a Will) specifically referring to this limited power of appointment.**

B. Upon the death of the last to die of Grantor and Grantor's Spouse:

1. Logan Newlin shall be sole Trustee of his Descendants Trust created pursuant to ARTICLE NINE below;

2. Larry Newlin shall be sole Trustee of his Descendants Trust created pursuant to ARTICLE NINE below; and,

3. Except as otherwise effectively appointed pursuant to Paragraph C. immediately below or pursuant to said ARTICLE NINE:

a. Larry Newlin, shall succeed Logan Newlin as Trustee of any Descendants Trust created for Logan Newlin or any of his descendants or appointees; and,

b. Logan Newlin, shall succeed Larry Newlin as Trustee of any Descendants Trust created for Larry Newlin or any of his descendants or appointees.

C. Subject to the foregoing, but except as otherwise limited by the exercise of any power of appointment pertaining to successor Trustees herein provided, each person who becomes a Trustee pursuant to the provisions of this instrument, except a Trustee who has been removed from office by a beneficiary pursuant to Paragraph E. below, shall have the limited power to appoint one or more person(s) or entities qualified to administer trusts as his or her Co-Trustee or as successor Trustee for any Trust for which he or she is serving as Trustee or Co-Trustee. This power may be exercised at any time, from time to time, or upon the Trustee's death, by a signed instrument in writing (including a Will) specifically referring to this limited power of appointment.

D. If any person named or appointed Trustee pursuant to the

provisions of this instrument should fail to become or cease to serve as Trustee for any reason (including without limitation as a result of death, disability, removal or resignation), and as a result there be no Trustee then serving for a Trust created or appointed according to this instrument, the Trustee for that Trust shall then be such one or more person(s) or entities qualified to administer trusts as may be selected by a majority of the then-current income beneficiaries of that Trust (which selection may be made by a beneficiary's legal or natural guardian or guardians if he or she is then under a legal disability or has failed to attain majority.)

E. In addition to the foregoing general provisions governing the succession of Trustees:

1. Any Trustee may resign as Trustee of any one or more Trusts (without being required to resign as Trustee of any other Trust) upon the giving of thirty days' prior written notice, duly signed and delivered to all the then current beneficiaries affected thereby.

2. Any Trustee OTHER THAN THE GRANTOR'S SPOUSE, LOGAN NEWLIN and LARRY NEWLIN, may be removed, with or without cause, by the majority of the then-current income beneficiaries of a Trust upon the giving of thirty days' prior written notice delivered to the Trustee (which notice may be made by a beneficiary's legal or natural guardian or guardians if he or she is then under a legal disability or is a minor.)

3. Notwithstanding the provisions of Subparagraph E.2. above, any Trustee who is determined to be "disabled" (upon the conditions and in the manner hereafter provided) shall immediately, and for the remaining term of that disability be disqualified to serve as Trustee. This disqualification shall endure through the entire period of disability, but shall end when the disabling condition ends, at which time that person may be restored as Trustee. In such event the duly nominated or appointed successor Trustee shall immediately assume the office of Trustee.

4. Upon such resignation or removal, or replacement for disability, the vacating Trustee shall promptly deliver to the remaining or successor Trustee all the property and assets of the relevant Trust Estate(s) in its possession or under its control. After full settlement of such Trustee's accounts, the resigning or removed Trustee shall stand fully discharged and released from any further liability or responsibility therefor.

F. The appointment or succession of any successor Trustee or any Co-Trustee shall become effective upon the filing of his, her or its written

acceptance and agreement to adhere hereto with: (i) the records of the Trust; (ii) the remaining Trustee(s), if any; and, (iii) the income beneficiary or beneficiaries of such Trust (or his, her or their legal or natural guardian or guardians, if any such beneficiary is then under a legal disability or is a minor.)

Of course these broad directives are supplemented in detail in the subsequent Article spelling out the Trustee's general powers, discretions and limitations.

C. Some Asset Protection Notions

Asset protection is rarely the driving force for modern estate planning, but it is still an important byproduct of the process.

1. Gifts in Trust

The cornerstone of asset protection thinking is a childishly simple twist, yet one too often forgotten:

What you don’t own can’t be taken from you.

That principle has provided the foundation on which various practitioners have developed a number of long term, multi-tiered beneficial transfer techniques. Usually these plans involve one or more trusts (largely because trust law is so very flexible and accommodating), sometimes supplemented (not always, but increasingly) with various limited liability business entities. These tax advantaged, asset-protected transfers to or for the benefit of our clients’ loved ones generally consolidate lawful protection from claims and taxes with substantial benefit, dominion and control for the intended beneficiaries.

Property subject to a nongeneral power of appointment is generally exempt from claims of the donee’s creditors. The donee/holder of a nongeneral power of appointment is not considered to have a property interest in the appointive power because his/her access is substantially restrained from providing an immediate economic benefit of the donee. An ascertainable standard limitation on present powers to withdraw, for example, is always reviewable by a court of competent jurisdiction. Since there is no property interest, the property subject to the nongeneral power is not includible for purposes of bankruptcy,

garnishment, divorce, Medicaid eligibility, or other calculations of the vulnerable holder's own property.[78]

Since so very much of these intertwined control and asset protection features depend upon recognizing and preserving the distinction between nongeneral and general powers of appointment there is substitute for careful, even detailed planning and drafting when including powers of appointment within the estate plan. Key issues that should always be considered include:

- * What power, or powers, over what interests in property, is/are being created?
- * Who is to have the power, and what limits are to apply over the scope and manner of its exercise?
- *. In whose favor may the power(s) be exercised, and under what conditions, if any?
- * To whom will the property pass in the event of default of appointment?
- * In what manner, and to what degree, may the power be exercised? (Remember, these powers affect titles, which some non-expert is going to examine someday, and that non-expert is going to require a reasonably reliable standard of proof before acting upon the holder's direction.)

Finally, **help your audience**, who more likely than not will find powers of appointment confusing. Don't just refer to a "power of appointment" or "power to appoint" without adding one or the other crucial qualifying adjectives:

- * If the point is to create a *nongeneral* power, with very important limitations, then specifically include the reference to "the nongeneral power to appoint", or something grammatically consistent with the text
- * Similarly, if your plan requires a *general* power of appointment, then say so

And, if the power is held by a beneficiary who is also serving as trustee, it won't hurt

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[78] *See, e.g.*, Uniform Powers of Appointment Act Section 504; 11 U.S.C. § 541(b)(1) (assets subject to a special power of appointment are not included in the bankruptcy debtor's estate.)]

to qualify a fully discretionary power as a "nonfiduciary" power. Sometimes that may be redundant, given other provisions several pages away, but a little redundancy can be a good thing sometimes.

In practice the specific terms, limitations, discretions, and controls will vary from client to client, situation to situation, and thus will require quite a bit of selective drafting in the resulting dispositive articles.

2. Self-settled Initiatives

If the predators can't reach what you *don't* own, then the converse is also true:

> **That which you own (including that which you have unfettered access to) is fair game for the bad guys.**

Generally speaking, creditors can reach the assets of a self-settled trust in which the debtor retains a present right to access or control those assets, even if the trust is otherwise an irrevocable transfer. The trustee in bankruptcy is deemed to "stand in the shoes" of the debtor, and therefore capable of exercising the debtor's ownership prerogatives. Property that is subject to a presently exercisable general power of appointment is generally subject to the creditors of the donee because it is construed as the practical equivalent of an ownership interest, at least for bankruptcy purposes.[79]

Several states (but not Illinois) have tried to help debtors protect their assets while retaining access and control by enacting "domestic asset protection trust" legislation, involving local trustees or co-trustees but affording the settlor a significant voice in investment and means of access. These statutory schemes vary widely, and have had varying degrees of success. They are also costly, and generally inconvenient for an Illinois investor.

Some commentators[80] are advancing an alternative to the self-settled asset protection

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[79] 11 U.S.C. § 541(b)(1)

[80] Most of this discussion of power of appointment asset protection trust thinking and planning is distilled from these three excellent sources:

* Alexander Bove, Jr., "Using the Power of Appointment to Protect Assets – More Power

trust in the form of what is called a "Lifetime Special Power of Appointment Trust" designed along the following lines:

- * Settlor creates and funds an irrevocable trust, with discretionary sprinkle benefits among a class of preferred beneficiaries *other than* the settlor
- * Some trusted party (friend, spouse, child, whether one or more) is vested with a non-fiduciary, inter vivos special power of appointment that
- * Is broadly drawn to appoint to everyone or anyone *other than* the powerholder, his or her estate, or the creditors of either; meaning, that the settlor is a permissible appointee
- * The transfer in trust can be designed to be either a presently completed gift, or incomplete for gift tax purposes, and can be designed as a grantor trust for income tax purposes so that trust income is taxed to the settlor. Those variables will depend on the settlor's other planning considerations.

Part of the argument in favor of this arrangement is the relative uncertainty of existing DAPT laws compared to well founded "black letter" law on the limited exposure of property subject to a nongeneral power of appointment. Because the donor/settlor severs all ownership, dominion and control – immediate *and* prospective – over the transferred assets, they are protected from his or her later creditors. Since the permissible appointees include the entire world, no *de facto* ownership interests can be presumed among any one or more members of the class, with or without family attribution. And no court can force a non-interested, non-fiduciary power holder to exercise his or her discretionary power.

The asset protection provided by a special power of appointment trust is not dependent on the state where the parties reside or the state where claims might be adjudicated. Moreover, should the settlor later be forced to bankruptcy he or she can truthfully say that

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Than You Ever Imagined," 36 ACTEC Journal 333 (Fall, 2010)

- * Lee McCullough, III, "Use 'Powers' to Build a Better Asset Protection Trust," Estate Planning Journal (January, 2011)
- * Mark J. Morrise, "Using the Lifetime Special Power of Appointment Trust in Asset Protection Planning." Unpublished presentation to the Estate Planning Section of the Utah State Bar (January, 2011)

he/she is *not* a beneficiary of the trust, making its terms non-disclosable and irrelevant.

It is essential that the transfer in trust not be fraudulent in fact, or violate the Fraudulent Transfer Act (740 ILCS 160/1 - 12), which generally requires:

* That no claims be pending or threatened against the donor at the time of the transfer
* That the donor not be rendered insolvent by the transfer
* There is no intent to defraud, including an intent to incur debts in the future that will be beyond the donor's capacity to repay

Fraudulent transfers made less than four years before a claim is made can be clawed back by creditors from the trustee. Note that the four years begins to run upon transfer to the trust, and not upon a subsequent exercise of the power, which of course is a continuation of the donor's original transfer.

Boston attorney Bove suggests an even more aggressive approach by allowing the settlor to retain an income interest until the clouds begin to form. Consider Bove's example, as quoted by Provo attorney Morrise in his Utah bar presentation:

> **"[A] settlor establish[es] an income-only trust for his own benefit, giving another party, say, one of his children, a [lifetime] special power of appointment in favor of the settlor's spouse and issue (other than the powerholder). If the trust is attacked (or about to be) by a creditor, the child could exercise her power (reserving the right to revoke the exercise) and appoint the trust property to a new trust for the benefit of the settlor's spouse while she remains a spouse. When the coast became clear and the litigation against the settlor is resolved, the child could reexercise her power and appoint the property back to the original trust for the benefit of the settlor. Meanwhile, the income from the 'new' trust could be paid out to the settlor's spouse, presumably offering some benefit to the settlor. . . . To make matters more difficult for the settlor's creditors, the new trust could be settled in another state."**[81]

[81] Alexander Bove, Jr., "Using the Power of Appointment to Protect Assets – More Power Than You Ever Imagined," 36 ACTEC Journal 333 at 336; quoted in Mark J. Morrise, "Using the Lifetime Special Power of Appointment Trust in Asset Protection Planning" at pages 7 & 8.

Conspiracy theorists abound in the creditor’s rights world, especially when it comes to examining transactions among family and friends. If there is in fact a pre-existing understanding that the notionally independent power-holder will exercise upon the request or direction of the settlor/donor/creditor, it seems likely that the entire transaction could be voided as fraudulent *ab initio.* A creditor might argue that the power holder is acting as the donor’s agent or that the arrangement is really a self-settled trust in sheep’s clothing.

IV. A SYSTEMATIC EXAMPLE:
Drafting For A Multi-Generation Farm Trust

From the foregoing discussion it is possible to design, with a high degree of confidence, a multi-generational family farm trust vehicle that is:

* Designed for continued, long term, family ownership and control of hard won farm ground; yet
* Flexible enough to be suitable for the administration of substitute assets in the event the traditional family business model evolves away from farming as a result of changing priorities

The purposes of the trust will vary from family to family but will usually include many of the following:

* Assuring all farm income for family members, including surviving spouses and descendants, with options for appointments to others, such as descendants' spouses
* Protecting the "active" farmer child's right to farm the ground while preserving in the other, non-farming descendants' their respective fractional rights to the landlord's share of the income
* Various degrees of restriction on the sale of land, but with enough wiggle room to invade principal for real needs
* Applying the suitable (complex) formulae to assure the best advantage of marital deduction, credit shelter and GST exemption amounts, and preserving

the 2032A Special Use Valuation option if the family qualifies and desires to accept the long term restrictions on use and transfer.

* Insulating the trust property -- not just land but other assets -- from the claims and demands of predators

Planning to avoid risks, while preserving benefit, access, and control in each immediately successive generation, and without undue taxation, can include procedures that:

* Name spouses/children as Trustees or Co-Trustees, or each child as Trustee or Co-Trustee of his or her own portion (a sub-divided trust)
* Allow an interested Trustee/beneficiary access to principal for health, education, maintenance and support (the "ascertainable standard" safe harbor afforded under Internal Revenue Code Sections 2041 and 2514.)
* Give each child/beneficiary a *limited* (nongeneral) power of appointment to end the trust or continue it on – or to redirect it – as he or she thinks best. This option extends planning discretion to each successor generation and preserves priceless flexibility; however, this flexibility can also be limited by terms restricting the class of permissible appointees and other terms of appointment.

The net effect is to give the surviving spouse, or children – and their children – substantially all of the practical benefit of outright ownership without the tax burdens or risks of loss. Since the child/beneficiary is not the outright owner in fee (as distinct from being the Trustee):

* The trust assets can't be reached by the beneficiary's personal creditors
* The children's spouses can never have a marital interest in the trust assets, which are thus exempt from divorce property settlements
* GST-exempt trust assets are not included in the child's (or grandchildren's) taxable estates, thereby avoiding duplicate taxation

All of these can be fine-tuned with specific trust instructions to maximize flexibility and assure family fairness.

That said, of course, the following examples, and comments are by no means authoritative, or exhaustive, and are included here more for the purpose of prodding the reader's own thinking on how best to apply these principles to your own practical realities, styles, and preferences.

A. The Single QTIP Qualifying Trust with GST Apportionment

For many families, where the administrative burden of multiple trusts is barely tolerated and never welcomed, and where the client is intent on providing first for the surviving spouse to the initial exclusion of the children, there is a simple charm to eschewing the A/B/C funding morass in favor of a single 2056(b)(7) fund that will be administratively severed by fractional formula on Schedule M of the estate tax return. Since the surviving spouse's share could exceed the GST exemption amount, the GST apportionment[82] between the exempt and non-exempt portions is built on top of the marital instructions. Note the "pecuniary Non-GST Exempt lead" allocation formula, which captures the bulk of the 2032A savings for the exempt fund, and the very broad precatory tax instructions in Paragraph G:

ARTICLE SEVEN: Disposition Upon Grantor's Death

This Agreement, as amended from time to time, shall become irrevocable upon Grantor's death. At such time the Trustee shall collect any property directed to pass to the Trust as a result of Grantor's death, whether under Grantor's Will or otherwise, and shall thenceforth hold, administer and distribute the Trust Estate according to the following provisions:

A. [debts; taxes; costs]

B. [specific gifts; charities]

C. [personal effects]

D. Subject to the foregoing, the Trustee shall then divide the Trust Estate then remaining (the "Net Trust Estate") into two portions, referred to as

[82] Commonly known as a "qualified severance". Code Section 2642(a)(3); Treas. Reg. 26.2642-6.

the "Non-Exempt Portion" and the "Exempt Portion".

1. The Trustee shall allocate to the Non-Exempt Portion a pecuniary amount equal to the amount, if any, by which the value of Grantor's Trust Estate (as finally determined for federal estate tax purposes) exceeds the "GST Exempt Amount".

2. The Trustee shall allocate the balance and remainder of the Net Trust Estate to the Exempt Portion.

3. Any property allocated in kind to the Non-Exempt Portion shall be valued for the purpose of satisfying the pecuniary amount required at its fair market value as of the actual date of allocation.

4. To the extent possible while consistent with the preceding requirements of this Paragraph D., Grantor's "Farm Property" (as hereinafter defined) shall be allocated to the Exempt Portion.

5. The "GST Exempt Amount" described in Subparagraph D.1. above means the unused portion of Grantor's generation skipping tax exemption allowable to Grantor under Internal Revenue Code Section 2631, reduced by the aggregate amount of allocations of such exemption before or after Grantor's death other than any allocations to the Exempt Portion.

E. If Grantor's Spouse survives Grantor, both the "Non-Exempt Portion" and the "Exempt Portion" shall pass to the "Marital Trust", to be further divided, held, administered and distributed pursuant to ARTICLE EIGHT below. All references to the Marital Trust or Trusts(whether one or more) shall apply to both the Non-Exempt Portion and the Exempt Portion unless otherwise stated; provided, however, that each such Portion, and any subdivision of each such Portion, shall at all times be segregated from the other as distinct Trust Estates.

F. If Grantor's Spouse does not survive Grantor, both the "Non-Exempt Portion" and the "Exempt Portion" shall pass to the "Descendants Trusts", to be further divided, held, administered and distributed pursuant to ARTICLE NINE below. All references to the Descendants Trusts (whether one or more) shall apply to both the Non-Exempt Portion and the Exempt Portion unless otherwise stated; provided, however, that each such Portion, and any subdivision of each such Portion, shall at all times be segregated from the other as distinct Trust Estates.

G. In furtherance of the foregoing provisions, and not in derogation

thereof, it is the Grantor's intention that the Trustee shall not be required to administer any Trust Estate that is only partially exempt from generation skipping taxes, but instead shall monitor the Trust Estates throughout the term of the Trust(s) provided for herein so as always to provide that: (i) the "Exempt Portion" shall consist of that portion of a Trust Estate to which sufficient generation skipping transfer tax exemption (as that term is defined under Internal Revenue Code Section 2631 and supporting regulations) has been allocated by the Transferor of that property (whether the Grantor as aforesaid, or some successor interest holder in the manner hereinafter provided) so as to produce an inclusion ratio of zero for that Portion; and, (ii) that the "Non-Exempt Portion" shall consist of all that part of a Trust Estate other than the Exempt Portion. It is the Grantor's desire, which is not binding on any beneficiary hereunder, that a taxable general power of appointment will be kept in effect over the Non-Exempt Portion property when the beneficiary believes that the inclusion of the property subject thereto in such beneficiary's gross estate for federal estate tax purposes may achieve a significant savings in transfer taxes by subjecting the property to the federal estate tax rather than a generation skipping transfer tax imposed under Chapter 13 of the Internal Revenue Code; and, that by providing for the creation of taxable general powers of appointment by certain beneficiaries as hereinafter provided the beneficiaries may make optimum use of the generation skipping transfer tax exemption (as that term is defined under Internal Revenue Code Section 2631 and supporting regulations) available to each such beneficiary, so that property previously held as part of the "Non-Exempt Portion" might thereafter be held as part of the "Exempt Portion." In apportioning property between the Non-Exempt Portion and the Exempt Portion:

1. The Trustee may rely upon the allocations of generation skipping transfer tax exemption made by the Transferor of the property to the Trust, and shall adjust the apportionments to conform with any later allocations, or revisions to allocations or values upon audit, in order always to maintain a zero inclusion ratio for the Exempt Portion; and,

2. If any such property was valued for the purposes of allocating generation skipping transfer tax exemption at a value other than the fair market value as of the date of the transfer (or deemed transfer), any property so apportioned to one or another Portion to maintain the zero

inclusion ratio shall be selected in such manner that such property shall have an aggregate fair market value fairly representative of the appreciation and depreciation in fair market value since the date of the original transfer of all property available for apportionment on each date of apportionment (or re-apportionment).

B. The Marital Trust

These marital trust provisions begin with the usual 2056(b)(7) QTIP model provisions, but:

* Paragraph B. (and later language) anticipates this trust being a qualified beneficiary for any retirement plans, sufficient to afford asset protection without triggering immediate recognition of the IRD as could be required by a pecuniary formula
* Paragraph C. allows the surviving spouse ascertainable standard access to principal assets
  * "other than" farm property, which is restricted under later provisions; and
  * subject to disqualification in the event of disability under later provisions
* Allows the surviving spouse a carefully crafted limited power of appointment to re-direct the trust estate among family members, but subject to a number of boundaries to his/her discretion
* To the extent not otherwise appointed, directs re-shuffling the marital exempt and non-exempt funds to maximum advantage per Rev. Proc. 64-19 "fairly representative" language, and the payment of resulting federal and Illinois estate tax from the remaining Non-Exempt fund

ARTICLE EIGHT: The Marital Trust Provisions.

The Trustee shall hold and administer the Marital Trust estate for the exclusive lifetime benefit of Grantor's Spouse in conformity with Grantor's intention to establish a transfer in trust of qualified terminable interest property that is eligible for the federal and Illinois estate tax marital deduction within the meaning of Internal Revenue Code Section 2056(b)(7). All references in this instrument that are inconsistent with this overriding intention shall be deemed amended or, if necessary, deleted, in order to conform with this overriding

intention. Except for the power to make tax elections [including specifically but without limitation the power to make partial or formula elections for qualified terminable interest property in order to obtain maximum lawful transfer tax advantage, which power is hereby specifically created in the Trustee] the Trustee shall have no power over the Trust Estate which if exercised could defeat the federal and Illinois estate tax marital deduction eligibility anticipated by this instrument.

A. Commencing upon Grantor's death, the Trustee shall pay to or for the benefit of Grantor's Spouse all of the net income of the Marital Trust in regular monthly or other convenient installments, and at least annually.

B. If the Trust is then the owner or the beneficiary of an individual account in any employee benefit or retirement plan, or any individual retirement or deferred benefit plan, the income of the individual account shall be income of the Trust. All of such income shall be timely withdrawn and paid to or for the benefit of Grantor's Spouse in regular installments, and at least annually.

C. The Trustee shall also pay to or for the benefit of the Grantor's Spouse so much of the Marital Trust principal (other than "Farm Property", as that term is hereinafter defined) as may be required from time to time to provide for Grantor's Spouse's health, education, maintenance and support in reasonable comfort only. Grantor's primary concern during the life of the Grantor's Spouse is for the Grantor's Spouse's support in reasonable comfort, without regard to the Grantor's Spouse's other assets or income, and in priority over the interest of any potential successor beneficiary; provided, however:

1. That all such distributions of principal shall always adhere to this ascertainable standard; and,

2. That all distributions of principal shall always be subject to the specific restrictions that apply in the event of the disability of a beneficiary that are hereinafter provided.

D. In addition, and during the month of June of each calendar year only, the Grantor's Spouse shall have the right to withdraw or demand distribution, free from trust, an amount of trust principal that does not exceed the greater of: (i) FIVE THOUSAND DOLLARS ($5,000.00); or, (ii) FIVE PERCENT (5%) of the value of the Marital Trust Estate on June 1 of each

year. This right of withdrawal shall be non-cumulative, may be exercised only by a signed written instrument delivered to the Trustee during the month of June of each calendar year, and shall lapse if not exercised on or before June 30 of each year.

E. The Trustee shall make no unsecured loans from the Marital Trust Estate without the written consent of Grantor's Spouse, and any unproductive property held in the Marital Trust shall be sold by the Trustee upon being directed to do so by the Grantor's Spouse.

F. Upon the death of the Grantor's Spouse the accrued and undistributed income of the Marital Trust shall be paid to the estate of Grantor's Spouse.

G. The Marital Trust shall terminate upon the death of Grantor's spouse, whereupon the Trustee shall then distribute the Marital Trust Estate remaining in compliance with the following provisions:

1. The Grantor's Spouse shall have the nongeneral, nonfiduciary testamentary power to appoint all, any portion of, or any beneficial interest in the Marital Trust Estate (including principal, income, the power to appoint successor interests or successor Trustees, and any other right, prerogative or privilege not elsewhere restricted by this instrument), outright or in trust,

[option 1]

* **but only to or for the benefit of such one or more of Grantor's descendants then living or thereafter born.**

[option 2]

* **to or for the benefit of such one or more person(s) or entities *other than* Grantor's Spouse, his/her estate, or the creditors of either.**

This power of appointment may be exercised by the Grantor's Spouse in such portions, amounts or manner as he/she Spouse may appoint by

[option 1]

* **a Will**

[option 2]

* a “valid testamentary instrument” (as that term is hereafter defined)

that specifically refers to such nongeneral power of appointment, and may be exercised by the Grantor’s Spouse in his/her sole and unfettered discretion, without obligation to act or not to act; provided, however, that no such appointment shall be effective:

a. to appoint such Trust property in a manner resulting in any Trust having a federal generation-skipping transfer tax inclusion ratio greater than zero and less than one;

b. to allow the distribution of Trust principal free of trust to any person who has not attained the age of 25 years;

c. to allow the sale, partition, mortgage, distribution free of trust, or other disposition of any separate parcel of "Farm Property" (as that term is hereinafter defined) except in strict compliance with the provisions therefor that are hereinafter provided; or,

d. to create in any appointee a taxable general power of appointment over the Exempt Portion of a Trust Estate or Trust property (although the limited power may be exercised to create in the appointee a general power of appointment over any Non-Exempt Portion so appointed).

2. Subject to the foregoing, and except as otherwise effectively appointed, the Trustee shall then distribute the Marital Trust Estate remaining as follows:2. Subject to the foregoing, and except as otherwise effectively appointed, the Trustee shall then distribute the Marital Trust Estate remaining as follows:

a. The Trustee shall add to the Marital Exempt Trust a pecuniary amount of the Marital Non-Exempt Trust property equal to the unused portion of Grantor's Spouse's generation skipping transfer tax exemption (as described in Internal Revenue Code Section 2631) remaining after all allocations of such exemption before or after Grantor's Spouse’s death other than to Grantor's Marital Exempt Trust. The Trustee may rely on the certification of his or her personal representative as to such amount.

b. The Trustee shall then pay, from the Marital Non-Exempt Trust property remaining, if any, any federal estate tax and state death taxes otherwise recoverable from the Marital Trust by reason of the death of

the Grantor's Spouse, but only to the extent such payment will not result in a federal generation-skipping transfer tax inclusion ratio for the Marital Exempt Trust greater than zero.

c. Subject to the foregoing, the Trustee shall then distribute both the Marital Non-Exempt Trust and the Marital Exempt Trust remaining to the Trustee or Trustees of the Descendants Trusts, to be held, divided, administered and distributed pursuant to ARTICLE NINE below. The Marital Non-Exempt Trust property shall be made part of the "Non-Exempt Portion" and the Marital Exempt Trust property shall be made part of the "Exempt Portion." All references herein to the Descendants Trusts (whether one or more) shall apply to both the Non-Exempt and Exempt Portions unless otherwise stated; provided, however, that each such Portion, and any subdivision of each such Portion, shall at all times be segregated from the other as distinct Trust Estates.

d. Any property allocated in kind to the Marital Exempt Trust pursuant to Sub-subparagraph G.2.a. above shall be valued for the purpose of satisfying the pecuniary amount required in that Sub-subparagraph at the value of such property as finally determined for federal estate tax purposes in Grantor's Spouse's estate, or, if such item is an investment or reinvestment of property included in his/her gross estate for federal estate tax purposes or the proceeds of any sale or other disposition of property so included or of any such investment or reinvestment, at the federal income tax basis of such property at the actual date of allocation to such trust; provided, however, that any property so allocated to the Marital Exempt Trust shall be selected in such manner that such property shall have an aggregate fair market value fairly representative of the appreciation and depreciation in fair market value since Grantor's spouse's death of all property available for allocation on each date of allocation.

Paragraph A., of course, is a QTIP mandatory income requirement. But Paragraph C. is a discretionary option creating a power of withdrawal over principal that is subject to an ascertainable standard, suitable for practical purposes by either a corporate fiduciary or the surviving spouse as his/her own trustee. The statement of the grantor's priority of purposes instructs the trustee to be generous within the confines of this standard, and provides the

trustee some shelter from the remaindermen's impatience to get their hands on the money. Note the subordination of all rights to principal to the self-amending special needs provision in the event of disability.

Paragraph D. is intended to strike a compromise between the grantor's desire to provide generous access, while limiting the period during which the 5 and 5 amount will be vulnerable to inclusion in the survivor's gross estate. (Of course, if the entire trust is elected for QTIP treatment it is going to be includible in the spouse's estate anyway; the protection is more important for those instances where the single trust receives a fractional QTIP election, or none at all.) In targeting the mid-year, 30-day term of June, the thought is that the survivor can plan for this withdrawal if he or she wants some extra cash, or let it lapse (with relief) on July 1, if not. The grantor trust income tax rules cannot be ignored for this period, but since the survivor has a mandatory income right anyway it would seem that in all but the very largest trusts that burden can be handled with skilled tax reporting on the fiduciary income tax return.

The nongeneral, nonfiduciary testamentary power of appointment in Paragraph E.1. provides a dispositional control mechanism for the survivor. He or she will have the opportunity, presumably many years after the death of the grantor, to reconsider the needs, desires and deserts of the family, and to adjust the distribution of the fund as circumstances may then indicate.

* Option 1 limits the class of permissible appointees to direct descendants.
* Option 2 opens the class to the entire world.

The missing “option 3" is everything in between, limited only by the client’s desires and strategic intentions, and the drafter’s skill in reducing those prerogatives to a rational and effective direction.[83]

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[83] Another advantage of placing this power in the survivor is to encourage the children and grand children to be kind to the power holder. Cynics can have a field day with this one, but there are plenty of times when the first spouse’s primary purpose is to extract that very contribution -- of kindness and attention -- from the potential takers.

Because some jurisdictions (and the Restatement (Third) of Trusts) suggest that when a power of appointment runs with the office of trustee there is a presumption that the power is subject to fiduciary principles, an express disclaimer of fiduciary duty is added to the interested trustee's discretion.

Testamentary powers have traditionally been exercised by a Will. But a Will is non-dispositive unless admitted to probate, and sometimes probate is either undesirable or impracticable. A "valid testamentary instrument" could be defined:

> **A valid testamentary instrument is: (a) the holder's valid Last Will and Testament, including any codicils thereto, actually admitted to probate by a court of competent jurisdiction, if any; or, (b) in default of the foregoing, then a revocable trust agreement made by the holder in his or her lifetime that became irrevocable upon the holder's death and provides for the appointment upon the holder's death by specific reference.**

Finally, Paragraph G.2. provides one of many possible alternatives for the essential provision for distribution in default of appointment.

C. The Descendants Trusts

These provisions supplement the division/disposition terms of the preceding Article, and govern the transition into the long term trust or trusts. Both parents are gone, and the property that has made its way to this stage is now net of estate tax and segregated for GST tax purposes.[84] One of two things can now occur: the Descendants' Trust can become a

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[84] Ideally there should be only two kinds of generation skipping trusts: (i) those that are intended to be wholly exempt, and thus insulated from GST tax and estate tax for more than one generation; and (ii) those that are not.

* Exempt trusts will have an inclusion ratio of "0", and remain exempt so long as no beneficiary is charged with gift or estate tax during its term
* Non-exempt trusts will have an inclusion ratio of "1", and each taxable distribution and taxable termination will subject the fund to the maximum GST equivalent tax

This trust language includes several references to preserve this distinction.

Non-exempt trusts are employed more for their asset protection features than for tax planning. To protect them from the GST tax a taxable general power of appointment is imposed strategically upon each successor beneficiary.

functional single entity, in which the children (or a predeceased child's descendants) have undivided interests[85], or the Trustee may, after gathering things together, promptly disperse them again by creating separate "Descendants Trusts" for each beneficiary.

What to do at this point is a crucial ultimate decision for the family, and deserves a lot of consideration of all the factors mentioned earlier, and then some: the degree of family cooperation; who's in charge; the desire to hold a single asset or business together; the relative competence or special needs of the family; and so forth. On balance, however, experience seems to show that most first-generation beneficiaries -- those who are being skipped for tax benefit and asset protection purposes -- will more readily accept the totality of the plan if each feels that he or she is in nominal control of his or her own inheritance and its destiny, since expectations of fairness count. More often than not this will mean forming separate trusts , and probably naming each adult beneficiary as at least a Co-Trustee.
Here is one approach suitable to a farming family context:

ARTICLE NINE: The Descendants Trusts Provisions

The Trustee shall divide all of the "Exempt Portion" and "Non-Exempt Portion" property directed to pass to the Descendants Trusts (while maintaining the distinction between the Exempt Portions and Non-Exempt Portions) pursuant to the foregoing into equal shares of each such Portion. One share of the Exempt Portion and one share of the Non-Exempt Portion shall be created for each of LOGAN NEWLIN and LARRY NEWLIN, (the "Grantor's Children" or "Child") living at that time, and one share of the Exempt Portion and one share of the Non-Exempt Portion shall be created for each deceased Child of Grantor who has one or more descendants then living, which shares shall be further divided into shares for such descendants, per stirpes. Each resulting share of the Non-Exempt Portion and the Exempt Portion shall be named for the Child or other descendant beneficiary for whom it was created

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[85] Thus invoking the "substantially separate and independent share" requirements of Code Section 2654 and Treas. Reg. 26.2654-1(a).

and thereafter held and administered as a separate Descendants Trust for his or her benefit according to the following provisions:

A. The Trustee shall pay to or for the benefit of the beneficiary all of the net income of the Trust in regular monthly or other convenient installments, and at least annually.

B. The Trustee shall also pay to or for the benefit of the beneficiary so much of the Trust principal (other than "Farm Property", as hereinafter defined) as may be required from time to time to provide for his or her health, education, maintenance and support in reasonable comfort only. Grantor's primary concern during the life of each Descendants Trust's current beneficiary is for the support in reasonable comfort of that current beneficiary, without regard to that beneficiary's other assets or income, and in priority over the interest of any potential successor beneficiary; provided, that all such distributions of principal pursuant to this Paragraph shall always adhere to this ascertainable standard.

C. In addition, and during the month of June of each calendar year only, the beneficiary shall have the right to withdraw or demand distribution, free of trust, an amount of Trust principal (other than "Farm Property", as hereinafter defined) that does not exceed the greater of: (i) FIVE THOUSAND DOLLARS ($5,000.00); or (ii) FIVE PERCENT (5%) of the value of the Descendants Trust on June 1 of each year. This right of withdrawal shall be non-cumulative, may be exercised only by a signed written instrument delivered to the Trustee during the month of June each calendar year, and shall lapse if not exercised on or before June 30 of each year.[86]

D. Notwithstanding the provisions of Paragraphs A. - C. above, all distributions of income and/or principal from each Descendants Trust, however or whenever created, shall be subject to the specific restrictions that apply in the event of the disability of a beneficiary that are hereinafter provided.

E. It is Grantor's expectation that no distribution of principal shall be made from any Exempt Portion until substantially all of the Non-Exempt Portion of that Descendants Trust has been exhausted.

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[86] See, Code Sections 2514(e) and 2041(b)(2). The price of this flexible access is that the 5% value of the trust will be includible in the beneficiary's estate if he or she dies before the power lapses. That is why the window is open for just one month during the year.

F. Upon the death of each Descendants Trust beneficiary his or her Descendants Trust Estate shall pass as follows:

1. The Beneficiary shall have the general nonfiduciary testamentary power to appoint any part or all of the "Non-Exempt Portion" of the Trust to his or her estate, but only by a Will which specifically refers to this general power of appointment [; provided, however, that the exercise of said power shall not be effective without the written consent and joinder of the then-acting president of the First State Bank of Allison, Denton, Illinois, or its corporate successor, which consent may be granted or withheld in his/her sole and unfettered non-fiduciary discretion, without obligation to consent or not to consent.]

2. Subject to the foregoing, the Beneficiary shall also have the nongeneral nonfiduciary testamentary powers:

a. To appoint the right to receive any part or all of the income from the "Exempt Portion" of his or her Trust Estate, and from that part of the Non-Exempt Portion not effectively appointed pursuant to Subparagraph F.1. above, to or for the benefit of his or her spouse for any period of time not to exceed the spouse's lifetime.

b. To appoint all, any portion of, or any beneficial interest in the Exempt Portion, and that part of the Non-Exempt Portion not effectively appointed pursuant to Subparagraph F.1. above, of his or her Trust Estate (including principal, income, the power to appoint successor interests or successor Trustees, the power to create successive limited or general powers of appointment, and any other right, prerogative or privilege not elsewhere restricted by this instrument), outright or in trust, but only to or for the benefit of such one or more of Grantor's descendants (other than the beneficiary/power holder) then living or thereafter born.

3. In each case these powers may be exercised in the Beneficiary's sole and unfettered discretion, without obligation to act or not to act, in such portions, amounts or manner as the Beneficiary may appoint by a Will which specifically refers to the power of appointment being exercised; provided, however, that no exercise of a nongeneral power of appointment shall be effective:

a. to appoint the Exempt Portion of the Trust property in a manner resulting in any trust having a federal generation-skipping

transfer tax inclusion ratio greater than zero;

b. to allow the distribution of Trust principal free of trust to any person who has not attained the age of 25 years;

c. to direct the sale, partition, distribution free of trust, or other disposition of any separate parcel of "Farm Property" (as that term is hereinafter defined) except in strict compliance with the provisions therefor that are hereinafter provided; or,

d. to create in any appointee a taxable general power of appointment over the Exempt Portion of a Trust Estate or Trust property (although the limited power may be exercised to create in the appointee a general power of appointment over any Non-Exempt Portion so appointed).

e. [other personal restrictions that the client may wish to apply, such as holding a related farm business together, preserving environmental preferences, etc.**]**

4. Except as otherwise effectively appointed, the Trustee shall collect all the property remaining in or passing to the Descendants Trust pursuant to the foregoing; reapportion the Exempt Portion and Non-Exempt Portion property to reflect any allocations of generation skipping transfer tax exemption taking effect upon the death of the Beneficiary, if any; and then divide all the "Exempt Portion" and "Non-exempt Portion" property (while maintaining the distinction between the Exempt Portions and Non-exempt Portions) into equal shares of each Portion so as to provide:

a. One such share of the Exempt Portion and one such share of the Non-Exempt Portion for each living child of the deceased Beneficiary, and one such share of each Portion for each deceased child of the deceased Beneficiary who has one or more living descendants, which shares shall be further divided into similar shares for such descendants, per stirpes.

b. If the Beneficiary is not survived by any descendants, then to provide one such share of the Exempt Portion and one such share of the Non-Exempt Portion for each surviving sibling of the Beneficiary, and one such share of each Portion for each deceased sibling who has one or more living descendants, which shares shall be further divided into similar shares for such descendants, per stirpes.

c. If the Beneficiary is not survived by any descendants or siblings, then to provide shares of each such portion for those persons who would inherit from the Beneficiary's intestate estate, in the manner and proportions prescribed by the Illinois rules of descent and distribution.

d. Each share allocated to one of the Grantor's descendants for whom a Descendants Trust then exists shall be added to his or her Trust Estate. Each share allocated to a new descendant beneficiary shall thereafter be held and administered as a new Descendants Trust. The Trustee shall administer the Exempt Portion and Non-Exempt Portion of that new Descendants Trust, and shall distribute the income and principal thereof to or for the benefit of that beneficiary in the same portions, amounts or manner, and subject to the same restrictions, prerogatives and powers of appointment (including specifically the defined general power of appointment over the Non-Exempt Portion and the defined nongeneral powers of appointment over the Exempt Portion) accorded by this instrument to each of the Descendants Trust's beneficiaries initially.

Paragraphs A. - E. are very similar to the administrative rights and restrictions applicable to the Marital Trust. Paragraph F.1 is a classic general power of appointment, limited to one of the four named appointees set forth in Code Sections 2514 and 2041, and intended to assure that the non-exempt portion of the fund will be taxed at the beneficiary's death (thereby avoiding a generation skipping transfer). The additional bracketed restriction is intended to mute the power holder's authority in fact by restricting the power's effective use to the consent of someone who has neither a substantial or adverse interest in the fund. If the donor has more faith in the beneficiary, this narrow general power can be rewritten to broaden the class of appointees to "**such one or more persons or entities, including the Beneficiary's estate**", and, of course, strike the reference to the President of the Denton Bank.

Conversely, Paragraph F.2 is a classic limited power over the exempt fund, and that part of the non-exempt portion not effectively appointed under Paragraph F.1, which also gives the beneficiary a second, limited, bite at redirecting the non-exempt fund among different family members without risking a taxable transfer, rotation of the applicable GST "Transferor" or the exempt fund's exempt status.

Paragraph F.3 reflects the method and manner for exercise, with such structural limitations as the client may require; Paragraph F.4 provides the default provisions; and both

Paragraphs continue the distinction between the general power-burdened "Non-Exempt" Portion and the nongeneral power flexibility built into the "Exempt" portion.

D. Farm Property and Management

These provisions allow the family to make critical non-tax administrative decisions, such as:

* the scope of the continued farm operation
* the degree of control to be afforded the continuing farm operator, and the amount of conflict to be endorsed and waived
* the restrictions – if any – that should apply on the disposition of "Farm Property" (a carefully defined term), but with specific exceptions for a future 1031exchange and carving out the homestead
* the source of payments for expenses that cannot practically be charged to trust principal.

This Article is limited in the main only by the family's intentions and imagination; and, for those practitioners who rarely advise farm operators, imagine a widget factory instead, and how these principles can be turned to other uses. Note the condensed but sufficient preferred right of purchase created at the end of Paragraph G.

ARTICLE TEN: Farm Property and Management
Grantor is convinced that his/her family has been blessed with the fruits of the land, land that has been acquired upon the strength of several lifetime's worth of hard work, frugality, and foresight. Preserving that land intact for the benefit of the Grantor's descendants is of utmost importance to Grantor and shall be a primary objective of the Trustee. Accordingly, the Grantor hereby declares and directs:

A. That Grantor considers Grantor's interests in agricultural real estate (and any and all other agricultural real estate held at any time by any one or more Trusts created by or as a result of this instrument, however acquired and wherever situated, including, without limitation, the real estate described on Exhibit A hereto; that portion dedicated to residences, sheds, bins, and other agricultural support facilities without the requirement that said agricultural real

estate actually be dedicated to producing crops; and, including specifically any interest in any business or other legal entity that owns an interest in agricultural real estate including without limitation shares in a corporation, a partnership interest in any limited or general partnership, a beneficial interest in or power of direction over a land trust, a membership interest in any limited liability company, or other entity of similar construction or purpose, all of which being referred to herein for convenience as "Farm Property"), to be a sound and proper investment and, subject to the following provisions, expressly authorizes the Trustee to invest in or retain indefinitely any part or all of any Trust Estate in Farm Property, to the exclusion of all other investments if necessary.

B. That the Trustee is specifically authorized and directed to continue to engage in farm operations and the production, harvesting and marketing of farm products; to retain farm management consultants, if desired; to lease land, equipment or livestock for cash or on shares; to purchase and sell, exchange or otherwise acquire or dispose of farm equipment and farm produce of all kinds; to make improvements, construct, repair, or demolish and remove any buildings, structures or fences; to engage agents, managers and employees and delegate powers to them; to engage in drainage and conservation programs; to terrace, clear, ditch and drain lands and install irrigations systems; to replace, demolish, or repair improvements and equipment; to fertilize and improve the soil; to engage in the growing, improvement and sale of trees and other forest crops; to participate or decline to participate in governmental agricultural or land programs; to perform such acts as the Trustee deems appropriate, using such methods as are commonly employed by other farm owners in the community in which the Farm Property is located; and in general to do all things customary or desirable in farm operations; provided, however, that the Trustee shall at all times conduct its farm operations in compliance with any Internal Revenue Code Section 2032A and/or other beneficial Internal Revenue Code provisions by which a recapture agreement at any time has been made and is in force.

C. That, because of the illiquid nature of Farm Property, and the Grantor's overall preference, the Trustee shall first pay currently from the gross income received from the Farm Property operations all of the expenses of holding and managing the Farm Property, including by way of example and not limitation: all interest and principal due on indebtedness for which the Farm Property (or any portion thereof) was mortgaged as security in Grantor's lifetime

(if any), in accordance with the schedule or schedules of payments required by the terms of such indebtedness, and before any penalty may accrue; all taxes and special assessments which may be levied against the Farm Property in a timely manner, and before penalty may accrue; the landlord's share of the cost of improvements, repairs, insurance, crop inputs, costs of preserving productivity and farm operations generally; reasonable cash reserves for depreciation and repairs; costs of administration of the Trust; and all other necessary and reasonable expenses, all of which costs shall be borne by the income beneficiaries without contribution from the Farm Property principal assets or those having a future interest in the Farm Property principal assets. The Trustee shall keep the buildings and improvements thereon insured for their fair insurable value; keep the buildings, waterways, and drainage thereon and easements appurtenant thereto in a reasonable state of repair and upkeep; and, use reasonable efforts to maintain the fertility of the soil; however, the Trustee shall not be required to maintain or insure improvements that become unproductive due to changing circumstances.

D. That the Grantor's son, Logan Newlin, shall have the right to tenant-farm the Farm Property as long as he desires and is capable of doing so in accordance with the crop-share lease arrangement now existing between him and the Grantor and such additional terms as he and the Trustee may agree. This opportunity to farm the Farm Property shall not disqualify him from being appointed or serving as a Trustee or Co-Trustee, or as farm manager; but to the contrary, the Grantor emphasizes his intention that any one or more of his descendants may, if otherwise qualified, appointed, or selected, serve in the multiple capacities of Trustee, farm tenant and/or farm manager, none of which shall be construed or interpreted as an actual or potential conflict of interest, nor limited by any duty that he/she disgorge his/her individual tenant's share of the profits according to the lease arrangement. Moreover, the Grantor acknowledges having been fully informed of the apparent conflict of interests inherent to circumstances when the farm tenant also serves as farm manager and/or trustee, and having been so fully informed such apparent conflict is freely and knowingly waived, except for harm actually caused by reason of gross negligence or willful malfeasance, it being the Grantor's intention to empower as tenants, farm managers, and potentially successor Trustee(s) persons who are members of his/her family and the natural objects of his/her bounty.

E. That the Trustee may consent to special use valuation of Farm Property for death tax purposes or a deferral of payment of federal estate tax or state death taxes, and may accept property which is subject to a lien for the payment of deferred death taxes or which has been specially valued; and, accordingly, the Trustee may take any action consistent with such consent or acceptance including execution of any agreement, consent to imposition of any lien, substitution of any security, acceleration of any payment, assessment of any tax or any other proceedings pertaining to special valuation, in each case without regard to the effect on the relative interests of any beneficiary.

F. That in supplement to the foregoing statements of purpose and declarations and directions, and not in limitation thereof, no beneficiary shall have the right to demand or withdraw and no Trustee shall have the power to sell, mortgage, petition for partition, or distribute as principal free from trust any portion of the Farm Property except:

1. As may prove actually necessary to discharge any federal or state death taxes remaining due upon the death of the Grantor or Grantor's Spouse after all other assets available for that purpose have been exhausted; or,

2. Upon the order of any court of competent jurisdiction having first made its finding on the strength of clear and convincing evidence that such is necessary for the best interests of all the current and remainder beneficiaries of all Trust Estates generally; however,

3. The foregoing restrictions of this Paragraph F. shall not apply:

a. To that portion of Farm Property constituting a natural, separate residential homestead. In the event any such residential homestead passes into Trust hereunder, the Trustee shall at any time have the power, but not the obligation, to survey, partition, and set aside any said farm homestead (including houses, support buildings, storage facilities and land traditionally not employed for growing crops, and as may otherwise be required by state or local zoning or land use authorities) and offer it for sale at its then-current value upon such terms and conditions as may then be in the best interest of the Trust(s), giving preference to any adult descendant of Grantor who may wish to buy it at its then-current value; or in the alternative, the Trustee may maintain and preserve said homestead for any beneficiary's residential use or as an income-producing property. In calculating value the Trustee may consider contributions, such as buildings and storage facilities, made by current or prior family residents.

b. To prevent the Trustee from exchanging one or more tracts of Farm Property for another, similar tract (or tracts) of agricultural real estate if the Trustee believes such an exchange would benefit the Trust Estate generally in a manner consistent with Grantor's stated intentions under this instrument; or,

c. To prevent the Trustee from conveying any part or all of the Farm Property to any one or combination of a corporation, a limited or general partnership, a land trust, a limited liability company, or other business organization if the Trustee deems such reorganization to be in the best interests of the Trust, and the Trust retains undiluted equitable ownership.

G. Upon termination of the Trust the Trustee shall distribute the Farm Property "in kind" to the vested beneficiaries, and each such distribution shall be conditioned upon a preferred right of purchase hereby created in all the Grantor's descendants per stirpes then living that no such beneficiary may sell or otherwise transfer any right, title or interest in or to any portion of his/her Farm Property without having first offered the subject interest for sale and purchase by any one or more of the Grantor's descendants who, as a condition of such purchase will agree not to reconvey said portion of the Farm Property without again first offering it for purchase by another descendant of Grantor. (The preferred right of purchase shall be for a purchase price equal to an average of two appraisals prepared by licensed Illinois land appraisers familiar with farm values in Post Oak County, and the terms of sale shall be those prevailing for similar sales of farm land on an "arms length" basis within the area. If more than one descendant of Grantor wishes to exercise the preferred right to purchase then each shall be allowed to do so in fractional proportions equivalent to the number participating in the purchase). This provision shall be liberally construed to enforce Grantor's intention to allow his/her descendants to hold on to as much of the Farming Family Farm land as they desire, while being fair to those other vested descendants who want a reasonable opportunity to cash out.

Occasionally, the following 2032A inducement is added:

H. Notwithstanding any dispositive provision herein contained to the contrary, if the refusal of any beneficiary (other than Grantor's spouse) to agree to special use valuation results in a failure to qualify for the election under

Internal Revenue Code Section 2032A and the Trustee (or Grantor's executor) is required to pay the federal estate tax and state death taxes attributable to the failure to qualify, then such payment shall be charged without interest as an advancement against the property otherwise distributable to or in trust for such refusing beneficiary and his or her descendants or appointees. All such tax payments shall be reimbursed to the Trustee or executor before any property shall be distributed to or for the benefit of the refusing beneficiary, and before any income or principal distribution shall be made to the beneficiary and his or her descendants or appointees from any trust created by or as result of this instrument. If the failure to qualify for the election under Section 2032A described in the preceding paragraph is caused by the refusal of more than one beneficiary to agree to special use valuation, then such tax payment shall be charged among said refusing beneficiaries' shares in the proportion that each such beneficiary's beneficial interest bears to the total beneficial interests represented by all refusing beneficiaries.

E. Asset Protection, Disability Provisions and the Special Needs Conversion

Long term trusts require looking out for the unforeseeable, even the unimaginable, including the possibility that a tall strong healthy child or grandchild may fall victim to accident and permanent disability. Rather than cringe from the thought, we should address the problem by availing the "special needs and comforts" trusts for loved ones without exposing trust principal to seizure for reimbursement by public aid agencies that may have provided basic shelter, sustenance and medical care. Volumes have been written on the subject of drafting trusts for the benefit of third parties that can be used for special needs, and while Congress (and the assorted state agencies) are growing more aggressive in seeking recovery of assistance payments, it makes sense to at least try to anticipate the problem with self-amending disability provisions.

Similarly, this is a logical place to append traditional spendthrift and other specific asset protection directives.

ARTICLE ELEVEN: Disability and Asset Protection

A. Wherever used in this instrument the term "disability" means any

legal, mental or physical condition which renders a person less than fully able to manage his or her person or estate, or his or her medical, personal or financial affairs.

1. The term shall include, but is not limited to, the stricter standard of "a medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months"; or, "any condition of comparable severity evidenced by marked functional limitations." Any person who has been determined to be disabled: (i) in the manner provided by Illinois statutes governing adjudication of disability [e.g., Article XIa of the Illinois Probate Act; 755 ILCS 5/11a-1 through 11a-23, or any similar or successor provision governing the same substantive topic]; (ii) for any purpose by the Social Security Administration; and/or, (iii) who has been determined (by any federal or state agency) to be disabled for Medicaid purposes, shall during the term of such determination be deemed to be disabled for the purposes of this instrument. Any person who has suffered a medically determinable condition of such severity as to be sufficient, in the judgment of his or her attending physician or physicians to require his or her institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis, shall during the term of such condition be deemed to be disabled for the purposes of this instrument.

2. To the extent a disability is not established by the findings set forth in Subparagraph A.1. immediately above, then:

a. The determination of a present disability, or the recovery from a past disability, affecting the Grantor or any person who is serving as Trustee shall be made in a signed writing by that person's attending physician after a personal examination. That written determination shall contain: (i) a description of the nature and type of the disability and an assessment of how the disability impacts on the ability of the person to make decisions; (ii) an analysis and results of evaluations of the person's mental and physical condition, and immediately apparent prospects for recovery; (iii) a statement expressing an opinion on whether the person shall require institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis; and, (iv) a conclusion and opinion on whether that person is disabled on the basis of the

criteria herein provided. This written determination shall be delivered to the current and successor beneficiaries and, if applicable, to any person nominated as successor Trustee hereunder, who shall then assume the office of Trustee in the manner provided elsewhere in this instrument.

b. The determination of a present disability, or the recovery from a past disability, affecting any beneficiary other than a person who is serving as Trustee hereunder shall be made by the Trustee in his, her, or its sole discretion on the basis of the criteria herein provided and such reasonable inquiry as the Trustee deems appropriate in the circumstances.

B. In the event any beneficiary (other than Grantor) suffers a disability then the Trustee's powers, discretions and obligations under this instrument with respect to the disabled beneficiary shall thenceforth, immediately, and without additional acts in furtherance be amended, restricted, and governed by the following provisions. These provisions shall apply through the entire period of disability, but shall end when the disabling condition ends and the trust administration shall revert to its status quo ante:

1. In the event that the disabled beneficiary is then serving as Trustee, he or she shall immediately, and for the remaining term of that disability be disqualified to serve as Trustee. This disqualification shall endure through the entire period of disability, but shall end when the disabling condition ends, at which time the beneficiary may be restored as Trustee. The successor Trustee shall be as elsewhere provided in this instrument.

2. Commencing immediately upon the disabling event, and until the disability ends, the Trustee shall withhold payment of Trust principal or income for basic support requirements such as food, clothing, medical care and shelter which the disabled beneficiary is able to receive from any local, state or federal government agency or agencies or any other source, whether public or private, and the beneficiary's power to withdraw, and the Trustee's discretion to distribute principal from any Trust shall thenceforth be limited accordingly.

3. During such period as the disabled beneficiary is receiving or eligible to receive assistance from local, state or federal government sources, or from private agencies, Trust principal or income shall be distributed to or for the benefit of the disabled beneficiary, if at all, only for the special needs, comforts or luxuries suitable for the beneficiary's happiness (including but not limited to travel, expenses for traveling companions if requested or necessary,

entertainment, supplemental medical and dental expenses, social services, and transportation) which will not otherwise be provided by any local, state or federal government agency or agencies, and no distribution shall be made for the basic support and care of the disabled beneficiary.

4. In no event may Trust principal or income be paid to, on the demand of, or for the benefit of any governmental agency or department and the Trustee shall do all things reasonable or necessary to at all times preserve the Trust Estate free of the claims of such governmental bodies.

C. The entitlement, discretion, privilege or interest of any beneficiary to make discretionary withdrawals or to receive distributions of the income or principal of any Trust Estate during his/her lifetime is contingent upon the restrictions hereinabove set forth. Any trust income which the Trustee does not distribute pursuant to the foregoing directions and restrictions shall be added to principal, and the Trustee shall pay currently any fiduciary income taxes accruing on said undistributed income.

D. In the event any proceeding is initiated by any governmental agency to breach, set aside, avoid, or otherwise revise these restrictions on any beneficiary's interest for the purpose of seeking reimbursement from the principal of any Trust Estate for goods, care, or services provided by or at the expense of any governmental body, private agency, or individual, or for any other purpose, then in such event the Trustee's power to distribute principal of the Trust to or for the benefit of the disabled beneficiary at any time during the period of disability shall immediately and without further action by any person terminate, and in such event all provisions for the demand or distribution of principal free of trust to, on account for, or for the benefit of the disabled beneficiary (other than the provision pertaining to termination of the trust in compliance with the Illinois "Rule Against Perpetuities") shall be suspended during the period of disability. If the disability endures until the beneficiary's death, then the beneficiary shall be deemed to have predeceased the date stated for distribution of principal free of trust.

E. The provisions of this Article are subordinate to the requirements necessary to preserve the federal estate tax marital deduction anticipated elsewhere in this instrument. Those requirements, including the requirement for the annual distribution of the Marital Trust income to Grantor's Spouse, and that no successor beneficiary shall have any right to the principal or income of any

Trust created for the exclusive benefit of Grantor's Spouse during the Grantor's Spouse's lifetime, shall supersede these provisions; and, to the extent these provisions are contrary to the requirements of said federal estate tax marital deduction, (but to such extent, only) the same shall, as and with respect to Grantor's Spouse, be deemed void.

F. Neither the principal nor the income of any Trust Estate (or any beneficial interest in any Trust Estate) shall be liable for or charged with any debts, contracts, liabilities or torts of a beneficiary, or for any duty of support that may or may not be owed by a beneficiary, and no interest in a Trust Estate shall be subject to seizure or other process by any creditor of any beneficiary. No beneficiary shall have the power to compel any discretionary distribution, anticipate, petition for partition, encumber or transfer his or her interest in any Trust Estate in any manner, and any purported anticipation, partition, encumbrance or transfer shall be void *ab initio*. Except in the event of: (i) termination; (ii) a permitted distribution to or for the benefit of a beneficiary; or, (iii) as otherwise effectively appointed, no Trustee shall have the power to assign, convey, sell, encumber, hypothecate, pledge, transfer, give, devise, or otherwise dispose of any right, title or interest in or to any portion of the Trust Estate, except for fair value and duly entitled as a substitute asset of the subject Trust Estate, to which all of the provisions of this instrument, and specifically this Article, shall first attach as a condition of such transfer. Nothing in this Article shall limit the lawful exercise of any power of withdrawal retained by Grantor, or the effectiveness of any disclaimer.

F. Protective Drafting

All of us forget things sometimes, or draft or review when we are tired, and like a reserve parachute to a skydiver it is a calming thing to incorporate some safeguard provisions into our boiler-plate provisions. Here are a couple that may be worth considering:

1. The Rule Against Perpetuities and Power Exercise Instructions

It is easy to get carried away with the long-term possibilities of a GST exempt trust and in the process forget the Rule against Perpetuities. An accidental violation of the Rule can still void the most well considered plan of deferred entitlement, and a savings clause

requiring vesting within the applicable period should be considered for every trust instrument providing for multi-generational benefit that is not otherwise intended to be a qualified perpetual trust.

Section 4-2 of the Probate Act (755 ILCS 4-2) "Testamentary powers of appointment" and Section 1 of the Power of Appointment Exercise Act (765 ILCS 320/1) "Non-testamentary powers of appointment" (attached as Exhibit A) offer a lot of support in this area, but sometimes a comprehensive provision on how powers of appointment are to be construed and exercised, with a built in Rule Against Perpetuities savings clause, might be desired. Here is one possibility:

ARTICLE ELEVEN: Powers of Appointment and Rule Against Perpetuities.

A. Each power of appointment created in this instrument is conditional upon the substantive limitations incorporated in the terms creating the power, and may be exercised only in conformity with those restrictions, conditions and limitations. Any exercise of a power that otherwise complies with the prescribed method of exercise but which exceeds the scope of the terms creating the power shall to the extent possible be deemed reformed and amended to comply with those restrictions, conditions and limitations and as so reformed and amended given full force and effect. Nevertheless, the purported exercise of a power that cannot through liberal construction be reformed and amended in compliance with the restrictions, conditions and limitations of the power shall be void.

B. Unless specifically provided otherwise, each general and nongeneral power of appointment held by a person who is also serving as a trustee shall be held and exercisable independent from the office of trustee and its duties. The powerholder may independently exercise or not exercise the power in whole or in part or not at all in the powerholder's sole and unfettered nonfiduciary discretion, without obligation to act or not to act, irrespective of the consequences upon any one or more of the permissible appointees, whether exclusive or inclusive, or upon any one or more of the takers in default of appointment, whether exclusive or inclusive.

C. Subject always to the restrictions, conditions and limitations incorporated in the powers to appoint herein created, any holder of a power of

appointment created in this instrument may within the scope of those limitations exercise such power either revocably or irrevocably, outright or in trust. If the appointment is in trust, the holder may select or extend an existing trust or trusts for the benefit of an appointee or create a different trust(s), select trustees, create new powers of appointment in the trustee or in the appointee which are no more broad than (and subject to the same restrictions, conditions and limitations of) the power being exercised, and establish such administrative powers or restrictions for a trustee as the holder deems appropriate.

D. The holder may create life estates, rights to income or principal, or other limited interests in an appointee with future interests in favor of other appointees, impose lawful conditions on an appointment, appoint different types of interests to selected appointees, impose lawful spendthrift provisions, and, in general, appoint to or among the permissible appointees in any manner not prohibited by applicable law or the terms creating the power initially.

E. In determining whether, in what manner, and to what extent a testamentary power of appointment has been exercised by a holder, the Trustee may act in reliance upon a court admitting an instrument to probate as the holder's last will or an order finding that the holder died intestate. Unless within six months after the holder's death the Trustee has actual notice of the existence of proceedings to probate a will of the holder, the Trustee shall assume the holder died intestate. In determining whether, in what manner, and to what extent an inter vivos power of appointment has been exercised by a holder, the Trustee may act in reliance upon the holder's signed written instrument that is actually delivered to the Trustee. Absent proof of delivery the Trustee shall assume the power has not been exercised.

F. Notwithstanding the foregoing, or any provision of this instrument to the contrary:

1. No holder shall have the power to exercise a power of appointment in a manner that would result in the suspending of the vesting, absolute ownership or power of alienation in any property governed by this instrument for one moment beyond the date for final termination of every trust created hereunder and for the distribution of the Trust Estate, outright and free of trust. No right, title, interest or power of any kind contained in or governed by this instrument shall be construed as to violate the applicable Rule Against Perpetuities as that Rule is applied in the State of Illinois, and any provision of

this instrument to the contrary shall be deemed amended as necessary to comply with said Rule.

2. Each Trust or Trust Estate created pursuant to or as a result of this instrument shall terminate at the end of twenty-one (21) years after the death of the last to die of all of Grantor's descendants who are living at the date this instrument becomes irrevocable. Upon such termination the Trustee shall distribute each Trust Estate outright and free of trust to those persons then eligible to receive or have the benefit of its income in proportion to their income interests, or if their interests are indefinite then in equal shares.

G. All references in this instrument to a "limited" or "nongeneral" power of appointment shall be conclusively construed (together with all other specific restrictions, conditions and limitations pertaining to such power) as being expressly not exercisable in favor of the power holder or his or her creditors, the power holder's estate, or the creditors of his or her estate.

This provision avoids the general power tax trap under Code Sections 2514(d) and 2041(a)(3) altogether by conforming with the Illinois Rule Against Perpetuities. However, more and more Illinois trusts are now opting out of the Rule by designating the intention that each trust be a "Qualified Perpetual Trust" as now allowed under 765 ILCS 305/1-6. Electing out allows dynasty treatment, but the GST planning will still require that the scope of the limited power(s) remain leashed. In such case, Paragraph F would be rewritten:

F. Each Trust created pursuant to or as a result of this instrument shall be a "Qualified Perpetual Trust" to the extent allowed by Illinois law; provided, however, that for the purposes of Internal Revenue Code Section 2514(d) no holder shall have the power to exercise a power of appointment to create another power which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power, such exercise of the first power shall, to the extent of the property subject to the second power, be deemed a transfer of property by the individual possessing such power.

Most of that language, of course, is lifted verbatim from Code Section 2514(d)

2. Legal Obligations of the Holder

Surprise general power of appointment treatment can emerge when a holder has a discretionary power for the benefit of persons toward whom he or she has a legally enforceable duty or obligation. This is especially so when a grandparent names a parent as custodian or trustee for the grandchild. Here is a protective provision:

> **Any power to make discretionary distributions of Trust principal to or for the benefit of a person who is serving as Trustee of a Trust (including distributions to the person's spouse and distributions in discharge of any legal obligation of the person) or any other discretionary power, the exercise of which could result in distribution of the principal to or for the benefit of such individual, shall be exercisable solely by the Trustee or Trustees other than that person. If no other Trustee is then serving, such power shall not be exercisable; provided, however, that the provisions of this paragraph shall not apply to a power to make distributions which, under this instrument, is limited: (i) by an "ascertainable standard" relating to the beneficiary's health, education, support or maintenance as that term is defined and applied by Internal Revenue Code Sections 2511, 2514 and 2041, and supporting regulations; or, (ii) to a non-cumulative right to withdraw or demand distribution of no more than the greater of $5,000.00 or five per cent of the aggregate value of a Trust Estate during any calendar year.**

3. Priority of Benefit and Investment Discretion

If the client's beneficial purpose is to provide each current beneficiary maximum latitude in the administration of his or her separate share, subject only to the tax avoidance and asset protection features built into the plan, it may be worth identifying that priority in concrete terms. The following could be a suitable addition to the Trustee's administrative powers.

> **No Trustee shall be liable for any mistake in judgment in the making or**

retaining of investments, or any other discretionary decision made by the Trustee, so long as any such decision is made in good faith. The Trustee shall have maximum latitude in making investments and shall not be bound by any duty to consider both the reasonable production of income and the preservation of capital value. [Subject to the overriding requirements of the marital deduction provisions provided elsewhere in this instrument,] [and subject further to the limitations to the disposition of "Farm Property" provided elsewhere in this instrument] the Trustee is otherwise specifically authorized to invest the entire Trust Estate: (i) in income producing assets; (ii) in assets selected for the potential of capital growth; (iii) any combination of income and growth investments; or, (iv) assets which neither produce income nor offer potential for capital growth but which the Trustee believes benefit the beneficiary generally. While relying upon the Trustee's fiduciary duties in all other respects as a material term of this Agreement, the Grantor exempts the Trustee from the duties of impartiality in investing with respect to current and successor beneficiaries, it being Grantor's intention to provide maximum benefit to each current beneficiary in priority over the interest of successor beneficiaries. The Trustee may but shall not be required to retain investment advisers, the cost of which shall be borne by the Trust Estate generally. In addition, the Trustee may but is not required to delegate investment functions in any manner consistent with the provisions of the Illinois Trusts and Trustees Act.

It is hard to imagine a more clear cut grant of individual discretion and priority. Nevertheless, note the bracketed limitations pertaining to the marital deduction requirements, and the possible application of "Farm Property" limitations.

4. No Conflict of Interest

Similar provision can be made to further head off conflict-of-interest issues while addressing the interested trustee tax problems:

Any individual acting as Trustee who is also a beneficiary of any Trust or Trust Estate created hereunder may deal with any Trust on an "arms-length" basis without obtaining the approval or confirmation of any Court or any other

beneficiary, and such dealings made in good faith shall be as binding and conclusive as though no such relationship or possible conflict of interest existed. Moreover, Grantor acknowledges having been fully informed of the apparent conflict of interests inherent to circumstances when a beneficiary also serves as Trustee, farm tenant, farm manager and/or other fiduciary capacity, and having been so fully informed such apparent conflict is freely and knowingly waived, except for harm actually caused by reason of gross negligence or willful malfeasance, it being the Grantor's intention to empower as Trustee, farm tenants, farm managers, and other fiduciaries persons who are members of his/her family and the natural objects of his/her bounty. Any such Trustee shall not be required to account for or disgorge any direct or indirect personal benefit he, she or it receives, or be personally liable for any loss that results, except by reason of gross negligence or willful malfeasance. Any power to make discretionary distributions of Trust principal to or for the benefit of a person who is serving as Trustee of a Trust (including distributions to the person's spouse and distributions in discharge of any legal obligation of the person) or any other discretionary power, the exercise of which could result in distribution of the principal to or for the benefit of such individual, Trustee or Trustees in conjunction with another person having a substantial and adverse interest in that property, and otherwise such power shall not be exercisable; provided, however, that the provisions of this paragraph shall not apply to a power to make distributions which, under this instrument, is limited by an "ascertainable standard" relating to the beneficiary's health, education, support or maintenance as that term is defined and applied by Internal Revenue Code Sections 2511, 2514 and 2041, and supporting regulations.

A second exception to what could otherwise be a taxable general power is allowed when that power may be exercised "only in conjunction with another person" having both a *substantial* and *adverse* interest in the property subject to the power.[87]

5. Compensation

All to often, family members are expected to assume these time-devouring, high-

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[87] Code Sections 2514(c)(3)(A) and (B), and Code Sections 2041(b)(1)(C)(i) and (ii).

maintenance administrative tasks without pay, and in the end they get about what they pay for. If it is the client's intention to keep the fiduciary fully engaged -- instead of shirking trust work in favor of making a living -- then compensation should be discussed and provided for. Illinois' statutory standard of "reasonable compensation" begs the question of what's fair, so tying the pay to an objective, measurable standard might be preferred.

Each person or entity serving as Trustee shall be entitled to a reasonable compensation for his, her, or its services (which, for each, may be equivalent to but shall not exceed the fees charged by First State Bank and Trust of Allison, Denton, Illinois, or its corporate successor, according to its fee schedule published from time to time during the term of the Trust and to reimbursement for actual, reasonable and necessary expenses incurred on behalf of the Trust.

6. Authority to Continue Farming

If the lengthy "Farm Management" article is not used the following briefer alternative could be added:

The Trustee shall have the power to continue to engage in farm operations and the production, harvesting and marketing of farm products; to participate or decline to participate in governmental agricultural or land programs; to retain farm management consultants or advisors and to engage agents, managers and employees and delegate powers to them; to lease land, equipment or livestock for cash or on shares; to purchase and sell, exchange or otherwise acquire or dispose of farm equipment and farm produce of all kinds; to make improvements, construct, repair, or demolish and remove any buildings, structures or fences; to engage in drainage and conservation programs and to terrace, clear, ditch and drain lands and install irrigation systems; to repair, improve, and construct farm buildings, fences, and drainage facilities; to develop, lease, or otherwise dispose of any mineral, oil, or gas property or rights; to borrow money for any of the purposes described in this paragraph;

and in general to do all things customary or desirable in farm operations.

7. Power to Sever Trusts

Essential to addressing the various transfer tax problems is the power to sever trusts on a fractional basis. Illinois has a specific provision for severing trusts "to satisfy *federal* tax requirement[s]"[88], the new Illinois estate tax requires a similar power to sever trusts "to satisfy *Illinois* tax requirements" as well. Until the legislature gets around to applying this patch, the following rewrite of the existing rule could be useful:

> **The Trustee shall have the power to sever any trust estate on a fractional basis into two or more separate trusts for any reason; to segregate by allocation to a separate account or trust a specific amount or gift made from any trust to reflect a partial disclaimer, to reflect or result in differences in federal or Illinois tax attributes, to satisfy any federal or Illinois tax requirement or election, or to reduce potential generation-skipping transfer tax liability, and income earned on a segregated amount or gift after segregation occurs shall pass to the designated taker of such amount or gift; and to consolidate two or more trusts having substantially similar terms into a single trust. In managing, investing, administering, and distributing the trust property of any separate account or trust and in making applicable tax elections, the Trustee may consider the differences in federal and Illinois tax attributes and all other factors the Trustee believes pertinent and may make disproportionate distributions from the separate trusts or accounts created. A separate account or trust created by severance or segregation shall be treated as a separate trust for all purposes from and after the date on which the severance or segregation is effective, and shall be held on terms and conditions that are substantially equivalent to the terms of the trust from which it was severed or segregated so that the aggregate interests of each beneficiary in the several trusts are substantially equivalent to the beneficiary's interests in the trust before severance; provided, however, that any terms of the trust before severance that would affect qualification of the trust for any federal or Illinois tax deduction,**

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[88] Section 4.25 of the Trusts and Trustees Act (760 ILCS 5/4.25)

exclusion, election, exemption, or other special federal or Illinois tax status must remain identical in each of the separate trusts and accounts created.

8. Power to Merge Trusts

Upon the passing of both parents it is not uncommon for two or more trusts of substantially identical beneficial terms -- two substantially similar Descendants Trusts under Mother and Father's plans, and maybe a parallel ILIT, for example – could be coming together for the benefit of a single beneficiary. While clients will tolerate multiple vehicles if they have to, and see the advantages, they seem to strongly prefer streamlining their business vehicles as much as possible.

The Trustee shall have the power to merge any Trust with any other Trust or trust property held for the benefit of the same beneficiary(ies) (under this or any other instrument) into one single Trust Estate if, in the opinion of the Trustee, the terms and federal transfer tax attributes of such trusts are substantially identical or such a merger can be effected without materially adversely affecting the interests of such beneficiary or beneficiaries.

9. Power to Allot Property

To avoid the administrative headache of fractionalizing property when funding the various trusts, and to take advantage of the latitude afforded by the pecuniary funding formula built into the example, the Trustee should have broad authority to pick and choose assets:

The Trustee shall have the power to allot to any trust an undivided interest in property, make joint investments for two or more trusts hereunder, distribute property in cash or in kind, or partly in each; to allot different kinds or disproportionate shares or undivided interests in property among the distributed shares, without regard to the income tax basis of such property or interest; and, except as specifically required elsewhere in this instrument, to determine the value of any property so allotted or distributed.

10. Tax Elections

This one should be obvious:

> **The Trustee shall have the power to exercise any discretion, election, or power permitted under any federal or state tax law that the Trustee deems advisable, without regard to its effect on the relative interests of the beneficiaries, and the Trustee shall make no corresponding adjustment between principal and income, or to the relative interests of the beneficiaries to compensate for the effect of the exercise of discretions, elections, or powers.**

G. Conflict Avoidance and Management.

Naturally, if the interested beneficiary is the sole trustee, conflicts should be at a minimum. But since the biblical confrontation of Cain and Abel the potential for family members to fuss – *seriously* fuss – has proven its way. As one prominent Arizona trial lawyer warned, we are about to see an explosion in the volume and complexity of trusts-and-estates disputes in the near future:

> **Estates are larger and more complex. An "Entitlement Generation" is coming of age. There's been an influx of more litigious probate lawyers as well as a proliferation of poorly drafted and incomplete trusts. Meanwhile, the majority of Americans are without estate plans even as their family trees grow more complicated and their lifespans get longer.**[89]

Failing to make provision for dealing with this potential is almost asking for it.

1. Alternative Dispute Resolution

Starting with mediation can be a good way to provide interested persons an opportunity to voice their concerns, frustrations, and agendas. Sometimes, just letting people express themselves -- and in a process well short of litigation -- can defuse the situation. Mediation

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[89] Peace, Kenneth J., *A Call to Mediate* July, 2007, TRUSTS AND ESTATES. A thorough examination of the conditions at play.

is not binding and is not a dispute determinant; rather, the mediator acts as a facilitator among the opposing interests and attempts to help them define issues, find common themes, and accommodate each other to the extent possible while moderating confrontation and calming ill will. Here is one possibility[90]:

> **Any dispute or controversy of every kind or nature arising under or as a result of this instrument shall be referred and submitted to mediation under the auspices of ____________, and no interested person shall have standing to pursue any action at law until that mediation has been completed, although any party may as necessary proceed in equity to preserve status until mediation has been completed.**

This provision may, of course, be followed with arbitration provisions or, in the alternative, a choice of law or venue, and an attorneys' fees clause.

2. Judicial Confirmation

Frequently, an individual trustee may find it advantageous to anticipate trouble by asking the Court in advance to confirm the trust and provide prior authority for actions that could be controversial.

> **No Trustee shall be personally liable upon any contract, note, or other instrument executed hereunder or for any indebtedness of the Trust Estate. To the extent that Grantor may lawfully waive any such requirements, no Trustee shall ever be required to qualify before, be appointed by, or account to any Court, or obtain the order of or approval of any Court in the exercise of any power of discretion herein given. However, the Trustee is hereby specifically authorized to petition the Circuit Court of the County where any one or another Trustee resides to have any Trust herein created confirmed by Order of Court**

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[90] "JAMS" and the American Arbitration Association are both leading voices for alternative dispute resolution methods, and have many representative clauses. www.jamsadr.com and www.adr.org

at any time the Trustee determines such confirmation useful in giving effect to this instrument, to resolving uncertainties, or to protecting the Trustee from inappropriate criticism.

3. *In Terrorem*

Some courts disapprove of *in terrorem* clauses, as do some states: in Florida they are generally unenforceable, while California has a distinct body of law recognizing and directing their implementation. However that may be, your author saw the following clause contribute to staving staved off a court fight largely because the potential antagonists weren't sure if it was valid, or not, and there was way too much money involved to risk it:

Grantor further declares and directs that he/she has created certain preferences for some of his/her children and grandchildren under this agreement that were not extended to others, and that he/she has chosen to exclude some people who might otherwise have had an expectation in his/her property, and the reasons for these decisions are well considered and need not be explained here. However, it is important to Grantor that all his/her children know that these decisions were not made out of any lack of affection or respect for the other children, and that Grantor's love and respect for all of his/her children is equal and immeasurable. It is Grantor's most fervent desire that all of his/her children, and their children, will respect the careful planning represented by this instrument; will cooperate in giving effect to these provisions as cheerfully and willingly as each can; and, will also respect each other's expectations, needs, burdens, and desires over the years to come. The cooperation that each of them extends to the others will demonstrate their appreciation for what Grantor has intended to do for the common benefit of all. Those who choose to cooperate in this manner will be honoring their forebears as well as themselves. Those who choose not to, or who wish in any way to challenge the provisions of this instrument, will be dishonoring their parents or grandparents, and themselves; and, in addition to provoking my eternal condemnation, will be demonstrating themselves unworthy of sharing in the family bounty.

Accordingly, and notwithstanding any beneficial terms contained elsewhere in this instrument, if any beneficiary hereunder, whether one or more, institutes or participates in any proceeding to contest or attack the validity of this instrument or any of the terms or provisions hereof, (except as a party defending this instrument) then any beneficial interest provided for that beneficiary or beneficiaries hereunder shall be revoked, and shall pass as if that beneficiary or beneficiaries, and all of his or her or their descendants, had predeceased Grantor. This provision shall apply regardless of whether such proceedings are instituted in good faith or with probable cause. Grantor has been advised that Illinois law sometimes disfavors provisions such as this, and in response respectfully invokes the protection of the Illinois courts and judiciary to construe this provision as broadly as may be possible or necessary to implement Grantor's carefully articulated purpose herein, to-wit: Grantor expects his/her family to abide by his/her wishes and not to fuss, and if they choose to fuss Grantor prays that they take nothing. Amen.

4. Trust Protectors

At first viewed askance, the notion of an outside advisor and helper is becoming more and more common, especially in the context of these long term trusts[91]. The office first developed to enable settlors of offshore asset protection trusts to continue to influence the control of those assets without exposure to creditors. Whether that worked, or not, the notion has expanded to appointing a domestic trust protector whereby the Grantor is, in effect, vesting one or more limited powers of appointment in a disinterested person who may or may not rise to fiduciary status depending on the drafting and scope of the assignment. Among the powers that can and frequently are delegated are the power:

* To remove or add trustees

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[91] *See*, Romanoff, Robert A., Ch. 6, "Drafting Considerations for Trusts", ADVANCED ASSET PROTECTION PLANNING, Illinois Institute for Continuing Legal Education (Spring, 2007), pp. 46 - 50 for a thorough explanation and comprehensive form. Rob and your author have been singing in chorus on these long term trust issues for more than a decade.

* To amend otherwise irrevocable instruments to comply with stated purposes in the light of changed circumstances
* To approve accountings and certain investment recommendations
* To initiate or supervise mediation or arbitration
* Subject to tax considerations, and the Grantor's intent, -- just about anything else

Which seems to raise the problem of -- just who is the trust protector working for? The settlor, or the beneficiaries? Two superb articles in the Cardozo Law Review[92] consider whether in empowering the trust protector you are diminishing the trustee, confusing authority, and perhaps merely exchanging one set of fiduciary/agency problems for another. Largely out of that concern, and more largely out of intuitive suspicion, your author has limited his use of trust protectors for select purposes. For example, not long ago the question of identity of potential charitable beneficiaries came up, and the following clause resulted:

> **Grantor hereby confers upon her friend and attorney, WILLIAM A. PEITHMANN, if then living, and if not then living to the then-serving President of the First Trust Bank of Post Oak, Illinois, the limited power of appointment to construe the provisions of this Subparagraph, to give it effect, and to determine the correct identity of each of the above-listed charitable organizations and their respective qualifications under Internal Revenue Section 501(c) as of the date of Grantor's death, which said powerholder may exercise in writing in his or her good faith but absolute discretion, and which shall be binding upon all persons or entities claiming any interest under this instrument.**

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[92] Sterk, Stewart E, *Trust Protectors, Agency Costs and Fiduciary Duty*, 27 CARDOZO LAW REVIEW 2761 (2006); and, Alexander, Gregory S., *Trust Protectors: Who Will Watch the Watchmen?*, 27 CARDOZO LAW REVIEW 2807 (2006).