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Emerging Topics and Trends to Follow

Concepts and techniques that have been gathering momentum

An interesting array of tax and non-tax estate planning and estate and trust administration concepts and techniques have been gathering momentum and seem likely to occupy our attention in 2024. A few of the predominant ones are discussed below.

Use it or Lose it

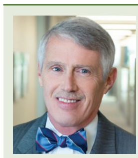
The 2017 Tax Act[1] increased the gift and estate tax basic exclusion amount under Internal Revenue Code Section 2010(c)(3) to $10 million as adjusted for inflation with a 2010 base year (the same base year under prior law). Thus, the basic exclusion amount for 2024 for gift and estate tax purposes, and the generation-skipping transfer (GST) exemption amount under IRC Section 2631(c), is $13.61 million (an amount unprecedented in the annals of federal tax law). Under the 2017 Tax Act, inflation adjustments each year will continue to increase the basic exclusion amount through 2025.[2] Under the 2017 Tax Act, on Jan. 1, 2026, the basic exclusion amount will revert to pre-2017 Tax Act levels.[3]

In response to IRC Section 2001(g)(2), enacted as part of the 2017 Tax Act, in which the Secretary of the Treasury was directed to prescribe regulations to carry out Section 2001(g) with respect to the difference between the basic exclusion amount applicable at the time of a decedent's death and the basic exclusion amount applicable with respect to any gifts made by the decedent, the Secretary issued Treasury Regulations Section 20.2010-1(c).[4] This provision (the so-called "anti-clawback" rule) ensures that, if an individual uses the increased basic exclusion amount for gifts made while the 2017 Tax Act's basic exclusion amount provisions are in effect and dies when they're no longer in effect, such individual's estate won't be treated, for estate tax purposes, solely because the increase in the basic exclusion amount effectuated by the 2017 Tax Act was eliminated, as if such individual made adjusted taxable gifts.

As 2026 inches ever closer, no serious commentator on federal estate and gift tax matters is predicting that, come Jan. 1, 2026, the basic exclusion amount as established by the 2017 Tax Act will be preserved. Accordingly, many clients, with the aid of their trusted advisors, are exploring making lifetime taxable gifts (outright or in trust but, preferably, in trust) sufficient in value to use their historically high basic exclusion amount before it slips away. Indeed, some of those clients, recognizing the benefit of removing post-gift investment return from their eventual taxable estates and the fact that federal tax legislation could reduce the basic exclusion amount before Jan. 1, 2026, aren't waiting until 2025 to take action.

SLATs

Some married couples have enough net worth to cause them to be concerned about the possibility that the estate of the survivor of them will be subject to federal estate tax if the 2017 Tax Act's basic exclusion amount isn't in effect at the death of the first of them to die and/or at the death of the survivor. However, they aren't so wealthy that they would be comfortable in making lifetime gifts large enough to use the currently elevated basic exclusion amount



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that would result in their losing the economic benefits of the assets to be gifted. Such couples want to employ an estate-planning strategy that involves making completed gifts for tax purposes that facilitate absorption of the basic exclusion amount then available but that doesn't involve relinquishing all access to the gifted property. A spousal lifetime access trust (SLAT), an irrevocable trust to which the settlor makes a completed gift (intentionally *not* qualifying for the gift tax marital deduction) and of which the settlor's spouse is a current beneficiary, may be an ideal estate-planning strategy for such a couple whose marriage is solid. SLATs have been in the estate planner's arsenal for as long as anyone can remember, although their popularity has dramatically increased in recent years and can be expected to proliferate in 2024.

The step transaction doctrine is a classic example of a trap for the unwary.

Implementing a SLAT, as opposed to an approach in which married clients seek to effectuate a completed gift to use or absorb their unused basic exclusion amount but directly retain some financial benefits of the gifted property, has recently become the preferred approach for many who want to "have their cake and eat it too." The preamble that accompanied promulgation of Treas. Regs. Section 20.2010-1(c) made cryptic reference to a then not-yet-developed anti-abuse rule, strongly hinting that the benefit conferred by that regulatory provision wouldn't be available with respect to transfers subject to a retained life estate or other retained powers or interests, that is, gifts whose value is included in the donor's gross estate at death. On April 27, 2022, the Secretary issued Prop. Regs. Section 20.2010-1(c)(3), which, as and when finalized, would generally foreclose application of the anti-clawback rule to completed gifts that aren't adjusted taxable gifts but, rather, are gifts whose value is includible in the donor's gross estate under IRC Sections 2035, 2036, 2037, 2038 or 2042. A properly designed SLAT wouldn't be implicated by any of those provisions of the IRC but, as a practical matter, would provide many of the same advantages, albeit indirectly, of a transfer with retained beneficial interests.

Step Transaction Doctrine

In a case in which: (1) both spouses wish to maximize their use of their remaining basic exclusion amounts in 2024; (2) one of them doesn't own assets sufficient in value to accomplish that objective; and (3) one of them has made larger lifetime taxable gifts than the other,[5] the only path to realizing that goal while not giving rise to gift tax liability for the wealthier spouse would be for the wealthier spouse to transfer assets to the poorer spouse.[6] The poorer spouse may then use the transferred assets to make a large gift to a third party, and, when the wealthier spouse also makes a large gift to a third party, the spouses' tax-saving objective may be achieved.

There is, however, a distinct danger in proceeding in this fashion. Transactions of the type described in the preceding paragraph could be re-characterized as a step transaction. The underlying theory would be that the poorer spouse was a mere conduit and that the substantive reality was that the wealthier spouse was the true donor of property to the ultimate, intended third-party donee. The results could be calamitous. The spouses' expectations of being able fully to use their then-remaining basic exclusion amounts without generating any gift tax liability for the wealthier spouse would be shattered—at the cost of millions of dollars in unexpected gift tax liability. This is precisely what happened in *Smaldino v. Commissioner*.[7]

The step transaction doctrine is a classic example of a trap for the unwary.[8] Consider the following methods to steer clear of the trap:

- There should be a significant amount of time (at least a few months) between the wealthier spouse's gift to the poorer spouse and the poorer spouse's subsequent gift.
- Engineer the wealthier spouse's gift to the poorer spouse and the poorer spouse's subsequent gift so they aren't of the exact same assets and/or not in the exact same amount.

- Ensure (and document the fact) that, at the time of the gift to the poorer spouse, the poorer spouse had a clear and unambiguous understanding that the wealthier spouse's impending gift to the poorer spouse was absolute and unrestricted and that the poorer spouse would be unrestrained in retaining the gifted property indefinitely or disposing of it at any time and in any manner whatsoever.

ESG Investing in a Trust

Much interest has been shown over the past few years, with no sign of abatement in 2024, in ESG (environmental, social and governance) investing, otherwise known as "socially responsible investing," or "SRI." Generally, ESG investing promotes the consideration of social and/or ethical issues in making investments.

> Trustees who invest to fulfill their own non-economic agenda, at the cost of lower returns on trust investments, breach their duty of loyalty to the beneficiaries.

Pursuing an ESG investment philosophy doesn't necessarily mean forfeiting financial returns. Depending on the particulars of a given strategy, it may be possible to make ESG-oriented investments whose economic performance is competitive with non-ESG-oriented investments. It's also possible, though, to adopt an investment approach that sacrifices economic returns in exchange for supporting one or more ESG objectives. Individuals are entitled to make investments that aren't optimally productive of financial returns and even investments that lose value. Other than in exceptional cases, however, trustees don't have such latitude.

If a trustee wishes to consider ESG investing, the analysis should start with the trust instrument. When a trust instrument contains explicit and clear instructions authorizing the trustee to engage in ESG investing, the trustee may select investments on the basis of ESG if such investments are otherwise appropriate for a trust and conform to the ESG parameters set out in the trust instrument, even though such investments aren't as lucrative for the trust as available alternative investments.[9] On the other hand, "[i]f the trustee thinks that the [ESG] returns will be below-market, [ESG] investing is very risky for the trustee to undertake absent specific language in the trust agreement or a binding release from the beneficiaries (which is very hard to get)."[10] In the absence of overriding trust instrument language, "[t]he trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust."[11]

Furthermore, a trustee who invests to fulfill the trustee's own non-economic agenda, at the cost of lower returns on trust investments, breaches the trustee's duty of loyalty to the beneficiaries espoused by Section 5 of the Uniform Prudent Investor Act.[12]

Additionally, trustees must act impartially as among the various beneficiaries of the trust.[13] It may not be possible (or appropriate) to engage in ESG investing when the personal philosophies and goals of the beneficiaries are in conflict, even when the investment produces competitive results.

If a trustee can make an ESG investment that produces returns as good as or better than non-ESG investments, no one will have grounds to complain under traditional prudent investor rule principles with which we're all familiar, but the converse is also true. A trustee who sacrifices investment return to pursue an ESG-related agenda won't have a leg to stand on in a breach of trust case unless the will or trust instrument expressly allows such ESG investing or the trustee gets informed, unanimous beneficiary consents, releases or ratification not induced by the trustee's improper conduct.[14]

Trustee Indemnification

Beneficiaries appreciate efforts by trustees to keep administration costs down, and the trust termination context is no exception. Trustees and beneficiaries sometimes enter into release and indemnification agreements that exonerate the trustee from liability for any breaches of trust and indemnify the trustee

for costs that may arise while winding up the trust. This approach is frequently preferred to the often more time-consuming, expensive alternative of the trustee's filing accountings with, and seeking to have them approved by, a court of competent jurisdiction.

The Uniform Trust Code (UTC) contains a directly relevant provision. UTC Section 1009 states that a trustee isn't liable to a beneficiary for breach of trust if the beneficiary consented to the conduct constituting the breach, released the trustee from liability for the breach or ratified the transaction constituting the breach, unless:

(1) the consent, release or ratification of the beneficiary was induced by improper conduct of the trustee; or

(2) at the time of the consent, release or ratification, the beneficiary didn't know of the beneficiary's rights or of the material facts relating to the breach.[15]

The trustee should take care not to present any such request as a demand or ultimatum.

Decades ago, trustees of terminating trusts seldom asked beneficiaries to give them a release, waiver and/or hold harmless agreement in exchange for making termination distributions, but, in recent years, such requests have become standard practice—especially for corporate fiduciaries. Indeed, some trustees also ask beneficiaries to give an indemnification for costs to be incurred in making termination distributions or, in some cases, a more comprehensive form of indemnification. In 2024, there's no reason to believe that this trend will recede anytime soon. Given the ever-increasing litigious nature of society, it seems more likely to accelerate.

A good example of how a release and indemnification of a trustee of a terminating trust may be effectuated is observed in the case of *Hastings v. PNC Bank*.[16] In *Hastings*, the Court of Appeals of Maryland (Maryland's highest court) found that a corporate trustee's request for a release and indemnification from trust beneficiaries prior to distributing the trust remainder to them was lawful. The beneficiaries complained that the trustee had "demanded" the release and indemnification and that what the trustee sought went well beyond the protections to which it was entitled under Maryland law. Rejecting the beneficiaries' positions, the court noted that "a trustee may engage in a self-interested course of action so long as the beneficiaries provide valid, informed consent"[17] and that a trustee, therefore, must be able to request such consent.

Starkly contrasting with *Hastings* is the more recent case of *Estate of Worrall v. J.P. Morgan Bank, N.A., Trustee*.[18] In *Worrall*, the Supreme Court of Kentucky, reversing and remanding to the trial court, dealt quite harshly with a trustee that sought from the sole beneficiary of a terminating trust a comprehensive release, discharge, approval of accounts and indemnification in exchange for the trustee's not proceeding with a court "intervention."

The court cited, quoted from and paraphrased various components of KRS 386B.8-180(1),[19] observed that the statute applied and stated that the trustee could have expeditiously effectuated termination distributions and protected itself from future liability to the beneficiary by following the procedures laid out in the statute.[20]

However, as observed by the court, and as admitted by the trustee, the trustee instead proceeded in a manner in direct violation of KRS 386B.8-180(5), which provides that:

> [n]o trustee [of a] trust shall request that any beneficiary indemnify the trustee against loss in exchange for the trustee forgoing a request to the court to approve its accounts at the time the trust terminates or at the time the trustee is removed or resigns . . .

The court pointedly stated that:

> it is simply beyond the pale for a trustee to extort such a document when the legislature has provided an adequate mechanism and remedy for the settlement and distribution of trust assets.[21]

The lessons to be derived from *Hastings* and *Worrall* for trustees of terminating trusts seeking beneficiary releases and indemnifications seem clear. First, the trustee should take care not to present any such request as a demand or ultimatum. Optics do matter. It should be made clear to beneficiaries that they're entitled not to release and indemnify the trustee and that the release and indemnification option is simply offered as a way to expedite termination distributions and reduce the associated costs. Second, if there's a statutory procedure available, follow it.

Endnotes

1. An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97 (Dec. 22, 2017).
2. Internal Revenue Code Section 2010(c)(3)(C).
3. *Ibid.*
4. Treasury Regulations Section 20.2010-1(c), REG-106706-18, 84 Fed. Reg. 64995 (Nov. 26, 2019).
5. This would seem to be a rather common scenario to be encountered by readers of *Trusts & Estates* in 2024.
6. Note that so-called "gift-splitting" (*see* IRC Section 2513) wouldn't work.
7. *Smaldino v. Commissioner*, T.C. Memo. 2021-127.
8. It's a trap not only in relation to planning for gifts to be made by spouses to third parties but also in creating and funding spousal lifetime access trusts.
9. *See* Uniform Prudent Investor Act (UPIA) Section 1(b).
10. Steve R. Akers, "ACTEC 2014 Fall Meeting Musings" (Nov. 18, 2014).
11. *Restatement (Third) of Trusts* Section 90 (2007); *see also* UPIA Section 2(a).
12. Specifically, the Comments to Section 5 of the UPIA explicate the conflict between the duty of loyalty and environmental, social and governance investing: "No form of so-called 'social investing' is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause."
13. UPIA Section 6.
14. "Only to the extent permitted by the terms of the trust or by the consent of the beneficiaries may the trustees of private trusts properly take social considerations into account in making investment decisions." 4 Austin W. Scott et al., *Scott & Ascher On Trusts* Section 19.1.13 (5th ed. 2007); *see also* Uniform Trust Code (UTC) Section 1009.
15. UTC Section 817(c) contains almost identical language.
16. *Hastings v. PNC Bank*, 54 A.3d 714 (2012).
17. *Ibid.,* at p. 726.
18. *Estate of Worrall v. J.P. Morgan Bank, N.A., Trustee*, 645 S.W.3d 441 (Ky. April 28, 2022).
19. There's no provision of the UTC that's analogous or similar to KRS 386B.8-180.
20. Under KRS 386B.8-180(1), the trustee of a trust that's terminating by its terms is to provide certain information about the trust to the beneficiary after which, if the beneficiary objects to any disclosed action or omission, the trustee may submit the objection to the proper court for resolution and charge the expense of commencing such a proceeding to the trust or resolve the objection with the beneficiary outside of court. The statute further provides that, as part of such a nonjudicial resolution, a release, an indemnity clause or both are acceptable.
21. *Worrall, supra* note 18, at p. 449.