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TAX RECOGNITION

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INTRODUCTION

Trusts and Estates is my favorite course to teach. Much of the doctrinal material covered is immediately seen by the students as intensely and gratifyingly practical and relevant, often in a very personal way. The cases we discuss frequently weave stories illustrating various and recurrent foibles in human behavior, and evoke a wide range of emotional responses. Students often find that they enjoy the course much more than they had anticipated that they would. Indeed, one of the pleasures of teaching Trusts and Estates is that the students' expectations upon entering the course are so low that it is hard not to exceed them.

It often happens that students with newly-discovered interests in estate planning and probate will stop by my office to ask questions about a career in that area of practice. Most of the time students eventually will ask whether one would be required to know much about tax law. Often I can tell from the looks on their faces that they are hoping that I will say no, but that deep down they know that the answer is yes. For some, this confirmation of their fears is a conversation-stopper. Others are more easily soothed, and some respond to this revelation without dismay. But the fact of the matter is that very few law students take a separate course on the federal transfer taxes.

At the Notre Dame Law School, where I now teach, the average enrollment in Trusts and Estates over the past eight years has been ninety, which is roughly half of each graduating class.[1] The average enrollment in Estate and Gift Taxation, by contrast, has been seventeen, which is less than ten percent of the class.[2] Notre Dame is hardly unusual in this regard. I

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1. E-mail from Anne Hamilton, Registrar, Notre Dame Law School, to Barry Cushman, John P. Murphy Foundation Professor of Law, Notre Dame Law School (Apr. 22, 2013, 11:36 AM) (on file with author); *J.D. Enrollment and Ethnicity*, UNIV. OF NOTRE DAME LAW SCH., http://www3.nd.edu/~ndlaw/consumer-info/Std509InfoReport.pdf (last visited Dec. 10, 2013).

2. E-mail from Anne Hamilton, Registrar, Notre Dame Law School, to Barry Cushman, John P. Murphy Foundation Professor of Law, Notre Dame Law School (Apr. 22, 2013, 11:36

formerly taught at the University of Virginia, which has a student body approximately twice as large as that of Notre Dame.[3] During the 2013–2014 academic year, 187 Virginia students enrolled in Trusts and Estates,[4] while only four enrolled in the course on Federal Taxation of Gratuitous Transfers.[5] Though I do not have precise data from prior years, those proportions roughly comport with my recollection of the pattern of enrollment at Virginia from 1998 to 2012. While a substantial percentage of law students take the basic course in Trusts and Estates, only a very small percentage follow up with a course in Federal Estate and Gift Tax.

This means that the basic course in Trusts and Estates provides our only opportunity to expose most of our students to some of the basic features of our transfer tax system. One might assume that anyone with sufficient wealth to be subject to the federal transfer taxes will engage specialized counsel who is sophisticated in these matters. In my experience, and in the experience of colleagues with whom I have discussed this issue, that assumption too often proves to be false. General practitioners are asked to draft wills and trusts for affluent clients, and even lawyers specializing in some other area of practice may occasionally be asked to draft a will for a friend or family member. A lack of familiarity with the outlines of the transfer tax system may cause such lawyers to overlook simple methods of tax savings and to commit costly errors. Moreover, certain provisions of the federal income tax can have significant estate planning consequences even for people whose estates will not be subject to the federal estate tax. Fortunately, the casebook that I use contains a number of decisions in which such tax issues appear just below the surface. I therefore try to take the occasional opportunity presented by these cases to introduce some basic tax concepts and planning strategies.

I have been using the Dukeminier casebook since I began teaching Trusts and Estates in 1992. The examples that I use in this article therefore are drawn from that text, though I have no doubt that other casebooks provide comparable illustrations. The cases that I discuss offer occasions to introduce features of each of the four relevant systems of federal taxation: the estate tax;

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3. *J.D. Enrollment and Ethnicity*, UNIV. OF NOTRE DAME LAW SCH., http://www3.nd.edu/~ndlaw/consumer-info/Std509InfoReport.pdf (last visited Dec. 10, 2013); *J.D. Enrollment and Ethnicity*, UNIV. OF VA. SCH. OF LAW, http://www.law.virginia.edu/pdf/about/aba_fall2012.pdf (last visited Dec. 10, 2013).

4. *Current Courses: Fall 2013*, UNIV. OF VA. SCH. OF LAW, http://lawnotes2.law.virginia.edu/lawweb/course.nsf/CBTBN?Openview&Expand=1#1 (last visited Dec. 10, 2013); *Current Courses: Spring 2014*, UNIV. OF VA. SCH. OF LAW, http://lawnotes2.law.virginia.edu/lawweb/course.nsf/CBTBN?Openview&Expand=3#3 (last visited Dec. 10, 2013).

5. *Current Courses: Fall 2013*, UNIV. OF VA. SCH. OF LAW, http://lawnotes2.law.virginia.edu/lawweb/course.nsf/CBTBN?Openview&Expand=1#1 (last visited Dec. 10, 2013).

the gift tax; the generation-skipping transfer tax; and the income tax. I take each of these in turn.

I. THE ESTATE TAX

A. Marital Deduction Planning

I often tell my students that if they read a case and cannot understand why a particular disposition was structured in a particular fashion, then the chances are good that the form of the disposition was driven by tax considerations with which they are not familiar. *In re Estate of Clarkson v. First National Bank of Omaha*[6] is just such a case. *Clarkson* appeared in the third through the sixth editions of the casebook, and though it has disappeared from more recent editions, I continue to teach it. The case concerns the right of an incompetent surviving spouse to take her elective share against her deceased spouse's will.[7] At the time Mr. Clarkson executed his will, his second wife had been incompetent for four years, and had no realistic prospect of restoration to competency.[8] Mr. Clarkson's will created a testamentary trust funded by one-fourth of his estate, from which Mrs. Clarkson was to be paid all of the income.[9] The trustee was given power to invade principal to the extent it deemed such invasion necessary or desirable to provide for Mrs. Clarkson's support and maintenance.[10] In addition, the trust conferred upon Mrs. Clarkson a testamentary general power of appointment over the remainder.[11]

The relevant Nebraska statute provided that the court should order an election against the will of a deceased spouse on behalf of an incompetent surviving spouse where such an election would be in the "best interests" of the surviving spouse.[12] The specific issue confronting the Nebraska Supreme Court was how to interpret that statutory standard.[13] Many courts would take into account a variety of surrounding facts and circumstances in making the "best interests" determination, including whether the surviving spouse would have wanted to abide by the deceased spouse's estate plan.[14] The Nebraska court instead adopted the minority view, which asks only whether the amount that the surviving spouse would take by electing against the will is of greater pecuniary value than the amount provided for in the will.[15]

6. *In re* Estate of Clarkson v. First Nat'l Bank of Omaha, 226 N.W.2d 334 (Neb. 1975).
7. *Id.* at 335.
8. *Id.*
9. *Id.* at 335–36.
10. *Id.* at 336.
11. *In re Estate of Clarkson*, 226 N.W.2d at 336.
12. *Id.* at 336–37.
13. *Id.* at 336.
14. *Id.* at 338.
15. *Id.* at 337–38.

Though the case is nominally about the standard to be applied in determining whether to order an election against a deceased spouse's will on behalf of an incompetent surviving spouse, it also provides an opportunity to introduce the students to some of the basics of marital deduction planning. The *Clarkson* majority observed that "[t]he will was made at a time when Mrs. Clarkson was incompetent. There is no possibility of her exercising the power of appointment granted in the will because her condition cannot improve."[16] The perceptive student will wonder why Mr. Clarkson conferred upon his wife a power that he knew that she could not and never would be able to exercise. Was he mocking his poor wife? Did he think that he was being funny?

Students are relieved to know that there is a more benign explanation for Mr. Clarkson's otherwise mysterious behavior. In giving his wife a testamentary general power of appointment over the remainder of the trust, he was seeking to qualify the bequest to the trust for the estate tax marital deduction.[17] Many students will already know that there is such a thing as the marital estate and gift tax deduction, but this account of Mr. Clarkson's actions presents an occasion to introduce the use of split-interest trusts in marital deduction planning. Students may not understand—and they need to understand—that the marital deduction merely provides a strategy for estate tax deferral. Of course, to the extent that an outright marital bequest has not been consumed by the surviving spouse, its value will be included in the surviving spouse's gross estate at death. But one cannot both take the marital deduction and avoid such subsequent inclusion in the surviving spouse's estate simply by giving the surviving spouse a life estate—which, at the moment after her death, has, for estate tax inclusion purposes, an actuarial value of zero—with a remainder to third parties.[18] The federal estate tax law does not permit the estate of the first to die to claim a marital deduction in such a case unless the marital bequest has been made in a form that will require any unconsumed portion of those assets to be included in the gross estate of the surviving spouse.

At the time Mr. Clarkson drafted his will in 1969, there were basically two ways to do this. One was an "estate trust," leaving a life estate to Mrs. Clarkson with the remainder to her estate.[19] Under such a plan the remainder of the trust would have been disposed of by the residuary clause of Mrs. Clarkson's most recent valid will, or if there were none, to her intestate

16. *In re Estate of Clarkson*, 226 N.W.2d at 336.

17. Justice McCown's dissenting opinion notes generally that the trust was drafted in order to qualify the bequest to the trust for the estate tax marital deduction, but does not explain the role that the testamentary general power of appointment played in that qualification. *Id.* at 339 (McCown, J., dissenting).

18. I.R.C. § 2056(b)(1) (2006).

19. *See* 26 C.F.R. § 20.2056(c)-2(b)(1) (2013); Rev. Rul. 68-554, 1968-2 I.R.B. 412–13.

successors, who were a son and a daughter by a prior marriage.[20] Mr. Clarkson, who wanted the bulk of the remainder to go to his two daughters from a prior marriage, therefore exercised the second option: a trust conferring upon his incompetent wife a life estate in all of the income and a testamentary general power of appointment over the remainder, with the bulk of the remainder to pass in default of appointment to his two daughters.[21] Conferring upon Mrs. Clarkson such a power of appointment would result in the inclusion of the value of the remainder in her gross estate under I.R.C. § 2041(a)(2).[22] Mr. Clarkson neither wanted nor expected Mrs. Clarkson to exercise the power. The sole reason for its inclusion was to qualify for the marital deduction.

The students naturally will recognize that this estate plan could work for Mr. Clarkson only because Mrs. Clarkson was incompetent and could not exercise her testamentary power of appointment in favor of her own children.[23] Had Mrs. Clarkson been competent, Mr. Clarkson would have had to trust her not to exercise the power in a way that frustrated his wishes. Here, however, one can explain that, had Mr. Clarkson written his will after 1981, he probably would have created a split-interest trust qualifying for the marital deduction in which Mrs. Clarkson was given no power to dispose of the remainder. Under I.R.C. § 2056(b)(7)(B), enacted in 1981, Mr. Clarkson could have created a Qualified Terminable Interest Property (QTIP) trust, providing for all of the income to go to Mrs. Clarkson for her life, with the remainder to pass to his children.[24] In order to qualify for the marital deduction, Mr. Clarkson's executor would have to make an irrevocable QTIP election on the estate tax return,[25] which would result in the inclusion in Mrs. Clarkson's gross estate of the value of the trust's remainder at the date of her death.[26]

Of course, split-interest marital deduction planning—and especially QTIP planning—requires the estate planner to be mindful of a series of technical requirements that must be satisfied in order to qualify for the marital deduction. Though students in a Trusts and Estates course need to be made

20. *See* 26 C.F.R. § 20.2056(c)-2(b)(1); Rev. Rul. 68-554, 1968-2 I.R.B. 412.

21. *See* I.R.C. § 2056(b)(5).

22. *Id.* at § 2041(a)(2). The estate plan involved in *In re* Estate of Janes, 681 N.E.2d 332, 334–35 (N.Y. 1997), a case concerning the trustee's duty to diversify taken up in the materials on the fiduciary obligation, provides an opportunity to reinforce this point. *See* JESSE DUKEMINIER & ROBERT H. SITKOFF, WILLS, TRUSTS, AND ESTATES 626 (9th ed. 2013).

23. And, in fact, even under these circumstances Mr. Clarkson's desires were frustrated. The court ordered the election, which resulted in the unconsumed assets passing not to Mr. Clarkson's remainder beneficiaries, but instead to the beneficiaries of Mrs. Clarkson's estate. This would not be the case under the Uniform Probate Code. *See* UNIF. PROBATE CODE §§ 2-203, 2-212, 2-202 (amended 2010).

24. I.R.C. § 2056(b)(7)(B).

25. *Id.* at § 2056(b)(7)(B)(v).

26. *See id.* at § 2044.

generally aware of the existence of such requirements, dilation upon their details is better confided to a course on the federal transfer taxes. Nevertheless, *Clarkson*—a case included in the text for purposes of illuminating divergent approaches to the issue of elective shares for incompetent surviving spouses—opens up opportunities to introduce students to the basics of split-interest marital deduction planning, and to alert them to the dangers awaiting those who engage in such planning without thoroughly familiarizing themselves with the technical requirements for securing the marital deduction.

Clymer v. Mayo[27] first appeared in the fourth edition of the casebook and has been included, albeit now in quite truncated form, in every succeeding edition. The case concerns the effect of divorce upon a disposition made in a revocable living trust in favor of a former spouse.[28] In 1973, Clara Mayo executed an unfunded revocable living trust and a pour-over will leaving the bulk of her estate to the trust.[29] Mrs. Mayo also made the trust the beneficiary of her retirement plan and a group life insurance policy acquired through her employer.[30] The trust provisions in turn created two subtrusts.[31] Trust A was to be funded with one-half of Mrs. Mayo's adjusted gross estate for federal estate tax purposes.[32] Mrs. Mayo's husband, James Mayo, was given the right to the income from Trust A, the right to invade the principal, and a general power of appointment over the remainder.[33] The balance of the trust assets were to pass to Trust B, which, after making a series of specific bequests, left a life estate in the remaining assets to Mr. Mayo, with the remainder passing to third parties.[34] In 1978 Clara and James divorced, but the settlement agreement made no reference to Mr. Mayo's interest in the trusts.[35] Clara died in 1981 without having amended the trust to remove James as a beneficiary, and the administrator of her estate petitioned for instructions concerning the effect of the divorce on the estate's administration.[36] The court held that the divorce had the effect of revoking all of the trust dispositions in favor of Mr. Mayo.[37]

Like *Clarkson*, *Clymer v. Mayo* provides an opportunity to introduce students to some of the basics of marital deduction planning. Here again, as in *Clarkson*, the surviving spouse was given a life estate with a general power of

27. Clymer v. Mayo, 473 N.E.2d 1084 (Mass. 1985).
28. *Id.* at 1087–88.
29. *Id.* at 1087.
30. *Id.*
31. *Id.*
32. *Clymer*, 473 N.E.2d at 1087.
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.* at 1087–88.
37. *Clymer*, 473 N.E.2d at 1095–96.

appointment in order to secure the marital deduction for a split-interest trust.[38] The full text of the *Mayo* opinion makes it clear that Trust A was designed to qualify for the marital deduction,[39] and one can explain to the students that at the time Mrs. Mayo executed her will and trust, one-half of the adjusted gross estate was the maximum amount that one could deduct for a bequest to a surviving spouse.[40] One can then explain that in 1981, Congress revised the law to make the marital deduction unlimited in value.[41] One can now leave one's entire estate to one's surviving spouse and pay no estate tax on the bequest.[42] Students may momentarily think that this revision to the estate tax law has made the type of A-B trust planning employed in *Mayo* obsolete. After 1981, Mrs. Mayo simply could have left as much of her estate to Trust A as she liked and taken the full deduction for that amount. There would be no reason to create Trust B.

Here is the opportunity to explain to the students why the A-B trust continues to serve as the template for most marital deduction planning. In 1981, Congress also introduced into the estate tax the unified credit, which now stands at $5,000,000 per person, indexed for inflation.[43] Between 1981 and 2010, the unified credit was non-transferable.[44] If one failed to use it in its entirety, the unused portion of the credit was forfeited. Estate planners therefore regularly established two trusts for the benefit of the surviving spouse. One was a "credit shelter" or "bypass" trust, which was funded with an amount equivalent to the portion of the deceased spouse's unified credit not previously used to offset gift tax liability. The surviving spouse could be given a right to income and limited access to principal in such a credit shelter trust, but upon the death of the surviving spouse, the trust assets would not be included in her gross estate for federal estate tax purposes. They would pass to the remainder beneficiaries free of federal estate tax. The balance of the deceased spouse's assets would fund the marital deduction trust—typically a QTIP trust. The surviving spouse would be given all of the income from the trust and perhaps some access to principal, but at her death the value of the remaining trust assets would be included in her gross estate.[45]

38. *Id.* at 1087.

39. *Id.* at 1091.

40. *See id.* at 1087 (the will and trust were executed on February 2, 1973); I.R.C. § 2056(c) (1970) (showing the law in effect at the time of Mrs. Mayo's will and trust).

41. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403, 95 Stat. 172, 301 (1981).

42. I.R.C. § 2056(a) (2006).

43. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act, Pub. L. No. 111-312, § 302, 124 Stat. 3296, 3301 (2010).

44. I.R.C. § 2010 (1982).

45. I.R.C. § 2044 (2006). The estate plan involved in Howard v. Howard, 156 P.3d 89 (Or. Ct. App. 2007), a case concerning the trustee's duty of impartiality taken up in the materials on

In 2010, Congress enacted legislation making the unified credit portable in some circumstances. A surviving spouse now can use any unconsumed portion of her deceased spouse's unified credit to shelter her own estate's assets from the estate tax (though if she has been widowed more than once, she can use only the unconsumed credit of the spouse by whom she was most recently widowed).[46] This change in the tax law reduces—though it does not eliminate—the incentive to use one's own unified credit lest it be lost. But there is another feature of marital deduction planning that will continue to create incentives to maximize one's use of the unified credit in the estate of the first to die. Recall that the marital deduction is merely a deferral mechanism—any unconsumed portion of the marital deduction trust will be included in the gross estate of the surviving spouse, at the value of the trust assets on the date of the surviving spouse's death. The estate tax value of the credit shelter trust assets, by contrast, is fixed at the date of the death of the first to die, and is not included in the surviving spouse's gross estate. Because the credit shelter bequest thus "freezes" the estate tax value of those assets, any appreciation in their actual value between the death of the first to die and the death of the surviving spouse will escape estate taxation at the couple's generational level. For this and for other reasons, the A-B trust scheme of marital deduction planning remains relevant today, and thus remains worthy of classroom discussion.

Finally, an introduction to the relationship between the unified credit and the marital deduction provides an opportunity to explain to students why a beneficiary without significant actual or foreseeable creditors might disclaim all or part of a substantial bequest. Students can readily understand why a beneficiary might disclaim property she does not wish to own, such as Aunt Minnie's thimble collection, or Uncle Fred's Superfund site.[47] But they often have a harder time understanding why someone might disclaim a substantial bequest of cash or stock. Once they understand the concept of an over-funded marital bequest, however, they can see why a surviving spouse might disclaim a portion of an outright marital bequest so as to utilize the deceased spouse's unified credit. And they can further comprehend why a decedent's will or trust might provide that any portion of the marital bequest disclaimed by the surviving spouse shall pass to a contingent credit shelter trust.[48]

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the fiduciary obligation, presents an opportunity to revisit the use of the A-B trust format in marital deduction planning. *See* DUKEMINIER & SITKOFF, *supra* note 22, at 658.

46. I.R.C. § 2010(c)(4).

47. *But see* Drye v. United States, 528 U.S. 49, 52 (1999) (disclaimer valid for purposes of state law not effective to exempt inherited property from federal tax lien imposed upon beneficiary); *see also* DUKEMINIER & SITKOFF, *supra* note 22, at 142.

48. *See, e.g.*, RONALD A. BRAND & WILLIAM P. LAPIANA, DISCLAIMERS IN ESTATE PLANNING: A GUIDE TO THEIR EFFECTIVE USE 125–26 (1990).

B. Charitable Deduction Planning

Connecticut Junior Republic v. Sharon Hospital[49] appeared in the fourth and fifth editions of the casebook. The case was included to illustrate traditional limitations on the power of courts to cure drafting mistakes made by the scrivener of a will.[50] Justice Ellen Ash Peters filed a powerful dissent to the majority opinion, arguing for a more liberal policy of relief for such mistakes.[51] Justice Peters's dissent later was vindicated by the court in *Erickson v. Erickson*,[52] and that decision replaced *Sharon Hospital* in more recent editions of the casebook. I have had the students read *Erickson*, but I continue to teach them *Sharon Hospital*, in large part because it provides an opportunity to alert them to some dangers in charitable deduction planning.

The facts of *Sharon Hospital* are as follows: In 1960, the testator executed a will in which he established a type of split-interest trust commonly called a charitable remainder trust.[53] The income was to be used for the benefit of a designated individual for life, with the remainder to pass to seven named charitable institutions (the 1960 charities).[54] In 1969, the testator executed a codicil eliminating the remainder interests of six of the seven 1960 charities, and substituting in their place ten new charitable institutions (the 1969 charities).[55] Later in 1969, Congress amended the estate tax law to require that bequests of remainder interests to charities be made in a specified manner in order to qualify for the estate tax charitable deduction.[56] The testator learned of this change in 1975 and instructed his attorney to amend the will and codicil so that the bequests to the 1969 charities would qualify for the charitable deduction.[57] The lawyer drafted a second codicil qualifying the remainder interests for the charitable deduction, but mistakenly reinstated the 1960 charities as the remainder beneficiaries.[58] The testator signed the 1975 codicil and died in 1979 before the mistake had been identified.[59] The 1969 charities sought relief for the scrivener's error, but a sharply divided Connecticut

49. Conn. Junior Republic v. Sharon Hospital, 448 A.2d 190 (Conn. 1982).

50. *Id.* at 191.

51. *Id.* at 200 (Peters, J., dissenting).

52. *See* Erickson v. Erickson, 716 A.2d 92, 98 (Conn. 1998).

53. *Sharon Hospital*, 448 A.2d at 191. A trust in which a charity is given a term of years or an estate *pur autre vie* followed by a remainder to private parties is commonly known as a charitable lead trust.

54. *Id.*

55. *Id.* at 191–92.

56. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 201, 83 Stat. 487, 566 (1969).

57. *Sharon Hospital*, 448 A.2d at 192.

58. *Id.*

59. *Id.*

Supreme Court followed the then-standard practice of refusing to admit extrinsic evidence of mistake, and affirmed the denials of the relief requested.[60]

The change to the tax law involved in *Sharon Hospital* was motivated by concerns that trustees of charitable lead and charitable remainder trusts were manipulating investment policy in order to provide those holding the private interests with greater benefits than might have been anticipated, at the expense of the charitable interests. The trustee of a charitable lead trust might invest heavily in assets having significant growth potential but providing little income to the charity; the trustee of a charitable remainder trust might invest in assets that produced significant income for the private life tenant but grew at below-market rates. These investment practices could result in the estate taking a larger charitable deduction than was warranted by the value ultimately received by the charitable beneficiary.[61] To prevent such abuses, the 1969 Congress enacted legislation providing that split-interest charitable trusts would not qualify for the charitable deduction unless they took the form of an annuity trust, a unitrust, or a pooled income fund.[62] The requirements imposed by the statute and regulations are quite technical—so technical, in fact, that in 1988 the Service began to take the unusual step of issuing Revenue Procedures containing model dispositive provisions.[63]

I do not work through these technical requirements with students in a basic Trusts and Estates course. But after explaining to them the tax problem involved in *Sharon Hospital*, I tell them that there is one very important lesson that I want them to take away from the case: you do not know how to do this. You may think that you can set up a trust providing for a life estate to a private party and a remainder to a charity, and then take a charitable estate tax deduction for the actuarial value of the remainder. You would be mistaken and that will occasion some unhappiness with you.[64] If you have a client who wants to establish such a trust, you need either to learn how to do this or to direct the client to someone who does know how to do it.

60. *Id.* at 199.

61. *See* H.R. REP. NO. 91-413, pt. 1, at 58 (1969).

62. I.R.C. § 2055(e)(2) (2006); I.R.C. § 2522(c)(2).

63. *See* Rev. Procs. 88-53, 1988-2 C.B. 712; 89-20, 1989-1 C.B. 841; 89-21, 1989-1 C.B. 842; 90-30, 1990-1 C.B. 534; 90-31, 1990-1 C.B. 539; 90-32, 1990-1 C.B. 546; 2003-53, 2003-2 C.B. 230; 2003-54, 2003-2 C.B. 236; 2003-55, 2003-2 C.B. 242; 2003-56, 2003-2 C.B. 249; 2003-57, 2003-2 C.B. 257; 2003-58, 2003-2 C.B. 262; 2003-59, 2003-2 C. B. 268; 2003-60, 2003-2 C.B. 274; 2005-52, 2005-2 C.B. 326; 2005-53, 2005-2 C.B. 339; 2005-54, 2005-2 C.B. 353; 2005-55, 2005-2 C.B. 367; 2005-56, 2005-2 C.B. 383; 2005-57, 2005-2 C.B. 392; 2005-58, 2005-2 C.B. 402; 2005-59, 2005-2 C.B. 412; 2007-45, 2007-2 C.B. 89; 2007-46, 2007-2 C.B. 102; 2008-45, 2008-2 C.B. 224; 2008-46, 2008-2 C.B. 238.

64. The deduction may be salvaged, however, through a reformation proceeding, provided that the requirements of I.R.C. § 2055(e)(3) (or I.R.C. § 2522(c)(4), as the case may be) can be and are satisfied. Clearly, an after-the-fact reformation proceeding to achieve tax savings that might have been obtained in the first place through competent drafting is a second-best solution.

C. Additional Opportunities

The Dukeminier casebook also offers other opportunities to make more discrete points about estate taxation. For example, in the section on disclaimers, the text helpfully notes that a beneficiary may disclaim a bequest to save on inheritance and income taxes.[65] Suppose, for example, that T were to leave property to his sister, A. A intends to leave all of her substantial estate to her only child, B. If A accepts the bequest from T, then the value of that property, to the extent that it is not consumed during A's life, will be subject to estate taxation in A's estate.[66] However, if A executes a valid, qualified disclaimer of the property, B will take the property under the state's anti-lapse statute, and the property will not be taxed in A's estate. Moreover, if B is in a lower income tax bracket than A is, the burden of taxation on income generated by the disclaimed property accordingly will be lower.[67]

Similarly, in the section on future interests, the text usefully observes that federal estate taxation of a future interest does not turn on whether that interest is vested or contingent, but instead on whether it is transmissible.[68] Contingent future interests passing from a decedent thus can result in the imposition of estate taxation. When discussing reversions, one can note that the value of a property interest transferred during life by the decedent may be subject to taxation in his gross estate if he has retained a significant reversionary interest in the property.[69] And when discussing adult adoption, one can observe that some states have inheritance taxes that peg the rate of taxation to the proximity of the relationship between the decedent and the beneficiary,[70] and that adoption of a non-relative can thus reduce the burden of inheritance taxation on the bequest.

Finally, the materials on nonprobate transfers and the elective share provide opportunities to introduce students to the basic federal estate tax treatment of death-time transfers passing outside of probate.[71] Students should

65. *See* DUKEMINIER & SITKOFF, *supra* note 22, at 140.

66. Depending upon how soon after T's death A dies, the burden of taxation may to some extent be reduced by the Credit for Tax on Prior Transfers. *See* I.R.C. § 2013.

67. *See, e.g.*, JESSE DUKEMINIER, ROBERT H. SITKOFF & JAMES LINDGREN, WILLS, TRUSTS, AND ESTATES 153 (8th ed. 2009).

68. DUKEMINIER & SITKOFF, *supra* note 22, at 849.

69. I.R.C. § 2037(a)(2).

70. *See, e.g.*, KY. REV. STAT. ANN. §140.070 (West 1995); NEB. REV. STAT. §§ 77-2004, 77-2005 (2006); N.J. ADMIN. CODE §§ 18:26-2.5, 18:26-2.7, 18:26-2.8 (1994); s*ee also* DUKEMINIER & SITKOFF, *supra* note 22, at 977–78 (discussing state estate and inheritance taxes). For another opportunity to discuss issues of state taxation, *see id*. at 741 (citing Davis v. U.S. Bank Nat'l Ass'n, 243 S.W.3d 425, 426, 431 (Mo. Ct. App. 2007), in which beneficiaries of a trust successfully sought to replace a Missouri trustee with a Delaware trustee, in part to reduce state-level income taxation).

71. DUKEMINIER & SITKOFF, *supra* note 22, at 435–93, 512–45.

understand that, while property passing at death under a revocable trust, joint tenancy, multiple-party bank or brokerage account, life insurance policy, pension account, and the like avoids the delays, expense, and publicity of probate, it does not escape federal estate taxation. If it did, then the annual revenue from the federal transfer taxes presumably would approach zero. Instead, the federal estate tax contains a series of provisions designed to include the value of such property in the decedent's gross estate.[72] The Uniform Probate Code, various state statutes, and some judicially-created doctrines follow a similar approach in seeking to prevent a spouse from unfairly depleting the value of the estate subject to his surviving spouse's elective share by disposing of much or all of his wealth through various forms of nonprobate transfer.[73] Instead, the Uniform Probate Code[74] and New York's Estates Powers & Trusts Law,[75] for example, include in the "augmented estate" subject to the elective share many of the types of nonprobate assets that would be included in the decedent's gross estate for federal estate tax purposes. And Delaware's elective share statute elegantly includes in the augmented estate the value of all of the assets includible in the decedent's federal gross estate, irrespective of whether an estate tax return is filed.[76]

Each of these points is worthy of at least a brief mention. But the most important areas to emphasize, in my judgment, are those in which the students are most likely to make costly mistakes in law practice—the marital and charitable deductions.

II. THE GIFT TAX

The most important things for students to understand about the gift tax are: (1) that it exists; (2) that it is offset by the unified credit, the marital deduction, and the charitable deduction;[77] (3) that transfers made on behalf of an individual directly to qualifying educational organizations and providers of medical care are excluded from the tax base under I.R.C. § 2503(e);[78] (4) that annual gifts of up to $13,000 per donee (indexed for inflation) are excluded from the tax base under I.R.C. § 2503(b);[79] and (5) that with respect to the "ed-med" exclusion and the annual exclusion, there is no analogous provision for exclusion from the estate tax.[80] Once they also understand that lifetime gifts

72. *See* I.R.C. §§ 2035–42.

73. *See infra* notes 74–75 and accompanying text.

74. *See* UNIF. PROBATE CODE § 2-205 (amended 2010).

75. *See* N.Y. EST. POWERS AND TRUSTS LAW § 5-1.1-A(b) (McKinney 1999).

76. DEL. CODE ANN. tit. 12, § 902(a) (2007).

77. *Survivors, Executors, and Administrators*, INTERNAL REVENUE SERVICE 25 (Feb. 8, 2013), http://www.irs.gov/pub/irs-pdf/p559.pdf.

78. I.R.C. § 2503(e) (2006).

79. *Id.* § 2503(b).

80. *See id.* §§ 2001–2210.

freeze the transfer tax value of the transferred asset and thus leverage the value of the unified credit, students will see that our transfer tax system creates significant incentives for lifetime giving—something that they will no doubt delight in telling their parents.

The Dukeminier casebook lends itself to a discussion of these features of the gift tax at various junctures. For example, the text notes that a disclaimer that is valid for purposes of state property law may nevertheless result in gift tax liability to the disclaimant unless the disclaimer also satisfies the requirements for a "qualified disclaimer" under I.R.C. § 2518.[81] In its discussion of planning for incapacity, the text points out that many states require that any desired authority for the holder of a durable power of attorney to make gifts on behalf of a principal be expressly conferred in the document.[82] Thus, if the principal wishes the agent to have the authority to reduce the size of the principal's taxable estate by making gifts that would qualify for the annual exclusion or the ed-med exclusion, the document should make that authority explicit.

The annual exclusion is arguably the most important of the basic gifting techniques, and I introduce it quite early in the course. The Dukeminier casebook's introductory materials raise questions about the practical feasibility of abolishing inheritance, were doing so thought desirable.[83] In the seventh edition, the text explicitly pointed out that the abolition of inheritance would require the eradication not only of testate and intestate succession, but also of nonprobate forms of transfer such as joint tenancies; inter vivos transfers of remainder interests subject to a retained life estate; payable-on-death and transfer-on-death designations on contracts and bank, brokerage, and pension accounts; and life insurance.[84] I continue to raise these points, adding that another hole in the dike that would have to be plugged of course would be outright inter vivos gifts. The costs of policing such donative activity obviously would be enormous, and those who have argued in favor of the annual exclusion from the gift tax sometimes have recognized this explicitly. As one commentator has put it, the annual exclusion's "purpose is to ensure that no IRS agent is needed under the Christmas tree to monitor small gifts."[85]

81. DUKEMINIER & SITKOFF, *supra* note 22, at 141.

82. *Id.* at 503.

83. JESSE DUKEMINIER, STANLEY M JOHANSON, JAMES LINDGREN & ROBERT H. SITKOFF, WILLS, TRUSTS, AND ESTATES 8–9 (7th ed. 2005).

84. *Id.*

85. Robert B. Ford, *Of Counsel: Annual Exclusion a Use-or-Lose Tax Benefit*, CRAIN'S CLEVELAND BUS., Dec. 10, 2001, at 19. *See also* John K. McNulty, *Statement of John K. McNulty, Professor of Law, University of California, Berkeley*, *in* 10 TAX REFORM—1976: A LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1976 (PUBLIC LAW 94-455) WITH RELATED AMENDMENTS 190, 194 (Bernard D. Reams & Emelyn B. House eds., 1992) (the exclusion ensures that "the tax authorities would not have to 'sit beneath the Christmas tree' or make liars

Students should understand that many annual exclusion gifts are made in trust, and that this gives rise to its own complexities. The initial challenge is presented by I.R.C. § 2503(b)(1)'s requirement that a gift be of a "present interest" in order to qualify for the annual exclusion.[86] A transfer of $13,000 to a trust in which there are both present and future interests therefore will not qualify in its entirety for the annual exclusion; the value of the portion allocated by the terms of the trust to the future interests will be ineligible. In order to qualify gifts to a trust for an annual exclusion, therefore, settlors commonly confer upon beneficiaries "demand powers"—powers to withdraw from the trust a certain dollar amount or percentage of the corpus each year. This demand power, which confers upon the beneficiary the right to immediate possession of the amount subject to the power, gives the beneficiary the requisite present interest in the contributed property. This in turn renders the contribution to the trust eligible for the annual exclusion.

This background helps the students to understand the trust involved in *Irwin Union Bank & Trust Co. v. Long*.[87] *Long*, which has been in the casebook since the fourth edition, is included to illustrate the traditional relation-back doctrine and its bearing on the rights of a creditor of the holder of an inter vivos general power of appointment to reach the assets subject to the power in satisfaction of her claims.[88] Laura Long created a trust in which she conferred on her son, Philip W. Long, Jr., "the right to withdraw from principal once in any calendar year upon thirty (30) days written notice to the Trustee up to four percent (4%) of the market value of the entire trust principal on the date of such notice, which right shall not be cumulative."[89] Philip's ex-wife sought to reach four percent of the trust corpus in order to satisfy her rights under their divorce decree, and the Indiana court held that she could not do so unless and until Philip actually exercised his power.[90]

Having been introduced to the present interest requirement, the students will now understand that Philip's demand power was probably included to qualify additional contributions to the trust for the annual exclusion. But, why, they might wonder, was the power made non-cumulative? And why was it limited to four percent of the principal?

In order for the students to understand these features of this particular power, they must further recognize that the conferral of such a power creates complications for its holder. Such a power is, of course, a general power of

out of taxpayers who inadvertently or otherwise failed to report the small transfers that take place, particularly within a family context.").

86. I.R.C. § 2503(b)(1) (2006).

87. Irwin Union Bank & Trust Co. v. Long, 312 N.E.2d 908 (Ind. Ct. App. 1974).

88. *See id.* at 909.

89. *Id.* at 910.

90. *Id.* at 909, 914.

appointment;[91] and as the notes following the case usefully observe, the holder of such a power is treated as the owner for federal transfer tax purposes.[92] If Philip exercises the power by giving the appointive property to someone else, he will be deemed to have made a taxable gift.[93] And to the extent that Philip holds such a power over the appointive property at his death, the property will be included in his gross estate for federal estate tax purposes.[94] This is why the power was made non-cumulative.[95] As the power is written, Philip will have only the value of four percent of the trust principal included in his gross estate at death. Had the power been cumulative, then for each year in which Philip did not exercise the power, he would be deemed to own an increasingly larger percentage of the principal at his death. In order to protect Philip from this consequence, the power is designed to *lapse* in any year in which he does not exercise it. And, of course, most trust beneficiaries holding demand powers understand, or are made to understand, that they are expected to allow the power to lapse each year. The power is not there to be exercised—it is there to make the annual exclusion available to those contributing to the trust.[96]

It is the fact Philip's demand power was expected to lapse annually that most likely accounts for its size. I.R.C. § 2514(e) provides that the lapse of a power is treated as a release of the power,[97] and I.R.C. § 2514(b) provides that the release of a power, like the exercise of power, shall be treated as a transfer of property.[98] This means that by allowing the power to lapse, Philip would be treated as having made a transfer to the trust. A portion of that deemed transfer would be allocated to future interests and thus would not be eligible for the annual exclusion. Allowing the power to lapse thus would result in gift tax liability for Philip. In addition, depending upon what other interests or powers

91. *See* I.R.C. §§ 2041, 2514.

92. DUKEMINIER & SITKOFF, *supra* note 22, at 807. The notes also provide useful information on tax planning with special powers of appointment. *Id. See also* Beals v. State St. Bank & Trust Co., 326 N.E.2d 896, 900 (Mass. 1975), which immediately follows those notes, and provides an opportunity to make an important point about the transfer taxes. That case, which has been included the casebook since the third edition, is ostensibly about whether a residuary clause implicitly exercises a general power of appointment. But the facts allow one to note that one can no longer avoid the potentially adverse tax consequences associated with a general power by releasing only those features of the power that make it general, thereby converting it into a non-taxable special power of appointment. *See* Treas. Reg. § 25.2514-3(c) (2013) (stating that a partial release of a general power of appointment does not effect a complete gift for Federal tax purposes).

93. I.R.C. § 2514(b).

94. *Id.* at § 2041.

95. *See Irwin Union Bank & Trust Co.*, 312 N.E.2d at 910.

96. *See* I.R.S. Tech. Adv. Mem. 8727003 (Mar. 16, 1987) for a humorous instance in which certain power-holders did not understand the drill.

97. I.R.C. § 2514(e).

98. *Id.* at § 2514(b).

Philip has with respect to the trust, the lapse of the power could also result in estate liability for Philip. Assume, for example, that Philip held a life estate in the trust created by his mother. I.R.C. § 2036(a) provides that the value of property transferred by a decedent during life in which he retained a life estate shall be included in his gross estate.[99] I.R.C. § 2041(a)(2) in turn provides for the inclusion of any property deemed to be transferred by exercise or release of a power of appointment "by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive."[100] I.R.C. § 2041(b)(2) in turn treats the lapse of a power as the release of a power.[101] Accordingly, in any year in which Philip allowed the power to lapse, he would be deemed to have made a transfer of property in which he retained a life estate, the value of which would be includible in his gross estate at death. Each annual lapse would thus augment the value of the property ultimately included in his gross estate.

In order to provide some relief from these potentially adverse consequences, I.R.C. §§ 2514(e) and 2041(b)(2) offer a limited safe harbor. Each of these sections provides that a lapse shall not be considered a transfer of property except to the extent that the amount subject to the power exceeds the greater of (a) $5000, or (b) five percent of the aggregate value, at the time of the lapse, of the assets out of which the power could have been satisfied.[102] So, for example, assume that a trust conferred upon a beneficiary a non-cumulative power to withdraw the value of any contribution made to the trust in any year. Assume that the value of the trust corpus, after the contribution of $13,000, is $60,000. If the power were to lapse, the beneficiary would be deemed to have transferred back to the trust $8000—the excess of the amount subject to the power ($13,000) over $5000. By contrast, if the trust corpus were valued at $300,000, there would be no constructive transfer, because the amount subject to the power ($13,000) would not exceed five percent ($15,000) of the aggregate value of the assets out of which the power could have been satisfied ($300,000). Under the former scenario, the beneficiary might experience adverse gift and estate tax consequences; under the latter he would not. A trust with a larger corpus thus tends to make it easier to reconcile the tension between securing the annual exclusion for trust donors, on the one hand, and protecting beneficiaries from adverse estate and gift tax consequences, on the other.

99. *Id.* at § 2036(a).
100. *Id.* at § 2041(a)(2).
101. *Id.* at § 2041(b)(2).
102. I.R.C. §§ 2514(e), 2041(b)(2).

Demand powers can be tailored in a variety of different ways, striking a range of balances between these two sets of interests.[103] Laura Long's trust nicely illustrates one common strategy for protecting the beneficiary from adverse transfer tax consequences. By defining the demand power either in terms of or so as to be within the so-called "five and five exception," a settlor can ensure that no lapse of the power will be taxable.[104] For example, a lapse of Philip Long's power never could result in a deemed transfer to the trust, because the amount subject to the power—four percent of the value of the trust assets—never could exceed five percent of the aggregate value of the assets out of which the power could have been satisfied. The same would be true had Philip been given the power to withdraw in any year the greater of $5000 or five percent of the value of the trust assets. The mystery is why Laura gave Philip only a four percent power when she could have given him a power over five percent. Perhaps he had been a naughty boy.

III. THE GENERATION-SKIPPING TRANSFER TAX (GSTT)

The Dukeminier casebook does a nice job of showing how the GSTT exemption—now five million dollars, indexed for inflation—has led to the erosion or elimination of the Rule Against Perpetuities,[105] and how that development has in turn led to liberalization of the traditional law of trust modification and termination, as well as to the enactment in several states of decanting legislation. The GSTT exemption allows a settlor to insulate trust assets initially worth five million dollars from the GSTT for as long as the trust is permitted to endure under the applicable state law, no matter how much those assets may appreciate in value over time. The longer the trust is permitted to endure, the greater the leverage a settlor is able to obtain from the exemption. Jurisdictions anxious to compete for trust funds have responded by relaxing or eliminating the constraints on trust duration previously imposed by their Rules Against Perpetuities.[106]

I do not get into the technicalities of the GSTT in the basic Trusts and Estates course, but there is a case in the chapter on future interests that provides an opportunity to introduce some of the basics. *In re Estate of Gilbert*,[107] which has appeared in every edition since the fifth, is included in the section on acceleration into possession to illustrate the adverse

103. *Compare, e.g.*, the powers involved in Kieckhefer v. Comm'r of Internal Revenue, 189 F.2d 118 (7th Cir. 1951), *and* Crummey v. Comm'r of Internal Revenue, 397 F.2d 82 (9th Cir. 1968), *with* I.R.S. Tech. Adv. Mem. 8004172 (Nov. 5, 1979).

104. Donald O. Jansen, *Giving Birth to, Caring for, and Feeding the Irrevocable Life Insurance Trust*, 41 REAL PROP. PROB. & TR. J. 571, 634–35 (2006).

105. DUKEMINIER & SITKOFF, *supra* note 22, at 895.

106. *See id.* at 897.

107. *In re* Estate of Gilbert, 592 N.Y.S.2d 224 (Surr. Ct. 1992).

consequences for a contingent succeeding interest that may result from a disclaimer of the preceding interest.[108] Peter Gilbert died in 1989 leaving an estate totaling more than forty million dollars.[109] His estate plan included two testamentary, discretionary trusts for the benefit of each of his four children—eight such trusts in all.[110] Upon the death of each child, the principal was to be paid to that child's issue.[111] Gilbert's son Lester, aged thirty-two, disclaimed his interests in the two trusts established for his benefit, apparently for religious reasons.[112] Under the New York statute, Lester was treated as having predeceased Peter, and the remainder interest in Lester's issue accelerated into possession.[113] Unfortunately, Lester did not yet have any issue, so the acceleration of the remainder resulted in its destruction.[114] Were Lester to have issue in the future, they would not share in the trust.[115]

The decision explains that the portion of Peter's estate not otherwise disposed of was allocated among the eight trusts in the following fashion: first, the amount of Peter's GSTT exemption—at the time, one million dollars—was divided into four discretionary trusts, one for the benefit of each of his children.[116] Then the residue was allocated in equal shares among the second set of discretionary trusts, again one for the benefit of each child.[117] Other than the fact that the residuary trusts were later to receive additional funding from the remainder of an elective share trust that Peter had established for his widow, the terms of Lester's two trusts appear to have been virtually identical.[118] The decision does not explain why Peter might have established two identical discretionary trusts for each of his children, one to which a proportionate share of the GSTT exemption was allocated, and another to which none of the exemption was allocated.[119]

Here one can pause briefly to explain the role that the exemption plays in determining the "applicable rate" of GSTT. Section 2641(a) defines the applicable rate as the product of the maximum federal estate tax rate and the "inclusion ratio."[120] Section 2642(a)(1) in turn defines the inclusion ratio as the

108. *Id.* at 225–28.
109. *Id.* at 224.
110. *Id.* at 225.
111. *Id.*
112. *Estate of Gilbert*, 592 N.Y.S.2d at 225.
113. *Id.* at 227–28.
114. *Id.* at 227.
115. *Id.*
116. *Id.* at 225.
117. *Estate of Gilbert*, 592 N.Y.S.2d at 225.
118. *Id.*
119. *Id.*
120. I.R.C. § 2641(a) (2006).

amount by which one exceeds the "applicable fraction."[121] The section goes on to define the applicable fraction (roughly) as the amount of the GSTT exemption allocated to the trust divided by the amount transferred to the trust.[122] With respect to the first of Lester's discretionary trusts, the applicable fraction equaled one: the amount of the exemption allocated to the trust equaled the amount transferred to the trust.[123] The inclusion ratio was therefore zero, and as a consequence the applicable rate was zero.[124] The first trust was made completely exempt from the GSTT. Distributions to "skip persons," that is, Peter's grandchildren, would not be subject to the tax. With respect to the second trust, by contrast, the applicable fraction equaled zero, because there was no exemption allocated to the trust.[125] The inclusion ratio was therefore one, making the applicable rate the maximum federal estate tax rate.[126] Distributions to skip persons from this trust would be taxed at the highest possible applicable rate.

Once students understand better *what* Peter Gilbert did, they will still want to know *why* he did it that way. Why did he create for each of his children one small trust that would be completely exempt from GSTT, and another, virtually identical trust that would be taxed at the maximum rate? Why not just create one big trust that would be taxed at something less than the maximum rate? Would the aggregate GSTT burden not be identical under each of these scenarios? Why bother to create and administer eight trusts where four would have done the job? Did Peter Gilbert regard transactions costs as consumption goods?

Here one can explain why the creation of completely exempt and completely non-exempt trusts is standard estate planning practice. Lester was not a skip person, and therefore distributions to him would not have been subject to GSTT. Any distribution to Lester of even partially-exempt assets would therefore have been to that extent a waste of Peter's exemption. That exemption should instead be used to shelter from tax only assets to be distributed to skip persons. Accordingly, Lester never would have seen a distribution from the exempt trust. His needs would have been met entirely from the assets of the non-exempt trust. Moreover, in an effort to more effectively leverage the value of the exemption, the trustee of the exempt trust would likely pursue a more growth-oriented investment policy than would the trustee of the non-exempt trusts, whose portfolio would likely be more heavily

121. *Id.* at § 2642(a)(1).
122. *Id.* at § 2642(a)(2).
123. *See id.*; *Estate of Gilbert*, 592 N.Y.S.2d at 225.
124. *See* I.R.C. §§ 2641, 2642(a)(2); *Estate of Gilbert*, 592 N.Y.S.2d at 225.
125. *See* I.R.C. § 2642(a)(2); *Estate of Gilbert*, 592 N.Y.S.2d at 225.
126. *See* I.R.C. §§ 2641, 2642(a)(2); *Estate of Gilbert*, 592 N.Y.S.2d at 225.

weighted toward income-producing assets. The additional trusts were worth the cost.

IV. THE INCOME TAX

I say just a few things about income taxation in the basic Trusts and Estates course. For those who have not yet had a class in Federal Income Taxation, I introduce the concepts of stepped-up basis for bequests and carryover basis for gifts of appreciated capital assets. When covering the process of estate administration, I talk about trusts and estates as taxable entities, and I inform the students of the need to file an annual Form 1041 fiduciary income tax return and analogous state income tax forms. I explain to them that trusts and estates are in general taxed on their income to the extent that they retain it, but that they are allowed a deduction for income distributed to beneficiaries, which the beneficiaries then report as income—unless, of course, the trust is a grantor trust. This prepares them to understand the benefits of income-splitting—of distributing the income from a productive asset among several (often lower tax bracket) beneficiaries so that the aggregate income tax burden is reduced by virtue of the progressive character of our income tax system—and the role that flexible grants of discretion in distributing trust income can play in optimizing that strategy.

Brainard v. Commissioner of Internal Revenue,[127] an old chestnut on the trust *res* requirement, has appeared in every edition of the Dukeminier casebook (albeit recently only in squib form). As its title suggests, the case involves a taxation controversy, arising in this instance as the result of a poorly executed and therefore unsuccessful attempt at income-splitting. In December of 1927, Mr. Brainard orally declared himself to be the trustee of any profits he made from stock trading during 1928, for the benefit of his wife, his mother, and his two young children.[128] Mr. Brainard made a substantial profit from trading in 1928, and after paying himself a fee, which he declared as income to himself, he credited the remaining profits on his books to the four named trust beneficiaries.[129] The beneficiaries in turn declared these amounts as income on their 1928 returns.[130] The Commissioner contended, and the United States Court of Appeals for the Seventh Circuit agreed, that no trust arose in 1927 because the future profits from trading did not yet exist and therefore could not constitute the requisite trust *res*.[131] The profits therefore were income to Mr. Brainard, and not to the trusts, when they came into existence, and therefore

127. Brainard v. Comm'r of Internal Revenue, 91 F.2d 880 (7th Cir. 1937).
128. *Id.* at 881.
129. *Id.*
130. *Id.*
131. *Id.* at 881–84.

were properly taxable to him alone.[132] His subsequent crediting of profits to the beneficiaries was simply a gratuitous transfer with no income tax consequences.[133] Had Mr. Brainard instead declared himself to be the trustee of specific securities in 1927, with the trust providing that profits from trading were to go to the four named beneficiaries, there would have been a trust *res* in 1927, and Mr. Brainard's income-splitting objective would have been achieved.

The section on taxation of grantor trusts[134] observes that the adoption of the grantor trust rules[135] has complicated such income-shifting strategies considerably. The text discusses these rules in greater detail than I pursue in class. I simply note that there are certain retained interests and powers—such as reversions and powers to revoke—that will result in the grantor being taxed on the trust income, irrespective of whether it is in fact distributed to the grantor. However, I do take this opportunity to observe that, though it might appear that retaining a power triggering the grantor trust rules is a bad idea, if done carefully it can be a good idea. In fact, estate planners commonly include some such powers—specifically, those that will not result in the inclusion of the value of the trust's assets in the grantor's gross estate—on purpose. Such "intentionally defective grantor trusts" allow the grantor to pay the income tax on the trust income without such payment being deemed a taxable gift to the beneficiaries.[136] The payment of the income tax depletes the grantor's estate, thereby lowering his ultimate estate tax liability, and effectively transfers to the beneficiaries greater net wealth at a lower transfer-tax cost.

CONCLUSION

I estimate that the amount of time that I spend explaining these basics of our income and transfer tax system comprises in the aggregate a little over one classroom hour. These subjects do not harbor the degree of human interest that one finds in, say, many will contest cases, and they are not always received with wide-eyed enthusiasm by every pupil. But an introduction to these features of the tax system, which are secreted in the interstices of many private law cases, does serve to alert students in a basic Trusts and Estates course to fundamental estate planning opportunities of which they should be aware, to dangers of which they might otherwise remain blissfully unaware, and of the need to learn more if they are to undertake certain kinds of estate planning

132. *Brainard*, 91 F.2d at 881, 884.
133. *Id.* at 882.
134. DUKEMINIER & SITKOFF, *supra* note 22, at 978–79.
135. *See* I.R.C. §§ 671–77 (2006).
136. Rev. Rul. 2004-64, 2004-2 C.B. 7.

projects. To paraphrase Harry Callahan, a lawyer has got to know his or her limitations.[137]

137. MAGNUM FORCE (Warner Bros. 1973).