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GIFTING

Optimized Gift Trusts & Funding Designs

Jonathon M. Morrison

Considerations and suggestions for creating a gift trust with maximum flexibility, access, use, and control while maintaining favorable tax treatment.

The golden age of federal estate tax minimization planning is upon us – but the window of opportunity is evaporating. The current legislative environment allows for most wealthy families to eliminate their 40% federal estate tax through a combination of tried-and-true gift planning strategies. To do so, however, families must gift large amounts of wealth out of their estates in order to lock-in their federal gift exemptions and "grandfather" their gift trusts in advance of anticipated tax, economic, and legislative changes (most notably, January 1, 2026, when federal gift exemptions are scheduled to be cut in half).

This article (i) briefly explains the anticipated changes in the economic and legislative landscape, (ii) details the benefits and terms of an "optimized" gift trust (that is, a trust with modern, state-of-the-art features that maximize the donor's flexibility, access, use, and control over the assets transferred to the trust, with minimal audit risk), (iii) details "funding design" guidelines for determining the ideal amount of assets and best method of transferring assets to the gift trust, and (iv) illustrates three different funding designs using a case study approach.

UPCOMING ADVERSE CHANGES TO TAX AND LEGISLATIVE ENVIRONMENT

Over the past few decades, the tax and legislative environment has become extremely favorable for families implementing federal estate tax minimization planning. There are currently many "arrows in the quiver," including (i) a handful of trust variants designed to reduce (and, in many cases, eliminate) the federal estate tax, (ii) all-time high federal gift, estate, and GST tax exemptions (*currently $13.61M per individual, which is more than 20 times greater than the $600,000 exemption in the early 2000s*), (iii) favorable interest rates (*the current IRS-set applicable federal rate is ~4% which is approximately the same as during the real estate boom in the mid-2000s*), and (iv) decades of taxpayer-friendly caselaw which has dramatically increased the benefits and flexibility associated with estate tax minimization planning structures. However, this "perfect storm" for estate tax minimization planning appears to be at an "inflection point" for three primary reasons:

Reduction of Federal Gift & Estate Exemption On January 1, 2026.

Although the 2017 Tax Cuts and Job Act ("TCJA") temporarily doubled the gift, estate and GST tax exemptions to the current amount above, the 2017 TJCA is scheduled to expire ("sunset") on January 1, 2026, which will cut the exemptions by about 50% to pre-2018 levels.

Fortunately, in 2019, the IRS issued final "anti-clawback" regulations providing that taxpayers who exhaust their exemption by making

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gifts before January 1, 2026, will effectively "lock in" their otherwise expiring exemptions.[1] (As occurred in 2012 and 2021, this will lead to an enormous temporary surge in demand for qualified high net worth planning attorneys to assist with making large gifts by December 31, 2025, to fully-exhaust exemptions.)

Increasing Interest Rates.

The most important estate tax planning vehicles for high net worth families (installment notes to IDGTs; CLATs; GRATs) rely on the arbitrage of low IRS-set interest rates (which are "locked-in" at the time of the transfer). As rates increase, the benefits of these powerful planning strategies will diminish.

Adverse Legislative Changes Anticipated.

Over the past several decades, the IRS has generally been on the losing end of federal estate tax cases. In recent years, however, there have been significant increased efforts by Congress, the IRS, and the Office of the President to "plug" perceived estate tax "loopholes."

Most notably, in 2021, Congress came dangerously close to passing "Building Back Better" (BBB) legislation which would have effectively abolished the use of "grantor trusts" (and family limited partnerships) which comprise the vast majority of estate tax planning trusts. If passed, the BBB would have perhaps dealt the most serious blow to federal estate tax minimization planning in over 40 years – and it is quite possible that a similar legislative attack could occur in the near-future. This sentiment is echoed in the Treasury's "Greenbook" which contains similar (and wider ranging) proposals to eliminate virtually all major estate tax planning strategies.

It should be noted that the proposed BBB legislation included "grandfathering" provisions such that grantor trusts funded *prior to enactment* would have been largely-exempt from the adverse legislation. In light of Constitutional limitations that generally prohibit retroactive tax law changes, it is expected that future legislation would also have similar "grandfathering" provisions. This underscores the importance of families acting well in advance of the next legislative attack.

THE OPTIMIZED GIFT TRUST DEFINED

For the reasons described above, there is an expiring window for wealthy families to transfer wealth to estate tax planning structures to minimize the federal estate tax, lock-in interest rates and exemptions, and "grandfather" the structures before potential adverse legislation.

> The golden age of federal estate tax minimization planning is upon us – but the window of opportunity is evaporating.

With this said, the vast majority of wealthy individuals are loath to make large gifts to trusts that are so-called "irrevocable" (*which is required to exempt the gifted assets from estate taxes and personal creditors*) unless such trusts offer these individuals a high degree of retained flexibility, access, use, and control over the assets. Common concerns – which can usually be solved through "thoughtful drafting and design" by an experienced estate planning attorney – include (i) the loss of control over investments (especially the right to direct the vote and sale of company stock), (ii) the need to change beneficiaries in the future (or redirect assets to charity), (iii) the potential need to "get the assets back," and (iv) privacy.

This desire, however, must be balanced with restrictions in the Tax Code (specifically, Sections 2036 and 2038) that prohibit a donor from retaining "too much control" over an irrevocable gift trust. Otherwise, the structure fails and the assets are included in the donor's taxable estate at death (forfeiting all of the intended federal estate tax benefits).

With the above in mind, an "optimized" gift trust (OGT) structure exemplifies the following characteristics in both the *trust terms* and the *funding design* (each discussed separately in the balance of this article):

- The OGT structure *maximizes* the donor's flexibility, access, use, and control for the donor's entire lifetime;
- The OGT terms create a "*state-of-the-art hybrid trust*" with all of the features generally accepted under modern irrevocable gift trust principles, including (i) generation-skipping trusts, (ii) dynasty trusts, (iii) asset protection spendthrift trusts, (iv) intentionally defective grantor trusts (IDGTs), and (v) spousal life access trusts (SLATs);
- The OGT funding design (i) minimizes (and ideally eliminates) the donor's federal estate tax at life expectancy, and (ii) ensures sufficient, stabilized liquidity to the donor for lifestyle expenses (and taxes) for the donor's entire lifetime;
- The OGT terms and funding design *minimize the risk of a successful challenge by the IRS* by (i) complying with favorable IRS caselaw and rulings (which currently allow for a donor to retain an enormous degree of control), and (ii) avoiding "grey areas" associated with trust designs that potentially carry more risk (such as "criss-crossed SLATs" and "BDITs"); and
- Rather than a "one-size-fits-all" approach, the drafting attorney utilizes the trust powers, rights and restrictions as "building blocks" to be included, excluded, and modified, in a modular fashion, to reflect the family's unique needs and objectives.

PRIMARY BENEFITS

Not all irrevocable gifts trusts are created equal. The OGT should possess characteristics that result in the following benefits to the donor and the donor's family:

Maximum Retained Access & Control.

The distinguishing feature of the OGT is that the donor retains maximum access, control, and flexibility over the irrevocably gifted assets by virtue of the "standard features" and "enhanced features" (*detailed later in this article*).

Assets Permanently Exempt from Estate Tax.

The OGT should qualify as a "generation skipping dynasty trust" so that the OGT assets (including all future income and appreciation occurring during the donor's life) escape the 40% federal estate tax at the donor's death

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and continue to remain exempt from federal estate taxes for many future generations (or perhaps forever, depending on the OGT's applicable state law).

Assets Permanently Exempt from Creditors and Lawsuits.

The OGT assets should be immediately and permanently insulated from the donor's (and the donor's heirs') future creditors, lawsuits, and divorcing spouses (by virtue of "lifetime discretionary spendthrift trust" mechanisms).

Estate Taxes Reduced by Donor's Payment of OGT's Income Taxes (Tax Burn).

The donor should be able to pay the OGT's annual income taxes, as long as possible, by virtue of the OGT's "intentionally defective grantor trust" (IDGT) feature. Known as "tax burn," this is the single most powerful way of effecting wealth transfer for clients with extremely high net worths since (i) the estate-tax-exempt OGT assets appreciate on a pre-tax basis, and (ii) the donor simultaneously "burns down" their taxable estate through the payment of increasingly larger income taxes (which the IRS famously ruled has no gift tax consequences).[2] As illustrated near the end of this article, financial models tend to indicate that all but the wealthiest of individuals can usually eliminate their federal estate tax at life expectancy as a direct result of this "tax burn" feature.

Privacy (Silent Trust).

Many parents are concerned about their young children discovering details about their inheritance. Thus, if possible, the OGT should include "silent trust" provisions (*which is authorized under the trust laws of many states*) to (i) prevent the Trustee from disclosing OGT-related information to the beneficiaries (until perhaps a certain age), and (ii) instead provide the donor (and other trusted persons following the donor's death) with all OGT-related information (as "designated representative").

STANDARD FEATURES

To maximize the donor's flexibility, access, use, and control, the following "Standard Features" (which are generally authorized by IRS rulings and caselaw) should be included in the OGT:

Donor's Power to Control Investments.

To avoid estate inclusion under Section 2036, the donor should not serve as Trustee of the OGT or control distributions to the beneficiaries. However, the donor should serve as the "Directing Investment Advisor" (DIA) pursuant to a directed trust arrangement (*which is authorized under the trust laws of nearly all states*) to decouple the fiduciary power to control *investments* (in the donor) from the fiduciary power to control *distributions* (in the Trustee). As DIA, the donor may safely control virtually all aspects of OGT investments, including the ability to purchase, sell, vote,[3] mortgage, lend, pay back loans (*including notes due to the donor himself*), and borrow on behalf of the OGT. For broader flexibility, (i) the statutory duty of diversification and prudent investor rule should be waived, (ii) concentrated positions should be authorized, and (iii) the donor (as DIA) should enjoy full indemnification for liability associated with losses (absent reckless or willful misconduct).

Donor's Power to Remove & Replace Trustee.

It is critical that the donor retain the power to change the identity of the Trustee since the Trustee controls distributions to the beneficiaries (both before and after the donor's death). Thus, the donor should retain the powers to (i) remove the Trustee (or a successor Trustee), with or without cause (perhaps limited to every 12-24 months if without cause), and (ii) nominate "non-related, non-subordinate" individuals or entities as replacement and/or successor Trustees. This power is specifically approved by the IRS.[4] A Trust Protector (*discussed in the "Enhanced Features" section below*) might also have the power to nominate *any* individuals or entities (including perhaps the Trustor) as successor Trustee.

Donor's Power to Sell Assets to OGT in Exchange for Note.

For donors who either (i) need ongoing access to the transferred assets (such as the annual income produced by the assets), and/or (ii) wish to transfer additional assets to the OGT (but have exhausted their lifetime gift exemption), the OGT should permit the donor (as DIA) to direct the Trustee to purchase assets from the donor (without capital gains tax by virtue of the OGT's IDGT feature) in exchange for other assets, including an interest-only or fully-amortizing promissory note (depending on the funding design). This power is specifically approved by the IRS.[5]

In addition to allowing for the transfer of additional assets to the OGT without utilizing the donor's lifetime gift exemption, the added benefit of a sale to the OGT is that it gives the donor the ability to (i) receive back a portion of the assets from the OGT in the future (via note repayment which the donor may calibrate to their income needs and direct the Trustee to prepay at any time without penalty), and/or (ii) forgive the note in the future as a gift (assuming sufficient gift exemption is then available).

> The IRS issued "anti-clawback" regulations providing that taxpayers who exhaust their exemption through gifts made before January 1, 2026, will effectively "lock in" their otherwise expiring exemptions.

Donor's Power to Swap Assets.

The donor should also retain the power, acting in a non-fiduciary capacity, to "swap assets" of equivalent value, in and out of the OGT. This power is specifically approved by the IRS.[6] Swapping illiquid assets into the OGT in exchange for cash or securities is an excellent way for the donor to address liquidity needs. (As noted above, a similar result can be achieved by the donor (albeit in a fiduciary capacity as DIA) directing the Trustee to purchase assets from the donor.)

Donor's Power to Repay Loans & Lend Assets.

The DIA should also be authorized to (i) accelerate repayment of loans (particularly, a note due from the OGT to the donor in case the donor needs liquidity), and (ii) make loans to the donor (although the OGT should mandate that any loans directed by the donor (as DIA) to himself must require adequate interest and adequate security to minimize the risk of triggering Section 2036). Considering the current low IRS-set interest rates (which can be locked in for many years or decades), lending and repayment powers are another ideal way for the donor to access the OGT's cash.

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Power to Cancel Gift.

If appliable state law allows, the OGT should contain disclaimer provisions to effectively give the Trustee a 9-month "wait-and-see period" following the gift. If circumstances change, the Trustee may retroactively cancel the gift offered by the donor to the OGT, negating any federal gift tax consequences to the donor. This feature could become very important for pre-2026 gift planning, particularly if legislative changes occur at the "final hour" to extend the federal gift exemptions (as previously occurred in December 2010 and October 2021), rendering a donor's need to make gifts to the OGT moot from a tax planning standpoint. Rather than parting with $13.61M (or $27.22M), the donor is simply out the legal fees paid to set up the OGT (which effectively served as an "insurance policy" against adverse estate tax legislation).

ENHANCED FEATURES

Depending on the donor's risk tolerance, the following "Enhanced Features" might also be included in the OGT for greater control, although the cautious, non-regular exercise of these powers is recommended:[7]

SLAT Powers.

For married couples, the OGT might include "spousal life access trust" (SLAT) provisions to give the non-donor spouse the following additional powers:

- Spouse as Trustee-Beneficiary. The power to receive discretionary distributions in the discretion of the Trustee, who may be the beneficiary-spouse (so long as discretionary distributions are limited to an ascertainable standard);[8]
- Limited Power of Appointment to Gift/Donate OGT Assets. The power to appoint (gift) OGT assets, during life or at death, to family members (*without gift tax*) and charities (*resulting in a corresponding charitable income tax deduction to the grantor*); and
- Appointment Back to Donor. Subject to applicable state law,[9] the power to appoint assets back to the donor-spouse in a trust that is exempt from federal estate tax and creditors.

When SLAT powers are used, the following issues should be considered:

Community Property.

Clients in community property states must pay special attention to ensure that the OGT-SLAT is funded with the donor-spouse's property. If possible, assets should be re-titled from community property to the donor-spouse's separate property well in advance of the transfer to the OGT (with the other spouse receiving assets of equal value). At a minimum, spouses should enter into a written agreement memorializing their intention that all transfers to the OGT-SLAT are sourced in the donor-spouse's assets.

If appliable state law allows, the OGT should contain disclaimer provisions to effectively give the Trustee a 9-month "wait-and-see period" following the gift. If circumstances change, the Trustee may retroactively cancel the gift offered by the donor to the OGT, negating any federal gift tax consequences to the donor.

Dual Criss-Crossed SLATs (& Alternatives).

A longstanding debate among estate planners concerns the viability of "criss-crossed SLATs" due to the arguably high (or low) risk posed by the so-called "reciprocal trust doctrine" (which, over-simplified, posits that the IRS can cause the SLATs to be included in the spouses' taxable estates if the IRS can prove, usually by circumstantial evidence, that each spouse funded a SLAT in exchange for a mutual promise by the other spouse to do the same).

Although compelling arguments have been made in favor of criss-crossed SLATs,[10] they certainly add some arguable degree of risk of both (i) estate tax inclusion at death, and (ii) the related inability to allocate GST exemption to the SLATs at the time of funding (due to the so-called "ETIP" rules).[11] This risk is particularly high when married clients contemporaneously fund criss-crossed SLATs, such as will likely occur in 2025 (most advisors that advocate criss-crossed SLATs recommend separating the SLATs by several years).

To reduce this risk, but achieve a similar tax and economic result, two alternate approaches to criss-crossed SLATs might be as follows:

- Spouse #1 (*which should usually be the older and/or less healthy spouse to maximize the probability of retained SLAT powers*) could fund a single SLAT with $27.22M for the benefit of Spouse #2 (*the healthier spouse*) and the spouses could make a "split gift election" to apply both spouses' combined $27.22M lifetime gift and GST exemptions to the SLAT (although a split gift election generally requires that distributions to the beneficiary-spouse's be limited to an ascertainable "health, education, support and maintenance" standard so as to quantify the spouse-beneficiary's interest in the trust at the outset, ideally as zero).[12]
- Spouse #1 could fund a SLAT for Spouse #2 with $13.61M, and Spouse #2 could fund a "non-SLAT" for the benefit of children with $13.61M (although distributions from both trusts should be limited to an ascertainable "health, education, support and maintenance" standard).[13]

Divorce Planning for One-Sided SLATs.

By nature, *non*-criss-crossed SLATs (i.e., one-sided SLAT planning) result in the beneficiary-spouse being placed in a better economic position than the donor-spouse. To minimize economic disparities and unintended consequences that might occur after the donor-spouse's death or divorce (particularly in the case of blended families), the SLAT might include one or more of the following restrictions:

- "Equal footing provisions" that cause the beneficiary-spouse to forfeit some or all of their "SLAT superpowers" in the event of divorce (or perhaps the filing of a petition for divorce), including forfeiture of (i) the power to continue serving as Trustee, (ii) the right to receive distributions as a beneficiary, and (iii) the right to appoint and donate assets from the OGT;
- A "notice and consent" provision that requires the beneficiary-spouse to (i) provide prior notice to the donor-spouse (but not the donor-spouse's consent which can result in estate tax inclusion under Sections 2036, 2038, and 2041), and (ii) obtain the prior consent of a trusted third-party (such

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as their estate planning attorney or Trust Protector) before taking certain actions, such as (1) distributing and/or appointing OGT assets in excess of a fixed dollar amount (or percentage of assets), and (2) appointing more assets to the beneficiary-spouse's side of the family (especially children from a prior marriage) compared to assets appointed to the donor-spouse's side of the family; and

- A side agreement between the spouses declaring that, in the event of a dissolution of their marriage, the spouses seek an equal distribution of assets such that, should any disparity occur due to the SLAT powers, the spouses request that a divorce court apply principles of equity to award one spouse a greater amount of assets so as to equalize them.

Trust Protector Powers. A close friend or non-immediate family member might be nominated as "Trust Protector" and possess the following additional powers, in the Trust Protector's sole and absolute discretion, to address unexpected changes in tax, family, and economic circumstances:

- Power to Remove & Reinstate Beneficiaries. The power to remove (and later reinstate) a child's (or grandchild's) interest in the OGT;
- Limited Power of Appointment to Redirect OGT Assets. The power to add beneficiaries and/or redirect the OGT assets to the donor's other family members (including perhaps a future spouse) and/or charities;
- Tax Reimbursement Power. The power (but not the obligation)[14] to reimburse the donor for income taxes paid while the OGT is a grantor trust; and
- Power to Appoint Assets Back to Donor (SPAT Power). The power to appoint OGT assets back to the donor, perhaps conditioned upon the Trust Protector's determination that the donor lacks sufficient income or assets (sometimes referred to as a "special power of appointment trust" or "SPAT" power).[15] Although some practitioners are skeptical of SPAT powers due to perceived Section 2036 risk, these powers have been used for decades[16] and there are at least as many as nine defenses to an IRS audit on Section 2036 grounds.[17] For a donor who believes there is any risk that he or she may need the OGT assets back in the future, the donor is strongly encouraged to consider conferring a SPAT power upon the Trust Protector (and perhaps request the Trust Protector to relinquish this power if and when the donor believes that they will never need the assets back from the OGT).

When naming a Trust Protector, consider the following suggested best practices:

- Non-Adverse, Unrelated Person. The individual nominated as Trust Protector (i) should not be a current or potential beneficiary of the OGT (a "non-adverse person")[18] so as to avoid the risk of triggering gift taxes upon exercise of the powers,[19] and (ii) should be a "non-related, non-subordinate person"[20] so as to minimize risk of inclusion in the donor's estate based on alter-ego principles.[21]
- Non-Fiduciary; Indemnification. Some Trust Protectors may be reluctant to exercise their powers (especially if beneficiaries will be adversely affected) in fear of fiduciary liability. To provide the Trust Protector with greater comfort, (i) the OGT should be governed by the laws of a state (such as Arizona)[22] that authorizes a Trust Protector to act in a *non-fiduciary* capacity pursuant to a limited power of appointment exercise in the Trust Protector's sole and absolute discretion, and (ii) the OGT should include broad "release and indemnity" provisions. The individual serving as Trust Protector should ideally not also be serving as the Trustee (to avoid "tainting" the Trust Protector's non-fiduciary status).
- Checks & Balances. Donors are oftentimes wary of a theoretical "rogue" Trust Protector who might take unintended actions. Thus, the Trust Protector's powers should be conditioned upon (i) prior written notice to the donor (but not the donor's consent which can result in estate tax inclusion under Sections 2036, 2038, and 2041), and (ii) the prior consent of the donor's trusted advisor (such as the donor's estate planning attorney). In addition, the donor might also retain the power to remove the Trust Protector with "good cause" (and perhaps "without cause," but perhaps only once every 12-24 months). Although it is not recommended that the donor possess the power to remove *and* replace the Trust Protector, the donor might give a trusted advisor (such as the donor's estate planning attorney) the power to nominate replacement and successor Trust Protectors.
- Lack of Acceptance. The donor might also (i) not inform the Trust Protector of his or her nomination, or (ii) seek the Trust Protector's acceptance of the role. This should reduce the risk of the IRS asserting an implied arrangement between the donor and the Trust Protector at the time of creation of the OGT.

Donor's Power to Serve as Trustee.

In some cases, (i) a company's governing documents may prevent a donor from transferring shares to a trust unless the donor is the Trustee, or (ii) a client simply insists that they serve as Trustee. On one hand, there is favorable caselaw going back to 1947 authorizing a donor to serve as Trustee so long as distributions are limited to a "health, education, support and maintenance" standard.[23] On the other hand, this is strongly discouraged since (i) the landmark *Estate of Powell*[24] case issued in 2017 appears to have resurrected the risk of estate tax inclusion based upon the donor retaining control over distributions (even in a *fiduciary* capacity), and (ii) the donor-trustee may not strictly abide by the required distribution standard. Thus, it is recommended that a donor who serves as Trustee resign and nominate an independent trustee as soon as possible (such as after the sale of the company that requires the donor to serve as Trustee).

THE FUNDING DESIGN

In addition to housing the transferred assets inside an optimized gift receptacle, it is equally important that the "*funding design*" of the plan be carefully considered:

Balancing Personal Liquidity & Estate Tax Minimization.

The funding design should avoid "under-gifting" and "over-gifting" such that the assets transferred to the OGT achieve two competing objectives:

- Sufficient assets should be *transferred* to the OGT to minimize (and ideally eliminate) the donor's federal estate tax at life expectancy, and

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- Sufficient assets should be *retained* by the donor to ensure sufficient, stabilized liquidity for the donor's lifestyle expenses (particularly, the "phantom" income taxes due to the grantor trust status of the OGT) without the need to (i) regularly access OGT funds (which raises IRS scrutiny), or (ii) prematurely toggle off grantor trust status of the OGT (which requires the donor to forfeit substantial direct and indirect controls, including swap powers, borrowing powers, SLAT powers, and Trust Protector powers).

Unlike the "standard features", the enhanced features could add risk of estate inclusion under Section 2036. On one hand, the *existence* of the enhanced features is widely-believed to be acceptable and defensible based on longstanding IRS guidance and/or taxpayer-friendly caselaw. On the other hand, the risk is largely dependent on how often and to what extent the powers are *exercised* during the donor's lifetime.

In the majority of cases, there is an ideal percentage of assets to be transferred to the OGT that results in (i) an initial "freeze" and gradual diminution (and eventual elimination) of the federal estate tax liability (primarily due to "tax burn" and personal spending), and (ii) stabilized liquidity available to the donor outside of the OGT (at the outset and through life expectancy) such that the donor's annual income (including note payments from the OGT, if necessary) generally offsets expenses (including lifestyle expenses and taxes paid on personal and OGT income).

In special cases, the design may also need to incorporate (i) a post-transfer loan between the donor and OGT (*for example, (i) donors making large gifts in anticipation of the 2026 sunset may need to borrow or "buy-back" gifted assets from the OGT for a note, or (ii) a donor with asset protection objectives might want to lend additional assets to the OGT in exchange for a long-term note*), and/or (ii) a one-time reimbursement (or distribution to a beneficiary-spouse enjoying SLAT powers) to pay capital gains taxes from a significant capital gain event (*such as a business sale*).

Financial Projections.

To determine the optimal funding design, a customized financial model should be prepared in advance of the transaction considering the following inputs (which should each be "stress-tested," deally using stochastic Monte Carlo software):

- The proportion and composition of assets to be (i) *retained* by the donor (for lifestyle and tax expenses), (ii) *gifted* to the OGT (for estate tax minimization), and (iii) *sold* to the OGT in exchange for a promissory note (for lifestyle and tax expenses, or to allow for the transfer of assets in excess of the donor's exhausted lifetime gift exemption);
- The donor's annual spending assumptions (*with COLA adjustments*);
- The donor's life expectancy;
- The donor's current and projected net worth (*including dynamic asset performance assumptions*);
- The duration of the OGT's grantor trust status (*ideally the donor should not need to "toggle off" grantor status for decades so as to retain substantial direct and indirect controls associated with the OGT*); and
- Discounts for lack of control and marketability (*although for younger clients with a longer life expectancy, discounts tend to be far less impactful on estate tax reduction than the "tax burn" associated with grantor trust status*).

Formula Funding Clauses.

For donors making large transfers of illiquid or hard-to-value assets (including businesses and "FLPs"), it is also extremely important to consider the use of the following "formula funding clauses." Despite some practitioners' reluctance to use formula clauses, the IRS has generally acquiesced or lost Tax Court cases where the value and/or percentage of the transferred assets is fixed (or reasonably determinable within a short amount of time) on the date of the transfer (perhaps subject to the final determination of the value for federal gift tax purposes) as noted below:

Formula Gift Assignment (Wandry).

In many cases, a donor will need to gift hard-to-value assets in urgent circumstances such that there may not be time to secure a qualified appraisal for gift tax purposes (i.e., before a "letter of intent" is received for the sale of a business, or at the end of 2025 to lock in the federal gift exemption). Moreover, even after securing the appraisal, there is always a risk that the IRS could challenge the appraisal and revalue the gifted assets at any time during the 3-year statute of limitations period applicable to federal gift tax returns.

In these cases, the donor should consider making a "*Wandry* formula gift" of interests in the hard-to-value asset equal to a fixed dollar amount (such as their remaining federal gift tax exemption) as finally determined for federal gift tax purposes, with an *estimated* transfer of interests to occur contemporaneously with reference to an appraisal secured within a short time period after the gift (90 days or less is recommended). This formula clause was approved in *Wandry*.[25] Moreover, even if an appraisal has been secured before the gift, a *Wandry* clause is still recommended to serve as a "gift tax blocker" in the event the IRS revalues the gifted assets on audit.

Formula Sale with Audit Adjustment Clause (Estate of King).

In the context of a *purchase and sale* of hard-to-value assets to an OGT (as opposed to a *gift*), the purchase price should not be tied to a fixed dollar amount (*except as explained in the "reverse double Wandry" situation discussed further below*). Rather, the purchase price should be the value of the transferred interests as finally determined for federal gift tax purposes, with an estimated purchase price determined by a qualified appraisal secured before (or within 90 days after) the sale. This way, in the event the IRS revalues the transferred assets on audit, the sale price adjusts to the larger revalued amount (thereby serving as a "gift tax blocker", avoiding a taxable gift on the excess which might otherwise occur if a fixed sale price were used). This formula clause was approved in *Estate of King*.[26] Following the 3-year gift tax statute of limitations

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period (when the risk of revaluation by the IRS has ended), the donor might consider forgiving the resulting note as a gift.

> A longstanding debate among estate planners concerns the viability of "criss-crossed SLATs" due to the arguably high (or low) risk posed by the so-called "reciprocal trust doctrine" (which, over-simplified, posits that the IRS can cause the SLATs to be included in the spouses' taxable estates if the IRS can prove, usually by circumstantial evidence, that each spouse funded a SLAT in exchange for a mutual promise by the other spouse to do the same).

Formula Gift/Sale to Ensure Transfer of Fixed Amount of Assets ("Double Wandry").

A combination of the two formula approaches is recommended for a donor who desires to (i) transfer a fixed amount of hard-to-value assets (for example, 100% of a business), (ii) exhaust the donor's gift exemption, and (iii) avoid the risk that the IRS could revalue the assets, causing a portion of the business to fail to transfer.

To accomplish this objective, the donor should (i) *gift* a to-be-determined percentage of the business to the OGT that has a value as finally determined for federal gift tax purposes equal to the donor's remaining gift tax exemption (*Wandry*), and (ii) *sell* the remaining balance of the business interests to the OGT for a note equal to the value of the purchased interests as finally determined for federal gift tax purposes (*King*).

Formula Sale/Gift to Ensure Fixed Sale Price ("Reverse Double Wandry").

A combination of the two formula approaches is recommended for a donor who desires to transfer hard-to-value assets to the OGT and (i) receive back a promissory note equal to a fixed dollar amount (for example, to ensure a $10M 20-year note which is determined to be sufficient for the donor's living expenses and taxes), and (ii) gift the balance of the hard-to-value assets (but not in excess of the donor's remaining gift tax exemption).

To accomplish this objective, the donor should (i) *sell* a to-be-determined percentage of the business that has a value as finally determined for federal gift tax purposes equal to $20M (*King*), and (ii) *gift* such remaining percentage of the business equal to the donor's remaining gift tax exemption (*Wandry*). A *second* sale of all interests in the business that are remaining (after the initial sale-gift) can also be implemented to ensure that the entire asset is transferred to the OGT, regardless of valuation.

OPTIMIZED FUNDING DESIGN SCENARIOS

Below are three common fact patterns that illustrate different funding designs:

Scenario #1: Pre-2026 Gift to Lock-In Exemption.

- Darren and Ashley have a $100M net worth: $40M liquid; $60M real estate.
- All assets are community property.
- Their main objective is to (i) minimize risk, and (ii) "lock-in" the $27.22M gift/GST exemption before 2026 as quickly and simply as possible (they are busy travelling and don't want to focus on estate planning).
- Darren is older than Ashley and he has had some health issues.
- Darren creates an OGT with SLAT powers in Ashley and transfers $27.22M of liquid securities from his 50% of the community property estate ($50M) to the OGT-SLAT.
- The spouses make a "split gift election" to apply both spouses' combined $27.22M exemption to the transfer.
- The spouses retain virtual full control over the OGT (without the "reciprocal trust doctrine" risks posed by a criss-crossed SLAT design), including: (1) Ashley, as the trustee and beneficiary until her death (or divorce), may withdraw funds for her "health, support and maintenance," appoint OGT funds to family members (without gift tax), and donate funds from the OGT; (2) As a more tax-efficient strategy, and/or if the couple prefers having maximum "cash in hand," Darren and Ashley could subsequently swap the $27.22M liquid securities back to themselves in exchange for real estate (or an FLP holding real estate and securities); and (3) Even if Ashley dies, Darren can still (i) control the OGT investments, (ii) borrow and swap assets in and out of the OGT, and (iii) request (but not direct) the Trust Protector to change the OGT's beneficiaries (and perhaps even appoint some or all of the assets back to Darren, per a SPAT power, in the event Darren does not have sufficient assets).

> For younger clients with a longer life expectancy, discounts tend to be far less impactful on estate tax reduction than the "tax burn" associated with grantor trust status.

Scenario #2: Business Owner Selling to Strategic Buyer.

- TJ operates a niche tech company that he believes could sell in 2 years for $100M to a strategic buyer.
- An independent firm recently determined the value of a 1% minority position in the company for gift purposes to be just $200,000 (or $20M for all interests). The main reasons include (i) the enterprise valuation was performed on a discounted cash flow perspective (rather than from the perspective of a strategic buyer who TJ believes would pay a large premium given his niche and competitive advantage in the industry), and (ii) the 1% minority interest enjoys valuation discounts for lack of control and lack of marketability.
- TJ has $10M in marketable securities (5% growth; 2% income) and a $5M personal home, but the rest of his estate is concentrated in the business.
- TJ is 50 years old and single.
- TJ spends $750,000 per year.
- TJ wants to leave his estate to his 2 nieces in the most tax-efficient manner.
- If TJ does not act, the 30-year financial projections indicate that TJ's nieces must pay federal estate tax liability of $166M (based on $442M future value of assets).

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- If TJ transfers a 49% interest in his company to the OGT (worth ~$10M based on the appraisal), the 30-year financial projections indicate: (1) An 85% reduction in TJ's nieces' federal estate tax from $170M to $23M (*the permanently estate-tax-exempt, creditor-protected OGT holds 85% of TJ's $442M total net worth at year 30*), (2) TJ's estate tax liability is "frozen" at no more than $23M over the next 30 years, and (3) At all times between now and year 30, TJ enjoys stabilized liquid assets of $40-60M (*i.e. TJ's annual spending and taxes (including taxes on OGT income) is roughly offset by TJ's annual income*).
- TJ proceeds with transferring 49% of the company to the OGT. However, to create a "gift tax blocker" in case the IRS disagrees with the $10M appraisal, TJ *gifts* a 10% interest and *sells* a 39% interest in exchange for a $8M interest-only promissory note (subject to an *Estate of King* audit adjustment clause). If the IRS audits TJ's gift tax return and successfully revalues the business, TJ has virtually no gift tax risk since he only gifted a 10% interest to the OGT (which should be well within his $13.61M exemption). If the IRS fails to audit within the 3-year statute of limitations period, TJ will likely forgive some or all of the $8M note (as a gift to the OGT, well within his $13.61M gift exemption).
- Although the financial model indicates that TJ will never need to access the OGT assets, TJ takes comfort in the fact that he retains most of the "Standard Features" and "Enhanced Features" (discussed above), just in case the next 30 years do not comport to the "rosy picture" illustrated in Exhibits 1, 2, and 3.

Scenario #3: Wealthy Retired Client.

- Brent is 62 years old, retired, and widowed.
- Brent sold his company years ago, but hasn't gotten around to estate planning.
- Brent has a $160M net worth: $100M marketable securities (4% growth; 2% income); $60M investment real estate producing $3M in net annual rental income.
- Brent spends $1M per year.
- Brent has 3 adult children to whom he wants to leave his estate in the most tax-efficient manner.
- If Brent does not act, the 30-year financial projections indicate that Brent's children will have to pay a federal estate tax liability of $270M (based on $685M future value of assets).
- Brent is willing to transfer assets out of this estate, but (i) he wants to retain investment control over the assets, and (ii) he feels that he worked hard for his wealth and doesn't want money going to non-family members (such as divorcing spouses or creditors), so he insists that his assets be centralized and perpetually managed inside of a family limited partnership (FLP) with restrictions on transfers of LP interests.
- If Brent transfers his assets to the FLP (naming himself as General Partner) and transfers a 1/3rd LP interest to an OGT for each of his 3 children, the 30-year financial projections indicate: (1) A 90% reduction in Brent's projected federal estate tax liability from $270M

Exhibit 1:

No Planning		
	Assets Inside Estate	$ 442,826,961
	Estate Taxes Paid	$ (166,730,785)
	Net Available to Heirs	$ 276,096,177
GST Exempt	$ 23,000,000	
Non-GST Exempt	$ 253,096,177	
Optimized Trust Planning		
	Inside Estate	$ 72,615,253
	Outside Estate	$ 370,211,708
	Estate Taxes Paid	$ (22,566,101)
	Net Available to Heirs	$ 420,260,860
GST Exempt	$ 386,411,708	
Non-GST Exempt	$ 33,849,152	
	Additional Wealth to Heirs	**$ 144,164,683**
	Estate Taxes Saved	**$ 144,164,683**
	Add'l Permanent Exempt Assets	**$ 347,211,708**

Exhibit 2:

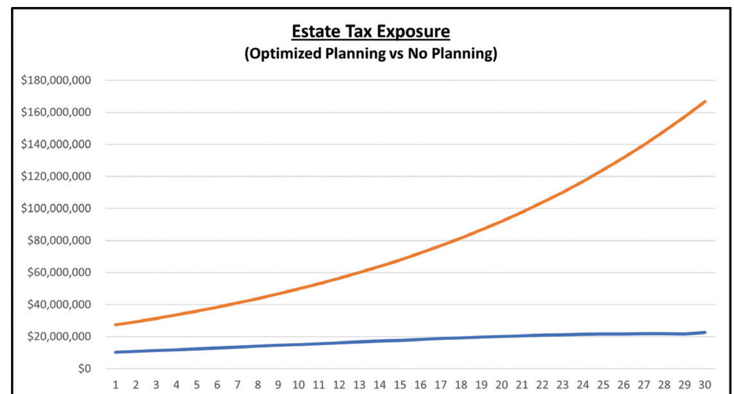
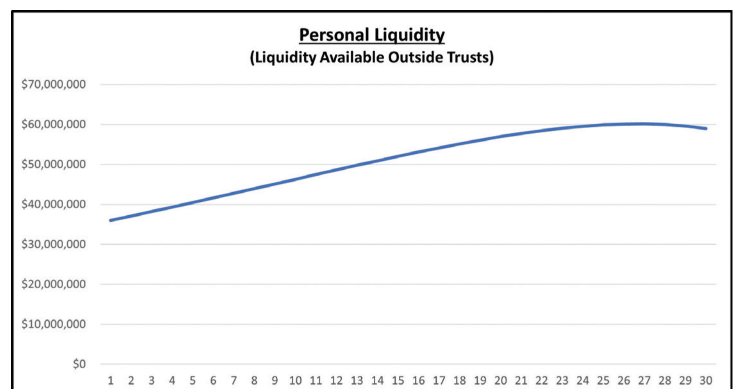


Exhibit 3:



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to $30M (*the permanently estate-tax-exempt, creditor-protected OGT holds 90% of Brent's $685M total net worth at year 30*), (2) Brent's estate tax liability is "frozen" at no more than $50M over the next 30 years ($50M gradually reduces to $30M), and (3) At all times between now and year 30, Brent has direct access to liquid assets of ~$100M (*including the note back to him – see below*).

- An independent valuation firm determines each 1/3rd FLP interest transferred to the 3 OGTs to have an aggregate federal gift tax value of $112M (*assuming a 30% minority interest discount*). Since Brent may only gift a 12% LP interest within his limited $13.61M gift/GST exemptions, the remaining 88% LP interest is sold to the OGTs in exchange for an aggregate $98M 30-year, fully-amortizing note paying Brent an aggregate annual note payment of $5.7M from the 3 OGTs. The financial model indicates that Brent's annual income of $5.7M for the next 30 years will be sufficient to cover his lifestyle expenses and annual taxes (including the "phantom" income taxes on the OGT's taxable income due to grantor trust status) such that he has positive annual cash flow and plenty of liquidity for his remaining lifetime.
- If Brent has a cash flow shortfall (particularly in years 20-30 when his COLA-adjusted lifestyle expenses and "phantom" income taxes become much larger), Brent may: (1) Direct the prepayment of the 30-year note and transfer some of the OGT funds back to himself, and (2) "Toggle off" the OGT's grantor trust status to stop paying its income taxes (Brent will be 92 years old in 30 years, at which time he expects to have enough certainty about his and his family's situation that he believes he will be comfortable relinquishing many of the OGT "access points" which is required to toggle off grantor trust status).

For illustrations of Brent's plan, see Exhibits 4, 5, 6, and 7.

A DISCLAIMER

In the author's experience, an extremely small number of irrevocable gift trust structures are truly "optimized" in the manner described herein. The explanation includes a number of factors, such as (i) federal estate tax minimization planning is notoriously complex, increasing the risk of mistakes and inefficiencies, (ii) there are a limited number of attorneys that specialize in the field (particularly in geographic areas that lack significant wealth) such that client demand far exceeds the supply of qualified attorneys (especially in years like 2025 when families will be taking action in advance of adverse legislation), (iii) heightened exemptions over the past 20 years has translated to less training of up-and-coming junior attorneys, and (iv) many clients incorrectly assume there is a one-size-fits-all, commoditized approach to irrevocable gift trust planning, which leads to shopping for a "lowest cost provider" who can inexpensively complete the trust (but perhaps at the risk of quality).

Exhibit 4:

No Planning		
	Assets Inside Estate	$ 684,483,786
	Estate Taxes Paid	$ (268,349,514)
	Net Available to Heirs	$ 416,134,272
GST Exempt	$ 13,610,000	
Non-GST Exempt	$ 402,524,272	
OGT Planning		
	Inside Estate	$ 119,422,648
	Outside Estate	$ 565,061,138
	Estate Taxes Paid	$ (28,697,242)
	Net Available to Heirs	$ 655,786,544
GST Exempt	$ 565,061,138	
Non-GST Exempt	$ 90,725,406	
	Net Add'l Wealth to Heirs	**$ 239,652,273**
	Estate Taxes Saved	**$ 239,652,273**
	Add'l Perm. Estate-Tax-Exempt Assets	**$ 551,451,138**

Exhibit 5:

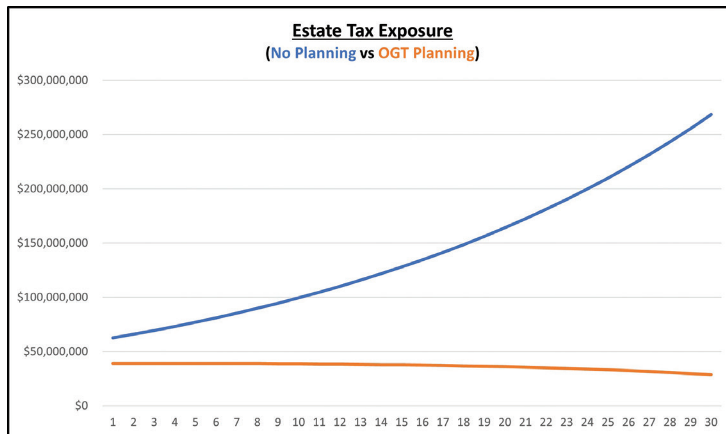

Exhibit 6:

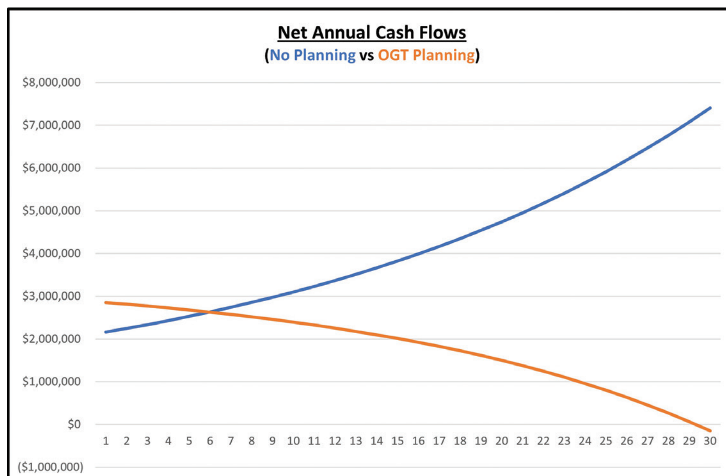

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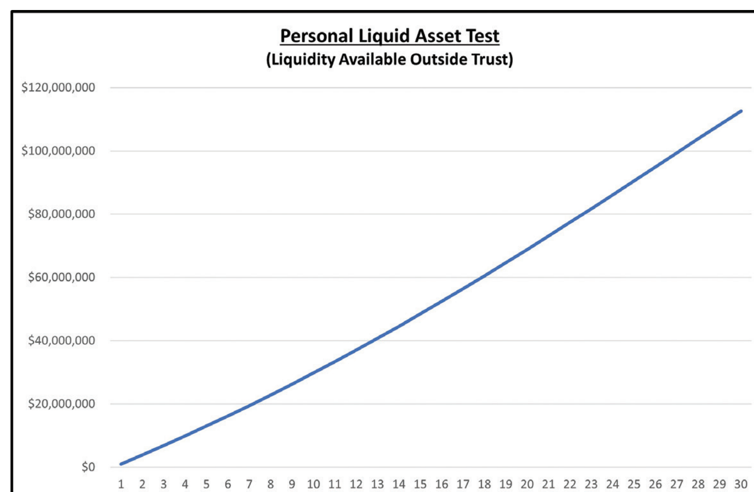
Exhibit 7:



Attorneys are encouraged to (i) consider "referring out" to a specialist if the practitioner does not routinely practice in the high net worth space, and (ii) remind clients that they are "building a house" for the majority of their wealth (*financial models generally indicate that the majority (if not all) of the donor's net worth will be held within the gift trust by life expectancy*) and stress the importance of building the house on a "solid foundation with proper levers and pulleys" to address unanticipated changes in tax, family or economic circumstances.

End Notes

[1] Treas. Reg. 20.2010-1(c).

[2] In landmark Rev. Rul. 2004-64, the IRS conceded that the donor's payment of the OGT's income taxes is not a gift, regardless of the amount of taxes paid.

[3] But see I.R.C. Section 2036(b) (providing donor controlling more than 20% of voting stock in controlled corporation may not retain right to vote trust's shares).

[4] See Rev. Rul. 95-58; Rev. Rul. 2004-64.

[5] Rev. Rul. 85-13.

[6] Rev. Rul. 2008-22.

[7] Unlike the "standard features", the enhanced features could add risk of estate inclusion under I.R.C. Section 2036. On one hand, the *existence* of the enhanced features is widely-believed to be acceptable and defensible based on longstanding IRS guidance and/or taxpayer-friendly caselaw. On the other hand, the risk is largely dependent on how often and to what extent the powers are *exercised* during the donor's lifetime. Upon audit, the IRS reserves the right to review the history of the OGT to determine whether there was an "implied arrangement" between the donor, the donor's spouse, and/or the Trust Protector that may rise to the level of estate inclusion under I.R.C. Section 2036. (See Rev. Rul. 2004-64.)

[8] See I.R.C. Section 2041(b)(1)(A) (ascertainable standard exception to general power of appointment).

[9] For example, see A.R.S. 14-10505(E) which expressly exempts the existence and exercise of such power from attacks by the grantor's creditors, bolstering the defensibility of the power under I.R.C. Section 2036.

[10] See Such, Dunn, and Meneau, "Reciprocal Trusts: Language That Causes Problems And Reciprocal Consideration," Perkins Coie LLP.

[11] I.R.C. Section 2642(f).

[12] See Steiner, "Gift-Splitting Where the Spouse is a Beneficiary," Tax Management – Estates, Gifts & Trusts Journal.

[13] See *Estate of Bischoff*, 69 T.C. 32 (1977) where four *non*-SLAT trusts were included in taxable estate due to each spouse serving as trustee of the trusts created by the other spouse where distributions were not limited to ascertainable standard and income could be accumulated in the discretion of the trustee.

[14] See Rev. Rul. 2004-64.

[15] See O'Connor, Gans, and Blattmachr, "SPATs: A Flexible Asset Protection Alternative to DAPTs," 46 ETPL 2 (February 2019).

[16] See Culp and Richardson, "Lifetime Special Powers of Appointment Offer Unique Planning Opportunities," 33 ETPL 10 (October 2006).

[17] Specifically, (i) the donor is retaining sufficient assets for their personal lifestyle expenses for the rest of their life, making it unlikely that assets will be given back to them (*a supporting cash flow model prepared at the time of OGT creation is strongly recommended*), (ii) the transfer of assets from the OGT back to the donor would defeat the main objectives of the OGT (namely, reduction in estate taxes and protection from the donor's creditors), (iii) the donor is not a beneficiary (which would otherwise cause the trust to be "self-settled" and perhaps subject to the donor's creditors under state law, resulting in estate inclusion), but a mere potential appointee, (iv) the Trust Protector could decide not to appoint the assets back to the donor without the donor possessing any fiduciary liability protections or rights (assuming the Trust Protector is serving in a non-fiduciary capacity which is recommended), (v) the OGT should include a "savings clause" stating that the Trust Protector may not possess any powers that would give rise to estate tax inclusion, (vi) some states (including Arizona) exempt a donor's creditors from attacking a trust based on discretionary tax reimbursement payments alone, (vii) the IRS held in landmark Rev. Rul. 2004-64 that I.R.C. Section 2036 will not automatically apply where discretionary tax reimbursement payments are made to a donor by an independent Trustee (which presumably includes an independent Trust Protector), (viii) some states either expressly authorize self-settled asset protection trusts (such as Nevada and Delaware) and/or exempt OGT assets from the donor's creditors if assets are transferred back to the donor, in trust, as result of a power of appointment exercise (such as Arizona), and (ix) if the Trust Protector did not accept the office of Trust Protector at the outset, it is difficult to argue there was an implied arrangement with the donor (I.R.C. Section 2036 generally requires the IRS to determine whether an implied arrangement existed at the time the trust was created).

[18] I.R.C. Section 672.

[19] See Chief Counsel Advice 202352018 (beneficiaries of irrevocable trust who consent or acquiesce to modification to add tax reimbursement power deemed to make taxable gift).

[20] I.R.C. Section 672.

[21] See Rev. Rul. 95-58; Rev. Rul. 2004-64 (trustee not deemed "alter ego" of grantor for I.R.C. Section 2036 purposes when independent).

[22] A.R.S. section 14-10818.

[23] *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

[24] *Estate of Powell*, 148 T.C. 392 (2017).

[25] *Wandry*, T.C. Memo. 2012-88.

[26] *King*, 545 F.2d 700, 708 (10th Cir.1976).

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