Pairing Tips for Vintage Wines and Vintage Trusts

Over the last 15 years, vintage wine has produced (by one measure) a 10.6% annualized return[1]. Some wines have done even better.

- **Domaine Leroy:** This long-time French winemaker saw 39% annual returns overall from 2020 to 2021[2]. One especially pricey bottle, a 2015 Domaine Leroy Richebourg Grand Cru, currently goes for around $30,000[3], and saw a 176% value increase from 2020 to 2022[4]. Tasting notes indicate this wine is "…majestic, complex and deep," filled with "…savory herbs, spices, sweet mixed berries, earth and minerals."
- **2016 G. B. Burlotto Barolo Monvigliero, Barolo DOCG, Italy:** This Italian Barolo experienced a 373% price increase from June 2020 to February 2022[5], and a bottle will set you back approximately $900[6]. Tasting notes describe this wine as "…full of fresh raspberries, pomegranates, blood oranges and beeswax."

For those with the funds to acquire and courage to open either of these bottles, the pairing would need to be just right. Perhaps fine chocolate or a dry-aged ribeye?

Just like vintage wines, vintage gift trusts (trusts setup some time ago) might appreciate over time and are susceptible to their own tasting notes and estate and tax planning pairings. A few common "tasting notes" for gift trusts might include:

- "Trust was clearly drafted by lawyer who got all his referrals from the local bank's trust department – no way to remove corporate trustee."
- "An okay trust that didn't contemplate the federal government turning the estate tax into a game of roulette."

All joking aside, there are significant "planning pairings" for beneficiaries of vintage gift trusts to consider. Here are just a few.

<u>Planning for Powers of Appointment</u>

Powers of appointment give a trust beneficiary the right to alter the ultimate distribution of the trust.

Powers of appointment come in two flavors:

- <u>A general power of appointment</u> causes the trust to be includible in the taxable estate of the beneficiary who holds the power. A general power of appointment typically contains language that allows the beneficiary to appoint assets to herself, her estate, her creditors, or creditors of her estate.
- <u>A limited/special power of appointment</u> is not included in the taxable estate of the beneficiary who holds the power. The scope of a limited/special power of appointment may be extremely broad (i.e., allowing the beneficiary who holds the power to appoint assets to "any person"), but would exclude the power holder's estate, creditors, or creditors of his or her estate.

Powers of Appointment Planning Pairings for Clients:

Consider the following planning pairings when it comes to powers of appointment:

- Method of exercise: What does the trust say about how the beneficiary is required to exercise the power? Most trusts explicitly require the power to be exercised expressly via the beneficiary's will, while some trusts allow this to be accomplished in any written form.
- Desire to exercise / estate plan conformity: Do the default distributive provisions of the trust conform to the beneficiary's estate plan? In most trusts, after a beneficiary passes away and in the absence of exercising a power of appointment, the trust will descend to the beneficiary's descendants. But what if the beneficiary has disinherited a child, or has a disabled child for whom significant special needs planning has been done?
- Tax basis planning: If the beneficiary holds a limited/special power of appointment, barring some other method of estate inclusion in the trust, the trust assets will not gain an income tax basis step-up upon the death of the beneficiary[7]. This might not generate the most efficient overall tax result.

In each of these cases, additional planning pairings are warranted to ensure smooth transition, conformance with estate and financial plans, and overall tax saving.

Planning for Withdrawal Rights

Many trusts grant current withdrawal rights to beneficiaries (to demand that the trustee distribute some part or all of the trust assets to the beneficiary). Technically, withdrawal rights are presently exercisable powers of appointment.

Withdrawal rights have three primary impacts on planning for the beneficiary who holds these rights:

- Estate inclusion: If a beneficiary has the right to withdraw trust property, that renders the corresponding trust value includible in the beneficiary's taxable estate[8]. Of course, if the withdrawal rights are staggered (one-third at 25, one-third at 30, one-third at 35), the estate inclusion only extends to the value of the trust that can be currently withdrawn.
- Asset protection: A common misconception is that the inclusion of a "spendthrift" clause in a trust will ensure the protection of the trust assets from the creditors of the beneficiary. This is not necessarily true in the case of a trust that grants unfettered withdrawal rights to a beneficiary.

  Unfortunately, the issue is complicated and relies on state law. For example, in the Land of Lincoln (Illinois), a presently exercisable withdrawal right eliminates the asset protection of a spendthrift trust[9]. This is the result even where the trust has an otherwise valid spendthrift provision[10].

  On the other hand, in the Old Line State (Maryland), state law expressly protects withdrawal rights and the beneficiaries that hold them[11].
- Income tax ownership: The grantor trust rules[12] are most typically used to determine the trust settlor's responsibility for paying income taxes on the trust's assets. In this context, the trust is either (i) a "grantor trust," in which case the settlor pays the taxes or (ii) a "non-grantor" trust, in which case the trust's income taxes are either borne by the trust or carried out to the beneficiaries along with trust distributions.

  But there is a third option that makes it possible for a trust beneficiary to be responsible for trust income taxes even without receiving distributions[13]. The existence of beneficiary withdrawal rights in a trust makes this possible and usually requires additional planning.

Withdrawal Right Planning Pairings for Clients:

After identifying the existence and scope of a trust beneficiary's withdrawal right under a trust, other planning considerations come into focus:

1. Estate planning: Since the withdrawal right causes the trust property subject to withdrawal to be includible in the beneficiary's estate, it's important to quantify the effect of withdrawal rights on the beneficiary's taxable estate to determine if more advanced estate tax planning is required.

2. Asset protection planning: If state law exposes trust assets to the beneficiary's creditors, further asset protection planning should be considered.

3. Income tax planning: If a beneficiary's withdrawal rights over a trust causes the trust to be "defective" as to the beneficiary, she likely should engage in further income tax planning.

While each of these considerations is important, exactly how they come into play for a particular trust beneficiary is subject to variables which must be accounted for in the beneficiary's financial, estate, and tax planning. Vintage trusts may not be as exciting (or as tasty) as vintage wines, but good estate, tax, and financial planning always pairs well with them.

[1] https://financebuzz.com/investing-in-wine#:~:text=Wine%20has%20had%20a%2010.6,re%20not%20a%20wine%20expert

[2] https://www.vinovest.co/blog/investment-wines

[3] https://www.wine-searcher.com/find/dom+leroy+grand+cru+richebourg+vosne+romanee+cote+de+nuit+burgundy+france/2015

[4] https://www.vinovest.co/blog/investment-wines#link-5

[5] https://www.vinovest.co/blog/investment-wines#link-11

[6] https://www.wine-searcher.com/find/g+b+burlotto+monvigliero+docg+barolo+piemonte+italy/2016

[7] IRC 1014(b)(9)

[8] IRC 2041

[9] 765 ILCS 3/505(b)(1)

[10] 765 ILCS 3/505(a)

[11] MD Est. & Trusts Code 14.5-507

[12] IRC sections 671-679

[13] IRC Section 678