New Issues Facing Contemporary Estate Planning for Married Couples

The American Taxpayer Relief Act of 2012 ("ATRA") has changed estate planning for all individuals, but especially for moderately wealthy couples. This memorandum offers basic estate planning concepts for married couples with small, medium and large estates in light of ATRA.

New Significance of Income Tax Planning

ATRA made somewhat permanent the lion's share of the provisions of the earlier 2001, 2003 and subsequent tax acts that were set to expire at the end of 2012. In the new tax act, income tax rates have been increased so that ordinary income rates can now top out at 39.6% with the possibility of additional 3.8% medicare surcharge on earned income plus the 3.8% percent medicare surcharge on investment income. Capital gains now have a new possibility of a higher rate of 20% plus the aforesaid 3.8% medicare surcharge on investment income. Effectively, this means investment income can be taxed at the federal level at 43.4% and long term capital gains at 23.8%. In addition, some states impose tax rates that can often exceed 10% or more.

Thus, the tax act means that individuals face higher income tax rates. These income tax rates and surcharges, coupled with state income taxes, can mean that couples can face tax rates approaching 50% or more on income. The new difference is that the estate tax has been significantly reduced (federal rate 40%) at the same time, coupled with a higher exemption and lower rate, meaning that in planning for all estates, future income taxes imposed on the beneficiaries now become more of a consideration in the overall planning.

Transfer Tax Planning

ATRA made permanent the basic $5,000,000 exclusion for estates with adjustments for inflation. For example, the exemption in 2017 is $5,490,000. With proper planning a couple can leave almost $11,000,000 to their heirs without having any estate tax involved. Furthermore, the estate tax marginal rate once you exceed the exemption is now at 40% of the excess, which for the first time in a long time is less than the highest income tax rates. Thus income tax planning becomes more paramount.

Portability Election

ATRA also made permanent the revised definition of "applicable exclusion amount" for federal estate and gift tax purposes. Now the applicable exclusion amount is the same for estate and gift tax purposes. Both exclusions were set at $5,000,000, adjusted annually for inflation, so will therefore increase each year.

A new provision has been added called the "deceased spouse's unused exclusion amount" often referred to as a DSUE amount. As a general rule, the DSUE amount consists of the unused portion of the deceased spouse's base exclusion amount. As might be expected, the availability of the DSUE amount is not available automatically, but requires an election by the deceased spouse's representative and filing of a tax form.

The Internal Revenue Service regulations were finalized in 2015 confirming the statutory requirement that in order to claim this election ("portability election"), the estate of the deceased spouse must file an estate tax return within nine (9) months of the decedent's death, unless they get a six (6) month extension, giving them fifteen (15) months. This is regardless of the size of the gross estate and regardless of whether an estate tax return would be required otherwise. The portability election then must affirmatively be made on such return.

The regulations further provide that estates that are not normally required to file a 706 Estate Tax Return may do a slightly simplified version of a 706, in that they are not required to have detailed appraisals of all assets, but instead may make reasonable estimates of the value of the property based on a determination of good faith with due diligence regarding the value of the assets. This, however, means that while perhaps a formal expensive appraisal for a business, for example, might not be required, an effort must be made to present the valuation in a reasonable approach, documenting the approach to the satisfaction of the Internal Revenue Service.

Most professionals initially felt that portability was not going to be an important issue, but since it has now been made a permanent part of the estate tax law (permanent as any tax law), there are situations where portability might prove to be a more advantageous method to plan for certain estates rather than the traditional marital deduction estate planning.

Dividing Married Couples into Groups

Because of these changes, the current structure of the federal income, estate and gift tax system makes it so that there can be more than one general template used for all married couples. Because of the current exemption and possibility of portability, effective tax planning suggests that married couples be sorted into one of three general "groups."

Group I:

This group consists of couples who have a combined estate value that is substantially less than one basic exclusion amount. Generally, I consider this group to be couples whose total estate is $4,000,000 and under. The amount is less than the exemption to allow for some reasonable appreciation in value of assets.

Group II:

This group consists of couples whose combined estate value is more than one exclusion amount but less than two. Generally, this group is for couples whose total gross estate is between $4,000,000 and $10,000,000, but not more than the approximate $11,000,000 total marital exemption.

Group III:

This group consists of couples with a combined net estate valued at more than two basic exclusion amounts. Generally, couples with a total gross estate in excess of $10,000,000 fall in this category to allow for appreciation.

The limitations are purposely placed at a figure that is below the current exclusion amount in each category to allow for reasonable appreciation in value of assets in the future. Of course, individual situations can vary depending on the nature of the individual's assets. If an individual's assets consist of items that are likely to appreciate substantially in the next few years, they may move up to the next higher group. Likewise, individuals whose assets are substantially all liquid and are not likely to show any appreciation may remain in the existing group or even drop to the next lower group.

For example, if an individual has $5,000,000 total assets which consists of $4,000,000 in life insurance and the remaining assets have little chance of appreciation, then it would be reasonably safe to assume they might fall in the Group I category for estate planning purposes. However, at that level they may want the security of planning as a Group II Couple.

Just as no two snowflakes are alike, no two estate plans are identical. The aforesaid groups are just beginning guidelines and need to be adjusted according to the age of the individuals, nature of assets and the likelihood of appreciation or depreciation of assets, the likelihood of receiving inheritances, and many other factors. The general estate planning for each group are discussed below.

Planning for Group I Couples

Generally, the Group I couples can provide outright distribution of all assets to the surviving spouse, which will then ensure a step-up in basis at each death. Even these couples might want to consider a portability election at the death of the first spouse, particularly when their estates begin to approach the applicable exclusion amount. The purpose of this memo is not to get into all the detailed planning aspects for this group.

Planning for Group II Couples

The Group II couples present the most challenging aspect of estate planning. This group often have total assets that exceed one exclusion amount so it is necessary to do some planning to avoid estate taxes at the first spouse's death, but yet choose a flexible method to ensure that most or all of the assets of the estate can receive a step-up in basis at the death of the second spouse. The term "step-up" is the common phrase for stating that assets get a basis equal to the fair market value at date of death. Obviously, it is not always true that assets get a step-up since we have noticed in recent years with the stock market and real estate market declines, assets can decline in value. However, generally assets that have been held for long periods of time will have a higher current fair market value than the original cost basis.

For this reason, we want to use the date of death values at the surviving spouse's death so as to get the highest tax basis for the individual heirs. Traditional Decedent-Survivor's Trusts accomplish this for the Survivor's Trust, whereas the assets of the Decedent's Trust will retain the value equal to the basis at the first spouse's death. Thus these assets will not receive any change or step-up in basis at the second spouse's death. The primary reason for most couples establishing the Decedent's Trust is to avoid estate taxes. However, with the newer provisions of the law it is possible to avoid the estate tax at the second spouse's death and yet still receive a step-up in basis of the total estate at the second spouse's death. This is done by utilizing the new portability election and other planning devices.

A second memorandum is attached that will explain in more detail the planning for Group II individuals using the portability election and flexible trusts to allow the surviving spouse to make decisions as to whether to elect portability, have a standard Decedent-Survivor's Trust arrangement, or some combination thereof. The good news is this will allow the surviving spouse to make this election, not at the time the estate plan is prepared but at the death of the first spouse. This provides substantial flexibility in planning.

The most flexibility obtained when using a revocable living trust is to provide for what is commonly called a "Clayton QTIP." The Clayton QTIP is just like a regular QTIP in that all income must be paid annually to the surviving spouse, and all of the trust distributions during the survivor's lifetime can only be made to the surviving spouse. Similarly, like a regular QTIP Trust the executor or personal representative has to elect to treat assets intended to qualify for the marital deduction as a "Qualified Terminal Interest Property Trust." However, the Clayton QTIP Trust contains additional provisions. To the extent the personal representative does not elect to qualify an asset as qualified terminal interest property, such property then passes automatically to the Decedent's Trust or Credit Shelter Trust.

This approach gives flexibility to the planning. For example, if the deceased spouse leaves everything to the Clayton QTIP Trust (hereafter referred to as the "Special QTIP Trust"), then within the period of making the election (nine months after the death of the individual, or fifteen months if the estate tax return is extended), the deceased spouse's personal representative then decides whether portability is the preferred option or whether the assets are to be passed to the Decedent's Trust (Credit Shelter Trust). However, the election to have all or part of the assets go into the Special QTIP Trust must be made by an election on the filing of the 706 tax return with portability election for any unused estate tax exemption. This transfer to the Special QTIP Trust will qualify for the unlimited marital deduction.

Therefore, the deceased spouse's taxable estate will be reduced to zero. The full DSUE amount can be transferred over to the surviving spouse. If the personal representative decides that a "sheltered trust" or Decedent's Trust is the best alternative, the personal representative can then select assets with a value equal to the deceased spouse's remaining applicable exclusion and then make a QTIP election for all other assets. Another planning option is open, the personal representative can fund the Decedent's Trust with only certain assets and leave everything else in the Special QTIP Trust. We have found this option useful when clients have property in a state that has an estate tax exemption less than the federal amount. The unelected assets then automatically pass to the Decedent's Trust or Credit Shelter Trust.

While this is similar to the disclaimer approach, this allows the decision between portability and Decedent's Trust or Credit Shelter Trust be postponed until after the first spouse dies. Furthermore, the limitations of the disclaimer (the fact that the surviving spouse can receive no benefit from assets being disclaimed) is not part of the problem. This provides the most flexibility and is one of the suggested approaches for administering estates that fall into this group. See the memorandum attached hereto titled "Flexible Estate Planning for Married Couples When Total Assets Fall Between $4,000,000 - $10,000,000" for a more detailed analysis.

Planning for Group III Couples

Planning for Group III couples follows the more traditional options available, using all of the traditional estate planning, namely, having a split of the assets at the first spouse's death into the Survivor's Trust, Decedent's Trust and QTIP Trust, using Irrevocable Life Insurance Trusts and other trusts for tax planning purposes.

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This memorandum has been prepared to provide general educational information on the stated subject matter. It should not be interpreted as providing specific legal advice or response to any individual questions or issues you may have. Application of the ideas and concepts presented should only be undertaken after you consult with your legal counsel and obtain their advice as it pertains to your individual situation.

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FLEXIBLE ESTATE PLANNING FOR MARRIED COUPLES WHEN TOTAL ASSETS FALL BETWEEN $4,000,000 - $10,000,000

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New Planning Opportunities Now Available

There are many new planning opportunities available for mid-size estates to permit greater flexibility in planning. For this purpose, the definition of "mid-size" is an estate for married couples whose total estate value (this includes the face value of life insurance) is somewhere between $4,000,000 and $10,000,000. Couples who fall above or below these amounts may use this planning, depending upon their particular circumstances, their age, nature of the assets, possibility of growth in value of assets, etc.

In the past, traditional estate planning called for an A-B Split, or Decedent-Survivor's Trusts, with the possibility of a Special QTIP Trust for assets in excess of the applicable exemption. Under the traditional estate planning formula, the maximum amount of the deceased spouse's assets would be placed in the Decedent's Trust and would carry with them the value at the date of death of the decedent. In community property states, the survivor's community property would also get a step-up to the value at date of death of the deceased spouse. Generally the amount allocated to the Decedent's Trust would be the lesser of the total deceased spouse's assets or the amount of the remaining applicable exemption available to the deceased spouse. If the value of the deceased spouse's assets exceed the remaining applicable exemption, such excess would go into a traditional QTIP Trust.

Then at the second spouse's death the assets in the Survivor's Trust and QTIP Trust would be included in the surviving spouse's estate and would get a new step-up in basis equal to the value at the date of death of the surviving spouse. However, any assets placed in the Decedent's Trust (the first deceased spouse's assets) would retain their original basis established at the first deceased spouse's date of death. This often results in situations where the assets in the Decedent's Trust had significant appreciation and potential for capital gains tax when sold by the heirs.

New opportunities are now available for planners, given the portability election, that allow planners to distribute all the assets to the surviving spouse and elect portability of the deceased spouse's unused exemption (DSUE). This allows for new planning opportunities. However, there may be situations where it is not advantageous to have all the assets go to the surviving spouse or the first deceased spouse may want to place certain restrictions on his or her share of the estate assets.

For example, in a situation where the first deceased spouse wants his or her assets to ultimately go to a particular person or persons, said spouse may not be comfortable leaving those assets outright to the surviving spouse who may change the ultimate beneficiary. Also, tax laws may change and exemptions may drop, assets may grow in value, or other circumstances where it may be advantageous to instead create a Decedent's Trust for some or all of the assets of the first deceased spouse. This lead to planners thinking of alternative methods to be able to get the step-up for all assets at the second death, and yet either restrict the surviving spouse's ability to change beneficiaries or to give the surviving spouse full freedom in naming beneficiaries.

All of this came about as a result of the permanence of the estate tax law as a result of the American Taxpayer Relief Act of 2012 (ATRA). This act made portability as permanent as any tax law. In 2015 final regulations regarding portability were issued to give guidance to planners in how to best use this new procedure. The opportunity now presents itself to have best of both worlds, a new step-up basis on all assets at the death of the surviving spouse yet, if desired, to be able to control the ultimate beneficiaries of the first spouse's share of assets or give complete control over all assets to the surviving spouse. The choice is open and allows flexibility with many final decisions made at the time of the first spouse's death rather than at the date the trust is written.

Detailed Facts Regarding Portability

Portability is only available for married couples. In the case of a married decedent, portability provisions allow the unused exemption of the first spouse to die to be preserved and used by the surviving spouse. This opportunity can arise under certain circumstances, namely:

1. The first decedent's total estate after deducting expenses is not large enough to use his or her estate tax exemption in full. In this situation the unused exemption can be preserved by the surviving spouse by making a portability election on a timely filed 706 estate tax return.

2. Another way portability may be used is to have the decedent's estate pass in a form that qualifies for the estate tax marital deduction or, in some circumstances, to have only a portion pass that way, so as to reduce the tax liability of the first deceased spouse's estate to zero. By filing a 706 estate tax return the legal representative of the deceased spouse can elect to transfer the unused exemption to the surviving spouse. This unused exemption is commonly referred to as DSUE.

Advantages of Electing Portability

There are many advantages of electing portability. A few of these are as follows:

1. <u>Simplicity</u>. If all assets are left in the control of the surviving spouse, there is no Decedent's Trust funded and substantially all of the deceased spouse's applicable unused exemption (DSUE) of the deceased spouse will be available to the surviving spouse. Even if the Decedent's Trust is funded, any of the DSUE can be made available to the surviving spouse.

2. <u>Step-up in Basis</u>. In a community property state, all assets receive a step-up in basis to the date of death value. As previously mentioned, at the second spouse's death, all assets included in the surviving spouse's estate get a new step-up in basis, not just the half of the estate originally belonging to the surviving spouse.

There are many other advantages that could be cited but these are the main ones.

Disadvantages of Electing Portability

There are a few disadvantages, namely:

1. The generation-skipping tax exemption is not portable and will be lost at the death of the first spouse unless used in some manner. In those situations where the estate assets are passing to a "skip generation" (grandchildren) or held in trust for the benefit of children and then to grandchildren, the generation skipping tax election can be made for the assets retained in either a Decedent's Trust or Special QTIP Trust.

2. A Decedent's Trust can be drafted and administered so as to provide creditor protection for the surviving spouse for assets in the Decedent's Trust, whereas if given outright to the surviving spouse such assets are not so protected.

3. The DSUE amount is not indexed for inflation but remains a fixed dollar amount depending upon what was available at the death of the first spouse.

4. Under certain circumstances the original DSUE can be lost through remarriage in situations where the surviving spouse survives his or her second spouse.

5. The major disadvantage of portability is that in order to use the DSUE of the first spouse to die, you must elect portability. Thus, an estate tax return must be filed even if such a return is not due for any other reason. This increases the cost of administering the estate of the first deceased spouse. However, this may not be as big a disadvantage as it might appear at first since many of the costs in preparing the estate tax return will be incurred anyway such as appraisals. In community property states all the assets of both spouses need to be valued at the death of the first spouse as all assets get a new tax basis. This valuation of assets is needed for future income tax purposes as well as for the 706 estate tax return. Thus a significant part of the cost of preparing a 706 estate tax return will already be incurred in any event.

Techniques Available to Estate Planner

In planning for these mid-size estates, it is desirable to have flexibility built into any planning program. Obviously, the simplest approach would be to have each grantor leave all of his or her assets to the surviving spouse, and then the surviving spouse files a 706 estate tax return for the deceased spouse and makes the portability election for the DSUE. However, this does not give the surviving spouse flexibility should there be disadvantages in this method of transferring assets that are discovered at the time the first spouse dies.

A second approach is using disclaimers. However, a disclaimer has a disadvantage in that in order to have a qualified disclaimer, the party must make the election within nine (9) months of the death of the first spouse and, most important, not have received **<u>any</u>** benefits from the disclaimed assets. While this may provide a certain amount of flexibility in allowing the surviving spouse to make certain decisions, it creates a problem since usually by the time planners are involved the surviving spouse has already used some of the income from the estate assets and would very likely not be able to disclaim the inheritance. Disclaimer planning requires very coordinated and knowledgeable parties to be sure no mishaps occur between the time the first spouse dies and the disclaimer is made.

Another alternative is using partial QTIP election. However, a more advanced form is to use what is termed a "Clayton QTIP" (referred to herein as "Special QTIP Trust"). The Internal Revenue Service Regulations allow an estate tax marital exemption for property passing to a trust that is designed to qualify as a QTIP to the extent that the legal representative of the estate of the deceased spouse elects QTIP status for the property. Such elected property qualifies for the marital deduction. To the extent a QTIP election is not made for particular property, no marital deduction is allowed for such property. The document can provide for all or part of the deceased spouse's share of the estate to pass to the Special QTIP Trust. To the extent the legal representative does not make a QTIP election the property will by default go to the Decedent's Trust.

For example, at the death of the first spouse if the legal representative failed to make a QTIP election the property that otherwise would go to a QTIP Trust might instead pass to a Decedent's or Credit Shelter Trust (B Trust). The Special QTIP provides the greatest flexibility in determining the extent in which portability is used and the allocation of the deceased spouse's property into various trusts.

Also in situations where it is desirable to utilize the generation-skipping tax exemption of the first spouse to die, such an election can be made for the assets passing either to the Decedent's Trust or Special QTIP Trust. Such advanced planning requires the combined efforts of an experienced estate and tax attorney and the parties involved, both at the planning stage and at the first grantor's death.

Summary of Application of Special QTIP Trust

In summary, to provide the most flexibility in estate planning for mid-size estates is to provide that at the death of the first spouse, all of his or her assets are allocated to a Special QTIP Trust. The trust then provides that any assets in which the deceased spouse's legal representative does not elect QTIP provisions are to be placed in the Decedent's or Credit Shelter Trust. Thus, at the death of the first spouse the deceased spouse's legal representative has nine (9) months to make this election or, if an extension is requested, fifteen (15) months from the death of the first spouse.

The most common scenario would be to elect all or part of the deceased spouse's assets to be placed in the Special QTIP Trust and any unused estate tax exemption would then be covered under the portability election so that the surviving spouse would get the use of this unused exemption amount. In addition, if the ultimate remainder beneficiaries are skip persons, the legal representative can elect to allocate the deceased spouse's generation-skipping exemption to the Decedent's Trust and/or the Special QTIP Trust.

As an alternative, under certain circumstances the parties might elect to have either all of the assets go into the Special QTIP Trust, or none of the assets go into the Special QTIP Trust and all of the assets go into the Decedent's Trust. This decision can be made by careful planning at the death of the first spouse. The major drawback is that the surviving spouse should not be the person who alone is empowered to make or not make the election to qualify for the marital exemption, as the IRS interprets that he or she would be deemed to make a gift to the extent the marital exemption is not elected for all assets.

For this reason, in doing this planning an independent party is selected to make the decision as to how much of the property is to be elected to remain in the QTIP Trust and how much, if any, is placed in the Decedent's Trust. The responsibility for the election is therefore taken out of the hands of the surviving spouse. This independent person must be considered independent under the tax law. Obviously, the most common candidates would be the family's accountant or a lawyer versed in tax and estate planning matters. Generally such a person under the law is legally independent of the surviving spouse and can make decisions without the consent of the family, but under practical circumstances would follow the best wishes of the family. Also, because this decision requires the expertise of someone who knows tax law as well as trust law and can do financial planning, a professional advisor should be involved. Thus, the family can achieve the best of both worlds by determining at the death of the first spouse what is the most advantageous plan from a family standpoint and a tax standpoint, given all of the facts known at that time.

Special Planning Points

There are certain special planning points to families available even under these circumstances. Thus at the death of the first spouse the family can then decide how much if any assets are placed in the Decedent's Trust and how much will be placed in the Special QTIP Trust, the election being made by the independent party. Such analysis can then take into account all of the factors (tax, legal, family circumstances, health of surviving spouse, etc.) present at that time.

Certain questions have been raised as to the appropriateness of giving the surviving spouse full control of the assets, or limited control. This flexibility is built in the Special QTIP Trust. Under QTIP Rules the surviving spouse must receive all of the income from the trust from the date of death of the first spouse to the date of the death of the surviving spouse. Also, the surviving spouse must be the sole beneficiary of any principal distributions from the QTIP Trust. The Special QTIP Trust is designed to cover the many circumstances faced by individuals. For example:

Situation #1: The husband and wife have been married many years and it is a first marriage for both of them. They have children from that common marriage and have no qualms about allowing the surviving spouse full control over the assets of the deceased spouse. Under these circumstances the Special QTIP Trust can then contain very liberal provisions for distribution of principal to the surviving spouse for literally any reason he or she wishes. It also can provide for power of appointment to appoint anyone except the surviving spouse, his or her estate or creditors. It can allow the surviving spouse to appoint his or her estate or creditors if desired.

Situation #2: Each spouse may desire his or her estate to go to particular persons and do not want to permit the surviving spouse full control over the deceased spouse's assets. In this circumstance, the trust can provide for no principal distributions but only income distributions, and for a limited power of appointment or no power of appointment to the surviving spouse.

Situation #3: In this situation you have something that falls between the above two examples, where they want to provide some of the flexibility mentioned in Situation 1 to the surviving spouse but not to the extent of the restrictions in Situation 2. The QTIP Trust can then be designed with as many or as few controls as possible. The only requirement on the QTIP Trust is that all income must be distributed to the surviving spouse.

Under certain circumstances it may be desirable to fund a Decedent's Trust and not elect QTIP status at all. The Decedent's Trust can have flexibility in its provisions regarding distributions of income, principal and ultimate disposition upon the death of the surviving spouse. In fact the Decedent's Trust can even provide that no income is distributed to the surviving spouse, but all income is distributed to other parties.

Summary

In summary, this new method available to mid-size estates allows a great deal of flexibility in planning for these estates under almost all circumstances. If desired, it can even be used in smaller estates. The ability to wait and see until the first party passes away is a distinct advantage in planning. Most estate plans are drafted where decisions are made when the documents are written and the first death may not occur for many years. The survivor is then "stuck" with those provisions, even though it may not be the decision that would have been made had the estate plan been updated.

Under the flexible Special QTIP approach, there is a great deal of flexibility build in the planning, so that the surviving spouse has many choices and alternatives available. Most couples who are in this mid-size estate range should consider this form of plan.

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