

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 was further modified by the 2017 Tax Cuts and Jobs Act which revised the income tax provisions in the Internal Revenue Code. This memorandum offers basic estate planning concepts for married couples with small, medium and large estates in light of these changes.

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 ATRA Tax Act, income tax rates were 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. Then came the 2017 Tax Cuts and Jobs Act in December, 2017, which made dramatic changes in the income tax law and tax rate structure. Individual and corporate rates were reduced. However, the individual top rate was only reduced to 37%.

Thus, the 2017 tax law means that individuals still face high top marginal income tax rates. However, these high marginal rates are modified by various provisions that tax different sources of income at lower rates. A full discussion of the income tax effects of the 2017 Tax Act is beyond the scope of this memorandum. Nonetheless, income taxes now have become a bigger concern for most individuals than estate taxes in planning one's estate, since for the majority of people there will be no federal estate tax liability at present levels. 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. For purposes of this Memorandum, I will not go into great detail on these income tax changes, but will concentrate the discussion on how these two acts affect estate 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 was \$5,490,000; however, the 2017 Act raised that exemption to approximately \$11,200,000. Thus, under the new law, with proper planning a couple can leave over \$22,000,000 to their heirs without having any estate tax involved. Furthermore, the estate tax marginal rate once you exceed the exemption is at 40% of the excess. Thus income tax planning becomes more paramount as most individuals will not face an estate tax.

Portability Election

ATRA also made permanent the revised definition of "applicable exclusion amount" for federal estate and gift tax purposes. Currently the applicable exclusion amount is the same for estate and gift tax purposes. Both exclusions were set at \$5,000,000. The 2017 Act raises this sum to about \$11,200,000, also adjusted annually for inflation, so it will increase each year.

ATRA added a new provision 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 an estate tax form. The 2017 Act retained the ability to have a portability election for the DSUE.

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 a 706 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 total. This is regardless of the size of the gross estate or 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 (as permanent as any tax law may be), 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. See the attached addendum that goes into more detail. Given the fact that most professionals agree the estate tax law will change in the future as different Congresses are elected, persons who have substantial estates (from \$5,000,000 to \$10,000,000 or more) need to give thought to designing flexibility in their estate plan.

Dividing Married Couples into Groups

Because of the current exemption and possibility of portability, 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. Effective tax planning suggests that married couples be sorted into one of three general "groups."

Group I:



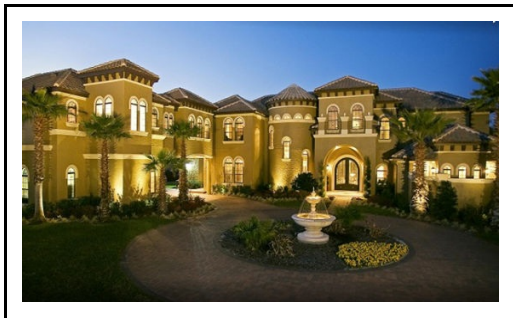
This group consists of couples who have a combined estate value that is substantially less than one basic exclusion amount as it is currently and even if the exclusion amount is reduced in the future. I consider this group to be couples whose total estate is \$4,000,000 and under.

Group II:

Generally, this group is for couples whose total gross estate is between \$4,000,000 and \$10,000,000 to allow for some reasonable appreciation in value of assets and to take into account that a Congress in the near future may reduce the current \$11,000,000 plus exemption to some lesser amount.



Group III:



Generally, couples with a total gross estate more than \$10,000,000 fall in this category to allow for appreciation in value of assets and to take into account that a Congress in the near future may reduce the current \$11,000,000 plus exemption to some lesser amount.

The limitations are purposely placed at a figure that is well below the current exclusion amount in each category to allow for reasonable appreciation in value of assets in the future and for the strong probability that a future Congress will reduce the exclusion amount in order to raise more money or to attain some social goal. 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 consist 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 identical, 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 is discussed below.

Planning for Group I Couples

Generally, the Group I couples may 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 the prior \$5,500,000 exclusion amount but not the new \$11,000,000 plus exclusion amount, but is the group most likely to be moved from estate tax free to a taxable estate by a new Congress. Therefore, 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 often want to use the date of death values at the surviving spouse's death to get the highest tax basis for the remainder heirs. Traditional Decedent's-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. Decedent's Trust assets will not receive any change or step-up in basis at the second spouse's death. The primary reason for most couples establishing a Decedent's Trust was to avoid estate taxes. However, with the newer provisions of the law it is possible to avoid 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's-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 is obtained when using a revocable living trust that provides 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 (sometimes referred to as Credit Shelter Trust).

This approach gives some 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 decides whether portability is the preferred option or whether the assets are to be passed to the Decedent's 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.

The biggest drawback is that the surviving spouse **must** file a 706 Estate Tax Return, make a decision as to how to allocate assets between the Special QTIP Trust and the Decedent's Trust, elect portability if desired, and do all this within no later than fifteen (15) months from the date of death of the first spouse, provided an extension of six (6) months is obtained within the first nine (9) months. Generally, to be effective an independent third party must be involved in making the election. 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.

While this is similar to the disclaimer approach, this allows the decision between portability and Decedent's 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 Addendum attached hereto 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. Couples with assets exceeding \$10,000,000 need to carefully consider the alternatives set forth in the attached Addendum. At present, with the \$11,000,000 plus exclusion amount, they will have no estate tax concerns. However, they fall in the group that will most likely be affected by future estate tax law changes that could result in a drastic reduction of the exclusion amount, as well as increased transfer taxes. Also, this group, as well as some in Group II, may be concerned with the generation skipping tax consequences.

Planning for Generation Skipping Tax

The good news is that the generation skipping tax exclusion is the same as the exemption exclusion amount. The bad news is that if portability is used as a planning device, there is **no** portability of the deceased spouse's generation skipping tax exclusion amount.

If there are plans to leave property to grandchildren or other "skip persons" or to place property in trust for children with the grandchildren being remainder beneficiaries, then consideration must be given to the consequences of the generation skipping tax. Full details are beyond the scope of this memo. However, if such skip persons are current or future beneficiaries, this issue must be considered.



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ADDENDUM TO FLEXIBLE ESTATE PLANNING MEMORANDUM AS A RESULT OF THE TAX ACT OF 2017

In the Tax Act of 2017, Congress increased the estate tax exemption to over \$11,000,000 per individual. Although it was labeled as semi-permanent, we all know that things can change with a new Congress. In light of the fact that the tax bill was quite partisan and it is likely that control of Congress and/or the presidency may change sometime in the near future, there may be future changes in the estate tax law. Based upon a survey of tax professionals shortly after the enactment of the 2017 Tax Act, almost 80% of them felt that the estate tax law would be changed sometime in the near future, and there was a good chance that the \$11,000,000 exemption will be reduced and the tax rates increased.

In the past, several congressional members have proposed reduced exemptions, some as low as \$1,000,000, so that for estates who may currently face no estate tax there is a strong possibility the law will change, causing the estate to be taxable either at the first death or the surviving spouse's death. For this reason, we have devised a program for our more advanced estate plans to give several options to the surviving grantor and trustee to elect a method of allocation of trust assets at the first death that will hopefully prove more advantageous than arbitrarily selecting one particular standard provision for the trust.

The purpose of this memo is to go into more detail regarding these options and to describe how they work, along with preparing a general listing of the pros and cons of each option. No system is perfect and, therefore, no option is perfect, but the flexibility of making these different options available at the first spouse's death will allow the surviving spouse to make decisions that will be most advantageous. In order to make this election, the trust requires the use of a third party who qualifies as "independent" under the Internal Revenue Rules and Regulations to actually make the election.

Using a third party to make the selection, rather than the surviving spouse, lends more credence to these options being recognized by the Internal Revenue Service and tax authorities. However, there is no assurance at this time, since it is an untested concept, that such elections and options will be recognized. Of course, in preparing a plan the grantors can pre-select one option to use, if they want more certainty. If the grantors want more certainty but a little less flexibility, they can elect Option No. 5 which is described in the following pages, as it was the preferred option prior to the 2017 Tax Act for many larger estates.

This addendum is attached to this memorandum to present some new concepts and ideas that may be considered by persons whose estates are likely to exceed \$10,000,000 at the death of the survivor. Nothing is certain in tax law, thus persons who fall in this range need to be aware that major changes can come about any time that will have a significant financial effect on their heirs.

Note: The following Options 1 and 2 generally should not be chosen in situations where each spouse wants to be sure that said spouse's property goes to his or her heirs, or where the parties do not want assets going to a new spouse if the survivor remarries. If it is a blended family and the parties are not concerned about the surviving spouse having complete control over the entire assets, options 1 and 2 may be included. We have found this to be true in smaller estates where a couple have been married for many years and want the simplicity of allowing the surviving spouse to have full control over all of the property and where neither spouse has concerns about the surviving spouse continuing with the program both originated.

Option No. 1: The entire trust estate is allocated to the Survivor's Trust.

This approach is the simplest to administer. All of the assets are now in the complete control of the surviving spouse. He or she may leave the assets to anyone he or she chooses. By electing portability, the surviving spouse will have available the remaining unused portion of the tax exemption of the deceased spouse, in addition to his or her own exemption.

PROS:

1. Easy to administer all assets under control of surviving spouse.
2. Step-up in basis to new date of death value of all assets at death of surviving spouse.
3. No restrictions on surviving spouse.
4. Surviving spouse can leave all property to whomever he or she chooses.
5. By electing portability the surviving spouse will have the maximum amount of exemption available at the survivor's death.

CONS:

1. All property subject to claims of creditors of surviving spouse.
2. Surviving spouse can disinherit any of original intended beneficiaries or leave entire estate to new spouse.
3. Generally need to elect portability which requires the filing of a form 706 Estate Tax Return at the death of the first spouse within the IRS required time limits.

Option No 2. The Decedent's Trust is funded with maximum amount and the balance, if any, is allocated to Survivor's Trust.

This is closer to the old traditional way of thinking. By funding the Decedent's Trust, the deceased spouse can control who gets assets of the Decedent's Trust at the death of the surviving spouse. As an alternative, the surviving spouse can be given a limited power of appointment to change beneficiaries in the Decedent's Trust among a select group of people. Now if the deceased spouse's share of the trust estate does not exceed the estate tax exemption, the surviving spouse can elect portability for the unused portion and thus have a greater estate tax exemption at the survivor's death.

PROS:

1. The deceased spouse can control the final beneficiaries of the Decedent's Trust and thus assure that at least that much of the deceased spouse's estate will go as he or she wishes.
2. If properly structured and administered, the assets of the Decedent's Trust will not be subject to the claims of the creditors of the surviving spouse.
3. The Decedent's Trust can retain capital gains realized on its property.
4. By electing portability the surviving spouse will have the maximum amount of exemption available at the survivor's death.

CONS:

1. The Decedent's Trust requires a separate trust and annual tax returns.
2. The surviving spouse generally gets all income from the Decedent's Trust, but access to principal by the surviving spouse is limited by the ascertainable standard rules. However, if included in the trust and provided the surviving spouse is not the trustee, the Decedent's Trust can pay all or part of its annual income to someone other than the surviving spouse. This provision can be viewed as a pro or con, depending upon the grantors' objectives.
3. Assets in the Decedent's Trust do not get a step up in basis at the death of the surviving spouse (note, it can also be a step down, remember "crash" of 2008-2009).
4. Additional accounting and administration is required as Decedent's Trust assets must be kept in separate trust and accounted for.
5. Decedent's Trust may require certain information to be provided annually to remainder beneficiaries (this may be able to be avoided by special language in the trust).
6. If there remains a portion of the deceased spouse's estate tax exemption, then generally there is a need to elect portability which requires the filing of a form 706 Estate Tax Return at the death of the first spouse within the IRS required time limits.

Option No 3: The Decedent's Trust is funded with maximum amount and the balance, if any, is allocated to a Conventional QTIP Trust

This is the traditional method of estate planning for large estates where three trusts are established at the death of the first grantor: a Survivor's Trust which is allocated all of the surviving spouse's share of the trust estate; a Decedent's Trust which is funded, from the deceased grantor's share of the trust estate, with the maximum amount so as not to cause an estate tax; and the balance of the deceased spouse's share of the trust is allocated to a QTIP Trust for the benefit of the surviving spouse. Again, if the Decedent's Trust is not fully funded and thus there is an unused portion of the deceased spouse's exemption (DSUE or DSUEA), an election is made (portability) to carry this unused exemption over for the use of the surviving spouse.

PROS:

1. The deceased spouse can retain control of the final beneficiaries of the Decedent's Trust and QTIP Trust and thus assure that at least that much of his or her estate will go as he or she wishes.
2. If properly structured and administered, the assets of both the Decedent's Trust and the QTIP Trust will not be subject to the claims of creditors of the surviving spouse.

CONS:

1. Both the Decedent's Trust and QTIP Trust are separate trusts and each requires an annual tax return.
2. Generally the surviving spouse gets all income from the Decedent's Trust; however, if included in the trust and provided the surviving spouse is not the trustee, the Decedent's Trust can pay all or part of its annual income to someone other than the surviving spouse. This provision can be viewed as a pro or con, depending upon the grantors' objectives. The QTIP Trust must provide that all income is paid to the

surviving spouse. For both trusts, access to principal by the surviving spouse may be limited by ascertainable standard rules.

3. Assets in the Decedent's Trust do not get a step up in basis at the death of the surviving spouse (note, it can also be a step down, remember the crash of 2008-2009).
4. Assets in the QTIP Trust do get a step up in basis at the death of the surviving spouse, since the value of the QTIP Trust is included in the surviving spouse's estate.
5. Additional accounting and administration is required since both the Decedent's Trust and QTIP Trust assets must be kept in separate trusts and each trust requires accounting and tax returns.
6. Both the Decedent's Trust and QTIP Trust may require certain information to be provided annually to remainder beneficiaries (this may be able to be avoided by special language in the trusts).

Option 4: All of the deceased spouse's assets are allocated to a Conventional QTIP Trust and Portability is Elected for the DSUE of the Deceased Spouse

This option and the next one are more direct results of the new portability rules giving estate planners more flexibility in planning larger estates that are or may be subject to estate taxes. By using a conventional QTIP Trust, there will be no estate tax due at the first death and the full DSUE of the deceased spouse will be available to the surviving spouse (by election of portability), yet the deceased spouse can control the ultimate beneficiaries of his or her share of the trust estate. Since the QTIP Trust is included in the estate of the surviving spouse, a full step up in basis of all assets can be obtained at the second death. By utilizing the QTIP Trust, a degree of asset protection from claims of creditors of the surviving spouse can be obtained for assets in that trust.

PROS:

1. The deceased spouse can retain control of the final beneficiaries of the QTIP Trust and thus assure that at least that much of his or her estate will go as he or she wishes.
2. If properly structured and administered, the assets of the QTIP Trust will not be subject to the claims of the creditors of the surviving spouse.

CONS:

1. The QTIP Trust is a separate trust and requires an annual tax return.
2. The QTIP Trust must provide that all income is passed to the surviving spouse. Access to principal by the surviving spouse may be limited by the ascertainable standard.
3. Assets in the QTIP Trust get a step up in basis at the death of the surviving spouse, since the value of the QTIP Trust is included in the surviving spouse's estate.
4. Additional accounting and administration is required since the QTIP Trust assets must be kept in a separate trust and such a trust requires accounting and tax returns.
5. The QTIP Trust may require certain information to be provided annually to remainder beneficiaries (this may be able to be avoided by special language in the trust).

Option 5: The trustee may elect to allocate all of the deceased spouse's assets to a Special QTIP Trust, or the trustee may elect to allocate a portion of said assets to a Decedent's Trust, portability is elected for the DSUE of the deceased spouse.

This option gives the trustee the most flexibility. If it is best to have all of the deceased spouse's assets in the Special QTIP Trust, the trustee can elect to do so. If for any tax, personal or business reason, it would be better to retain certain assets in the Decedent's Trust, the trustee can have such assets allocated to the Decedent's Trust by not electing QTIP status for such assets. Furthermore, if all of the deceased spouse's exemption is not utilized, then portability may be elected to carry over the unused portion to the surviving spouse.

PROS:

1. This option provides the most flexibility in allocation of assets to achieve the desired long term benefits.
2. All of the PROS previously set forth in Option No. 4 for the Decedent's Trust and QTIP Trust are achieved.

CONS:

1. This option requires the most work and complexity. It will require the assistance and guidance of a competent estate and trust planner, especially one who also understands income and estate taxes.
2. All of the individual CONS previously set forth in Option No. 4 for the Decedent's Trust and QTIP Trust apply here.

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CAUTION: PLEASE BE ADVISED

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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PLEASE NOTE: Based on IRS Circular 230, the Internal Revenue Service may consider this memorandum as a "covered opinion." Therefore, we make the following disclaimer regarding its usage. Any tax advice we provide in this communication is not intended or written to be used, and cannot be used by you or any other person or entity for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or any applicable state or local law. It is provided for information and guidance only. You need to consult with your tax advisor regarding any tax issues that arise in the funding and operation of your trust.

IRS Circular 230 Disclosure

Pursuant to recently enacted U.S. Treasury Department Regulations and to ensure compliance with the requirements imposed upon us by the United States Internal Revenue Service, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.
