TAX TAIL

Will the Tax Tail Still Wag the Estate Planning Dog?

Longstanding estate planning strategies may address tax situations that many clients no longer face under current tax law, creating the need for revised planning.

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Trust and estate planning practitioners tend to focus on tax planning first and client desires second. This is a natural response to the fact that many planners advising clients today cut their teeth on a $600,000 exclusion amount (1987-1997) when a house, a (small) IRA, and a life insurance policy could result in a taxable estate. In fact, the estate tax exclusion amount did not exceed $2 million until the anomalous year of 2009, when it spiked to $3.5 million. The tax tail has so completely wagged the planning dog for so many years that in the wake of the American Taxpayer Relief Act of 2012 (ATRA), many practitioners find themselves at a loss in advising clients who really do not need all that traditional estate tax planning, or do not need it in the traditional configuration. Practitioners have all become familiar with the statistics about how few U.S. citizens will be subject to the estate tax under the current regime. The Tax Policy Center estimates that only 3,800 estates in the entire country-which is a miniscule 0.14%, or 1 in every 700 people who die-will pay any estate tax in 2013.

ATRA was signed into law by the President on 1/2/2013. The unified credit amount, as codified in **Section 2010(c)** produces a permanent applicable exclusion amount for estates and gifts of $5 million, indexed for inflation. The inflation-adjusted amount was $5.12 million for 2012 and $5.25 million for 2013; it rose to $5.34 million for 2014. The generation-skipping transfer (GST) exemption is the same as the estate and gift tax applicable exclusion amount: that is, $5 million indexed for inflation or $5.34 million in 2014. The top estate and gift tax rate is 40% and applies to estates of decedents dying after 2012 and to taxable gifts made after that date. The GST tax rate is a flat 40% and applies to GSTs after 2012. The Chapter 13 (GST) provisions added as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) were all made permanent, including the automatic allocation of GST exemption to indirect skips under **Section 2632(c)** , the allowance of "qualified severances" under **Section 2642(a)(3)** , retroactive allocation of GST exemption under **Section 2632(d)** , and "9100 relief" under **Section 2642(g)** .

Portability of the deceased spousal unused exclusion (DSUE) amount is now permanent. Significantly, ATRA made a technical correction to the language of the portability rules to clarify that a surviving spouse can use the portable exclusion amount that the last deceased spouse received from a prior spouse.

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A casual observer might ask, "how permanent is permanent?" Specifically, ATRA eliminated the sunsetting provisions in EGTRRA and The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("The 2010 Act"), which had generally extended EGTRRA provisions for two years. **1**

In contemplating planning after ATRA, it is also important to keep in mind what ATRA did not do. ATRA contained none of the proposals for closing estate, gift, and GST tax "loopholes" contained in the Obama Administration's General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (the "Green Book").

One Green Book proposal would require that all GRATs last for a minimum term of ten years and a maximum term of the grantor's life expectancy plus ten years. The proposal would also require that all GRATs have some minimum remainder interest and would have precluded the use of GRATs with decreasing annuity payments.

Valuation discounts for closely held corporations, FLPs, and FLLCs have long been in the crosshairs of Congress and the Treasury. Prior Green Books contained proposals to severely reduce the use of this popular planning tool in intrafamily gifts, primarily by giving the Treasury greater regulatory authority to create more durable rules for disregarding restrictions under **Section 704(b)** in valuing interests in these entities. Curiously, the 2014 Green Book omits this proposal.

The Green Book "consistent basis" proposal would require that the income tax basis of property received from a decedent be equal to its estate tax value.

The Green Book proposal would also limit the use of dynasty trusts by providing that the allocation of GST exemption to a transfer would protect the transfer from the GST tax for no more than 90 years. On the 90th anniversary of the creation of a trust, the GST exemption allocated to the trust would terminate and the inclusion ratio would move to one.

Perhaps most ominously, the Green Book proposal would align the income and transfer tax rules that apply to grantor trusts. More specifically, the proposal would require that where the income tax rules treat a grantor as the owner of the trust, (1) the assets of the trust be included in the gross estate of the grantor; (2) distributions from the trust to any beneficiary during the grantor's life would be subject to gift tax; and (3) any trust assets in the trust when the grantor ceased to be treated as the owner for income tax purposes would be subject to gift tax. The proposal would be effective with regard to trusts created on or after the date of enactment and with regard to any portion of a pre-enactment trust attributable to a contribution made on or after the date of enactment.

The Obama Administration's 2014 Green Book renews the call to return to 2009 exclusions and rate levels. In 2009, the top rate was 45% and the exclusion amounts were $3.5 million for the estate tax and the GST exemption, but only $1 million for the gift tax. There would be no indexing for inflation. The 2014 Green Book calls for this to return in 2018, however.

Make hay while the sun shines

If appropriate, practitioners should consider taxable gifts. While the basic structure of ATRA is unlikely to change soon, it is far simpler to change the tax rate. The 40% rate is a relative bargain compared to the highest marginal rate of 55% that applied for many years prior to EGTRRA. In fact an additional surtax of 5% above that highest rate applied to taxable estates above $10 million, resulting in an effective rate on some estates of 60%.

In addition to traditional annual exclusion gifting, high net worth clients who have already used their $5 million exclusion amount should consider annually gifting assets with a value equal to the inflation adjustment to the $5 million exclusion amount. In 2013, the exclusion amount increased by $130,000. In 2014, it increased by $90,000, to $5.34 million.

As discussed above, some "wish list" items including the return to 2009 rates and exclusion levels in 2018 and restrictions on GRATS, valuation discounts, and dynasty trusts wait in the wings. The 2014 Green Book also raised the specter of new legislation to effectively eviscerate installment sales to IDGTs by aligning the income and gift tax rules that apply to grantor trusts. Who knows when these ideas might resurface? If these planning techniques could benefit a practitioner's clients, now may be the time to proceed.

Estate Planning After ATRA

Below is a synopsis of estate planning strategies to consider in the current tax climate.

Portability as part of the planning process. Portability of a DSUE amount may be one of the planners' most effective new tools. Very briefly, portability is available to a surviving spouse of a deceased spouse dying after 2010. A surviving spouse can use the DSUE amount only if the executor of the deceased spouse timely files an estate tax return and makes an appropriate election on the return. [2] A significant limitation is that the GST exemption is not portable.

A surviving spouse can only use the DSUE amount of his or her last deceased spouse even if, on the date of death of the surviving spouse, the surviving spouse is married to another (then living) individual. [3] If a surviving spouse remarries and then that subsequent spouse dies before the surviving spouse, the surviving spouse's DSUE amount will be only that amount subject to a valid election in the subsequent spouse's estate. If the last deceased spouse of such surviving spouse had no DSUE amount, or if a portability election is not made, the surviving spouse will have no DSUE amount. [4] In other words, DSUE amount can, in effect, be lost.

Use of the DSUE amount with taxable gifts. It is important to remember, however, that the DSUE amount can be used (and preserved) by the surviving spouse with gifts made during life or with transfers at death. Gifting the DSUE amount can be a very effective planning technique. Gifts made by the surviving spouse will first use the DSUE amount from the last deceased spouse, before using the surviving spouse's own basic exclusion amount. [5]

Thus, a surviving spouse can lock in the use of the DSUE amount from the last deceased spouse by making gifts of the DSUE amount received from that spouse. This is the case even if the portable exclusion amount is from a person who would not qualify as the "last deceased spouse" at the time of the surviving spouse's death. [6] A wife who survives the death of more than one husband could use the DSUE amount from each of them by making taxable gifts of the DSUE amount before the death of the next husband, assuming a valid portability election was made for each of them. Because of the "last deceased spouse" rule, the DSUE amount may not be aggregated and all used at once. The DSUE amount used for gifts in this fashion will not be lost on the death of a successor "last such deceased spouse."

It will be important for planners to inquire about portability elections made by clients with deceased spouses, including a review of the Federal Estate (and Generation-Skipping Transfer) Tax Return (Form 706) on which the election was made. Of course, Federal Gift (and Generation-Skipping Transfer) Tax Returns (Form 709) should also be requested and reviewed.

Benefits of relying on portability. Portability helps those who do not plan. For example, individuals in the following circumstances will benefit:

(1) Individuals who do not have an estate plan that uses the exclusion amount (i.e., individuals

without a will, and those with a will without tax planning).

(2) Individuals with substantial nonprobate assets passing to the surviving spouse.

(3) Couples who have not equalized estates before the death of the poorer spouse.

An individual can leave retirement assets outright to the surviving spouse, which is advantageous for income tax purposes, without forgoing the use of the first spouse's exclusion amount. Because of the difficulty in qualifying a bypass trust to be a designated beneficiary, funding a bypass trust with qualified retirement assets was historically an expensive, but often unavoidable, way to use the estate tax exclusion of the first spouse to die.

An individual can leave appreciating assets outright to the surviving spouse and can receive a basis adjustment under **Section 1014** at the surviving spouse's death. In contrast, assets left to a family trust do

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not receive a basis adjustment at the second death. By relying on portability, instead of funding a family trust to use the first spouse's exclusion amount, the costs associated with funding and administering a family trust are also avoided.

If a decedent owns property in a state with a state estate tax, a traditional bypass trust could be funded with an amount equal to the state estate tax exclusion (typically less than the federal exclusion). The balance of the estate of the decedent could pass to the surviving spouse in an outright transfer, qualified terminable interest property (QTIP) trust, general power of appointment (GPOA) marital trust, or by right of survivorship. A portability election could be made for the DSUE amount.

Portability shortcomings. For several reasons, portability should not be relied on as a planning tool in every case. Those reasons include the following:

(1) The DSUE amount is determined at the first spouse's death, and is not subsequently increased for any inflation adjustments. In contrast, if a family trust is funded at the first death, the assets of the trust may increase significantly by the time the surviving spouse dies. The original corpus of the family trust and all appreciation will be sheltered from estate tax at the surviving spouse's death. However, the appreciation will potentially be subject to capital gains tax and to the new 3.8% Medicare tax (also called the net investment income tax, or NIIT). **7**

(2) Leaving assets outright to the surviving spouse, instead of funding a family trust, means that the assets do not receive the same protection offered by a trust against the surviving spouse's creditors and rights of a second spouse. (See additional discussion below regarding the benefits of trusts.)

(3) The GST exemption is not portable. If a family trust is funded, the first spouse's GST exemption can be (and normally is) allocated to the family trust. If it is important to use both spouses' GST exemptions, or at least more than one exemption, then the planner should not rely solely on portability at the expense of a family trust.

(4) Portability of the federal exclusion amount does not mean portability of state estate tax exclusion

amounts. State exclusion amounts will be portable only if the states enact legislation to allow for portability. To date, only Hawaii provides for portability of the state exclusion amount for Hawaii estate tax purposes.

(5) A Form 706 must be filed in order to preserve the portable exclusion amount, regardless of whether a Form 706 is otherwise due. In contrast, a family trust can be funded and the assets passing to the trust will use the first spouse's exclusion amount, even if a Form 706 is not required and filed.

(6) The DSUE amount can be misused. In second marriage situations with taxable estates, where traditional formula A/B planning has not been done, and the estate of the first to die passes outright to the surviving spouse in a QTIP trust, the executor (who might also be the surviving spouse) could make a portability election and a QTIP election (if the plan includes a marital trust), but then the surviving spouse could make gifts to his or her children using the DSUE amount of the first to die, leaving no exclusion amount to apply against the marginal tax generated by the QTIP. With traditional A/B trust planning, the exclusion amount of the first spouse to die would have been used on the first death, where it could not have been co-opted by the surviving second spouse.

Authorize the fiduciary to make the portability election. Consider adding a provision to planning documents authorizing the executor to make the portability election on a timely filed Form 706. Since significant expense may be incurred, it is appropriate not only to authorize the election but to provide that it be a cost of administration. An alternative clause might provide that the surviving spouse could compel the executor to make the election, but only if the surviving spouse pays the cost. Caution is advised, however. In some circumstances, such as a second marriage with two sets of children, the expense of the portability election could potentially be borne by the children, as beneficiaries of the first spouse to die, while the benefits of the election would

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accrue to the children of the second spouse to die.

Combined assets (and taxable gifts) below $5.34 million. From an estate and income tax perspective, a married couple with combined assets, the value of which, together with taxable gifts made during life, is never expected to exceed the estate and gift tax exclusion amount, could safely execute what are colloquially referred to as "I love you" wills on the first death. These wills leave all assets to the surviving spouse on the first death and outright to descendants (or other devisees) on the second. No estate tax will be due on the first death due to the unlimited marital deduction, and none will be due on the second death due to the large exclusion amounts currently in effect. Traditional bypass trust planning will not be necessary for estate tax avoidance purposes.

Because the $5 million exclusion amount is indexed for inflation, it will likely keep pace with even the most ambitious saving and investing program. The inflation adjustment from 2012 to 2013 was $130,000 (increasing from $5.12 million to $5.25 million), about 2.6% of $5 million. The adjusted exclusion amount for 2014 is $5.34 million, for an increase of $90,000. Few surviving spouses in this situation will see their assets grow beyond the estate tax exclusion amount available to them on their death, which of course will

not only consist of their own exclusion but, in some cases, the DSUE amount from the first deceased spouse, if an election is made.

Section 1014 , as discussed below, provides a basis adjustment to all of the assets includable in the surviving spouse's gross estate equal (in most cases) to fair market value on his or her date of death. Therefore, if the surviving spouse owns all of the marital assets acquired by the couple during life on his or her death, the tax basis in the entire estate will be "stepped-up" (or down, as the case may be).

Notwithstanding the likelihood of a positive result for income tax purposes, $2.5 million (assuming each spouse owns half of the probate estate) is still a lot of money. There are many good reasons to create trusts for surviving spouses and descendants, even if federal estate tax is no longer a concern.

Second marriages. Many spouses are concerned that a new spouse could dissipate the marital assets that should rightly pass to children from the first marriage through commingling, profligacy, undue influence, or elections for a spousal share. While a marital agreement might be the best protection, a trust is a powerful tool (and one the first decedent can control), especially as regards commingling of assets and reckless spending. Further, in second marriage situations, where one or both of the parties have children from previous marriages, the first spouse to die may not want to leave his or her children's inheritance completely up to the surviving spouse. A trust for the spouse's benefit during his or her life, with the remainder to the decedent's descendants is a tried and true approach.

Incapacity. It might be advantageous to preserve the assets in trust for a spouse or descendant who lacks capacity. In certain circumstances, a special needs trust (SNT) might be desirable. The structure of such a trust will vary depending on state law.

Creditors. Creditors of trust beneficiaries in many states can attach trust assets only where the debtor beneficiary can compel the trustee to make a distribution, (e.g., unitrust payments). Where trustees have "uncontrolled discretion" regarding distributions, creditors may often be kept at bay indefinitely. **8** Spendthrift provisions, which provide that the beneficiary cannot sell, pledge, or encumber his or her beneficial interest in the trust, and that a creditor cannot attach a beneficiary's interest, should be included as well, even though pure discretionary trusts may not necessarily need them. **9**

Spendthrift tendencies. As discussed above, and is generally recognized, a well-drafted trust, preferably with a corporate trustee (or at least co-trustee) can be very effective in protecting a beneficiary from himself or herself.

Trusts for descendants. Trusts can be created for children and more remote descendants, eventually passing to skip persons (grandchildren or more remote descendants) without payment of estate or GST tax. For such trusts, it will be important that GST exemption be properly allocated.

Combined assets (and taxable gifts) between $5.34 million and $10.68 million. Midsized estates (i.e., larger than one applicable exclusion amount, but smaller than both combined) have always

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presented planning conundrums, even when the exclusion amount was of a more modest size. Again, from a pure transfer tax perspective, portability will provide a significant planning backstop, allowing a post-death election by the surviving spouse to use the decedent's DSUE amount along with his or her own applicable exclusion amount. However, the reasons discussed above for creating trusts on the first death, coupled with the fact that the GST exemption is not portable, incline one to consider the following plans where post-mortem choices and elections can determine the amounts passing from the decedent that will qualify for the marital deduction or pass to a bypass trust.

Disclaimers. Disclaimer plans have long been used as a "wait and see" post-mortem technique allowing the surviving spouse to disclaim all or part of an outright devise to him or her to a bypass trust (or outright to descendants) which would avoid estate tax inclusion in the surviving spouse's estate. Any growth in value in the bypass trust would also escape estate taxation, but would be subject to capital gains tax on the sale of assets by the trust or ultimately by beneficiaries to the trust. This was an easier decision when the marginal estate tax rate was 55% compared to an approximate capital gains rate of 20%.

Disclaimers present problems, however. The survivor must obtain qualified and timely legal advice after the death of the first spouse.

Also, the bypass trust cannot allow the disclaiming spouse a power of appointment, unless limited to an ascertainable standard (which is not practical with a testamentary power of appointment). Especially in a second marriage situation, the surviving spouse may not be motivated to disclaim property to a trust that will pass to unrelated remainderpersons (e.g., children from the decedent's first marriage). Finally, qualified disclaimers must be made within nine months of the first spouse's death with no exceptions or extensions.

"One lung" (or non-formulary) QTIPs, with or without disclaimers. One lung QTIPs gained a following with the ongoing uncertainty during the last few years surrounding the fate of the estate tax and the size of the exclusion. Very generally, on the first death, the entire residue would pass to a marital trust that would qualify for the unlimited marital deduction under **Section 2056(b)(7)** , if the required election was made on the decedent's Form 706. The regulations allow for partial elections. **10** Under the laws of many states and pursuant to the authority provided in most such trusts, the marital trust can be divided into a share for which a QTIP election has been made and a share for which no election has been made. The QTIP share will qualify for the marital deduction and eventually be included in the survivor's taxable estate under **Section 2044** .

The partial election would historically have been made only if necessary to reduce federal estate taxes to zero. A reverse QTIP election can also be made under **Section 2652(a)(3)** to treat the QTIP trust as if the first decedent is the transferor for Chapter 13 purposes even after the survivor's death. This allows maximum use of both spouse's GST exemptions.

The spousal trust beneficiary can be provided a right to disclaim to a bypass trust, in the event that spray provisions to descendants are considered more desirable than the required QTIP provisions. The spousal

beneficiary can also be given a limited testamentary power of appointment over the QTIP trust (unlike over the bypass trust in a disclaimer plan, as discussed above). **11** Coordinating the QTIP election and the portability election is discussed below.

Clayton QTIPS. **Regs. 20.2056(b)-7(d)(3)** and 7(h), Example 6, allow the following planning opportunity: The testator can direct that property will pass to a QTIP trust, but if the QTIP election is not made as to some or all of the trust, then the non-elected portion will pass to, or for the benefit of, different persons, including a trust which would not qualify for the marital deduction. Unlike a trust funded by way of a disclaimer, the trust could provide the spouse with a special power of appointment. Further, the personal representative has up to 15 months (or possibly longer) after the death of the decedent to make the election. **Reg. 20.2056(b)-7(b)(4)** provides that to be valid, an election must be made on "the last estate tax return filed by the executor on or before the due date of the return, including extension, or, *if a timely return is not filed, the first estate tax return filed by the executor after the due date*" (emphasis added).

An independent, non-spouse personal representative should make the election, rather than the surviving spouse, to avoid breaching fiduciary obligations and to counter the argument that the surviving spouse made a gift by making, or possibly not making, the QTIP

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election. Even an independent personal representative is still bound by fiduciary obligations, however. The executor could be exonerated in the document for this election (or failure to elect).

If a QTIP election is not necessary, but the terms of the QTIP are preferable to the terms of the alternative devisee (presumably a bypass spray trust), may an unnecessary QTIP election be effectively made? See the discussion regarding **Rev. Proc. 2001-38** , below.

Formulas. As has been widely discussed since the estate tax exclusion amounts began moving into the stratosphere in 2009 when the applicable exclusion amount increased from $2 million to $3.5 million, traditional "reduce to zero" marital deduction formula plans risk overfunding the bypass trust in many cases, leaving the surviving spouse with few assets over which he or she has much control, or ultimately subject to a basis adjustment under **Section 1014** on his or her death. This will be especially problematic in plans where the marital share and the non-marital (bypass trust) share benefit different remainder beneficiaries, especially if the bypass trust will pass to beneficiaries that the surviving spouse may not favor, such as the first decedent's descendants from a prior marriage.

A planner could consider capping the amount passing to the bypass trust. However, this will increase the marital share, and potentially increase estate tax includability. As long as the marital share passes to a trust for which a valid QTIP election can be made and the executor has the authority to make a partial QTIP election and divide the trust, the taxable portion of the marital trust need not be overfunded. Even if it is, portability should alleviate the problem in most cases.

GST planning. If the clients desire to maximize use of both GST exemption amounts, both spouses need

to fund exempt trusts or otherwise pass assets to skip persons. If the children and the children's descendants (the skip persons) are all descendants of the couple, traditional bypass trust planning could be employed. This, of course, requires that each spouse have roughly half of the marital assets so that GST exemption can be allocated on the first death.

If it is not feasible or desirable to transfer assets outright between spouses, consideration should be given to use of a lifetime QTIP under **Section 2523(f)** . If properly drafted and the requisite election is made on the settlor's timely filed Form 709, the lifetime QTIP will qualify for the marital deduction and on the death of the spouse for whose benefit the lifetime QTIP was created, the trust will be included in his or her estate under **Section 2044** , allowing that spouse to be the Transferor for Chapter 13 purposes under Section 2651(a)(1)(A). This, of course, assumes that the donor spouse did not make a "reverse QTIP" election under **Section 2652(a)(3)(b)** .

Combined assets (and taxable gifts) exceed $10.68 million. The estates of these clients will continue to be subject to the estate, gift, and GST tax, as before. Except for portability, ATRA did not change the basic structure of Chapters 11, 12, 13, and 14. The transfer tax techniques that worked before ATRA will continue to work for these clients. This, of course includes well-drafted planning documents, using formula marital deduction and GST trust planning. Estate reduction planning should be continued with the use of leveraged gifts. These techniques have included, and should continue to include, discounted gifts with closely held family entities, such as LLCs and FLPs, and undivided interest in property discounts. Life insurance (generally held in ILITs) should continue to be considered where liquidity will not exist to pay estate tax. Lifetime gifting, including the efficient use of annual exclusion gifting should be encouraged.

Freeze techniques, such as QPRTs, GRATs, and sales to IDGTs should continue to be considered and implemented.

Formulas. Traditional marital deduction formulas and GST trust formulas will work as efficiently for these couples as they ever did. In fact, with the ever-increasing exclusion amounts, due to annual indexing, these formulas will be more necessary than ever to soak up the additional exclusion amount available to decedents who may have used most of their available exclusion through lifetime gifting. Consider the inclusion of disclaimer provisions in bypass trusts, however, for clients with little remaining exclusion amount, as the cost of trust administration may be unwarranted for small amounts representing only the exclusion provided by indexing. Broad authority in the (non-beneficiary) trustee to terminate and distribute the trust may also be desirable.

QTIP trusts. These versatile trusts are widely used and will be the staple of most planning for high net worth married couples. The one lung QTIP trust, discussed above, can be a very effective vehicle for these clients, for most of the same reasons discussed with regard to the mid-sized estates. Where estate tax is a certainty, the QTIP election will almost certainly be made in every case, at least for a portion of the trust. Therefore, it is recommended that the authority for a partial election and subsequent division of the trust be provided in

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the planning document. Direction should also be provided regarding further trust division to facilitate a reverse QTIP election. The right in the surviving spouse beneficiary to disclaim to a bypass trust with spray provisions should be considered.

The surviving spouse may be given a power of appointment exercisable on death. This should be a limited, non-general power of appointment. If the surviving spouse is given a general power of appointment as defined in **Section 2041** , neither a partial QTIP election nor a reverse QTIP election will be possible.

GST planning. GST planning will remain as viable as ever, maybe more so, as the affluent seek to preserve their wealth for the benefit of their children and grandchildren. This planning may often combine gift planning with testamentary GST planning. Lifetime trusts funded with life insurance or other assets are often structured to be GST exempt. The terms of these trusts may be mirrored in the testamentary documents, so that trusts created after the second death using remaining GST exemption may be merged with the lifetime exempt trusts.

Again, formula or one-lung QTIP plans will be necessary to efficiently use the GST exemptions of both spouses, as the new portability provisions do not apply to the GST exemption. It will also be essential that each spouse have sufficient assets in his or her own name to fund a GST exempt bypass trust or over which a reverse QTIP election may be made.

Maximizing basis adjustment on the second death

The general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death, or, if the decedent's executor so elects, at the alternate valuation date prescribed in **Section 2032** . **12**

Property acquired from a decedent includes, principally, all property acquired from a decedent, which is includable in the gross estate of the decedent if the decedent died after 1953. It is not necessary that an estate tax return be required to be filed for the estate of the decedent or that an estate tax be payable. Property acquired prior to the death of a decedent which is includable in the decedent's gross estate, such as property transferred by a decedent in contemplation of death, and property held by a taxpayer and the decedent as joint tenants or as tenants by the entireties is within the scope of this rule. The rule also includes property acquired through the exercise or nonexercise of a power of appointment where such property is includable in the decedent's gross estate. **13**

The goal will generally be to include as much property as possible in the surviving spouse's estate without triggering an estate tax.

QTIP trusts and basis adjustments. Property acquired from a decedent also includes property includable in the gross estate of the decedent under **Section 2044** (i.e., property for which a valid QTIP election was made pursuant to **Section 2056(b)(7)** by the executor of the first spouse to die).

Therefore, theoretically, even in an estate with little or no potential for estate taxation, a timely QTIP election could be made for property devised to a properly drafted QTIP trust on the first death. A portability election could also be made on the same estate tax return. The property would then be included in the survivor's estate under **Section 2044** . As long as the survivor's gross estate, including the QTIP trust, is safely under the applicable exclusion amount, together with DSUE amount received from the deceased spouse, no estate tax will be due, but the trust beneficiaries will obtain an adjusted basis in all of the assets. This would not be the case with a bypass trust.

The Temporary Regulations issued in June 2012 indirectly approve this planning by illustrating the Form 706 return preparation requirements in an example where the decedent left his entire nontaxable probate estate to a QTIP trust for his spouse, for which a QTIP election has been made. **14**

Is this planning too good to be true? The IRS issued **Rev. Proc. 2001-38 15** in response to numerous requests for relief in situations in which the estate of the first spouse to die made an unnecessary QTIP election. The Procedure notes that in some cases QTIP elections were made when a taxable estate (before allowance of the marital deduction) was less than the applicable exclusion amount under **Section 2010(c)** . The QTIP election was not necessary because no estate tax would have been imposed whether or not the QTIP election was made. In other cases, QTIP elections were mistakenly made for bypass trusts.

A QTIP election once made is irrevocable and carries tax implications for the surviving spouse, not the least of which is inclusion in his or her taxable estate. Specifically, the procedure applies to cases where the election was not necessary to reduce the estate tax liability to zero. **16** If the election is within the scope of the Procedure, the election will be ignored for federal estate and GST tax purposes, and the property will not be subject to transfer tax

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in the surviving spouse's estate. The Procedure sets forth a process whereby the taxpayer can establish his or her right to relief. It does not state whether the IRS could ignore an election within the scope of the procedure of its own accord or whether the relief is solely within the control of the taxpayer. This is the crux of the issue.

The portability question would arise in the following circumstance: Al died in 2011 leaving his entire $4 million estate to a QTIP trust for Betty. Al had made no taxable gifts. His basic exclusion amount is $5 million. The QTIP election is made and the portability election is made. The QTIP trust is within the scope of **Rev. Proc. 2001-38** (as the election was not necessary to reduce the estate tax liability to zero). Was Al's entire $5 million DSUE amount ported to Betty?

The plain language of the Procedure would appear to allow the taxpayer to have it both ways. If the assets in the QTIP appreciate to $5 million, the Procedure could be invoked, voiding the QTIP election. In this case, $1 million of DSUE amount is preserved, as compared to having the $5 million trust included under **Section 2044** with $5 million of DSUE amount. The $1 million of DSUE amount remains because if

the QTIP election is voided, only $4 million of Al's exclusion was used on his death. If the assets in the QTIP go down in value to $3 million, the election would be left in place, resulting in a $3 million inclusion under **Section 2044** with $5 million of DSUE amount. The concern is that the IRS would declare the QTIP election void of its own accord to avoid this result. Proceed with caution, pending further word from the IRS.

General power of appointment trusts under Section 2056(b)(5) . A trust drafted to comply with the requirements of **Section 2056(b)(5)** (sometimes referred to as a GPOA trust) will be included in the surviving spouse's estate under **Section 2041** , thus qualifying for basis adjustment under **Section 1014** . GPOA trusts do not have the planning flexibility of QTIP trusts. However, a GPOA trust does not require an election for it to be treated as qualifying (fully or partially) for the marital deduction. Therefore, **Rev. Proc. 2001-38** will have no application, and there is no risk that the IRS could "undo" the marital deduction and the resultant estate tax inclusion which will yield the basis adjustment on death.

While both GPOA trusts and QTIP trusts are includable in the taxable estate of the surviving spouse, the estate tax calculation at the survivor's death is very different and the right to reimbursement from the trust estate may be more easily waived by the surviving spouse with use of a GPOA trust.

To qualify as a GPOA trust, for marital deduction purposes, the surviving spouse must have a right to all of the income for life, and no other person may be a beneficiary of the trust. The surviving spouse must also be given a general power of appointment over the trust, exercisable during his or her life or by will, or both.

Be aware that any trust for the benefit of a surviving spouse under which the spouse has a general power of appointment as defined in **Section 2041** will be included in the surviving spouse's estate and entitled to a stepped-up basis, whether or not it qualified for the marital deduction on the first death. However, to the extent it did not qualify for the marital deduction on the first death (e.g., the trust would terminate on the surviving spouse's remarriage), it would have used some of the basic exclusion amount available to the first spouse, hence reducing his or her DSUE amount. This will need to be considered on a case-by-case basis.

A GPOA trust may offer less creditor protection than a QTIP trust, especially if the spouse holds a lifetime power of appointment. [17]

Estate trusts. Another trust arrangement that does not require an election and would not be affected by **Rev. Proc. 2001-38** is the "estate trust." If at the termination of a trust created for the sole lifetime benefit of the surviving spouse, who is a U.S. citizen, the trust corpus, and any accumulated income, will pass to the surviving spouse, or his or her estate, the property passing to the trust from the decedent will qualify for the marital deduction. [18] Because no person, other than the surviving spouse, or his or her estate, receives any interest in the property, no exception from the terminable interest rules is necessary.

The advantages of an estate trust are that the corpus will qualify for the marital deduction in the decedent's estate, but the trust income need not be distributed to the surviving spouse. This may be

advantageous if the surviving spouse has independent income that is already taxed at a higher bracket. Moreover, unproductive property can be held as an asset of an estate trust, even without the consent of the surviving spouse. While this trust will be entitled to a basis step-up under **Section 1014** because it will be included in the gross estate of the surviving spouse, the most obvious disadvantage is that the trust corpus must pass through probate at the surviving spouse's death

and thus would be subject to estate administration expenses and claims of the spouse's creditors.

Intentional estate inclusion. In a case where clearly no estate tax will be due, but basis adjustment is desirable, it may be worthwhile to review the client's prior transfers with an eye towards includability. **Section 2036** includes in a decedent's gross estate the value of property that was transferred by the decedent during the decedent's lifetime if the decedent retained or reserved the use, possession, right to income, or other enjoyment of the transferred property.

To avoid characterization as a retained interest, the decedent must have "absolutely, unequivocally, irrevocable and without possible reservation" parted with all of his or her title, possession, and enjoyment of the transferred assets. **19**

In *Estate of Trombetta*, **20** an "implied agreement" (resulting in estate inclusion) was found where the decedent, after transferring property to an irrevocable trust, made all decisions with respect to the property, took the lead role in negotiating the refinancing of the property, and retained sole signatory authority with respect to disposition of the property. She also retained the right, along with the co-trustees (her children), to distribute excess income to herself.

In *Estate of Riese*, **21** a house in a QPRT was not included in the decedent's estate, despite the fact that the decedent failed to pay rent to the remainder beneficiaries of the QPRT for the six months between the termination of the trust term and decedent's death because it was found that there was an agreement and understanding that the decedent was supposed to pay rent. It may be worth exploring terminated QPRTS nevertheless for situations where lack of rent was not accompanied by an agreement to pay, if estate inclusion is the goal.

Re-examine assets subject to valuation discounts or control premiums. An interest in an undivided interest, as tenants in common, in property owned by a decedent at death (or if gifted) will usually be entitled to a discount, generally due to the potential cost of a partition. Tenancy in common property between spouses can be easily changed to joint tenancy property, which will not be eligible for a discount in the estate of the first co-tenant to die. **22** Alternatively, one co-tenant spouse can convey his or her interest to the other spouse who would then own the whole, thus eliminating the discount.

Tenancy in common property between spouses (or non-spouses) could be partitioned physically, creating two independent wholly owned assets. The partition of an undivided single property into independent properties is not usually a taxable event for income tax purposes. **23**

Consideration may be given to liquidation of FLPs or LLCs created for the purpose of obtaining valuation discounts in the past. Generally, a partner does not recognize gain on a distribution of assets from a partnership except to the extent that money distributed exceeds the partner's basis in the interest. [24] Proceed with caution, however. The distribution to one partner of appreciated property contributed by another partner within the seven years preceding the distribution will cause the contributing partner to recognize the pre-contribution appreciation, as if the partnership had sold the property at its fair market value on the date of distribution. [25] Also, in many, if not most, cases there are valid state law creditor protection reasons for holding business and investment assets in a limited liability entity.

Application of a control premium to the majority shareholder's stock for estate valuation purposes could result in a higher basis for capital gains purposes under **Section 1014** . [26]

Conclusion

The increased applicable exclusion amount and the advent of portability have changed the playing field significantly. Formula marital deduction plans and discounting techniques may not be a practitioner's first priority in every plan, as they were for many years. A very different set of rules will now need to be considered. In many cases, more options will be available. However, since the changes are so recent, practitioners have little guidance and should proceed cautiously.

1

Act section 101(a)(1).

2

Section 2010(c)(5) .

3

Temp. Reg. 20.2010-3T(a)(3) .

4

Temp. Reg. 20.2010-3T(a)(2) .

5

Temp. Reg. 25.2505-3T(b).

6

See **Temp. Reg. 20.2010-3T(b)** .

7

Section 1411 .

8

See In re Marriage of Jones, 812 P2d 1152 (Colo., 1991); Goforth v. Gee, 975 SW2d 448 (Ky., 1998); Uniform Trust Code (UTC) section 504(b); Restatement (Third) of Trusts section 60.

9

UTC section 502; Restatement (Third) of Trusts section 58.

10

Reg. 20.2056(b)-7(b)(2)(i) .

11

Section 2056(b)(7)(B)(ii)(II) .

12

Section 1014 ; **Reg. 1.1014-1(a)** .

13

Reg. 1.1014-2(b) .

14

Temp. Reg. 20.2010-2T(a)(7)(ii)(C), Example 2 .

15

2001-1 CB 1335.

16

See, e.g., **Ltr. Rul. 201338003** .

17

See UTC section 505(b). (The UTC has been adopted in 26 states.)

18

Regs. 20.2056(c)-2(b)(1)(i) , (ii), and (iii).

19

Estate of Trombetta, **TC Memo 2013-234** , RIA TC Memo ¶2013-234, 106 CCH TCM 416 (citing Estate of Church, **37 AFTR 480** , 335 US 632, 93 L Ed 288 (1949)). See also Estate of Thompson, 382 F.2d 367 (CA-3, 2004), holding that "whether a decedent retained an interest in transferred property depends upon whether there is an express or implied agreement at the time of transfer that the transferor will retain lifetime possession or enjoyment of, or right to income from, the transferred property." Transfers of property where the decedent continued to exclusively use the property may support the position that the decedent retained possession or enjoyment pursuant to an agreement with the donee and therefore the property should be included under **Section 2036** . See Estate of Linderme, **52 TC 305** (1969) (house

included in decedent's estate where the decedent had transferred ownership to his three sons in 1956 but continued to live in the home until he entered a nursing home in 1963. The house remained vacant until the decedent died in 1964). See also, **Rev. Rul. 70-155, 1970-1 CB 189** , holding that a donor's continued exclusive occupancy of a transferred residence rent free until death, pursuant to an understanding by all parties, is includable in his gross estate; see also **Rev. Rul. 78-409, 1978-2 CB 234** .

20

Note 19, *supra.*

21

TC Memo 2011-60 , RIA TC Memo ¶2011-060, 101 CCH TCM 1269 .

22

Section 2040(b) .

23

See **Ltr. Ruls. 9633028** and **9327069** .

24

Section 731(a) .

25

Section 704(c) .

26

Estate of Salsbury, **TC Memo 1975-333** , PH TCM ¶75333, 34 CCH TCM 1441 .

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