A Tsunami in the Estate Planning World

The 2013 Tax Act, subtlety emerging into our estate planning life much the same way the IPhone has subtlety reduced our available free time, has had major impacts on our practice as estate planners.

Quantitatively, not many estate and gift tax provisions were changed. The two most dominant alterations were an increase in the estate and gift tax exemption to what is now an indexed 5.45 million amount, and the advent of portability.

But those two changes have drastically altered the estate practitioner's practice landscape in a tremendous variety of areas:

1. Type of estate tax plans and how to draft for them.
2. Advocacy of changing title between spouses
3. Types of planning done for clients
4. IRS reviews
5. Development of new practice areas
6. Commodization
7. Malpractice
8. Domicile planning
9. Life insurance
10. Basis planning
11. Unwinding of family limited partnerships
12. Charitable planning (specifically, charitable lead trusts)
13. GRATs.

This article, part one of a multi part discussion, will focus on the first item and how planners should have evolved their practice consistent with the impact of the [2013 Act] on these areas.

Building a Pyramid

Portability and income tax planning, which essentially have to be a “wait and see” decision until the first spouse passes away, have caused the estate plan documents to be potentially extremely complicated to construct, or brutally easy.

Easy. Use the single fund QTIP trust in Your Planning.

Marriage may be a Hassle, but the Marital Deduction Remains Important in Husband and Wife Estate Planning

Almost all of husband/wife estate planning involves a marital deduction, either an outright marital or a trust benefitting the surviving spouse. Greater than 50% and probably closer to 75% to 80%, of gifts to the spouse are in the trust format. Certain trusts qualify for the marital deduction and others do not.

Most trusts these days will be in the qualified terminable interest property ("QTIP") format in order to qualify for the marital deduction. The older variety, the general power of appointment trust, was proper pre-1982 and has been disappearing ever since. Moreover, because of portability, most trusts are set up with either a single fund QTIP or a credit shelter trust also qualifying for the QTIP, with the expectation that Rev Proc 2001-38 will not interfere with a QTIP election done to increase the portability amount (i.e., over a portion that otherwise would not be subject to estate tax because of the $5.45 million exemption amount).

To Be or Not Be QTIP

For a proper QTIP, among the major requirements that are reviewed on audit, there must be a mandatory income interest to the surviving spouse ("The trustee shall pay to my spouse all income not less often than annually." (Note, not discretionary.)

Also, no person other than the surviving spouse can be beneficiary of the trust during the spouse's lifetime. A trust that allows the trustee to distribute principal to either the spouse or children, even pursuant to an ascertainable standard, would not qualify.

And lastly, a QTIP election must be made on the Form 706, Schedule M.

In 1982, We Spoke of the Single Fund QTIP Endearingly. Post 2013, We Should Speak of it with Reverence

With the advent of portability, as well as divergent state inheritance tax statutes, the single fund QTIP may be the most practical strategy in will and trust drafting. One predicate needs to be noted-there is an older IRS ruling, Rev Procedure 2001-38 that could imply that QTIP status could not be "electable" if there is already no estate tax. This was recently given life blood in a private letter ruling, PLR-110405-15, January, 2016.

That is, if the gross estate were $5 million, no lifetime taxable gifts, and the surviving spouse wanted to elect QTIP status, the ruling could be interpreted to mean "no," because even without QTIP status being elected there would be no estate tax.

The estate planning community has advocated for clarification that QTIP elections in estate tax returns required only to elect portability are valid. We would hope the Treasury understands the practical reasons to practitioners to allow for this flexibility. Assuming the Treasury allows for this result, the single fund QTIP allows the practitioner to achieve the following for his or her client:

1. For the portability decision to be decided at the surviving spouse's passing; estates may want to include 100% of the property in the surviving spouse's estate in order to achieve a step-up in income tax basis. The goal will be either is to make a partial QTIP election in order to create a credit shelter trust out of the non-elected portion (the $5.450 million

estate tax exclusion amount) or a full QTIP election in order to put all the property in the surviving spouse's estate for basis step up reasons. [1]

2. For state inheritance tax to be avoidable at the first spouse's passing if that state has a QTIP marital deduction, even if that state has a credit that is decoupled from the federal credit.
3. Ease in drafting.
4. Ease in client understanding.
5. Ease in administration until multiple trusts are created (post-mortem).
6. Commonality of trust terms.

With All Its Warts, Here Then is the Drafting

The way of the drafting world these days are complicated forms made even more complicated because of portability, Clayton elections, state inheritance taxes, and the $5.45 million dollar current exemption.

The most simplified estate plan that incorporates all the possible trusts that should be created at the first spouse's passing in a GST plan would read as follows:

> 3.3 **Gifts if Spouse Survives.** If my spouse survives me, then I make the following gifts:
>
> (a) **Non-Qualified Property**. I give the non-qualified property that is included in my estate for federal estate tax purposes to the trustee to hold as the GST Family Trust, but only to the extent that the value of this property as finally determined for federal estate tax purposes does not exceed my Available GST Exemption Amount. I give any remaining non-qualified property to the trustee to hold as the Family Trust.

[1] This flexibility would be eliminated if Revenue Procedure 2001-38 is interpreted by the Service to not allow for QTIP elections when there is no estate tax. In that instance, though, the flexibility for planning for portability will become more difficult in all settings, whether it is a single fund QTIP or a credit shelter trust.

(b) **State Exempt Gift**. I give the State Exempt Gift to the trustee to allocate in portions as follows: The trustee shall hold the GST State Exempt Gift portion as the GST Family Trust and shall hold the non-GST State Exempt Gift portion as the Family Trust.

(c) **Excess Federal Exempt Gift**. I give the Excess Federal Exempt Gift to the trustee to allocate in portions as follows: The trustee shall hold the GST Excess Federal Exempt Gift portion as the GST Election Trust and shall hold the non-GST Excess Federal Exempt Gift portion as the Election Trust.

(d) **Residue Gift**. I give the Residue Gift to the trustee to allocate in portions as follows: The trustee shall hold the GST Residue Gift portion as the GST Marital Trust and shall hold the non-GST Residue Gift portion as the Marital Trust.

Really? Can a client understand that? Does a client want to understand that? Can you? Your 4th year associate? How does portability play into this?

Life would be so much easier if you had a bequest that said: "I give the Balance of the Trust Estate to the trustee to hold as the Marital Trust."

And you can.

Easy for the client to understand? You bet, and you can say that portability can be decided on[2]; the credit shelter can be decided on; deferral of state inheritance tax can be decided on.

Marital Trust

The trustee shall administer the Marital Trust as follows:

1.1 ***Mandatory Payment of Income.*** *Beginning with my death, the trustee shall pay all the income to my spouse at least annually. Notwithstanding any other provision of this*

[2] See fn. 1 though because the impact of Revenue Procedure 2001-38 is not yet known.

instrument, on the death of my spouse any accrued or unpaid income shall be paid to my spouse's estate.

1.2 ***Discretionary Payment of Principal.*** *Beginning with my death, the trustee may pay to my spouse as much of the principal as the trustee from time to time considers necessary for the health, education, support, or maintenance in reasonable comfort of my spouse.*

1.3 ***Power of Appointment at Death***. *On the death of my spouse, the trustee shall distribute the principal not required for payment of the Marital Trust Death Taxes to any one or more of my descendants, or any one or more charitable organizations which shall then be in existence as entities described in Sections 170(c) and 2055(a) of the Code, as my spouse appoints by Will, specifically referring to this power of appointment.*

1.4 ***Distribution on Termination***. *On the death of my spouse, the trustee shall distribute the Marital Trust as follows:*

(a) ***Make-Up Charitable Gift***. *The trustee shall distribute the Marital Trust principal not required for payment of the Marital Trust Death Taxes, not otherwise effectively appointed, Madison Youth Programs, if it is then in existence, for its general charitable purposes.*

(b) ***Child's Separate Trusts***. *I give the principal of the Marital Trust not required for payment of the Marital Trust Death Taxes and not otherwise effectively appointed, which shall remain after the application of subparagraph (a) of this paragraph, to the trustee to allocate in shares of equal value for my then living children, subject to the Child's Separate Trust withholding provisions hereof; provided that if a*

child of mine shall not then be living but a descendant of the child shall then be living, the trustee shall distribute the share that would have been allocated for the deceased child, if living, per stirpes to the child's then living descendants.

The Proof is in the Post-Mortem Pudding

The engineering occurs after the first spouse passes away. A distribution is made to the marital trust. Then the practitioner begins his or her work.

A QTIP election can be made over a fraction of the marital trust for state or federal purposes. Assume a $4,000,000 state exempt trust is needed, and a $5,000,000 federally exempt trust is needed as to total property in the trust of $10,000,000. The federal QTIP percentage is then 5/10; and since a $1,000,000 trust is needed for state QTIP purposes, then you elect 1/10 for state QTIP over the full property (essentially 20 % of the non QTIP portion).

Three shares then: 50% is federally elected QTIP; 50% has no election over it for federal purposes; and as to that 50 % over which no QTIP election is made, 20 % of that (10% overall) has a state QTIP election. All three shares are created as separate subtrusts prior to the filing of the federal estate tax return, nine months after date of passing. And at that time of creation and funding, the Trustee should fund and divide the trust into separate trusts, using date of funding values to satisfy these fractions.

And the estate planner's world pre-mortem is perhaps a happier place.