

NAVIGATING THE POST-ATRA UNIVERSE  
(and documenting the flight plan)

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**I. INTRODUCTION.**

The American Taxpayer Relief Act of 2012 (“ATRA”) was passed January 2, 2013. Prior to ATRA, choosing an estate plan design was typically clear-cut. While there has always been collateral damage, so to speak, with each design (e.g., no step-up in basis for a bypass trust), the pros typically outweighed the cons so that the decision was simpler. Now with a higher estate tax exemption, lower estate tax rates, higher capital gains taxes, and portability, choices have multiplied, the lines have blurred, and the decision is not as clear-cut. In a post-ATRA universe, it is critical for the professional to ascertain and prioritize the client’s major concerns and objectives in order to navigate the choices.

**II. BEFORE ATRA.**

**A. Estate Tax Exemptions.** Historically, estate tax exemptions were modest. The estate tax exemption from 1948 to 1976 was \$60,000. From 1976 to 1986, the estate tax exemption was gradually phased in to \$600,000. In 2001, the estate tax exemption was incrementally increased over the next ten years (e.g., \$3.5 Million in 2009) with the threat that higher exemptions could sunset back to \$1 Million if Congress did not extend or enact the law permanently. During this period, unless the taxpayer died in a particular year with the increased estate tax exemption, he or she had no assurance that the future exemption would be greater than \$1 Million.

**B. Estate Tax Rates.** Until 2011, the highest estate tax rates were 50%-55% which were considerably higher than the capital gains tax rates.

**C. No Portability.** Prior to 2011, if one spouse died and left all assets to the surviving spouse, the first spouse’s estate tax exemption was lost. This

was commonly referred to as a stacking problem: the surviving spouse owned all assets with only one estate tax exemption to shelter the estate from estate tax. Many couples were concerned their estates would exceed one exemption.

**D. Pre-ATRA Wills/Revocable Management Trusts.** Since the estate tax is due generally nine months after death regardless of whether assets are sold or not, and with such high estate tax rates, the clear focus of most couples was to reduce or eliminate the estate tax. If the spouses’ joint estate exceeded one exemption and they wished to benefit each other at the first passing, a testamentary bypass trust was used. The bypass trust held the deceased spouse’s assets for the surviving spouse’s benefit while excluding them from the surviving spouse’s estate. The bypass trust was typically funded with assets equal to or less than the decedent’s remaining estate exemption amount. Although the bypass trust had certain disadvantages such as maintenance costs and no step-up in basis, these were clearly outweighed by potential estate tax savings. See the simple flowchart (Appendix 1).

**E. Many Testamentary Bypass Trusts in Existing Plans.** Consequently, many testamentary bypass trusts have been included in Wills and Revocable Management Trusts over the last few decades and many still exist in couples’ plans today. For younger lawyers, it is important to know these pre-ATRA factors in order to understand why their clients with modest estates have these testamentary trusts in their existing documents.

**III. POST-ATRA UNIVERSE.**

**A. Estate Tax Exemption.** The estate tax exemption for 2016 is \$5.45 Million per person,

and it is indexed for inflation, so presumably it will increase each year.

**B. Estate Tax Rates.** The maximum estate tax rate currently is 40%.

**C. Portability.** Internal Revenue Code Section 2010(c) (that is, portability) provides that the executor at the first spouse's death can decide whether to elect portability. Under portability, the executor may elect on Form 706 for the surviving spouse to carry over the deceased spousal unused exclusion (DSUE) amount. Thus, a surviving spouse receiving all of the decedent's assets as an outright marital bequest could add the DSUE to his or her own exclusion amount. For many clients, portability allows the client to design a much simpler plan such as an outright marital bequest. Nevertheless, outright marital bequests and portability have their own pros and cons that must be weighed. Portability could also be used in conjunction with a QTIP trust.

**D. Estate Tax vs. Capital Gains Tax.** Less than 1% of future estates might pay estate tax; however, the great majority of heirs could owe capital gains tax upon selling inherited assets that don't benefit from a step-up in basis. Does this mean 99% of all couples should adopt outright marital bequests so that the heirs may receive a step-up in basis at the surviving spouse's death? No. Many couples have non-tax reasons for creating a spousal testamentary trust due to concerns about: 1) a surviving spouse's remarriage, 2) a spouse changing the ultimate disposition, 3) asset protection, or 4) children by a prior marriage of either spouse.

**E. New Focus on Step-Up in Basis.** Post-ATRA has put a new focus on step-up in basis at the surviving spouse's death for estates of \$11 Million or less. While this is justified, certain factors may lessen such emphasis. The surviving spouse's age could have a bearing on whether a great deal of thought and expense is undertaken to lessen a future capital gains tax burden. For example, if clients are in their late 80's, are very

conservative and have primarily CDs and bonds, a second step-up in basis at the surviving spouse's death most likely would be nominal. In a blended family situation, an outright marital bequest may not be desired and the election of QTIP and portability may contain risk discussed in V.B.3. below. In such a case, a traditional bypass trust may be used despite forgoing the step-up in basis. Although "step-up" is almost universally used when referring to a change in basis after death, an asset steps down in value at the surviving spouse's death if it drops in value prior to the surviving spouse's death. Thus, while "step up" is used often in this outline, "basis adjustment" is a more accurate term.

#### **IV. BYPASS TRUST VS. PORTABILITY POST-ATRA.**

We now have two basic methods for utilizing both spouses' estate tax exemptions while benefitting the surviving spouse with estate assets--the traditional testamentary bypass trust and portability. Nevertheless, due to many factors, there are many variations and combinations that make this area extremely complex. What appears to be a simple fork in the road is actually a complex mixing bowl interchange.

##### **A. The Primary Advantages of a Traditional Bypass Trust:**

1. Protection from the surviving spouse changing the disposition of the assets at the second death;
2. Protection from the surviving spouse's creditors;
3. The trust's assets plus appreciation are not included in the surviving spouse's estate for estate tax purposes (this is only an advantage if the assets would have caused estate tax at the surviving spouse's death since they will not receive a step-up in basis);

4. The decedent's unused GST exemption can be allocated to the bypass trust;

5. If the decedent's estate is less than his remaining estate tax exemption, there is no requirement to file Form 706, U.S. Estate Tax Return;

6. It reduces the potential conflict in blended family situations involving QTIP and/or portability elections. See QTIP + Portability - Happy Couple or Recipe for Discord - Appendix 3;

7. It could reduce state inheritance tax if the client owns real property in a decoupled state; and

8. A surviving spouse's remarriage will not jeopardize utilizing the first spouse's estate exemption.

**B. The Primary Disadvantages of a Traditional Bypass Trust:**

1. The trust assets at the surviving spouse's death do not receive a step-up in basis;

2. Maintenance costs such as funding, accounting, and annual income tax returns;

3. The maximum trust income tax rate is reached at \$12,300 of income (2015); and

4. If the spouse serves as trustee, there are fiduciary duties owed to the remainder beneficiaries and a potential exists for conflict and liability.

**C. The Primary Advantages of Electing Portability:**

1. Simplicity for the surviving spouse (other than filing the Form 706);

2. Receiving a step-up in basis at surviving spouse's death; and

3. Might be the better option for clients with large qualified plans and IRAs who want to use spousal rollover instead of a testamentary trust.

**D. The Primary Disadvantages of Electing Portability:**

1. The cost and effort of preparing Form 706;

2. Risk of surviving spouse changing the disposition of the assets, especially if the couple has a blended marriage or if the surviving spouse remarries;

3. Risk to the assets if surviving spouse has subsequent liabilities;

4. Portability in conjunction with an outright marital bequest does not allow the deceased spouse's unused GST exemption to be carried over to the surviving spouse's remaining GST exemption; and

5. Portability only applies to the DSUE of the last deceased spouse so it is lost a) surviving spouse remarries and b) if the new spouse dies before fully utilizing his estate tax exemption (assuming the surviving spouse did not use DSUE via gifts prior to new spouse's death).

**E. Portability + QTIP Trust Instead of an Outright Marital:** Rather than using an outright marital bequest, consider using a QTIP Trust in conjunction with portability for clients concerned about portability's shortcomings. A QTIP Trust could be designed to avoid the disadvantages in 2 - 4 in paragraph D. above.

1. The QTIP trust could be drafted such that decedent's assets would be protected from the surviving spouse changing the disposition of the assets.

2. The QTIP trust could be drafted as a spendthrift trust protecting against the surviving

spouse's creditors.

3. If a QTIP Trust is used, the first deceased spouse's GST exemption could be used by making a reverse QTIP election under §2653(a)(3).

4. For a couple concerned about 1 - 3 above, QTIP + portability can be an excellent design if the beneficiaries of the QTIP Trust and the surviving spouse's estate are the same at the surviving spouse's death. In contrast, in a blended family context electing portability and QTIP treatment could have complications. See V.B.3. below and QTIP + Portability - Happy Couple or Recipe for Discord?, Appendix 3.

## **V. POST-ATRA WILL/REVOCABLE MANAGEMENT TRUST (RMT) OPTIONS (as they relate to the surviving spouse). See Post-ATRA Flowchart Appendix 2.**

**A. Simple Will/RMT With an Outright Marital Bequest-Option to Elect Portability at First Death.** In this structure the first spouse to die gifts all assets to the surviving spouse outright and free from trust. Generally, this is best suited for the couple with an estate less than \$11 Million where simplicity and a step-up in basis at the surviving spouse's death outweigh any non-tax reasons for a trust.

**B. Will/RMT With a QTIPable Marital Trust-Option to Elect Portability at First Death.** In this structure, the first spouse to die gifts assets to a spousal trust whereby the surviving spouse has a beneficial interest for life such that it would qualify for the marital deduction under §2056(b)(7). The trust is designed so that QTIP treatment could be elected by the Executor or without such election, the trust would be a bypass trust. Generally this is best suited for the couple with an estate less than \$11 Million that has non-tax reasons for creating a trust but wants the flexibility of allowing the executor to make a QTIP election to obtain a step-up in basis at the surviving spouse's death. By making a QTIP

election (§2057(b)(7)), the assets will be included in surviving spouse's estate (§2044) and will receive a step-up in basis (§2014). Portability should be elected if the joint estate is greater than one exemption and the QTIP election is made. In addition, even if the joint estate is less than one exemption, portability may be elected at the first death if the surviving spouse wishes to have the DSUE of the first spouse to help shelter assets from estate tax just in case either the QTIP assets or surviving spouse's assets significantly increase in the future or if the surviving spouse receives an inheritance.

**1. Clayton Provision.** Additional flexibility can be built into the QTIPable Trust structure by adding a Clayton feature. This would be a secondary trust similar to a typical traditional bypass with discretionary income and principal distributions under a HEMS (i.e., health, education, maintenance and support) standard and permissible spray provisions to descendants while the surviving spouse is alive (other variations of a bypass trust could be used). The Clayton provision would be activated by the executor making a partial QTIP election, and the portion of the trust not receiving the QTIP election would be controlled by the Clayton provisions in a separate trust. With such flexibility, the decision of whether a QTIP Trust, traditional bypass trust or a combination of the two can be delayed until the first spouse's death.

There is debate among commentators as to whether the surviving spouse should serve as executor if making a partial QTIP election involving a Clayton provision. The issue is whether or not the spouse has made a gift of assets that would have been in the QTIP Trust. Although there are highly regarded commentators who do not feel this will cause any gift issues, is safer to avoid the problem by having someone other than the surviving spouse serve as executor if a Clayton provision is used. A Clayton provision with spray provisions for descendants is normally not appropriate for blended family situations.

**2. Reverse QTIP Election.** Since portability does not allow the deceased spouse's unused GST exemption to be carried over by the surviving spouse, an outright marital bequest will result in wasting the deceased spouse's unused GST exemption; however, if portability is used in conjunction with a QTIP Trust instead, the executor can make a reverse QTIP election under §2653(a)(3) whereby the deceased spouse is treated as being the transferor for GST allocation purposes despite the QTIP assets being included in the surviving spouse's estate for estate tax purposes. Thus, the reverse QTIP election will utilize part or all of the deceased spouse's unused GST exemption.

**3. Danger for Blended families.** Many practitioners will use this technique because it is a logical solution to the dilemma of a client that needs a trust for non-tax reasons, but wants the possibility of a step-up in basis at the surviving spouse's death which is not available with a traditional bypass trust. Nevertheless, in the blended marriage context or other situations where the beneficiaries of the QTIP Trust and the surviving spouse's estate are different, there are some traps for the unwary. See QTIP + Portability - Happy Couple or Recipe for Discord - Appendix 3.

**a. §2207A Reimbursement.**

When new laws, such as portability, are passed, there can be unintended results caused by other existing IRC sections. Such is the case with §2207A. It provides that a QTIP trust must reimburse a surviving spouse's estate for the difference between the amount the surviving spouse's estate pays with the QTIP assets included and the amount the surviving spouse's estate would have paid without the inclusion of QTIP assets. §2207A was passed to protect a surviving spouse from estate tax on assets that are included in his estate from an accounting perspective when the assets, in fact, are controlled independently by a QTIP trust.

**b. Example.** Fred and Mary are in their early fifties, have been married for 20 years, and they each have children from previous marriages. They want to "park" their assets in trust for the surviving spouse's benefit, but they want their assets to go to their respective children at the surviving spouse's death. Fred's estate is \$2 Million and Mary's estate is \$3 Million. They draft a testamentary trust QTIPable for flexibility purposes so if the executor wants the possibility of obtaining a step-up in basis at the surviving spouse's death, he could elect QTIP treatment so that assets are included in the surviving spouse's estate and portability so that the surviving spouse will have the DSUE to offset the value of the QTIP assets now includable in the estate. Fred dies and the executrix elects QTIP treatment and portability for the possibility of securing a step-up in basis in the QTIP trust assets. Mary carries over Fred's DSUE of \$5.45 Million. Since the surviving spouse's beneficiaries will be different from the QTIP trust beneficiaries and Mary could live a few more decades, various scenarios could unfold at Mary's death 35 years later (at which time her exemption is \$8 Million):

i. Scenario 1 - Great Result. Fred's QTIP trust grows to \$4 Million and Mary's estate grows to \$8 Million. Mary's taxable estate is \$12 Million (her \$8 Million plus QTIP's \$4 Million) and her estate exemption is \$13.45 Million (her \$8 Million plus DSUE of \$5.43 Million). Thus, if the assets are sold by the heirs, millions of dollars of capital gains have been eliminated without any estate tax liability. Everybody wins.

ii. Scenario 2 - Unfair Result to Fred's Children. QTIP trust grows to \$5 Million and Mary's estate is worth \$12 Million (Mary's parents died after Fred and since she was an only child, her estate grew significantly through the years). Mary's taxable estate is \$17 Million and her estate exemption is \$13.45 Million (her \$8 Million plus DSUE \$5.45 Million) so her estate tax liability is \$1.42 Million (\$17 Million - \$13.45 Million = \$3.55 Million x 40%).

Who is ultimately responsible for paying the \$1.42 Million? Fred's children via the QTIP trust, due to §2207A. But Fred's exemption was \$5.45 Million when he died and the QTIP trust had grown to \$5 Million at Mary's death, so the DSUE covered the value. Regardless, §2207A operates such that the QTIP must reimburse the surviving spouse's estate for the difference between the estate tax the surviving spouse must pay and what she would have paid if her taxable estate did not include the QTIP trust. In this case, had the QTIP assets not been included in her estate, no estate tax would have been due - \$12 Million taxable estate less \$13.45 Million (\$8 Million + DSUE). Mary's children receive Mary's \$12 Million estate tax free while Fred's children bear 100% of the estate tax.

iii. Scenario 3 - Unfair Result to Mary's Children. After Fred's death, Mary's tax lawyer informed her of the dangers of Scenario 2 above and mentioned she could cure the problem by waiving §2207A in her Will so that if estate tax was owed at her death, her estate would pay the tax without any reimbursement owed by the QTIP Trust. Mary dies with a \$10 Million estate and the QTIP Trust grew to \$8 Million (some of Fred's mineral interest in farm land in South Texas became very productive). Mary's taxable estate is \$18 Million and her estate exemption is \$13.45 Million so the estate tax is \$1.82 Million (\$4.55 Million x 40%). Who is ultimately responsible for the tax? Mary's estate. But Fred's exemption was \$5.45 Million at his death and the QTIP is worth \$8 Million. Fred's children via the QTIP trust don't have to pay anything? Yes, because Mary waived her §2207A reimbursement right.

iv. Scenario 4 - Remarriage. Mary remarries a wealthy businessman and she survives him. His estate utilizes his exemption on his own children; thus, Mary loses her DSUE. The QTIP Trust is worth \$5 Million at Mary's death and her estate is worth \$10 Million and her estate exemption is \$8 Million. Her estate is \$15 Million and her estate

tax is \$2.8 Million (\$15 Million - \$8 Million = \$7 Million x 40%). Her estate tax would have been \$800,000 without the inclusion of the QTIP Trust assets. Therefore, the §2207A reimbursement claim against the QTIP Trust would be \$2 Million.

v. No Crystal Ball. If the surviving spouse could live for decades, will the executor want to risk such unpredictable burden of estate tax liability? Is the possibility of receiving the extra step-up at the surviving spouse's death worth the potential risk in light of §2207A? In many cases, it is safer to not elect QTIP treatment and opt for the traditional bypass and forego the step-up in basis at the survivor's death (See Paragraph D below for possible strategies to obtain a step-up in basis in a bypass trust).

vi. Late QTIP Election? If the executor knew for certain that the trust and/or the surviving spouse's estate would not grow enough to cause an estate tax at the surviving spouse's death, a QTIP election could safely be made and §2207A would not apply. What if the executor could postpone filing the Form 706 and wait a few decades to actually determine current values at that time and if the §2207A problem doesn't exist, a late Form 706 could be filed electing QTIP treatment? This wait and see technique was presented by Mickey R. Davis at the 62<sup>nd</sup> Annual Tax Conference-Estate Planning Workshop in a presentation entitled, "Planning for New Basis at Death." Treas. Reg. §20.2056(b)-7(b)(4)(i) provides that a QTIP election can be made on the first late filed return if no timely return was filed. Accordingly, it appears that the executor could wait until the fifty-eight year old widow is eighty-three and if no estate tax would result if a QTIP election was made, file a late Form 706 and make the QTIP election. See Treas. Reg. §20.2056(b)-7(b)(3). This would result in §2044 including the trust assets in the surviving spouse's estate and obtaining a basis adjustment (of course, if the trust assets have gone down in value, the executor will



not want to make a QTIP election). Please note that the trust assets plus the surviving spouse's assets would need to be less than the surviving spouse's remaining estate exemption since portability could not be elected on the late Form 706 for the first deceased spouse. For an executor who does not feel comfortable with the risk of electing QTIP treatment at the first spouse's death, this technique could be an interesting possibility. Despite this intriguing opportunity, there are practical considerations such as will an individual executor still be alive? If not, the backup may need to be appointed by the court in order to make the election. Was the estate formally closed or should it be left open to accommodate this technique in the future?

**C. Traditional Tax Planned Will/RMT With Formula Bypass/QTIP or Outright Marital.**

This structure is the standard used for decades. The bypass trust shelters the first spouse's remaining estate tax exemption with the balance as an outright marital bequest or held in a QTIP trust. Formulas are used to ensure that the correct values are allocated to the bypass trust and the marital bequest. Funding considerations can dictate whether the marital bequest or bypass trust is the upfront bequest or residue. There are several variations of available formulas and funding mechanisms. Generally, this design still makes sense for the wealthy couple that wants to avoid or mitigate estate tax if their estate exceeds \$11 Million. This structure could also be used in a blended family situation where the client does not want to assume the risks outlined in Appendix 3 or a situation with a young surviving spouse who might remarry and potentially lose the DSUE.

**D. Will/RMT With Testamentary Trust With Possibility of Step-Up at Surviving Spouse's Death.** Creative tax lawyers have devised designs whereby the assets in a testamentary trust intended not to qualify for the marital deduction could still receive a step-up in basis. While the aim is to have the protections of the trust and basis adjustment at the surviving spouse's death,

there are risks associated with these various techniques which may outweigh basis adjustment considerations depending on the client's specific facts and the trust's purpose. For a more exhaustive discussion of the techniques described below, see the outline entitled "Estate Planning for Married Couples With Estates of \$2 Million to \$10 Million" Steve Akers presented at the 62<sup>nd</sup> University of Texas Tax Conference.

1. Give a Third Party the Power to Grant a General Power of Appointment to Surviving Spouse. The power could require the consent of a non-adverse party if the Settlor did not want the surviving spouse to have total control over the power. Assuming the independent third party determined there was no risk of estate tax if the trust assets were included in the surviving spouse's estate, the general power of appointment could be granted to the surviving spouse.

2. Formula General Power of Appointment. The Settlor would grant the surviving spouse a general power of appointment designed to be narrow in scope to mitigate risk that the surviving spouse could exercise it in a manner different than Settlor's intended disposition. A formula would apply such that the general power would be limited in amount so not to cause an estate tax.

3. Delaware Tax Trap. The trust would be designed to give the surviving spouse a limited power of appointment. The power would include the power to grant a new presently exercisable general power of appointment in someone else. The perpetuities savings clause would need to be worded such that the interests of beneficiaries must "vest" within the rule against perpetuities time period rather than requiring they be "distributed" within that time.

4. Caution on techniques 1 - 3. The techniques briefly addressed above are complex with numerous advantages and risks. Spouses that choose a testamentary trust because they want to ensure that the trust assets will be distributed a

certain way will assume risk by granting a general power of appointment to someone else. Can that risk be mitigated enough to satisfy the client? Before using any of these techniques, much more research and “engineering” would be in order.

Nevertheless, if the deceased spouse has a material amount of remaining unused exemption left after funding the bypass, consider electing portability for the DSUE so that the surviving spouse will have extra exemption in the event the general power of appointment is granted. For example, a couple has a \$6 Million community property estate. They each have a bypass trust with the possibility of the surviving spouse possessing a general power of appointment. Husband dies with a \$3 Million estate, and the bypass trust is funded with \$3 Million. Portability is elected on Form 706 and \$2.45 Million is carried over for wife. The wife’s estate grows to \$4.5 Million and the bypass trust to \$4 Million. The general power of appointment is granted to wife. Wife dies when her exemption is \$6.2 Million. Since portability was elected at husband’s death, the wife carried over the husband’s \$2.45 Million to add to her \$6.2 Million for a total exemption of \$8.65 Million. Since her estate is \$8.5 Million (her \$4.5 Million + \$4 Million bypass trust - she had a power of appointment over) she owes no estate tax, while the assets in the bypass trust receive a step-up in basis (from \$3 Million at husband’s death to \$4 Million at wife’s death.) The granting of the general power of appointment and filing of portability saved the family capital gains tax on \$1 Million without incurring an estate tax on the wife’s estate.

**E. Will/RMT With a Disclaimer Bypass Trust.** This structure would typically have an outright marital bequest conveying all assets to the surviving spouse, but it would also contain a special provision that if the surviving spouse disclaims any estate assets, they will flow into a traditional bypass trust. Please keep in mind that a disclaimer bypass trust design does not allow the surviving spouse to possess a limited power of

appointment over the bypass trust. Generally, this design would be well-suited for a couple that has no non-tax reasons for creating a spousal testamentary trust, but due to a potential asset that could explode in the future and dramatically increase their net worth, they prefer that the surviving spouse have the flexibility of “activating” the bypass trust via a disclaimer. The disclaimer could isolate only the explodable asset or it could include additional estate assets. While the disclaimed assets plus any appreciation are not subject to estate tax at the surviving spouse’s death, they do not receive a step-up in basis. For example, husband and wife have a community property estate of \$6 Million and husband has separate property in Karnes County minerals currently worth \$1 Million. They prepare disclaimer wills containing bypass trusts. The husband passes away and wife decides to accept all community property assets, but to disclaim the minerals into a traditional bypass trust and as Executrix elects portability for the balance. Wife dies twenty years later and her estate is worth \$9 Million and the bypass trust has \$7 Million. The wife’s exemption is \$6.8 Million at her death, plus husband’s \$4.45 Million (\$1 Million was used on the bypass trust). Her estate owes no estate tax.

## **VI. GATHERING, ANALYZING AND DOCUMENTING DESIGN DECISIONS.**

Armed with this information, how does the practitioner ascertain clients’ objectives and priorities and how does a client choose the design? Once the design is adopted, how is that documented?

**A. Sample Questionnaire.** The questionnaire at Appendix 4 is an attempt to gauge what the client’s primary concerns are in order to narrow down the options. Each spouse may have different concerns, and it is suggested that each spouse complete a separate questionnaire. The lawyer can decide whether to send the questionnaires out prior to the meeting or merely obtain the information at the meeting. In any event, the more technical questions will require an

explanation from the lawyer before answering.

**B. Analysis of Flowchart - Appendix 2.** Once questions are obtained from the questionnaire, the flowchart in Appendix 2 can be used to help navigate the choices. The flowchart is designed to be an in-house tool for the lawyer and most likely would confuse the client. Nevertheless, a highly analytical client such as an engineer or CPA may find the flowchart helpful.

**C. Sample Design Acknowledgment.** To quote Prof. Stanley M. Johanson from his Tax Law Update outline at the 39<sup>th</sup> Annual Advanced Estate Planning and Probate Course (June, 2015), "Document, document, document! . . . it is important - *no imperative* - that the credit shelter versus the portability topic be discussed with the clients at estate planning time . . . and to document that that discussion took place. True, the issue of whether an election should be made does not arise until the death of the first spouse. However, the estate plan prepared for the clients may preclude a portability election (e.g., a bypass trust plan)." See sample Design Acknowledgment in Appendix 5.

**D. Sample Basis Adjustment Acknowledgment.** Due to the new focus on basis adjustment and the risks of using QTIP trusts with blended families, the lawyer might consider using an acknowledgment documenting that various options were considered and the option chosen. See sample Basis Adjustment Acknowledgment in Appendix 6.

**E. Portability Acknowledgment (to be used at first death - not at time of initial plan).** To quote Prof. Johanson once again from the same outline, "Hindsight, anyone? Perhaps you have noticed (he said with a modicum of understatement) that heirs and other disgruntled family members are blessed with perfect hindsight, and in this context would have no difficulty concluding the "obvious." If it turns out that, in retrospect, the decision to elect portability [should] [should not] have been made, making the

wrong decision (or making no decision at all because, it is alleged, the topic was not even discussed) was obviously the result of the attorney's negligence - so grossly negligent, in fact, to warrant the imposition of punitive damages." See sample Portability Acknowledgment in Appendix 7 that would be executed pursuant to the estate administration of the first spouse to die.

**F. Thanks.** The author wishes to acknowledge and thank Steve Akers for his review and comments regarding Appendices 2, 4 and 5.

## VII. MODIFY EXISTING PLANS?

**A. Notification Conundrum.** Is a client for which we prepared a plan twelve years ago still our client or not? Should we send them a letter notifying them of the dramatic tax law changes? Typically, when the estate documents are executed and we send the exit letter to the client, we are trained to notify them that it concludes our representation until the client engages us again. Notwithstanding this practice, in reality many clients think of us as their lawyers and expect us to keep them abreast of major tax law changes.

1. Awkward Moment . It is an awkward conference when the widow from Seguin that just lost her husband comes in with a \$1.2 Million estate and a will with a bypass trust you prepared in 1995 when the estate tax exemption was \$600,000. They had been married once and the only reason they created the trust was to avoid estate tax. Now you explain to her all the legal and accounting work necessary to fund and maintain the bypass trust when there are now no estate tax savings. Perhaps a family settlement agreement with all the beneficiaries is in order to allow the assets to pass free from trust to the surviving spouse and remainder beneficiaries (the children would need to be comfortable that the surviving spouse would not remarry before agreeing to a family settlement agreement). How many of these clients do you have? Most likely you have many depending on your years of

practice.

2. Sample Letter. Some commentators suggest that lawyers send letters to clients notifying them of the tax law changes. For lawyers who conclude that they should send such a letter, please see a sample letter in Appendix 8. Certainly, the lawyer could improve on this letter, but may serve as a helpful starting point.

**B. Simplify.** For couples with estates comfortably under one exemption with existing Wills/Revocable Management Trusts (RMTs) containing bypass trusts for whom reducing estate tax is the sole purpose, preparing new outright marital bequest Wills/RMTs may be in order. Even so, the clients may want to retain GST trusts for descendants for a host of reasons. For couples with estates larger than one exemption, but comfortably under two exemptions with existing Wills/RMTs with bypass trusts with the sole purpose of reducing estate tax, an extensive discussion and evaluation of an outright marital bequest with portability vs. bypass trust should take place.

**C. Retain a Testamentary Trust - But What Type Based on Step-up in Basis Issues?** For couples that have non-tax reasons for creating a trust and who currently have a traditional bypass trust, the question is: 1) do they keep the traditional bypass trust or 2) switch to a QTIPable trust or 3) build in a general power of appointment feature with the possibility of securing a step-up in basis at the surviving spouse's death? The answer most likely would depend on the size of the estate. Couples with estates greater than \$11 Million will typically retain the traditional bypass/marital structure and those with estates less than \$11 Million who have been married once will likely change to a QTIPable trust to provide flexibility for the executor to decide at the first death to keep the bypass trust or make a QTIP and portability election to secure a step-up in basis in trust assets at the surviving spouse's death. For couples with blended families, perhaps the traditional bypass trust or a bypass trust designed

to allow for a step-up in basis is the better fit. The design will be specific to that family's circumstances.

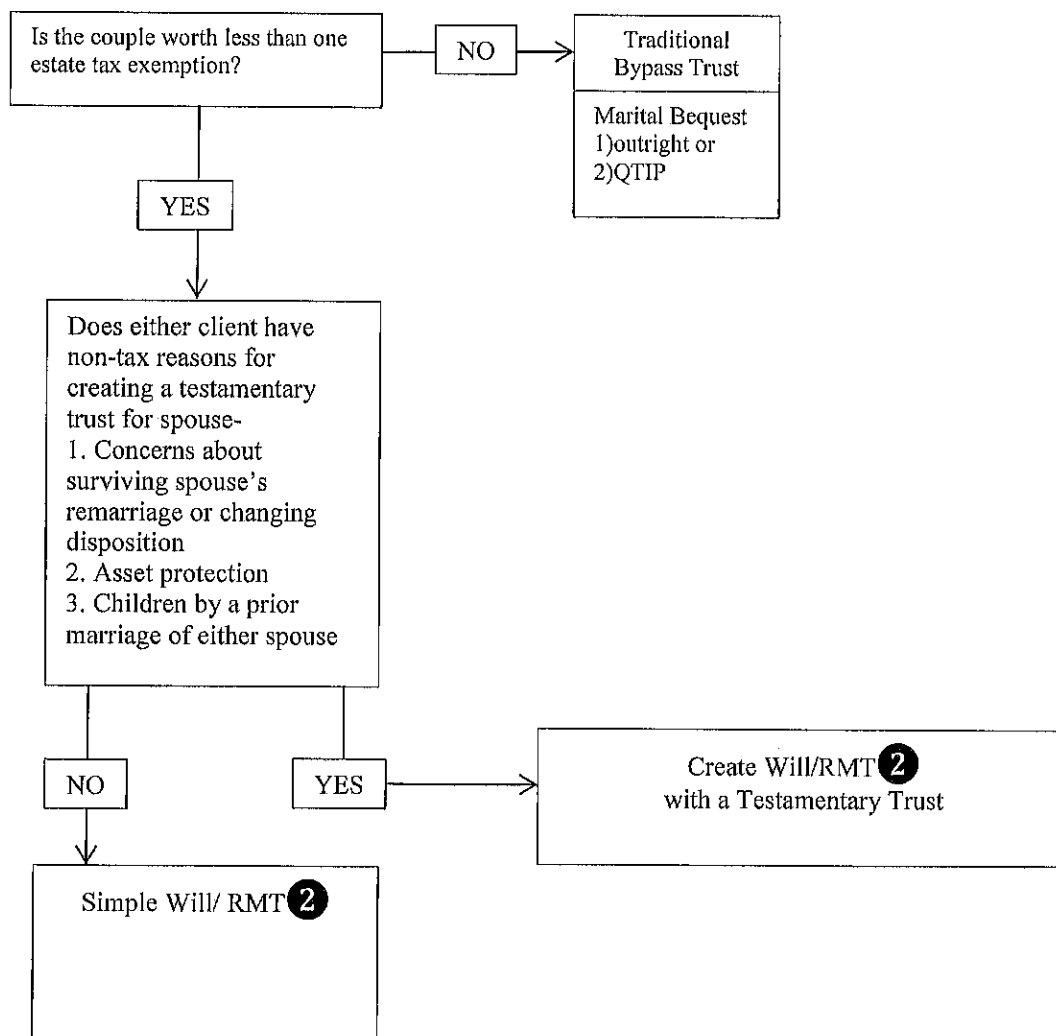
**D. Other Post-ATRA Issues for Existing Plans.**

Please see Jordan M. Ware's excellent outline entitled, "Oh, What a Relief it is: Curing Estate Plans That No Longer Make Sense In Light of the American Taxpayer Relief Act of 2012 presented at the 39<sup>th</sup> Annual State Bar of Texas Advanced Estate Planning & Probate Course, June 10-12, 2015.

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## Appendix 1

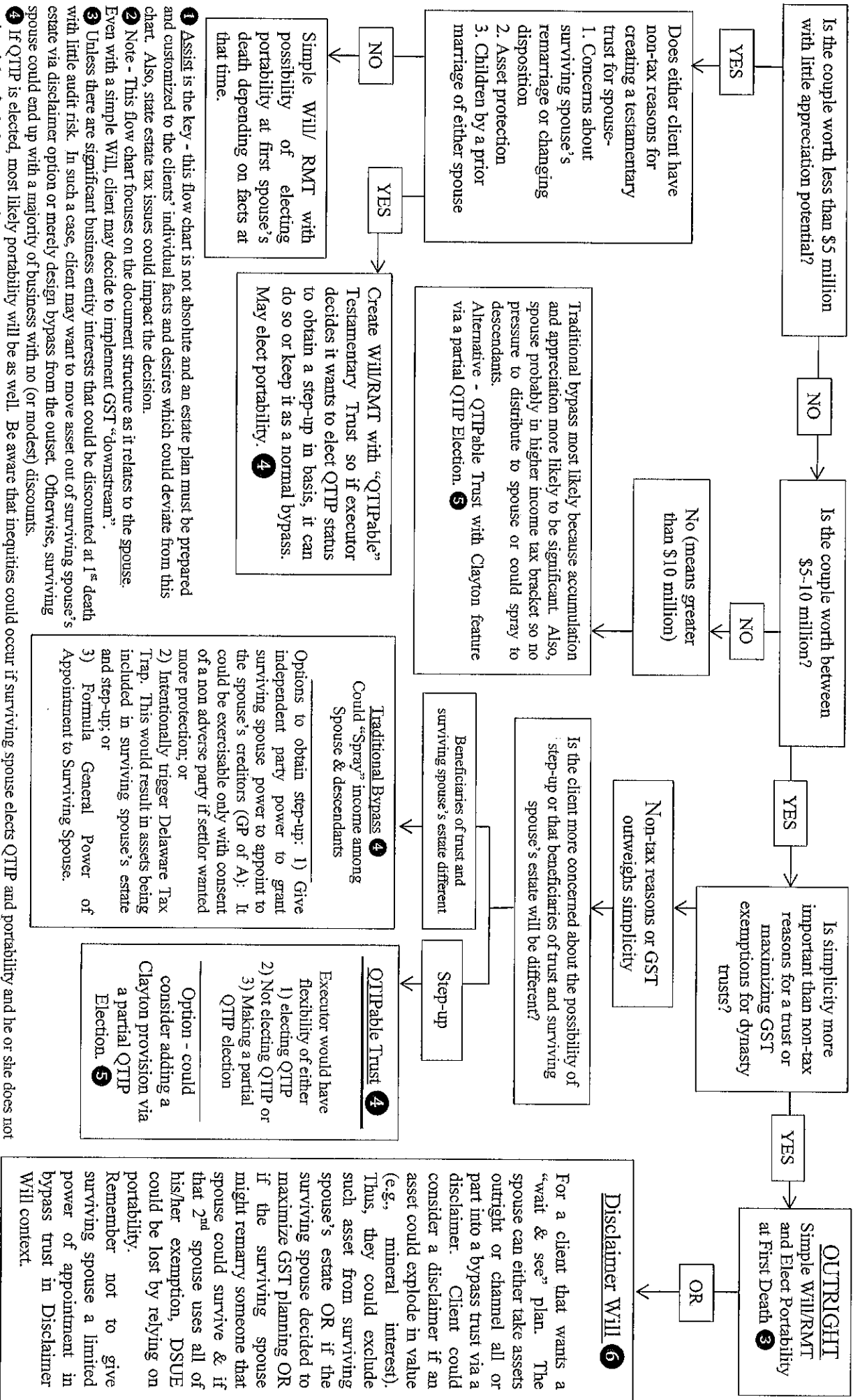
### Flow Chart as to type of Document As It Relates to Surviving Spouse <sup>1</sup> (Pre-American Taxpayer Relief Act 2012)



<sup>1</sup> General Guideline, clients' particular facts could influence a different decision.


<sup>2</sup> RMT=Revocable Management Trust

Flow Chart to Assist **1** Attorney as to type of Document As It Relates to Surviving Spouse **2**  
 (Post-American Taxpayer Relief Act 2012)



**1** Assist is the key - this flow chart is not absolute and an estate plan must be prepared and customized to the clients' individual facts and desires which could deviate from this chart. Also, state estate tax issues could impact the decision.  
**2** Note - This flow chart focuses on the document structure as it relates to the spouse. Even with a simple Will, client may decide to implement GST "downstream".  
**3** Unless there are significant business entity interests that could be discounted at 1<sup>st</sup> death with little audit risk. In such a case, client may want to move asset out of surviving spouse's estate via disclaimer option or merely design bypass from the outset. Otherwise, surviving spouse could end up with a majority of business with no (or modest) discounts.  
**4** If QTIP is elected, most likely portability will be as well. Be aware that inequities could occur if surviving spouse elects QTIP and portability and he or she does not waive right of reimbursement from QTIP. No such potential abuse exists with a traditional bypass trust. Portability may make sense even with traditional bypass depending on how much exemption is left over after funding bypass trust.  
**5** Warning: Best for surviving spouse not to be the Executor making the QTIP election if there is a Clayton provision; otherwise, there could be gift implications.  
**6** There are other variations of the disclaimer approach that are beyond the scope of this flow chart.  
 © Charles A. Granstaff, 2014  
 This Flow Chart was previously published in Volume 52, No. 2, Real Estate, Probate and Trust Law Reporter, State Bar of Texas and Trusts and Estates.  
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# TRUSTS & ESTATES

The  WealthManagement.com journal for  
estate-planning professionals



**Giving Good Face**—“At the Studio With IKA 1” (35<sup>3</sup>/<sub>4</sub> in. by 26<sup>1</sup>/<sub>4</sub> in.) by Julian Opie, sold for \$42,745 at Sotheby’s recent Contemporary Art Day Auction in London on July 1, 2014, p. 4.

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By Kristin T. Abati & Renat V. Lumpau

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By John T. Bannen & Kristin A. Occhetti

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Two strategies that work together

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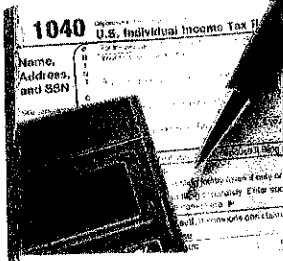
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## FEATURE: ESTATE PLANNING & TAXATION

By **Charles A. Granstaff**

### Portability + QTIP

A happy couple or a recipe for family discord?

**T**he 2012 American Taxpayer Relief Act has greatly changed the engineering of estate plans. Now, with a \$5.34 million (in 2014) exclusion amount indexed for inflation, lower estate tax rates, higher capital gains rates and Internal Revenue Code Section 2010(c) (that is, portability), practitioners are often designing flexible plans to maximize step-up in basis. For some couples, the new law may greatly simplify their planning, but for others, options abound, resulting in greater complexity. (See “Surviving Spouse Documents,” p. 24.)

#### Spousal Testamentary Trust

A couple married once with children from that marriage, perhaps with an estate worth \$2 million to \$3 million, may simply choose to leave all their assets to each other and secure a step-up in basis at the surviving spouse's death. The executor at the first spouse's death can decide whether to elect portability. Under portability, the executor may elect on a Form 706 for the surviving spouse to carry over the deceased spousal unused exclusion (DSUE) amount. Thus, a surviving spouse receiving all of the decedent's assets could add the DSUE to his own exclusion amount. (For more information about DSUE, see “The DSUE Coin Flip,” by John T. Bannen and Kristin A. Occhetti in this issue, p. 17).

Nevertheless, many couples will have non-tax reasons for creating a spousal testamentary trust due to concerns about: 1) a surviving spouse's remarriage, 2) changing the ultimate disposition, 3) asset protection, or 4) children by a prior marriage of either spouse. For

many taxpayers with modest estates using testamentary trusts, it seems logical for the executor to elect qualified terminable interest property (QTIP) status for a trust that qualifies under IRC Section 2056(b)(7). This election allows assets that otherwise aren't subject to estate tax (assuming they don't appreciate too significantly) to receive a step-up in basis at the surviving spouse's death. The portability election adds a new dimension to this strategy. Since IRC Section 2044 requires the surviving spouse to include the value of the QTIP property in his estate, an executor may elect portability. While the QTIP trust assets are included in the surviving spouse's estate and receive a step-up in basis, portability allows the surviving spouse to use the DSUE (fixed in the year of the first to die) to offset the value of the QTIP trust assets. Portability isn't without its drawbacks, however, particularly for increasingly common blended families.

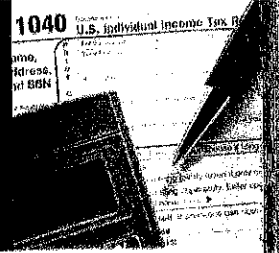
#### Example 1

Suppose Ralph and Betty have been married 15 years, and both have children from prior marriages. Ralph wants to create a testamentary trust for Betty for her life, with the remainder interest benefitting his children from a previous marriage. The trust is designed so the executor has the option to elect QTIP status at Ralph's death. Ralph dies in 2014 with a \$3 million estate. His executor elects QTIP status under Section 2056(b)(7) so that if the assets go up in value, Ralph's children will receive a step-up in basis at Betty's death. The executor also elects portability so that Betty can use Ralph's DSUE, because the QTIP assets will be included in her estate. Betty dies a few years later with her own \$10 million estate and a \$6 million exclusion amount. In the meantime, the QTIP trust has grown to \$5 million. Betty's gross estate is \$15 million (her \$10 million, plus \$5 million



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from the QTIP). Her exemption is \$11.34 million (her \$6 million, plus Ralph's \$5.34 million DSUE from 2014). The federal estate tax on Betty's estate is \$1.464 million (( $\$15 \text{ million} - \$11.34 \text{ million} = \$3.66 \text{ million}$ ) x 40 percent), but Betty's estate doesn't necessarily pay the bill.

### IRC Section 2207A

Section 2207A was passed to protect a surviving spouse from estate tax on assets that are included in his estate from an accounting perspective when the assets, in fact, are controlled independently by a QTIP trust. It provides that a QTIP trust must reimburse a surviving spouse's estate for the difference between the amount the surviving spouse's estate pays with the QTIP assets included and the amount the surviving spouse's estate would have paid without the inclusion of QTIP assets. In Example 1, Betty's estate would have paid nothing, had she died with a \$10 million estate, because she would have had \$11.34 million in exemptions. Thus, Ralph's QTIP trust must pay \$1.464 million of its \$5 million to Betty's estate, even though Betty's estate has to pay nothing on a \$10 million estate. Ralph's remainder beneficiaries are going to be unpleasantly surprised to discover this outcome. The advantage of their \$2 million ( $\$5 \text{ million} - \$3 \text{ million}$ ) step-up in basis is overshadowed by their obligation of \$1.464 million in estate tax reimbursement to Betty's estate under Section 2207A.

To further complicate things, if Betty's estate fails to exercise the Section 2207A right of recovery, Treasury Regulations Section 20.2207A-1(a)(2) treats such failure as a gift from Betty's beneficiaries to the beneficiaries of the QTIP trust. Moreover, Betty's executor may have a state law fiduciary duty to pursue the claim.

### Waiver of Reimbursement

A potential solution to this inequity is for the drafter of Ralph's will to require that, if a QTIP election has been made and the executor wishes to elect portability, Betty waive her reimbursement right under Section 2207A. Section 2207A(a)(2) requires such a waiver to be included in the surviving spouse's will or revocable trust. In Example 1, that would cure the problem. Betty's estate would pay the \$1.464 million in estate tax because Ralph's estate was less than the

DSUE carried over. But, what if Ralph's QTIP assets increased a great deal more than that? Say Ralph's assets increased from \$3 million to \$8 million before Betty died, and Betty had waived her reimbursement right under Section 2207A? Now Betty's family pays all the estate tax, and Ralph's children receive the entire \$8 million with no estate taxes. Betty benefitted by carrying over a \$5.34 million exemption, but her estate pays \$1.064 million more than the benefit she received by the DSUE carryover (( $\$8 \text{ million} - \$5.34 \text{ million} = \$2.66 \text{ million}$ ) x 40 percent). In hindsight, if Ralph's executor had known that the assets would grow from

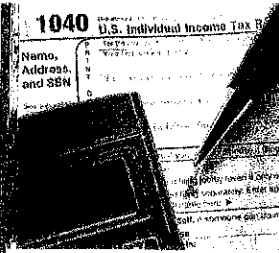
To the extent assets grow but stay under the exclusion amount, waiving Section 2207A works well.

\$3 million to \$8 million, he wouldn't have elected QTIP status, and the trust would have operated as a traditional bypass trust excluded from Betty's estate.

Executors who elect QTIP status in hopes of receiving a step-up in basis and surviving spouses who waive Section 2207A must consider this dilemma. To the extent assets grow but stay under the exclusion amount, waiving Section 2207A works well. In contrast, estate tax can be significant and levied unpredictably if QTIP assets grow substantially, perhaps because the surviving spouse lives much longer or because of some windfall regarding the property, such as discovery of natural resources. The DSUE is a fixed dollar amount, and the QTIP assets could have decades to grow, depending on the surviving spouse's age. A blanket Section 2207A waiver could be just as dangerous for the surviving spouse's family as a lack of a waiver is for the family of the first to die.

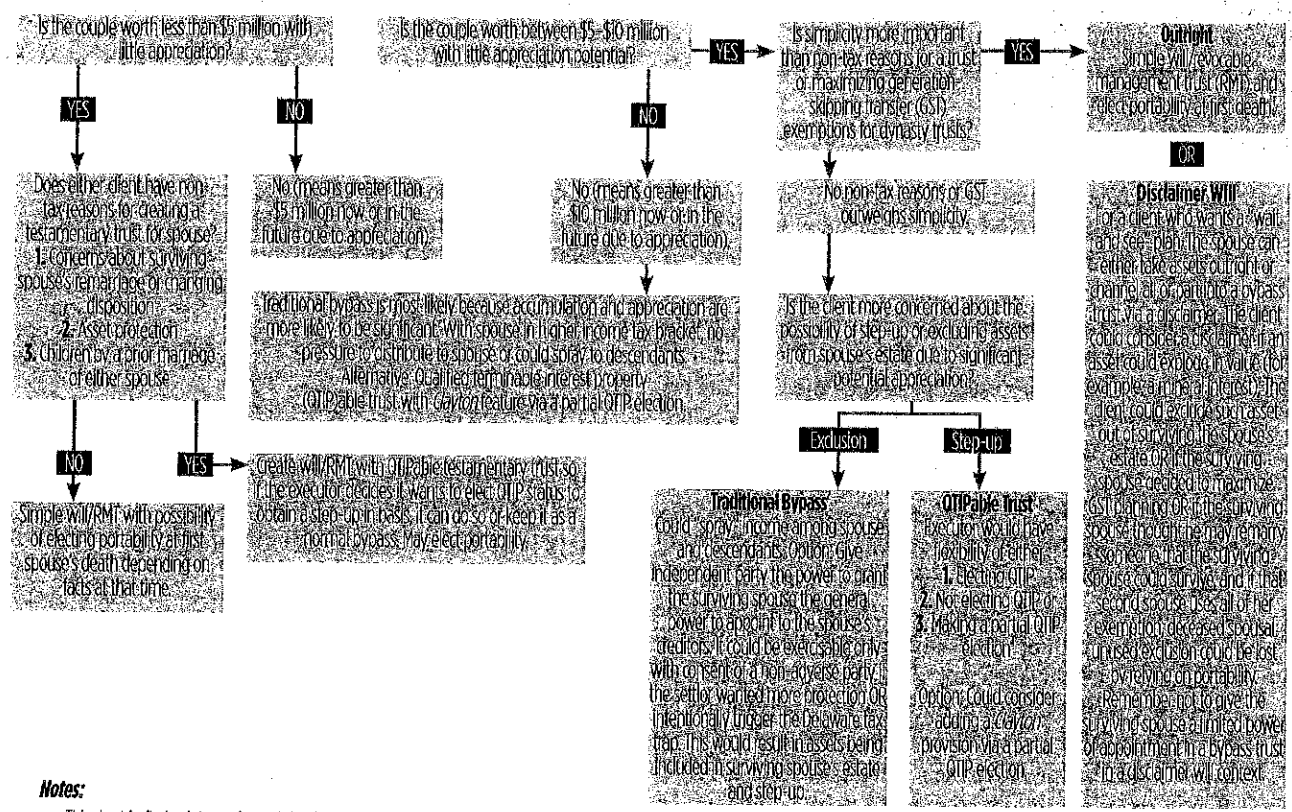
### Formula Waiver

Perhaps a more precise solution is for an executor who's elected QTIP treatment and wishes to elect portability



## Surviving Spouse Documents

Assess the various options



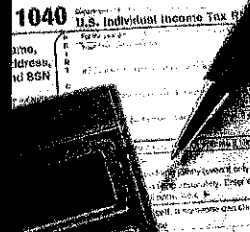
- Notes:**
- This chart isn't absolute, and an estate plan must be prepared and customized to the client's individual facts. Also, state estate tax issues could impact the decision.
  - This chart focuses on the document structure as it relates to the spouse.
  - Even with a simple will, a client may decide to implement generation-skipping transfer "downstream."

### Endnotes

1. Unless there are significant business entity interests that could be discounted at the first death with little audit risk. In such a case, a client may want to move assets out of the surviving spouse's estate via a disclaimer option or merely design bypass from the outset. Otherwise, the surviving spouse could end up with a majority of business with no (or modest) discounts.
2. If a qualified terminable interest property trust (QTIP) is elected, most likely portability will be as well. Be aware that inequities could occur if the surviving spouse elects QTIP and portability, and he doesn't waive the right of reimbursement from the QTIP. No such potential inequity exists with a traditional bypass trust. Portability may make sense even with traditional bypass, depending on how much exemption is left over after funding a bypass trust.
3. *Ibid.*
4. Warning: It's best for the surviving spouse not to be the executor making the QTIP election if there's a *Clayton* provision; otherwise, there could be gift implications.
5. There are other variations of the disclaimer approach that are beyond the scope of this chart.

— Charles A. Granstaff

This flow chart was previously published in Volume 52, No. 2, Real Estate, Probate and Trust Law Reporter, State Bar of Texas



**Sample Formula Waiver**

*Wording for the surviving spouse to sign*

I, Mary Doe, in exchange for the Executor making a portability election in the Estate of John Doe, hereby waive any right of reimbursement under Section 2207A of the Internal Revenue Code with respect to the Mary Doe Marital Trust (the Marital Trust), but only to the extent of the federal estate tax assessed against my estate attributable to the value of the Marital Trust assets equal to an amount up to but not exceeding the amount of the deceased spousal unused exclusion amount (the DSUE amount) as finally determined from the Estate of John Doe (whether or not such DSUE amount is available to my estate at the time of my death). The amount of the reimbursement right from the Marital Trust that is waived shall be determined by the following calculation process: (1) Determine the amount of reimbursement that would be due to my estate from the Marital Trust under Section 2207A but for this waiver (the Section 2207A reimbursement amount); (2) If the value of the Marital Trust assets for estate tax purposes at my death is equal to or less than the DSUE amount, the full Section 2207A reimbursement right is waived; (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, enough of the Section 2207A reimbursement amount is waived such that my estate will bear no more federal estate tax than if: (i) the Marital Trust assets were not included in my gross estate for federal estate tax purposes, and (ii) if only my applicable exclusion were used not including the DSUE amount. I agree that I will include this formula waiver in my Will or Revocable Trust in accordance with Section 2207A(a)(2).

*I'd like to thank Steve Akers for his insight and significant contributions to the language of this formula waiver and Al Golden's insight and comments.*

*— Charles A. Granstaff*

to have the surviving spouse sign a formula waiver that's designed only to waive Section 2207A as to the benefits the surviving spouse derived from the DSUE carried over. Thus, each family pays its share of any estate tax. While facts and circumstances vary from client to client and wording must be carefully tailored to the situation, see "Sample Formula Waiver," this page, for language that you could include in this waiver.

**Example 2**

Ralph and Betty have been married 15 years. Both have children from prior marriages. Ralph dies in 2014 with a \$3 million estate. QTIP status and portability are elected. Betty dies a few years later with her own \$10 million estate and a \$6 million exclusion amount. The QTIP

trust has grown to \$8 million at Betty's death.

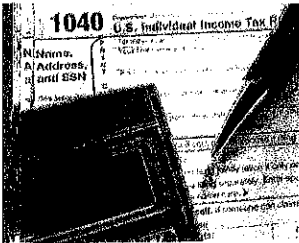
<b>1. Total tax:</b>	
Betty's	\$10 million
+ Ralph's (QTIP)	<u>\$8 million</u>
	\$18 million
Betty's exemption	( <u>\$6 million</u> )
DSUE (Ralph)	<u>(\$5.34 million)</u>
	\$6.66 million
	<u>x 40%</u>
	\$2.664 million

<b>2. Fair allocation:</b>	
A. QTIP should pay: \$1.064 million calculated as follows:	
	\$8 million
	<u>(\$5.34 million)</u>
(Betty benefitted from \$5.34 million DSUE)	\$2.66 million
	<u>x 40%</u>
	\$1.064 million

B. Betty should pay: \$1.6 million calculated as follows:	
	\$10 million
(\$18 million gross estate less \$8 million QTIP)	<u>(\$6 million)</u>
(\$11.34 million less the \$5.34 million DSUE)	\$4 million
	<u>x 40%</u>
	\$1.6 million
\$1.6 million (Betty pays) + \$1.064 million (QTIP pays)	
	= \$2.664 million total estate tax

<b>3. Applying proposed formula 2207A waiver:</b>	
Total Section 2207A potential reimbursement amount:	\$ 2.664 million
Surviving spouse's estate tax if no QTIP or DSUE were factored in:	\$1.6 million
Amount of Section 2207A reimbursement waived:	\$1.6 million
Amount of Section 2207A reimbursement owed by QTIP trust:	\$1.064 million

**4. Conclusion:** This is a fair result because the QTIP trust must only reimburse the surviving spouse's estate for the tax on the increased QTIP trust asset



value exceeding the DSUE (that is, (\$8 million - \$5.34 million = \$2.66 million) x 40% = \$1.064 million).


### Remarriage

Temporary Regulations Section 20.2010-1T(d)(5) provides that the DSUE available at the surviving spouse's death relates to the most recently deceased spouse married to the surviving spouse. Temp. Regs. Section 25.2505-2T(a)(1) allows the surviving spouse to apply the DSUE to gifts even if he remarries, as long as his new spouse is alive; however, once the new spouse dies, the DSUE from the prior deceased spouse is lost. Despite whether the surviving spouse might benefit from a potential new DSUE, losing the first DSUE could cause more hardship on one of the parties, depending on how the elections and any waiver were structured. If the surviving spouse remarries a wealthy individual who dies having fully used his applicable exclusion amount, the surviving spouse will have no DSUE. The executor should consider refraining from making QTIP and portability elections involving wealthy younger surviving spouses more apt to remarry, unless it's clear that the surviving spouse will promptly gift and fully use the DSUE.

### Additional Concerns

While the formula Section 2207A waiver solves the allocation problem described above, there are additional concerns that practitioners will need to consider before using such a waiver. Could the agreement be construed as a contingent QTIP election? Because Section 2207A(a)(2) requires the waiver to be included in a will or revocable trust, can an executor and surviving spouse contract to make a will? Unfortunately, when new laws, such as portability, are passed, there can be unintended results caused by other IRC sections. Such is the case here.

When concerns about potential complications and inequities with electing both portability and QTIP status outweigh planning for a step-up in basis, the traditional bypass trust might be a better fit because Section 2207A doesn't apply. Alternatively, bypass trusts can be designed so that the assets could receive a step-up in basis by being included in the surviving spouse's estate (for example, invoking the Delaware tax trap). Such techniques are beyond the scope of this article, although they're not without their own drawbacks. Drafters who include QTIP trusts in their documents to potentially receive a

step-up in basis at the surviving spouse's death but fail to appropriately consider portability and Section 2207A, may put executors in difficult situations. While the executor could certainly still require such a waiver prior to the portability election in the absence of guidance in the will or revocable trust, the executor's job will be easier and less controversial if the governing documents address these issues. The testator may also wish to insert language in the document giving the executor sole discretion as to whether a QTIP election or portability election is made and exculpating the executor from liability to any beneficiary or person for either making or forgoing such elections. Otherwise, many executors may decide the risks outweigh the merits of serving. 



### SPOT LIGHT

**Singing The Blues**  
"Art Blakey" (24 in. by 18 in.) by Frederick J. Brown, sold for \$5,000 at Swann Auction Galleries' recent African-American Fine Art Sale in New York on June 10, 2014. The Chicago-raised Brown referenced religious, historical and urban themes in his work but was especially noted for his numerous portraits of jazz and blues artists.

## Appendix 4 Estate Planning Questionnaire for

(each spouse should fill out a separate questionnaire)

**Dated** \_\_\_\_\_

In order for us to better assist you, we need to know what are your major concerns vs. minor concerns. The answers may not give us a definitive design to your plan, but they could give us a good indication of your objectives. Please take a moment to answer these questions. Your attorney will help you address any unanswered questions in your conference:

	NO or Not Concerned										YES or Very Concerned	
1. Do you think the value of your estate will significantly increase in the future (including future inheritances)?	1	2	3	4	5	6	7	8	9	10		
2. Are you concerned about your spouse remarrying and/or changing the estate plan?	1	2	3	4	5	6	7	8	9	10		
3. Factoring in family dynamics, are you concerned with beneficiaries at the first spouse's death pestering or harassing (or even suing) the surviving spouse about their future inheritance?	1	2	3	4	5	6	7	8	9	10		
4. Are you concerned about your assets ultimately going down to grandchildren once your children die?	1	2	3	4	5	6	7	8	9	10		
5. How concerned are you about your assets obtaining a "step-up" in basis at the surviving spouse's death? (If you are not familiar with this concept, we'll explain at meeting).	1	2	3	4	5	6	7	8	9	10		
6. Factoring in the assets your spouse will own and have access to at your passing, are you more concerned that your spouse have access to your assets even if that results in the reduction in assets available to the remainder beneficiaries or is preservation of the core assets for children and/or other relatives a bigger concern?	1											
		_____ Spouse								_____ Children		
			_____ Balance									

7. Is it more important to you to keep things simple for the surviving spouse or is it more important to protect the assets from the surviving spouse's potential liability or remarriage or creditors?

Simplicity  
for spouse

Asset  
Protection

**QUESTIONS 8-11 SHOULD BE ANSWERED IN CONFERENCE AFTER ATTORNEY EXPLANATION**

8. If you were to use a trust, are you more concerned about your assets not being included in your spouse's estate (i.e., concern that the joint estate will exceed \$5.25 million indexed for inflation or that Congress may lower the estate tax exemption) or are you more concerned that the assets are included in surviving spouse's estate in order to receive a step-up in basis for capital gains tax purposes?

Estate tax  
exclusion

"Step-up"\*  
In basis

9. If portability is elected by your Executor, do you want your estate to pay for the preparation of the Form 706 to make such election or would you prefer your spouse to pay the cost out of his or her own funds?

Estate  
will pay

Spouse  
will pay

10. Do you want to give full discretion to your Executor regarding whether or not to make a QTIP election and/or a portability election?

Yes

No

11. Do you wish to exculpate your Executor from liability in connection with such discretion?

Yes

No

\* If you choose "step-up" and have concerns about your joint estate exceeding your estate exemption, portability should be elected to increase exemptions.

Signed: \_\_\_\_\_

Dated: \_\_\_\_\_

**Appendix 5**  
**Acknowledgment of Estate Plan Chosen**  
(For couples with a net worth exceeding \$5 million)

In January of 2013 Congress passed the American Taxpayer Relief Act 2012 (an extremely favorable estate tax law), but the number of options and their pros and cons can be a bit overwhelming. Without the proverbial “crystal ball,” it will be impossible for you or us to design the perfect plan. Hindsight, as they say, is always 20/20. Nevertheless, by diligent “engineering” on the front end, your plan will have a much greater chance of success. Our responsibility is not to dictate what you should do, but instead to educate you and provide logical recommendations based on your facts and desires so that you can make an educated decision.

For couples with a net worth exceeding approximately \$5 million (or those who feel future growth will exceed that) who desire to benefit each other and to utilize both spouses’ estate tax exemption amounts (in 2016 \$5.45 million per taxpayer, increased for inflation for future years) to minimize estate taxes, two primary techniques and a “hybrid” are available:

1. Elect Spousal Portability on the IRS Form 706 Estate Tax Return of the first spouse to die (allows the surviving spouse to carryover first spouse’s unused exemption). Portability could be used in conjunction with an outright marital bequest or a QTIP trust.

2. Create a testamentary bypass trust at the first spouse’s death. This allows first spouse to die to “park” his assets in trust for the benefit of the surviving spouse with such assets plus appreciation passing estate tax free to remainder beneficiaries at the surviving spouse’s subsequent death (but assets will not receive a basis adjustment). Please note that it is possible to create a bypass trust that will be included in the surviving spouse’s estate whereby the trust assets would receive a basis adjustment.

3. Employ a Disclaimer Will (hybrid) , whereby the surviving spouse can EITHER a) take the assets outright or b) disclaim them into a bypass trust for the surviving spouse’s benefit. This is not “all or nothing” in that the spouse can accept certain assets while disclaiming others. Electing portability could make sense in conjunction with this technique.

Each vehicle has distinct advantages and disadvantages. The next page helps match the advantages of the techniques with various concerns you may have. Your specific concerns will have a significant bearing on which technique you choose.

<u>Are you most concerned about?</u>	<u>Advantage Portability &amp; Outright Marital</u>	<u>Advantage Traditional Bypass Trust</u>	<u>Advantage Trust with QTIP Election &amp; Portability</u>
1. Simplicity - as to flow of assets.	✓		
2. Expect significant appreciation in the Estate.		✓	
3. Cost of Preparation of Form 706 to Elect Portability at the death of the first spouse to die.		✓*	
4. Less maintenance going forward after estate is settled.	✓		
5. Obtaining a second step-up in basis for income tax purposes.	✓		✓
6. The ability to protect the assets for multiple generations (GST considerations).		✓	✓
7. Concern that the surviving spouse could remarry and change the testamentary plan at the second death.		✓	✓
8. Concern that children or stepchildren will badger, harass (or even sue) the surviving spouse about their remainder interest if a trust is created.	✓		
9. If the surviving spouse remarries and survives a new spouse and the new spouse utilizes his or her exemption, the surviving spouse could lose the DSUE of the first deceased spouse.		✓	

\* Note in some cases, even if a traditional bypass trust is used, it may be advisable to elect portability if bypass did not fully utilize deceased spouse's exemption in which case the cost of the portability election would be incurred in any event.



Many clients will have concerns about some or all 9 items, but no technique generally satisfies all the concerns. After a thorough explanation of the advantages and disadvantages, we have chosen\*:

Date: Signature:

- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
- \_\_\_\_\_
1. Simple testamentary plan (i.e., everything to each other) via Will or revocable management trust "RMT" and with option to elect portability. We understand that if portability is elected, the preparation of the Estate Tax Return by our CPA or tax lawyer is a one time cost that could take 20-80 hours to prepare depending on the estate's complexity.
  2. Traditional bypass trust at first spouse's death (electing portability could still be an option depending on how much goes into the bypass trust).
  3. Create a QTIP testamentary Trust such that executor can decide at the first spouse's death whether to elect QTIP treatment or leave trust as a traditional bypass. In some estates that have non-tax reasons for creating a testamentary trust, such a trust could be "QTIPable" at first spouse's death so that the surviving spouse could decide the format of the trust - 1) either elect QTIP Trust status which would include assets in surviving spouse's estate and provide a step-up in basis, 2) not elect QTIP status (i.e., nonqualified trust often referred to as a bypass trust) and whereby assets would not be included in surviving spouse's estate and would not receive a step-up, or 3) a combination of 1 and 2 via a partial QTIP election. In order to elect QTIP status, an IRS Form 706 will need to be prepared and filed and portability most likely would be elected.
  4. Hybrid-Disclaimer Will/RMT-Simple on front end (i.e., all to each other) with the ability for surviving spouse to disclaim if he or she feels the testamentary trust is a better fit at that time. This option would not make sense if remarriage is a concern. A disadvantage of this approach is that if the spouse disclaims, the spouse could not have a testamentary "limited power of appointment" to redirect how the assets would pass among specified beneficiaries at the surviving spouse's subsequent death.

\*Note that the selections below are broad categories of techniques and there may be variations and customized features within the framework of each technique.

P:\WP2\Client Communications\Estate Planning\Appendix 5.vpd

APPENDIX 6

BASIS ADJUSTMENT ACKNOWLEDGMENT  
(for blended families)

We acknowledge that we have a blended family and desire to transfer some or all of our assets in a testamentary trust for the surviving spouse whereby the first spouse to die controls the disposition at the surviving spouse's death. We realize that in a traditional trust, the trust assets would not receive a basis adjustment at the surviving spouse's death. We also understand that there are trust designs that could be used to obtain a basis adjustment at the surviving spouse's death, but those designs have their own risks. We have chosen the following design:

Date                      Signature

\_\_\_\_\_  
\_\_\_\_\_                      \_\_\_\_\_  
1. Traditional bypass trust. I realize there will be no opportunity for a step-up in basis in trust assets at the surviving spouse's death.

\_\_\_\_\_  
\_\_\_\_\_                      \_\_\_\_\_  
2. QTIPable bypass trust. If QTIP election is made, QTIP trust assets would receive a basis adjustment. I realize that if the QTIP election is made at my death and the surviving spouse's estate or the QTIP trust assets increase significantly in value, unfair tax allocations could result to either my family or my spouse's family (under §2207A).

\_\_\_\_\_  
\_\_\_\_\_                      \_\_\_\_\_  
3. Special Bypass Trust designs involving general powers of appointment (several variations including third party power to grant surviving spouse a general power of appointment, giving the surviving spouse a formula general power of appointment and intentionally triggering the Delaware Tax Trap). While the design could be refined to mitigate the risk that the power holder could exercise it in a manner that deviates from the desires of the first spouse to die, some risk would still exist. The design under this number 3 would increase the legal fees for the estate plan due to the extra time to "engineer" and draft the technique.

Appendix 7  
Sample Portability Acknowledgment  
(Assumes that the surviving spouse is also the executor.  
If not, adjust letter accordingly)

Letterhead

\_\_\_\_\_, 2016

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Executrix of the Estate of \_\_\_\_\_

RE: Our file # \_\_\_\_\_

MEMORANDUM

Facts: It appears the estate will be less than \$5.45 million; thus, no estate tax will be due. Moreover, as we have discussed, the preparation of an Estate Tax Return (i.e. Form 706) will not be required. Nevertheless, you may elect to have a Form 706 prepared and filed to be eligible to benefit from the “portability” of your deceased spouse’s unused exemption (DSUE) to you.

Current Law: ATRA 2010 §303 changed the law effective January 1, 2011 to provide that the executor of a deceased spouse’s estate may transfer any unused estate exemption to the surviving spouse. This law was made permanent by the American Taxpayer Relief Act of 2012 (ATRA 2012). In effect, portability adds your spouse’s unused federal estate tax exemption (“exemption”) to yours for both federal gift and estate tax purposes. For example, if your spouse made no lifetime taxable gifts and left everything outright to you, [his/her] exemption was never used since everything going to you qualified for the unlimited marital deduction. In this example, if you file the Form 706 timely [his/her] \$5.45 million exemption could be added to yours. Under current law, this would give you \$10.9 million exemption going forward. While your exemption is indexed for inflation, the DSUE will be frozen in the amount of exemption in the year of death.

Required Action Necessary to Qualify for Portability: In order to carry over the deceased spouse’s unused exemption (DSUE), the Internal Revenue Code requires the decedent’s Estate to file a Form 706 within nine months after the decedent’s death and make a portability election. Since the Estate was less than \$5.45 million, but for this portability election, you have no requirement to

prepare and file an estate tax return. This type of a return is significant to prepare and could take your CPA or our office numerous hours to complete, depending on the complexity of the estate.

Tough Decision: As Executor, you are faced with a difficult decision. Armed with the proverbial "crystal ball" such that you knew what your estate value will be at your passing along with what the federal estate exemption will be at that time, the decision would be easy. Carrying over the deceased spouse's unused exemption (DSUE) could potentially save the family significant estate tax or it may not save any estate tax depending on your estate value and the law at the time of your passing.

Safest Answer: The safest answer is to meet the criteria to qualify for portability assuming the decedent's unused exemption eligible to be transferred is significant. It is similar to an insurance policy in that you or the estate pays to have the estate tax return prepared to elect portability in return for securing millions of dollars in estate exemption to be available at the surviving spouse's passing. If the Executor could have qualified to increase the surviving spouse's exemption and does not, the Estate's ultimate beneficiaries could be disappointed.

Potentially Wasted Expense and Effort. On the other hand, the expense and effort to have the return prepared could be considered "overkill" if at the time of your passing, your net worth is comfortably less than your one exemption.

Additional factors you need to be aware of:

1. If you remarry, keep in mind only the most recent deceased spouse's unused exemption may be used by the surviving spouse. Therefore, if you were to remarry and survive your new spouse and he/she uses his/her exemption, you will lose the DSUE (unless you gifted it before his or her death).
2. The surviving spouse can use the unused exemption amount for gifting.
3. Portability does not apply to generation-skipping; therefore, you cannot carry over the decedent's unused GST amount.
4. Portability is not available to non-resident aliens.
5. The DSUE amount is not subject to being reduced if Congress later reduces the basic exemption amount.

Conclusion: Unfortunately, this decision must be made in the next few weeks so that if you decide to qualify for the portability exemption, the estate tax return can be timely prepared and filed. Please see the election below and select your choice by initialing the appropriate line and return to our office. We have made an extra copy of this memo for you to keep for your records. If you would like to visit more about this, please call our office or set up an appointment. Alternatively, if you would like our office to visit with your CPA about this decision, please let us know. We apologize in advance for these complications, but we are trying our best to help you deal with the options pursuant to the current tax laws.

Yours very truly,

Charles A. Granstaff  
Attorney at Law

CAG/dp

cc: \_\_\_\_\_, CPA (email: \_\_\_\_\_)

### Acknowledgment

I, \_\_\_\_\_, Executor/trix of the Estate of \_\_\_\_\_ hereby acknowledge that Granstaff, Gaedke and Edgmon, P.C. has thoroughly explained the advantages and disadvantages of electing portability by filing a Form 706 U.S. Estate Tax Return to me.

Date: \_\_\_\_\_ Signature: \_\_\_\_\_

After a thoughtful analysis, I have made the following decision:

(Place your initials next to your selection)

\_\_\_\_\_ The Executor elects to pursue portability

\_\_\_\_\_ The Executor elects not to pursue portability

Appendix 8  
Sample Letter to Client Concerning  
ATRA

January 12, 2016

John & Mary Taxpayer  
123 City Street  
Anywhere, Texas 12345

RE: Significantly Different Estate Tax Environment  
Our file No.: \_\_\_\_\_

Dear Mr. & Mrs. \_\_\_\_\_:

Finally, after over a decade of uncertainty and looming sunset of temporary laws, Congress decided the fate of the estate tax. The good news is Congress passed two extremely favorable laws which will exclude most taxpayers from paying estate tax while giving them more flexibility and options which will allow some couples to simplify their plans.

1. The estate tax exemption for 2016 is \$5.45 million per person indexed for inflation. It was passed as a permanent law that will not sunset automatically at a later date (but that does not mean Congress could not change it in the future). Most tax experts predict the exemption will remain high over the long-term.
2. A new concept called portability was passed. If the first spouse passes away and the surviving spouse wants to take advantage of the deceased spouse's unused \$5.45 million (for 2016), the executor can file a Form 706 and elect to carryover the unused \$5.45 million (for 2016) and add it to the surviving spouse's unused \$5.45 million exemption. This gives taxpayers an option unavailable in years past. Prior to portability, the primary method for the deceased spouse to utilize his or her exemption while benefitting the surviving spouse was through a testamentary trust (bypass trust) activated at the first spouse's death.

Based on the above changes to the estate tax laws, IF the sole reason for including a bypass trust in their plan was to save estate tax, couples may not want or need it under current tax laws. Several such surviving spouses that have come into our office to probate recently have been disappointed that they have the complications of the trust when they now have no estate tax exposure under the new law. Despite this, there may be other non-tax reasons for the bypass trust such as concerns about a surviving spouse remarrying and changing beneficiaries that may result in a client wishing to retain the bypass trust. For those of you who prefer to read more on this subject, please find the attachment entitled "Short History."

Furthermore, typically formulas are often used by lawyers in tax planned documents and if your spouse is not the primary beneficiary of your bypass trust, the higher exemptions could cause a drastic change in the amount each beneficiary receives. If your spouse is the beneficiary of the bypass trust (typically the case), this will not be a problem. Although the new law is very favorable and gives taxpayers many more options, determining what is best for you must be based on your specific facts.

Unless a compelling circumstance necessitates a quicker review, estate plans should be revisited every 4 -6 years in any event. In light of the sweeping changes in the American Taxpayers Relief Act of 2012, you should review your estate plan with a lawyer to ensure your planning objectives are met. If you would like a lawyer in our office to assist you, we would appreciate your patience due to the number of clients receiving this correspondence.

Yours very truly,

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Attorney at Law

### Short history:

For many years the estate tax exemption was \$600,000 per person. If a couple had a community property estate exceeding \$600,000, they typically would insert a bypass trust inside their will (or revocable trust). At the first spouse's death, the deceased spouse's assets would flow into the bypass trust for the surviving spouse's benefit for life and at his or her death, the trust assets would pass on to the beneficiaries estate tax free. This is what you currently have in your wills. Below we discuss the disadvantages and advantages of retaining a bypass trust.

#### Disadvantages of a Traditional Bypass Trust:

There are pros and cons with most things in life and bypass trusts are no exception. In the past, a bypass trust would save a client hundreds of thousands of dollars in estate tax, so this huge tax advantage almost always outweighed the disadvantages which are:

1. Complexity of surviving spouse dealing with a trust.
2. Filing separate income tax returns for the trust annually.
3. Compressed trust income tax rates (this can be avoided by distributing income to spouse each year).
4. No step-up in basis for capital gains purposes at second death for assets held in the bypass trust.

Now with the higher exemptions and portability, a couple with an estate of \$3 million might ask themselves, "Do I want to burden my surviving spouse with a bypass trust if the advantages under the new law do not apply to us?" Utilizing portability, a couple could have a simple will leaving everything to each other and still pass up to \$5.45 million, or up to \$10.9 million if the portability option is elected, to their beneficiaries estate tax free. Please keep in mind though, an estate tax return must be prepared to elect portability.

Nevertheless, while one reason for creating the bypass trust was to avoid estate taxes, there may be non-tax reasons a client would prefer to keep the bypass trust in place such as a spouse's concern about a surviving spouse remarrying, a surviving spouse changing the ultimate disposition of the assets, or exposing assets to surviving spouse's future liabilities. If a trust is necessary and a step-up is important, it is possible to create a trust whereby the underlying assets could receive a step-up in basis. Thus, a discussion with an attorney before making any decision to simplify would be prudent.

#### Advantages of a Traditional Bypass Trust

1. If one spouse is concerned about the surviving spouse changing the disposition of the assets at the second death, the bypass trust is safer than leaving everything to the spouse outright. For instance, say a couple has children from prior marriages and the spouses want to ensure their assets ultimately benefit their children or one spouse is concerned that their spouse might remarry and benefit a new spouse with family assets.



2. If a couple has a combined estate that exceeds \$10.9 million now.
3. If a couple is concerned that their estate could explode in value in the future.
4. If a couple has a strong desire to ensure their grandchildren ultimately receive their assets after their children die and their estate exceeds \$5.45 million (portability does not apply to generation-skipping).