CONTEMPORARY ESTATE PLANNING PARADIGMS FOR MARRIED COUPLES

Samuel A. Donaldson

Professor of Law
Georgia State University College of Law
Atlanta, Georgia

Senior Counsel
Perkins Coie LLP
Seattle, Washington

The combination of the American Taxpayer Relief Act of 2012 and the 2017 Tax Cuts and Jobs Act fundamentally changed tax planning, especially for wealthy married couples. This short handout offers basic estate planning templates for married couples with small, medium, and large estates, respectively, in light of these developments.

I. BACKGROUND

A. The Significance of Income Tax Planning

The following chart offers a visual comparison of pre- and post-Act tax brackets for 2018:

Federal Income Tax Brackets for Individuals, Estates, and Trusts – ORDINARY INCOME

PRE-TAX CUTS AND JOBS ACT*				POST-TAX CUTS AND JOBS ACT (THROUGH 2025)			
2018 Taxable Income Exceeding				2018 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Rate	Single	Married	Trusts and Estates	Rate
$0	$0		10%	$0	$0	$0	10%
$9,525	$19,050	$0	15%	$9,525	$19,050		12%
$38,700	$77,400	$2,600	25%	$38,700	$77,400		22%
$93,700	$156,150	$6,100	28%	$82,500	$165,000	$2,550	24%
$195,450	$237,950	$9,300	33%	$157,500	$315,000		32%
$424,950	$424,950		35%	$200,000	$400,000	$9,150	35%
$426,700	$480,050	$12,700	39.6%	$500,000	$600,000	$12,500	37%

* From Revenue Procedure 2017-58, issued October 19, 2017.

The chart on the next page explains the taxation of capital gain and dividend income:

Federal Income Tax Brackets for Individuals, Estates, & Trusts – CAPITAL GAINS & DIVIDENDS

PRE-TAX CUTS AND JOBS ACT*				POST-TAX CUTS AND JOBS ACT (THROUGH 2025)			
2018 Taxable Income Exceeding				2018 Taxable Income Exceeding			
Single	Married	Trusts and Estates	Cap Gain Rate	Single	Married	Trusts and Estates	Cap Gain Rate
$0	$0	$0	0%	$0	$0	$0	0%
$38,700	$77,400	$2,600	15%	$38,600	$77,200	$2,600	15%
AGI > $200,000	AGI > $250,000		18.8%	AGI > $200,000	AGI > $250,000		18.8%
$426,700	$480,050	$12,700	23.8%	$425,800	$479,000	$12,700	23.8%

* From Revenue Procedure 2017-58, issued October 19, 2017.

Importantly, the Tax Cuts and Jobs Act made no changes to the application of §1014, which provides a fair-market-value-at-date-of-death basis for property acquired from a decedent.

B. The (In)Significance of Transfer Tax Planning

The American Taxpayer Relief Act of 2012 made permanent the $5,000,000 basic exclusion amount for federal estate, gift, and generation-skipping transfer taxes that was introduced in the Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010. The basic exclusion amount adjusted for inflation after 2011.

For decedents dying in	The basic exclusion amount is
2011	$5,000,000
2012	$5,120,000
2013	$5,250,000
2014	$5,340,000
2015	$5,430,000
2016	$5,450,000
2017	$5,490,000

Pursuant to Revenue Procedure 2017-58, the basic exclusion amount for 2018 was set to be $5,600,000. But the Tax Cuts and Jobs Act doubles the basic exclusion amount under §2010(c)(3) from $5 million to $10 million, with adjustments for inflation after 2011 using a new, "chained-CPI" method. Thus, **the basic exclusion amount for 2018 is $11,180,000** (nearly twice the $5.6 million figure originally estimated for 2018).

The Act provides that the basic exclusion amount will revert to $5 million (adjusted for post-2011 inflation) after 2025. The estimated revenue loss from doubling of the basic exclusion amount is $83 billion over ten years.

The House Bill called for a temporary repeal of the estate and generation-skipping transfer taxes, along with a reduction in the tax rate applicable to taxable gifts. But the Senate Bill focused only on doubling the basic exclusion amount, an approach adopted in the Conference Bill. Thus, the federal wealth transfer taxes survive, but once again suffer a significant reduction in scope.

As a result of ATRA and the Tax Cuts and Jobs Act, some married couples have been rendered "statutorily poor:" they used to have taxable estates when the exclusion amount was much lower, but they no longer have taxable estates now that, with only a modicum of planning between the two of them, they can transfer $10.9 million without triggering federal wealth transfer taxes. For these couples, transfer tax planning has obviously become much less significant.

But even wealthy couples with taxable estates may not fear wealth transfer taxes as they once did, for ATRA set the rate of federal estate and gift taxes at a flat 40%. That is less than the 55% maximum rate that would have kicked in had ATRA not imposed a 40% rate. And the 40% rate is awfully close to the marginal tax rates faced by many couples with taxable estates.

Year	Transfer Tax Rate	Highest Income Tax Rate
2010	0%	35% ordinary, 15% capital
2011 – 2012	35%	35% ordinary, 15% capital
2013 - 2017	40%	43.4% ordinary, 23.8% capital
2018	40%	40.3% ordinary, 23.8% capital

For some couples, therefore, federal wealth transfer tax planning is no more important than federal income tax planning. That is dramatically different than where we were a decade ago.

Year	Transfer Tax Rate	Highest Income Tax Rate
2000	37-55%	39.6% ordinary, 28% capital
2001	37-55%	39.1% ordinary, 20% capital
2002	41-50%	38.6% ordinary, 20% capital
2003	41-49%	35% ordinary, 15% capital
2004	45-48%	35% ordinary, 15% capital
2005	45-47%	35% ordinary, 15% capital

C. The Portability Election

ATRA also made permanent the revised definition of the "applicable exclusion amount" used for federal estate and gift tax purposes. Instead of expressing the applicable exclusion amount as a fixed dollar amount ($2 million in 2006, 2007, and 2008; $3.5 million in 2009; $5 million in 2010), the applicable exclusion amount now is the sum of the basic exclusion amount ($5,000,000 as adjusted for inflation) and the "deceased spousal unused exclusion amount," referred to in the

regulations as the “DSUE Amount.” Very generally, the DSUE Amount consists of the unused portion of a deceased spouse’s basic exclusion amount.

The DSUE Amount is not available automatically; the statute requires an election by the deceased spouse’s executor. Regulations finalized in 2015 confirm the statutory requirement that an estate claiming the portability election must file an estate tax return within nine months of the decedent's death (unless an extension of time for filing has been granted), regardless of the size of the gross estate and regardless of whether an estate tax return would otherwise be required to file a return. But in the case of smaller estates, the regulations provide that estates not otherwise required to file a Form 706 may, in lieu of reporting the value of certain property that qualifies for the marital or charitable deduction, instead estimate the total value of the gross estate (including the values of the property that do not have to be reported on the estate tax return under this provision), based on a determination made in good faith and with due diligence regarding the value of all of the assets includible in the gross estate.

Planners and commentators initially dismissed the portability election as a safety net for taxpayers who, for whatever reason, failed to engage in traditional marital deduction planning. It was easy to dismiss the portability election in part because when it was first introduced in late 2010, it was scheduled to last for only two years. Now that the election is more or less a permanent feature of federal wealth transfer tax planning, however, planners cannot dismiss the portability election so easily. Indeed, in some cases the portability election might prove preferable to traditional marital deduction planning.

II. SORTING MARRIED COUPLES – THE “BUCKET” APPROACH

Planning for married couples, however, could change significantly. The current structure of the federal income, estate, and gift tax system makes it so no one template can be used for all married couples. Instead, modern tax planning requires married couples to be sorted into one of three “buckets,” each with its own template.

BUCKET ONE	BUCKET TWO	BUCKET THREE
Combined net worth less than one basic exclusion amount (no more than $11.18 million in 2018)	Combined net worth more than one basic exclusion amount but not more than two basic exclusion amounts (more than $11.18 million but not more than $22.36 million in 2018)	Combined net worth more than two basic exclusion amounts (more than $22.36 million in 2018)

This section of the materials offers a possible template for each bucket. Before doing so, two points must be stressed from the outset. First, the application of state estate, gift, and inheritance tax laws may affect the relative size of each bucket and even, perhaps, the total number of buckets in play. Suppose, for example, that a married couple with a $7 million

combined net worth resides in a state that imposes its own wealth transfer tax with an exclusion amount of only $2 million. The strategies discussed below for Bucket One assume no transfer tax at all will be imposed. If the amount of state estate tax is a concern, the planner in this example might limit the Bucket One template to couples with combined net wealth of $2 million or less and use some of the strategies from Bucket Two in an attempt to plan for the state estate tax. But even that approach requires caution, as state estate tax systems may not permit all of the options described in Bucket Two, most notably QTIP and portability elections. So where state transfer taxes are an issue, the planner will need to give careful consideration as to how these templates may be applied successfully to couples that face liability for such taxes.

Second, just as no two snowflakes are alike, no two estate plans are ever identical. What follows are general templates that a planner can use as a starting point in designing the precise estate plan that will work best for any particular married couple. These templates do not consider the special issues that arise, for example, in planning for a beneficiary with special needs, planning for couples that hear the word “dynasty” and get all atwitter, or planning for couples that intend to leave the bulk of their wealth to one or more charitable organizations. Likely no one will use the exact templates set forth herein, but hopefully they provide a helpful framework for building plans that will actually be implemented.

A. Planning for Bucket One Couples. There is a three-part template for married couples with a combined net worth not in excess of the basic exclusion amount.

BUCKET ONE TEMPLATE
* Trust or outright gift upon death of first spouse?
* Ensure stepped-up basis for all assets on death of surviving spouse
* Consider protective portability election

Transfer Upon First Spouse’s Death: Trust or Outright Gift? The couple needs to decide how the assets of the first of them to die should pass. For most couples, there are two choices: by outright gift to the surviving spouse or to a trust of which the surviving spouse is a beneficiary. In answering this question, taxes are irrelevant. Clients choosing to use a trust will be doing so for non-tax reasons. Those reasons could include: (1) the desire of the first spouse to die to control the disposition of his or her assets after death; (2) a concern that the surviving spouse may not have the capacity or desire to manage the assets; and (3) a concern that assets in the name of the surviving spouse might be vulnerable to creditors.

Of course there are also good reasons for clients to prefer an outright gift, like the desire to avoid the costs of trust formation and administration or the desire to avoid the complexity of trusts (you can’t get much simpler than an outright gift). Happily, Bucket One couples are free to choose the method that works best for them; taxes do not control any of the decisions here.

Ensure All Assets Get Stepped-Up Basis on Survivor’s Death. Since transfer tax planning is not an issue for Bucket One couples, it is crucial that planners get the income tax planning piece

right. And that means ensuring everything gets a fresh-start, fair market value basis for income tax purposes upon the surviving spouse's death.

Where couples choose to let assets pass to the surviving spouse by **outright gift**, the step-up in basis on the surviving spouse's death is assured since the spouse owns everything. At this point, however, it is worth mention that the fresh-start, fair market value basis on property passing from a decedent can cause a "step-down" in basis as well (as where the property's value at the time of the surviving spouse's death is less than the surviving spouse's adjusted basis in the property). While estate planners are well-trained in making sure such losses are recognized prior to death so they are not lost, clients will sometimes find a way to die before fully purging loss assets from their portfolios. "Step-downs" will thus happen from time to time. But most beneficiaries will benefit from the application of the fair-market-value-at-date-of-death rule.

Obtaining a stepped-up basis for everything on the surviving spouse's death is more complicated where the couple decides to have assets pass from the first spouse to die via a **trust**. If structured as a typical irrevocable trust, the assets of the trust will not receive a stepped-up basis on the death of the surviving spouse because those assets are not included in the surviving spouse's gross estate for estate tax purposes. For Bucket One couples using trusts, therefore, the key is to create a trust that causes inclusion of the trust assets in the survivor's gross estate. Gross estate inclusion is not an adverse result for Bucket One couples, recall, because federal wealth transfer taxes are not an issue: even if everything is included in the surviving spouse's gross estate, the total size of the estate is less than the surviving spouse's basic exclusion amount.

There are at least two ways to structure a trust so that it results in gross estate inclusion, thus assuring that the assets get a stepped-up basis on the surviving spouse's death. First, the trust instrument can give the surviving spouse a testamentary power to appoint all or any portion of the trust estate to the surviving spouse's estate. This is a **general power of appointment**, and property subject to a general power of appointment is generally includible in the gross estate of the power-holder. In order for this approach to get the maximum advantage, the surviving spouse should be entitled to all of the income from the trust (payable at least annually) for the surviving spouse's life. This makes the property passing to the trust eligible for the estate tax marital deduction, thus maximizing the amount that can pass to the surviving spouse through a portability election, as described below. But since estate taxes are not a factor for Bucket One clients, it is not critical that the surviving spouse receive the income. Nor is it crucial that the power be so broad; it is sufficient, for example, that the spouse has a testamentary power to appoint the trust property only to the creditors of the surviving spouse's estate.

Second, the trust can be structured to qualify for the qualified terminable interest property ("**QTIP**") exception to the terminable interest rule. If a trust meets the requirements for a QTIP election and the executor of the estate of the first spouse to die properly makes the QTIP election, the assets remaining in trust upon the death of the surviving spouse will be included in the surviving spouse's gross estate, thus assuring here too that the assets qualify for a stepped-up basis. Some practitioners had been concerned that the Service might disregard QTIP

elections made by the estate of a Bucket One deceased spouse on the grounds that the QTIP election was not necessary to avoid imposition of federal estate tax. In Revenue Procedure 2016-49, however, the Service made clear that it would not disregard a valid QTIP election unless requested to do so by the executor.

Consider the Protective Portability Election. By definition, estate taxes are not an issue for Bucket One couples. Even if the clients completely bungle the handling of the first spouse's estate, the surviving spouse alone has a basic exclusion amount ample enough to shelter all of the property from federal wealth transfer taxes. Thus one may rightfully wonder why the Bucket One template would consider the need for a portability election.

Planners might consider a portability election upon the death of the first spouse simply because the surviving spouse may come into other, unexpected wealth (prizes, jackpots, punitive damage awards, treasure trove) or may see unexpected surges in the value of assets. In any of those cases, having the deceased spouse's unused exclusion amount in addition to surviving spouse's own basic exclusion amount could prove helpful. Since the only cost to making the portability election is filing a timely estate tax return that would be subject to the relaxed reporting requirements described above, this would likely be cheap insurance.

B. Planning for Bucket Two Couples. Planning for these couples is perhaps the most challenging. Clearly *some* transfer tax planning is in order; if the planner does nothing and wastes the first spouse's applicable exclusion amount, the surviving spouse will not have sufficient exclusion to cover the couple's combined net worth, even if those assets do not appreciate in value after the death of the first spouse.

The question, though, is what kind of planning makes the most sense. Before 2011, we always used our friend, the credit shelter trust. Even where the credit shelter trust made no sense outside the world of taxes, it was often the only recourse to make sure each spouse's exclusion was utilized fully. Now, however, we also have the portability election at hand. And for clients in Bucket Two, the portability election is usually all we need to make sure federal wealth transfer taxes remain a nullity. So the planner has to consider which is better: using the good, old-fashioned credit shelter trust or the new-fangled portability election.

When Credit Shelter Trust is Better. In many cases, the credit shelter trust will be the better option. The two principal advantages of credit shelter trusts are these:

(1) Asset Appreciation Expected. Unlike the basic exclusion amount, the "deceased spousal unused exclusion amount" from a portability election does not adjust for inflation. Thus, for example, suppose the executor of the first deceased spouse elects to have a $11 million DSUE Amount pass to the surviving spouse. When the surviving spouse dies 25 years later, the basic exclusion amount will be substantially higher, but the DSUE Amount will still be $11 million.

On the other hand, assets placed in a credit shelter trust will not be subject to estate tax on the death of the surviving spouse no matter how much they may appreciate in value. If the assets owned by the surviving spouse are expected to appreciate substantially before the surviving spouse's death, then, the credit shelter trust will usually be the preferred option.

(2) Client Wants to Use the Generation-Skipping Transfer Tax Exemption. While the portability election applies for both federal estate tax and federal gift tax purposes, it does not apply for purposes of the generation-skipping transfer tax. On the other hand, executors can elect to apply the GSTT exemption to assets placed in a credit shelter trust, permanently shielding the trust assets from the generation-skipping transfer tax. If the couple wants to make significant provision for grandchildren and other beneficiaries further down the line of descent, the credit shelter trust will be more attractive.

When Portability is Better. But there are situations where portability may have the edge over credit shelter trusts. Here are three that come to mind:

(1) Some Assets Don't Fit Well in Credit Shelter Trusts. Retirement accounts and residences make for poor assets in a credit shelter trust. For income tax purposes we can generally achieve better results by naming the surviving spouse as beneficiary instead of a trust. For purposes of excluding gain from the sale of a residence, moreover, title in the surviving spouse's name is better since trusts cannot occupy a residence, one of the conditions required for excluding gain.

(2) Some Surviving Spouses Don't Survive Long Enough. If the surviving spouse does not live for a meaningful period of time following the first spouse's death, there is little chance that assets inside of a credit shelter trust will have had an opportunity to appreciate in value to any significant extent. So after undergoing the expense, delay, and complexity involved in funding and administering the credit shelter trust, it would do no better than the simple, cost-effective portability election.

(3) Stepped-Up Basis May be More Important. Remember that assets owned either outright by the surviving spouse or by a QTIP trust will get a stepped-up basis for income tax purposes on the death of the surviving spouse. Assets inside of the typical credit shelter trust, however, do not get a step-up in basis. One must therefore check the balance sheets, for if the lurking capital gain in the estate is substantial yet the combined net worth puts the couple just over one basic exclusion amount, the step-up in basis matters much more than the estate tax savings—to the point that a credit shelter trust may be unwise.

BUCKET TWO TEMPLATE
* Trust or outright gift upon death of first spouse?
* If <u>outright gift</u> preferred, use disclaimer planning
* If <u>trust</u> is preferred, use *Clayton* QTIP

So the decision between a credit shelter trust and a portability election, ultimately, comes down to the answers to these five questions: (1) when will the first spouse die?; (2) what assets will the couple have at the time of the first spouse's death?; (3) how much longer will the surviving spouse live after the death of the first spouse?; (4) what will the basic exclusion amount be when the first spouse dies?; and (5) what will the transfer tax rates be upon the death of the first spouse? If we know this information, we can make the right choice. But few planners will be in a position to answer these questions with any confidence. Accordingly, the important theme for all planning in Bucket Two is **flexibility**. We want a plan that can let the couple choose the right path (credit shelter trust or portability election) when they have better answers to those five questions (i.e., after the death of the first spouse) instead of a plan that forces them to commit to one path now when there is so much uncertainty. This template does that.

Transfer Upon First Spouse's Death: Trust or Outright Gift? It all starts with the same question posed to Bucket One couples: if taxes were not an issue, what should happen to the assets when the first spouse dies? Since we can create an effective plan regardless of which option the couple chooses (outright gift or trust), tax consequences have no relevance at this stage. See the Bucket One template for discussion of when couples might prefer outright gifts over trusts and vice versa.

Outright Gifts – Disclaimer Planning. If the couple elects to have the assets of the first spouse pass to the survivor by outright gift, then the testamentary document (will or living trust) should contain a provision whereby any gift properly **disclaimed** by the surviving spouse shall pass to a credit shelter trust. This way, we keep both portability and the credit shelter trust on the table, and we need not choose between them until after the death of the first spouse to die.

If, for example, we know after the death of the first spouse that portability is the better option (because the survivor is not expected to live long, or because of the nature of the assets, or because of whatever other reason), the surviving spouse simply accepts the gift. The executor can then file an estate tax return that claims a full marital deduction. This reduces the taxable estate to zero (since all passes to the surviving spouse outright), and then the unused applicable exclusion amount passes to the surviving spouse. But if we decide that a credit shelter trust is the better option, the spouse can disclaim the gift (or disclaim an amount equal to the amount of the first spouse's remaining applicable exclusion amount) and by operation of the instrument the gift will pass to the credit shelter trust.

This structure postpones making the ultimate decision until after the death of the first spouse. Like any plan making use of qualified disclaimers, the planner should discuss with the couple the practical constraints involved. For instance, the surviving spouse must not accept the benefit of any of the deceased spouse's property in order for any disclaimer to be valid. That means funds will need to be available for the surviving spouse so that the survivor is not tempted to accept the benefit of the deceased spouse's property before the final decision whether to make a disclaimer has been made.

Trusts – Clayton *QTIP.* If the couple instead opts to have the assets of the first spouse pass to the survivor through a trust, a good vehicle is the so-called *Clayton* QTIP trust. A *Clayton* QTIP is just like a regular QTIP trust in that all income is to be paid at least annually to the surviving spouse and trust distributions during the spouse's lifetime can be made only to the surviving spouse. And like a regular QTIP trust, the executor has to elect to treat assets intended to qualify for the marital deduction as "qualified terminable interest property." But the *Clayton* QTIP trust contains an additional provision: to the extent the executor does not elect to qualify an asset passing to the trust as qualified terminable interest property, such property shall automatically pass to a credit shelter trust.

An example illustrates the flexibility of this approach. Suppose the deceased spouse's will leaves everything to a *Clayton* QTIP. If the deceased spouse's executor decides that portability is the preferred planning option for whatever reason, the executor will make the QTIP election on a timely filed estate tax return for all of the assets in the trust. The gift will qualify for the unlimited marital deduction, meaning the deceased spouse's taxable estate will be reduced to zero and the full deceased spousal unused exclusion amount can port over to the surviving spouse. If the executor instead decides that the credit shelter trust is best, the executor can select assets with a value equal to the deceased spouse's remaining applicable exclusion amount and then make the QTIP election for *all other assets*. The unelected assets will pass automatically to the credit shelter trust.

As with the disclaimer approach, the *Clayton* QTIP allows the couple to defer making the decision between portability and the credit shelter trust until after the first spouse dies. It thus provides the needed flexibility.

C. Planning for Bucket Three Couples. Unlike good stories, we have saved the most boring for last. Not much has changed when it comes to advising, say, the $50 million estate. The techniques used prior to both the Act and the American Taxpayer Relief Act remain attractive now. Choosing between portability and a credit shelter trust alone will not be enough.

The planner still needs to consider strategies that can reduce the amount of wealth subject to tax while still retaining the desired level of control over and cash flow from the assets in the estate. These strategies include: spousal lifetime access trusts (SLATs); irrevocable life insurance trusts (ILITs); grantor retained annuity trusts (GRATs); charitable lead trusts (CLATs and CLUTs); charitable remainder trusts (CRATs, CRUTs, NIMCRUTs); donor-advised funds, private foundations, and pooled income funds; family limited partnerships (FLPs) and limited liability companies; installment sales to "defective" grantor trusts; and dynasty trusts. Of course, even some Bucket Two couples may find one or more of the these strategies useful in their own planning as well. But it's now primarily Bucket Three couples that are concerned with gross estate minimization.