DRAFTING IN THE DARK – HOW TO BUILD FLEXIBILITY INTO ESTATE PLANS DURING TIMES OF UNCERTAINTY[1]

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A. Introduction

Steve Akers of Bessemer Trust called the post-2017 Tax Act period "déjà vu on steroids." Once again practitioners found themselves on the other side of a sea-change of the transfer tax regime only to have "stability" for a number of years. As in 2012, the current tax environment presents unique planning opportunities. However, the results of the most recent election may mean that Cinderella's coach turns back in to a pumpkin sooner than expected, and we are back to a $5 million exclusion amount (or even $3.5 million!!).

This paper will examine techniques to best take advantage of the increased basic exclusion amount while we have it, and to build flexibility in to our planning so that our client's needs are still met if, and when the law changes. The first part of this paper will address testamentary planning, from disclaimer plans to more sophisticated planning using marital and non-marital trusts. The second part of this paper will explore planning techniques for lifetime transfers.

Although this paper focuses on transfer and income tax planning, it is important to remember that these considerations should be secondary to the goals and needs of the client, regardless of the size of the client's estate. Planners should consider family dynamics such as a blended family, any concerns for undue influence over a surviving parent, any disabilities or incapacities of descendants, asset protection considerations, successive spouse considerations, and the nature and liquidity of the client's assets.

B. Current Transfer Tax Regime

1. Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act of 2017 (the 2017 Tax Act) significantly changed our approach to planning. Before the 2017 Tax Act, the first $5,000,000 (as adjusted for inflation in years after 2011) of transferred property was exempt from estate tax, gift tax, and generation-skipping tax. For estates of decedents dying and gifts made in 2018, this "basic exclusion amount" as adjusted for inflation, would have been $5,600,000 ($11,200,000 for a married couple). With proper planning, the unused portion of a deceased spouse's exclusion amount (DSUE) could be added to that of the surviving spouse for purposes of the estate tax and gift tax. We refer to this as portability of the DSUE.

[1] Some of the drafting examples included in this manuscript are based on the examples in the BB&T Estate Planning Forms Manual originally authored by Graham Holding and Christy Eve Reid and recently updated by Jessica Hardin and John Forneris of Robinson Bradshaw in Charlotte, NC. It is an invaluable resource for NC trust and estate attorneys.

For decedents dying and gifts made from 2018 through 2025, the 2017 Tax Act doubles the basic estate and gift tax exemption amount from $5,000,000 to $10,000,000. Indexing for inflation brings this amount to $11,700,000 for 2021, ($23,400,000 per married couple), with the same basic portability techniques available. The 2017 Tax Act doesn't specifically mention the generation-skipping transfer tax (GST), but because the GST exemption amount is based on the basic exclusion amount, the GST exemption amount is similarly adjusted.

With the passage of the 2017 Tax Act, essentially practitioners are planning around two, and in some cases three, estate tax exclusion amounts. This paper will refer to the first exclusion amount as the "Old Exclusion Amount." This is the exclusion amount under I.R.C. § 2010(c)(3), before the change made by the 2017 Tax Act (i.e. $5,000,000, indexed). The second exclusion amount (the "New Exclusion Amount") is the § 2010(c)(3) amount as altered by § 2010(c)(3)(C) (i.e., $10,000,000, indexed). The third exclusion amount is any DSUE available to a surviving spouse. In planning with the DSUE, note that the 2017 Tax Act augmented DSUE does not vanish January 1, 2026. Treas. Regs. §20.2010-2(c)(1).

Unless Congress acts sooner, on January 1, 2026 the New Exclusion Amount "vanishes" and we are left with the Old Exclusion Amount. In the interim, the Old Exclusion Amount and the Combined Exclusion Amount (Old plus New Exclusion Amounts) will both increase with chained CPI indexing. The increase in the Old Exclusion Amount and Combined Exclusion Amount over the next seven years, assuming a CPI increase of 1% per year is as follows:

Year	1.0% Rate of Increase Old Exclusion Amount	1.0% Rate of Increase Combined Exclusion Amount
2021	5,850,000	11,700,000
2022	5,908,500	
2023		
2024		
2025		
2026	6,111,172	N/A

2. Clawback

The doubling of the basic exclusion amount by the 2017 Tax Act set the stage for yet another clawback debate. The question was what effect would the sunset of the applicable provisions of the 2017 Tax Act have on gifts made during the time that the basic exclusion amount was doubled. Would those gifts, although covered under the New Exclusion Amount, be clawed-back in to a decedent's estate if he died after the New Exclusion Amount disappears? Congress partially addressed clawback, adding a new I.R.C. Section 2001(g)(2) which provides as follows:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between:

> (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
>
> (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

On November, 12, 2019, the Treasury issued final regulations to address the clawback concern. Section 20.2010-1(c)(1) of the Regulations provides that if the credit attributable to the basic exclusion amount for determining the gift tax payable on any post-1976 gift is greater than the credit attributable to the basic exclusion amount allowable in determining the estate tax liability, then the basic exclusion amount used in computing the donor's estate tax liability will be the higher basic exclusion amount attributed to determining the gift tax payable. The final regulations contain the following example:

> Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $11.4 million in basic exclusion amount allowable on the dates of the gifts. The basic exclusion amount on A's date of death is $6.8 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15 [addressing same-sex married couples]. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) applies, and the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on A's post-1976 gifts.

What these regulations do not provide is an "off the top" option for the use of the New Exclusion Amount. In other words, there is no direction that making a $5 million gift in 2018-2026 will first use the New Exclusion Amount, leaving the Old Exclusion Amount (after sunset or repeal of the 2017 Tax Act) to be applied against the estate tax at the donor's death. Consider the following example.

> Bill has an Old Exclusion Amount of $5,850,000 and a New Exclusion Amount of $5,850,000. Combined, he has a Basic Exclusion Amount of $11,700,000.00. The New Exclusion Amount "vanishes" January 1, 2026. Assume no inflation adjustment to the Basic Exclusion Amount. Assume Bill has $11,700,000 of wealth.
>
> Bill gives away $5,850,000 of wealth in 2021. He pays no gift tax because his Basic Exclusion Amount of $11,700,000 covers the gift. Bill dies in 2026 with $5,850,000. What is the estate tax occasioned at Bill's death in 2026?

Estate Tax Calculation

Taxable Estate:	$5,850,000
Adjusted Taxable Gifts:	$5,850,000
Tax Base:	$11,700,000
Tentative Tax (40%)	$4,680,000
2026 Applicable Credit	$2,340,000 [attributable to the Old Exclusion Amount]
Tax Due:	$2,340,000

Do gifts during the period that a donor has both the Old Exclusion Amount and the New Exclusion Amount use the New Exclusion Amount first? According to the Regulations, the answer is no. If a donor who has not previously made any taxable gifts makes a $5,850,000 gift in 2021, and if the donor dies after the New Exclusion Amount sunsets, the donor effectively will be treated as having used $5,850,000 of the Old Exclusion Amount, and none of the New Exclusion Amount. To take advantage of this "window of opportunity" in case the New Exclusion Amount later disappears, the donor must make a gift in excess of the $5,850,000 Old Exclusion Amount.

Contrast this approach with the one that taken by the portability Regulations. The portability Regulations provide that a surviving spouse is considered to apply her DSUE amount from her last deceased spouse to a taxable gift before the surviving spouse's own basic exclusion amount. Treas. Regs. §25.2505-2(b). In effect, this allows a donor to use the exclusion amount received from donor's last deceased spouse before using her own exclusion amount.

During this time of uncertainty, gifting will likely take center stage. It may be the one time that making a gift will result in a tax-free removal of value from the donor's estate. In any other time, making a gift does not remove the value of the gift from the donor's transfer tax base because it is included as an adjusted taxable gift. However, if the donor makes a large gift and the exclusion amount is later reduced, the donor will be able to apply the gift tax exclusion amount used during life, if that amount is greater than the exclusion amount in effect at the donor's death.

In fact, the transfer tax advantages of making large gift this year in order to use the New Exclusion Amount are so great that clients may consider borrowing funds to make gifts. With interest rates at historic lows, clients may be able to borrow money, make the gift to use the exclusion amount before it disappears, and not part with any assets. Trust beneficiaries may also consider borrowing trust assets to make tax-advantaged gifts.

3. Planning and Drafting

How do you plan and draft in the face of an ever changing transfer tax landscape? One way to evaluate planning and drafting opportunities for our clients is in relation to their wealth. Consider the following categories.

a. Couple with combined wealth not exceeding one Old Exclusion Amount (<$5,850,000).

There is no way this couple can leave their wealth in a fashion that will generate a transfer tax. However, while are no transfer tax planning implications to their estate plan, there are income tax/basis implications. This couple will never need the New Exclusion Amount.

b. Couple with combined wealth exceeding one Old Exclusion Amount; but not exceeding two Old Exclusion Amounts; i.e. not exceeding the Combined Exclusion Amount (between $5,850,000 and $11,700,000).

This category is almost as straight-forward was the one above. There is only one way to generate transfer tax - the first spouse to die, having wealth in excess of one Old Exclusion Amount, must leave all of his wealth in a fashion that does not qualify for the marital deduction and/or charitable deduction. Of course, the surviving spouse has an Elective Share right to potentially generate a marital deduction sufficient to result in no transfer tax. Absent that one occasion, there is no need to divide assets between spouses for transfer tax purposes. If the first spouse to die leaves everything to surviving spouse, the DSUE is available to the surviving spouse. If the first spouse to die transfers sufficient property to credit shelter trust (thereby using his Old Exclusion Amount), there will be no estate tax liability as one Old Exclusion Amount will be sufficient to shelter the surviving spouse’s wealth. This couple will never need the New Exclusion Amount.

c. Couple with combined wealth exceeding: (i) two Old Exclusion Amounts; plus (ii) one New Exclusion Amount; but not exceeding twice the Combined Exclusion Amount (between $11,700,000 and $23,400,000).

Two Old Exclusion Amounts will not cover all of this couple's wealth. At a minimum, they will need: (i) two Old Exclusion Amounts; plus (ii) at least one New Exclusion Amount. Therefore, this couple will need to use at least one New Exclusion Amount via an inter vivos and/or testamentary transfer. Obviously, the only way to use one New Exclusion Amount via testamentary transfer is for one spouse to die prior to January 1, 2026 (or prior to sooner Congressional action). Dying makes available the New Augmented DSUE to the surviving spouse. It also allows for the decedent to fund a credit shelter trust using the Old Exclusion Amount and the New Exclusion Amount of the decedent. At the death of the second to die, the wealth exposed to estate tax should not exceed one Old Exclusion Amount, or one Old Exclusion Amount, plus available DSUE.

If neither spouse agrees to die before the tax law change, they will need to make an inter vivos transfer to use one New Exclusion Amount. As noted above, a donor must use all of his Old Exclusion Amount to get to the New Exclusion Amount. That is, he must make a gift of at least $11,700,000 to fully use one New Exclusion Amount. Both spouses giving $5,850,000 would accomplish nothing because each would only use his or her Old Exclusion Amount. One spouse must give $11,700,000. Of course, other techniques for reducing the combined estates are available, in particular "perfect gifts". Perfect gifts are gifts which do not constitute "adjusted taxable gifts". That is, perfect gifts are gifts that qualify for the annual exclusion, medical exclusion and/or tuition exclusion. Techniques for freezing the combined estates are also available.

d. Couple with combined wealth exceeding twice the Combined Exclusion Amount afforded by the Old Exclusion Amount and the New Exclusion Amount (over $22,800,000).

Now, the couple needs to use both New Exemption Amounts via either inter vivos and/or testamentary transfers. As to testamentary transfers, both spouses need to die prior to January 1, 2026 (or sooner Congressional action). Absent a willingness on behalf of the spouses in this regard, both spouses need to make gifts fully utilizing their New Exemption Amount prior to the tax law change. The considerations noted in paragraph 3 above apply with equal force.

C. Testamentary Planning

1. Disclaimer Plan

Facts: Harold and Wilma have been married 35 years and have three children together. There are no children from prior relationships. Each child is a responsible adult, in a good marriage and the family gets along well with each other. The value of Harold and Wilma's combined gross estates is less than the Old Exclusion Amounts available to both of them today, but would exceed the projected Old Exclusion Amounts if the current law changed.

In this scenario, Harold and Wilma are well below the combined Old and New Exclusion Amounts, so using the New Amount before it the law changes is not a concern. Therefore, the planner may want to use an approach that provides flexibility in the case of death after the tax law changes – the disclaimer plan. Under this plan, assets are directed to the surviving spouse, but language is built in to the governing document directing any assets that are disclaimed by the surviving spouse to a credit shelter trust which will be excluded from the surviving spouse's gross estate at her later death. An obvious advantage of this approach is that it allows the surviving spouse and her advisors to assess the couple's financial situation and the tax environment in existence at the death of the first spouse and plan accordingly. It also ensures that a credit shelter trust will not be unnecessarily funded and that those assets will not be denied a second step-up in basis at the surviving spouse's later death.

Any discussion with clients about a disclaimer plan should also include a discussion of portability. It is important to educate clients about these options so that when the time comes to make a decision (a time that will be very difficult on its own) all parties are informed as to the options. Even if the death of the first spouse occurs after the sunset of the provisions of the 2017 Tax Act, the surviving spouse's Old Exclusion Amount along with the DSUE may obviate the need for her to disclaim any assets.

Drafting Example 1:

If my wife survives me, all of the remaining trust assets shall be distributed outright to my wife. My wife may disclaim all or any part of the trust assets distributable to her as she shall specify in an instrument in writing deposited with my Executor within the time allowed by law after my death. In the event of such a disclaimer, the Trustee shall administer the property affected thereby under the provisions of _________ of this Article [credit shelter trust].

Drafting Example 2:

If my wife survives me,

1. All of the trust property shall be distributed outright to my wife, except that if my wife disclaims, in whole or in part, her interest in any such property, the Trustee shall hold the disclaimed property in the [credit shelter trust] and dispose of it for the benefit of my wife [OPTION – my wife and my issue] in accordance with the provisions of Section ______ of this Article.

2. If my wife disclaims, in whole or in part, her interest in any property allocated to the [credit shelter trust], the Trustee shall dispose of the disclaimed property as if my wife did not survive me.

Planners must be cautious in relying on a disclaimer plan. There is no guarantee that the surviving spouse will be competent or willing to make the necessary disclaimer. To address the first situation, planners may include a specific power in the spouse's durable general power of attorney that allows the agent to disclaim assets on behalf of the spouse.

Drafting Example 3:

My agent may at any time waive, renounce or disclaim in whole or in part my interest in, right of succession to, or power over any property, including a power of appointment, even if the effect of such disclaimer benefits my agent.

It is also important to advise clients that the surviving spouse may not access any account that she may want to disclaim later. In order to be a qualified disclaimer for transfer tax purposes, the disclaimant must not have accepted the disclaimed property or any benefit of the disclaimed property. Treas. Regs. §25.2518-2(a)(4). This may be particularly confusing for a spouse who has just lost her partner of many years and is caught up in trying to gather and administer assets as quickly as possible. It is important that the spouse understands that she should not access any account, other than perhaps an account previously held jointly with her spouse, before talking to her attorney and CPA.

It is incumbent upon the planner to ensure that the couple's assets are properly titled, as failing to do so can render the best drafted disclaimer plan worthless. Ideally, the value of husband and wife's combined estates would be split as evenly as possible and in the separate names of husband and wife (or their respective revocable trusts). Also, beneficiary designations should be properly prepared naming the spouse as the primary beneficiary and the credit shelter or family trust as the contingent beneficiary. That way, if a spouse disclaimed assets from a retirement account or life insurance policy, those assets would pass to the proper trust.

Finally, the surviving spouse may not exercise, nor be granted, a power of appointment over the disclaimed assets. Treas. Regs. §25.2518-2(e)(1)(i) provides that the requirements for a qualified disclaimer are not met if "[t]he disclaimant, either alone or in conjunction with another, directs the redistribution or transfer of the property or interest in property to another person (or has the power to direct the redistribution or transfer of the property or interest in property to another person unless such power is limited by an ascertainable standard)." Drafters have long heeded this warning and generally do not include a power of appointment in a trust to which a surviving spouse may disclaim assets.

Interestingly, one commentator argues that drafters have missed the mark, and a great planning opportunity in this respect. Edwin P. Morrow, III relies upon Treas. Regs. § 25.2518-2(e)(2) for this argument. That regulation provides,

> [i]n the case of a disclaimer made by a decedent's surviving spouse with respect to property transferred by the decedent, the disclaimer satisfies the requirements of this paragraph (e)(2) if the interest passes as a result of the disclaimer without direction on the part of the surviving spouse either to the surviving spouse or to another person. If the surviving spouse, however, retains the right to direct the beneficial enjoyment of the disclaimed property <u>in a transfer that is not subject to Federal estate and gift tax</u> (whether as trustee or otherwise), such spouse will be treated as directing the beneficial enjoyment of the disclaimed property, unless such power is limited by an ascertainable standard.

(emphasis added).

Mr. Morrow argues that a general power of appointment can be retained by the surviving spouse and not disqualify her disclaimer for federal transfer tax purposes, because her right to direct the beneficial enjoyment would be one that is subject to Federal estate tax. *Optimal Basis Increase and Income Tax Efficiency Trust,* Edwin P. Morrow, http://ssrn.com/abstract=2436964 (2017). Consequently, Mr. Morrow argues that the surviving spouse could be given a formula general power of appointment over assets in the credit shelter trust in order to obtain a later step-up in basis. *Id.* at 78. This paper will address planning with formula general powers of appointment later.

This author believes it would be too risky to allow the surviving spouse to retain a general power of appointment over disclaimed property, Mr. Morrow's interpretation of the above-cited regulations appears to be at odds with the plain language of I.R.C. § 2518, which states that the disclaimed property must pass <u>without the direction</u> of the disclaimant. Certainly the exercise of a general power of appointment would be a direction by the disclaimant. Additionally, this author believes that the language in Treas. Regs. § 25.2518-2(e)(1) regarding the "power to direct redistribution" is not the same as the "right to direct beneficial enjoyment" in Treas. Regs. § 25.2518-2(e)(2). Canons of statutory construction tell us that Treasury would not have used different language in consecutive sections of this regulation to mean the same thing. The more likely interpretation is that the "power to direct redistribution" means a power of appointment (limited or general) and the "right to direct beneficial enjoyment" means the power as a trustee or other fiduciary.

If reliance on Treas. Regs. § 25.2518-2(e)(2) is misplaced, then the surviving spouse would have made a taxable transfer of the disclaimed property AND would then subject the property to estate tax at her later death, by virtue of I.R.C. § 2041. This would certainly not be the intended result.

In order to avoid this possibility, planners should always review the language of the governing document to make sure that the trust into which the spouse is disclaiming does not give the spouse a power of appointment, limited or general. If it does, that power of appointment must be disclaimed as well. Most documents will contain a savings clause, like the one below, to ensure that any missed power of appointment is also disclaimed.

Drafting Example 4:

<u>Special Provisions for Disclaimed Assets</u>. If, in the absence of this section, any disclaimed assets would pass to a trust created under this Agreement that is subject to individual or fiduciary powers held by the disclaiming party that would disqualify the disclaimer for purposes of Section 2518 of the Code, then the disclaimed assets shall instead be held in a separate trust that is in all respects identical to the original trust except that the disclaiming party will be prohibited from exercising those powers.

2. Marital Trusts

With portability came a new era in estate planning and a new exclusion amount to utilize in planning. Married couples can now pass twice as much to the next generation without incurring an estate tax and without the trouble of a trust though the use of the Old Exclusion Amount and the DSUE. Many practitioners have questioned whether the days of trust planning are gone, in favor of the more straightforward approach of an outright distribution to the surviving spouse. However, the benefits of trust planning go far beyond simply mitigating or eliminating estate tax liability. The drawbacks of relying only on portability for a client's estate plan include the following:

a) No asset protection from creditors, including a successive spouse
b) The deceased spouse's unused exclusion amount is not indexed for inflation
c) Portability does not apply to the generation-skipping transfer tax exemption
d) Must file an estate tax return to elect portability
e) The deceased spouse's unused exclusion amount is lost if the spouse remarries and survives second spouse
f) The surviving spouse can waste the deceased spousal unused exclusion amount if she agrees to split gifts with new husband.

Morrow at 4-9.

Assuming a planner wants to avoid these shortcomings and include a marital trust in a couple's estate plan, the following types of trusts may be used.

a. General Power of Appointment Trust

Facts: Harold and Wilma have been married 50 years and have three children together. There are no children from prior relationships. The value of Harold and Wilma's combined gross estates is less than the Old Exclusion Amounts available to both of them, and is expected to remain so even after the sunset of the 2017 Tax Act, or a sooner legislative change. Harold and Wilma wish to leave assets in trust for each other for non-tax reasons.

Use of the New Exclusion Amount is not important here because Harold and Wilma's assets are not expected to exceed the value of the Old Exclusion Amount. What is important to Harold and Wilma is using a trust for the surviving spouse for non-tax reasons and obtaining a second step-up in basis at the second death. A general power of appointment marital trust may be a good option.

We rarely see general power of appointment trusts because they do not provide the type of protection most spouses are trying to achieve. A general power of appointment trust is described in I.R.C. § 2056(b)(5) and requires that: (1) the surviving spouse be entitled to all income payable annually or in more frequent intervals; (2) the spouse have the power to appoint the assets of the trust to <u>herself or her estate</u>; and (3) no other person has the power to appoint any interest in the trust. Note that the power in the spouse to appoint assets to her creditors or the creditors of her estate, although a general power of appointment, will not qualify the trust for the marital deduction under I.R.C. § 2056(b)(5).

Because of the requirement that the surviving spouse have the power to appoint trust assets to herself or her estate, this trust is of limited usefulness. The protection from creditors or a successive spouse that most grantors are trying to achieve is thwarted by the power of appointment. However, in cases where clients are older, married and have only children of the marriage, a general power of appointment trust may be useful because assets can be left to the spouse in a marital deduction trust without filing an estate tax return to make the QTIP election. The assets in the marital trust will receive a second step-up in basis at the surviving spouse's death. Of course, assets in the martial trust may receive a step-down in basis at the surviving spouse's death.

Drafting Example 5:

1. *During my wife's lifetime, all of the net income derived from the Marital Trust shall be paid to or applied for the benefit of my wife in monthly or quarterly installments. At my wife's death, any undistributed income shall be distributed to my wife's estate.*

2. *During my wife's lifetime, the whole or any portion of the principal of the Marital Trust shall be transferred and delivered, discharged of the trust, to such person or persons (including my wife), in such amounts or proportions and in such manner as my wife from time to time appoints or directs in writing.*

3. *The Trustee may, in the absolute discretion of the Trustee, pay to or apply for the benefit of my wife so much of the principal of the Marital Trust as the Trustee from time to time deems requisite or desirable.*

4. *At my wife's death, the remaining assets of the Marital Trust shall be distributed to such appointee or appointees (including my wife's estate) as my wife appoints and directs in an effective will or codicil specifically referring to this general power of appointment. If my wife fails to exercise this power of appointment with regard to all or any portion of the trust assets, such unappointed assets shall be administered and disposed of in accordance with the provisions of ________________.*

Drafting Example 6:

1. During my wife's lifetime, the Trustee shall distribute all of the net income of the trust to my wife in convenient installments at least quarter-annually.

2. The Trustee may distribute all or any portion of the principal of the trust to my wife in such amounts and at such times as the Trustee, in its discretion, may determine.

3. In addition, the Trustee shall distribute all or such portion of the principal of the trust to my wife and such other appointees, and in such manner and proportions, either outright or in trust, as my wife may appoint from time to time by instructions signed by her and delivered to the Trustees.

4. Upon my wife's death, the Trustee shall distribute all or so much of the then remaining trust property to such appointees, including the estate of my wife, and in such manner and proportions, either outright or in trust, as my wife may have appointed by her last will making specific reference to this general testamentary power of appointment. The balance of the then remaining trust property which has not been effectively appointed by my wife in accordance with her general testamentary power of appointment shall be disposed of in accordance with the provisions of_______________.

b. Standard QTIP

Facts: Harold and Wilma have been married 20 years and have two children together. Harold also has a child from a previous marriage. The value of Harold and Wilma's combined gross estates is less than the Old Exclusion Amounts available to both of them, and is expected to remain so even after the law changes.

Again, use of the New Exclusion Amount is not the driver of this plan because the Old Exclusion Amount should suffice to shelter assets from estate tax. What is most important is protecting assets for all of Harold's children and obtaining a second step-up in basis at Wilma's later death. This is there a typical QTIP marital trust would come into play. Assets could be left to a trust for the surviving spouse that qualifies for the marital deduction, but the spouse would have no power to direct assets. This would prevent her from being able to disinherit Harold's child from a previous marriage.

Section 2056(b)(7) of the Internal Revenue Code sets out the requirements for a valid QTIP trust. The spouse must have the right to all the income from the trust, payable annually or more frequently; no other person may have an interest in the trust; and the executor must make the election to have the trust treated as a QTIP trust on a timely filed estate tax return.

For some time, practitioners have not used QTIP trusts in the above scenario because they thought the IRS would determine that the QTIP election was not necessary (because the decedent's estate was not subject to estate tax and no marital deduction was needed), and therefore disregard the election entirely. This fear stemmed from Rev. Proc. 2001-38 which was issued to provide relief for surviving spouses when a predeceased spouse's estate made a QTIP election that did not reduce the estate tax lability. Revenue Procedure 2001-38 was designed to help taxpayers and outlined circumstances under which the IRS would ignore the unnecessary QTIP election. However, some practitioners feared that the IRS would use this Revenue Procedure offensively to disregard a QTIP election that did not reduce the estate tax due in the estate of the first spouse to die, but was nevertheless still intentionally made. Thankfully, in 2016 the IRS issued another Revenue Procedure clarifying that the IRS would continue to disregard unnecessary QTIP elections but only for estates which did not elect portability. Rev. Proc. 2016-49.

There are several drawbacks to this type of planning. First, assets in the QTIP trust may get a step-down in basis at the surviving spouse's death. (I.R.C. § 1014). Another drawback is with valuations. Consider a husband and wife owning 50% each in a closely held business. At the husband's death, his 50% interest passes to a QTIP trust for wife, with wife retaining her 50% interest in her own name. At wife's later death, the interest in the QTIP trust and the interest in wife's individual name will be valued as two separate interests and therefore subject to discounts (See *Mellinger v. Comm'r*, 112 T.C. 26 (1999)). This will reduce the value of the interests and necessarily reduce the amount of step-up in basis for those interests. On the other hand, if the wife had died owning 100% of the business interests in her sole name, no discount would apply. Morrow at 15. Note that this would likely not be an issue with a general power of appointment trust because the surviving spouse would have effective control over the assets in that trust, eliminating the basis for a discount.

Drafting Example 7:

1. *During my wife's lifetime, all of the net income derived from the Marital Trust shall be paid to or applied for the benefit of my wife in monthly or quarterly installments. At my wife's death, any undistributed income shall be distributed to my wife's*

estate.

2. *Principal. The Trustee may, in the absolute discretion of the Trustee, pay to or apply for the benefit of my wife so much of the principal of the Marital Trust as the Trustee from time to time deems requisite or desirable to fulfill the stated purposes of the Marital Trust.*

3. *Termination. At my wife's death, the remaining assets of the Marital Trust shall be administered and disposed of as follows:*

(a) *Tax payment. If my wife does not otherwise direct in her Will by specific reference to this Article, I direct the Trustee to pay to the personal representative of her estate, or directly to the taxing authority, the incremental death taxes payable by my wife's estate and attributable to her interest in the Marital Trust. [NOTE – this is not necessary to qualify the trust for the marital deduction, but is often included by drafters so that the QTIP trust bears its own share of any estate tax liability; See I.R.C. § 2207A]*

(b) *Disposition of remainder. The remaining assets of the Marital Trust shall be administered and disposed of in accordance with the provisions of ________________________. [NOTE – may include a testamentary limited power of appointment for spouse (I.R.C. § 2056(b)(7)(B)(ii)(II)]*

4. *Unproductive Asset. My wife may require the Trustee either to make any trust asset productive of income or to convert any unproductive asset within a reasonable time to one which produces income consistent with its value. [Treas. Regs. § 20.2056(b)-7(d)(2), referencing § 20.2056(b)(5)(f)]*

5. *Death Taxes. The personal representative of my estate may elect to qualify some part or all of the Marital Trust for the federal estate tax marital deduction. No death taxes shall be paid from any portion of the trust which my personal representative elects to qualify for the federal estate tax marital deduction unless all other assets available for payment of death taxes shall be insufficient.*

6. *Partial QTIP Election. If the personal representative of my estate elects to qualify only a portion of the Marital Trust for the federal estate tax marital deduction, the Trustee shall have the continuing authority at any time prior to the close of the administration of my estate to divide the trust principal into two shares based upon the percentage which would be included in my wife's gross estate for federal estate tax purposes determined as if she had died immediately prior to such division, and the resulting shares shall thereafter be administered as identical separate trusts. Any principal distributed to my wife prior to the creation of the separate trusts shall be allocated ratably to the separate trusts upon their creation. Thereafter, any distribution of principal to my wife shall be made only from the trust qualifying for the federal estate tax marital deduction until that trust is exhausted.*

Drafting Example 8:

During the lifetime of my wife,

1. The Trustee shall distribute all of the net income of the trust to my wife in convenient installments at least quarter-annually. Any unproductive property in the trust shall be converted by the Trustee within a reasonable time upon receipt of signed instructions from my wife to this effect.

2. The Trustee may distribute all or any portion of the principal of the trust to my wife in such amounts and at such times as the Trustee, in its discretion, may determine except that such distributions shall be made first from the portion of the trust, if any, which qualified for the marital deduction in the federal estate tax proceeding relating to my estate.

3. If the personal representative of my estate elects to qualify only a portion of the property passing to the Wife's Trust for the federal estate tax marital deduction, the Trustee, in its discretion, may at any time separate all of the property that would be includible in my wife's gross estate for federal estate tax purposes as if she died immediately before such separation from the property not so includible and hold such properties in two separate Wife's Trusts each of which shall be disposed of in accordance with the provisions of this Section.

Upon the death of my wife,

1. The Trustee shall distribute to my wife's estate all the undistributed income of the trust, including income accrued to the date of the death of my wife.

2. The then remaining principal of the Wife's Trust shall be disposed of as follows______________. [NOTE – may include a testamentary limited power of appointment for spouse]

c. Clayton QTIP

Facts: Harold and Wilma have been married 20 years and have two children together. Harold also has a child from a previous marriage. The value of Harold and Wilma's combined gross estates is less than combined basic exclusion amounts available to both of them, but may be more than the basic exclusion amounts when the provisions of the 2017 Tax Act sunsets (or the law is sooner changed).

In this situation, the key drivers of the plan are the same as with the QTIP trust above; however, Harold and Wilma also need the flexibility of a credit shelter trust if the value of their assets will exceed the Old Exclusion Amount available to them after the law changes. Here, a Clayton QTIP may be useful.

The Clayton QTIP derives its name from a 1991 Tax Court case which denied the marital deduction for a trust, the terms of which provided that if the decedent's executor did not make the QTIP election, the property would pass to a separate trust. *Clayton v. Comm'r*, 97 T.C. 327 (1991). In *Clayton*, the decedent directed an amount equal to his available exclusion amount to "Trust A" - a credit shelter trust - and left the residue of his estate to "Trust B", a trust designed to qualify for the marital deduction. The language of Mr. Clayton's will provided as follows:

> In the event my executors fail or refuse to make the election under Section 2056(b)(7)(B)(II)(v) of the [Internal Revenue Code], with respect to my Trust B property on the return of tax imposed by Section 2001 of the [Internal Revenue Code] then the property with respect to which such election was not made shall pass to and become part of the corpus of Trust A for the benefit of my Trust A beneficiaries.

Clayton at 328.

The Tax Court held that because the terms of the instrument provided that if the executor did not make the election, the assets would pass to a trust which was not a qualified terminable interest, the Executor essentially had the power to direct assets away from the marital trust to the non-qualified trust. According to the Court, this violated I.R.C. § 2056(b)(7)(B)(ii)(II) which provides that no person may have the power to appoint any of the trust property to any person other than the surviving spouse. The Court also noted that because the Executor had the power to direct assets from the marital trust to the non-qualified trust, it meant that the surviving spouse would technically not be entitled to all the income from the property in the marital trust, as required under I.R.C. § 2056(b)(7)(B)(ii).

Several Circuit Appeals Courts reversed the *Clayton* decision and the Tax Court ultimately reversed itself in *Clack v. Comm'r*, 106 T.C. 131 (1996). In *Clack*, the Tax Court acknowledged that it will no longer disallow the marital deduction for interests that are contingent upon the executor's election under I.R.C. § 2056(b)(7)(B)(v). In light of this ruling, the IRS promulgated a new regulation – Treas. Regs. § 20.2056(b)-7(d)(3)(i), which provides in relevant part that a "qualifying income interest for life that is contingent upon the executor's election under section 2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse."

The Clayton QTIP offers flexibility like the disclaimer option in that the decision as to if and by how much to fund the marital trust may be left until after the first spouse's death. However, that decision may be made up to 15 months after the death of the first spouse, instead of the nine-month widow a survive spouse has to make a qualified disclaimer. Also, the credit shelter trust under the Clayton QTIP plan may give the spouse a limited power of appointment, which is not available under the disclaimer plan. Morrow at 11.

One word of caution, an estate plan with a Clayton QTIP provision should have an independent executor. *Id.* If the surviving spouse has the ability to reduce or eliminate her mandatory income interest, there is an argument that she could be making a gift of that interest. (See *Regester v. Comm'r*, 83 T.C. 1 (1984) holding that when donor who had an income interest in a trust, exercised her limited power of appointment over the trust corpus to appoint the corpus, donor made a gift of the income interest).

Drafting Example 9:

A. If my wife survives me,

1. The Trustee shall set aside and hold as a separate trust referred to as the "Wife's Trust" to be disposed of for the benefit of my wife in accordance with the provisions of the Section of this Article entitled "Wife's Trust" (i) that fraction of the trust property with respect to which the personal representative of my estate makes an election under Section 2056(b)(7) of the Code (the "QTIP election"), or (ii) all of the trust property if my executor makes a QTIP election with respect to all of the trust property eligible for such election.'

2. The Trustee shall set aside and hold in a separate trust referred to as the "Family Trust" to be disposed of for the benefit of my wife and issue in accordance with the provisions of the Section of this Article entitled "Family Trust" the balance of the trust property, if any, or all of the trust property if no QTIP election is made with respect to the trust property.

Any assets which, in passing to my wife, would not qualify for the federal estate tax marital deduction shall be allocated to, or first be used to satisfy the gift to, the Family Trust.

B. If my wife does not survive me, then

1. If a child of mine survives me, all of the trust property shall be held in trust and disposed of for the benefit of my children and their issue in accordance with the provisions of the Section of this Article entitled "Trusts for Children."

2. If no child of mine survives me, all of the trust property shall be disposed of for the benefit of my issue and the other contingent beneficiaries in accordance with the provisions of the Section of this Article entitled "Contingent Beneficiaries."

3. Non-Marital Trusts

Consider situations in which a practitioner may not want to use a traditional marital trust. One reason may be that the planner wants to allow for distributions to children and grandchildren during the life of the surviving spouse. That would not be allowed under the terms of a marital trust because in order to qualify for the marital deduction, the spouse must be the only permissible beneficiary during her lifetime. Planners should become familiar with techniques that allow for the possibility of estate inclusion for the assets in a non-marital trust for the surviving spouse to cause estate inclusion.

These techniques may also be useful when considering whether to modify existing irrevocable trusts to allow for possible estate inclusion. This may come up in two situations. First, when the beneficiary of the irrevocable trust will have no estate tax liability, even with the inclusion of trust assets, by reason of the Old Exclusion Amount it would be a good idea to trigger inclusion for the second step-up in basis. Secondly, if you have a beneficiary that will likely not survive the sunset of New Exclusion Amount, it may be a good idea to trigger estate inclusion so that you do not lose the benefit of the New Exclusion Amount.

a. Independent Trustee with Power of Distribution

Perhaps the easiest way to build in flexibility for a second step-up in basis at the surviving spouse's death is to give an independent Trustee the power to distribute principal to the surviving spouse. This also allows the Trustee to pick the appropriate appreciated property, leaving behind any property which may be subject to a step-down in basis.

Of course, the ideal time for a Trustee to make such a distribution would be as close to the death of the surviving spouse as possible. However, absent a clairvoyant trustee, it will be very difficult for a Trustee to know the best time to make a distribution. Waiting too long could result in a lost opportunity due to the unexpected death of the surviving spouse. Making a distribution too soon could thwart the intent of the grantor by leaving assets susceptible to the whims and creditors of the surviving spouse.

Because of these unknowns, it may be difficult to find a trustee willing to exercise this power. It puts pressure on the trustee to keep tabs on the physical and financial health of the surviving spouse in order to determine the best time to make a distribution.

Drafting Example 10:

The Trustee may, in the absolute discretion of the Trustee, pay to or apply for the benefit of my wife so much of the principal of this Trust as the Trustee from time to time determines.

Drafting Example 11:

Distributions to Save Taxes. *The independent Trustee should consider making distributions which, in the independent Trustee's opinion, may result in overall tax savings. For example if the independent Trustee has reason to believe that the beneficiaries of my spouse's estate will be substantially similar to the beneficiaries of the Family Trust, the independent Trustee should consider distributing assets from the Family Trust to my spouse to obtain a stepped-up basis for such assets in my spouse's estate when the assets to be distributed, together with the value of other assets includible in my spouse's gross estate, would likely not exceed the amount sheltered from estate tax in my spouse's estate by reason of the applicable exclusion amount.*

b. Contingent General Power of Appointment

The terms of the credit shelter trust could grant the surviving spouse a contingent power of appointment which could be triggered if necessary to include all or a portion of the assets in the credit shelter trust in the surviving spouse's estate. The contingent nature of the power would be achieved through the use of a formula which would apply the power only to extent that the surviving spouse has any unused exemption amount. Ideally, the power would apply first to assets with the most appreciation.

Estate planners commonly use formulas in planning – in funding credit shelter and marital trusts, disclaimers, and partial QTIP elections. The Service has also sanctioned the use of formula general powers of appointment in the past. In PLR 200403094, husband's trust contained the following provision:

> At my wife's death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife's estate or to or for the benefit of one or more persons or entities, in such proportion, outright, in trust, or otherwise as my wife may direct in her Will.

The Service ruled that wife possessed a testamentary general power of appointment over assets equal to her remaining applicable exclusion amount. Accordingly, if wife predeceased husband, the value of the property over which she held the general power of appointment would be included in her gross estate. (See also PLR 200604028 holding that a power of appointment over property equal to husband's available applicable exclusion amount, less the value of his taxable estate, was a general power). Lester B. Law and Howard M. Zaritsky, *Basis after the 2017 Tax Act – Important Before, Crucial Now*, Heckerling Institute on Estate Planning (2019), at 86-87.

Interestingly, in both of these Rulings, the Service never questioned the fact that the assets subject to the general power of appointment were determined by reference to the spouse's available applicable exclusion amount after subtracting the value of his or her taxable estate (less the property subject to the power), which could only be determined after death. *Id.*

As with the independent Trustee's power discussed above, this technique allows for the selection of appreciated assets for inclusion in the surviving spouse's estate and leaving loss assets so as to not receive a step-down in basis. However, this technique may be preferable to the power to distribute trust principal in that: (i) it can be structured as a self-adjusting formula clause which will not require an independent party to keep tabs on the physical and financial health of the surviving spouse; and (ii) it requires no action on the part of the Trustee. *Id.* at 90.

There are disadvantages to this technique to keep in mind. First, any time planners incorporate a formula in drafting, they must be very precise to make sure it operates in the manner the planner and the client intend. Secondly, this technique should not be used along with a disclaimer plan as the spouse should have no contingent power of appointment over property she previously disclaimed.

Drafting Example 12:

My wife shall have the power to appoint to the creditors of her estate the lesser of (i) all of the assets of the trust or (ii) a portion of the assets of the trust equal to my wife's then-available Federal applicable exclusion amount as defined in the Code at the death of my wife, reduced by my wife's taxable transfers (including lifetime and testamentary transfers). If this general power of appointment is not applicable to all of the assets of the trust as described above, and if not prohibited by applicable law, this general power of appointment shall apply first to those trust assets which have a cost basis, determined as of my wife's date of death absent the grant of this power, relative to fair market value that results in the smallest percentage and then cascading to those assets having the next smallest such percentage relative to fair market value, and so on. My wife shall exercise this power in an effective will or codicil specifically referring to this general power of appointment. If my wife fails to exercise this general power of appointment with regard to all or any portion of the [credit shelter trust] assets, such unappointed assets of the [credit shelter trust] shall be administered and disposed of in accordance with the provisions of ____________________.

Drafting Example 13:

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the [credit shelter trust]. The numerator of such fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax payable by reason of my spouse's death. The denominator of the fraction shall be the value of the [credit shelter trust] as of my spouse's date of death.

My spouse may exercise this general power of appointment over such fractional share to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright or in trust, as my spouse may direct in her last Will and Testament.

Drafting Example 14:

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the Appreciated Assets, as that term is hereinafter defined. The numerator of such fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the *federal estate tax payable by reason of my spouse's death. The denominator of the fraction shall be the value of the Appreciated Assets as of my spouse's date of death.*

The Appreciated Assets shall mean those assets owned by the [credit shelter trust] upon my spouse's death with the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a), if such assets passed from my spouse with the meaning of Code § 1014(b).

My spouse may exercise the general power of appointment over such fractional share to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright or in trust, as my spouse may direct in her last Will and Testament.

c. Use of Trust Protector

In 2012, North Carolina added Article 8A to the North Carolina Uniform Trust Code. That Article allows a trust agreement to appoint a "power holder" who has authority to take certain actions with respect to the trust, but who is not the trustee. (N.C. Gen. Stat. § 36C-8A-1). The powerholder is also sometime called a trust protector. North Carolina law specifically provides that a trust protector may have the power to (1) direct investments and discretionary distributions; (2) modify or amend the trust agreement under certain circumstances; (3) remove and appoint trustees; and (4) grant a power of appointment to one or more beneficiaries. N.C. Gen. Stat. §36C-8A-2.

The terms of the credit shelter trust could give a trust protector the broad power to grant a general power of appointment to the surviving spouse. This power of appointment could be tailored to apply to only appreciated assets, leaving any depreciated assets out of the surviving spouse's estate and thereby avoiding a step-down in basis. This technique also eliminates the need for a formula. However, the same issues are raised as with the power in an independent trustee to make distributions to the surviving spouse: it may be difficult to find a trust protector willing to wield this type of power, and it is difficult to know the best time to grant such a power of appointment. *Id.* at 99.

Also, for the reasons mentioned above, this technique should not be employed in a disclaimer plan.

Drafting Example 15:

<u>Power to give beneficiary a general power of appointment</u>. The Trust Protector shall have the power to give my wife the power to appoint any portion or all of the assets of the affected trust to the creditors of my wife's estate in a writing signed and dated by the Trust Protector. This testamentary general power of appointment may empower my wife to appoint to the creditors of her estate the lesser of (i) all of the assets of the trust or (ii) a portion of the assets of the trust equal to my wife's then-available Federal applicable exclusion amount as defined in the Code at the death of my wife, reduced by my wife's taxable transfers (including lifetime and testamentary transfers). In addition, if this general power of appointment is not applicable to all of the assets of the

trust as described above, and if not prohibited by applicable law, this testamentary general power of appointment may be applied first to those trust assets which have a cost basis, determined as of my wife's date of death absent the grant of this power, relative to fair market value that results in the smallest percentage and then cascading to those assets having the next smallest such percentage relative to fair market value, and so on. This general power of appointment may be exercised in a writing signed and dated by my wife.

D. Gifts

1. Spousal Lifetime Access Trusts

Gift planning before a change to the 2017 Tax Act will focus on using a donor's New Exclusion Amount before it disappears. Take, for example, a married couple with assets in excess of the sum of the Old Exclusion Amount and the New Exclusion Amount. They will want to take advantage of the New Exclusion Amount, but as noted above, in order to reap the full benefits of the New Exclusion Amount, a donor will need to make a gift that exceeds his Old Exclusion Amount. This means that one spouse will need to make a gift of $11,700,000 in 2021.

Many couples are reluctant to part with this amount of wealth. For those couples, a spousal lifetime access trust ("SLAT") may be the solution. In this trust, the grantor would make a large gift to a trust for wife and children. Wife could be Trustee of the SLAT, make distributions to herself pursuant to an ascertainable standard and make discretionary distributions to her children. As long as the couple is together, husband will still indirectly have the benefit of the funds.

To add in more flexibility, clients may also incorporate any of the techniques discussed above with regard to non-marital trusts in order to provide for later estate inclusion in the wife's estate in case that the New Exclusion Amount is made permanent or the estate tax is repealed completely.

One question clients have when discussing this technique is what happens if the beneficiary spouse dies prematurely? Has the grantor spouse then lost all access to the trust funds? An option to address this is to include a provision in the SLAT that allows a powerholder to make a loan to the grantor spouse. The long-term AFR for February 2021 is 1.46%, meaning the grantor spouse should be able to leverage the loan funds by investing and receiving a higher rate of return. Below is sample language allowing a powerholder to make loans back to the grantor spouse.

Drafting Example 16

> *<u>Authority to Direct Trustees to Make Loans to Grantor</u>. I appoint ________ as Loan Director. During my lifetime, the Loan Director shall have the power, exercisable at any time and from time to time in a nonfiduciary capacity (within the meaning of Section 675 of the Code) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to compel the Trustees to loan some or all of*

the trust property to me without adequate security within the meaning of Section 675(2) of the Code although with adequate interest within the meaning of that section. I direct that this power is not assignable. If _________ fails or ceases to act as Loan Director for any reason, the successor Loan Director shall be such individual (other than me, my spouse, any person acting as a Trustee under this instrument or anyone who is an adverse party within the meaning of Section 672 of the Code) whom ____________________ shall have designated by instrument in writing. Any person acting as a Loan Director hereunder shall also have the power to name a successor Loan Director by an instrument in writing delivered to my Trustee.

Another option to hedge against the untimely death of the beneficiary spouse is to give the beneficiary a power to appoint trust assets in favor of the settlor spouse. However, this runs the risk of estate inclusion under §§ 2036(a)(1) and 2038. (See Rev. Rul 76-103, holding that seven irrevocable trusts were includable in a decedent's gross estate under §§ 2036(a)(1) and 2038 because, under applicable state law, the decedent's creditors could reach trust income and principal. See also Rev. Rul. 2004-64 holding that if a trustee is obligated to reimburse the grantor for income tax payments incurred by the grantor's deemed ownership of the trust, the full value of the trusts' assets is includable in the grantor's taxable estate under §2036(a)(1).

This would likely not be an issue in the one of the nineteen states[2] that allow creditor protection for assets transferred to a trust created by and individual for his own benefit, commonly known as self-settled asset protection trusts or domestic asset protection trusts. Unless the Service could show that there was a prearranged plan for the beneficiary spouse, use to exercise the power in favor of the grantor spouse, there should be no estate inclusion.

Another issue arises when the spouses get divorced. Care in drafting must be taken to ensure that not only the financial benefits to the ex-spouse cease, but also all of the ex-spouse's rights and powers under the agreement. Below is some sample language to achieve this:

Drafting Example 17

In the event I file or my spouse files a petition for legal separation or dissolution of marriage, my spouse, my spouse's parents, all descendants of my spouse's parents who are not my descendants and all spouses of such persons who are not descendants of my parents shall be deemed to have died intestate on the date of such filing for all purposes of this Agreement [(other than for purposes of the Section titled "Rule Against Perpetuities")] and (i) any exercises of powers of appointment by such persons that have not become effective prior to the date of such filing shall be null and void; provided, however, that if court order(s) are issued dismissing all such

[2] The nineteen states are Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming

petitions (whether filed by me or my spouse) and I accept the dismissal of such petitions filed by my spouse by a signed instrument, then (i) all such persons shall no longer be deemed to have died intestate for all purposes of this Agreement and (ii) any exercises of powers of appointment by such persons that were not effective prior to the filing of such petitions shall no longer be null and void,

Drafting Example 18

In the event I file or my spouse files a petition for legal separation or dissolution of marriage:

a. my spouse shall no longer be a beneficiary of any trust hereunder and any exercises of powers of appointment by my spouse that have not become effective prior to the date of such filing shall be null and void;

b. my spouse may continue to serve as a trustee of any trust hereunder (if designated as such), and retain any powers my spouse may have to create plans of trustees and to remove trustees; and

c. my spouse's parents, all descendants of my spouse's parents who are not my descendants and all spouses of such persons who are not descendants of my parents ("my spouse's family") shall be deemed to have died intestate on the date of such filing for all purposes of this Agreement [(other than for purposes of the Section titled "Rule Against Perpetuities")]and

d. any exercises of powers of appointment by my spouse's family that have not become effective prior to the date of such filing shall be null and void and (ii) all plans created by my spouse's family in their individual, fiduciary and representative capacities shall be null and void;

provided, however, that if court order(s) are issued dismissing all such petitions (whether filed by me or my spouse) and I accept the dismissal of such petitions filed by my spouse by a signed instrument, then (i) my spouse shall continue to be a beneficiary of any trust hereunder that names my spouse as a beneficiary, (ii) no member of my spouse's family shall be deemed (pursuant to the foregoing provisions of this subsection to have died intestate for any purposes of this Agreement, and (iii) any exercise of power of appointment by my spouse or a member of my spouse's family that was not effective prior to the filing of such petitions shall no longer be null and void.

See David Handler, *From Here to Eternity: Designing Trusts for the Long Haul,* 2020 Duke University Estate Planning Conference.

2. Lifetime QTIP Trust

When there is a disparity in wealth between two spouses, a lifetime qualified terminable interest trust ("Lifetime QTIP") may be a useful solution to making sure the New Exclusion Amount of the poorer spouse is fully utilized. Richard S. Franklin and George D. Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exclusion,* Estates Gifts & Trusts Journal, May 14, 2019. Section 2525 of the Internal Revenue Code allows for an unlimited deduction against the gift tax for transfers to a spouse. However, as with the estate tax, that deduction is not allowed for a transfer of a terminable interest unless certain criteria are met. One option to qualify such transfer for the gift tax marital deduction is to make the transfer to a trust, in which the spouse has the right to all income from the trust and the donor makes the election on a timely filed gift tax return I.R.C. § 2523(f).

As with the SLAT, as long as the couple is married, both spouses may, in effect, enjoy the use of the property. However, contrary to a SLAT, distributions cannot be made to children during the lifetime of the spouse. The Lifetime QTIP will also protect the assets from the claims of the donee spouse's creditors.

Upon the death of the beneficiary spouse, the assets remaining in the Lifetime QTIP will be included in her estate by virtue of I.R.C. § 2044 and will receive a second-step up in basis. Also, the spouse's executor will be able to allocate the spouse's GST Exemption to the trust assets. For this reason, it is important NOT to make the reverse QTIP election when the Lifetime QTIP is established.

What if, in 2025, the couple decides that they need to take advantage of the New Exclusion Amount before it sunsets. At that time, beneficiary spouse could transfer her income interest in the Lifetime QTIP to a trust for the couple's descendants. That transfer would trigger the application of I.R.C. § 2519, which provides that "any disposition of a qualifying income interest for life in any property [for which a deduction was allowed a deduction under § 2523(f)] shall be treated as a transfer of all interest in such property other than the qualifying income interest." The disposition of the income interest would cause the beneficiary spouse to be deemed to have made a gift of the entire interest in the Lifetime QTIP, therefore using her increased exclusion amount. *Id.* The beneficiary spouse would allocate her GST exemption to the transfer on a timely filed gift tax return.

One downside to the use of the Lifetime QTIP is that care must be taken to ensure that the step transaction doctrine does not apply. If the poorer spouse wishes to make a lifetime transfer of her interest in the QTIP to use the increased exclusion amount before it disappears on December 31, 2025, there should be NO prearranged plan for the transfer, and the transfer should not happen close in time to the creation of the Lifetime QTIP.

3. Upstream Gifts

One technique that is a bit at odds with traditional estate planning is to make a gift to a person in an older generation. This type of gift would not necessarily be to use the donor's New Exclusion Amount, but to use the older person's Exclusion Amount and obtain a step-up in basis. Other than being a poor use of the donor's New Exclusion amount, the drawbacks to this planning include exposure to the older person's direction and creditors and the possibility that the older person dies within 1 year and leave the gifted property to the donor, thereby eliminating the basis step-up under I.R.C. § 1014(e). Law and Zaritsky at 110. There is also the risk of the inadvertent exercise of the power by the donee, because many boilerplate provisions define a testator's "residuary estate" to include all property over which the testator has an unexercised power of appointment. That is why you will commonly see the following language in wills:

Drafting Example 18

> *I devise and bequeath all the residue and remainder of my property and estate of every nature, real and personal, tangible and intangible, including any lapsed legacy or devise, but excluding all assets over which I have a power of appointment, all of which is hereinafter referred to as "my residuary estate," to* ____________________.