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Marital Deduction Revocable Trusts: Funding Formulas to Minimize Tax and Maximize Spousal Benefits

Selecting, Structuring, and Applying Pecuniary Marital, Non-Marital and Fractional Share Formulas

WEDNESDAY, OCTOBER 2, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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MARITAL DEDUCTION REVOCABLE TRUSTS: FUNDING FORMULAS TO MINIMIZE TAX AND MAXIMIZE SPOUSAL BENEFITS

SELECTING, STRUCTURING, AND APPLYING PECUNIARY MARITAL, NON-MARITAL AND FRACTIONAL SHARE FORMULAS

Presented by:

Mark L. Dodds, Esq., LLM & David M. Grant, Esq., MAcc

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The Unlimited Marital Deduction

- Tax Free Transfers between Spouses. This deduction allows for tax free transfers of unlimited amounts of assets between spouses during life and at death.

- Results in Deferral of Estate Tax. The result is that the surviving spouse does not have to pay any tax on the estate of the first spouse to die. In other words, the marital deduction postpones the federal estate tax.

- Example. As an example, Bill Gates can pass to Melinda Gates $70 billion in assets, or *vice versa*, so long as they are married at the time of the transfer, free of transfer tax until the passing of the last of them to die.

QTIP Trusts

- What is a terminable interest? Basically, it is an interest in property that can expire due to the passage of time, or that can terminate due to the occurrence of some future event. Generally terminable interests left to spouses cannot qualify for the marital deduction.

- Exception for QTIP Trusts.   If an interest in a trust is terminable, it may still qualify if it meets certain requirements.

- Purpose of a QTIP Trust. To control the ultimate disposition of a decedent's property, while still having a transfer to the QTIP Trust qualify for the marital deduction, thereby deferring (if not altogether getting rid of) transfer tax.

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QTIP Election Required

The tax code permits the estate's executor to claim the marital deduction for amounts transferred to a QTIP trust by making an irrevocable election on the decedent's Federal estate tax return (or by the Donor on a gift tax return for lifetime QTIP transfers).

QTIP Requirements

- <u>In General</u>. Property passing to a QTIP will qualify for the marital deduction so long as the surviving spouse has a lifetime income interest in the property.

- <u>The Rule</u>. IRC Section 2056(b)(7) states that QTIP property means property:
  (1) which passes from the decedent,
  (2) in which the surviving spouse has a qualifying income interest for life, and
  (3) to which an election under this paragraph is made.

- <u>Powers of Appointment</u>. Moreover, ALL income must go to the spouse for life, and it must be payable annually or in more frequent intervals. In order to qualify for the marital deduction, no person (not even the spouse) may have a power of appointment over any part of the QTIP property to appoint to anyone other than to the surviving spouse.

Inter Vivos QTIP Trusts

- <u>Common Estate Planning</u>. Generally when planning for spouses of unequal wealth the wealthy (or propertied) spouse transfers assets to the non-wealthy (or non-propertied) spouse in order to efficiently absorb both spouses' unified credits and GST exemptions.

- <u>Problem when non-wealthy Spouse dies first</u>. While testamentary QTIP planning under IRC Section 2056(b)(7) can provide an avenue for efficient use of both spouses' exemptions, it is ineffective where the non-propertied spouse passes first. If the non-propertied spouse predeceases owning no (or insufficient) property, his or her transfer tax exemptions are wasted because ownership of the property is required for it to be estate taxable.

- <u>Lifetime Gifting may provide the Solution</u>. Therefore, gifting property to the non-propertied spouse during life is necessary to capture the transfer tax exemptions of both spouses regardless of who dies first. IRC Section 2523(f) allows the propertied spouse to make a tax-free gift to his or her spouse through an irrevocable QTIP trust created *during life*. Like its testamentary counterpart, an *inter vivos* QTIP election treats the donee spouse as the transferor of the QTIP thus subjecting the transferred property to estate tax at the donee spouse's death or to gift tax upon disposition of the property during life.

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Life Estate with Power of Appointment (LEPA) Trust

IRC Section 2056(b)(5) provides that if an interest in property passes from the decedent to his surviving spouse (whether or not in trust) and the spouse is entitled for life to all the income from the entire interest or all the income from a specific portion of the entire interest, with a power in her to appoint the entire interest or the specific portion, the interest which passes to her is a deductible interest.

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Requirements of a LEPA

To be deductible, a transfer to a LEPA must satisfy all five of the conditions set forth below:

- The surviving spouse must be entitled for life to all of the income from the entire interest or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest.
- The income payable to the surviving spouse must be payable annually or at more frequent intervals.
- The surviving spouse must have the power to appoint the entire interest or the specific portion to either herself or her estate.
- The power in the surviving spouse must be exercisable by her alone and (whether exercisable by will or during life) must be exercisable in all events.
- The entire interest or the specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

A Note on Long Stable Marriages

In cases where both spouses have been married for a long time and all children are the product of that union, many clients may prefer to utilize the marital deduction by a simple outright bequest to their spouse, rather than through a marital deduction trust. Obviously the credit shelter trust would first be funded in large taxable estates to make efficient use of the decedent's remaining unified credit.

Characterization of Property

- Balance while living. Where one spouse has more property than another to begin with, an agreement might be entered into so as to "balance" the values in a way which maximizes use of both spouses' unified credit amounts and GST exemptions.

- Consider community property. In some states states, property could be re-characterized by agreement to be community property. This might better allow for efficient use of both spouses' unified credits and GST exemptions, as well as provide favorable basis step-up on community property capital assets at death of first spouse.

Funding Formulas

Generally, two types of trust funding formulas exist:

- Pecuniary Formula. Pecuniary formulas are easier to draft and administer than fractional share formulas, since they simply designate a defined dollar amount to be distributed to one share, with the balance in excess of the defined, pecuniary amount going to the other share. If valuation changes occur during the postmortem administration period, the calculation is minimally affected, since the formula continues to place the defined amount in the share designated by the pecuniary formula.

- Fractional Share Formula. With a fractional share, it is impossible to determine the actual amount of either share until postmortem administration is complete, since the fraction itself is affected by non pro rata distributions (such as the payment of estate taxes from the non-marital share), and changes in valuation.

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Selecting the Correct Funding Formula

The choice of a marital deduction funding formula can affect:

- The amount passing to the surviving spouse (and therefore, additional tax may be due upon the surviving spouse's death);
- Whether income tax will be triggered upon funding the marital and credit shelter bequests; and
- The ease of administration.

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Pecuniary Non-Marital (Reverse Pecuniary) Formula

- Using the non-marital or reverse pecuniary approach, a sum equal to the applicable exclusion amount ($5.25 million for 2013), adjusted by any credits, deductions, and other non-marital bequests, goes to the non-marital share.
- The balance remaining goes to the marital share.

Benefits of Reverse Pecuniary Formula

- Intuitive. This formula is one of the more intuitive ones and is quite easy to describe to clients. The client can easily understand that the funding of the credit shelter trust with the applicable exclusion amount of, currently, $5.25 million will preserve the exclusion against estate tax on the second death.

- Appreciation Transferred to Marital Share. With this formula, any appreciation (or depreciation) occurring between the date of death and the date of funding will be transferred to the marital share. *More on this at the following slide…*

Transfer of Appreciation (or Depreciation)

With Pecuniary Non-Marital (Reverse Pecuniary) formula, any appreciation (or depreciation) occurring between the date of death and the date of funding will be transferred to the marital share.

- Appreciation could increase tax on large estates. Transferring appreciation to the marital share will most likely increase the funding amount passing to the marital share, which will increase the surviving spouse's gross estate and may increase estate tax due upon death.

- Depreciation could decrease tax on large estates. Transferring depreciation to the marital share will decrease the surviving spouse's gross estate and may decrease estate tax due upon death.

- For small second estates could be beneficial. If the surviving spouse doesn't have an estate large enough to utilize all of the federal estate tax credit available on his or her estate, then use of the pecuniary non-marital formula is beneficial, since capital gains will be eliminated because the appreciated assets transferred to the surviving spouse in the increased marital share will be included in the taxable estate of the surviving spouse, thereby receiving a stepped-up basis at the survivor's death, presuming the marital bequest assets have appreciated in value from the date of death.

Pecuniary Marital Formula

- Using the pecuniary marital approach, the sum allocated to the marital share is the smallest amount that must qualify for the marital deduction in order to reduce, to the extent possible, federal estate tax due on the first spouse's death, with the balance going to the non-marital share.

- Characteristics can be seen on the next slide…

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Pecuniary Marital Formula (cont…)

- <u>Less intuitive</u>. The marital formula is not as intuitive as the non-marital formula, since the marital formula is circular.

- <u>Appreciation Transferred to Non-Marital Share</u>. Appreciation or depreciation occurring between date of death and date of funding will be transferred to the non-marital share.

- <u>Could Reduce Estate Tax on Second Death</u>. Transferring this appreciation to the non-marital share removes the appreciation from the surviving spouse's gross estate and is beneficial to the heirs of the credit shelter trust by increasing the amount which is allocated to the estate tax exempt credit shelter trust and thereby reducing the amount allocated to the marital trust which is taxable in the estate of the surviving spouse if the surviving spouse's estate, which includes the marital bequest, exceeds his or her applicable exclusion amount.

Fractional Share Formula

- Proportional Fractional Interest. Generally, the fractional share formula requires that the marital share and the non-marital share each have a proportional fractional interest in each asset or a proportional fractional interest in the total of the decedent spouse's assets.

- Both Shares go Up and Down Proportionally. Thus, the value of the marital and the non-marital shares both change with appreciation or depreciation between the date of death and date of distribution. It is not necessary to split every asset of the decedent's estate, only that once the credit shelter and marital trusts are funded, both trusts will reflect appreciation and deprecation from the date of death to the date of funding are proportionally allocated in the appropriate fraction between the credit shelter and marital trusts.

Benefits of Fractional Share Approach

1) Avoidance of Capital Gains Tax. One benefit of using a fractional share formula is the avoidance of potential capital gains tax recognition of appreciation occurring between date of death and date of distribution of assets, which can occur with pecuniary formulas. This fact reduces any pressure regarding timing of funding the shares. Although it does not seem the IRS looks for this issue on audit, the law does state that when funding a pecuniary trust, any appreciation in the funding assets from the date of death to the date of funding is subject to tax recognition.

2) Less need to revalue assets. In addition, if each asset is, in fact, allocated proportionally between the fractional credit shelter and marital trusts, then revaluing the assets at date of distribution will not be required, since a proportion of each asset will be allocated to each share. This, however, results in each share receiving its proportional share of any post-death appreciation. However, if assets are not split proportionally based upon date of death values, but rather the trusts are funded in total proportionally only and not proportionally with respect to each asset of the decedent's estate, then it will be necessary to re-value the assets at the time of funding the trusts.

3) Fair to all beneficiaries. With proportional division of each asset under the fractional share formula no beneficiary should feel that another beneficiary received "better" assets since all beneficiaries share equally in all assets.

Disadvantages of Fractional Share Method

1) Everyone owns a piece of everything. Co-ownership of assets can put fractionalized ownership in hands of individuals who don't get along with each other. What's more, assets may not even be easily divisible. Real estate or business assets may not lend themselves to being easily divided among beneficiaries. **NOTE**: If this formula is used, it is strongly advisable to include authorization for the trustee to distribute assets between beneficiaries in economically equal proportions, without being required to split ownership of tangible assets.

2) Cannot pick and choose particular assets. Flexibility is lost in distributing assets to the most appropriate share for maximizing tax benefits. With pecuniary formulas, the fiduciary has flexibility in picking and choosing assets to fund the marital and credit shelter trusts. Assets that appreciate in value would likely fund the credit shelter trust. Assets that depreciate in value, or assets that the surviving spouse desires (residence or investment assets), may be allocated to the marital trust. Generally, fractional formulas do not permit pick-and-choose flexibility or there is no benefit from picking and choosing because all appreciation and depreciation must be allocated proportionally.

3) Hard to adjust for income and growth. It is much more difficult to adapt income and growth as appropriate for various beneficiaries.

4) Complexity guaranteed. Similar to the potential problems with the pecuniary formula, a fractional share formula will still require funding of separate trust shares, even where values are low enough that estate taxes will not be paid.

Marital Trusts for Non-U.S. Citizens

- QDOTs. A Qualifying Domestic Trust ("QDOT") allows taxpayers who are not U.S. citizens to claim the marital deduction for estate tax purposes, while keeping the property in trust for other future contingent beneficiaries. A non-citizen spouse is not otherwise eligible for the marital deduction when using trusts.

- Used for large estates. QDOTs can be used when trust assets would likely be subject to the federal estate tax (married couple with taxable estate greater than $5 million), without the marital deduction otherwise being available.

- Another Option: Survivor could become citizen. Without a QDOT, the surviving spouse must become a U.S. citizen before her deceased spouse's estate tax return is filed, in order to take advantage of the martial deduction for a transfer in trust.

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QDOT Requirements

1) One Trustee must be either a U.S. citizen or a domestic corporation that is authorized to retain estate tax out of the trust assets.

2) No distribution can be made from the trust, except for income, unless the trustee who is a U.S. citizen or domestic corporation has the right to withhold estate taxes from the distribution.

3) The Trust must meet withholding and collection regulations.

4) The executor must elect on the estate tax return to treat the trust as a QDOT.

5) Thereafter, the Form 706-QDT should be filed annually to report distributions from the trust.

6) The law imposes other certain security requirements (e.g., posted bond) to ensure the payment of the estate tax. These requirements are dependent upon the size of the estate, who the domestic trustee is, and to what extent the trust property is located within the United States.

Other QDOT Considerations

1) One Trustee must be either a U.S. citizen or a domestic corporation that is authorized to retain estate tax out of the trust assets.

2) No distribution can be made from the trust, except for income, unless the trustee who is a U.S. citizen or domestic corporation has the right to withhold estate taxes from the distribution.

3) The Trust must meet withholding and collection regulations.

4) The executor must elect on the estate tax return to treat the trust as a QDOT.

5) Thereafter, the Form 706-QDT should be filed annually to report distributions from the trust.

6) The law imposes other certain security requirements (e.g., posted bond) to ensure the payment of the estate tax. These requirements are dependent upon the size of the estate, who the domestic trustee is, and to what extent the trust property is located within the United States.

What’s Up with Portability?

Now (since 2010) married couples may use “portability” to add any unused portion of the estate tax exemption of the first spouse to die to the surviving spouse's estate tax exemption. This will effectively allow married couples to pass up to $10.5 million to their heirs free from federal estate taxes with absolutely no planning at all. With that said, it may not be wise for portability to be solely relied upon for estate tax and marital deduction planning.

Portability Limitations

1) Remarriage Complicates Things. Be aware that the order of deaths can cause loss of a portable exemption from a prior spouse. The portability exemption might create an incentive to later “shack up” while preserving the first deceased spouse’s exemption through portability and use a credit shelter trust for the new roommate. An alternative to “living in sin” might be to use the first spouse’s portability exemption by gift, then get married.

2) Necessity to File Estate Tax Return. Claiming portability requires the timely filing of an estate tax return by the executor of the estate of the first spouse to die. Depending upon the size of one’s estate, the question of when to file the estate tax return may be complex.

3) GST Exemption is not Portable. You should also understand that the $5.25 million GST exemption is *not* portable, unlike the estate tax exemption. Traditional trust planning with a bypass trust is often still necessary to avoid wasting the GST exemption.

4) Portability not Applicable to State Death Taxes. Although this change may come, many state death tax regimes do not yet incorporate portability into their systems. *See* the attached Appendix for limited state death tax information.

5) Open Statute of Limitations. If portability is elected, the statute of limitations on the deceased spouse’s estate remains open until the statute has run on the survivor’s estate. Otherwise, the statute of limitations expires three years after filing of the first spouse’s estate tax return.

6) Asset Protection. Use of a credit shelter trust may provide certain asset protection benefits not otherwise available to the surviving spouse.

7) Protecting Children from Prior Marriage. The credit shelter trust might also help protect inheritance for children of the first spouse to die.

Making Qualified Disclaimers

A qualified disclaimer, described under IRC § 2518, requires the following:

1) The disclaimant puts the disclaimer in a signed writing, identifying the disclaimed property.

2) The disclaimer is received by the transferor of the interest, his legal representatives, or the holder of legal title to the property to which the interest relates no later than nine (9) months after the date of transfer creating the interest (or nine months after the disclaimant reaches 21).

3) The disclaimant **does not accept the interest or any of its benefits.**

4) As a result of the refusal, the interest must pass without direction on the part of the disclaimant either to the spouse of the transferor/decedent or to a person other than the disclaimant.

If each of these four conditions is met, the disclaimant will be treated as if he or she never received the gift. The property interest will pass to whoever is next entitled to receive. Using the qualified disclaimer can be an effective post-mortem estate-planning tool, to be used based upon the current circumstances of the estate's beneficiaries. Proper prior planning, understanding that disclaimers might be used, opens up a world of opportunities when drafting trusts.

THANK YOU

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