LEGAL ALERT

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NEW MILLENIUM ESTATE PLANNING: CAN THIS BE TRUE?

By: George F. Bearup

For the last twenty-five (25) years, conventional wisdom with regard to planning for wealthy married couples was to use two (2) Trusts, one Trust for each spouse. The philosophy behind this approach was that when one spouse died, the assets in his or her Trust would be "locked in", they would not qualify for the federal marital deduction, but a large part of the Trust's assets would ultimately escape estate taxation by virtue of the use of the deceased spouse's unified tax credit (i.e., the amount passing to the credit shelter trust.) A corresponding benefit was that the assets owned in one spouse's Trust at the time of his or her death would enjoy a full *step-up* in income tax basis. (IRC §1014) However, the assets held in the surviving spouse's Trust would not experience a tax basis "stepped up." So, assets sold by the deceased spouse's Trust faced few capital gains, while the surviving spouse still had to struggle with capital gains. This was the way the estate planning worked for wealthy married couples for the past two (2) decades.

Last year's Tax Act forced many to re-evaluate this two (2) Trust regime. Since each deceased spouse may now pass $1 million federal estate tax free, and fewer married couples enjoy the benefit of an estate in excess of $1.0 million, the disfavored technique of a Joint Trust was revisited with renewed interest. Married clients like the notion of a Joint Trust; it parallels the manner in which they usually own their assets which is as joint tenants or by the entireties. Obviously, with a Joint Trust there is one less Trust to worry about. A Joint Trust leaves the survivor in control of the entire marital estate, and there is far less paper to keep track of.

Historically the major drawback to the use of a Joint Trust was the danger that a taxable gift occurred upon either "funding" the Joint Trust, or on the death of one spouse if the Trust became irrevocable on that event. This worry was based on the *terminable interest rules* of the Internal Revenue Code's marital deduction. The danger was that if assets were transferred into a Trust that required the consent of the other spouse to modify or change, a gift had been made (because complete and total dominion over the gifted assets was lost by the donor,) but since the donor spouse still retained some powers over the Trust's income, the gift would not qualify for the federal gift tax marital deduction. The result: A taxable gift occurred, even though only the spouses were the beneficiaries of their own Joint Trust, funded with their own assets.

Consequently, lawyers tended to shy away from the use of a Joint Trust, particularly where a disproportionate amount of assets were transferred into the Trust by both spouses, i.e., not just jointly held assets, out of the fear that some of the transferred assets did not qualify for the federal gift tax marital deduction. There was also the lingering worry about whether the assets held in the Joint Trust upon the death of one spouse would enjoy any *step-up* in income tax basis. Normally, assets that are owned jointly between a husband and wife only enjoy a 50% *step up* in the income tax basis upon the

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death of one spouse, so that if the surviving spouse sells the asset [other than the marital home,] there was a pretty good chance that capital gain recognition would occur.

This new way of looking at Joint Trusts for married couples after the 2001 Tax Act (due to the $1.0 million estate tax exemption that is now available to the surviving spouse's estate, and the even larger $1.5 million scheduled for 2004) received a second "boost" with two (2) recent Private Letter Rulings. My reaction after reading both of those Private Letter Rulings was: "Can this be true?" (Actually, I really said something different!) The fact pattern in each of these Private Letter Rulings is slightly different, but the facts can be summarized by the following estate planning example.

Assume that a husband and wife create a Joint Trust. The Joint Trust is funded with assets that the husband and wife owned as joint tenants with full rights of survivorship, as the entireties, or in their individual capacities. The total value of the assets is $1.5 million. The Joint Trust provides that it may be altered or amended by either the husband or the wife with the consent of the Trustee while both husband and wife are living. During their joint lives, the Joint Trust may be revoked by either the husband or the wife in whole or in part, and, if the Trust is revoked, the Trustee must, if so directed, transfer the trust assets in accordance with the directions of either the husband or the wife. During their joint lives, the Trustee is required to pay all of the net income to the husband and the wife unless they request in writing that a portion of the income be added to trust principal. In addition, the Trustee is required to pay to the husband and wife or in accordance with their instructions, so much of the trust principal as either spouse may request. Upon the death of either the husband or the wife the Joint Trust becomes irrevocable. The husband and wife are the Co-Trustees during their lifetimes. Upon the death of one spouse, the surviving spouse acts as the sole Trustee. If the surviving spouse is unable to act or unable to continue to act then their living children or the survivors of their children act as Trustees. Finally, if none of the children can act or refuse to act or they resign, the Trustee may be chosen by a majority of the income beneficiaries of the Trust.

As noted, upon the death of one spouse the Joint Trust then becomes irrevocable. At that time, the Joint Trust contains a conventional division and distribution formula. Under that formula, one part of the Trust's assets equal to the maximum marital deduction allowable to the deceased spouse's gross estate, reduced by the amount necessary to create the largest taxable estate after utilizing the decedent's unified credit and which results in no tax being due, is transferred to the "marital trust" portion. The balance goes to the *family trust* portion. This is the conventional "reduce to zero" marital deduction formula under the example, $1.0 million passes to the family portion and $500,000 passes to the marital portion.

During the life of the surviving spouse, the Trustee is required to pay the net income from the marital portion to the surviving spouse at least quarter annually. Amounts of trust principal are also distributable to the surviving spouse as he or she may direct. Upon the death of the surviving spouse, the Trustee is required pay any remaining principal in the marital portion to the persons that the surviving spouse appoints by his or her Last Will, i.e., a general testamentary power of appointment marital deduction.

The residue under the Joint Trust is known as the *family portion*, which provides that during the lifetime of the surviving spouse the Trustee is required to pay all of the net income from the family portion to the surviving spouse. The Trustee may also pay so much trust principal to or for the benefit of the surviving spouse and to the children of both donors as the Trustee deems advisable for their

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health, support, maintenance and education. Upon the death of the surviving spouse, the remaining income and principal in the family portion is distributed to the spouse's living children.

The surprise! Part of the Private Letter Ruling comes from the IRS' tax treatment of the Joint Trust. The IRS held that the value of the entire trust estate, meaning all of the assets held in the Joint Trust not just the part contributed by the deceased spouse, will be included in the gross estate of the first spouse to die. The IRS made many "jumps in logic" to reach this *helpful* conclusion. What it means is that *all* assets owned by a married couple will receive a new tax basis on the death of one spouse, without any immediate estate tax exposure.

IRC §2033 provides that the value of the gross estate includes the value of all property to the extent of the interest in the asset held by the decedent at the time of his or her death. Under IRC §2038(a), the assets contributed to the Joint Trust held by the deceased spouse prior to the creation of the Joint Trust will be included in the decedent's estate, because the control and enjoyment of those assets previously held by the deceased spouse, before the Joint Trust was created, is retained through the power to alter, amend, revoke or terminate the Joint Trust.

As for its more "artful dancing," the IRS then focused on IRC §2041(b)(1), which is the "general power of appointment" estate tax inclusion provision. To support its conclusion that all of the assets held in the Joint Trust will enjoy a full step-up in income tax basis pursuant to IRC §1014(a), the IRS pointed out that since each of the donor/spouses holds a power to revoke the entire Joint Trust during their lifetime, while the portion of the trust property that the deceased spouse transferred to the Joint Trust would be includible in the deceased spouse's gross estate under IRC §2038, the balance contributed by their surviving spouse was subject to the deceased spouse's general power of appointment. Because either spouse possessed the power to direct the Trustees to pay so much of the trust principal as that spouse requested during his or her lifetime, and that power was not limited to specific individuals and can be exercised in favor of that spouse, that spouse's creditors, that spouse's estate, and the creditors of that spouse's estate, that portion of the Joint Trust property that the surviving spouse transferred to the Joint Trust would nonetheless be includible in the deceased spouse's gross estate under IRC §2041, as a general power of appointment. Consequently, all of the assets in the Joint Trust, because they are taxable in the first spouse's estate, will enjoy a full "step-up" in income tax basis. All assets can be sold by the surviving spouse without fear of incurring capital gains taxation.

Note one exception. Under IRC §1014(e) if appreciated property is acquired by the deceased spouse by gift during a one (1) year period ending on the date of the donee's death, then the property will *not* receive a step-up in tax basis. Accordingly, for this arrangement to work, for all assets to enjoy a full "step-up" in income tax basis, the Joint Trust will have had to have been created, funded, and exist for at least one (1) year before a spouse's death.

A IRS second ruling is that the surviving spouse will be treated as making a gift that qualifies for the federal gift tax marital deduction to the deceased spouse with respect to the portion of the trust property that is attributable to the surviving spouse's contribution to the Joint Trust. This is the metaphysical part of the IRS' reasoning. It finds an instantaneous gift to the other spouse on the moment of that spouse's death. The IRS' analysis, and the step up in basis result will not work if the implied gift is to the decedent's estate. Technically, the gift is incomplete when the Joint Trust is first funded, since the donor/spouse reserves the power to reinvest full beneficial title to the gifted property in himself or herself. It is when the first spouse dies, and the Joint Trust becomes irrevocable by its terms, that IRC §2523 kicks in, which is the unlimited gift tax marital deduction. As the IRS noted:

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> *In this case, the surviving donor spouse will relinquish dominion and control over his or her interests in the Joint Trust property on the death of the first spouse. Accordingly, on the death of the first donor-spouse, the surviving spouse will make a completed gift under Section 2501 of the surviving donor's entire interest in the Trust. This gift will qualify for the marital deduction under IRC §2523.*

Briefly, two (2) other conclusions reached by the IRS. One is that to the extent that the family portion is funded, any portion of the property that passes to the family portion that originated with the surviving spouse will *not* constitute a taxable gift by that surviving spouse. Second, any future payments from the family portion to beneficiaries other than the surviving spouse, e.g., children; grandchildren, will *not* constitute a gift from the surviving spouse to these beneficiaries and none of the property attributable to the surviving spouse held in the family portion of the Joint Trust will be includible in the estate of the surviving spouse.

Boiled down to its bare essence, with these Private Letter Rulings, Joint Trusts should now become the favored estate planning device, particularly for marital couples who have estates somewhere between $1 million and $2.0 million. The reasons follow.

- There was always the worry that if the spouse who owned the fewer amount of assets died first, the full utilization of the deceased spouse's estate tax credit could not be fully utilized. That is no longer the case with this Joint Trust technique. Now, the surviving spouse's assets can be "used" by the deceased spouse to fully maximize the deceased spouse's available estate tax credit.

- Making the Joint Trust technique even better than jointly held property. (Some commentators now advocate the use of a *disclaimer* by the surviving spouse of a fractional interest in the jointly held property, to "push" assets into the taxable estate of the first spouse to die, to soak up the unused estate tax credit.) With jointly owned assets, there is only a 50% "step-up" in the income tax basis for federal income tax purposes. If a *disclaimer* is to be used by the surviving spouse to "move assets" back to the decedent, a probate estate will have to be opened. Now all of the assets held in the Joint Trust will sustain a full "step-up" in the income tax basis. What this means is that the surviving spouse can sell all of the assets in the marital portion (if any) and not worry about any capital gain tax the same with respect to the family portion.

- Similarly, assets can be distributed from the family portion to children or others (depending upon the financial needs of the surviving spouse) without much, if any, capital gain tax consequence, and without any gift tax consequence.

- As noted, under the allocation formula, no estate taxes will be due on the first spouse's death. Under the example, $1.0 million is sheltered by the deceased spouse's applicable estate tax exemption. The $500,000 is deferred from estate taxes by virtue of the unlimited marital deduction. Upon the survivor's death, he or she can leave an estate of $1.0 to $1.5 million (depending on the year of death) without estate tax consequences.

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The Joint Trust proves to be a "better deal" than the current common technique where assets are held in the surviving spouse's separate Trust, under the two (2) Trust regime, where the survivor's Trust assets do not enjoy any step-up in the income tax basis.

These conclusions in Private Letter Ruling 200101021 were reiterated in Private Letter Ruling 200210051. While we are always cautioned that Private Letter Rulings may not be used or cited as precedent (IRC §6110(k)(3)), these two Private Letter Rulings nonetheless provide a distinct roadmap to planning for married couples in the future, which will lead to: (i) less paper to keep track of; (ii) the full utilization of the first spouse's applicable exemption amount that will be available to shelter assets from federal estate taxes on the first spouse's death; (iii) no gift tax consequences when "funding" a Joint Trust between a husband and wife, regardless of who owned what assets before the Trust was created, putting aside the old "terminable interest" worries of the past; (iv) provide a complete *step-up* in the income tax basis of *all* assets owned by a husband and wife on the death of the *first* spouse; (v) avoiding estate taxes on the death of the first spouse and deferring, or possibly eliminating, estate taxes on the death of the surviving spouse (depending upon the year of his or her death); and (vi) avoiding probate in either spouse's estate through the use of the Joint Trust.

These Private Letter Rulings, plus the 2001 Tax Act's increasing applicable exemption amount, warrant reconsideration of the old reciprocal marital deduction trust planning technique that so many spouses have used over the past 20 years.

If you have any questions, please feel free to contact George Bearup or any of the attorneys listed below.

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