Planning for the 99% - Portability v. Credit Shelter Trust

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Permanent income, estate, gift and GST tax rates

- Income Tax
  - 39.6% highest marginal rate
  - 20% maximum rate for LTCG and qualified dividends
  - 3.8% surtax on net investment income
- Estate, gift and GST tax
  - $5.34 million estate, gift and GST exemption, indexed for inflation
    - Exemption increased by $90,000 from 2013 to 2014 in year with low inflation. Exemption increase will be more substantial when inflation is higher.
  - 40% rate
  - Unified estate and gift tax
  - Portability for estate and gift tax exemption but not GST purposes

Key Points

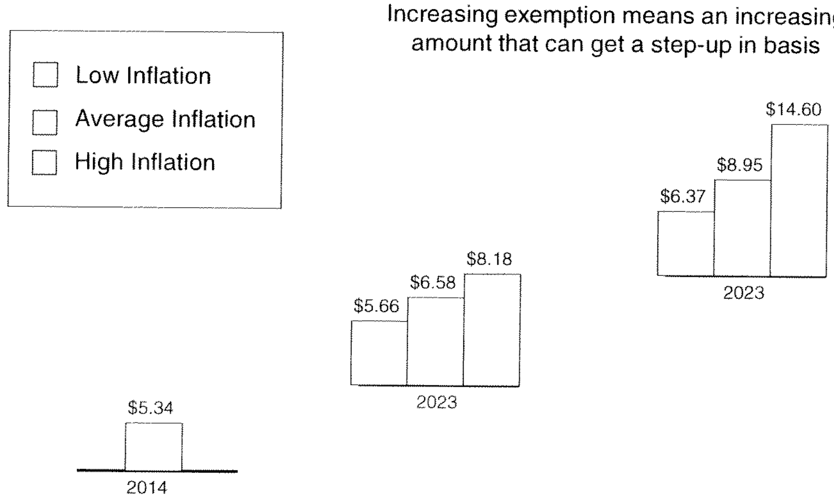
- Clients below the exemption – Rubik's Cube of Simplicity
  - New paradigm – estate planning as we have known has changed
  - Income tax focus for most clients
  - Portability v. bypass trust
  - Gap between income tax and estate tax has narrowed
  - Basis step-up will become the focus for most estates
  - Must build flexibility into the plan
    - Planning is more difficult for the $5 to $10 million client than it is for an UHNW client so flexibility is important
- Planning for UHNW remains the same

Portability is a game changer

- $5.34 million exemption per person, $10.68 million exemption per couple
- Permanent
- Grows with inflation
- If exemption not used, it is portable
- Must file estate tax return to be entitled to portability
- Takes most estates out of a taxable situation

Forecasted Exclusion Amount

Increasing exemption means an increasing amount that can get a step-up in basis



Portability of Exemption

- Deceased spouse's unused exemption amount (DSUE) may be passed to surviving spouse
  - May be used for gifts during life or to offset estate tax at death
- Two requirements to qualify for portability:
  - Estate tax return must be filed
  - Elect portability on deceased spouse's estate tax return
    - Election can't be made on a late filed estate tax return
      - Thus, can't wait until surviving spouse's death to see if portability will be needed later
      - Once made, the election is irrevocable
- Amount of portable exemption is <u>lesser</u> of:
  - (1) the $5 million exemption (indexed to date of death for inflation) or
  - (2) the excess of the "last deceased spouse's" basic exclusion amount over the spouse's taxable estate plus adjusted taxable gifts
- Exclusion of first spouse to die is not indexed for inflation
- S/L on deceased spouse's estate tax return stays open for purposes of determining the deceased spouse's unused exemption amount.
- There is no portability of the generation skipping tax exemption
  - To the extent the first spouse to die does not fully utilize his or her $5 million GST exemption, the unused portion is lost
  - Example: H leaves $10 million estate to W. H's executor transfers his DSUE to W. W dies with her $5 million exemption plus H's $5 million DSUE. W leaves her entire estate to grandson. The combined $10 million exemption shelters the entire estate from FET but only $5 million of the transfer from GST.

Portability – Proposed Regulations

- Last return filed by the return due date, including extensions, will supercede any previously filed return.
  - PR can supercede a previously filed return on a subsequently timely-filed 706
  - Once due date for 706 has passed, portability election on last filed return is irrevocable.
- Requires filing an estate tax return within 9 months of death, including extensions, regardless of the size of the estate.
  - Estates below the filing requirement can estimate the size of the marital or charitable deduction.
  - 706 instructions may provide ranges of dollar values
- Create an ordering rule
  - Surviving spouse uses DSUE amount before using his/her own basic exclusion amount
- DSUE amount available to surviving spouse includes both the DSUE amount of the last deceased spouse <u>and</u> any DSUE amount from a prior deceased spouse that has already been used up
  - (1) gift the deceased spouse's DSUE amount,
  - (2) remarry (someone with no assets and short life expectancy), outlive the new spouse and (4) repeat as needed.

Portability of Exemption – The Tricky Stuff
What if the Spouse Remarries???

- Statute only allows the surviving spouse to use the "last deceased spouse's" exemption
- Example:
  - Mary is married to John and John dies
  - Portability is elected
  - John's unused exemption is transferred to Mary
  - Mary subsequently marries Tom
  - Mary can use John's exemption until Tom dies
  - When Tom dies, Tom becomes Mary's "last deceased spouse"
  - Tom's unused exemption is transferred to Mary and John's unused exemption is no longer available to Mary.
  - What if Tom's executor doesn't elect to transfer his unused exemption to Mary. Is John's unused exemption still available to Mary. No – Proposed Regs cover this.
- Eliminates the ability to collect DSUE from multiple marriages
  - Can't keep remarrying to accumulate exemptions
- The last deceased spouse's unused exemption is used before the surviving spouse's exemption – See Example 3 in JCT explanation.

Portability of Exemption – The Tricky Stuff
What if the Spouse Remarries???

- Gifting issue
- Example:
  - Mary is married to John and John dies
  - Portability is elected
  - John's unused exemption is transferred to Mary
  - Mary makes significant lifetime gifts and marries Tom
  - Mary's gifts use up John's unused exemption amount first

Portability v. Credit Shelter Trust
Non-Tax Factors

Portability	Credit Shelter Trust
Simplicity –don't want to give assets to poorer spouse or create trusts	Preference for sophisticated distribution provisions
Competent spouse	Spouse not capable of managing assets, needs professional management
First, good marriage	Second marriage, blended family, potential remarriage, undue influence, beneficiaries with disabilities
Assets difficult to deal with in credit shelter trust (e.g. qualified plan, IRA, real estate)	Assets are easy to manage, liquid
Creditor protection not a concern	Desires creditor protection
Control not important	Decedent retains control over assets
Re-titling assets not necessary	Must re-title assets to use exemption
DSUE not indexed for inflation	Assets in credit shelter trust can grow
Spouse's spending rate will exceed growth	Trust distribution will meet beneficiary's needs

Portability v. Credit Shelter Trust

Tax Factors

Portability	Credit Shelter Trust
Greater interest in basis step-up in both estates than protecting appreciation from tax	Desire to protect assets and appreciation from tax in surviving spouse's estate – no basis step-up
Desire to avoid increased income tax applicable to trusts	Trust instrument gives trustee distribution flexibility
Use of generation skipping tax exemption not important	Use of generation skipping tax exemption (GST exemption not portable)
State estate taxes not important	Ability to shelter state estate tax exemption – most states don't allow portability
No valuation issues	Start S/L on hard to value assets used to fund credit shelter trust
No remarriage contemplated	DSUE from predeceased spouse lost if the surviving spouse remarries and survives the next spouse
DSUE not indexed for inflation	Assets grow transfer tax-free
Spouse can use DSUE to gift to an IDGT fbo issue	Lifetime giving by spouse not contemplated

Things to Think About

- Applicable exclusion amount will grow over time, excluding more from the estate.
- Increased applicable exclusion amount means a large estate tax free step-up in basis if you have the right assets
- May want to force estate tax inclusion to get step-up in basis
- Leave assets outright to surviving spouse by joint ownership, beneficiary designation or a simple will
- IRA/Retirement plans
  - No longer have to force IRAs/401(k) into the credit shelter trust to avoid wasting the estate tax exemption.
  - Can now pass IRA/401(k) outright to beneficiary because unused exemption is portable and can be passed to the surviving spouse

Things to Think About

- Gap between income tax and estate tax rates has narrowed
- Advantage of portability: second step-up in basis
- Portability better than bypass trust due to step-up in basis
  - Increase in rate of return favors portability
- Use state exemption
  - What do you do in state like Illinois with a high ($4 million) exemption?
  - Analysis must be done state by state
  - Consider clients domiciled in a no state estate tax state with property in a state estate tax state

Things to Think About

- For those with a by pass trust in estate plan
  - Revisit – may not need now with portability and increased exemption
- Use independent trustee or trust protector with discretionary powers to distribute assets to spouse to get step-up in basis at second death
- Give trust protector the right to grant a GPOA to trust beneficiary e.g. spouse
- IRS will probably hold Rev. Proc. 2001-38 not applicable to estates which elect QTIP to pass maximum exemption via portability
- DSUE amount is really an asset you are leaving to the surviving spouse
  - If you wouldn't leave an asset outright to a surviving spouse, you shouldn't leave a DSUE amount to a surviving spouse

Things to Think About

- Want to address portability election in estate planning documents
  - Whether the election will be made
    - Obtain waiver letter from PR if portability not elected
  - Should election be mandatory or discretionary?
  - Executor has authority to make the election
  - Who will bear cost associated with filing the portability election?
  - Providing for portability in prenuptial agreement

Pre-Marital Considerations

- Portability and QTIP Election
  - Leave assets to QTIP, remainder to kids from prior marriage
  - Gives surviving spouse a larger portable amount
  - Agree in prenuptial agreement that portability election will be made if the surviving spouse agrees to waive reimbursement right under §2207A
  - QTIP won't be reduced by estate taxes attributable to increase in surviving spouse's gross estate due to inclusion of QTIP
  - Otherwise, surviving spouse could make gifts of his/her assets to his/her own heirs using the deceased spouse's DSUE amount

Who Has Authority to Make the Election?

- First spouse's estate is $2 million
- Makes no portability election
- Second spouse dies with $8 million estate
- Could have used first spouse's exemption
- Kids from first marriage wouldn't make the portability election

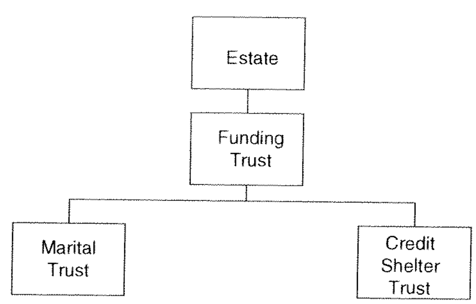
Things to Think About

- Use portability and DSUE to create a grantor trust
  - DSUE fixed
  - In grantor trust DSUE grows
  - Transfer assets outright to surviving spouse
  - Surviving spouse makes a gift to a grantor trust of the DSUE amount
    - State estate tax is avoided
      - Most states don't add prior gifts to state estate tax base
      - Only CT and MN (as of 7/1/2013) have a gift tax (TN recently repealed their gift tax)
  - Spouse pays income tax on trust's income preserving trust corpus
    - Potential Pac Man result – income tax comes back to eat you up
  - Grantor trust status can be terminated at any time
  - No basis step-up at surviving spouse's death
    - But surviving spouse can could purchase or substitute high-basis assets prior to death with no income tax consequences

Things to Think About

- There is always the possibility that Congress could amend the statute to make portability less attractive
  - The DSUE may decrease if the basic estate tax exclusion amount is later reduced by Congress
    - The DSUE to be applied at any particular time cannot exceed the basic exclusion amount
- Remedy for failure to make DSUE election
  - Rev. Proc. 2014-18 – only for decedents who died in 2011-2013
  - Get 9100 relief
  - Theory for 9100 relief – statute doesn't say when the estate tax return under the filing threshold has to be file so the time to file the portability election is not statutory – it is established by the regulations.

Traditional Estate Planning



	Marital Trust	Credit Shelter Trust
First Death:	No Tax	No Tax
Second Death:	Tax	No Tax

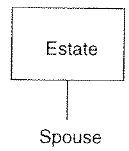
Planning in Decoupled States for Estates Under $10 Million

- Three basic options:
  - Disclaimer plan – O/R or in marital trust to spouse, disclaimer to bypass trust
  - Single QTIP
    - Allows decision to be made in 15 months versus 9 months for a disclaimer
  - Clayton QTIP

Planning in Decoupled States for Estates Under $10 Million

- O/R marital bequest and rely on portability
  - May result in otherwise avoidable state estate tax on the second death because in almost all states the state exemption is not portable
- O/R marital bequest and use disclaimer by-pass
  - Use contingent bypass trust perhaps limited to the lesser of the Federal or state exemption amount
  - Could do waterfall disclaimer e.g. disclaim to QTIP, disclaim to bypass trust
  - Provides flexibility
  - Spouse can choose between portability and credit shelter trust
- Single QTIP with/without Clayton provisions
  - Provides asset protection
  - Basis step-up at death of surviving spouse
  - Make reverse QTIP election to use GST exemption of predeceased spouse
  - Permits DSUE amount of predeceased spouse to be ported to surviving spouse
  - 15 months to make QTIP election v. 9 months for disclaimer
  - Issue: Rev. Proc. 2001-38 – ignore QTIP election if election not necessary to reduce estate tax to zero

O/R Marital Bequest, Rely on Portability



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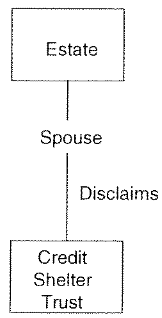

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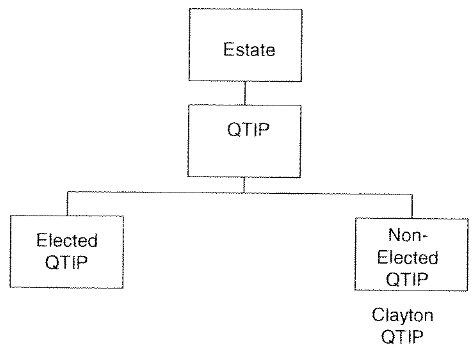
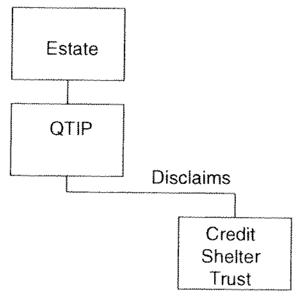
Single QTIP with/without Clayton provisions



Planning in Decoupled States for Estates Under $10 Million

- Single QTIP with disclaimer provisions
- Mandatory state by-pass trust, balance to spouse O/R and rely on portability
  - Invest in fixed income in by-pass trust so the appreciation goes outright to spouse to get the step-up in basis
- Mandatory by-pass with remainder to state exemption QTIP/Federal by-pass (states with state-only QTIP election such as Massachusetts)
  - By-pass for state exemption, "gap" trust for federal exemption in excess of state exemption (state only QTIP), balance to trust that qualifies for Federal marital deduction – 3 trust approach
- Mandatory by-pass with remainder to QTIP trust (state does not recognize state only QTIP e.g. NY/NJ)
- Mandatory by-pass with Delaware tax trap marital for balance of estate to cause state estate tax inclusion
  - For estates of modest wealth that will not trigger any estate tax

Single QTIP with Disclaimer Provisions



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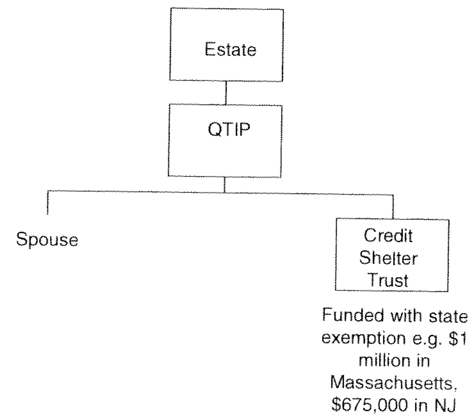
Mandatory State By-Pass Trust, Balance to Spouse O/R and Rely on Portability



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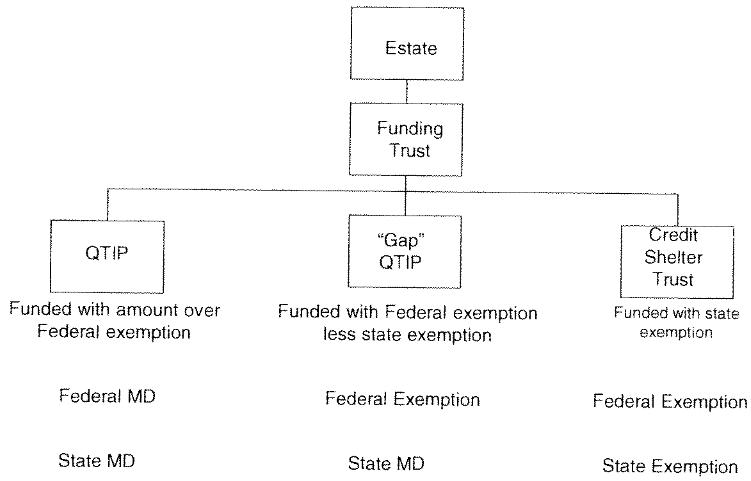

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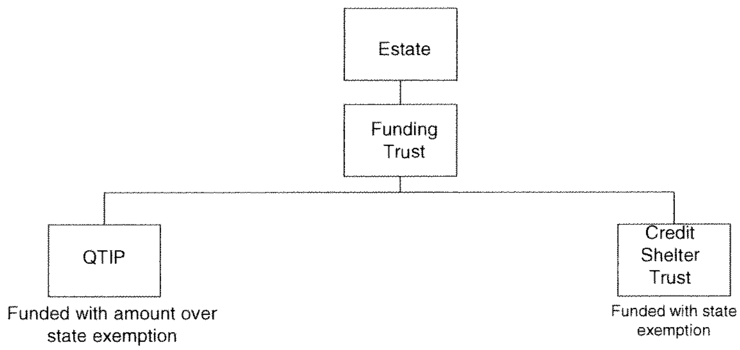

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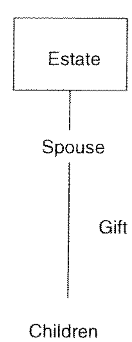
Planning in Decoupled States for Estates Under $10 Million

- O/R to surviving spouse followed by gift to heirs using DSUE
  - Uses DSUE to eliminate risk that DSUE is lost if spouse re-marries and new spouse dies
  - Assets out of spouse's estate
  - Basis step-up lost
- O/R to surviving spouse followed by gift to grantor trust to use DSUE amount and preserve swap rights
  - Allows spouse to swap trust low basis assets for cash of high basis assets
  - Spouse gets basis step-up at death for low basis assets
  - Spouse loses access to the gifted funds
- O/R to surviving spouse and gift to DAPT to use DSUE and preserve swap rights
  - Overcomes shortcoming of spouse losing access to gifted funds
  - Spouse is or could be a discretionary beneficiary

O/R to surviving spouse followed by gift to heirs using DSUE



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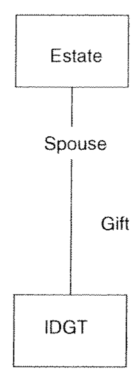

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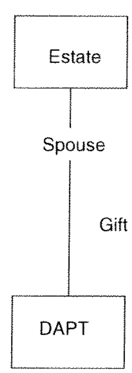

Planning in Decoupled States for Estates Under $10 Million

- O/R to surviving spouse followed by non-qualified disclaimer to use DSUE
  - For those who don't want to create a separate grantor trust to receive a gift of the DSUE amount
  - Incorporate intended provisions of grantor trust into will or other dispositive instrument
- State exemption by-pass trust and gap QTIP followed by spouse's gift of income interest in QTIP to use DSUE
  - Another way for spouse to use DSUE amount without triggering state estate tax at the first death
  - QTIP trust can be divided into a separate QTIP trust so the gift under §2519 is only the amount equal to the DSUE
- State exemption by-pass and gap GPOA marital trust and exercise GPOA to a DAPT to use DSUE

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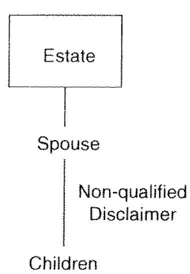

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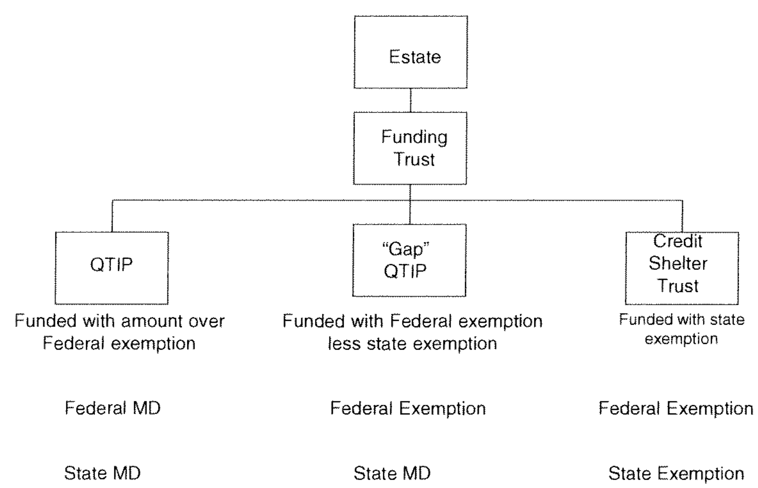

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Portability of Exemption – Factors to Consider

- Size of combined estates of H and W
  - Is the DSUE needed to exempt both estates from estate tax?
- Future growth of surviving spouse's estate
  - Will surviving spouse need the DSUE to exempt her estate from estate tax?
  - Remember, the surviving spouse could win the lottery!!!
- Future changes in the tax law
  - Will Congress change the portability rules or the amount of the exemption?
- Desire for surviving spouse to make sizable lifetime gifts
  - The DSUE will allow the surviving spouse a larger gift tax exemption for lifetime gifts.
- The need to protect assets from creditors
  - Assets left outright to the surviving spouse under portability will be subject to creditors whereas assets left in a credit shelter trust can have spendthrift provision or otherwise structured as a DAPT
- The ability to get a "step-up" in basis at the surviving spouse's death
  - Assets left outright to the surviving spouse under portability will be included in the surviving spouse's estate but will receive a "step-up" in basis at the death of the surviving spouse whereas assets left in a credit shelter trust will not be included in the surviving spouse's estate and will not receive a "step-up" in basis.

Portability of Exemption – Factors to Consider

- Anticipated inflation increase in surviving spouse's exemption
  - Will it cover the appreciation in assets left outright to the spouse
- Life expectancy of the surviving spouse after the death of the first spouse
- Chance of surviving spouse remarrying a new spouse who dies before the surviving spouse
  - May want to make gifts if client has accumulated a previous spouse's portable exemption and plans to remarry
- Portability causes no restriction on surviving spouse's access to the assets of the first spouse to die during the survivor's remaining lifetime whereas assets passing to bypass trust restricts the surviving spouse's access

Conclusion

- Portability most attractive in estates over one applicable exclusion amount but unlikely to exceed twice the applicable exclusion amount
- There are a number of factors to consider
- Estate planning for the 99% has become more complicated
- It is very difficult to predict at the time an estate plan is drafted whether to rely on portability or use a traditional marital trust/bypass trust estate pln

Thank you!