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From: **Steve Leimberg's Estate Planning Newsletter**
Subject: **James M. Kane: Opt-In or Out Estate Planning for Under $10 Million Married Couples**

"For the bulk of married couples who likely will not have combined assets exceeding $10 million, this commentary focuses on three QTIP estate planning options as one package that provide flexibility for the surviving spouse to opt-in or out at the time of the first spouse's death for (i) beneficiary defective trust status for a QTIPable credit-shelter trust (defective as to the surviving spouse) and (ii) putting into place a second stepped-up basis for the QTIPable credit shelter trust assets at the surviving spouse's subsequent death.

Many of these under-$10 million married couples will benefit from no federal estate tax, but without adequate planning face considerably greater income tax exposure. This increased income tax stems from (i) the compressed trust ordinary income tax rates, the additional 5% capital gains rate, and the 3.8% Medicare investment tax at these compressed trust thresholds and (ii) a failure to leverage the stepped-up basis as fully as possible at each spouse's death."

We close the week with commentary by **James M. Kane** that focuses on estate planning options for married couples with a combined estate under $10 million.

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EXECUTIVE SUMMARY:

For the bulk of married couples who likely will not have combined assets exceeding $10 million, this commentary focuses on three QTIP estate planning options as one package that provide flexibility for the surviving spouse to opt-in or out at the time of the first spouse's death for (i) beneficiary defective trust status for a QTIPable credit-shelter trust (defective as to the surviving spouse) and (ii) putting into place a second stepped-up basis for the QTIPable credit shelter trust assets at the surviving spouse's subsequent death.

Many of these under-$10 million married couples will benefit from no federal estate tax, but without adequate planning face considerably greater income tax exposure. This increased income tax stems from (i) the compressed trust ordinary income tax rates, the additional 5% capital gains rate, and the 3.8% Medicare investment tax at these compressed trust thresholds and (ii) a failure to leverage the stepped-up basis as fully as possible at each spouse's death.

COMMENT:

The following key points address this under-$10 million married couple planning:

> (1) This QTIP planning includes beneficiary defective trust provisions for the first-to-die spouse's QTIPable credit-shelter trust, with the surviving spouse being able to opt-in or out of this defective trust status at the first spouse's death depending on the circumstances at that time. This beneficiary defective trust status as to the surviving spouse is in line with the tax and statutory discussion in IRS Letter Rulings 201216034 (January 11, 2012) and 9311021 (December 18, 1992).
>
> (2) This planning uses a single QTIP trust estate plan, and retains the ability to divide the trust into credit-shelter and marital deduction portions of the estate, if the first-to-die spouse ends up with property exceeding her estate exemption. This allows the credit-shelter trust to be QTIPable. This also enables the surviving spouse to decide at the first spouse's death whether to opt-in or out of portability as to the credit-shelter trust, depending on the circumstances at the first spouse's death. This factor brings into play the possibility of second stepped-up basis for the QTIP credit-shelter trust assets at the

surviving spouse's death.

(3) The surviving spouse's decision to opt-in or out of the defective trust status and the second stepped-up basis is designed with three options at the time of the first spouse's death, as follows:

(a) Option One: Defective Trust Status and a Second Stepped-Up Basis for the Surviving Spouse

This first option gives the surviving spouse a 15-day withdrawal right for the QTIPable credit-shelter trust that commences on the 61st day following the first spouse's death. This 61st day element (as an example) is to give some time for the surviving spouse to review his options. It also provides a definite interim period so that the QTIP trust arguably is not deemed defective as to the first spouse (for example, if this were an *inter-vivos* QTIP trust created and funded during life by the first-to-die spouse).

The 15-day withdrawal period lapses at the end of the 15-day period, but includes a continuing withdrawal right for the surviving spouse subject to a $5,000 or 5-percent annually recurring lapse.

In addition, and *expressly* conditional on and to the extent the surviving spouse makes no withdrawal during the 15-day period, the surviving spouse beginning at the end of the 15-day period gets a continuing power of substitution (under Section 675(4) of the Internal Revenue Code).

This Option One also purposely relies on inclusion of the QTIP trust assets in the surviving spouse's estate under Section 2044. Therefore, the first-to-die spouse's estate must correspondingly claim a marital deduction for the QTIPable credit-shelter trust. This marital deduction also, as a side benefit, simplifies the estate tax return preparation requirements and enables the surviving spouse to use portability of the first spouse's estate exemption at the surviving spouse's later death for inclusion of the value of the QTIP trust assets in the surviving spouse's estate (under Code Section 2044).

(b) Option Two: For a Reasonable (future) Possibility the Married Couple's Estates May Exceed their Combined Estate Exemptions

This Option Two includes the same 15-day withdrawal right with the continuing right of withdrawal subject also to the annual $5,000 or 5-percent lapse. However, the difference in Option Two compared to Option One is that

that the first-to-die spouse's estate <u>will not</u> claim a marital deduction for the QTIPable credit-shelter trust.

The primary goal of this Option Two is to make the QTIPable credit-shelter trust defective as to the surviving spouse. In contrast to Option One, the extent of a second stepped-up basis for the trust under this second option depends on what portion, if any, of the continuing withdrawal right has not lapsed at the surviving spouse's death.

Option Two is a good option, for example, in a situation where the first spouse dies younger than expected, with the result the surviving spouse thereafter may likely live long enough for the bulk of his continuing withdrawal right to lapse under the $5,000 or 5-percent annual calculations.

If there is inclusion of the non-lapsed withdrawal right value in the surviving spouse's estate, the surviving spouse's estate will get the benefit of a second stepped-up cost basis. The surviving spouse also will use his own estate exemption and any available portion of the first spouse's unused estate exemption in computing whether the surviving spouse's estate is subject to estate tax.

Option Two, therefore, is a somewhat, reasonable gamble so as to ensure defective trust status, but with a hedging approach as to inclusion of the QTIP trust in the surviving spouse's estate.

(c) Option Three: Terminates Entirely the Effect of the Surviving Spouse's Withdrawal and Substitution Powers

All bets are off under this Option Three. If circumstances later develop at the time of the first spouse's death so that neither defective trust status nor a second stepped-up basis is warranted, the surviving spouse can renounce and terminate the entire effect of these withdrawal and substitution powers.

Accordingly, under this Option Three the first spouse's estate <u>will not claim</u> a QTIP marital deduction for the QTIPable credit-shelter trust and no portion of the trust assets later will be includible in the surviving spouse's estate. The QTIP trust, furthermore, will not be a beneficiary defective trust as to the surviving spouse and no portion of the QTIPable trust assets will get a second stepped-up basis at the surviving spouse's death.[i]

IRS Letter Rulings 201216034 and 9311021

In Letter Ruling 201216034 the IRS concluded that *beneficiary* withdrawal powers coupled with the beneficiary's power to substitute trust assets trigger beneficiary defective trust status as to the trust beneficiary for purposes of the trust being an eligible S corporation shareholder. The trust in this letter ruling gave the beneficiary (who was also the trustee) a withdrawal right that continued after the initial withdrawal period subject to an annual $5,000 or 5-percent lapse. The trust also gave the trust beneficiary a substitution power, in a non-fiduciary capacity, to acquire the trust assets by substituting other assets of an equivalent value. Typical of most defective trust letter rulings, the IRS stated that, as a factual matter, to the extent the beneficiary's power to substitute is exercisable in a non-fiduciary capacity the beneficiary under Code Section 678(a)(2) will be treated as the owner of the portion of the trust assets over which his withdrawal power had lapsed.

The facts in Letter Ruling 9311021 are similar to the above 2012 letter ruling and involved separate irrevocable trusts funded by the settlor for each of his three sons. Coupled with both an initial withdrawal right, with the $5,000 or 5-percent lapsing provisions, and with each son's power to substitute (as to his respective trust), the IRS concluded the withdrawal powers along with the substitution power resulted in beneficiary defective trust status as to the trust beneficiary for purposes of the trust being an eligible S corporation shareholder.

Commentator Criticism of IRS Letter Rulings 201216034 and 9311021

There has been some limited criticism from commentators that the above Letter Rulings 201216034 and 9311021 are wrong. Wrong based on an argument that the trust beneficiary's non-fiduciary substitution power can result in the trust being defective only as to the grantor of the trust under Code Section 678(b). Therefore, the trust cannot be defective as to the trust beneficiary using a substitution power. Section 678(b) provides that a trust is not treated as owned by another power holder under Section 678(a) if the original grantor "is otherwise treated as the owner" under the other provisions of Section 671 *et seq.* other than Section 678.

Furthermore, some commentators have referred to Rev. Proc. 2007-45 to support the above criticism. This revenue procedure includes IRS sample trust provisions that meet the requirements of an *inter-vivos* CLAT, both grantor trust and non-grantor trust versions. This revenue procedure includes the 675(4) power to substitute as a triggering provision making the CLAT defective as to the grantor.

So as to distinguish the above criticisms of Letter Rulings 201216034 and 9311021 from the above QTIPable credit-shelter planning as to a surviving spouse, two important points begin this discussion:

One. The QTIPable credit-shelter trust comes into existence only at the time of the first-to-die spouse's death. There is no other "grantor" who arguably falls under the above limiting language of Section 678(b).

But, even if there were a prior grantor (such as if the QTIP trust had been an *inter-vivos* QTIP trust that was to the first-to-die spouse), the 60-day gap in time following the first spouse's death up to the commencement of the surviving spouse's withdrawal right is arguably sufficient so as not to deem the first-to-die spouse as a continuing grantor.

If the original grantor were, or is, the grantor for defective trust purposes the above criticisms may be correct. This original grantor limitation is consistent among IRS letter rulings generally. *See, for example,* IRS Letter Ruling 9321050 in which the IRS reversed its prior conclusion in Letter Ruling 9026036. The earlier 1990 ruling had favorably concluded (incorrectly thereafter according to the IRS) the particular trust was defective as to someone other than the grantor.

Two. The surviving spouse's power-of-substitution comes into effect only on the condition and to the extent of any QTIP trust property the surviving spouse does not withdraw during the initial 15-day withdrawal period. This conditional aspect of the substitution power is to help bolster an argument under the "release or modification" language of Section 678(a) so that the surviving spouse's decision not to withdraw operates as his modification of such right by triggering into effect the surviving spouse's substitution power.

In broader terms, criticism of Letter Ruling 201216034 suggests a substitution power can never apply to a third-party other than the grantor. This critical notion appears to be based on an argument that a continuing power as to a trust beneficiary (a substitution power in this instance) can relate back only to the grantor by virtue of Section 678(a)(2).

From a statutory construction perspective, the language of Section 678(a)(2) reads "as [such power] **would**, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof". [Emphasis added.] This statutory language is a subjunctive use of the word "would". That is, if such power *were* applicable to the grantor. This arguably implies there are circumstances where a 671-577 power is not applicable to the grantor.

The above criticism in reliance on Section 678(a)(2) also substantively rewrites Section 678(a)(2) as though it were otherwise written "as [such power] **does** (emphasis added), within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof." [Emphasis added.] This affirmative use of "does" rather than "would" could otherwise support an argument of exclusivity as to the grantor. But, that is not the statute.

Finally, as to Rev. Proc. 2007-45, two points distinguish this revenue procedure from Letter Rulings 201216034 and 9311021. First, under no circumstances can the grantor, trustee, or any interested person have the power to exchange property with a charitable trust. This is expressly prohibited under the Section 4941(d) self-dealing rules. The IRS in Rev. Proc. 2007-45 appears to have applied the above substitution power in a liberal manner so as to apply in this CLAT situation, rather than as a statement of limitation for the effect of a substitution power as to someone other than the grantor. Second, there are no other powers or provisions in the sample CLAT forms that in any manner give a trust beneficiary the grantor trust status for purposes of applying Code Section 678(a).

Third-Party Creditors and Withdrawal Rights

An important non-tax checklist item related to the above planning options is how the applicable state law for creditor claims might apply to the surviving spouse's withdrawal right. This withdrawal right planning may not be suitable in states that treat lapsed withdrawal rights as continuing self-settled trust contributions. In some instances for additional asset protection the surviving spouse's continuing withdrawal right after the 15-day period can require the consent of an independent trustee. *See, for example*, Treas. Reg. Section 20.2041-3(c)(2).

Final Thoughts

Keep in mind Option Three above provides a bail-out in its entirety in the event circumstances were to change (including greater clarification as to the criticism of Letter Ruling 201216034). There appears to be no interminable downside to this three-option planning.