Flexible Estate Planning for Married Couples in an Uncertain Estate Tax Environment

by James G. Blase, CPA, J.D., LL.M.

James G. Blase, CPA, J.D., LL.M., is principal with the law firm of Blase & Associates LLC in St. Louis, Missouri. The law firm focuses primarily on estate and income tax planning. He is a frequent author on a variety of estate and income tax planning topics and is an adjunct professor of estate planning at St. Louis University School of Law.

Executive Summary

- Estate planning for married couples requires more flexibility in light of changing federal estate tax exemption amounts over the next three years, and a still uncertain estate tax environment. A return to exemption amounts as low as $1 million or $2 million is not likely even under a Democratic president and Congress, though an amount falling below $3.5 million is possible, considering budget deficits.
- Planning for estates smaller than $1 million (including IRAs, life insurance, and retirement benefits) is relatively simple. Couples should avoid unnecessarily dividing non-community property assets between them and setting up a credit shelter trust.
- Medium-sized estates of $1 million to $3 million are the most challenging size of estate, requiring a case-by-case approach. Part of the challenge is not knowing where Congress will eventually place the estate tax exemption amount. Also challenging is that a recovering stock market could dramatically inflate a couple's estate value.
- Using joint revocable trusts with disclaimer trust provisions is a good, flexible strategy. It also provides some asset protection, though disclaimer trusts eliminate the step-up in income tax basis for heirs.
- For estates valued over $3 million, equalizing estates remains an important strategy in order to take advantage of separate estate tax exemptions. But planners should not make a blanket decision to always pay IRAs or qualified plan benefits outright to a surviving spouse.
- Because of the uncertain future of federal estate taxes, exemption and disclaimer trusts should be drafted with an "escape hatch."
- Charitable planning strategies also may need to change for many estates.

Estate planning approaches for married couples must be re-examined in light of the hefty rise in the federal estate tax exemption in effect for those dying in 2009 and thereafter. Couples with "small" estates (in relation to the current $3.5 million federal estate tax exemption) will no doubt want to take advantage of the larger estate tax exemption in order to simplify their estate planning, provide maximum protection from potential lawsuits, and reduce income taxes to their heirs. Couples with "large" estates need to focus more on a proper division of their assets in order to take maximum advantage of the likely larger estate tax exemption, which may also require them to examine new alternatives for protecting their newly divided assets from potential lawsuits.

It's the vast majority of married couples who have "medium-sized" combined estates, however, for whom estate planning has become the most challenging. Their estates have roughly $1 million to $3 million in assets, including life insurance, individual retirement accounts, and qualified plan benefits. Estate planners now need to examine these situations on a case-by-case basis, making sure the clients not only minimize or eliminate their estate tax exposure, but do so in a manner that will not result in unnecessary income taxes or capital gains taxes, and which will not unnecessarily expose the couple to lawsuits. A much more flexible approach to drafting estate planning documents will be required in these "medium-sized" situations—one that not only will take into consideration the current $3.5 million estate tax exemption, but also potential increases or decreases in the size of the estate tax exemption down the road, and potential changes in the size of the couple's estate.

Future of the Estate Tax

Existing law. Most readers of this article will remember the estate tax law that was passed on Memorial Day of 2001. Under this law, the estate tax exemption gradually rose from its then level of $675,000 to $1 million for individuals dying in the years 2002–2003, $1.5 million for years 2004–2005, $2 million for years 2006–2008, and, finally, $3.5 million for 2009. In 2010, the estate tax is scheduled to be repealed, but if an individual is "fortunate enough" to survive to the year 2011, he or she will be faced with an estate tax exemption of only $1 million.

President Obama and Democrat-controlled Congress. Although President Barack Obama has vowed in general to repeal the Bush tax cuts for the wealthy, in the last year of his campaign for the presidency he backed off this general position when it came to the federal estate tax. He now favors a $3.5 million estate tax exemption and a 45 percent maximum estate tax rate. The new Democrat-controlled Congress makes it likely he will eventually get his wish.

In early June 2008, Congress passed its non-binding budget resolution for the 2009 fiscal year. The Senate passed the resolution on party lines, with the Democrats in the majority. Under the budget resolution, both the estate tax exemption and maximum estate tax rate would be frozen at their 2009 levels of $3.5 million and 45 percent, respectively.

In mid-July 2008, Senator Carper (D-DE) introduced Senate Bill 3284 with two co-sponsors, Senator Voinovich (R-OH) and Senator Leahy (D-VT). The bill would permanently fix the estate tax exemption at $3.5 million (indexed for inflation) and the maximum estate tax marginal rate at 45 percent. The initiative represents a rare occasion in which senators from both sides of the aisle have co-sponsored estate tax reform legislation. As this article went to press, this bill was in the first step in the legislative process. The Senate Finance Committee must first deliberate, investigate, and revise the bill before it goes to general debate. Nevertheless, especially considering the fact that in the recent past the Senate has been the major stumbling block when it comes to estate tax reform legislation, the bill represents another indicator that a return to a $1 million or even a $2 million federal estate tax exemption appears unlikely.

Synopsis. Based on the foregoing summary of the existing law and current estate tax proposals, it would appear unlikely that we will ever return to the "pre-Bush" estate tax exemption level of $675,000, or even to the $1 million level that the estate tax exemption was previously scheduled to reach in the year 2006. It would appear possible, however, that the exemption could fall below the $3.5 million level and return to the $2 million exemption level at some point, especially if the wars in Iraq and elsewhere were to escalate and significant budget deficits remain. On the other hand, an estate exemption amount of $5 million or more in the near future would seem very unlikely.

> "Under the budget resolution, both the estate tax exemption and maximum estate tax rate would be frozen at their 2009 levels of $3.5 million and 45 percent, respectively."

Estate Planning for Estates Under $1 Million

Focus on simplicity. Estate planning for married couples with combined estates under $1 million (including life insurance, IRAs, and retirement benefits) is much simpler today than it was pre-Bush. The unlikelihood that we will ever return to the $1 million exemption level, or even the $2 million level, will normally make it unnecessary, in non-community property states, to divide assets between a husband and wife having a combined estate under $1 million in order to achieve two estate tax exemptions.

Avoiding unnecessary exemption-equivalent trusts. Thus, estate planners should advise married clients with combined estates of less than $1 million to avoid unnecessarily dividing non-community property assets between them and its often concurrent establishment of an exemption-equivalent or credit-shelter trust effective at the death of the first spouse. As discussed later, dividing assets previously owned by the couple jointly as tenants by the entirety may unnecessarily expose either spouse to lawsuits. Also as discussed later, unnecessarily establishing exemption equivalent or credit shelter trusts may result in an equally unnecessary loss of a step-up in the income tax basis for the trust's assets at the surviving spouse's death. It also could potentially result in a full or partial loss of the special $250,000 exclusion that would otherwise be available if the surviving spouse were to sell the couple's principal residence during his or her lifetime. Finally, severing joint tenancies and otherwise dividing assets between married partners unnecessarily may have unintended consequences in the event of a subsequent divorce.

If a couple is nevertheless concerned that the size of their combined estate will eventually exceed the federal estate tax exemption level, their estate planning should entail all of the discussion contained in the next two sections of this article.

Planning for Estates Between $1 Million and $3 Million

Planning should be on a case-by-case basis. Planning for married couples with combined estates worth $1 million to $3 million will obviously be more complex than planning for married couples with

combined estates under $1 million. Perhaps somewhat surprisingly, however, planning for combined estates between $1 million and $3 million will likely become more complex than planning for much larger estates.

The increased complexity in this "middle-value estate" area is caused by two primary forces. First, notwithstanding the position of President Obama, the non-binding budget resolution passed by Congress in early June 2008, and the bi-partisan Senate Bill 3284 introduced in July, it is impossible to predict with any degree of certainty the near or long-term future of the federal estate tax, except perhaps to say that it appears unlikely the exemption amount will fall below the $2 million level. Second, history demonstrates that the stock market (and to a lesser extent other assets such as real estate) can, at any point, rapidly run-up in value, so much so that a combined estate valued at less than $2 million today could become a combined estate with a value over $3 million in less than a year's time.

> "Disclaimer trusts provide the couple with flexibility to make decisions about anticipated future estate tax exemptions and stock market performance anytime within nine months of the death of the first spouse."

Estate planners always need to be cognizant of potential future run-ups in the value of the stock market and other assets, and their relationship to possible future estate tax exemption levels. For example, assume that a husband and wife have a combined estate of $2 million today, or less than the current $3.5 million estate tax exemption. If this couple adopts the simplified "sweetheart will" approach to estate planning, whereby everything is simply left to the surviving spouse outright, it may be possible that, by the time of the surviving spouse's death, his or her estate may have grown to a value exceeding the estate tax exemption available at that time. This is because it is simply impossible at the present time to predict with certainty (1) the estate tax exemption level when the surviving spouse dies and (2) the future of the stock market and the value of other volatile assets.

Other relevant factors in this case-by-case estate planning process for married couples with $1 million to $3 million combined estates will include (1) the couple's age, (2) their future earnings potential, (3) their projected future expenses such as college education for their children and retirement expenses, (4) the couple's approach to investing such as equities versus fixed-income allocation, (5) the amount of the exemption applicable to estate or inheritance taxes payable in the particular state, if any, and (6) anticipated inheritances, if any.

Use of joint revocable trust coupled with disclaimer trust provisions. Given the future uncertainty in the size of the federal estate tax exemption, as well as the uncertain future of the stock market and the value of other volatile assets, one suggested estate planning course for medium-sized estates would be to maintain joint ownership of assets between a husband and wife, but couple it with an estate plan that establishes a "disclaimer trust" for the benefit of the surviving spouse and, if desired, the couple's children. As part of this plan, all life insurance and other assets owned by either spouse separately would be made payable to a joint revocable trust at the death of the spouse, either via life insurance beneficiary designation or via transfer on death (TOD) or pay on death (POD) beneficiary designation. Normally, IRA and qualified plan benefits would not be made payable to the revocable trust under this plan, other than possibly as secondary beneficiary for the benefit of the couple's children at the death of the surviving spouse.

Under this "disclaimer trust" approach to solving the dilemma of uncertain future estate tax exemption and asset value, the surviving spouse would have up to nine months after the death of the first spouse to decide what portion, if any, of the joint and community property survivorship interest, life insurance proceeds, or TOD or POD beneficial interests to disclaim. The portion disclaimed would then pass to a disclaimer trust for the benefit of the surviving spouse and, if desired, the couple's children. If properly drafted, the assets of the disclaimer trust would not be includible in the surviving spouse's gross estate for federal estate tax purposes, and there would not be a taxable gift by the surviving spouse upon executing the disclaimer. Disclaimer trusts thus provide the couple with flexibility to make decisions about anticipated future estate tax exemptions and stock market performance anytime within nine months of the death of the first spouse.

Care must be taken not to rely solely on the ability to disclaim assets titled as joint tenants with right of survivorship, however, as it is not always possible to disclaim a survivorship interest in an asset just because it is titled in the names of both spouses as joint tenants with right of survivorship. The Internal Revenue Service takes the position that assets owned in the typical joint bank account (including a certificate of deposit or money market account) or joint brokerage account, wherein either party has a power to withdraw the entire account unilaterally, can only be disclaimed to the extent the person making the disclaimer did not transfer assets or funds to the account. Similar rules do not apply to other types of jointly owned assets, such as real estate.

Focus on asset protection. The joint disclaimer trust approach provides another significant advantage: it allows the couple the opportunity to preserve a level of asset protection. Tenants by the entirety property may only be attached by joint creditors

of both spouses, and not severally by creditors of one spouse only. The protections afforded by the joint disclaimer trust approach generally are not available for community property or when assets must be divided between two spouses, as in the case of larger estates, discussed later in this article.

Disadvantages of disclaimer trusts. The disclaimer trust approach provides maximum flexibility to deal with an uncertain future estate tax exemption and an uncertain stock market and value of other volatile assets. In many instances this approach helps insulate assets from lawsuits. Nonetheless, estate planners must be mindful that the disclaimer approach also carries with it several potential disadvantages. Among them:

1. Disclaimers of survivorship interests in jointly owned property cause probate of the disclaimed survivorship interest at the death of the first spouse (although disclaimers of other assets payable to the trust at the death of the first spouse, such as life insurance, will not).
2. The surviving spouse may not be given the power, either as trustee or via a power of appointment, to appoint trust assets to children or other descendants. Any such power must be exercised by a co-trustee or person other than the surviving spouse.
3. The disclaimer approach relies on future voluntary action by a surviving spouse, which may end up not taking place.
4. If assets are disclaimed by the surviving spouse and pass to a disclaimer trust, the assets of the disclaimer trust will not receive a step-up in the income tax basis at the surviving spouse's death. This could cause the couple's children to incur added capital gains taxes after the couple's death. But as discussed more fully later in connection with estate tax exemption trusts generally, this problem is minimized if the disclaimer trust is properly drafted.

Before advising a surviving spouse to execute a disclaimer, the estate planner must therefore be mindful of the potential disadvantages, and only recommend the disclaimer to the extent there is a reasonable likelihood it could result in significant estate tax savings at the surviving spouse's death.

Alternative use of an exemption-type trust in certain situations. If a significant portion of the couple's taxable estate consists of life insurance proceeds or other assets owned by the spouses separately rather than as joint tenants (including each spouse's interest in community property), there's an approach that might be preferable to the disclaimer-trust approach. A provision can be made in the joint revocable trust document that any life insurance proceeds and other assets payable to the revocable trust as a result of the first spouse's death, along with that spouse's separate property and one-half interest in the community, pass to an exemption-type trust for the surviving spouse and children. The benefit of this approach is that it avoids the first three of the above-listed disadvantages of the disclaimer trust approach. And similar to the disclaimer trust approach, the fourth disadvantage can be minimized if the exemption trust is properly drafted, as discussed more fully later.

> "Before making a blanket decision to always pay IRAs or other qualified plan benefits outright to a surviving spouse, consideration needs to be given to a host of different factors."

Estate Planning for Estates Over $3 Million

Importance of equalizing estates. For larger estates exceeding $3 million, the question is how to plan in light of the potential for alternative tax law scenarios outlined at the outset of this article. With one important exception discussed later regarding the choice of primary beneficiary for IRAs and qualified plan benefits, this answer is actually easier for large estates than it is for medium-sized estates. Until we have a definitive resolution to the estate tax exemption and maximum estate tax rate situation (which will likely not come until late in 2009), estate planners will be wise to assume that, except in community property states, it will still be necessary to divide large estates between a husband and wife in some fashion that will take advantage of each of their separate estate tax exemptions.

Planning for IRAs and qualified plan benefits. The planning difficulty for large estates will be in deciding how to handle IRAs and other forms of qualified retirement plan assets. Although it is possible to designate an individual's revocable trust as beneficiary of their IRA or qualified plan proceeds after their death, doing so will mean that the benefits must be paid out over the life expectancy of the surviving spouse, as the oldest beneficiary of the revocable trust—even if the trust instrument is properly drafted. The ability to maximize the deferral potential of the IRA or other qualified retirement plan interest is therefore not achieved under this approach.

On the other hand, designating the surviving spouse as outright beneficiary of the IRA or qualified plan benefits in order to achieve the maximum "stretch-out" of the benefits for federal and state income tax purposes is not always the wisest choice either, especially if doing so may mean larger estate taxes at the surviving spouse's death. Before making a blanket decision to always pay IRAs or other qualified plan benefits outright to a surviving spouse, consideration needs to be given to a host of different factors. These include the potential surviving spouse's age, the

value of the surviving spouse's independent estate (including any potential inheritance), and whether this is a second marriage that includes children from either or both spouses.

The older a potential surviving spouse becomes (especially if he or she has already attained age 70½), obviously the less important income tax deferral becomes. If the surviving spouse has a significant independent estate or stands to inherit a substantial sum, adding qualified plan or IRA benefits to this amount may result in unintended estate taxes at the surviving spouse's death. If a second marriage is involved, with children of either or both spouses, designating the surviving spouse as the outright beneficiary of the IRA or qualified plan could obviously turn out to have disastrous unintended results for the children of the first spouse to die.

> "Because of the uncertain future of the federal estate tax, exemption and disclaimer trusts should be drafted to include an 'escape hatch.'"

A final and perhaps the most overlooked factor in determining whether an outright distribution of the IRA or qualified plan to the surviving spouse should be made—notwithstanding the potential for increased estate taxes in the surviving spouse's estate—is the practical question of whether the surviving spouse is even in a financial position to maximize the deferral potential of the IRA or qualified plan benefits. Estate planners routinely advise that the IRA or plan benefits be paid outright to the surviving spouse in order to take advantage of the spousal rollover rules. Yet they often do so without asking what, if any, portion of the proceeds the surviving spouse will require for the rest of his or her life. If planners ask and the response is that it is likely that funds from the IRA or qualified plan will be required by the surviving spouse before age 70½, creating the maximum possible stretch-out opportunity becomes meaningless.

If the estate is large enough to merit a division of assets between the two spouses, the estate planner should then consider paying all or part of the IRA or qualified plan benefits to the participant's revocable trust as primary beneficiary in order to fully fund the estate tax exemption of the first spouse to die. The estate planner should be aware, however, that the IRS may take the position that all potential remainder beneficiaries under the trust (that is, potentially including heirs who are older than the surviving spouse) may need to be considered for purposes of determining the oldest beneficiary of the trust.

On the other hand, after dividing the assets other than the IRA and qualified plan benefits between the two spouses, the planner may find that the value of the surviving spouse's estate will likely be substantially lower than the estate tax exemption amount at his or her death. In this situation it might not be necessary to pay the IRA or plan benefits to the first decedent's revocable trust as primary beneficiary, unless other concerns exist, such as the potential that the surviving spouse may choose to leave the benefits to a new spouse or children from a previous marriage.

Avoiding High Income Tax Rates on Exemption and Disclaimer Trusts

A significant problem associated with trusts designed to hold assets equal in value to the federal estate tax exemption, as well as trusts designed to hold assets disclaimed by a surviving spouse, is that the maximum federal income tax bracket applies to trust income at levels as low as just over $10,000. This maximum bracket generally applies only to ordinary interest, rents, annuity payments, and payments under IRAs or qualified plans, but in the future it could apply to dividends.

It would be a simple matter to avoid the high trust-tax rates on ordinary income by distributing all of the ordinary income of the exemption or disclaimer trust to the surviving spouse. This simplistic approach negates the principal purpose of the exemption or disclaimer trust, however, by adding to the value of the surviving spouse's taxable estate.

The preferred approach is to grant the surviving spouse the sole power to withdraw any items of trust income otherwise taxed to the trust at the maximum bracket. As long as the trust agreement is properly drafted,[1] the surviving spouse may be granted this power, without adverse estate or gift tax consequences, and the income of the trust that would otherwise have been taxed at the trust's maximum tax bracket will instead be taxed at the surviving spouse's tax bracket. Taxing the surviving spouse on the trust income, without requiring him or her to actually withdraw the same, thus preserves the primary estate planning purpose of the exemption or disclaimer trust.

Early Termination of Exemption and Disclaimer Trusts and Family Partnerships

Because of the uncertain future of the federal estate tax, exemption and disclaimer trusts should be drafted to include an "escape hatch" designed to allow for the potential early termination of the trust and distribution of the trust principal to the surviving spouse. The escape hatch could be used if the federal estate tax is ever repealed or if the amount of the federal estate tax exemption is ever increased to a level where the surviving spouse need no longer worry about estate taxes. The escape hatch should include an exemption level that comfortably exceeds the value of the surviving spouse's assets, including the assets in the exemption or disclaimer trust. As long as the trust document has been properly prepared,[2] usually by being certain the surviving spouse does

not personally possess the termination power, these escape-hatch clauses will preserve the ability to achieve a stepped-up income tax basis on the trust assets at the surviving spouse's death, in appropriate cases. This is because assets owned outright by the surviving spouse or by the surviving spouse's revocable trust at death receive a step-up in income tax basis at the surviving spouse's death, whereas assets owned inside of a disclaimer or exemption trust will not.

Consideration also should be given to terminating an existing family limited partnership (FLP) early if the partnership is no longer necessary to minimize estate taxes. This would occur when the value of the client's or couple's estate is substantially less than a new higher federal estate tax exemption amount (or twice the amount, in the case of a married couple). Unnecessarily continuing an FLP under such circumstances may cause an unnecessary reduction in the stepped-up income tax basis of the partnership's underlying assets at death, due to the valuation discount the limited interests receive for federal estate tax purposes. A lower step-up in income tax basis will obviously result in increased capital gains taxes for the client's or couple's heirs when the underlying assets of the partnership are eventually liquidated.

Use of Domestic Asset Protection Trusts

Dividing assets between spouses that were previously owned by them in tenancy by the entirety form, in order to take maximum advantage of each spouse's larger estate tax exemption, carries with it the disadvantage of exposing the divided assets to lawsuits. The same situation generally applies to community property. Strategies to minimize this exposure include minimizing the value of the separate property in the hands of the spouse in the higher-risk profession, and, where possible, recharacterizing community property as separate property and transferring all of the same to the lower-risk-profession spouse. The higher-risk-profession spouse's trust can then be funded with asset-protected IRAs, qualified plan benefits, or life insurance proceeds (all subject to limits).

The couple also may opt to use one or more of the forms of domestic asset protection trusts currently available in several states.[3] If the domestic asset protection approach is considered, however, the planner needs to be aware that an argument exists under the recently amended federal bankruptcy code that a ten-year waiting period applies to transfers to such trusts, similar to the five-year waiting period that applies generally to transfers made for Medicaid planning purposes.

Estate Planning for Second Marriages

The larger projected federal estate tax exemption makes it easier to do estate planning for second marriages that include children of either or both spouses. This is because the larger exemption enables each spouse, if survived by the other spouse, to leave a larger portion of their estate directly to the children of their previous marriage, without incurring estate taxes.

What if a second-marriage couple instead prefers to leave the bulk of the first decedent's assets in trust for the benefit of the surviving spouse, with the remainder passing to the children of the first decedent at the surviving spouse's death? The larger federal estate tax exemption may actually make it possible for the first decedent to leave the assets in the form of a qualified terminable interest property trust for the benefit of the surviving spouse, rather than in the form of a more conventional estate tax exemption trust. The purpose of this unusual technique would be to achieve a stepped-up income tax basis for the children of the first decedent, at the death of the surviving spouse. Basis step-up would not be available with the more conventional estate tax exemption trust.

Charitable Tax Planning

In the past, most charitable bequests generated a charitable estate tax deduction benefit to the decedent's estate, thus saving the beneficiaries of the estate as much as 55 cents for each dollar the decedent left to charity. With the projected larger estate tax exemption, however, most bequests to charity will no longer generate an estate tax benefit to the decedent's family. Therefore, in some cases, it may now be best for the couple to instead leave the amount they wish to eventually go to charity to their children first. The couple should express their desire that the children would then donate the same amount to charities designated by their parents. As long as the couple is confident their children will carry out their wishes, this technique will have the benefit of generating income tax deductions to the couple's children after the couple's death, without reducing the amount the charities ultimately receive. A similar planning process should apply for unmarried clients.

Conclusion

It is incumbent on estate planners that they prepare new estate plans for married couples and, where necessary, revise existing plans, to account for the larger but still fluid federal estate tax exemption. Unnecessary exemption-equivalent or credit-shelter trusts and family limited partnerships, which at best will have the effect of causing unnecessary capital gains taxes to the next generation, should be eliminated, and other arrangements should be re-examined and modified where appropriate to minimize the potential for unnecessary income taxes in the future.

Endnotes

1. Blase, J., 2003, "Recent Tax Acts Require Focus on Income Tax Aspects of Estate Planning," *Estate Planning* 30, 617 (December): 619–622.
2. Ibid., 618–619.
3. See, for example, Blase, J., 2005, "The Missouri Asset Protection Trust," *Journal of the Missouri Bar* 61, 72 (March–April).