


TRUSTS & ESTATES

The  WealthManagement.com journal for
estate-planning professionals



Giving Good Face—“At the Studio With IKA 1” (35³/₄ in. by 26¹/₄ in.)
by Julian Opie, sold for \$42,745 at Sotheby’s recent Contemporary
Art Day Auction in London on July 1, 2014, p. 4.

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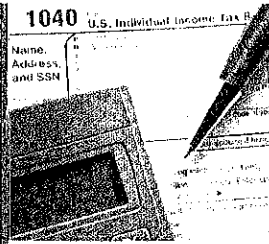
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FEATURE: ESTATE PLANNING & TAXATION

By **Charles A. Granstaff**

Portability + QTIP

A happy couple or a recipe for family discord?

The 2012 American Taxpayer Relief Act has greatly changed the engineering of estate plans. Now, with a \$5.34 million (in 2014) exclusion amount indexed for inflation, lower estate tax rates, higher capital gains rates and Internal Revenue Code Section 2010(c) (that is, portability), practitioners are often designing flexible plans to maximize step-up in basis. For some couples, the new law may greatly simplify their planning, but for others, options abound, resulting in greater complexity. (See “Surviving Spouse Documents,” p. 24.)

Spousal Testamentary Trust

A couple married once with children from that marriage, perhaps with an estate worth \$2 million to \$3 million, may simply choose to leave all their assets to each other and secure a step-up in basis at the surviving spouse's death. The executor at the first spouse's death can decide whether to elect portability. Under portability, the executor may elect on a Form 706 for the surviving spouse to carry over the deceased spousal unused exclusion (DSUE) amount. Thus, a surviving spouse receiving all of the decedent's assets could add the DSUE to his own exclusion amount. (For more information about DSUE, see “The DSUE Coin Flip,” by John T. Bannen and Kristin A. Occhetti in this issue, p. 17).

Nevertheless, many couples will have non-tax reasons for creating a spousal testamentary trust due to concerns about: 1) a surviving spouse's remarriage, 2) changing the ultimate disposition, 3) asset protection, or 4) children by a prior marriage of either spouse. For

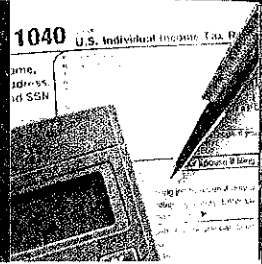
many taxpayers with modest estates using testamentary trusts, it seems logical for the executor to elect qualified terminable interest property (QTIP) status for a trust that qualifies under IRC Section 2056(b)(7). This election allows assets that otherwise aren't subject to estate tax (assuming they don't appreciate too significantly) to receive a step-up in basis at the surviving spouse's death. The portability election adds a new dimension to this strategy. Since IRC Section 2044 requires the surviving spouse to include the value of the QTIP property in his estate, an executor may elect portability. While the QTIP trust assets are included in the surviving spouse's estate and receive a step-up in basis, portability allows the surviving spouse to use the DSUE (fixed in the year of the first to die) to offset the value of the QTIP trust assets. Portability isn't without its drawbacks, however, particularly for increasingly common blended families.

Example 1

Suppose Ralph and Betty have been married 15 years, and both have children from prior marriages. Ralph wants to create a testamentary trust for Betty for her life, with the remainder interest benefitting his children from a previous marriage. The trust is designed so the executor has the option to elect QTIP status at Ralph's death. Ralph dies in 2014 with a \$3 million estate. His executor elects QTIP status under Section 2056(b)(7) so that if the assets go up in value, Ralph's children will receive a step-up in basis at Betty's death. The executor also elects portability so that Betty can use Ralph's DSUE, because the QTIP assets will be included in her estate. Betty dies a few years later with her own \$10 million estate and a \$6 million exclusion amount. In the meantime, the QTIP trust has grown to \$5 million. Betty's gross estate is \$15 million (her \$10 million, plus \$5 million



Charles A. Granstaff is a partner at Granstaff, Gaedke & Edgmon, P.C. in San Antonio



from the QTIP). Her exemption is \$11.34 million (her \$6 million, plus Ralph's \$5.34 million DSUE from 2014). The federal estate tax on Betty's estate is \$1.464 million ($(\$15 \text{ million} - \$11.34 \text{ million} = \$3.66 \text{ million}) \times 40 \text{ percent}$), but Betty's estate doesn't necessarily pay the bill.

IRC Section 2207A

Section 2207A was passed to protect a surviving spouse from estate tax on assets that are included in his estate from an accounting perspective when the assets, in fact, are controlled independently by a QTIP trust. It provides that a QTIP trust must reimburse a surviving spouse's estate for the difference between the amount the surviving spouse's estate pays with the QTIP assets included and the amount the surviving spouse's estate would have paid without the inclusion of QTIP assets. In Example 1, Betty's estate would have paid nothing, had she died with a \$10 million estate, because she would have had \$11.34 million in exemptions. Thus, Ralph's QTIP trust must pay \$1.464 million of its \$5 million to Betty's estate, even though Betty's estate has to pay nothing on a \$10 million estate. Ralph's remainder beneficiaries are going to be unpleasantly surprised to discover this outcome. The advantage of their \$2 million ($\$5 \text{ million} - \3 million) step-up in basis is overshadowed by their obligation of \$1.464 million in estate tax reimbursement to Betty's estate under Section 2207A.

To further complicate things, if Betty's estate fails to exercise the Section 2207A right of recovery, Treasury Regulations Section 20.2207A-1(a)(2) treats such failure as a gift from Betty's beneficiaries to the beneficiaries of the QTIP trust. Moreover, Betty's executor may have a state law fiduciary duty to pursue the claim.

Waiver of Reimbursement

A potential solution to this inequity is for the drafter of Ralph's will to require that, if a QTIP election has been made and the executor wishes to elect portability, Betty waive her reimbursement right under Section 2207A. Section 2207A(a)(2) requires such a waiver to be included in the surviving spouse's will or revocable trust. In Example 1, that would cure the problem. Betty's estate would pay the \$1.464 million in estate tax because Ralph's estate was less than the

DSUE carried over. But, what if Ralph's QTIP assets increased a great deal more than that? Say Ralph's assets increased from \$3 million to \$8 million before Betty died, and Betty had waived her reimbursement right under Section 2207A? Now Betty's family pays all the estate tax, and Ralph's children receive the entire \$8 million with no estate taxes. Betty benefitted by carrying over a \$5.34 million exemption, but her estate pays \$1.064 million more than the benefit she received by the DSUE carryover ($(\$8 \text{ million} - \$5.34 \text{ million} = \$2.66 \text{ million}) \times 40 \text{ percent}$). In hindsight, if Ralph's executor had known that the assets would grow from

To the extent assets grow but stay under the exclusion amount, waiving Section 2207A works well.

\$3 million to \$8 million, he wouldn't have elected QTIP status, and the trust would have operated as a traditional bypass trust excluded from Betty's estate.

Executors who elect QTIP status in hopes of receiving a step-up in basis and surviving spouses who waive Section 2207A must consider this dilemma. To the extent assets grow but stay under the exclusion amount, waiving Section 2207A works well. In contrast, estate tax can be significant and levied unpredictably if QTIP assets grow substantially, perhaps because the surviving spouse lives much longer or because of some windfall regarding the property, such as discovery of natural resources. The DSUE is a fixed dollar amount, and the QTIP assets could have decades to grow, depending on the surviving spouse's age. A blanket Section 2207A waiver could be just as dangerous for the surviving spouse's family as a lack of a waiver is for the family of the first to die.

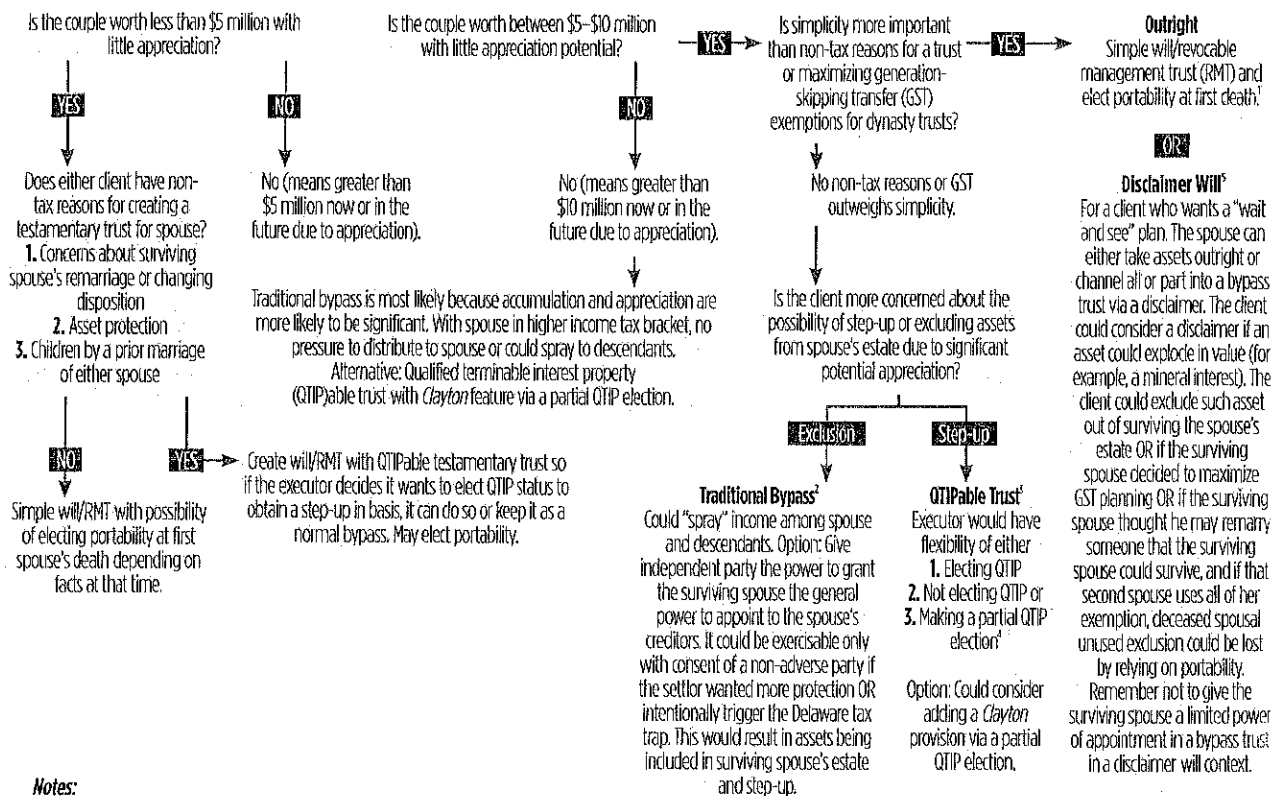
Formula Waiver

Perhaps a more precise solution is for an executor who's elected QTIP treatment and wishes to elect portability

FEATURE: ESTATE PLANNING & TAXATION

Surviving Spouse Documents

Assess the various options



Notes:

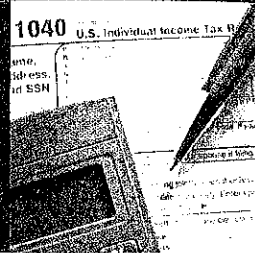
- This chart isn't absolute, and an estate plan must be prepared and customized to the client's individual facts. Also, state estate tax issues could impact the decision.
- This chart focuses on the document structure as it relates to the spouse.
- Even with a simple will, a client may decide to implement generation-skipping transfer "downstream."

Endnotes

1. Unless there are significant business entity interests that could be discounted at the first death with little audit risk. In such a case, a client may want to move assets out of the surviving spouse's estate via a disclaimer option or merely design bypass from the outset. Otherwise, the surviving spouse could end up with a majority of business with no (or modest) discounts.
2. If a qualified terminable interest property trust (QTIP) is elected, most likely portability will be as well. Be aware that inequities could occur if the surviving spouse elects QTIP and portability, and he doesn't waive the right of reimbursement from the QTIP. No such potential inequity exists with a traditional bypass trust. Portability may make sense even with traditional bypass, depending on how much exemption is left over after funding a bypass trust.
3. *Ibid.*
4. Warning: It's best for the surviving spouse not to be the executor making the QTIP election if there's a Clayton provision; otherwise, there could be gift implications.
5. There are other variations of the disclaimer approach that are beyond the scope of this chart.

— Charles A. Granstaff

Professor of Law, Case Western Reserve University, Cleveland, Ohio; Director, Trusts and Estates Institute, Case Western Reserve University, Cleveland, Ohio



Sample Formula Waiver

Wording for the surviving spouse to sign

I, Mary Doe, in exchange for the Executor making a portability election in the Estate of John Doe, hereby waive any right of reimbursement under Section 2207A of the Internal Revenue Code with respect to the Mary Doe Marital Trust (the Marital Trust), but only to the extent of the federal estate tax assessed against my estate attributable to the value of the Marital Trust assets equal to an amount up to but not exceeding the amount of the deceased spousal unused exclusion amount (the DSUE amount) as finally determined from the Estate of John Doe (whether or not such DSUE amount is available to my estate at the time of my death). The amount of the reimbursement right from the Marital Trust that is waived shall be determined by the following calculation process. (1) Determine the amount of reimbursement that would be due to my estate from the Marital Trust under Section 2207A but for this waiver (the Section 2207A reimbursement amount). (2) If the value of the Marital Trust assets for estate tax purposes at my death is equal to or less than the DSUE amount, the full Section 2207A reimbursement right is waived. (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, enough of the Section 2207A reimbursement amount is waived such that my estate will bear no more federal estate tax than if: (i) the Marital Trust assets were not included in my gross estate for federal estate tax purposes, and (ii) if only my applicable exclusion were used not including the DSUE amount. I agree that I will include this formula waiver in my Will or Revocable Trust in accordance with Section 2207A(a)(2).

—I'd like to thank Steve Akers for his insight and significant contributions to the language of this formula waiver and Al Golden's insight and comments.

— Charles A. Granstaff

to have the surviving spouse sign a formula waiver that's designed only to waive Section 2207A as to the benefits the surviving spouse derived from the DSUE carried over. Thus, each family pays its share of any estate tax. While facts and circumstances vary from client to client and wording must be carefully tailored to the situation, see "Sample Formula Waiver," this page, for language that you could include in this waiver.

Example 2

Ralph and Betty have been married 15 years. Both have children from prior marriages. Ralph dies in 2014 with a \$3 million estate. QTIP status and portability are elected. Betty dies a few years later with her own \$10 million estate and a \$6 million exclusion amount. The QTIP

trust has grown to \$8 million at Betty's death.

1. Total tax:	
Betty's	\$10 million
+ Ralph's (QTIP)	<u>\$8 million</u>
	\$18 million
Betty's exemption	(\$6 million)
DSUE (Ralph)	<u>(\$5.34 million)</u>
	\$6.66 million
	x 40%
	\$2.664 million

2. Fair allocation:	
A. QTIP should pay: \$1.064 million calculated as follows:	
	\$8 million
	<u>(\$5.34 million)</u>
(Betty benefitted from \$5.34 million DSUE)	\$2.66 million
	x 40%
	\$1.064 million

B. Betty should pay: \$1.6 million calculated as follows:	
	\$10 million
(\$18 million gross estate less \$8 million QTIP)	<u>(\$6 million)</u>
(\$11.34 million less the \$5.34 million DSUE)	\$4 million
	x 40%
	\$1.6 million

\$1.6 million (Betty pays) + \$1.064 million (QTIP pays)
= \$2.664 million total estate tax

3. Applying proposed formula 2207A waiver:	
Total Section 2207A potential reimbursement amount:	\$ 2.664 million
Surviving spouse's estate tax if no QTIP or DSUE were factored in:	\$1.6 million
Amount of Section 2207A reimbursement waived:	\$1.6 million
Amount of Section 2207A reimbursement owed by QTIP trust:	\$1.064 million

4. Conclusion: This is a fair result because the QTIP trust must only reimburse the surviving spouse's estate for the tax on the increased QTIP trust asset

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value exceeding the DSUE (that is, (\$8 million – \$5.34 million = \$2.66 million) x 40% = \$1.064 million).

Remarriage

Temporary Regulations Section 20.2010-1T(d)(5) provides that the DSUE available at the surviving spouse's death relates to the most recently deceased spouse married to the surviving spouse. Temp. Regs. Section 25.2505-2T(a)(1) allows the surviving spouse to apply the DSUE to gifts even if he remarries, as long as his new spouse is alive; however, once the new spouse dies, the DSUE from the prior deceased spouse is lost. Despite whether the surviving spouse might benefit from a potential new DSUE, losing the first DSUE could cause more hardship on one of the parties, depending on how the elections and any waiver were structured. If the surviving spouse remarries a wealthy individual who dies having fully used his applicable exclusion amount, the surviving spouse will have no DSUE. The executor should consider refraining from making QTIP and portability elections involving wealthy younger surviving spouses more apt to remarry, unless it's clear that the surviving spouse will promptly gift and fully use the DSUE.

Additional Concerns

While the formula Section 2207A waiver solves the allocation problem described above, there are additional concerns that practitioners will need to consider before using such a waiver. Could the agreement be construed as a contingent QTIP election? Because Section 2207A(a)(2) requires the waiver to be included in a will or revocable trust, can an executor and surviving spouse contract to make a will? Unfortunately, when new laws, such as portability, are passed, there can be unintended results caused by other IRC sections. Such is the case here.

When concerns about potential complications and inequities with electing both portability and QTIP status outweigh planning for a step-up in basis, the traditional bypass trust might be a better fit because Section 2207A doesn't apply. Alternatively, bypass trusts can be designed so that the assets could receive a step-up in basis by being included in the surviving spouse's estate (for example, invoking the Delaware tax trap). Such techniques are beyond the scope of this article, although they're not without their own drawbacks. Drafters who include QTIP trusts in their documents to potentially receive a

step-up in basis at the surviving spouse's death but fail to appropriately consider portability and Section 2207A, may put executors in difficult situations. While the executor could certainly still require such a waiver prior to the portability election in the absence of guidance in the will or revocable trust, the executor's job will be easier and less controversial if the governing documents address these issues. The testator may also wish to insert language in the document giving the executor sole discretion as to whether a QTIP election or portability election is made and exculpating the executor from liability to any beneficiary or person for either making or forgoing such elections. Otherwise, many executors may decide the risks outweigh the merits of serving. ☉



SPOT LIGHT

Singing The Blues

"Art Blakey" (24 in. by 18 in.) by Frederick J. Brown, sold for \$5,000 at Swann Auction Galleries' recent African-American Fine Art Sale in New York on June 10, 2014. The Chicago-raised Brown referenced religious, historical and urban themes in his work but was especially noted for his numerous portraits of jazz and blues artists.

