RECENT TAX AND ESTATE PLANNING DEVELOPMENTS

January 2014

Presented For

THE SOCIETY OF FINANCIAL SERVICE PROFESSIONALS

Atlanta Chapter

February 20, 2014

DOUGLAS W. DUNCAN

© Copyright 2014

LEFKOFF, DUNCAN, GRIMES, MCSWAIN & HASS
ATTORNEYS AT LAW
A Professional Corporation

Suite 200, Piedmont Place
3520 Piedmont Road, N.E.
Atlanta, Georgia 30305

www.lefkoff-duncan.com

telephone (404) 262-2000
facsimile (404) 262-2897

Table of Contents

Acknowledgment and Circular 230 Notice . . . . . ii.

I. Federal Estate and Gift Taxes 1
- A. After ATRA 1
- B. The Administration's Current Revenue Proposals 2
- C. 2013 Estate and Gift Tax Developments 3
  1. Life Insurance Incidents of Ownership 3
  2. More on Incidents of Ownership 4
  3. Sales Close to Date of Death 5
  4. Marital Deduction 7
  5. Special Valuation Rules of Chapter 14 7
  6. Beneficiary-Owned Trusts Added to No-Ruling List 7

II. Generation Skipping Tax Developments 8

III. Income Tax Planning 9
- A. After ATRA 9
- B. 3.8% Medicare Surtax 10
  1. IRC §1411 10
  2. Net Investment Income 11
- C. Planning to Reduce Income Taxes 12
  1. Basis step-up at Death of Either Spouse 12
  2. Intra-Family Income Shifting 13
  3. Planning to Reduce 3.8% Tax on Net Investment Income 14
  4. Deferred Compensation Planning 16
  5. "DING" Trusts - Favorable Rulings 19
  6. Charitable Remainder Trusts 20
  7. Insurance / Annuity Arbitrage Planning 22

IV. Asset Protection Planning 24

V. Recognition of Same-Sex Marriage 25
- A. Judicial Developments 25
  1. In Windsor v. United States 25
  2. In Hollingsworth et al. v. Perry 25
  3. Other Judicial Developments 26
- B. Responses of Federal Agencies 27
  1. The Internal Revenue Service 27
  2. Other Federal Agencies 27
- C. Tax Consequences of Recognition of Same-Sex Marriages 28
  1. Potential Advantages 28
  2. Potential Disadvantages 28
- D. Non-Tax Issues 29
  1. Inheritance Disputes 29
  2. Spousal Property Rights 30
  3. Pre-Nuptial Agreements 30
  4. Will and Trust Construction Issues 30

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

Acknowledgment

Most of the material in this outline is not original to the author, who has compiled and borrowed liberally from professional advance sheets, newsletters, and recent update materials provided by other learned professionals, including the proceedings of the most comprehensive symposium on this subject matter, The Heckerling Institute on Estate Planning.

NOTICE

To comply with requirements imposed by the Department of the Treasury the author informs you that any U.S. tax advice contained in this communication (including any attachments and examples) is not intended or written by the author to be used, and that it cannot be used, by any taxpayer for the purpose of (1) avoiding penalties that may be imposed on the taxpayer, or (2) supporting the promotion or marketing of any transaction, strategy, or matter addressed herein.

RECENT TAX AND ESTATE PLANNING DEVELOPMENTS

(January 2014)

I. Federal Estate and Gift Taxes

A. After ATRA

○ For the first time since 2001 we have a law which is "permanent" or at least not subject to a sunset date.

○ The "basic exclusion amount," as it is called in § 2010(c)(2) (commonly viewed as the exemption equivalent of the unified credit), is set at $5 million, indexed for inflation after 2011 ($5,340,000 for 2014). This applies for both estate and gift tax purposes. The GST exemption is the same as the estate tax exemption.

○ The estate and gift tax rate, and GST tax rate, is a 40 percent flat rate once a taxpayer has exceeded the applicable exemptions.

○ Portability is permanent.

○ The state death tax credit remains history and the state death tax deduction is permanent.

○ The short-lived qualified family-owned business interest ("QFOBI") deduction is permanently ended.

○ The technical provisions of the 2001 Tax Act are now permanent, including:

(a) liberalization of the rules on the estate tax deduction for conservation easements under § 2031(c);

(b) automatic allocation of GST exemption to transfers to GST trusts;

(c) permitting certain retroactive allocations of GST exemption;

(d) permitting qualified severance of trusts for GST tax purposes;

(e) permitting the Service to allow late allocations of GST exemption;

(f) substantial compliance rules for allocation of GST exemption;

(g) slight easing of the rules on the deferred payment of estate taxes on closely-held business interests under § 6166; and

(h) waiver of the statute of limitations on certain special use valuation of farm real estate under § 2032A.

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

None of the Administration's proposed "revenue raising" (or "loophole closing") transfer tax changes, such as tightening the rules on GRATs, valuation discounts, and sales to a grantor trust, were adopted.

B. The Administration's Current Revenue Proposals -

These continue to include proposed changes which would significantly impact estate planning, but it seems unlikely that much progress will be made by the Administration with the Presidential election cycle just ahead. The proposals and the projected revenue impact include:

○ Require in inherited property to be based on Transfer Tax Values
($1.896 billion over 10 years)

○ Require a Minimum Ten-Year Term for GRATs ($3.894 billion over 10 years)

○ Impose a 90-Year Limit on the Allocation of GST Exemption
("negligible" revenue effect over 10 years)

○ Modify the Transfer-for-Value Rule for Life Insurance - adding some reporting requirements when a policy is sold and would "modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies." ($641 million over 10 years)

○ Reinstate the 2009 Tax Rates and Exemptions so that the estate, gift, and GST rates and exemptions should be returned to their 2009 levels (top estate and gift tax rate and sole GST tax rate of 45 percent; $3.5 million estate tax applicable exclusion amount and GST exemption, and $1 million gift tax exemption). The change would be effective for 2018.
($71.693 billion between 2018 and 2023)

○ Sales, Exchanges, and Similar Transfers to Grantor Trusts - include in a grantor's gross estate the value of any assets held by a grantor trust deemed owned by the deceased grantor on the date of his or her death, and to treat distributions from such grantor trusts made during the grantor's lifetime as completed taxable gifts. ($1.087 billion over 10 years)

○ GST Tax Treatment of HEETs ("Health and Education Exclusion Trusts") would "clarify" that the § 2611(b)(1) exclusion, like the § 2503(e) gift tax exclusion, applies only to a direct payment by an individual donor to the provider of medical care or to the school in payment of tuition, and not to trust distributions, even if the distributions are made in that same direct way and for those same purposes. (projected to lose $171 million between 2014 and 2023 because taxpayers would stop paying gift tax or using exemption to create these)

○ Limiting Stretch IRAs to Five Years After the Participant's Death (other than for the Participant's surviving spouse.) ($4.911 billion over 10 years)

○ Limiting Total Accrual of Tax-Favored Retirement Benefits to amount necessary to fund the maximum allowed benefit under a defined benefit plan. Contribution or accrual in excess of these limits would be treated like an excess deferral is treated under current law – the taxpayer would include the amount of the excess accumulation in income and would have a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. ($9.342 billion over 10 years)

C. 2013 Estate and Gift Tax Developments

1. Life Insurance Incidents of Ownership: CCA 201328030, PLR 201327010

The right to receive life insurance policy dividends is determined not to be an incident of ownership. Chief Counsel Advice 201328030 (March 18, 2013).

Before their divorce, the insured and his wife executed a property settlement agreement. The decedent was required to maintain life insurance policies with a specified death benefit for the sole benefit of his former spouse. The decedent was required to pay all of the premiums and assessments on the policies and was denied the right to borrow against or pledge the policies. The policy dividends, however, expressly and exclusively belonged to the decedent.

When the decedent died the insurance company paid the policy proceeds to his former spouse. The IRS Chief Counsel's Office stated in advice that the decedent's right to the policy premiums was not an incident of ownership for federal estate tax purposes. Therefore, the proceeds were not includible in the deceased insured's gross estate. [Note, even if the proceeds had been includible, there would have been a claimed deduction in the estate for a "debt" payable to the former spouse supported by consideration of release of marital property rights.]

The legislative history of § 2042 also states that the incidents of ownership rules are supposed to be similar to the statutory scheme governing those powers that would cause other property to be included in a decedent's gross estate under other sections of the estate tax law. The CCA noted that the Tax Court has repeatedly stated that dividends paid on a life insurance policy are not themselves an economic benefit for purposes of the incidents of ownership test, citing Estate of Bowers v. Commissioner, 23 T.C. 911 (1955) where a decedent agreed to carry life insurance on his life payable to his former wife as part of a divorce settlement, and Estate of Jordahl v. Commissioner, 65 T.C. 92, 99 (1975) in which the court held, "it is well established that, since dividends are nothing more than a reduction in the amount of premiums paid, the right to dividends is not an incident of ownership."); and Schwager v. Commissioner, 64 T.C. 781, 792 (1975) reciting that certain powers may be retained which will not constitute incidents of ownership, such as the right to receive policy dividends.

The conclusion of the CCA is not surprising, except perhaps in that it demonstrates that neither then examining agent nor his manager knew the law on this point. But the cited cases have fairly narrow common facts which should not lead one to conclude that the right to receive dividends will never be an incident of ownership of the policy.

The characterization of policy dividends as a mere adjustment in premiums dates to the Supreme Court's decision in Penn Mut. Life Ins. Company v. Lederer, 252 U.S. 523 (1920), in which the impact of dividends paid on the tax liability of the insurance company was the question. The Supreme Court held that the gross income of a life insurance company should be reduced by the aggregate of all dividends paid by it to any policy holder

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

by credit upon a premium or by abatement of a premium. The dividend, than, was characterized as a return of premium previously received by the insurance company.

In this CCA, and the cases cited, the right to receive the dividend accompanied the obligation to pay the premium. That makes it easy to conclude that the dividend is not a separate economic right but is only a reduction in the liability to pay the policy premium. But what if the policy was "paid up" or the dividend exceeded the premium required? In Estate of Carlton v. Commissioner, 34 T.C. 988 (1960) the Tax Court left that question open by finding, "The possibility that decedent might have lived long enough that the insurance dividends would exceed the premiums due on the policies in any year is too remote to constitute an incident of ownership in the insurance policies." Similarly, what if the insured transferred a policy to an ILIT but retained the right to receive the policy dividends? Who would not feel economically benefitted by receiving a gift of the right to receive policy dividends without the obligation to pay the policy premiums? This issue should still be approached cautiously by estate planners, especially if the facts do not line up with those of the CCA or the cited cases.

2. More on Incidents of Ownership Letter Ruling 201327010

The insured/taxpayer's wife purchased insurance policies on the taxpayer's life naming herself as beneficiary and her estate as the successor. The insured paid none of the premiums on the policies. Upon the wife's death, the ownership of the policies passed to a family trust of which the taxpayer/insured was the trustee and the trust protector. Under the terms of the family trust, income and principal were distributable to the insured as a permissible trust beneficiary and to the children in the discretion of the insured as trustee. The taxpayer/insured also had a broad special power of appointment over the property in the family trust (including the policies), which power is held in a non-fiduciary capacity, by which he could direct the transfer of ownership of the policies or the proceeds to others.

This ruling arises from the insured's desire to be certain that the insurance proceeds would not be included in his gross estate. He divided the family trust into two separate family trusts. Family Trust One was funded with the insurance policies and Family Trust Two was funded with the remaining assets. The taxpayer/insured relinquished, with respect to Family Trust One, his roles of trustee and trust protector, his ability to be reappointed as trustee, and his power of appointment. The taxpayer then requested this ruling determining that he would have no incidents of ownership causing the insurance proceeds to be included in his gross estate.

The IRS noted that before the division of the family trust into the two separate trusts, the taxpayer possessed incidents of ownership through his powers as trustee and the broad special power of appointment which he held individually. As a result, both the fiduciary powers and the individually held powers would constitute incidents of ownership in the policies under § 2042. After the division, taxpayer held only a beneficial interest as a permissible distributee of income and principal, in the discretion of a trustee other than himself, but no powers over the policy or proceeds. Thus, after the division, taxpayer did not have any incidents of ownership. The IRS ruled that as long as the taxpayer survived the three-year period of § 2035(a), the proceeds of the policies would escape inclusion in his

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

gross estate. The ruling based this on Reg. §20.2042-1(c)(4), which provides that a decedent is considered to have an incident of ownership in an insurance policy on his life if, under the terms of the policy, the decedent (either alone or in conjunction with another person) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

NOTE, this ruling confirms that the insured's beneficial interest in the trust which holds the policies is not an incident of ownership in the policies, so long as the insured does not have a power over the policy or the proceeds.

3. Sales Close to Date of Death -

(a) In **Estate of Kite v. Commissioner**, T.C. Memo 2013-43 (Feb. 11, 2013), Mrs. Kite sold partnership interests to her children at age 75, in exchange for a deferred private annuity with payments commencing 10 years after the date of the transaction. Mrs. Kite died 3 years after the date of the transaction, with no annuity payments having been received.

The Tax Court ruled that the sale of assets for the private annuity was not a gift. As a result, it was not a transfer with a retained economic interest and the property was not includible in Mrs. Kite's gross estate. Using the IRS actuarial tables was appropriate, even though the annuity payments would not begin for 10 years and Mrs. Kite had only a 12½ year life expectancy, because Mrs. Kite was not terminally ill at the time of the sale and she had at least a 50 percent chance of living more than one year. The sale was not illusory and was bona fide because the annuity agreement was enforceable and the parties demonstrated their intention to comply with the annuity agreement. The court found "that the annuity transaction was a bona fide sale for adequate and full consideration." Even though Mrs. Kite died sooner than expected, her physician had provided an affidavit that there was no reason to expect that she would not have a normal life expectancy, and she actually lived more than 18 months, giving rise to an assumption that the IRS § 7520 actuarial tables are appropriate.

(b) In **Chief Counsel Advice 201330033** (Feb. 24, 2012) and **Estate of Davidson v. Commissioner**

In the CCA, the Chief Counsel's Office finds that a gift occurred when stock was sold to a grantor trust for a self-cancelling installment note and the taxpayer survived for only six months after the sale. Shortly after the sale transaction was completed, the taxpayer was diagnosed with a terminal illness. The CCA distinguished its facts from Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003) in which the transferor was found to have died unexpectedly five months after entering into a sale of income producing real estate for a self-cancelling installment note. It seems like the CCA is saying that the taxpayer did not make a sufficient effort to determine the status of his health when the SCIN transactions were implemented, and should have known that he had a short life expectancy in which the SCIN mortality premium would not be determined from the normal tables.

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

This case is currently in the Tax Court for determination in Estate of Davidson v. Commissioner, Tax Court Docket No. 13748-13 (filed June 14, 2013). From the record of that case, it appears that

(I) the decedent's primary physician provided an opinion about 2 months before the SCIN transactions that "Mr. Davidson continues an active exercise schedule, and is routinely working at home or in the .... office. Based on regular medical assessments and oversight, I believe that Mr. Davidson is in good health commensurate with his age group, and participates in a healthy lifestyle, exercise regimens, and activities which require keen mental rigor. He has no current conditions which will impact his actuarial life expectancy."

(ii) only a few weeks before the SCIN transactions, the primary physician provided another report stating that he had completed a routine medical assessment of Mr. Davidson the prior week and concluded that "there are no changes in his health and he has no current conditions which would impact his actuarial life expectancy and continues to work in his usual capacity."

It was based on these opinions that the taxpayer's advisors computed the mortality premium in the SCINs based on a 5.6 year life expectancy provided in the IRS tables. One of the IRS medical experts estimated that the decedent had a significantly shorter life expectancy, 2.5 years. He estimated that the decedent had only a 19.3 percent probability of surviving for five year term of the SCINs. The expert never personally examined the decedent but based his estimates on the decedent's medical records as well as prognostic studies and statistical studies. Then, in connection with the estate tax audit, the decedent's medical records were reviewed by four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS. All four medical consultants concluded that the decedent had a greater than 50 percent probability of living at least one year in January 2009 (the date of the SCIN transactions), giving rise to a presumption under §7520 that the use of the IRS published tables is appropriate.

One of the issues in this case is whether the §7520 regulations are applicable to SCIN transactions. §7520 declares that it is applicable to transactions "to determine the present value of an annuity, income interest, remainder interest, or reversionary interest" even if the individual who is a measuring life is in poor health as long as he or she is not terminally ill, defined to mean the person has a greater than 50 percent probability of living at least one year. The Service's position in its answer is that "whether or not the decedent was terminally ill within the meaning of Reg. §1.7520-3(b)(3) is not relevant." Therein lies the dispute that is squarely before the court, whether the presumptions of §7520 apply to SCINs as they do to private annuity transactions.

(c) **Estate of Giovacchini v. Commissioner, T.C. Memo 2013-27** The value of property was determined based on a sale more than 2 years after date of death.

Husband died in 1997 and left his entire estate to Wife, including a piece of real estate near Lake Tahoe, California of about 2,500 acres. In 1999, Wife transferred ownership of the Land to a trust, and in 2000 the trust sold a 50 percent interest in the land to a family LLC, which was an entity controlled by Wife's three daughters and their husbands. The LLC paid $2.5 million for its 50 percent interest in the land. No appraisal

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

was done with respect to the sale of the 50 percent interest. The sale price was determined by the family and by the family's CPA using the value determined by the appraisal of the land in Husband's estate (3 years earlier) plus an annual increase for inflation based on the consumer price index.

Wife then died in 2001, owning ½ of the land as part of her estate. The estate reported the fair market value of Wife's ½ interest based on a 2001 value of $8 million (for the entire parcel), less a discount for the fractional interest. The estate also asserted that the value in 2000 at the time of the sale to the LLC should be based on $7.4 million (for the entire parcel), less a discount for the fractional interest.

The IRS asserted that the value was best evidenced by the family's 2003 sale of the property to the U.S. Forest Service for $29 million.

The Tax Court determined that it was proper to take into account the 2003, sale of the land as evidence of the value for both estate and gift tax purposes. Although post-death events are generally irrelevant in determining the fair market value of property as date of death, that guideline is generally not applicable when the subsequent event is an arm's-length sale of the subject property itself within a reasonable time of the valuation date, and there had not been a "material changes in circumstances between the valuation date and the date of sale." It concluded that the sale of the land 31 months after the date of the gift, and about 16 months after the date of death, was reasonably close to both relevant valuation dates and was the best evidence of value. It determined that the fair market value of the property for estate tax purposes was $21.3 million as of date of death, and the value for gift tax purposes was $18.5 million. Fortunately, the court found that the estate was not liable for the under-valuation penalties because it had relied on professional advisors in valuing the property for both estate and gift tax purposes, and the appraisers were provided the information they needed to accurately appraise the property based on what was known at that time.

4. Marital Deduction Windsor v. United States, 570 U.S. ___, 133 S. Ct. 2675, 186 L. Ed. 2d 808 (2013) U.S. Supreme Court finds Section 3 of the Defense of Marriage Act defining marriage as between a woman and a man unconstitutional, thus allowing the marital deduction for all property passing to surviving spouse in same-sex marriage.

(see further discussion in Section V. below.)

5. Special Valuation Rules of Chapter 14 - Estate of Elkins v. Commissioner, 140 T.C. No. 5 (2013)

The Tax Court ignored an agreement limiting partitioning under § 2703 but allowed a 10 percent valuation discount for fractional interest in art. For valuation purposes, a partnership or LLC covenant against partitioning the underlying property may be more restrictive than state law and treated as an "applicable restriction."

6. Beneficiary-Owned Trusts Added to No-Ruling List: Rev. Proc. 2013-3

The Service has indicated its discomfort with "beneficiary defective" trusts and added that strategy to the No-Ruling List. In a typical use of this technique, a grantor (assume Mother) creates a trust with a modest contribution (such as $5,000) and gives the

beneficiary (assume Daughter) a § 678 power of withdrawal (*Crummey* power) that will apply to the entire contribution. Upon lapse of the power (presumably free of gift and estate tax consequences under the so-called five-and-five exception in sections 2514(e), 2041(a)(2), and 2041(b)(2)), that withdrawal right is assumed to make the *entire* trust a grantor trust wholly owned by Daughter for income tax purposes. Daughter then sells an asset to the trust in exchange for a note and argues that the sale is not a gain or loss realization event because the trust was ignored with respect to the beneficiary under § 678. Meanwhile, the beneficiary has on-going entitlements to trust income and corpus.

Proponents of this strategy argue that Daughter may transfer substantial wealth to the trust by such sale transactions, without any income tax realization, enjoy the use and income from that trust property for her lifetime, and exclude all of the trust property from her gross estate at death, because the Daughter did not create the trust and did not make a gratuitous transfer of property to the trust with a retained interest or power.

As a result, the Service will not issue a ruling in such cases regarding (1) whether that person will be treated as the owner of any portion of a trust; (2) whether trust assets are includible in a trust beneficiary's gross estate under sections 2035, 2036, 2037, 2038, or 2042, whether or not the beneficiary dies within 3 years of selling such property to the trust; (3) whether the sale of property (including insurance policies) to a trust by a trust beneficiary will be treated as a taxable gift under § 2501; and (4) whether the sale of property (including insurance policies) to a trust by a trust beneficiary is subject to § 2702.

II. Generation Skipping Tax Developments

1. Letter Ruling 201311004 (Nov. 28, 2012). GST tax does not apply to distributions received from a trust established by a nonresident decedent.

Donor was not a resident or citizen of the United States, and created a Trust outside of the United States, with property which was located outside of the United States. The taxpayer is not a US citizen but is a resident of the US, and is a beneficiary of the Trust, and would be a skip-person under U.S. generation skipping transfer tax law. The trustee desired to terminate the Trust and make the final distribution to taxpayer because the cost of administration of the trust and taxes were expensive.

The Service held that the GST tax would not apply. When the Trust was established, Donor was neither a citizen nor a resident of the United States. The residence and the cash transferred to the Trust were not situated in the United States. As a result, the transfers to the Trust were not subject to U.S. gift tax. Under Reg.§26.2663-2, the GST tax does not apply to taxable distributions or taxable terminations to the extent that the initial transfer of property to the trust by non-resident alien transferor was not subject to federal estate or gift tax. As a result, Trust distributions received by the taxpayer from the Trust were not subject to the GST tax..

2. Other Rulings. There were numerous rulings generously granting extension of time to file various documentation or elections related to the GST tax, and approving certain changes to GST exempt trusts without jeopardizing the exempt status. See Letter Rulings 201314017 (Dec. 19, 2012), 201314018 (Dec. 19, 2012), 201321002 (Dec. 18, 2012),

201307004 (Oct. 26, 2012), 201314032 (Dec. 20, 2012), 201345029 (Aug. 9, 2013), 201322031 (Feb. 27, 2013), 201320004 (Jan. 14, 2013), 201322010 (Jan. 24, 2013) and 201322015 (Jan. 24, 2013), 201345004 (Aug. 1, 2013), 201345026 (Aug. 1, 2013), 201345027 (Aug. 1, 2013), and 201345028 (Aug. 1, 2013), and 201345005 (Aug. 6, 2013).

III. Income Tax Planning

A. After ATRA

The transfer tax rate is now level at 40% after substantial exemptions (almost $10.7 million indexed for inflation). As a result, a much smaller group of taxpayers will be seriously threatened by the imposition of those taxes at death. However, exposing assets to the estate tax at death provides a new income tax basis equal to the date-of-death value. Transferring assets during life to remove them from the estate tax liability leaves the basis unchanged. For assets which have appreciated substantially during life, or assets which have been received in a tax-free exchange transaction, the income tax savings from the basis step-up will often be much more important to the family than estate tax savings.

Some of the primary sources of low-basis assets include:

- Land and stock received from a prior generation and held for life
- Foresightful or fortuitous investments
- Development of successful closely-held business entities
- Tax-free exchanges of property under IRC §1031
- Sale of closely-held stock to an ESOP and reinvestment in qualified securities.

The effective income tax rates have increased by (a) higher rates applicable to ordinary income, capital gains, and qualified dividends at upper income brackets, (b) reduced itemized deductions and exemptions at upper income brackets, and (c) an added 3.8% Medicare surtax on net investment income over a threshold amount, The federal and state income tax incurred on realized capital gains can readily reach almost 30% (or more for depreciable property). For most people, exposing those assets to the estate tax system at death will, after applying the available exemptions, result in little or no estate tax but a substantial income tax savings if such assets are eventually sold.

As a result, many more people will see more of their income being lost to current taxes, and planning to reduce that drain will be of much greater importance than planning for estate tax avoidance.

[See next page.]

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

From Prof. Sam Donaldson

<table>
<tr><th colspan="2">Taxable Income exceeding</th><th colspan="4">2014 Federal Income Tax Rates for Individuals</th></tr>
<tr><th>Unmarried</th><th>Joint</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Earned Income (including 1.45% employer contribution)</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$9,075</td><td>$18,150</td><td>15%</td></tr>
<tr><td>$36,900</td><td>$73,800</td><td>25%</td><td rowspan="5">15%</td></tr>
<tr><td>$89,350</td><td>$148,850</td><td>28%</td></tr>
<tr><td>$186,350</td><td>$226,850</td><td rowspan="2">33%</td></tr>
<tr><td>AGI over $200,000**</td><td>AGI over $250,000**</td><td rowspan="3">3.8%</td><td rowspan="3">3.8%</td></tr>
<tr><td>$405,100</td><td>$405,100</td><td>35%</td></tr>
<tr><td>$406,750</td><td>$457,600</td><td>39.6%</td><td>20%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and section 1202 stock).

** Note too that unmarried individuals with adjusted gross incomes in excess of $254,200 and joint filers with adjusted gross incomes in excess of $305,050 are subject to the phase-out of both personal exemptions and itemized deductions.

Taxpayers with taxable income exceeding $457,600 (joint) will see the federal tax attributable to their capital gains and qualified dividends increase from 15% in 2012 to 23.8% after ATRA (not counting the effect of the cut-back in itemized deductions.) That is 58.67% increase in the tax imposed on such income.

B. 3.8% Medicare Surtax

1. IRC §1411 (added by the Affordable Care Act) imposes a surtax (in addition to federal income taxes) of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning after December 31, 2012. This is commonly referred to as the "Medicare tax". Final regulations interpreting this law were published on December 2, 2013, sunning some 100 pages.

For individuals, the tax is 3.8% of the lesser of —

(a) the individual's modified adjusted gross income in excess of a threshold amount ($200,000 for individuals and $250,000 for couples, which is not indexed for inflation), or

(b) the individual's net investment income for the year.

NOTE: Marriage penalty - unmarried couple would have $400,000 of exemption.

For estates and trusts, the tax is 3.8% of the lesser of—

(a) the estate's or trust's adjusted gross income in excess of the highest income tax bracket threshold ($11,950 for 2013 and $12,150 for 2014), or

(b) the estate's or trust's undistributed net investment income.

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

2. <u>Net Investment Income</u> is defined in §1411(c) as

(a) interest, dividends, annuities, royalties, and rents;

(b) profits from a trade or business where the taxpayer does not "materially participate (a "passive activity"),

(c) profits from a trade or business of trading in financial instruments or commodities, even if the taxpayer does materially participate, and

(d) taxable net gain from the disposition of property (e.g., capital gains from stock sales, mutual fund capital gain distributions, etc.), but not gains from selling property held in a trade or business where the taxpayer materially participates.

In general, if an item of income does not fit within these definitions, then it is not part of taxable Net Investment Income for purposes of §1411.

<u>Included</u> in Net Investment Income ("NII")-

a. Interest received is generally taxable, but tax-exempt interest from a state or local bond is *not* part of NII, and "self-charged interest" when the owner of an active business lends money to the business is not part of NII.

b. Dividends (both qualified and non-qualified)

c. Annuities. The taxable annuity income from a non-qualified annuity (an annuity that is not from a qualified retirement plan), including the gain from a sale of an annuity contract. An annuity paid by an employer as compensation (such as a deferred compensation benefit) is <u>not</u> part of NII.

d. Royalties

e. Rents. Net rental income is generally considered investment income that is part of NII. There is an exemption, however, for a "real estate professional" who qualifies under §469 and who materially participated in one or more rental real estate activities either (I) for more than 500 hours during the year or (ii) for more than 500 hours in any five of the preceding ten taxable years.

f. Income from ownership of a trade or business in which the taxpayer does not materially participate. For business interests held in trust, the IRS says that material participation is determined entirely with reference to the involvement of the <u>trustee</u>. (Technical Advice Memorandum 201317010 (Jan. 18, 2013)).

g. NII includes net taxable gain attributable to the sale or exchange of property (other than property held in a trade or business where the taxpayer materially participates). This would include gains from the sales of stocks, bonds, mutual funds, investment real estate or a vacation home, and capital gain distributions from mutual funds. Gains that are deferred or exempt under other income tax statutes are also deferred or exempt for purposes of the 3.8% tax, such as installment sales, §1031 like-kind exchanges, §1033 involuntary conversions, and the §121 exclusion applicable to a sale of a principal residence. Note that gains realized by a dealer or a trader in commodities or financial instruments is part of NII whether or not the taxpayer materially participates.

h. Reduced by deductible investment expenses, but that may be impacted by the deduction limitations on miscellaneous itemized deductions subject to the 2% of AGI threshold.

<u>Excluded</u> from Net Investment Income -

a. Trade or business income, and gains from the sale of business property, where taxpayer materially participates. [The taxpayer must generally have performed over 500 hours of work in the business during the year, but there are certain conditions in which a person can work fewer than 500 hours and still qualify for material participation. In addition, retired partners or owners who receive distributions of business profits after they have retired may qualify for "material participation" based on their past service. As noted above, where the business interest is held in a trust, it is the activity of the Trustee which must satisfy the material participation test. Also, if the business itself has passive investment income, that will not be converted to business income under these rules.]

b. Rental income of a "real estate professional" is excluded. When there is extensive involvement by the owner/taxpayer, particularly when significant services are rendered, it is possible for the rental activity to rise to the level of a trade or business and be excluded from computing NII..

c. Income that is not interest, dividends, annuities, gains, etc. as enumerated in the statute, such as:

(I) Tax-exempt income - If income is exempt from taxation under general income tax rules, it is also exempt from the 3.8% Medicare surtax. Examples include tax-exempt interest on state and local bonds

(ii) Compensation and self-employment income - Although compensation and self-employment income is not subject to the 3.8% tax it is already subject to social security taxes.

(iii) Qualified retirement plan distributions

(iv) Alimony

(v) Lottery income and prizes, social security benefits, and unemployment payments.

C. Planning to Reduce Income Taxes

1. Basis step-up at Death of Either Spouse. For married taxpayers, it is obviously preferable to have the low-basis property owned by (and included in the estate of) the first spouse to die. In order to limit death-bed transfers between spouses to generate a basis step-up, Congress adopted IRC §1014(e) which provides that no basis step-up is applicable to an asset which:

(I) was received by the decedent by gift within 1 year prior to death, and

(ii) passes from the decedent to (or is acquired from the decedent by) by the donor who gave it to the decedent, or the donor's spouse.

The question is what planning strategies may be available to overcome §1014(e) so that the death of either spouse will result in a basis step-up. While that may sound aggressive, it is the automatic, default, result of living in a community property state where there is a basis step-up on the entire community property even though only ½ is included in the deceased spouse's estate for estate tax purposes. (IRC §1014(b)(6))

a. Joint Revocable Trust. Husband and Wife create a Joint Trust, to which each of them contributes some property - for instance Husband contributing X% and Wife contributing Y%. Either of them is empowered to revoke the trust, and to receive their % interest of the trust property at any time. If not revoked, then upon the death of either spouse the deceased spouse has a general power of appointment - a power to direct the ownership of the entire trust property to anyone he/she may wish. That power causes the entire trust to be included in the estate of the deceased spouse, both the X% portion and the Y% portion.

The IRS has issued private letter rulings and a technical advice memorandum finding that a gift occurs upon the death of the first spouse, the surviving spouse having given his/her portion to the deceased spouse, and that gift qualifies for the marital deduction. If the deceased spouse exercises the power of appointment to distribute the trust property back to the surviving spouse, then the % portion which was owned by the surviving spouse is squarely caught by §1014(e).

However, suppose the deceased spouse directs that the trust property not be distributed to the surviving spouse, but that it be placed in a trust for the benefit of the surviving spouse and their descendants. Many people believe that the distribution to the trust is not equivalent to a distribution back to the surviving donor spouse, and is not caught by §1014(e). The court's holding in Estate of Kite v. Commissioner, (Section I.C.3.(a) above) seems to hold that even where 1014(e) might apply, if the property is returned to a trust for the donor spouse then there is no bar to the basis step-up. If implemented correctly, this is probably a strategy in which the taxpayers have nothing at risk, and there is virtually no ongoing cost of administration of such a joint trust.

b. Community Property Trust. Assuming that a married couple does not want to simply relocate their residence to a community property state, it may be possible to create a trust in such a state which will be afforded the status of community property when either spouse dies. Alaska enacted a specific statute providing for an "Alaska Community Property Trust" applicable to both Alaskan couples and non-Alaskan couples. Such a trust must have an Alaskan Co-Trustee, so if you don't have a friend or family member living in Alaska then this will require the appointment (and expense) of an Alaskan corporate trustee.

2. Intra-Family Income Shifting. With these adverse changes for upper income taxpayers, the difference in income tax brackets within a family will often be sufficiently large to encourage strategies which can shift taxable ordinary income to lower-bracket children. For example, if one assumes:

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

(a) Parents are in maximum tax brackets, subject to the Medicare surtax, and losing itemized deductions equal to 3% of their AGI above a threshold amount ($254,200 if filing single, or $305,050 for married filing jointly,) and

(b) children are in a 28% tax bracket for ordinary income, and are not subject to the Medicare surtax, and are not losing any itemized deductions, and

(c) parents sell their $1 million real estate investment partnership interest to children for a promissory note at an interest rate of only 1.75% per annum (the January 2014 Mid-term rate), and

(d) the real estate partnership earns 7% in annual rental income, which the family consumes, and is expected to appreciate at a 5% annual rate, then

The net change in after-tax spendable income in the family (comparing (I) the Parent's after-tax income after ATRA to (ii) the children's after-tax income (after payment of interest to Parents) and the Parent's after-tax interest income from the children, is as follows:

Net Change in Family Spendable Income

Year	Before	After	Change	Δ %
1	$38,220	$47,355	$9,135	23.9%
2	$40,131	$49,875	$9,744	24.3%
3	$42,138	$52,521	$10,383	24.6%
4	$44,244	$55,299	$11,055	25.0%
5	$46,457	$58,217	$11,760	25.3%
6	$48,779	$61,280	$12,500	25.6%
7	$51,218	$64,496	$13,277	25.9%
8	$53,779	$67,873	$14,093	26.2%
9	$56,468	$71,419	$14,950	26.5%
10	$59,292	$75,142	$15,850	26.7%

3. Planning to Reduce 3.8% Tax on Net Investment Income -

(a) Reducing or avoiding the 3.8% Medicare tax will involve either

(I) reducing the taxpayer's Adjusted Gross Income, or

(ii) reducing the taxpayer's Net Investment Income.

(b) The following planning alternatives may be worth consideration:

(I) Move investments to tax-exempt bonds, in which the tax exempt interest is not part of Net Investment Income.

(ii) Owner of an S corporation also owns the premises on which the company operates its business, and leases those premises to the company. The net rental income will now be part of Net Investment Income subject to the Medicare surtax. However, if rent is reduced

to a nominal amount, the increased S corporation earnings would be exempt because Owner materially participates in the business.

(iii) Work over 500 hours (or a lesser amount if allowed under the regulations) in the family business in order to satisfy the material participation requirements.

(iv) Consider investing assets which produce NII in certain life insurance contracts for which the income tax treatment is governed by IRC §72. The investment accumulation inside the policy is not currently taxable (and therefore not part of NII), and the owner can withdraw substantial amounts without recognizing taxable income.

(v) Re-analyze a ROTH IRA conversion of your qualified plan assets, and use current investment assets outside the plan to pay the tax. The income from the investment assets used to pay the income tax, which is subject to the 3.8% tax, will be gone, and all withdrawals from the ROTH account will then be free of both regular income tax and the Medicare surtax.

(vi) If taxpayer is over 70 ½, and if Congress continues to allow charitable distributions from an IRA, then fund planned charitable gifts from the IRA in order to prevent that part of the Minimum Required Distribution from becoming part of AGI.

(vii) Shift Net Investment Income to other family members who are not subject to this 3.8% tax. That could be done with a gift of investment assets to family members or trusts for them, or low-interest loans to family members with which they can invest in property.

(viii) Shift NII to Charity as part of planned giving.

(A) Give appreciated assets to charity to fund planned charitable gifts rather than selling, recognizing the gain in NII, and then making a charitable gift.

(B) If taxpayer making substantial annual charitable gifts, fund with transfer of investment property into non-grantor charitable lead trust. This removes the investment income from both AGI and NII (avoiding the new cut-back on the annual charitable deductions) and has some significant benefit in avoiding estate taxes at death.

(C) Lend up to $250,000 to charity interest-free. (Note that this limitation may be reduced if the proposed regulations under §7872 become final.)

(D) Use charitable remainder trust to recognize large capital gains on sale of property. If taxpayer would not otherwise want to make the large charitable gift at death, consider using some of the CRT distributions to fund a "wealth replacement trust" with life insurance.

(ix) Avoid income spikes which will push AGI over the threshold ($250,000 joint) through installment sales of property to spread the gain recognition over several years.

4. Deferred Compensation Planning. With higher income tax rates on high-earning taxpayers, in addition to the 3.8% Medicare surtax on Net Investment Income, many people will again find tax-deferral opportunities much more attractive.

(a) Most closely-held businesses have become "pass through" entities (such as S corporations and LLCs) in recent years, so that all of the net business income is taxable directly to the business owners. Prior to ATRA, the personal income tax rates had not been sufficiently high to make it worthwhile to consider deferral of income since about 2001.

(b) C corporations, on the other hand, pay income tax on net corporate income at the corporate level, and they begin at a much lower rate. The federal income tax rate on the first $50,000 of taxable income in a C corporation is only 15%, a substantial reduction from the effective 41.6% (assuming the 3.8% Medicare surtax does not apply) top federal rate on taxable income.

(c) Often, an S corporation or LLC can "carve out" a line of business or a part of its business activity and shift it (and its income) to a C corporation, providing a 15% taxpayer with up to $42,500 ($50,000 less 15% income tax) of after-tax income which it can use for the benefit of the business owner. Examples:

(I) An automobile dealership might move its finance, leasing, and extended warranty business to a C corporation.

(ii) A steel fabricator moved its "delivery and erection" services to a separate C corporation.

(iii) The owner of a chain of restaurants combined the meat purchasing for all the locations into a single C corporation.

(iv) A veterinarian moved the animal boarding and grooming business to a separate C corporation.

(d) Illustration. FamCorp, Inc. is an S corporation owned by John B. Owner, age 48, who has been able to add about $88,000 per year (before taxes) to his retirement savings in order to better secure his ability to retire at age 65. His total taxable income, including the taxable profits from FamCorp, is about $500,000 annually.

(I) We will assume that Mr. Owner's investments will earn an average annual return of 7.82% gross (about the 20 year average of the S&P 500 index), and this his expenses (fees and commissions) will be about 0.88% per year, for a net realized average annual return of 6.94%. Only 1% per year is taxable as ordinary income, and the balance is taxable as long-term gains or qualified dividends.

(ii) If he continues to invest the same $88,000 of his income annually (before taxes) and withdraws from the investment fund to pay income

taxes on the invested income and the realized investment returns, his result over the next 17 years will be as follows:

Age	Year	Annual Deposit (Withdrawal)	Realized Investment Return	Withdrawal For Taxes	Year-End Value
48	1	$88,000	$6,107	$0	$94,107
49	2	$88,000	$9,854	($40,112)	$151,850
50	3	$88,000	$13,759	($41,592)	$212,017
51	4	$88,000	$17,929	($41,675)	$276,271
52	5	$88,000	$22,347	($42,269)	$344,349
53	6	$88,000	$27,028	($42,899)	$416,478
54	7	$88,000	$31,987	($43,566)	$492,899
55	8	$88,000	$37,242	($44,273)	$573,868
56	9	$88,000	$42,809	($45,022)	$659,656
57	10	$88,000	$48,708	($45,815)	$750,549
58	11	$88,000	$54,957	($46,655)	$846,850
59	12	$88,000	$61,579	($47,546)	$948,883
60	13	$88,000	$68,595	($48,490)	$1,056,988
61	14	$88,000	$76,028	($49,489)	$1,171,526
62	15	$88,000	$83,903	($50,549)	$1,292,881
63	16	$88,000	$92,247	($51,671)	$1,421,457
64	17	$88,000	$101,088	($52,860)	**$1,557,684**

(iii) The net after-tax accumulation in Mr. Owner's retirement account will be $1,557,684. If he continues to realize the same investment results, he can begin to liquidate the account over a 15 year period to provide supplemental retirement income of $159,321 annually (before taxes), or $133,824 average after taxes, as follows:

Age	Year	Annual Deposit (Withdrawal)	Realized Investment Return	Withdrawal For Taxes	Year-End Value	Net After-Tax Retirement Income
64	17	$88,000	$101,088	($52,860)	**$1,557,684**	$0
65	18	**($159,321)**	$97,046	($54,120)	$1,495,410	**$105,201**
66	19	**($159,321)**	$92,725	($13,830)	$1,428,814	**$145,491**
67	20	**($159,321)**	$88,103	($20,400)	$1,357,595	**$138,921**
68	21	**($159,321)**	$83,160	($21,487)	$1,281,435	**$137,834**
69	22	**($159,321)**	$77,875	($22,449)	$1,199,989	**$136,872**
70	23	**($159,321)**	$72,222	($23,291)	$1,112,890	**$136,030**
71	24	**($159,321)**	$66,178	($24,013)	$1,019,747	**$135,308**
72	25	**($159,321)**	$59,714	($24,618)	$920,139	**$134,703**
73	26	**($159,321)**	$52,801	($25,104)	$813,619	**$134,217**
74	27	**($159,321)**	$45,408	($25,467)	$699,706	**$133,854**
75	28	**($159,321)**	$37,503	($25,703)	$577,888	**$133,618**
76	29	**($159,321)**	$29,049	($25,800)	$447,616	**$133,521**
77	30	**($159,321)**	$20,008	($25,739)	$308,303	**$133,582**
78	31	**($159,321)**	$10,339	($25,484)	$159,321	**$133,837**
79	32	**($159,321)**	$0	($24,957)	($0)	**$134,364**

(iv) Alternatively, if Mr. Owner has identified a line of business which he moves to a new C corporation, "NewCorp, Inc." That business activity generates about $70,000 per year in gross income, with

$20,000 of operating expenses, leaving NewCorp with net taxable income of $50,000. NewCorp then pays federal and state income taxes of about $10,050, leaving the corporation with $39,950 of net after-tax income.

(v) Mr. Owner replaces some of his life insurance with a policy designed to optimize the internal investment return and provide only the minimum insurance death benefit (about $1.3 million), He recovers premiums of about $2,300 (the term insurance cost) and make his annual investment deposit to the policy in the amount of $88,000, less the $50,000 moved to NewCorp, plus the term insurance premium recovery of $2,300, or $40,300.

(vi) NewCorp, Inc. then uses its after-tax corporate income to provide a "split-dollar" insurance loan benefit to Mr. Owner, to be used to pay Mr. Owner's income taxes and the remainder added to the investment in the policy. The investment results inside the policy are assumed to be identical to those illustrated above, and the investment fund will grow as follows:

Age	Year	Participant Pre-tax Deposit (Withdrawal)	Employer Interest Bonus or Pension Supp.	Participant Pays Taxes	Participant Borrows (Repays Loan) For SDLR	Accumulated Balance of Participant Loans	Total Year-End Account Value	Net Life Insurance Death Benefit
48	1	$40,300	$999	($18,187)	$39,950	($40,401)	$62,576	$1,329,054
49	2	$40,300	$2,009	($18,187)	$39,950	($81,661)	$125,152	$1,287,343
50	3	$40,300	$3,040	($18,187)	$39,950	($123,594)	$187,728	$1,245,410
51	4	$40,300	$4,089	($18,187)	$39,950	($166,211)	$250,304	$1,240,392
52	5	$40,300	$5,154	($18,187)	$39,950	($209,523)	$312,880	$1,261,707
53	6	$40,300	$6,237	($18,187)	$39,950	($253,541)	$375,456	$1,287,212
54	7	$40,300	$7,337	($18,187)	$39,950	($298,278)	$438,032	$1,317,301
55	8	$40,300	$8,456	($18,187)	$39,950	($343,743)	$506,548	$1,367,112
56	9	$40,300	$9,592	($18,187)	$39,950	($389,950)	$616,817	$1,424,019
57	10	$40,300	$10,748	($18,187)	$39,950	($436,911)	$734,439	$1,487,967
58	11	$40,300	$11,922	($18,187)	$39,950	($484,637)	$853,680	$1,559,481
59	12	$40,300	$13,115	($18,187)	$39,950	($533,142)	$981,837	$1,639,133
60	13	$40,300	$14,327	($18,187)	$39,950	($582,438)	$1,119,554	$1,727,555
61	14	$40,300	$15,560	($18,187)	$39,950	($632,537)	$1,267,474	$1,825,375
62	15	$40,300	$16,812	($18,187)	$39,950	($683,454)	$1,426,332	$1,933,316
63	16	$40,300	$18,085	($18,187)	$39,950	($735,201)		
64	17	$40,300	$19,379	($18,187)	$39,950	($787,792)	$1,782,203	**$2,184,849**

(viii) Mr. Owner has now accumulated investment value of $2,184,849, subject to a debt owed to NewCorp of $787,792.

(ix) Upon retirement, Mr. Owner will begin to withdraw supplemental retirement income from the policy for a 15 year period. With those withdrawals, he will repay the NewCorp split-dollar loan, and NewCorp will use those funds to provide him with a deferred compensation benefit.

(x) Because of the special rules applicable to life insurance investments (IRC §72), those policy withdrawals will be free of any income tax to Mr. Owner, and only his deferred compensation payments from

NewCorp will be taxable. His expected net after-tax retirement income from this plan (including the deferred compensation) will increase to $198,925 annually, as follows:

Age	Year	Participant Pre-tax Deposit (Withdrawal)	Participant Pays Taxes	Participant Borrows (Repays Loan) For SDLR	Accumulated Balance of Participant Loans	Net After-Tax Retirement Income
65	18	($227,180)	($28,254)	($62,606)	($750,221)	$198,925
66	19	($227,180)	($28,254)	($62,606)	($704,806)	$198,925
67	20	($227,180)	($28,254)	($62,606)	($658,254)	$198,925
68	21	($227,180)	($28,254)	($62,606)	($610,540)	$198,925
69	22	($227,180)	($28,254)	($62,606)	($561,632)	$198,925
70	23	($227,180)	($28,254)	($62,606)	($511,501)	$198,925
71	24	($227,180)	($28,254)	($62,606)	($460,117)	$198,925
72	25	($227,180)	($28,254)	($62,606)	($407,449)	$198,925
73	26	($227,180)	($28,254)	($62,606)	($353,464)	$198,925
74	27	($227,180)	($28,254)	($62,606)	($298,129)	$198,925
75	28	($227,180)	($28,254)	($62,606)	($241,411)	$198,925
76	29	($227,180)	($28,254)	($62,606)	($183,275)	$198,925
77	30	($227,180)	($28,254)	($62,606)	($123,685)	$198,925
78	31	($227,180)	($28,254)	($62,606)	($62,606)	$198,925
79	32	($227,180)	($28,254)	($62,606)	$0	$198,925

(xi) As a result of (a) minimizing current income taxes using the favorable C corporation tax bracket, and (b) the favorable tax rules applicable to investment accumulation in, and withdrawals from, the life insurance policy, Mr. Owner has increased his after-tax retirement income attributable to these savings from about $133,824 annually for 15 years to $198,925 for 15 years (a 48% increase.) In addition, at the end of the 15 year retirement pay-out, there remains a permanent life insurance death benefit for his family of about $855,000.

5. "DING" Trusts - Favorable Rulings. A "Delaware incomplete gift non-grantor trust" (or "DING" Trust) is designed to be funded in a state with favorable state income tax rules, without incurring a gift tax to fund it, so that trust income and gains may escape state income taxation. the IRS has recently released a series of favorable private letter rulings finding that such trusts, if properly constructed, (a) will not be treated as "grantor trusts" for income tax purposes, and will therefore not be subject to tax based on the grantor's state of residence, and (b) the grantor's funding of such a trust will not result in a taxable gift. (PLRs 201310002 through 201310006)

(a) In Georgia, the regular 6% tax rate is applicable to capital gains as well as ordinary income. If the federal rate on the capital gain will be 20% (top tax bracket), then Georgia adds another 6%.

(b) In New York, that state tax rate may be nearly 13%!

(c) The DING Trust may shift the applicable state income tax to the state of the trust's situs, so long as the property being sold does not, itself, have a tax situs elsewhere. For example, gain from the sale of real estate will be taxable in the state in which the real estate is located, regardless of the tax residence of the owner. However, personal property (most anything which is not real estate) is typically treated as having a tax situs at the residence of its owner. Therefore, transfer of low-basis stock to a DING Trust located in a tax-friendly state may shift the tax situs to that state, even though the trust's creator and the transferor of the stock to the trust was a Georgia resident.

(d) Some states (including Georgia) have an income tax statute or regulation which attempts to assert state taxing jurisdiction over any trust which was created by a resident of their state, regardless of where the trust is located. In a recent Illinois case such a statute was found to be unconstitutional. Other courts have questioned whether such an approach is enforceable where there is no other connection between the law of that state and the administration of the trust.

6. Charitable Remainder Trusts to Avoid Recognition of Taxable Gain.

Charitable remainder trusts provide for the payment of a defined income stream to some person for a period of time, with the remainder of the trust property left to some charitable purpose. For instance, Mary could establish such a trust and provide that a certain defined amount of income would be paid to herself and her husband, George, for life, with the trust property remaining after both of you have died passing to her favorite charity. Because the "remainder" of the property is ultimately committed to charitable purposes, the trust is afforded some special tax treatment normally granted only to charitable organizations.

(a) Even though charity may not receive any benefit from this arrangement for many years, Mary is allowed a current charitable income tax deduction for the present value of the remainder interest allocated to charity. That is, she is allowed to deduct an amount equal to the current value of the property given to the trust minus the actuarial value of the income interest which the trust must pay to Mary and George.

(b) Because the remaining trust property will ultimately pass to charity after Mary and George have died, the trust itself pays no income tax on either the sale of property or the receipt of income. This is an extraordinary tax benefit, because the trust can sell low-basis assets for reinvestment, and receive income on its investments, with no obligation to pay income tax. As a result, Mary and George will frequently create a much larger investment portfolio paying income to themselves for life from a charitable trust than they could create by selling the same property outside the trust where they are subject to the normal tax rules.

(c) Example: Assume George and Mary (both age 65) own shares of American Widget valued as $1,000,000 and yielding an annual dividend of $20,000. Their basis is $100,000. Their total taxable income is $250,000. They would like to increase their income, preserve the value of the stock for their children, and avoid some federal income tax if possible.

(I) If they sell the stock for reinvestment purposes, they will generate a $900,000 capital gain and face an income tax on the gain (federal and state) of about $270,000 (including the Medicare surtax and cut-back of itemized deductions), leaving only $730,000 to invest. They assume they can comfortably invest to yield a 7% total return without undue risk, consuming the full amount each year which would produce annual pre-tax income of $51,100.

(ii) Mary and George might create a Charitable Remainder Trust for the $1,000,000 in stock and retain a 7% income stream for as long as either of them is living. The Trustee may sell the stock tax free, so that the entire $1,000,000 is available to invest for income production, yielding trust distributions to Mary and George of $70,000 per year. In addition, Mary and George get a current income tax deduction of about $224,000, which we assume will be worth about $60,000 in income tax savings over the next six years in their present tax bracket.

(iii) However, they have given some of their children's inheritance to charity. If they had not planned on making that charitable gift at death, then they probably desire to replace that inheritance for the benefit of their children. George and Mary might give about $11,000 per year to a trust for their children for eleven years for the purchase of a $730,000 Survivorship Whole Life insurance policy. This special life insurance policy insures both Mary and George, but only pays its death benefit after both of them have died. As a result, the premium required is much less than the normal premium which would be required to insure either Mary or George alone. Upon the deaths of their parents, the children will receive the death benefit free of any estate tax.

	Sell Stock, No Trust	Annuity Trust, Insurance Trust
1. Income	$36,500	$70,000
2. Insurance cost *	0	($11,000)
3. Income tax on sale	(225,000)	0
4. Pre-Tax income	$51,100	$59,000
5. Income tax savings	0	$60,000
6. Net to children **	$730,000	$730,000
7. Net to charity	0	$1,000,000

* Optional - payable for 11 years
** Assuming zero estate tax

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

7. Insurance / Annuity Arbitrage Planning. For taxpayers older than about age 62 who have substantial taxable investment income, it is possible to create an arbitrage value between the actuarial assumptions used in some negotiated life annuity contracts and those used in certain guaranteed life insurance policies. In addition, the special income tax treatment of the life income payments from the annuity contract, compared to the new higher tax rates applicable to the net investment income, enhance that arbitrage value. The trust structure employed to accomplish this is a "Guaranteed Income - Principal Replacement Trust" or "GIPRT." [Note, in general, the older the taxpayer is the greater the value of the arbitrage position.]

(a) Sam is age 63 and has $3 million currently invested in AA grade corporate bonds with a 3.27% yield to produce secure income with minimum market risk. After ATRA, his net income is taxed at a much higher rate (about 48.7%), composed of the 39.6% basic federal income tax, the 3.8% Medicare surtax, an effective added 2% from lost itemized deductions, plus a 6% state income tax.

(b) For 2014, his expected interest income from this bond portfolio is $98,100, from which he will pay income taxes of about $47,751, leaving net after-tax income of $50,349. Sam would like to improve his net spendable income without assuming greater investment risk.

(c) Sam might liquidate the bonds and invest the $3 million of proceeds in a GIPRT package including a guaranteed fixed annuity payment for Sam's lifetime and a guarantee of return of the full $3 million principal investment at Sam's death.

(i) Sam could expect to receive a guaranteed annual payment of $207,983 for his lifetime from Insurance Company "A". Upon Sam's death, that payment would cease.

(ii) Insurance Company "B" would guarantee to pay the full $3 million principal amount to Sam's estate (or a trust for his family) upon Sam's death, in exchange for premiums of $75,628 annually for Sam's 20 year actuarial life expectancy, and $8,468 per year thereafter for Sam's remaining lifetime.

(iii) The special income tax rules applicable to such annuity contracts allow Sam to recover his investment in the contract over his life expectancy free of income tax. Therefore, for 20 years about $139,000 of the annuity payments are fully exempt from income tax.

(iv) As a result, Sam's net spendable income from this investment is increased to about $98,000 annually for his lifetime - after all taxes and after the cost of the life insurance providing the guaranteed refund the investment at his death.

year	GIPRT Guaranteed Receipts	Principal Replacement Charge	Sam's Income Tax	Sam's Net After-Tax Income	Equivalent Pre-Tax Bond Yield @ 48.68% Tax Rate
1	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
2	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
3	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
4	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
5	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
6	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
7	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
8	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
9	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
10	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
11	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
12	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
13	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
14	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
15	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
16	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
17	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
18	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
19	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
20	$207,423	($75,628)	($33,502)	**$98,293**	6.38%
21	$207,423	($8,468)	($33,502)	**$165,453**	10.75%
22	$207,423	($8,468)	($94,219)	**$104,736**	6.80%
23	$207,423	($8,468)	($100,965)	**$97,990**	6.36%
24	$207,423	($8,468)	($100,965)	**$97,990**	6.36%
25	$207,423	($8,468)	($100,965)	**$97,990**	6.36%
26	$207,423	($8,468)	($100,965)	**$97,990**	6.36%
27	$207,423	($8,468)	($100,965)	**$97,990**	6.36%
28	$207,423	($8,468)	($100,965)	**$97,990**	6.36%
29	$207,423	($8,468)	($100,965)	**$97,990**	6.36%
30	$207,423	($8,468)	($100,965)	**$97,990**	6.36%

© Lefkoff, Duncan, Grimes, McSwain & Hass, P.C.

(v) Primary advantages - guaranteed result for life and substantially enhanced after-tax income.

(vi) Primary disadvantages - can be funded only with cash and, once established, is illiquid.

IV. Asset Protection Planning

1. Ohio enacts domestic asset protection trust legislation. Ohio became the fourteenth state to permit domestic asset protection trusts when HB 479, which included the Ohio Legacy Trust Act, was signed by the Governor. The Act became effective on March 27, 2013. The Ohio legislation is similar to that of other domestic asset protection statutes.

2. District Court strikes down asset protection trust. In re Huber, 201 B.R. 685, 2013 WL 2154218 (Bankr. W.D. Wash, May 17, 2013) The District Court in Washington, in a Bankruptcy matter, has invalidated a domestic asset protection trust created in Alaska, under Alaska's asset protection statute, which was a state other than the grantor's residence (Washington.)

The Court found, in determining that Washington law should apply rather than Alaska law, that the trust's only connection with Alaska was the location of the trustee and the administration of the trust in Alaska. On the other hand, when the trust was created, the Grantor and the trust beneficiaries all resided in Washington, the trust assets (other than a certificate of deposit) were transferred from Washington, Grantor's creditors were located in Washington, and the drafting attorney was located in Washington. When the trust was created, therefore, Alaska had only a minimal relation to the trust, but Washington had a substantial relation to the trust.

Second, the court held that the transfers to the trust were fraudulent under the Bankruptcy Code. §548(e)(1) of the Bankruptcy Code states that the trustee in bankruptcy may avoid any transfer to a self-settled trust or similar device made by the debtor on or within 10 years before the bankruptcy petition, if the debtor is a beneficiary of such trust or device and the debtor made the transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted, on or after the date that such transfer was made.

This is probably not the end of this story. The Bankruptcy trustee will, based on this order, attempt to levy on the Alaska trust assets. It is expected that the Alaska trustee will resist on various legal grounds, and that some ultimate resolution to this issue will be found in an appellate court.

NOTE: There have been several other cases in the last 18 months in which courts at various levels have viewed such trusts in an unfriendly light and clearly looked for legal theory with which to find that they do not prevent creditors from pursuing the trust assets.

V. Recognition of Same-Sex Marriage

A. Judicial Developments

1. In Windsor v. United States, 570 U.S. ___, 133 S. Ct. 2675, 186 L. Ed. 2d 808 (2013), the U.S. Supreme Court determined in an estate tax case that Section 3 of the Defense of Marriage Act ("DOMA") defining marriage as between a woman and a man is unconstitutional. Edith Windsor was the executor of the estate of her deceased spouse, Thea Spyer. Windsor and Spyer had lived in a committed relationship for decades. They were legally married in 2007, in Ontario, Canada. At the time, New York recognized same-sex marriages performed in other jurisdictions, but the state did not allow same-sex couples to marry in New York until 2011. When Spyer died in 2009, Windsor filed an estate tax return claiming the full estate tax marital deduction for assets that passed to her under Spyer's estate plan. The Internal Revenue Service disallowed the deduction, and Windsor, as executor, paid the deficiency. Windsor then filed a suit for refund of the federal estate tax on the basis that Section 3 of the federal Defense of Marriage Act (DOMA) violates the Equal Protection Clause of the Fifth Amendment of the United States Constitution.

In February 2011, the Justice Department announced that it would no longer defend DOMA's constitutionality because a heightened standard of scrutiny should apply to classifications based on sexual orientation and Section 3 is unconstitutional under that standard. As a result of the Justice Department's decision, the Bipartisan Legal Advisory Group of the U.S. House of Representatives (BLAG) moved to intervene in this case to defend the constitutionality of the statute. Windsor moved for summary judgment in the District Court. The district court granted the motion for summary judgment, finding as a matter of law that the offending provision of DOMA was unconstitutional. The Court of Appeals for the Second Circuit upheld the District Court's ruling, and
the Supreme Court granted certiorari on December 7, 2012.

In a 5-4 decision, the Supreme Court affirmed the holdings of the District Court and the Court of Appeals, and struck down section 3 of DOMA, holding that the offending provision deprived persons of equal liberty in violation of the Fifth Amendment. Note that state law governing marriage was not at issue in the Windsor decision, because New York law already recognized same-sex marriage lawfully entered into in another jurisdiction. Even so, the language of the majority decision would seem to be applicable to a state law which seeks to invalidate a same-sex union entered into lawfully in another jurisdiction.

2. In Hollingsworth et al. v. Perry . 570 U.S. ___, 133 S. Ct. 2652 (2013), the Supreme Court of California decided that marriages between same-sex couples would be recognized and equal to all other marriages performed in the state. Five months later in a ballot initiative known as Proposition 8, opponents of marriage equality successfully added a new provision to the California constitution whereby

only a marriage between a man and a woman would be valid or recognized in the state.

Kristen Perry and her spouse, Sandra Stier, filed an action seeking to compel state officials and their respective county clerks to issue marriage licenses notwithstanding the language of Proposition 8. The plaintiffs claimed that the language added to the California Constitution by Proposition 8 violated their rights guaranteed by the Fourteenth Amendment to the U.S. Constitution and that they should be allowed to marry. The state officials refused to defend Proposition 8, and the district court allowed a group of individual citizens – the group that had supported Proposition 8 – to defend the language added as a result of the ballot initiative. A federal district court in California held that Proposition 8 was unconstitutional and ordered state officials not to enforce it. The state officials elected not to appeal the matter, but the individual citizens did appeal the decision to the Ninth Circuit Court of Appeals. That court was unsure whether the petitioners – the individual citizens who had supported Proposition 8 – had standing to appeal. The federal appeals court certified the question to the California Supreme Court, which held that the proponents of the ballot initiative had standing under federal law to defend the constitutionality of the ballot initiative. The Ninth Circuit heard the appeal and upheld the lower court on the merits.

The United States Supreme Court, however, did not reach the merits of the case. Instead, they determined that the opponents of marriage equality — the individual citizens — did not have standing to pursue the appeal. As a result, the decision of the district court stood, holding that Proposition 8 was unconstitutional. Because the Supreme Court did not reach the merits of the Perry case, and did not itself hold Proposition 8 to violate the U.S. Constitution – the decision is not a precedent one way or the other in any other state.

3. Other Judicial Developments:

(a) In **Obergefell v. Kasich**, 2013 U.S. Dist. LEXIS 102077 (S.D. Ohio July 22, 2013), a post-Windsor case, an Ohio federal District Court ordered the Ohio registrar of death certificates not to accept a death certificate for John Arthur unless it records his status as married and records James Obergefell as his surviving spouse. Arthur and Obergefell, residents of Cincinnati, had been in a committed relationship for 20 years. During the course of Arthur's dying, the couple were married in Maryland, and flew home to Cincinnati that same day. Ohio has prohibited in the state code and state constitution the recognition of marriage of gay or lesbian couples. The plaintiffs sought a preliminary injunction to prevent the Ohio registrar of death certificates from issuing a death certificate upon Arthur’s death identifying Arthur as anything other than married to Obergefell at the time of this death. The district court found that the plaintiffs would suffer irreparable harm if Arthur’s death certificate did not recognize

his marital status and, in light of Windsor, the plaintiffs were likely to prevail on the merits of their case.

(b) In **Cozen O'Connor v. Tobits**, 2013-2 U.S.T.C. (CCH) ¶50,453 (E.D. Pa. July 29, 2013). The surviving spouse of a same-sex couple who married in Canada and resided in Illinois (which recognized the validity of the Canadian marriage) had not signed a waiver of the right to receive survivor benefits of a qualified profit sharing plan. The decedent's parents were named as the beneficiaries. The Retirement Equity Act of 1984 requires automatic survivor benefits that can be waived only with the proper consent of the participant and the participant's spouse. The court determined that the survivor is the "surviving spouse" under Windsor and ruled that the surviving spouse is entitled to the benefits rather than the parents because she had not consented to a waiver of the survivor benefits.

B. Responses of Federal Agencies

1. The Internal Revenue Service applies a place of celebration rule to same-sex marriages. Rev. Rul. 2013-17, 2013-38 I.R.B. 201. The IRS, following the decision in Windsor, ruled that same-sex couples who are legally married in states or foreign countries that recognize the validity of their marriages will be treated as married for all federal tax purposes, even if they live in a state or other jurisdiction that does not recognize same-sex marriages.

2. Other Federal Agencies have differed on the place of celebration vs. place of domicile approach, but most seem to either apply a place of celebration rule or are moving toward it.

(a) Secretary of State John Kerry announced on August 1, 2013, that the United States will immediately begin issuing immigrant visas to same-sex couples, as long as the marriage is valid in the jurisdiction where it took place (*i.e.*, a place of celebration standard).

(b) The Pentagon announced on August 14, 2013, that the same-sex spouses of military personnel will be entitled to the full benefits that are available to spouses (including health care and housing benefits, extra compensation when the spouse is deployed and unable to live at home, and access to base facilities). In addition, the Pentagon said it will grant leave to same sex unmarried couples who are stationed in one of the 37 states where same-sex marriage is illegal to enable them to travel to a jurisdiction where the couple may be married.

(c) The Department of Health and Human Services (HHS) ruled on August 29, 2013, that legally married same-sex couples, regardless of where they live, are eligible for Medicare benefits that are available to married couples.

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

(d) The Department of Labor on September 18, 2013, provided guidance affording legally married same-sex couples the right to participate in employee benefit plans even if they do not live in states that recognize the marriage. This applies to pensions, 401(k) plans, health plans, and other similar benefits.

(e) The Social Security Administration, however, seems to be applying a domicile standard. The Social Security Administration is putting a hold on applications for spousal benefits if the married couple resides in a state that does not recognize same-sex marriages (applying a "domicile standard").

(f) Attorney General Eric Holder announced on September 5, 2013, that the **Department of Veterans Affairs** will no longer enforce a law regarding veterans' benefits that excludes same-sex couples. If at least one spouse is a veteran, the couple will qualify for benefits that other veterans and their spouses receive, as long as the couple lives in a state that recognizes same-sex marriage (thus adopting a domicile standard).

C. Tax Consequences of Recognition of Same-Sex Marriages

1. Potential Advantages

(I) Gift Tax and Estate Tax Marital Deduction for property being transferred to one's spouse.

(ii) Portability of Unified Credit exemption

(iii) Disclaimer Planning - a surviving spouse is uniquely allowed to make a qualified disclaimer even though they retain an interest in the disclaimed property through a trust.

(iv) Gift Splitting for gifts to third parties

(v) Joint Income Tax filing, and they should consult with their advisor regarding whether they might amend earlier returns to claim joint filing status.

(vi) Spousal roll-over election for qualified retirement accounts

(vii) Tax Treatment of Divorce. The favorable tax rules in §§ 1041 and 2516 for transfer of property pursuant to a marriage settlement agreement or divorce will be available to same-sex spouses. Alimony payments to a same-sex spouse may be deductible (and income to the recipient ex-spouse), or they may elect to not claim a deduction or recognize taxable income under § 71. Qualified Domestic Relations Orders (QDROs), which divide qualified retirement benefits at divorce, will be available.

© 2014, Lefkoff, Duncan, Grimes, McSwain & Hass, P.C. Atlanta, Georgia

(viii) Community Property. If same-sex married couples live in a community property state they will be entitled to a 100% basis adjustment on the death of either spouse.

(ix) GST Planning - Both spouses may apply their GST exemptions to transfers in trust, and the "reverse-QTIP election" will be available.

2. Potential Disadvantages

(I) The "Marriage Penalty" for federal income taxes will apply. Same-sex spouses with two incomes who previously filed income tax returns as single individuals will now be required to file either jointly or "married filing separately" returns, in either case being subject to the "marriage penalty" resulting in increased income tax as a result of pushing their combined income into the higher brackets, combining their AGI for purposes of the 3.8% Medicare surtax, and the cut-back on itemized deductions.

(ii) Mortgage Interest Deduction restrictions for federal income tax purposes. Unmarried taxpayers may each benefit by being allowed to deduct mortgage interest on as much as $1.1 million of mortgage debt. Married couples may deduct only the interest on a combined maximum of $1.1 million.

(iii) ERISA Consent in Employee Benefit Plans. Same-sex spouses will now need to get spousal consent in order to designate anyone other than their spouse as the beneficiary of their retirement plan.

(iv) Chapter 14 Special Valuation Rules. A same-sex spouse will be treated as a "family member" for purposes of Chapter 14. They will no longer be able to use GRITs, but will be limited to GRATs or GRUTs. Also, shareholder transactions will now be subject to the rules of Chapter 14, and the spouse will no longer be a non-family member for purposes of fixing the value of a buy-sell at death.

(v) State Income Tax Issues Certain sates have enacted law which expressly disavow same-sex marriage and have said that same-sex couples must file separate state tax returns even if they file a joint federal return. These states currently include Arizona, Idaho, Kansas, Louisiana, Michigan, North Carolina, North Dakota, Ohio, Oklahoma, Utah, Virginia, and Wisconsin.

D. Non-Tax Issues

1. Inheritance Disputes. Many same-sex couples harbor great fear regarding the status of the surviving partner in possible disputes with the family of the deceased partner over inheritance rights. It will now be possible for the survivor

to have the legal status of the decedent's spouse, which will resolve many of those fears. Even if the decedent's Will is challenged, the state inheritance rights of the "surviving spouse" will always be superior to those of other family members.

2. Spousal Property Rights. From state to state, there are numerous property rights which are uniquely available to married spouses. Other than community property in those states, some states recognize:

> **Dower and Curtesy**, which vest in a surviving spouse certain rights to all of the real property owned by the deceased spouse
>
> **Year's Support**, in Georgia, which gives to a surviving spouse a first priority claim against the estate of a deceased spouse to provide for the surviving spouse's support for a period of a year - and can defeat the claims of any other unsecured creditor.
>
> **Tenancy By Entirety**. This is a form of joint ownership available only to spouses. It is like joint tenancy with rights of survivorship, except that neither spouse can convey any interest in the property to a third party unless both spouses consent. It can be a very valuable asset protection tool.

3. Pre-Nuptial Agreements. Many same-sex couples have entered into property agreements of various sorts, but are now eligible to use pre-nuptial agreements, and are probably subject to the state law governing the enforceability of such agreements. Those existing property agreements probably did not address the various income tax, gift tax, and estate tax questions, qualified plan issues, and legal support rights and obligations which are applicable to a lawfully married couple. All such agreements should now be reviewed.

4. Will and Trust Construction Issues. There will be Will construction issues in non-recognition states. For example, if a Will in State X grants a beneficiary in State Y a power of appointment exercisable in favor of the beneficiary's "spouse," what state law will apply to determine the spouse of a same-sex marriage?