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Planning For Married Couples After the 2012 Tax Act: Should You Transfer Assets to Your Spouse Outright or in Trust?

In this installment of the Passionate Estate Planner, we consider one of the fundamental estate planning questions that married couples need to answer: Whether assets should pass to the surviving spouse outright, or in trust? While this has always been an important question, the enactment of the 2012 Tax Act in January 2013 may have made it more difficult to answer.

Under the 2010 Tax Act, the estate and gift tax exclusions and the generation skipping transfer ("GST") tax exemption were each increased to $5 million per person (with indexing for inflation beginning in 2011). These amounts were made permanent by the 2012 Tax Act. These gift and estate tax exclusion levels effectively eliminated estate tax concerns for the majority of Americans, since most people will have an estate worth less than $5,000,000.

The 2010 Tax Act also introduced the concept of "portability" of the estate and gift tax exclusions (but not the GST tax exemption). Under the pre-2010 Tax Act rules, if a deceased person left most or all of his assets outright to his surviving spouse, his unused gift and estate tax exclusions would be lost, as they could not be transferred to the surviving spouse for her later use. The only way to preserve the benefits of a deceased spouse's estate and gift tax exclusions while still allowing the surviving spouse to benefit from the deceased spouse's assets was to have the assets pass into trust for the surviving spouse, rather than outright. The new portability rules are designed to allow a deceased person's remaining gift and estate tax exclusions to be transferred to his surviving spouse, eliminating the need for the deceased spouse to have assets pass to the surviving spouse through trust in order to preserve the exclusions. Portability is not automatic, because the executor of the deceased spouse's estate must timely file an estate tax return in order to elect to have the deceased spouse's remaining estate and gift tax exclusions transferred to the surviving spouse. Even if the election is properly and timely made, the surviving spouse may also end up losing the deceased spouse's exclusions, if she remarries and survives another spouse. However, the existence of the portability rules does create an option for married couples who want to be able to take advantage of both spouses' estate and gift tax exclusions but who don't want to have to use trust-based planning to do so.

One question faced by estate planning attorneys since the 2010 and 2012 Tax Acts is this: If high exclusions effectively eliminate estate tax exposure for most potential clients, and those remaining married couples with continuing estate tax exposure are able to use portability (without trusts) to benefit from both spouses' exclusions, will there still be any demand for estate planning which uses trusts? Or, will most potential clients elect to keep their documents as short and simple as possible by having all assets simply pass to the surviving spouse outright?

Midway through 2013, we are starting to see the answer to this question in our practice. While there are couples who choose the simplest possible estate plans, most of our married clients continue to choose plans which include trusts for the surviving spouse as well as trusts for

later intended beneficiaries such as children and grandchildren. You may now be asking, "Why would people choose more complex planning over simpler planning?" The answer is that planning which uses trusts can provide a number of significant benefits in addition to any estate tax reduction relating benefits, and that these other benefits are still very attractive even if estate taxes are no longer a concern. The choice involves weighing the potential benefits and potential negatives of a simple plan against the potential benefits and potential negatives of a trust based plan. The rest of this newsletter will discuss these benefits and negatives. We hope this discussion will help you when you consider your own planning choices.

Outright Transfers. Let's start by reviewing the benefits of transferring assets to a surviving spouse outright. One advantage is that the documents needed will be shorter and simpler, which can also mean fewer issues to consider and decide when planning and less cost to have appropriate documents prepared. A second advantage is that no additional sets of records and no additional income tax returns will be required. A third potential advantage is that, since all of the remaining assets will be potentially subject to the estate tax at the surviving spouse's death, the basis which is used to calculate capital gains and losses when the assets are sold by the surviving spouse's estate or the surviving spouse's beneficiaries will be the fair market value of the assets as of the date of the surviving spouse's death. This is often referred to as a "basis step-up." However, you should note: the basis step-up can also be a basis step-down, if the value of an asset has declined since it was acquired by the deceased owner rather than increasing. In addition, there is no basis adjustment available for tax-deferred retirement savings assets, such as those held in IRAs, 401(k) accounts or other qualified plan accounts, and deferred compensation programs.

Transfers in Trust. The benefits provided by trusts can be summarized as follows: asset protection, control, and transfer tax protection. The negatives of trust based planning can similarly be summarized as: greater complexity and potential income tax consequences.

1. **Asset Protection Benefits**. A properly structured trust can protect the assets it holds from unwanted outsiders, such as a beneficiary's spouse in a divorce, a beneficiary's creditors, and predators who may wish to take advantage of a beneficiary, especially as the beneficiary reaches old age. This can help ensure that both the surviving spouse and the beneficiaries who are intended to receive assets after the surviving spouse's death are protected in the event the surviving spouse remarries, incurs debts such as high uninsured medical bills, or becomes the target of a gold-digger or unscrupulous friend, family member, or care giver.

2. **Control Benefits**. Assets which remain in a trust at the death of the surviving spouse will be controlled by the provisions of the trust. The trust may allow the surviving spouse some degree of power to make changes, but those changes can be limited as the deceased spouse intended. For example, while a surviving spouse can be given the ability to change the trust terms so that one child receives a larger share than another, the surviving spouse generally would not be given the ability to add completely new beneficiaries to the trust. It may be possible, depending on how flexible the trust's terms are during the surviving spouse's lifetime, that the surviving spouse can remove assets from the trust and divert those assets, either intentionally or unintentionally. However, even in a very flexible trust where the surviving spouse is the primary, favored, beneficiary, the surviving spouse will generally have to resort to deliberate

actions in order to end up diverting significant portions or all of the trust's assets away from the deceased spouse's intended ultimate beneficiaries. In other words, having assets pass to a trust for the surviving spouse helps ensure that the trust's assets will end up with the deceased spouse's desired beneficiaries with no real effort on the surviving spouse's part. If assets pass to the surviving spouse outright, however, the spouse could very easily accidentally divert the assets away from the deceased spouse's intended beneficiaries, such as by adding a new spouse or one of the children to the surviving spouse's accounts "so that they can help me write checks and pay my bills." The surviving spouse may even need to take specific steps in order to ensure that assets she owns outright end up with the deceased spouse's intended beneficiaries.

Let's look at the remarriage situation in more detail. A surviving spouse remarries after the death of her spouse. If the surviving spouse's existing estate planning documents do not address this situation, and no updates are done, the new spouse could end up receiving a significant share of assets even if the surviving spouse's Will says it all goes to the children from her prior marriage. If the surviving spouse goes to her estate planning attorney for updates, in most cases the new spouse will also be involved. If assets received from the deceased original spouse are held in trust for the surviving spouse, the trust assets may not even become part of the conversation with the estate planning attorney, and, without the surviving spouse doing anything at all, the trust assets will end up passing as originally intended. If the surviving spouse received the assets from the deceased original spouse outright, however, the surviving spouse will need to go out of his or her way to ensure that those assets pass to the children or other loved ones instead of to the new spouse. This means that the surviving spouse could even need to tell the new spouse: "I do not care if you have to live out of a trash can, these assets are going to go to my children as my deceased spouse and I agreed." Or, if the surviving spouse decides that she wants to leave assets to the new spouse, rather than to the children, she is completely free to do so.

Many couples who are both in their first marriage may believe strongly that the surviving spouse would do whatever it takes to ensure that their assets end up with their children, and not with others. In many cases, however, after one spouse is deceased, the surviving spouse does decide to change the plan. In addition, if the surviving spouse has or adopts additional children, she will often want to provide for those children as well as her children from the deceased spouse, and may feel that it is perfectly fair to do so with assets received from the deceased spouse. If the couple already has a blended family situation, where either or both of them has children from prior relationships, they may be more willing to recognize the control benefits of passing assets to the surviving spouse in trust and less likely to rely on the surviving spouse to "do the right thing" with her own planning.

3. **Tax Issues**. Trusts can have both tax benefits and tax disadvantages. Tax issues should always be reviewed when a trust-based plan is being considered. However,

most of our clients do not allow the tax considerations to be the deciding factor, and instead make the decision of whether to use a trust based plan on non-tax factors.

a. **Relying on portability requires a fairly complex estate tax return to be filed within 9 months after the death of the first spouse to die.** Where spouses decide to rely on portability to obtain the benefit of the estate tax exclusion of the first spouse to die, the first spouse's Executor will be faced with a very short window of time in which he must both decide that the portability election will be made and have the necessary estate tax return prepared and filed. If the estate tax return is not filed, or a due date extension properly requested, within 9 months after the deceased spouse's death, the opportunity is lost forever. A 6 month due date extension is available but only if the extension is requested on time. Relief from these timing rules may be available in the future, but for now you should not count on being able to get any such relief. Estate tax returns are very complex, technical returns, and require a large volume of information and documents to prepare and file. There is a set of rules under which the level of detail and supporting documents required is lessened somewhat if **all** property is essentially passing outright to the surviving spouse, but it's still a complicated, time-consuming, and potentially expensive process.

b. **The deceased spouse's estate tax exclusion is frozen under portability, but using a trust for the surviving spouse allows the deceased spouse's exclusion to cover future growth in the value of the trust's assets.** Under portability, the value of the deceased spouse's remaining estate tax exclusion is frozen at the value it had at the deceased spouse's death, and it will not be adjusted for future inflation. This means that, if the assets increase in value faster than the surviving spouse's own exclusion grows, there is a potentially significant risk that the combined exclusions will not be able to cover all of the combined asset value at the surviving spouse's death. If the deceased spouse's exclusion is instead used, even in part, to cover assets which are transferred to a trust for the surviving spouse (such as a "credit shelter trust"), the trust will shelter **all** of the remaining assets it holds at the surviving spouse's death, even if the value of those assets has increased well beyond the value of the exclusion used. This allows the deceased spouse's exclusion to be leveraged. However, if the value of the trust assets goes down between the date of the deceased spouse's death and the date of the surviving spouse's own death, then some of the exclusion amount used to cover the trust would have been wasted.

c. **A basis "step-up" may not be easily available for assets held in a trust at the surviving spouse's death, while the use of portability helps ensure that a basis step-up (or step-down) will occur at the surviving spouse's death.** If a trust is used for the surviving spouse, the trust's assets will not receive a "step-up" (or "step-down") in income tax basis at the surviving spouse's death if they have increased (or decreased) in value since the deceased spouse's death. Basis step-up or step-down depends on the assets being included in the surviving spouse's estate for estate tax purposes, whether or not any estate tax

is actually paid. Many estate planning attorneys, including us, are currently considering the best ways to balance the ability to get a step-up in basis on appreciated assets at the surviving spouse's death while still allowing clients to enjoy the other benefits of using a trust for the surviving spouse and avoiding the potential step-down in basis on depreciated assets.

d. **Income taxation: portability's simplicity vs trust's tax rate flexibility.** Trusts which are created at a person's death for the benefit of a surviving spouse are generally irrevocable, non-grantor trusts. This means that the trust is treated as a separate taxpayer from the surviving spouse, and requires its own set of financial records, as well as the filing of its own state and federal income tax returns. Where outright transfers to the spouse are made (relying on portability), the income earned by the surviving spouse is simply taxed like any other income the surviving spouse earns. However, where trusts are used, flexibility may exist in deciding who should be taxed on the trust's income for any given year, and what rates will apply to that income. Income retained by a trust is taxed at the Trust's rates, but income distributed to a beneficiary is taxed to the beneficiary at the beneficiary's individual tax rates. Under current law, trusts are taxed at the highest rate of 39.6% beginning at a mere $11,950 of accumulated income. At this level of accumulated income, the trust is also subject to the new 3.8% Medicare tax on certain passive investment income. So, under current law, Trustees will likely want to distribute the trust's income to the spouse to have it taxed at the spouse's individual income tax rates. With special trust drafting, the taxation of both ordinary income and capital gains can both be distributed to the spouse. Of course, while trust tax rates are currently generally higher, no one knows what future law changes will bring, so trusts are flexible enough to take advantage of the rules existing now and in future years.

e. **The desire to maximize asset protection benefits for children or other loved ones favors using trusts at the first spouse's death.** A final potential issue with portability applies mainly for those who wish to use long-term trust based planning to provide asset protection and other benefits to their children or other loved ones. We refer to this type of planning as "GST Planning" because it leverages the clients' generation-skipping transfer ("GST") tax exemptions. The GST tax exemptions, however, are not portable. This means that clients who wish to maximize the use of their combined GST tax exemptions should **not** rely on portability and an all-outright-to-the-surviving spouse plan. Doing so will cause them to lose the use of the deceased spouse's GST tax exemption completely. The use of a trust for the surviving spouse, however, can allow the deceased spouse's GST tax exemption to be preserved.

There are a lot of factors which should be considered when determining how to pass assets between spouses under an estate plan. The estate planning attorneys at Morgan & DiSalvo are prepared to help you consider your situations, these numerous factors, and various other important issues, and develop an estate plan which will carry out your desires and achieve your goals in a way which is comfortable for you. Please feel free to contact us at sollila@morgandisalvo.com or (678) 720-0750 to schedule a free estate planning consultation.