# CHAPTER 5 - STEP 5
# INHERITANCE PLANNING

We have now provided the preliminary considerations that apply to almost anyone who wants to plan their estate.

Now we can get to the core purpose of estate planning.

This involves determining who you want to benefit from your estate plan, and how they are best served with respect to inheriting directly, in trust, or otherwise.

Before we cover creditor protection, tax planning, and related considerations in a client meeting, we encourage clients to think through the practical implications of devising assets out- right or in trust for a beneficiary so that our tax, creditor, and estate planning is designed with their inheritance goals in mind.

**Should You Trust a Trust?**

We have seen countless individuals inherit monies or receive large gifts only to have them dissipated in a few months or years, with the beneficiary and his or her family becoming penniless or again dependent upon the parent or other family members for financial sustenance.

On the other hand, we have seen beneficiaries unhappy because instead of inheriting outright they have become the beneficiaries of trusts accumulated for the purpose of preserving assets for their benefit, and are not permitting the beneficiary to spend the money immediately and live a life without having to work.

In some cases, the primary fear or dissatisfaction comes from the inability to control or influence a trust company or individual trustee who may be improperly handling investments or making poor distribution decisions.

To ameliorate both of the above problems, we commonly suggest and implement a Beneficiary Controlled Accountable Trusteeship" ("BCAT"), where upon reaching a certain age or achieving certain goals, such as completing a college education and finding gainful employment, a beneficiary has the right to serve as co-trustee and to designate one or more individuals or a licensed trust company to serve as co-trustees in order to provide appropriate safeguards and accountability.

Many clients feel much safer choosing this type of arrangement rather than appointing an unproven or inexperienced co-trustee, especially where there may be a marriage or in-law situation now or in the future that could cause an individual to lose control of assets intended for him or her.

According to a recent study, over 50% of marriages end in divorce within 20 years. Although we do not have statistics for the divorce rates of marriages that have lasted longer than 20 years, we are saddened and surprised every year when we see 30 and 40 year marriages that ultimately end in divorce.

When we meet with a married couple and explain that on the wife's death the husband might marry a "Hooters girl with lovely children" and may lose most of his individual assets to this "new family," the co-trustee conversation can have great meaning!

By the same token, a husband might die leaving an inheritance to his wife, who might remarry

a well-meaning man who would like to advise her on how to invest her assets, or could need loans or capital contributions for a business or real estate investment that may fail miser- ably.

We commonly see well-meaning and semi-well-meaning advisors descend upon a recently widowed spouse who is in need of moral support and does not have the ability to determine whether financial proposals and decisions are being properly made.

Oftentimes, the surviving spouse is not aware that many financial advisors are paid on a commission basis, and may be influenced by recommendations that primarily benefit the advisors! Having a trust arrangement in place at least for the first few years after the death of a loved one can be invaluable in these circumstances.

Young or middle-aged clients will often assume that they can safely hold family assets as a sole trustee but realize upon discussion that they may need co-trustees as they age. We all get older and frailer as life proceeds, and anyone who lives to old age could end up being in their 80s or 90s and be physically or mentally compromised. At this time, well or not so well-meaning children, spouses of children and others may make heavy handed attempts to receive gifts and loans or to influence investments or other decisions, which essentially nullify the surviving spouse's independence. This is much less likely when the surviving spouse serves as co-trustee with an independent trust company or trustworthy advisor who is not part of the family dynamics, but is smart enough to help the surviving spouse deal with these problems. Some clients choose not to impose this requirement until the surviving spouse remarries or cohabitates with someone else, or reaches an older age where dementia becomes more common, such as age 75. Dementia affects one in fifty people between the ages of 65 and 70, but the odds increase to one in five for people over 80 years of age!

**Avoiding Probate by Using Revocable Living Trusts**

Probate is the process whereby a deceased person's assets are moved out of his or her name into the name of trusts or beneficiaries as set forth under his or her last will and testament.

Florida law requires that the probate court judge preside over a proceeding to assure that the correct will is given effect, that the "personal representatives" selected under the will are bonded and understand their responsibilities, that creditors are paid, and that beneficiaries receive what they are entitled to receive, along with an accounting of expenses and income generated during the probate process.

Probate is often criticized because it requires hiring a lawyer and can involve a significant amount of paperwork and "red tape," which can be expensive. Legal and trust companies are able to charge based on a percentage of the assets going through the probate process, meaning that the family of someone who dies with a large estate may end up paying huge probate costs. However, if a person has most of his or her assets under a revocable living trust that avoids probate, these companies typically charge a smaller percentage or a much smaller fixed fee.

Many people use pay on death accounts, joint with right of survivorship accounts, and other techniques to avoid probate, and these can backfire severely. For example, some parents will place assets in joint names with a child who then gets into a divorce or a car accident, and half or more of the asset gifted can be lost. One client put his car in joint names with his son, and then his son had an accident and the client lost hundreds of thousands of dollars because the son did not have enough liability insurance.

When assets are held under a revocable living trust, the successor trustees named under the trust can administer these assets privately without probate or consequent delay, expense, or public access to required information. As a result, expenses can be significantly reduced, but without court oversight there is a higher chance of theft, misadministration, or failure to follow reasonable guidelines.

A revocable living trust is completely separate and different from a living will, and is an

arrangement whereby an individual can place assets under a trust that he or she can control while alive and competent. The trust can name an alternate successor trustee or trustees who can take over control and administration of the assets in the event of the person's incapacity. If the person ends up in a guardianship, the trustee of the revocable trust can continue to control the assets and the living trust. On death, the assets under the trust pass without having to go through probate.

The decision as to whether to use a will or a trust system is an important one, but many Floridians are led to believe that as long as they have a trust everything will be fine, without regard to how the trust is actually used, and they may be told or simply assume that a revocable trust will protect their assets from creditors, which is never the case. In fact, even an irrevocable trust in Florida that can be used for the Grantor will be accessible to the Grantor's creditors!

Many married couples will share a joint trust or set up separate revocable trusts depending upon their situation. We see many grave errors made by non-specialist lawyers and other advisors when it comes to trust system selection and design for married couples. For example, it may be best to allow all assets to be owned by the surviving spouse if the considerations dis- cussed earlier in the book do not apply, but many joint living trusts do not allow a high degree of control for a surviving spouse. Also, some trusts will not allow for a proper method of holding assets in trust for a surviving spouse so that the assets will be protected from the surviving spouse's creditors and will be counted in that spouse's estate for estate tax purposes.

An article that we published in a tax advisor's periodical on various trust systems will be of interest to many professional advisors reading this book, as well as a good number of readers and is as follows:

**SELECTING REVOCABLE TRUST SYSTEMS FOR CHILDREN**
**By: Alan Gassman, Christopher Denicolo and Kristen Sweeney**
**Reprinted with permission from Leimberg Information Services 02-Apr-09 Steve Leimberg's Estate Planning Newsletter - Archive Message #1439**

**EXECUTIVE SUMMARY**

Advisors have a wide variety of revocable trusts at their disposal, and there are a number of important factors that must be carefully considered. This commentary will review:

1) Protective Beneficiary Trusts,
2) "All to Survivor" Joint Trusts,
3) "First Death Lock-Up" Trusts,
4) "Separate Trust for Each Spouse" Trusts,
5) "Joint 100% Lock-Up" Trusts, and
6) "Joint 50% Lock-Up" Trusts.

**FACTS**

Many estate plans involve revocable trusts, and selection and implementation of an appropriate plan is more of an art than a science.

Factors that should be considered when selecting a revocable trust system include:

1) Whether a surviving spouse or beneficiary should have total control or protective advantages that may be available;
2) Whether income tax savings for a surviving spouse may be desirable,

and

3) What assets and beneficiary designation situations the client may have.

**NOTE**

Revocable trusts can be used to avoid probate and guardianship, but during the life- time of the Grantor if the Grantor establishes and owns the trust, there is no creditor protection, Medicaid protection, or income or estate tax savings. After death, such protections and savings may apply depending on the revocable trust system selected.

## COMMENT

## CONSIDERATIONS FOR A SINGLE INDIVIDUAL

Many unmarried individuals establish and maintain revocable trusts primarily to avoid probate and guardianship of their estate. Probate is the process whereby assets owned in individual names must be processed through the Probate Court System, in order to ensure that:

1) The proper Will has been identified and approved;
2) Accountings are received by beneficiaries;
3) Creditors are paid, and
4) A fiduciary is appointed as personal representative to execute and monitor all of the above.

Many clients choose to bypass the "red tape" and expenses associated with the probate system by placing their assets under a revocable trust.

Immediately upon its formation, the trust is controlled and administered by a non-court appointed relative, friend, professional or trust company.

Life insurance, annuities, and even pension benefits can be paid to the revocable trust upon death to facilitate the uniform distribution of assets. For pension plan purposes, it may be advantageous to instead name individuals who are able to withdraw the pension benefits out of an inherited IRA ratably over their life expectancy. Such ratable withdrawals may also apply under an appropriately drafted revocable trust agreement, but special technical language and planning is required to effectuate this.

Some clients choose to place their homestead under a revocable trust, which does have certain advantages. For instance, in Florida, as long as the client is alive, the homestead can qualify for the Florida $50,000 homestead exemption and the 3% cap on increases in value.

However, placing the homestead under a revocable trust also presents a potential danger from creditors. There is one bankruptcy court decision which has indicated that the constitutional protection of homestead from creditors will not apply when the homestead is owned under a revocable trust.

While other bankruptcy court decisions have not found this to be the case, our office generally suggests the more conservative approach of leaving the homestead outside of the revocable trust.

Clients who still wish to avoid probate of their homestead may be able to use a "Lady Bird Deed," which maintains creditor protection while still avoiding probate.

## PROTECTIVE BENEFICIARY TRUSTS

A revocable trust will commonly provide that upon the death of the client the trust assets will divide into separate protective trusts for any children or other beneficiaries. Each child or other beneficiary may serve as sole or Co-Trustee for his or her benefit and receive amounts deemed reasonably appropriate to maintain his or her standard of living as well as to benefit his or her children.

The advantage of such a continuing trust includes protection from:

1) Estate tax at the child's level;

2) Creditor and divorce claims that the child might have in the future, and

3) Inappropriate or risky spending and investments, which may be curtailed by man- dating that the child serve with a Co-Trustee, i.e. a trusted relative, family friend, professional, or trust company.

## REVOCABLE TRUST SYSTEMS FOR MARRIED COUPLES

Revocable trusts for married couples incorporate the above principles, but married couples have a number of configurations to choose from:

## "ALL TO SURVIVOR" JOINT TRUST

The simple "All to Survivor" joint revocable trust. A married couple who would typi- cally own their assets jointly with right of survivorship may prefer to use a revocable trust in order to facilitate avoiding probate upon the second death, and avoiding guardianship over trust assets if a spouse is declared by a court to be competent.

Although most couples who would use right of survivorship as their primary estate plan can simply have assets pass by Will on second death, using an All to Survivor Joint Trust assures that there would be a revocable trust in place after the first death. The All to Survivor Joint Trust eliminates the surviving spouse's need to engage in estate planning and decision- making regarding the use of a revocable trust after the first death.

## NOTE

Clients should be careful to confirm that the joint revocable trust with survivorship can be considered to be a tenancy by the entireties ownership vehicle for the married couple.

Under Florida law joint assets held as tenants by the entireties between a husband and wife are not subject to the creditor claims of an individual spouse unless both spouses owe the creditor. This is a very good reason to keep assets jointly as tenants by the entireties where spouses are creditor exposed.

Most joint revocable trust forms used by lawyers will not qualify the trust assets to be considered as held by tenancy by the entireties, but with proper drafting this can be accom- plished.

**"FIRST DEATH LOCK-UP TRUSTS"**

There are several good reasons that a married couple might wish to have some or all of their assets "locked up" in a protective trust upon the first death, including:

1) Avoidance of federal estate tax upon the second death.

2) Creditor protection for the surviving spouse upon the first death.

3) Securing a Co-Trustee for the surviving spouse to help prevent loss of assets to un- due influence, poor investments, or unwise distributions or loans to friends or family members. The surviving spouse can serve as Co-Trustee with the power to select and replace the other Co-Trustee, and can receive benefits as needed for the spouse and descendants.

The "All to Survivor" Joint Trust described above will not provide these protections. Therefore, the married couple wishing to have the protections provided by a "Lock-Up Trust" may choose one of the following three revocable trust systems:

1) "SEPARATE TRUST FOR EACH SPOUSE" TRUST SYSTEM

2) COMPLEX JOINT TRUST: "JOINT 100% LOCK UP" TRUST SYSTEM

3) COMPLEX JOINT TRUST: "JOINT 50% LOCK-UP" TRUST SYSTEM

These 3 trust systems are described in more detail below.

**"SEPARATE TRUST FOR EACH SPOUSE" TRUST SYSTEM**

Each spouse will have a separate trust that "locks up" upon the first death to benefit the surviving spouse with those assets held by such trust and those assets made payable to the trust by beneficiary designation.

The "Separate Trust for Each Spouse" trust system is the most popular, and traditionally has been the only revocable trust system used by most estate planning lawyers. In this system, a "bypass trust" or "family trust" can be established upon the first death to be held for the surviving spouse without the assets under such trust being subject to federal estate tax, credi- tor claims of the surviving spouse, or claims of future spouses and the descendants of future spouses.

Most of the married couple trust work that our office performs uses the Separate Trust for Each Spouse trust system with separate trusts for each spouse, but there are other alterna- tives.

**"COMPLEX JOINT LOCK-UP" ALL ASSETS**

Clients who may instead be better suited for a "Complex Joint Trust" would typically have one or more of the following characteristics:

1) Clients who prefer a simpler plan with assets under one trust as opposed to two.

2) Clients who wish to "lock up" more than the assets of the first dying spouse upon the first death (which is the case under the Separate Trust for Each Spouse trust sys- tem). The surviving spouse would become Co-Trustee of the trust holding these as- sets. Similar to the Separate Trust for Each Spouse trust system, these assets are held without being subject to federal estate tax, creditor claims of the surviving spouse, or claims of future spouses and the descendants of future spouses.

3) Clients who have had an All to Survivor Joint Trust in the past and do not wish to retitle to separate revocable trusts when updating their planning.

As stated above, clients who elect to have a Complex Joint Trust may choose between a "JOINT 100% LOCK-UP" trust system and a "JOINT 50% LOCK-UP" trust system.

Most wealthy clients who use a revocable trust system choose a "JOINT 100% LOCK-UP" trust system in order to achieve the following:

1. The ability to claim a "stepped up" basis for income tax purposes on all assets held under the joint revocable trust. For example, a stock purchased for $200 that is worth $1,100 with capital gains tax only owed on $100 worth. With a typical joint revocable (ATS) trust there is only a "step up" for half of the value upon death, so the capital gains tax would be based upon the excess of $1,100 over $100 plus $500.
2.
3. The ability to "lock up" as much in assets as possible to avoid estate tax upon the sec- ond death. For example, a married couple with good earnings may have $4,000,000 worth of assets and may wish to lock up a full $3,500,000 worth of assets in a bypass trust upon the first death, with the expectation that the surviving spouse will have future earnings and the possibility that the estate tax exemption will be reduced in the future.

The Joint 100% Lock-Up Trust has special design features that allow the trust assets to be considered for federal income and estate tax purposes to have passed from the first dying spouse into the surviving spouse's trust upon the first death.

This is done by giving each spouse the right to execute a separate document directing how the trust assets would pass if that spouse were to die first. To ensure that the first dying spouse does not appoint assets to somebody other than the surviving spouse or the Joint 100% Lock-Up Trust, the tax law permits the appointment of "Trust Protectors," who have the power to disapprove any exercise of such "power of appointment" by the first dying spouse.

For example, a husband and wife could appoint one or two close family friends or ad- visors as Trust Protectors under the trust. Their sole function would be to have the power to disapprove either spouse's decision to direct assets anywhere besides the Joint 100% Lock-Up Trust or the surviving spouse, unless the surviving spouse also approves of such direction of assets.

The tax law does permit the entire Joint 100% Lock-Up Trust to be held upon the first death for the surviving spouse, without being subject to federal estate tax upon the surviving spouse's death. The tax law is not clear on whether all the assets of the trust receive a "stepped up" basis upon the first death.

Many tax commentators, myself included, believe that all assets inside a revocable trust should receive the "stepped up" basis. But the IRS has disagreed.

**"JOINT 50% LOCK-UP" TRUST SYSTEM**

The other Complex Joint Trust that can be used for estate tax and/or protective trust planning would be the "JOINT 50% LOCK-UP TRUST". This is a simpler document than the Joint 100% Lock-Up Trust, but only allows the lock up to 50% of the assets of the couple upon the first death.

The Joint 50% Lock-Up Trust does provide a "stepped up" income tax basis for the 50% of the assets that are locked up, but there is no stepped up basis for the other 50% of the assets. Under the Joint 50% Lock-Up Trust , the spouse who dies first cannot override the mutually agreed trust document, as he or she could under the Joint 100% Lock-Up Trust system, and therefore the language used in the trust document is not as complicated.

**BE SURE TO CONSIDER MEDICAID ISSUES**

Medicaid planning for a married couple adds one more twist to revocable trust structur- ing. Unfortunately, the Medicaid regulations provide that assets passing by revocable trust into a protective trust for a surviving spouse can qualify, unless such assets have passed through the probate estate of the first dying spouse.

We may therefore suggest to clients who wish to help ensure that their spouse will qual- ify for Medicaid without using trust assets place the assets in their personal names, to pass into a revocable trust system by a "Pour Over Will" upon the first death.

**PLANNING TIPS**

Obviously, revocable trust planning is varied and complex. We hope that this commentary will open up planning opportunities, as well as common configurations, to clients and advisors.

As with most estate planning techniques, "one size does not fit all." It is best to structure a joint trust (or any trust for that matter) that is appropriate for the client's needs and circumstances.

Our office has developed a special kind of joint revocable trust that may facilitate allowing all assets in the trust to receive a higher income tax basis based upon the fair market value of the assets on the date that the first spouse dies. Our article entitled It's Just a JEST, the Joint Exempt Step-Up Trust is as follows and may be of interest to professional advisors and some sophisticated individuals. The JEST trust is certainly not for everyone, but it will be a powerful planning tool for a few Floridians.

A more complicated concept relating to joint trusts involves the consideration of whether the married couple would like to attempt to obtain a new fair market value income tax basis for all joint assets, and the ability to have joint assets benefit the surviving spouse without being subject to federal estate tax on the surviving spouses death.

Unfortunately, the laws are not very clear on this, but professional advisors may be inter- ested in the following article, which describes a new type of joint trust that the author has been involved with designing.

A letter to a client on this subject is as follows:

*Dear Client:*

*I wanted to provide you with an example of how a JEST trust works.*

*Let's say that a husband dies in 2014 leaving everything to his wife, but the wife has the ability to disclaim some portion of what the husband sends her into a trust that can benefit her for her lifetime without being subject to federal estate tax.*

*Let's say that the couple has $20,000,000 worth of assets.*

*If the wife accepts all of the assets and does not disclaim any of them then they will all be subject to federal estate tax on her death.*

*Her estate tax exemption on her death will be based upon her $5,340,000 present exemption, plus increases in the Consumer Price Index taking place after 2014, plus the husband's unused $5,340,000 portability allowance, which does not grow with inflation.*

*If she receives the portability allowance but remarries and her successor spouse dies before her and does not leave her a portability allowance, then the portability allowance left by the husband in our example above completely disappears.*

*Let's say that the client disclaims $3,000,000 worth of assets that will be held for her benefit without being subject to federal estate tax at her death.*

*Let's say that those $3,000,000 worth of assets grow to $7,000,000 in value before she dies.*

*That whole $7,000,000 in value passes without being subject to federal estate tax, and she still has $2,430,000 from her husband's portability allowance, so assuming that she does not remarry, upon her death the amount that passes estate tax free for the assets outside of the $7,000,000 in the trust that is already estate tax free will be based upon $2,340,000, plus whatever the $5,340,000 allowance has grown to.*

*Now, let's say that the wife decides that she will rely upon portability completely but would like to maximize the amount that will be held in a protective trust for her daughter for life, so as to never be subject to estate tax at the daughter's level.*

*She can disclaim up to $5,340,000 worth of the assets that would have been coming over from the husband into the special trust, and the trustees of the special trust can make a "Clayton Q-TIP election" so that those assets will be subject to federal estate tax as if they belong to the wife when she dies, and the wife will have the entire $5,340,000 portability allowance from the husband.*

*The advantage here is that the husband has a $5,340,000 generation skipping tax exemption that enables that amount in assets to be placed into the Clayton Q-TIP trust on the husband's death (after the disclaimer and the Clayton Q-TIP trust election have been made) and if that $5,340,000 grows to $12,000,000 before the wife dies it will nevertheless be able to pass to a trust that can benefit the wife's daughter without being subject to federal estate tax at the daughter's level.*

*So in a situation like yours, if one of you dies, the spouse has the disclaimer option, the using portability option, and the Clayton Q-TIP option.*

*We have added these provisions to your husband's Will as you can see by the attached comparison pages.*

*All of these decisions have to be made within nine months of the first dying spouse's date of death.*

*I hope that this is useful, but please let me know if you need further explanation.*

*Best personal regards,*
*ATTORNEY*

**IT'S JUST A JEST, THE JOINT EXEMPT STEP-UP TRUST**

**By: Alan Gassman, Thomas Ellwanger & Kacie Hohnadell**

**Reprinted with permission from Leimberg Information Services 03-Apr-13 Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2086**

"There are two primary concerns that arise when dealing with joint trusts in non-com- munity property states: 1) whether, upon the first dying spouse's death, all joint trust assets (in- cluding those contributed by the surviving spouse) can be used to a fund a credit shelter trust for the benefit of the surviving spouse without later being included in the surviving spouse's estate, and 2) whether, upon the first dying spouse's death, it is possible to obtain a step-up in basis for all trust assets, no matter which spouse contributed them to the trust.

After extensively researching these issues and reviewing alternative structures, we have designed a joint trust planning technique, entitled the 'Joint Exempt Step-Up Trust (JEST).' The JEST should allow a married couple in a common law state to make maximum use of the first dying spouse's unused estate tax exemption by fully funding a credit shelter trust upon the first dying spouse's death, even if this requires using assets contributed by the surviving spouse. We also believe that with proper structuring the joint trust can provide a full step-up in basis for all of the trust assets.

Although not without risk or some uncertainties clients who want a stepped up basis for all 'joint' assets, and to maximize use of credit shelter trust funding on the first death should have the opportunity to consider this strategy. While the risks herein described do exist, there is also the risk that the family will ask the planner why these techniques were not used to avoid capital gains taxes and facilitate making full use of the first dying spouse's estate tax exemption amount. Practitioners will have to invest significant time to understand issues, to develop trust documents that take the above and many other considerations into account, and make sure that clients understand the risks and possible advantages of the system."

**EXECUTIVE SUMMARY**

Many legal scholars and practitioners have considered whether a married couple liv- ing in a non-community property state can contribute assets to a joint trust, which upon the first spouse's death would be used to fund credit a shelter trust and to facilitate a full step-up in basis. LISI commentators Alan Gassman, Tom Ellwanger and Kacie Hohnadell analyze the many issues that arise with respect to joint trusts and present an innovative joint trust design strategy that can be used to avoid or reduce the issues at hand. In addition to letting members in on this new innovative technique, this letter describes a number of interesting concepts that relate to joint trust planning and also concepts that relate to joint trust planning and its impact upon estate tax, gift tax, and creditor protection objectives.

**FACTS**

There are two primary concerns that arise when dealing with joint trusts in non-commu- nity property states: 1) whether, upon the first dying spouse's death, all joint trust assets (in- cluding those contributed by the surviving spouse) can be used to a fund a credit shelter trust

for the benefit of the surviving spouse without later being included in the surviving spouse's estate, and 2) whether, upon the first dying spouse's death, it is possible to obtain a step-up in basis for all trust assets, no matter which spouse contributed them to the trust.

After extensively researching these issues and reviewing alternative structures, we have designed a joint trust planning technique, entitled the "Joint Exempt Step-Up Trust (JEST)." The JEST should allow a married couple in a common law state to make maximum use of the first dying spouse's unused estate tax exemption by fully funding a credit shelter trust upon the first dying spouse's death, even if this requires using assets contributed by the surviving spouse. We also believe that with proper structuring the joint trust can provide a full step-up in basis for all of the trust assets. This technique is clearly explained in our JEST chart. If you would like to receive a copy of the JEST chart please email agassman@gassmanpa.com.

The basic structure of the JEST is as follows: a married couple funds a jointly-established revocable trust, with each spouse owning a separate equal share in the trust. Either spouse may terminate the trust while both are living, in which case the trustee distributes 50% of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable when the first spouse dies.

Upon that first death, the assets of the first dying spouse's share will be applied this way:

- First, assets equal in value to the first dying spouse's unused estate tax exemption will be used to fund Credit Shelter Trust A for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will escape estate tax liability upon the surviving spouse's death.

- Second, if the first dying spouse's share exceeds his or her unused exemption, then the excess amount of that share will be used to fund Q-TIP Trust A for the benefit of the surviving spouse and descendants. The assets will avoid estate tax because of the marital deduction. They will receive a stepped-up basis on the first dying spouse's death and again on the surviving spouse's death, at which time they will be potentially subjected to estate tax.

If the first dying spouse's share is less than his or her exemption amount, then the surviv- ing spouse's share will be used to fund Credit Shelter Trust B with assets equal to the excess exemption amount. We believe that the assets of Credit Shelter Trust B should avoid estate taxation at the surviving spouse's death although the surviving spouse originally contributed these assets to the JEST.

We also believe that the assets of Credit Shelter Trust B should receive a full stepped-up basis at the first death. IRS opposition on this issue can be expected, at least for the time being, but how this trust is structured may help obtain a favorable result.

Finally, the remainder of the surviving spouse's share (if any) will be used to fund Q-TIP Trust B, under which the surviving spouse will be at least an income beneficiary. We believe

that there is a good chance that these assets will also get a basis step-up if the surviving spouse retains only the right to receive income; again, we think more rights for the surviving spouse will somewhat lessen the chance of that result.

The tax and other issues raised by this technique are further discussed below.

## COMMENT

Over the last 20 years, the IRS has issued four significant rulings touching on joint trust arrangements, three private letter rulings and a TAM.[1]

The first was TAM 9308002, which was issued in 1992. The facts indicated that both spouses funded a joint revocable trust, which granted each spouse a general power of appoint- ment over the entire trust in the form of a right to direct payment of his or her debts and taxes from any of the trust assets. The IRS determined that all trust assets were included in the first dying spouse's estate under IRC Section 2041. However, the IRS ruled that assets contributed by the surviving spouse were in effect gifted to the first dying spouse upon that spouse's death; since those assets passed back to the surviving spouse within one year, those assets could not receive a basis step-up because of IRC Section 1014(e).

PLRs 200101021 and 200210051 addressed the same issues. In both PLRs, married cou- ples formed joint revocable trusts. In one ruling, each spouse had a lifetime power to with- draw the income and principal; in the other, the first to die spouse was given a testamentary general power of appointment over the entire trust. In both rulings, upon the first spouse's death, the assets of the joint trust were used first to fund a credit shelter trust (in the amount of the first dying spouse's unused exemption) for the surviving spouse's benefit. Both PLRs made the following determinations:

1) All of the joint trust assets were included in the first dying spouse's estate. The assets contributed by the first dying spouse were included under IRC Section 2038; the assets contributed by the surviving spouse were included under IRC Section 2041.

2) Upon the death of the first dying spouse, the surviving spouse made a completed gift to the first dying spouse of the assets contributed by the surviving spouse. The gift quali- fied for the gift tax marital deduction.

3) Because of Section 1014(e), only the assets contributed by the first dying spouse could receive a step-up in basis.

PLR 200403094 addressed similar issues in a slightly different context. Rather than a joint trust, the ruling dealt with a revocable trust to be created and funded by a husband. If the wife died first, the trust agreement provided her with a testamentary general power of appoint- ment over trust assets equal in value to her remaining exemption, less her own assets. In that case, the wife will exercise the power by appointing assets to set up a credit shelter trust for the

[1] *See* PLRs 200101021, 200210051, 200403094, and TAM 9308002.

husband's benefit. The IRS ruled as follows:

1) The husband's creation of the power of appointment would constitute a gift to the wife which would be considered completed at her death if she died before him.

The gift from him would qualify for the gift tax marital deduction.

2) If the wife died first, assets contributed by the husband to the trust but appointed by the wife to a credit shelter trust for the husband would not be included in the husband's estate for estate tax purposes at his later death.

No basis issue was discussed.

These rulings sparked renewed interest in using joint trusts as a way to make sure that both estate tax exemptions of a married couple would be fully used, without having to split up assets and set up a living trust for each spouse. Although no ruling allowed a total basis step- up for the marital property at the first death, there was speculation about weaknesses in the IRS arguments on that point and potential ways to rebut those arguments.

However, some commentators have expressed concern about the favorable results of the rulings, none of which has any value as precedent. The estate tax laws at the time of the rul- ings did not give a surviving spouse the benefit of any exemption not used by the first spouse to die—i.e., there was no portability. Thus, the commentators pointed out, the IRS was being lenient in these rulings so as to permit a simpler way to achieve basic estate tax savings. But the IRS was not giving the comfort of a Revenue Ruling which practitioners could rely upon, meaning that it could change its position on some or all of the favorable decisions in the rulings.

After extensively reviewing these issues, we believe that our JEST technique can be used to maximize the use of both spouses' estate tax exemptions, as well as setting up a situation to provide the best possible arguments in favor of getting a total basis step-up on all assets at the first death. Nevertheless, because it is an area without binding precedent, any practitioner should carefully consider the concerns that commentators have raised. Where practitioners (or clients) are particularly risk-averse, thought might be given to getting an IRS ruling.

Using a joint trust arrangement can complicate creditor protection aspects of trusts. Throughout this article we touch on that issue.

Below, we provide an in depth explanation of the "mechanics" of the JEST and discuss the various issues surrounding this technique.

**JEST CREATION**

In implementing the JEST, the married couple first establishes a joint revocable trust. Each spouse will have a separate share consisting of any assets contributed to the trust by that spouse. To avoid having to retitle assets, pre-existing revocable trusts can become separate

shares of the joint revocable trust by amendment and restatement.

The trust agreement will give each spouse an equal share of the trust assets. While both spouses are living, either spouse can revoke the agreement and terminate the trust, in which case the trustee will transfer the trust assets back to the spouses in equal shares.

Unequal funding of the trust raises the possibility of a gift on funding. A spouse who contributes more than 50% of the assets but only has the power to get back 50% in a unilateral termination has presumably made a completed gift of the difference. Transferring property held in a tenancy by the entireties would result in such a gift if, as is generally the case, the tenancy can only be severed by joint action of the parties. The severance occurring when en- tireties property is added to the trust would be a gift by the younger spouse, who has a greater actuarial interest in the property.[2]

Estate planning attorney Michael Mulligan has suggested that any gift on funding is incomplete until the first death, whether or not a spouse can terminate the trust and take back assets. He states that "[u]nder the laws of most states, the retained right to distributions of in- come and principal would cause any contribution by a beneficiary to the trust to remain subject to claims of the beneficiary's creditors. If applicable state law permits a settlor's creditors to reach property conveyed to a trust, such conveyance does not constitute a gift for Federal gift tax purposes."[3]

If a gift on funding does occur, so long as both spouses are U.S. citizens, one might as- sume that the gift tax marital deduction should eliminate tax concerns (unless a spouse is a non- citizen, where the marital deduction does not apply). This is the position the IRS has taken in the rulings. However, as discussed below, questions have been raised by commentators as to whether the IRS is correct in applying the marital deduction in this situation.

Mr. Mulligan's comment as to funding touches on another issue. Holding properties in tenancy by the entireties usually provides creditor protection because the properties can only be reached by creditors with a claim against both spouses. Tenancy by the entireties property transferred into a joint trust will lose the entireties status and this creditor protection unless (1) the joint trust satisfies all unities required by tenancy by the entireties law (which will not be the case with a JEST), or (2) the governing law explicitly provides that trust assets can be desig- nated by a married couple to be treated as tenancy by the entireties property, even if the unities are not satisfied. Delaware, Virginia, Hawaii and Illinois are examples of jurisdictions having such statutes.

2 See IRS Reg. Section 25.2511-2(c). In PLR 200101021, the IRS held that the contribution of tenants by the entireties assets to a joint trust did not constitute a gift by either spouse under this regulation, because each spouse retained the right, acting unilaterally, to revoke his or her transfer and revest title in himself or herself, rendering the gift incomplete. Much as we like the result, we think it ignores the actuarial difference between the interests of the spouses.

3 Michael D. Mulligan, Is It Safe to Use a Power of Appointment in Predeceasing Spouse to Avoid Wasting Applicable Exclusion Amount? 23 Tax Mgmt. Fin. Plan. J (Sept. 18, 2007).

## WHEN THE FIRST DEATH OCCURS

Upon the first dying spouse's death, the joint trust becomes irrevocable. The trust assets are still in two equal shares—one attributable to the first dying spouse, and one attributable to the surviving spouse. We will assume that the first dying spouse has not exercised his or her general power of appointment.

Assets of the first dying spouse's share equal in value to the first dying spouse's unused estate tax exemption will be used to fund Credit Shelter Trust A for the benefit of the surviving spouse and descendants (or surviving spouse, then descendants). If the first dying spouse's share exceeds his or her unused exemption, then the excess amount can be used to fund Q-TIP Trust A for the lifetime benefit of the surviving spouse, and later for the couple's descendants.

All of these assets receive a stepped-up basis at the first death, unless they were gifted to the first dying spouse by the surviving spouse within a year before the first dying spouse's death, when IRC Section 1014(e) denies the step-up.

Turning to the surviving spouse's share, if the first dying spouse's share is less than the first dying spouse's exemption amount, then the surviving spouse's share is used in Credit Shelter Trust B. Like Credit Shelter Trust A, this can be for the benefit of the surviving spouse and descendants (or the surviving spouse, then descendants), although including the spouse as a beneficiary may imperil getting a basis step-up for these assets at the first death.

If there are assets remaining in the surviving spouse's share after fully funding Credit Shelter Trust B, the remainder of the surviving spouse's assets will be used to fund Q-TIP Trust B, with the surviving spouse as lifetime beneficiary and the descendants as remainder benefi- ciaries. Again, the extent of the surviving spouse's interest may affect the basis argument.

The results of this technique are as follows:

## CREDIT SHELTER TRUST A

The assets of Credit Shelter Trust A will be treated as coming from the first dying spouse. They will be included in the first dying spouse's gross estate for estate tax purposes pursuant to IRC Section 2038 because of the first dying spouse's lifetime right to revoke the trust and receive back these assets. These assets are sheltered from estate tax liability at the first death by the first dying spouse's estate tax exemption. Unless the Section 1014(e) one year rule applies, the inclusion of these assets in the first dying spouse's gross estate will provide a stepped-up basis.[4]

A spendthrift provision in Credit Shelter Trust A will provide creditor protection to the surviving spouse because the first dying spouse (rather than the surviving spouse) will be deemed the grantor/transferor of the trust. Increased creditor protection could be provided by

4 PLRs 20010102 & 200210051; see also Mulligan, supra n. iii (stating that "[p]roperty which is contributed by the pre-deceasing spouse and included in such spouse's estate under §§ 2036 and 2038 rather than § 2041 is unaffected by § 1014(e), and acquires a new income tax basis under § 1014(a)"). Of course, Section 1014(e) could apply if the first dying spouse receives the property from the surviving spouse and dies within a year after contributing it to the trust.

limiting the surviving spouse to distributions in the discretion of the trustee according to an "ascertainable standard," such as distributions for health, support, maintenance, and educa- tion. In most jurisdictions, limiting discretionary distributions to the surviving spouse by such a standard prevents creditors of the surviving spouse from being able to reach the trust assets or demand trust distributions.

## Q-TIP TRUST A

Similarly, the assets of Q-TIP Trust A will also be included in the first dying spouse's estate under IRC Section 2038. They will avoid estate tax at that time because of the estate tax marital deduction. These assets will receive a stepped-up basis on the first dying spouse's death unless Section 1014(e) applies. Since the assets remaining at the surviving spouse's death will be includable in the surviving spouse's estate under Section 2044, those assets will receive another basis step-up then.

Even with a spendthrift provision, Q-TIP Trust A cannot provide total creditor protec- tion for the surviving spouse because qualifying for the marital deduction requires that all trust income be paid to that spouse. Creditors will be able to reach the income distributions after they are received by the spouse. However, the principal can be further protected by making principal distributions discretionary and limited by an ascertainable standard.

The trustee can potentially minimize or eliminate the surviving spouse's income expo- sure by investing in low or zero dividend stocks or other cash neutral investments. Of course, this will require implicit consent of the surviving spouse because of the surviving spouse's right to have marital trust assets be productive.[5]

## CREDIT SHELTER TRUST B AND QTIP TRUST B

Let's look at how the first death affects the surviving spouse's share of the JEST.

### *Issue 1: Estate Tax on Credit Shelter Trust B*

Credit Shelter Trust B is designed to use up the first dying spouse's estate tax exemption if the first dying spouse's share of the trust is smaller than that exemption amount. This re- quires having assets from the surviving spouse's share go into Credit Shelter Trust B after hav- ing been includible in the estate of the first dying spouse for estate tax purposes, even though these assets are from the surviving spouse's share of the JEST.

By providing the first dying spouse with a testamentary general power of appointment over all of the trust assets, we make the assets of Credit Shelter Trust B includible in the first dying spouse's estate under IRC Section 2041, as was the case in most of the rulings.[6]

5 Treas. Reg. 20.2056(b)-5(f)(5).

6 The same conclusion was reached in PLR 200210051, where each spouse had the power, to withdraw all of the trust assets while both were living. We do not recommend that approach because it would most likely subject all of the trust assets to creditor claims against either spouse prior to the first death. Otherwise, claims against one spouse should only imperil that spouse's share of the trust.

The rulings to date made clear the IRS's view that with proper drafting, Credit Shelter Trust B would not be considered as funded by the first dying spouse and would not be includ- ible in the gross estate of the surviving spouse, even if the surviving spouse is a beneficiary of that trust.

Risks: Taxable Gift Treatment on Funding of Credit Shelter Trust B and Inclusion in Sur- viving Spouse's Estate

The IRS rulings are promising, but they are not binding on the Service and cannot be cited as precedent. It is certainly possible for the IRS to come to different conclusions in the future.

One concern expressed by Mr. Mulligan is that Section 2041 may not apply to the joint trust assets because the first dying spouse's power of appointment is effectively contingent upon the surviving spouse's failure to withdraw his or her share of the trust assets before the first death. His fear is that the contingency may turn the testamentary power of appointment into a power only exercisable in conjunction with the creator of the power—something which is not considered a general power of appointment under IRC Section 2041(b)(1)(C)(i).[7]

That would mean that assets of the surviving spouse's share could not be applied to use up the first dying spouse's exemption if the first dying spouse's share is insufficient. It opens the door to an argument that the assets in Credit Shelter Trust B are includible in the gross es- tate of the surviving spouse under IRC Sections 2036 and 2038.

According to Mr. Mulligan, the Service could reach the same result by a "conduit" or "step transaction" argument by looking at the entire transaction as one in which the surviving spouse is viewed as the actual contributor of the assets of Credit Shelter Trust B, again trig- gering Sections 2036 and 2038 rather than Section 2041. He cites several cases in which, for example, one party who transferred assets to a second party is deemed to be the actual grantor of a trust created by the second party with those assets.[8]

In the end, however, Mr. Mulligan points out that the lifetime QTIP rules justify ignoring these arguments where spouses are involved. Spouse A can set up a lifetime QTIP for Spouse B

7 Mulligan, supra n. 3

8 Footnote 14 of Mr. Mulligan's article supports this concept by citing the cases of Mahoney v. U.S., 831 F. 2d 641 (6th Cir. 1987); Marshall Estate v. Commissioner, 51 T.C. 696 (1969); Sinclaire Estate v. Commissioner, 13 T.C. 742 (1949); and Schwartz Estate v. Commissioner, 9 T.C. 229 (1947). In each of these cases, the IRS successfully showed that trust assets were included in the beneficiary's estate, even though the beneficiary did not directly contribute the assets to the trust. In Mahoney, a father created a trust for his son's benefit and funded it with stock. The son then executed a promissory note to his father in an amount equal to the stock's value. The son died and the IRS concluded that the trust assets were included in the son's estate because he was the party who in substance transferred assets to the trust by paying consideration to his father at the time the stock was transferred to the trust. Citing to Marshall, Sinclaire, and Schwartz, the court concluded "that although [the father] nominally created the Trust, the decedent must be con- sidered the effective grantor of the Trust to the extent of his contribution." a trust created by the second party with those assets. In Sinclaire, the decedent transferred assets to her father, and her father funded a trust for the decedent using those assets before her death. The Tax Court found that the trust assets were included in the decedent's estate, noting that "in substance and reality decedent was the settlor of the trust and that her father acted only as her agent in its creation."

with Spouse A's assets; the trust can benefit Spouse A after the death of Spouse B; but Sections 2036 and 2038 do not bring the assets back into Spouse A's estate. Apparently inclusion in the estate of Spouse B under Section 2044 "cleanses" the trust assets, so that Spouse B is considered to be the source of them. Mr. Mulligan sees no reason why the same concept should not apply in the joint trust arena.

In their 2008 article, Mitchell Gans, Jonathan Blattmachr and Austin Bramwell share Mr. Mulligan's concern about the step transaction doctrine. They fear that the IRS could determine that the surviving spouse is the transferor of the Credit Shelter Trust B assets, causing inclu- sion under Sections 2036 (if the surviving spouse had the right to receive income from Credit Shelter Trust B) or 2038 (if the surviving spouse has a special power of appointment over the trust). They note that even if the surviving spouse has neither an income interest nor a power of appointment over the trust assets, being merely a discretionary beneficiary, Section 2036 could apply for one of two reasons: (i) the Service could find an "implied understanding" that the surviving spouse would receive distributions from the trust or (ii) the Service could decide that the ability of creditors of the surviving spouse, under state law, to reach assets of the trust because it is considered to be self-settled.[9]

Some planning may be possible to minimize the risk of estate tax inclusion. Perhaps careful drafting can negate an "implied understanding." Drafting to avoid creditors (such as by setting up Credit Shelter Trust B in a jurisdiction which protects self-settled trusts) can be helpful both for tax and non-tax reasons (the non-tax reasons being discussed below).

One could always try to structure the funding of the joint trust to minimize the need for a Credit Shelter Trust B created with assets from the surviving spouse. Of course, this eliminates one advantage of joint trust planning, the ability to ensure full use of both spouses' exemptions without having to split assets up or move them around.

In the end, the PLRs and TAM are a weak bulwark against a later IRS attack on these issues unless there are strong reasons for the IRS to continue to support the same reasoning. Messrs. Gans, Blattmachr, and Bramwell fear that the reasoning in the rulings could invite abuse by taxpayers seeking to overcome the step transaction doctrine in other contexts. Mr. Mulligan seems to feel that the QTIP analogy will continue to support the rulings. Planners forced to con- front this issue and seeking certainty may consider getting rulings of their own.

Two alternative questions can be asked:

1) Does inclusion of Credit Shelter Trust B in the surviving spouse's estate cause a significant problem? If the alternative to a joint trust arrangement would not result in full use of both exemptions anyway, then what is the harm if that aspect of the joint trust arrangement doesn't work?

9 Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim? 42 Real Prop. Prob. & Tr. J. 413 (2007–2008).

2) Is there a way to minimize the harm caused by inclusion?

On the second point, consider the result if Credit Shelter Trust B is structured as a de- fective grantor trust with the surviving spouse as grantor. This might be done by giving the surviving spouse the power to replace Credit Shelter Trust B assets with assets of equal value. The surviving spouse would owe income taxes for trust income left in the trust or distributed to other beneficiaries, and the tax payments would reduce her taxable estate without being considered gifts.

For example, if Credit Shelter Trust B is funded with $2 million worth of assets and the surviving spouse has a $5.25 million estate tax exemption, it would seem that, at worst, the sur- viving spouse would have been deemed to have made a $2 million gift to the trust. If the trust is moved to an asset protection jurisdiction and the spouse does not have a power of appointment over trust assets, all growth in the trust that occurs during the surviving spouse's remaining lifetime can escape federal estate tax, notwithstanding that the trustee may have discretion to make distributions to the surviving spouse.

***Issue 2: Creditor Protection***

Risk: No Creditor Protection from the Surviving Spouse's Creditors

Where an individual transfers assets to a trust for his or her own benefit, the British common law (and most states which follow it) allows the individual's creditors to reach those assets. Just as there is a risk that the surviving spouse may be considered to have transferred assets to the trust for estate tax purposes, there is a risk that the surviving spouse could be considered the transferor of the assets for creditor purposes. This could allow creditors of the surviving spouse to reach the assets of Credit Shelter Trust B if the surviving spouse is the ben- eficiary.

Note that the two issues would arise in different contexts, probably in different legal jurisdictions, and the decisions might not be consistent. Depending on the outcome, the estate tax could take part of Credit Shelter Trust B on the surviving spouse's death, but even worse, creditors could take all of the assets.

The best way to minimize the risk of actual creditors would be to situate the Credit Shelter Trust B in an "asset protection trust jurisdiction" such as Nevada, Alaska, Delaware, or Nevis, where creditor protection is available for self-settled trusts.

An alternative that could help for creditor protection purposes, but not federal estate tax purposes, would be to have the trustee invest in a family LLC or limited partnership to obtain charging order protection so that creditors of the surviving spouse would have a more difficult time obtaining assets from Credit Shelter Trust B. But, just as an IRS determination does not apply to creditors, taking actions which as a practical matter deter creditors by using LLC and limited partnership structures does not prevent the IRS from concluding that creditors of the

surviving spouse can reach into Credit Shelter Trust B, and thereby cause its assets to be con- sidered as owned by the surviving spouse for estate tax purposes.

***Issue 3: Marital Deduction***

Risk: The Gift May Not Qualify for the Marital Deduction

Under our proposed JEST, gift tax consequences may arise at two points in the life of the trust.

First, because each spouse will have individual right, while both spouses are alive, to terminate the trust and receive back half of the assets, a gift would occur upon funding the trust if the spouses do not contribute equal amounts or, in most cases, if the spouses contribute property held as tenants by the entireties. Unless the recipient spouse is not a citizen, the gift tax marital deduction should eliminate any gift tax consequences.

Second, in the rulings, the IRS concluded that upon the first spouse's death, the surviv- ing spouse would make a completed gift to the deceased spouse of the assets that the surviving spouse contributed to the joint trust.[10] This is because as of the first death the surviving spouse relinquishes dominion and control over those assets, either by losing the power to revoke those assets or because the assets are subject to the first dying spouse's testamentary general power of appointment (or, under our suggested arrangement, for both reasons). The rulings go on to conclude that this completed gift by the surviving spouse would qualify for the estate tax marital deduction (assuming the first deceased spouse was a citizen).

Common sense suggests that the IRS is correct on the marital deduction issue. Of course, common sense is not always a reliable guide to the workings of the tax laws. While the IRS rulings don't go into detail on the marital deduction question, the Service must have reached two conclusions:

1) That the gift occurred at a time when the spouses were married, and

2) That the gift did not involve a non-deductible terminable interest.

Reminding us again that this determination has been made in non-binding rulings, the commentators have suggested that these are conclusions the IRS may later abandon.[11]

They point out that whether the gift was made when the spouses were married turns on exactly when it was made. If it was considered made after the moment of death, the parties were not then married, and the marital deduction would not apply. If it was considered made before or at the moment of death, then the first requirement of the deduction is met.

10 See PLRs 200101021, 200210051 & 200403094.

11 Mulligan at 9 et seq.; Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?* 42 Real Prop. Prob. & Tr. J. 413, 422 et seq. (2007–2008).

Messrs. Blattmachr, Gans, and Bramwell take comfort from the authorities dealing with the death of spouses in common disasters.[12] There it has been held that a gift occurs at the moment of death, rather than after death. These commentators opine that "no policy justification exists for refusing to extend this rationale to the [joint trust] strategy."[13]

Messrs. Blattmachr, Gans, and Bramwell also bring up the Ninth Circuit Court of Appeal's 1935 decision in Johnstone v. Commissioner,[14] in which the court suggested that a transfer occurs the moment before death rather than after death. However, their discussion reveals that later cases have cited Johnstone, with the result not always being consistent. On the other hand, Johnstone did not involve spouses, while the simultaneous death authorities do. We believe that practitioners can be fairly confident that the gift at death will be deemed to be made during the marriage.

The terminable interest issue is more problematic. The facts in the rulings show no outright gifts or QTIP election. The question is whether the surviving spouse receives enough rights in the gifted property to satisfy IRC Section 2523(e): a right to receive lifetime income and a general power of appointment over the applicable interest.

In PLR 200210051, each spouse had the right to demand distributions of income and principal while both were living, effectively having a lifetime general power of appointment. In the others, the first spouse to die received only a testamentary general power of appointment with no particular income rights. Under the rulings, the IRS allows a marital deduction, but there is no discussion of the terminable interest issue.

To Messrs. Blattmachr, Gans, and Bramwell, getting the marital deduction would seem to require relying on case law allowing a marital deduction where a spouse may elect whether to accept a gift and does accept it.[15] Finding acceptance here would seem to require that the surviving spouse exercise the testamentary power of appointment. One ruling did involve the exercise of the power; the rest did not. And, these commentators feel that even exercise may not be enough, since the relevant cases all involve spouses who personally accept outright gifts, not just spouses who receive a power of appointment.

Clearly we hope that the IRS will not change its position on the marital deduction issue and will eventually issue a definitive ruling. In the meantime, short of requesting a ruling for each joint trust we prepare, how can we increase our chances of avoiding a marital deduction problem on QTIP TRUST B?

Certainly there is no harm in using language so closely identified with the marital deduction that the Service may grant the deduction without giving the subject much thought. As an example, one of the rulings made the first deceased spouse's testamentary general power of appointment "exercisable alone and in all events." This language added nothing, but it does scream out, "marital deduction!"

12 *Id*. at 422–430.
13 *Id*. at 422–430.
14 76 F.2d 55 (9th Cir. 1935).
15 Gans, Blattmachr and Bramwell at 429.

More substantively useful may be the inclusion of a joint trust provision allowing both spouses to withdraw principal from the trust while both are living, as found in PLR 200210051, which could help bring the gift within the statutory requirements of Section 2523(e).[16] Having Credit Shelter Trust B set up and funded by exercise of the testamentary power of appointment should improve the odds of coming within the case law on gifts made by election.

If all else fails, a savings clause in the trust agreement could provide that should the gift tax marital deduction not apply, Credit Shelter Trust B would be funded only to the extent of the surviving spouse's estate tax exemption (or to an amount slightly less than the surviving spouse's exemption to permit future gifting and a cushion for valuation issues that could apply in later years). That way the surviving spouse could avoid a gift tax on assets going into that trust at the first death. So long as the terms of Credit Shelter Trust B don't subject the remaining assets to estate tax at the second death, the parties should be no worse off than if they had not tried to use a joint trust to protect both exemptions. Of course, description of the contingency could alert the Service to the marital deduction issue if it is not otherwise aware of it.

Stepped-Up Basis

In its rulings, the IRS has denied that the assets of the surviving spouse's share of the joint trust will get an IRC Section 1014(a) basis step-up in non-community property jurisdic- tions at the first death even though the assets are includible in the gross estate of the first dying spouse.

We believe the IRS is wrong. We believe that a basis step-up should be available. The risk to practitioners would seem minimal, since it is confined to not getting a step-up which would not have been otherwise available for clients not living in community property states. Although we expect the Service to continue to contest the issue, we also think there are ways to significantly increase the chances of a successful outcome.

In the rulings, the IRS denied a step-up to assets which, prior to the first death, were in the surviving spouse's share of the trust. The IRS asserted that the step-up was prohibited by IRC Section 1014(e).

Section 1014 generally provides that the basis of property in the hands of a person ac- quiring the property from a decedent, or to whom the property passed from a decedent, is the fair market value of the property at the date of the decedent's death. However, Section 1014(e) provides the following exception to this rule:

> If appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent's death, and the property is acquired from the decedent by, or passes from the decedent to, the donor of such property, the basis of such property in the hands of the donor is the adjusted basis of the property in the hands of the decedent immediately before the death of the dece-

16 Each spouse would seem to have a lifetime general power of appointment, which eliminates the need for income payments to qualify for the marital deduction. *See* Treas. Reg. Section 25.2523(e)-1(f)(6). (Whether each spouse is comfortable with the other spouse having such a power is another question.)

dent.[17] [Emphasis added].

For Section 1014(e) to apply, the property must be "acquired by" or "pass to" to the origi- nal contributor of such property—in this case, the surviving spouse. How does this language apply when the property does not pass directly to the surviving spouse, but instead passes to a trust for the benefit of the surviving spouse? The Service thinks it does, but does not have an explanation. We share the belief of many others that the Service has stretched the literal lan- guage of the law in so concluding. To us, "acquired by" or "pass to" should apply only if full ownership is transferred back to the surviving spouse.

Assets originating with the surviving spouse will wind up in Credit Shelter Trust B or QTIP Trust B. The less interest the surviving spouse has in these trusts, the easier it is to argue that Section 1014(e) should not bar a step-up.

For example, we think it is clear that a step-up should be allowed if the surviving spouse is not a beneficiary of the Credit Shelter Trust B. Of course, economic considerations may require that the surviving spouse be a beneficiary. Some planners have asserted that Section 1014(e) should not apply if the surviving spouse is only a discretionary beneficiary. There have not been any rulings or cases that explicitly confirm this conclusion, but it's difficult to say that property "passed to" or was "acquired by" a discretionary beneficiary, who by definition has no certain rights to the property.

The requirements of the estate tax marital deduction require that the surviving spouse be an income beneficiary of QTIP Trust B. Again, we and others feel that should not bar a step- up; nor should the right to receive principal in the discretion of the trustee, or a special power of appointment. But, the fewer rights the surviving spouse has, the better the argument for a step-up may be.

## CONCLUSION:

The JEST technique eliminates many of the concerns that have prevented estate planners in non community property estates from using joint trusts in the manner approved by the IRS in PLR's 200101021 and 200210051. Although not without risk or some uncertainties clients who want a stepped up basis for all "joint" assets, and to maximize use of credit shelter trust funding on the first death, should be offered this strategy. While the risks herein described do exist, there is also the risk that the family will ask the planner why these techniques were not used to avoid capital gains taxes and facilitate making full use of the first dying spouse's estate tax exemption amount.

Practitioners will have to invest significant time to understand issues, to develop trust documents that take the above and many other considerations into account, and make sure that clients understand the risks and possible advantages of the system. We hope that every law firm reading this article implements at least 23.8 JESTs this year, and we are not jesting!

17 PLR 200101021 (p. 4), PLR 200210051 (p. 4).

In drafting trust agreements, it is important to consider the circumstances under which the trustee may make distributions to the beneficiaries. To help clients decide the best approach for their particular situation, we have prepared the following list of considerations for clients and advisors to take into account when drafting trust documents:

**SPECIAL CLAUSES FOR TRUST AGREEMENTS**

**By: Alan S. Gassman and Christopher J. Denicolo**
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Not all trusts are created equal.

While the trust agreements that we typically prepare for clients have a number of clauses that give instructions to trustees on how and when to determine what income, support, and principal payments should be made to beneficiaries, different clients have different views and preferences. Here is a list of questions and approaches that can be considered in trust design and implementation.

1. Whether to let the beneficiary of a particular trust have a voice as co-trustee or the ability to replace any acting trustee with a licensed trust company or other trustworthy trustee or advisor.

2. Whether to require that the beneficiary would have a prenuptial agreement or a post- nuptial agreement before being able to inherit from a trust or to receive any significant benefits or to have control.

3. Whether there should be a monthly or annual distribution amount guideline that would be presumed to be the maximum that a person should receive, the minimum that a per- son should receive, or a provision that gives a minimum and a maximum that can be changed with the Consumer Price Index.

4. Whether young beneficiaries should be required to finish a four year degree, a post-undergraduate degree, work full time, have a profession, or be a full time homemaker with children before being able to receive any significant benefits.

5. Whether a beneficiary should have an "incentive clause" where the trust would pay minimal benefits except to match W-2 or other professional or entrepreneurial earnings or pay an hourly rate based upon actual hours worked by the beneficiary in any notable endeavor.

6. Whether individuals who may have tendencies towards alcoholism, drug abuse, gam- bling problems, or other addictions should have separate guidelines and standards.

7. Whether any spouse or a long time spouse should have the ability to be:

(a) Added as a beneficiary after a certain number of years of consecutive marriage;

(b) To serve as a trustee for the benefit of descendants if that spouse will not be a beneficiary (or if he or she will).

8. Whether the beneficiary should have the power to appoint some portion of the assets upon death to a class of persons, or entities, which can include your descendants, or certain qualified charitable organizations.

9. Whether the beneficiary should have a power to appoint some portion of the assets upon death to a trust that could benefit the long term spouse and would then eventually be devised to the descendants upon his or her death, or upon his or her re-marriage.

10. Whether a beneficiary will be able to receive a percentage or other specified portion of the trust assets for use in business, or entrepreneurial endeavors if the Trustee deems appropriate.

11. Whether a Trust Protector Committee should be appointed, with the power to change the trust language or to direct the trustees as to certain matters or parameters. This is also known as a "King Solomon Clause."