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Trusts

Linda Kotis of Ivins, Phillips & Barker illustrates how creation of a ''first-to-die trust'' can mitigate concerns about the inheritances of adult children on a parent's second marriage. The donor parent can use an inter vivos irrevocable trust to benefit the new spouse and protect his or her children at the same time, by giving the children a share of the trust when the first spouse dies, Kotis writes. She looks at estate tax and other benefits of such a plan, as well as considerations for implementation.

Reassuring the Reluctant Giver, or the First-to-Die Trust: How the Spouse In a Second Marriage Can Make a Lifetime Gift and Still Keep Control

BY LINDA KOTIS

A parent's second marriage can raise concerns for his or her adult children. They may fear that their inheritance is at risk—their father or mother could decide to include the new spouse in his or her will. Or the new spouse could persuade the parent to leave his or her estate to the new spouse's kids at peril to the parent's own family.

The creation of a ''first-to-die trust'' is a technique for mitigating these concerns. The parent (the donor) could fund an inter vivos irrevocable trust for the new spouse and protect his or her children at the same time, by giving the children a share of the trust when the first spouse dies. Or the children could have some rights to income or principal, even before the first spouse's death.

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But then the donor has to face the fear of parting with control of assets he or she might need or want. The trust could be set up so the donor could still have direct access to trust property during his or her lifetime, through loans and repurchase of assets from the trust. Indirect access would be available through distributions made to the new spouse.

While there is a reduced likelihood of incurring a federal estate tax for most couples due to increased exclusion amounts, the first-to-die trust is timely in offering opportunities for:

- reducing liability for both federal and state estate tax;
- basis planning with the donor's assets;
- using the remaining estate tax exemption of the donor's first spouse; and
- removing appreciation from the estate.

The first part of this article gives an overview of a trust created for a hypothetical couple. The next section illustrates the estate tax benefits of the plan, then other benefits are addressed. Finally, the article touches on implementation of the plan and families best suited for the plan.

The Plan and Its Components

Overview

The first-to-die trust is similar to a strategy sometimes recommended by estate planners: An individual creates a trust that provides his or her spouse with income and distributions of principal in the discretion of the trustees. When the spouse dies, whatever principal remains passes to the children of the individual who created the trust. The donor achieves several goals—he or she provides for family members, transfers wealth out of his or her estate, and creates tax savings.

What makes the first-to-die trust different is that the donor's children don't have to wait for the spouse to die to benefit from the trust. Let us take a look at how the plan might work.

The Family

Samantha (age 62) lost her first husband Darrin in January 2013. She met Rob (age 59), six months after her husband's death; Rob had recently lost his wife, Laura. Samantha and Rob married a year later, in June 2014, and moved to the District of Columbia. Samantha has two grown children, Tabitha (age 35) and Adam (age 32). Rob has an adult son, Ritchie (age 27).

Samantha is the wealthier spouse, with $10 million in assets. Rob has about $4 million in his own name. Samantha is considering transferring $4 million to an irrevocable trust for Rob.

Trust Provisions

Rob would receive income distributions for health, education, maintenance and support (HEMS). Rob could serve as trustee. He could appoint an independent trustee, such as a family friend or trust company, to make discretionary distributions of principal. The accompanying diagram shows the setup of the trust.

Division on Death of Either Spouse

If Samantha dies before Rob, the trust could be split into two separate shares. One share would remain in trust for Rob and the other share would pass to Samantha's kids, either outright or in trust. When Rob later dies, the assets left in his trust could pass to his son, Ritchie. Or, instead, his share could be added to shares previously distributed to Tabitha and Adam.

If Rob is the one who dies first, then all remaining assets would pass to Tabitha and Adam.

And there are other options. One would be a trust provision to give a limited power of appointment to Rob. So, if Rob dies first, he could appoint the remaining assets in favor of the descendants of Samantha's parents, to a trust created under the original agreement. Because this class of descendants includes Samantha, she could come in as the beneficiary until her death. When she dies, Adam and Tabitha would receive the remainder of her trust.

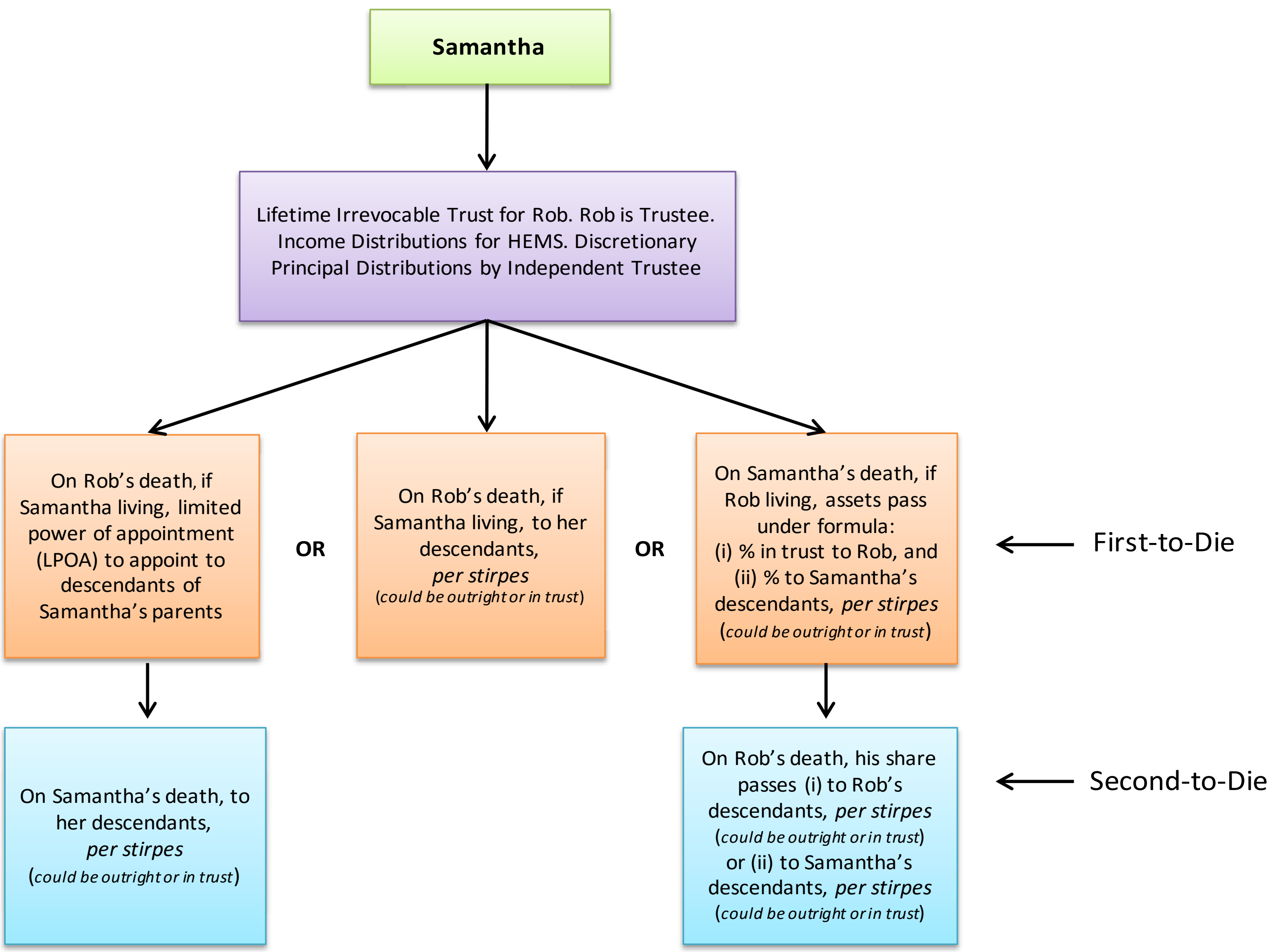

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Table 1: Comparison of Federal, State Estate Tax Liability for Lifetime Gift

	Exemption Amount Used	Federal Estate Tax	State Estate Tax	Total Estate Tax
$10 Million Taxable Estate	$5,450,000	$1,402,400	$1,044,000	$2,446,400
$6 Million Taxable Estate w/$4 Million Lifetime Gift	$5,450,000	$1,626,400	$484,000	$2,110,400
Tax Savings w/Lifetime Gift & Using Exemption During Life	N/A	($224,000)	$560,000	$336,000

Protections for Children and Donor

There are ways to protect the children's future interests. For example, instead of the HEMS standard and giving Rob access to discretionary principal distributions, the trust could be an all-income trust with the power to convert to a unitrust (a trust that pays a certain fixed percentage of the trust's net fair market value on an annual basis).[1]

Or, the trust could have a provision for distributions to Tabitha and Adam while Rob is still alive, such as:

- a discretionary distribution each year;
- a unitrust interest; or
- an annual exclusion gift ($14,000 in 2016).[2]

There are also options for protecting Samantha, if her financial resources become strained. The trustees could have discretion to reduce or postpone distributions to Tabitha and Adam, as they determine to be in Rob's best interests. This would preserve principal available to generate income, make loans to Samantha or provide for distributions that Rob could use for Samantha's benefit as well, as discussed later in this article.

Tax Benefits of the Plan

Estate Tax Savings

Samantha's transfer to a trust for Rob removes assets from her estate. This could reduce her tax liability, because she is likely to have a federal taxable estate at death.

Every person has a unified credit against gift tax otherwise due on a gift during his or her lifetime. Gift tax and estate tax are calculated using the same unified table, using a series of graduated rates beginning at 18 percent.[3]

If any of Samantha's basic exclusion amount is left, that is, the amount of the federal estate tax exemption available to shield her estate from federal estate tax, it will be applied to the gift.[4] If she uses part of her gift tax exemption during her lifetime, then the estate tax exemption left for use at her death is reduced by the amount applied to the lifetime gift. If Samantha has made previous gifts and has no exemption left, then she must pay gift tax.

State Tax Savings

As mentioned previously, Samantha and Rob live in the District of Columbia. Any plan to remove assets from Samantha's estate during her lifetime could mean escaping some portion of a hefty state estate tax liability. Granted, D.C. has an estate tax exemption amount. But at the present time, the exemption is $1 million,[5] less than the basic exclusion amount. This gap means that more of Samantha's estate is subject to state tax than it is to federal tax.[6]

And this benefit, a lesser burden on Samantha's estate from state estate tax, isn't just limited to estates in D.C. Other states impose a state estate tax or inheritance tax.[7] On the other hand, most states, even those with state estate tax, don't impose gift tax on lifetime gifts.[8] So transfers during one's lifetime don't require either the payment of a state gift tax or use up any state estate tax exemption.

Table 1 illustrates how Samantha's estate is affected if she dies without making a gift during her lifetime versus the taxes due at death after a lifetime gift was made. Assume that her basic exclusion amount is $5.45 million and there were no prior gifts.

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[1] See the Delaware Code for a definition of unitrust at Tit. 12, Del. Code Section 61-106.

[2] Section 2503(b) of the Internal Revenue Code; Rev. Proc. 2015-53.

[3] I.R.C. Section 2001(c).

[4] I.R.C. Section 2010(c)(3).

[5] D.C. Code Section 47-3702(a-1)(1) states:

> (a-1) A tax is imposed on the taxable estate of every resident decedent dying after December 31, 2015, as follows:
> (1) The rate of tax shall be 16%; except, that the portion of the taxable estate that does not exceed the current zero bracket amount shall be taxed at 0%, and if the taxable estate exceeds the zero bracket amount, the following tax rates shall be applied to the incremental values of the taxable estate above the zero bracket amount:
> (A) The rate of tax on the taxable estate over $1 million but not over $1.5 million shall be 6.4%; . . . .

[6] D.C. estate tax applies only to the value of the estate above the state exemption threshold amount. This hasn't always been the case in the District. Until the law was amended in 2015, under the D.C. tax regime estate tax liability began on the first dollar of the estate, including the exemption amount, once it was determined that a decedent had a taxable estate, not on the amount above the exemption.

[7] In addition to the District of Columbia, these states impose a state estate or inheritance tax: Connecticut, Delaware, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oregon, Rhode Island, Vermont and Washington. See The American College of Trust and Estate Counsel 2016 State Death Tax Chart (Revised May 14, 2016), http://www.actec.org/resources/state-death-tax-chart.

[8] According to Joel Michael, legislative analyst, Minnesota House, Connecticut is the only state that imposes a true gift tax. See Information Brief, Survey of State Estate, Inheritance, and Gift Taxes (Updated December 2015), http://www.house.leg.state.mn.us/hrd/pubs/estatesurv.pdf.

Table 2: Comparison of Federal, State Estate Tax Liability With Gift, Using DSUE

	Exemption Amount Used	Federal Estate Tax	State Estate Tax	Total Estate Tax
$10 Million Taxable Estate	$9,175,000	$0	$1,044,000	$1,044,000
$6 Million Taxable Estate w/$4 Million Lifetime Gift	$9,175,000	$136,400	$484,000	$620,000
Tax Savings w/Lifetime Gift & Using Exemption During Life	N/A	($136,400)	$560,000	$423,600

Table 1 shows that by removing $4 million from her estate, Samantha would lower her state estate tax liability by $560,000. Note that reducing her state tax liability would affect her federal liability by decreasing the deduction for the state death tax. Even so, she would still have an overall tax savings of $336,000.

Therefore, Samantha's use of her basic exclusion amount during her lifetime would go further than applying it at death. Her savings on state estate tax liability would be enhanced by tax savings on appreciated assets no longer in her estate, as discussed later.

Use of DSUE

There may be more opportunities to save estate taxes. Let us assume Samantha's husband Darrin died with an estate worth $1.5 million and that part of his basic exclusion amount was used to reduce his federal tax liability to zero. In 2013, the basic exclusion amount was $5.25 million.[9] The remaining amount of Darrin's exemption, the deceased spousal unused exemption (DSUE),[10] is therefore $3.725 million.

On Darrin's estate tax return, his executor elected portability of his remaining exemption amount.[11] This means that Samantha as Darrin's surviving spouse could use the DSUE during her lifetime to shelter gifts that would otherwise be taxable.[12] DSUE not used during Samantha's lifetime may be used on her death. She receives the benefit of $3.725 million plus $5.45 million (current basic exclusion amount in 2016).[13]

The total of the DSUE and her basic exclusion amount is her applicable exclusion amount (AEA).[14]

Table 2 illustrates how DSUE would apply to a lifetime gift or at death. Samantha's AEA is $9.175 million, an increase of 40 percent over her federal exemption amount alone.

If Samantha uses her DSUE at death, there is a state estate tax liability of $1,044,000 on the $10 million estate. No federal estate tax is due because the deduction for state estate tax reduces the federal taxable estate (the tentative tax base) to $8,956,000 ($10,000,000 – $1,044,000), an amount below the AEA of $9,175,000.

If Samantha makes a $4 million lifetime gift and uses part of her DSUE, she reduces her D.C. tax liability by $560,000. As in Table 1, reducing her D.C. tax liability decreases the deduction for the state death tax. In this example, the decreased deduction causes her to have to pay federal estate tax. But again, she still has an overall tax savings of $423,600.

Most Recently Deceased Spouse

Samantha could choose to use the DSUE during life or at death. This is the case as long as she predeceases Rob. If, however, Rob dies first, Samantha inherits Rob's remaining exemption amount.

Any unused portion of Darrin's DSUE will expire. This is because the portability of the deceased spouse's exemption is available only with respect to the most recently deceased spouse.[15] If Rob uses most of his estate tax exemption amount to pass some or all of his estate to Ritchie, then the amount of DSUE Samantha inherits from Rob could be far less than the amount inherited from her late husband Darrin.

Samantha could choose to use the DSUE during life or at death, as long as she predeceases Rob.

Note that if Samantha does use up Darrin's DSUE on her lifetime gifts, and she survives Rob, then she still might come out ahead when Rob dies. This would be the case if Rob has any remaining exemption amount and his executor has elected portability.

This is another reason it makes sense for Samantha to give away assets during her lifetime—to ensure she uses as much as possible of Darrin's DSUE, and to maximize the use of Rob's DSUE if she survives him. It also provides even more tax savings than the scenario shown in Table 1 above.

Other Benefits of the Plan

Asset Freeze

The plan ''freezes'' asset value on the date of the gift for purposes of estate tax. Any appreciation in the assets is tax free. Table 3 illustrates the appreciation removed from Samantha's estate by making the $4 million lifetime gift, and the resulting estate tax savings. This example assumes a growth rate of 5 percent per year over 10 years.

So even for the couple who lives in a state with no state estate tax, they still benefit by getting assets out of the estate.

[9] Rev. Proc. 2013-15, Section 2.13.
[10] I.R.C. Section 2010(c)(4); Treas. Reg. Section 20.2010-1(d)(4).
[11] I.R.C. Section 2010(c)(5)(A).
[12] Treas. Reg. Section 25.2505-2(a), (b).
[13] Rev Proc. 2015-53, Section 3.33.
[14] I.R.C. Section 2010(c)(2).
[15] Treas. Reg. Section 20.2010-1(d)(5). The identity of the last deceased spouse is unchanged by a subsequent marriage with respect to using DSUE for a lifetime gift while the new spouse is living. See Treas. Reg. Section 25.2505-2(a)(3).

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Table 3: Asset Appreciation and Estate Tax Savings on Appreciation

	Appreciation at 5% for 10 years	Appreciation on Removed Assets	Federal Tax Savings on Appreciation	State Tax Savings on Appreciation
$4 Million Out of Estate	$6,515,579	$2,515,579	$908,283	$109,371

Total Estate Tax Savings: $1,017,654

Asset Preservation

The irrevocable trust could be used as a vehicle to ''park'' some kinds of assets. For example, some marketable securities may not generate much income. Therefore, unless those securities are distributed in kind or sold by the trust to generate income, they could be preserved as investments available to the donor's children.

Donor Benefits

Any income or principal distributions to Rob are indirectly available to Samantha as well. Rob could use the distributions for the couple's household costs, mortgage payments, vacations or other expenses Samantha might have paid if the assets had still been held in her own name.

Grantor Trust Powers

The trust would be a grantor trust as to income because Samantha's husband is a beneficiary.[16] Samantha could also be given certain grantor trust powers. She could buy assets from the trust. She could take out loans from the trust or make loans to the trust. She could swap out assets. All of this without generating taxable income for her or causing inclusion in her estate.[17]

Basis Planning

Samantha could swap high-basis assets held outside the trust for low-basis assets held inside the trust. This provides two benefits.

First, this would ensure that the low-basis assets would be included in her estate and therefore receive a step-up in basis on Samantha's death. When an heir of her estate receives those low-basis assets and then later sells them, the heir will recognize less gain on the sale.

Second, this would benefit the beneficiaries of the trust. Assets owned by the trust won't receive a step-up in basis on Samantha's death. So when the substituted assets are sold, their basis will be higher than that of the assets originally contributed to the trust. Therefore, there will be less gain.

Income Tax Payments

Being a grantor trust means that Samantha is treated as still owning the trust assets for income tax purposes.[18] This allows her to pay income tax on the trust even though she receives no income. Therefore, her payment can be thought of as an additional gift to the trust.

Alternatively, the trust could include a provision allowing the trustees to reimburse her for paying income taxes. This won't cause trust assets to be included in Samantha's estate, if:

- the trustee is given discretion but isn't required to reimburse for taxes paid; and
- her creditors can't reach trust assets due to that provision.[19]

Another option is to make a distribution to Rob that he can then use for the couple's joint income tax liability.

Implementing the Plan

Candidates for the Plan

Who are good candidates for the plan? A husband or wife in a second marriage whose assets exceed the federal estate tax exemption amount, and who has assets suitable for transfer to an irrevocable trust. That means, for example, a spouse with a large number of retirement accounts may not be the ideal donor.

Also, if the donor has used up his or her exemption on other lifetime gifts and has to pay gift tax, he or she should be expected to live at least three years after the transfer. Otherwise, the gifts and the gift tax paid will be included back in the taxable estate.[20]

Who are great candidates for the plan? Same as above, plus one or both spouses have DSUE.

Reassuring Clients

How does the planner address a client's reservations? The donor can be reassured that putting his or her assets in trust doesn't preclude access, either directly or indirectly. Loans to the donor, if needed, provide direct access. Because the donor is part of the marital couple, funds distributed to the spouse are indirectly available as well, when the spouse uses them for the benefit of both parties.

And by directing a portion of remaining principal to his or her children on the death of the first spouse, the donor will know that, regardless of which spouse survives the other, assets won't be completely exhausted and something will be left for his or her children. In effect, by relinquishing some control now, the donor can actually gain more control throughout his or her lifetime and after death.

Conclusion

Dealing with a blended family isn't always easy. Even in an amicable situation, family members may harbor

[16] I.R.C. Section 677(a)(1).
[17] I.R.C. Section 675.
[18] I.R.C. Section 671; Treas. Reg. Section 1.671-1.
[19] Rev. Rul. 2004-64.
[20] I.R.C. Section 2035(b).

underlying concerns about a stepparent's access to what adult children view as rightfully theirs. For the spouse who wants to share his or her wealth with both the new mate as well as his or her own children and has sufficient means to do so, an irrevocable trust with a ''first-to-die'' provision will allow her children to benefit regardless of the order of the spouses' deaths. Also, terms could be included to give the children some rights to current income or principal even before the first spouse's death.

This trust structure may work especially well for those who risk a large state estate tax liability or have some amount of DSUE to use on lifetime gifts. And, it is worth considering for all who wish to preserve assets for their children while still sharing a portion of wealth with the second spouse.

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