

**BRAVE NEW WORLD
OF
ESTATE PLANNING**

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by

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*“Reports of my death are greatly exaggerated.”
--Mark Twain*

INTRODUCTION

The reunification of the gift, estate and generation-skipping transfer taxes, the increased applicable exemption amounts and the availability of portability of unused exemption have opened up an entirely new world of tax planning opportunities for modest estates (\$10.9 million or less for a couple). At what top planners are referring to as the intersection of estate and income tax, many practitioners are finding their new focus to be tax basis management and overall tax minimization.

In addition to shifting the tax planning aspect of estate planning, the portability of exemption and hugely increased applicable exemption have skewed older estate plans designed when the exemption was lower. Clients expected a certain proportionate division among beneficiaries. Such critical decisions as the amount grandchildren will receive in proportion to what children will receive and, in multiple marriage situations, the amount the surviving spouse will receive compared to what children of a client’s prior marriage will receive all need to be revisited.

I have always asked clients how they would design their estate plans if estate taxes weren’t an issue. Now, minimizing transfer taxes is no longer an issue for most clients. Conversations are about how to obtain a stepped-up basis on the death of the second spouse to die while still effecting the clients’ non-tax goals.

| Year | Exclusion Amount | Max/Top tax rate |
|-------------|-------------------------|-------------------------|
| 2001 | \$675,000 | 55% |
| 2002 | \$1 million | 50% |
| 2003 | \$1 million | 49% |
| 2004 | \$1.5 million | 48% |
| 2005 | \$1.5 million | 47% |
| 2006 | \$2 million | 46% |
| 2007 | \$2 million | 45% |
| 2008 | \$2 million | 45% |
| 2009 | \$3.5 million | 45% |
| 2010 | Repealed | |
| 2011 | \$5 million | 35% |

| Year | Exclusion Amount | Max/Top tax rate |
|------|------------------|------------------|
| 2012 | \$5.12 million | 35% |
| 2013 | \$5.25 million | 40% |
| 2014 | \$5.34 million | 40% |
| 2015 | \$5.43 million | 40% |
| 2016 | \$5.45 million | 40% |

I. Setting the Tax Stage

A. **Estate Tax**: Effectively repealed for most clients. In 2016, 99.9% of the estates of Americans will not pay any estate taxes.

B. Capital Gains Tax:

| | | |
|----|---|--------------|
| 1. | Federal | |
| | a. Long term capital gains | 20% |
| | b. Tax on net investment income (joint income of \$250,000+) | 3.8% |
| 2. | California top bracket | <u>13.3%</u> |
| 3. | Capital gains tax on realized long-term gains | <u>37.1%</u> |
| 4. | For collectibles, add 8% (28% total) | 45.1% |

C. Taxes on Ordinary Income:

| | | |
|----|---|--------------|
| 1. | Individuals | |
| | a. Federal tax bracket (income over \$466,950 for couples filing joint) | 39.6% |
| | b. California | <u>13.3%</u> |
| | | <u>52.9%</u> |
| 2. | Trusts/estates | |
| | a. Federal (excess over \$12,400) | 39.6% |
| | b. California | <u>13.3%</u> |
| | | <u>52.9%</u> |

II. Setting the Personal Stage

A. Long-term Marriages.

1. Are children all of this marriage?

2. Are clients close in age and health?

B. Shorter term Marriages.

1. Are there children of prior marriages?
2. Is one spouse substantially younger than the other?
3. Are all assets separate property?
4. How does spouse #2, 3, 4, etc. get along with client's children?

III. Should We Bypass the Bypass Trust?

A. Non-Tax Considerations.

1. Long-Term Marriage.

- a. Children?
- b. Spousal capacity?
- c. Rapacious caregivers?
- d. Financial literacy?

2. Shorter Term Marriage.

- a. In California, 60% of all marriages end in divorce.
- b. In the U.S., 50% of first marriages, 67% of second marriages and 73% of third marriages end in divorce.
- c. The vast majority of children are born of first marriages.
- d. If client's current spouse is close in age to client's children, watch out for vulture syndrome, King Lear symptoms and increased isolation by new spouse.

B. Benefits of a Bypass Trust.

1. No estate tax benefit in most cases.
2. No income tax downside until the second death if ordinary income and realized capital gains are annually distributed to beneficiaries.
3. Generation-skipping transfer tax exemption is not portable. Bypass Trust allows full use of both spouse's GSTT exemptions. A QTIP

trust also allows full use of GSTT exemptions if a reverse QTIP election is made.

4. Protection from predators.
5. Lock in for children of current or prior marriage.

C. Planning Flexibility.

1. Survivor can have testamentary limited power of appointment.
2. Survivor's access to income and principal can be cut off upon remarriage if desired.

D. Why Bypass the Bypass?

1. Less complicated.
2. Less confusing for surviving spouse.
3. Lower ongoing administrative costs.
4. No step-up in basis on second spouse's death.

IV. Alternatives to a Bypass Trust

A. Portability of Exemption.

1. Considerations in deciding whether to rely on portability.
2. Timing: 15 months.
3. What gets appraised.
4. Who pays costs of return preparation?

B. Disclaimers.

1. Timing: 9 months.
2. Acceptance of Benefits.
3. Family situation.
4. Loss of flexibility – survivor cannot have limited power of appointment.
5. No step-up on second death.

C. Partial QTIP Elections.

1. Children can't be beneficiaries.
2. Step-up on second death.
3. Can cut off access to principal on surviving spouse's remarriage.
4. Does not jeopardize marital deduction as long as spouse is only beneficiary, receives all of the income at least annually and can direct that property be productive of income.

D. The Clayton QTIP.

1. Nonelected marital trust can have different provisions from QTIP elected portion. Can be sprinkle trust for spouse and children.
2. Principal distributions to surviving spouse can be cut off.
3. Children can continue to receive financial help without using gift tax exemption of surviving spouse.
4. Does not jeopardize marital deduction. Elected QTIP still passes from deceased spouse.

V. Step-Up in Basis

A. Guidance for the executor or trustee.

1. Expressly state that the goal is to obtain a stepped-up basis on the second death.
2. Use a trust without a Bypass Trust and give trustee guidance on partial QTIP election, Clayton QTIP and portability.

B. Using independent trustees or special trustees to grant general powers of appointment.

1. Obtain step-up by causing inclusion in surviving spouse's estate.
2. Use formula as to scope?

C. Delaware "tax trap" planning.

1. Trap arose when Delaware repealed the rule against perpetuities.
2. Holder of limited power of appointment exercises that power to:

- a. Create a second trust which includes a second limited power, and
 - b. Second limited power can, under local law, be validly exercised to postpone vesting for a period ascertainable without regard to date of creation of original power.
3. Causes estate tax inclusion for holder of the initial limited power of appointment if that initial limited power is so exercised.
 4. Availability of testamentary exercise provides flexibility to get stepped up basis in estate of holder of that power.
- D. Family considerations and potential conflicts of interest.

VI. **GST Planning**

- A. Review testamentary formula-funded GST trusts for children and grandchildren.
- B. Nonexempt outright, with exempt in trust for life: staying in sync with client goals.
- C. Reverse QTIP election.

VII. **Incapacity of Either Spouse**

- A. Generally, both spouses must join in amending revocable trusts.
- B. Options:
 1. Other spouse as attorney-in-fact under Durable Power of Attorney.
 2. Substituted judgment petition.
 3. Petition under Probate Code Sec. 3100.
 4. Always easiest when remainder beneficiaries are the same for the Bypass Trust and the Survivor's Trust and surviving spouse is unlikely to change that.
 5. More complicated if there are children of prior marriages and/or those beneficiaries of Bypass Trust have difficult relationship with surviving spouse.
- C. **Modification by Attorney-in-fact.**
 1. Does attorney-in-fact have the power to create, modify, revoke or terminate a trust established by the principal?

2. Does trust also allow such actions by attorney-in-fact?
3. No court filing or remainder beneficiary consents needed, but best practice is to obtain consent of remainder beneficiaries.

D. Substituted Judgment Petition.

1. If incapacitated spouse is a conservatee, the conservator or another interested party can petition for modification of trust. This only works when trust provisions do not expressly limit the powers of amendment to actions by husband and wife together while both have capacity.
2. All beneficiaries of the trust and heirs at law must be given notice of substituted judgment petition.
3. The petition should advise the court that:
 - a. Complex estate planning isn't necessary given size of estate,
 - b. Creation and administration of Bypass Trust would be burdensome, and
 - c. Step-up on second death will potentially reduce liability of remainder beneficiaries for long-term capital gains taxes.

E. Petition Under Probate Code Section 3100.

1. If one spouse is incapacitated but not a conservatee, and other spouse has capacity or is a conservatee, can seek court approval of proposed action under P.C. Section 3101(k).
2. Probate Code Section 3102 provides for court approval of an amendment, modification or termination of a trust.