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The Marital Step-Up Trust™

A Fundamental Shift in How an
Estate Plan Should be designed

By

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Introduction

For the past 12 years, effective estate planning, especially Federal Estate Tax planning, has been subject to tremendous uncertainty and change. Congress established a Federal Estate Tax in 1918 and has imposed varying rates of taxes on different estate sizes ever since. Federal Estate Taxes were scheduled to be repealed over a ten-year period as a result of the passage of the so-called "Bush Tax Cuts" in 2001. However, the permanency of those changes required ratification by a future Congress. For a variety of reasons (i.e., the terrorist attacks of 9/11, Hurricane Katrina, wars in Afghanistan and Iraq, the change of control of Congress in 2006, and the economic downturn beginning in 2007), the permanent repeal of these Federal Estate Taxes never occurred. Without any action, estate and gift tax rates were scheduled to increase in 2011 to 55% on estates and/or gifts of $1 million or more.

At the end of 2010, Congress and the President made two significant, but temporary, changes to the estate tax regime. First, they increased the gift and estate tax exemption to $5 million per person. Second, they created a new concept called Portability, which essentially allows a surviving spouse to utilize the unused estate and gift tax credit of a deceased spouse. Both of these changes were set to expire at the end of 2012. As part of the fiscal cliff negotiations that culminated at the end of 2012, both of these changes were made permanent.

Traditional Planning

Virtually all current estate plans were designed to take advantage of the laws as they existed before 2011. Although estate planners use a whole host of different terminology (ABC Trusts, Credit Shelter Trusts, Family and Marital Trusts, Marital Bypass Trusts), when it comes to estate taxes virtually all estate plans had the same two basic objectives. The first was to ensure that there were no estate taxes due at the death of the first spouse to die. The second was to attempt to transfer as much value as possible at the death of both spouses with the least amount of estate tax.

In order to accomplish these two objectives, it was important to attempt to ensure each spouse had sufficient assets titled in each's name so that each spouse could take full advantage of his or her credit. It also required the use of an irrevocable trust established at the death of the first spouse which held the deceased spouse's assets up to the credit available against the tax. For example, if a husband and wife had $2 million in assets, the traditional estate plan was to put half of those assets in separate trusts for each spouse (or a joint trust which was essentially divided in half) so that upon the death of a spouse, his or her credit could be used against those assets and would ultimately not be included in the surviving spouse's estate for estate tax purposes. This strategy was primarily designed to double what a married couple could pass without estate tax.

What Changed

At the end of 2012, three important changes occurred. First, the Federal Estate Tax exemption was dramatically increased. Second, Portability (described below) was made permanent and became a huge potential estate tax planning tool. Third, Congress increased

income tax rates and reduced the benefits of itemized deductions and personal exemptions. In other words, Federal Estate Taxes became a significantly smaller issue for the vast majority of Americans while at the same time income taxes became a much bigger issue, especially for individuals inheriting appreciated assets.

Portability

The best way to understand why Portability was created is through an example. Suppose a couple collectively had $10.68 million in assets, but $9.68 million was titled in one spouse's name and $1 million was titled in the other spouse's name. Each of them establish a trust and place their respective assets in each spouse's trust. Then let's suppose the spouse with $9.34 million died first at a time when the credit against estate taxes is $5.34 million (i.e., the exemption in 2015). Using the traditional estate planning model, the first $5.34 million would go into a Family Trust for the benefit of the surviving spouse and children and would use the surviving spouse's credit against the estate tax. The remaining amount would go into a Marital Trust for the benefit of the surviving spouse alone and would be designed to ultimately be included in the surviving spouse's estate for estate tax purposes. Upon the death of the second spouse, assuming no growth on the assets, said estate would comprised of the $1 million in a separate trust and $5.34 million in the Marital Trust created by their deceased spouse. Accordingly, with a credit of $5.34 million, there would be no Federal Estate Taxes owed.

However, what if the spouse with the $1 million died first? Those assets would go into a Family Trust for the benefit of the surviving spouse, but that spouse's unused exemption would be lost forever. When the second spouse died, there would be a $5.34 million credit. However, with $9.68 million in assets and a forty percent (40%) estate tax rate, there would be a Federal Estate Tax of $1.736 million. Many in Congress realized that it was unfair that a couple could owe either no estate tax or $1.736 million in estate tax based solely on their order of death.

Accordingly, beginning in 2011, Congress established Portability that allows a surviving spouse to essentially "inherit" and utilize the unused estate tax exemption of the first deceased spouse. In our example, if the spouse with $1 million in assets died first, the surviving spouse could elect to receive the decedent spouse's unused exemption and utilize it upon the death of the second spouse. In order to transfer the credit to a surviving spouse, a Federal Estate Tax Return must be properly and timely filed within 9 months of the date of death of the first spouse to die. For this reason it is prudent to file a Federal Estate Tax Return upon the death of the first spouse.

What's Wrong with the Traditional Planning Model?

Most estate plans currently in existence do not take the recent and dramatic changes to the law into account, which tend to create issue. First, if the estate plan establishes a trust that uses any portion of a deceased spouse's estate tax credit, then the only way to take advantage of Portability is to file a detailed Federal Estate Tax Return that provides in-depth valuations on all of the assets going into that trust. If that is not properly and timely filed, then Portability is lost so the unused exemption is forfeited. Second, that trust will be required to file income taxes each year as a complex trust for federal income

tax reporting requirements, which adds to the complexity of managing the trust and could also increase overall income taxes owed. Third, upon the death of the surviving spouse, none of the assets in that trust would be eligible for a "step-up" in basis (an adjustment in the basis of assets upon a person's death to the then current fair market value), which could result in significant capital gains taxes to the heirs.

Alternately, you could attempt to take advantage of Portability and basis step-up by simply transferring the assets of the first spouse to die directly to the second spouse. The issue with that estate plan is the lose of the asset protection benefit, such that those assets may be subject to potential creditor claims (i.e. a future spouse).

The Solution: The Marital Step-Up Trust™

We designed the Marital Step-Up Trust™ in order to combine the advantages of simplicity, Portability, step-up in basis, and asset protection into a single trust. A traditional marital trust is similar to the Marital Step-Up Trust™ in that both provide potent asset protection for the surviving spouse. It also allows a doubling of the Federal Estate Tax Exemption by taking advantage of Portability. However, unlike a traditional estate plan, the Marital Step-Up Trust™ allows a surviving spouse to take advantage of full Portability by filing a simplified Federal Estate Tax Return without any timely and expensive valuation requirements. This simplified process is allowed by the IRS because all of the assets going into the Marital Step-Up Trust™ qualify for the marital deduction. Also, unlike a traditional plan, Marital Step-Up Trust™ provides heirs with a full step-up in basis upon the death of the surviving spouse. That benefit is even more important with the recent higher income tax rates. Finally, the Marital Step-Up Trust™ will be taxed as a simple trust rather than a complex trust, which makes it much easier to file and report income.

The table below summarizes the three options and how the Marital Step-Up Trust™ utilizes the advantages of the other two approaches while counter-acting the disadvantages.

What if Estate Taxes are Still an Issue?

With a $5.34 million credit for individuals and a $11.68 million combined exemption for married couples, very few estates will be subject to Federal Estate Taxes. That said, some individuals and families are over those amounts and/or they may own assets that have the potential for significant appreciation in value. We designed the Marital Step-Up Trust™ with special language that allows a surviving spouse to identify certain assets and hold them in a way that allows those assets to grow and appreciate outside of the surviving spouse's estate for Federal Estate Tax purposes. This enables a couple to wait until the first spouse's death to decide exactly how to structure and fund their trusts based upon the then relevant tax laws, the nature and make-up of their assets, and their own personal goals and objectives.

What About Remarriage?

Special tax rules apply in the event one spouse dies and the surviving spouse remarries. Accordingly, it is important to consult with an estate planning attorney before remarrying in order to determine whether it would be worth taking advantage of the

deceased spouse's unused Federal Estate Tax exemption prior to remarriage. A pre-marital agreement is also something that should always be considered when remarrying, especially when children are involved. A properly drafted and planned marital agreement can help ensure that the new spouse is appropriately provided for while also protecting assets for the benefit of the children.

Other Key Elements of a Comprehensive Estate Plan

Reducing estate, gift, and income taxes of an estate is important, but it is not the only reason to effectively plan your estate. In fact, a comprehensive estate plan can be one of the greatest gifts you can give to your family. It can also ensure that your wishes are effectuated and help to avoid unnecessary conflicts and public disclosure of your affairs. In addition to proper tax planning, a comprehensive estate plan needs to effectively address four other critical issues:

1. **Control -** If something happens to you, who do you want making medical decisions for you? If you die, who do you want to raise your minor or disabled children? Who do you want to manage money for your children until they are old enough, and when is old enough? And, most importantly, do you have the flexibility to update and change your planning as life events change? A properly drafted estate plan can memorialize your wishes.

2. **Asset Protection -** Lawsuits, divorces, bankruptcies, and bad business deals can also have a devastating impact on the transfer of wealth. In fact, the impact of taxes and outside attacks that most family wealth does not pass beyond the third generation. We prefer to incorporate asset protection into estate plans so spouses, children, and grandchildren can benefit from an extra layer of protection.

3. **Privacy -** Probate is the court-supervised process of changing title to assets. The best estate plans work to avoid the time and expense associated with probate as well as the public nature of the probate process. A revocable living trust and proper titling assets can avoid probate that publically lists family members, addresses, and descriptions and values of property.

4. **Family Harmony** – We have found in our experience that most family conflicts resulting after the death of a family member is the result of an ambiguous or nonexistent estate plan. The best way we can advise our clients to help avoid these family conflicts is to ensure that a person's estate plan is up to date and clear. Even if children are treated unequally under a well drafted plan, those children who were treated unequally will blame mom and dad who drafted the plan as opposed to pointing fingers at each other. The family unit stays intact and everyone still has Thanksgiving dinner together well into the future.

Conclusion

The dramatic estate and income tax laws changes that occurred at the end of 2012 have resulted in a fundamental shift in how an effective estate plan should be drafted and implemented. It is important that you have your current planning reviewed to make sure it takes full advantage of these changes so that you can not only effectively and efficiently manage your estate, but also limit the potential impact on your estate by taxes or future creditors.

DIFFERENCES UPON DEATH OF FIRST SPOUSE

	No Planning	**Traditional Estate Plan**	**Marital Step Up Trust™**
Asset Protection	None	**Yes**	**Yes**
Avoids Probate	No	**Yes**	**Yes**
Federal Estate Tax Return Required for Portability	**Yes, but no formal valuations required**	Yes, but formal valuations required	**Yes, but no formal valuations required**
Full Step Up in Basis at Second Death	**Yes**	No	**Yes**
Income Tax Reporting Requirements	**No additional requirements**	Yes, taxed as a complex trust	**Taxed as a simple trust**

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