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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2086

Date: 03-Apr-13
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Gassman, Ellwanger & Hohnadell: It's Just a JEST, the Joint Exempt Step-Up Trust**

"There are two primary concerns that arise when dealing with joint trusts in non-community property states: 1) whether, upon the first dying spouse's death, all joint trust assets (including 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."

Now, **Alan Gassman, Tom Ellwanger** and **Kacie Hohnadell** provide members with their commentary on the Joint Exempt Step-Up Trust. The authors sincerely thank **Howard Zaritsky, Michael Mulligan, John Meier**, **Christopher J. Denicolo** and **Kenneth J. Crotty** for words of wisdom and contributions made in prior literature, and for their input on previous editions of this article.

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Here is their commentary:

EXECUTIVE SUMMARY:

Many legal scholars and practitioners have considered whether a married couple living 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-community property states: 1) whether, upon the first dying spouse's death, all joint trust assets (including 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, which can be accessed by **CLICKING HERE**.

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 surviving 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.[i]

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 appointment 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

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 couples formed joint revocable trusts. In one ruling, each spouse had a lifetime power to withdraw 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 qualified 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 appointment 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 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 rulings 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 entireties property is added to the trust would be a gift by the younger spouse, who has a greater actuarial interest in the property.[ii]

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 income 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."[iii]

If a gift on funding does occur, so long as both spouses are U.S. citizens, one might assume 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.

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 designated 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.

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 beneficiaries. 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.[iv]

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 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 education. 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 protection 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 exposure 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.[v]

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 requires having assets from the surviving spouse's share go into **Credit Shelter Trust B** after having 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.[vi]

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 includible 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 Surviving 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).[vii]

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 estate 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 triggering 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.[viii]

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 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 inclusion 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.[ix]

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, Blattmacher, 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 confront 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?

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 defective 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 surviving 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 Creditor Shelter Trust B if the surviving spouse is the beneficiary.

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 considered 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 surviving spouse would make a completed gift to the deceased spouse of the assets that the surviving spouse contributed to the joint trust.[x] 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.[xi]

may later abandon.

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.

Messrs. Blattmachr, Gans, and Bramwell take comfort from the authorities dealing with the death of spouses in common disasters.[xii] 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."[xiii]

Messrs. Blattmachr, Gans, and Bramwell also bring up the Ninth Circuit Court of Appeal's 1935 decision in *Johnstone v. Commissioner*,[xiv] 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.[xv] 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!"

More substantively useful may be the inclusion of a joint trust provision

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).[xvi] 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 jurisdictions 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 acquiring 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 decedent.[xvii] [*Emphasis added*].

For Section 1014(e) to apply, the property must be "acquired by" or "pass to" to the original 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 language 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

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.[xviii] 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!

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Tom Ellwanger

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

[ii] 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.

[iii] 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).

[iv] PLRs 20010102 & 200210051; *see also* Mulligan, supra n. iii (stating that "[p]roperty which is contributed by the predeceasing 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.

[v] Treas. Reg. 20.2056(b)-5(f)(5).

[vi] 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.

[vii] Mulligan, *supra* n. 3.

viii] 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 considered the effective grantor of the Trust to the extent of his contribution." a trust created by the second party with those assets. In *Sinclair*e, 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."

[ix] 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).

[x] *See* PLRs 200101021, 200210051 & 200403094.

[xi] 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).

[xii] *Id*. at 422–430.

[xiii] *Id*. at 424.

[xiv] 76 F.2d 55 (9th Cir. 1935).

[xv] Gans, Blattmacher and Bramwell at 429.

[xvi] 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.)

[xvii] PLR 200101021 (p. 4), PLR 200210051 (p. 4).

[xviii] *See* Brian E. Barreira, *Proper Medicaid Planning May Permit Keeping the Home in the Family* (May 12, 2011) (stating that "[t]he discretionary nature of the trust should allow a complete step-up in basis as of the deceased spouse's date of death for capital gains tax purposes").

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