JEST Offers Serious Estate Planning Plus for Spouses—Part 1

A joint exempt step-up trust (JEST) may produce a full step-up in tax basis and full funding of a credit shelter trust for clients in non-community property states.

ALAN S. GASSMAN, CHRISTOPHER J. DENICOLO, AND KACIE HOHNADELL, ATTORNEYS

Revocable trust planning for married couples living in non-community property states continues to be a challenge for planners and clients. Couples who have estate tax exposure and want to have at least some assets held in a credit shelter trust after the death of one spouse typically establish separate revocable trusts for each spouse. The trust of the first dying spouse then becomes an irrevocable credit shelter trust on death, which captures assets owned only by the first dying spouse.

This vehicle can work well where the first dying spouse's trust will have enough assets to fully fund the credit shelter trust, but a great many couples with estate tax exposure do not have $10.5 million of assets that can be split between them to facilitate this funding on the first death. Furthermore, separate traditional revocable trusts do not provide a mechanism that permits the surviving spouse's assets to receive a stepped-up basis on the first death.

Alternatively, joint trust ownership can basically work like a right-of-survivorship asset on the first death, for the primary purpose of avoiding probate. This can yield a one-half stepped-up basis on the joint trust assets, and may permit the surviving spouse to disclaim up to one-half of those assets—or even more if the first dying spouse placed the assets into the joint ownership arrangement.[1] The disclaimed assets can pass to a credit shelter trust, which can benefit the surviving spouse and descendants. As long as the surviving spouse does not retain a power of appointment over the trust assets and does not have discretionary power and is governed by an ascertainable standard to vest trust property in himself or herself, the disclaimed credit shelter trust can also avoid estate tax on the surviving spouse's death.

The above systems can work well to some degree for couples with assets expected to remain well below the estate tax threshold who want a partial stepped-up basis and good family and creditor protection by using a trust system after the first death. However, this system involves locking up only a portion of the assets, and also obtaining a stepped-up basis on only part of the assets, which falls far short of what can be done with traditionally drafted joint trusts in community property states.

JEST advantages

The joint exempt step-up trust (JEST) is designed to enable a mar-

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The authors thank Thomas J. Ellwanger for his careful review and assistance in the design of the JEST.

ried couple residing in a non-community property state to use a joint trust or coordinated separate trusts to maximize the ability to enjoy the stepped-up basis and estate tax protection benefits described above, without undue risk of harm or undue inconvenience to the couple or their family. It also helps to maximize familial protection and harmony.

Many practitioners are understandably reluctant to implement a strategy that will produce uncertain results. In contrast, however, the authors have found that many clients are amenable to adopting strategies with uncertain tax benefits if use of the structure has no material cost or downside. With the JEST arrangement, on the first spouse's death, the practitioner and his or her clients can determine how to best proceed with reference to tax reporting, and possibly even obtaining a private letter ruling if the law has not become clearer by that time. Furthermore, possible alternate tax benefits may apply if the expected tax results are not as designed, as explained below. The JEST is designed not only to derive the benefits of the technical advice memorandum (TAM) and three letter rulings discussed below, but also to overcome the obstacles to stepped-up basis, and to establish a strong lifetime trust system with advantageous back-up tax treatment if these four IRS pronouncements are for some reason not applicable.

This two-part article first describes the JEST structure, then analyzes estate tax, gift tax, and creditor protection concerns posed by others. It also builds on Edwin P. Morrow's recent writings on Optimal Basis Increase Trusts, and uses techniques he has helped develop to help assure a second basis step-up on the death of the surviving spouse.

Planning alternative. A more foolproof method exists for allowing a married couple residing in a non-community property state to obtain a stepped-up basis and full funding of a credit shelter trust on the first death. This involves setting up an Alaska Community Property Trust with an active Alaskan trustee.[2] Many clients will prefer this method, but fees and costs associated with it are considerably higher than with a JEST, and many layman and professionals who have not studied this area find the Alaska Community Property Trust to sound less credible than the JEST, although that is clearly not the case under present law, assuming that the IRS and applicable courts would not find the Alaska Community Property Trust to be a contrivance or alter ego arrangement.

Basic JEST structure

The basic structure of the JEST is as follows:

1. A married couple funds a jointly established revocable trust, with each spouse owning a separate share in the trust. (The shares can be unequal or specifically designated if that is preferred.)
2. Each spouse has the right to terminate the trust while both are living. In that event, the trustee will distribute each spouse's separate share accordingly. If the spouses already each have separate living trusts, these can be amended to become subshare trusts under the JEST. This avoids the need to retitle assets and change beneficiary designations.
3. The JEST becomes irrevocable when the first spouse dies. The first dying spouse has a power of appointment over all trust assets in order to have the trust assets considered to pass through his or her estate for estate tax and stepped-up basis purposes. Some spouses and advisors are concerned that the first dying spouse could disrupt the intended disposition of assets by disinheriting the surviving spouse through the use of the testamentary general power of appointment. However, this risk can be eliminated by restricting the exercise of the power of appointment by the first dying spouse, and also requiring advanced approval by non-adverse parties of the exercise, as discussed below.

On the first death, the assets of the first dying spouse's share are applied in the following manner:

- First, assets equal in value to the first dying spouse's unused estate tax exemption are used to fund Credit Shelter Trust A for the benefit of the surviving spouse and descendants. These assets receive a stepped-up basis and escape estate tax liability on the surviving spouse's death.
- Second, if the first dying spouse's share exceeds his or her unused estate tax exemption, the excess funds go to QTIP Trust A to benefit the surviving spouse and descendants in a manner that qualifies for the federal estate tax marital deduction and allows the QTIP Trust A assets to receive a stepped-up basis, both on the first dying spouse's death, and again on the surviving spouse's death. Only the surviving spouse can benefit from QTIP Trust A during his or her lifetime.

[1] Section 1014(b)(9). See also Reg. 1.1014-1.

[2] See Blattmachr and Blattmachr, "*Huber:* Alaska Self-Settled Trust Held Subject to Claims of Creditors of Grantor-Beneficiary," LISI Asset Protection Newsletter #225 (5/22/2013).

EXHIBIT 1
JEST Credit Shelter Trust B Planning

CREDIT SHELTER TRUST B

Formed from assets of the share of the surviving spouse.

Expected to be considered as being transferred to Credit Shelter Trust B by the first dying spouse for federal estate tax purposes pursuant to Ltr. Ruls. 200101021 and 200210051.

The IRS could claim that Credit Shelter Trust B was funded by the surviving spouse.

ALTERNATIVE A

Accepted as funded by first dying spouse.

Will not be subject to estate tax at the level of the surviving spouse.

Will not be subject to creditor claims of the surviving spouse.

This is the optimum result.

ALTERNATIVE B

Considered as funded by surviving spouse.

Might be subject to estate tax at the level of the surviving spouse.

Might be subject to creditor claims of the surviving spouse, unless local law of the Trust provides otherwise

Strategy 1 - Incomplete Gift Treatment

The surviving spouse maintains a power of appointment over the Trust assets, which causes the Trust to be considered as an incomplete gift for federal gift tax purposes, and the Trust assets will be considered as owned by the surviving spouse for estate tax purposes on his or her death.

In light of the IRS' position in CCA 201208026, it is best to give the surviving spouse a lifetime power of appointment over the assets in Credit Shelter Trust B to assure that an incomplete gift results for federal gift tax purposes.

If there are separate children for each spouse or a concern that the surviving spouse might not appropriately exercise a power of appointment, then it could be limited to being exercisable only with a consent of non-adverse parties, or limited to the extent needed to avoid imposition of federal gift tax by funding under a formula clause.

Strategy 2 - Complete Gift Treatment

Considered as a complete gift by surviving spouse.

If the surviving spouse disclaims all powers of appointment over the Trust, then the transfer to Credit Shelter Trust B is considered to be a complete gift by the surviving spouse, and the Trust will not be subject to federal estate tax of the surviving spouse's estate.

The value of the assets passing to Credit Shelter Trust B would reduce the surviving spouse's $5,250,000 exemption.

Give the surviving spouse the power to replace Trust assets with assets of equal value so then it can be considered a defective grantor trust if this occurs.

NOTE applicable to both Strategy 1 and Strategy 2: Situs Credit Shelter Trust B in an asset protection trust jurisdiction to avoid having creditors be able to reach into the Trust, and also to avoid the Trust being included in the surviving spouse's estate if the surviving spouse was considered as a contributor to the Trust for federal estate and gift tax purposes.

- If the first dying spouse's share is less than his or her exemption amount, then the surviving spouse's share is used to fund Credit Shelter Trust B with assets equal to the excess exemption amount. The assets of Credit Shelter Trust B should avoid estate taxation at the surviving spouse's death, notwithstanding that the surviving spouse originally contributed these assets to the JEST and had the power to take them back up until the time of the first dying spouse's death, for reasons described below.

The assets of Credit Shelter Trust B should also receive a full stepped-up basis on the first death, as discussed below. To help assure the full stepped up basis, it is best for the surviving spouse not to be a beneficiary of Credit Shelter Trust B, or perhaps to be only an "addable beneficiary" of Credit Shelter Trust B if certain events occur and it is determined appropriate to do so at the discretion of independent Trust Protectors. For example, the surviving spouse might be added as a beneficiary if and when his or her personal net worth goes below a certain level, or on the occurrence of other circumstances.

The Section 1014(e) one-year rule (discussed in Part 2 of this article) should not apply to cause loss of a stepped-up basis where the surviving spouse is not a recipient of assets that he or she was considered to have gifted to the first dying spouse within one year of the first dying spouse's death.

The JEST credit shelter trust planning concept is summarized in Exhibit 1; the steps for implementation are summarized in Exhibit 2.

Segregation of assets. The assets passing from the surviving spouse's share into a Credit Shelter Trust B have been segregated, and the trust can be separately managed, tracked, and altered. Three reasons for segregating the assets are as follows:

1. If Credit Shelter Trust B may be subject to federal estate tax in the surviving spouse's estate, it probably should be spent before the assets of Credit Shelter Trust A, or invested in assets expected to grow less quickly than the assets in Credit Shelter Trust A.
2. If Credit Shelter Trust B is considered as having been funded by the surviving spouse, then he or she may be advised to disclaim any beneficial interest and any power of appointment over the trust assets. This would establish the trust as a completed gift for the benefit of the common descendants of the couple, as further discussed below.
3. If Credit Shelter Trust B is considered to have been funded by the surviving spouse for state law purposes, then creditors of the surviving spouse may be able to reach Credit Shelter Trust B assets, unless it is sitused in an asset protection trust jurisdiction. As a result, the trust could be subject to estate tax in the estate of the surviving spouse.

Drafting tips. The trust draftsperson should, therefore, consider providing one or more of the following features under Credit Shelter Trust B:

1. Fund and at least initially situs it in an asset protection trust jurisdiction, unless determined otherwise by one or more trustees or trust protectors, so as to provide creditor protection.
2. Do not name the surviving spouse as a beneficiary of the trust unless or until he or she is added as a beneficiary by trust protectors, and then only if circumstances exist that may appear unlikely at the time of funding.
3. Give the surviving spouse the right to disclaim or renounce the testamentary power of appointment that would typically be given to him or her under the trust. That way, if the IRS considers the trust to have been funded by the surviving spouse, the surviving spouse could choose one of the following alternatives: (a) have the trust's funding considered to be an incomplete gift for income tax purposes by retaining a lifetime limited power of appointment over the assets in such trust; (b) disclaim or renounce the powers of appointment and have the transfer of assets to the trust be considered as a completed gift,[3] or (c) request that the trust protectors take away the power of appointment, in which event the three-year look-back rule under Section 2035 should not apply, because the spouse himself or herself will not have released or relinquished the power.[4]

[3] See Reg. 25.2511-2.

[4] See Reg. 2035(a), which provides that property is included in the gross estate if: "(1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death." The power would then be retained by the trust protector and should not be included in the estate of the surviving spouse.

4. The surviving spouse should have the power to replace Credit Shelter Trust B assets with assets of equal value, so that it can be considered a "defective" grantor trust for income tax purposes if the surviving spouse is considered to be the grantor of the trust. Then, if the IRS argues that the surviving spouse was the grantor and the IRS' position is accepted, the spouse will be able to pay the income taxes he or she would have incurred over the years to the trust without this being considered a taxable gift.
5. An independent trustee or trust protectors may have the renounceable power to pay the trust assets in Credit Shelter Trust B to the surviving spouse, which they may use if it is determined that Credit Shelter Trust B is not needed, or which they may renounce if it is determined that such transfer of assets to the surviving spouse is not in the best interests of the family.
6. An independent trustee or trust protectors should also have the power to give the surviving spouse a taxable general power of appointment over some or all of the trust assets under both Credit Shelter Trust A and Credit Shelter Trust B. This facilitates a step-up in basis for some or all of such assets, in the event that stepped-up basis planning will save more tax dollars than avoidance of estate tax for some or all of the credit shelter trust assets.
7. The trust language should encourage gifting and gift tax return filing. The surviving spouse may wish to make a small gift to Credit Shelter Trust B in the same calendar year as the first dying spouse's death and file a gift tax return disclosing the existence of Credit Shelter Trust B, how it was funded, the pertinent gift tax issues described in this article, and the assumption that the only gift made by the surviving spouse to Credit Shelter Trust B is the small transfer described above.

If the IRS does not challenge the position taken on the gift tax return (i.e., that the surviving spouse did not make a taxable gift to Credit Shelter Trust B other than the post death gift), then it should be prevented from later claiming that the surviving spouse's $5.25 million exemption was reduced by such transfer. While the IRS would not be prevented from later claiming that the spouse was a contributor to the trust for purposes of determining if trust assets should be subject to federal estate tax in the surviving spouse's estate if he or she retained a power of appointment, or a right or power over trust assets that would subject those assets to estate taxes under Section 2036, this estate tax inclusion should nevertheless not apply if the surviving spouse renounces all powers of appointment over Credit Shelter Trust B, and is either not a beneficiary of the trust, or the trust is sitused in an asset protection jurisdiction.

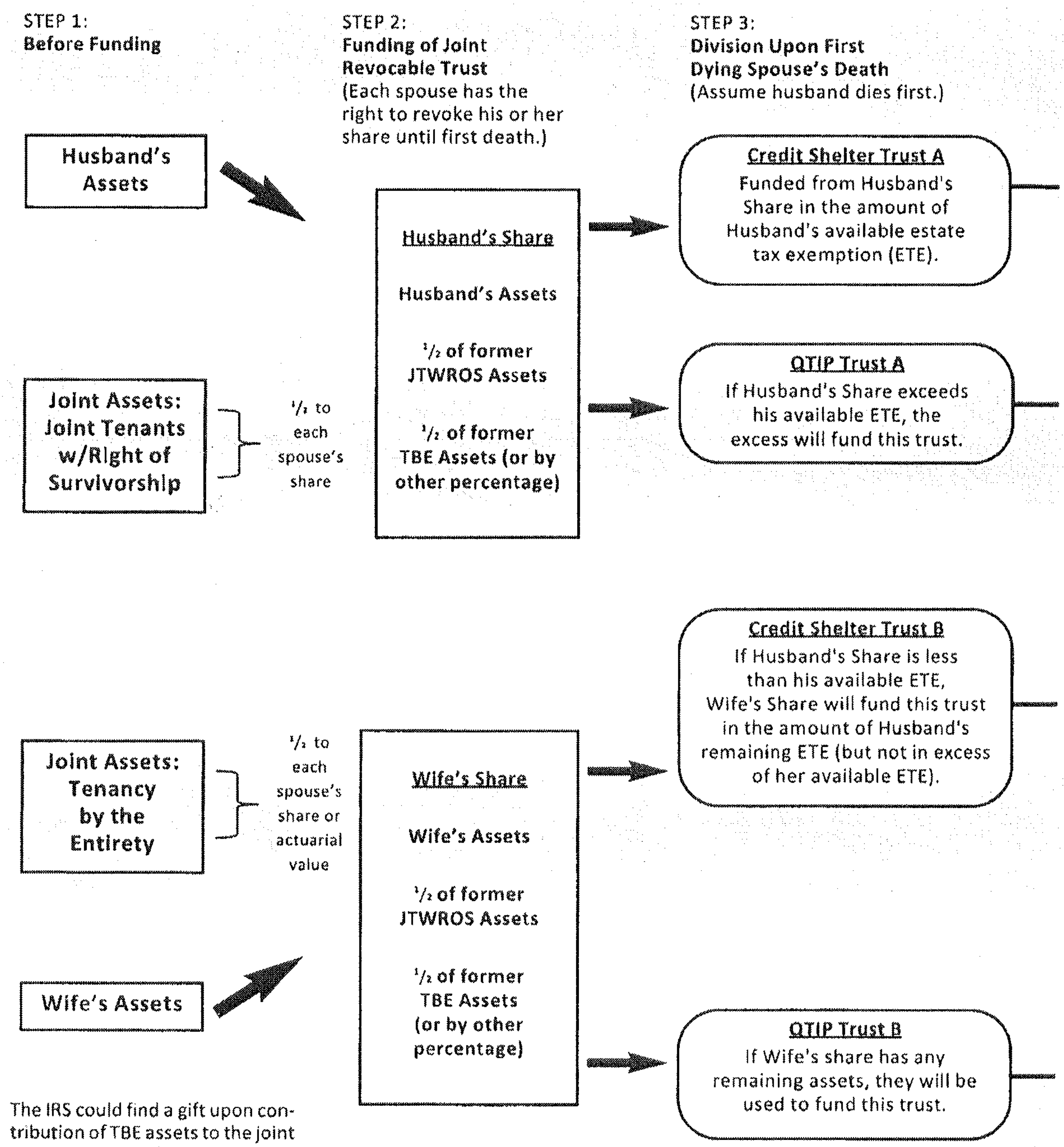
First dying spouse. When the estate tax return of the first dying spouse is filed, the IRS may take the position that Credit Shelter Trust B was actually funded as a gift by the surviving spouse. If this occurs, the surviving spouse will have a portability allowance (or a greater-than-first-claimed portability allowance) as the result of using less than all of the first dying spouse's exemption amount, assuming a federal estate tax return is filed for the estate of the first dying spouse. In any event, no estate or gift tax would be triggered by an IRS conclusion that Credit Shelter Trust B was funded from the assets of the first dying spouse, unless the surviving spouse's deemed contribution to Credit Shelter Trust B exceeds his or her estate tax exemption amount and no retained power of appointment prevents a completed gift from occurring.

Under federal gift tax principles, a gift made to a trust is incomplete if the person making the gift has a power to appoint the trust assets on death, and, according to CCA 201208026, also has the power to prevent trust assets from being paid to individuals other than the donor. Many authorities, including the authors, believe that the CCA is incorrect, and that no power to prevent trust assets from being paid to individuals other than the donor is needed.[5] Nevertheless, conservative planners will want to draft the trust agreement to give the surviving spouse a lifetime power of appointment over the Credit Shelter Trust B assets.

If the surviving spouse renounces the power of appointment over the Credit Shelter Trust B assets, it might be best to do so by a formula, with language such as "such renouncement shall be limited to that portion of the power of appointment that I can renounce without being subject to federal gift tax, based upon a fraction, the numerator of which is my estate tax credit exemption amount and the denominator of which is the value of the trust assets.

[5] See Gassman, Share, Crotty, and Hohnadell, 'Planning After IRS Memo 201208026: How Foreign Can Creditor Protection Trust Laws Get?,' LISI Asset Protection Planning Newsletter #207 (9/11/2012). See a so Zeydel, "When is a Gift to a Trust Complete—Did CCA 201208026 Ge[illegible] Right? [illegible] 17 J. Tax'n 142 (Se[illegible]ember 2[illegible]?

EXHIBIT 2
JEST Chronology: The Four Steps From Drafting to Implementation



The IRS could find a gift upon contribution of TBE assets to the joint revocable trust, but this gift will qualify for the marital deduction if recipient spouse can withdraw what is added to his or her share. Also see Ltr. Rul. 200201021.

Step 3 note:

CST A and CST B can be merged if there is no concern with estate tax, stepped-up basis, creditor protection, or credit shelter trust effectiveness.

QTIP Trust A and QTIP Trust B can be merged if there is no concern with respect to stepped-up basis or credit protection effectiveness.

EXHIBIT 2, *cont'd*
JEST Chronology: The Four Steps From Drafting to Implementation, *cont'd*

STEP 4:
Results of JEST Technique

- For Wife' and descendants' benefit (limited by ascertainable standard).
- Assets will receive a stepped-up basis.
- Assets are protected from Wife's creditors.
- Assets escape estate tax on Wife's death.

- Wife can be beneficiary of income and principal.
- Assets will receive a stepped-up basis on Husband's death, and then again on Wife's death.
- Assets included in Wife's taxable estate.
- Will be protected from Wife's creditors.

- Assets may receive a stepped-up basis, but this is more likely if Wife is not a beneficiary.
- May escape estate tax liability on Wife's death.
- For creditor protection and estate tax exclusion purposes, CST B may be moved to an APT jurisdiction.

  Special consideration: If Wife is found to have a gift of trust assets to Husband upon Husband's death, this gift may qualify for the marital deduction.
- If the IRS argues that Wife has gifted to the trust, the gift will be incomplete because of her power of appointment.

- Wife will be the income beneficiary
- Assets may receive a stepped-up basis on Husband's death and again on Wife's death.
- Assets included in Wife's estate.
- May not be protected from Wife's creditors unless moved to APT trust jurisdiction.
- If the IRS argues that Wife has gifted to the trust, the gift will be incomplete because of her power of appointment.

Example. A surviving spouse has $1 million in available estate tax exclusion, and Credit Shelter Trust B has $3 million of assets. The surviving spouse would at most renounce only one-third of his or her general power of appointment.

Finally, the remainder of the surviving spouse's share (if any is left after the complete funding of Credit Shelter Trust A, and Credit Shelter Trust B to the extent needed to make full use of the first dying spouse's estate tax exemption allowance) will be used to fund QTIP Trust B, under which the surviving spouse will be at least an income beneficiary. We believe that there is a better chance that the assets funding QTIP Trust B will also receive a basis step-up if the surviving spouse retains only the right to receive income.

The tax and creditor protection issues raised by these techniques are further discussed below.

Evolving IRS guidance

Over the last 20 years, the IRS has issued three private letter rulings touching on joint trust arrangements and a TAM.[6]

TAM 9308002. The TAM predated the three letter rulings, and 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. Both spouses also had the right to unilaterally revoke the trust during the spouses' joint lifetime. The IRS determined that all trust assets were included in the first dying spouse's estate under Section 2041. The IRS ruled, however, that assets con-

[6] See Ltr. Ruls. 200101021, 200210051, and 200403094; TAM 9308002.

tributed to the trust by the surviving spouse were in effect gifted to the first dying spouse on that spouse's death. Therefore those assets are treated as having come back to the surviving spouse within one year, so as not to be qualified to receive a basis step-up under Section 1014(e).

Many clients are amenable to adopting strategies with uncertain tax benefits if use of the structure has no material cost or downside.

First two private rulings. Ltr. Ruls. 200101021 and 200210051 addressed the same issues. In both rulings, 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 spouse to die was given a testamentary general power of appointment over the entire trust. In both rulings, on 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 letter rulings 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 Section 2038; the assets contributed by the surviving spouse were included under Section 2041.
2. On the first dying spouse's death, 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 to the trust by the first dying spouse could receive a step-up in basis.

Third private ruling. Ltr. Rul. 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's will provided that the appointed assets would pass to a credit shelter trust for the husband's health, education, support, and maintenance. The IRS ruled as follows:

1. The husband's creation of the power of appointment would be a gift to the wife, which would be considered completed at her death if she died before him. The husband's gift 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.
3. Stepped-up basis was not discussed.

JEST scenarios

Below are two examples of where clients might prefer the JEST arrangement over conventional non-community property state planning.

Example 1. John and Mary are both successful professionals who have very little liability exposure and plenty of insurance coverage. They also have a $500,000 house, $1 million in IRAs and pension plans, and $3 million of investments in brokerage accounts.

They are in their early 40s and expect to become estate taxable based on savings rates and investment assumptions. They project that $4.5 million of assets, growing at 7% per year, will be worth $67,385,060 in 40 years. In contrast, their combined exemption of $10.5 million, growing at an assumed consumer price index rate of 3%, will be only $34,251,397 at that time.

They have two teenage children and feel very strongly that their joint assets should never be spent on anyone other than one another and their common descendants.

John and Mary have reviewed their situation and would like to have their entire $3 million of investment assets held under a protective trust system on the first death, to help assure that a remarriage by the surviving spouse would not cause loss of significant assets for the surviving spouse and the two children.

They would also like to have the best chance possible for a stepped-up basis on the death of one of them, so that the survivor would be able to better diversify by selling some of their investments without incurring capital gains tax, and also to fund a credit shelter trust with $3 million in assets.

They understand that with the JEST arrangement, the IRS could assert that on the first death, the surviving spouse made a $1.5 million gift to what will be called Credit Shelter Trust B, but that this can yield estate tax savings and creditor protection advantages that could be very worthwhile for the surviving spouse and their common descendants.

Example 2. Bill and Maria are in their mid-70s, and have a house worth $500,000 and personal assets (i.e., non-IRA, non-pension accounts) worth approximately $7 million that have a tax basis of $2 million. They have not been diversifying or otherwise adjusting their investments because they are unwilling to pay a 23.8% capital gains tax, but would like to be able to adjust their investments without paying any taxes if one of them dies. Bill and Maria do not expect to become estate taxable, but they recognize that this could occur.

They would like to have all of their assets held under protective trusts if one of them dies, because the survivor would be under significant emotional pressure, and might be inclined to remarry. They would also like the best chance possible of receiving a stepped-up basis on all $7 million worth of joint assets, but would prefer not to pay an annual trustee fee to a trust company in Alaska if this is the only other choice.

They recognize that by the present numbers, $3.5 million would pass to Credit Shelter Trust A on the first death and $1.75 million would pass to Credit Shelter Trust B. They recognize that the surviving spouse might be considered to have funded Credit Shelter Trust B, but that if so, this could be considered to be an irrevocable trust for the primary benefit of their children that could still grow estate tax free. After weighing these considerations, they decide to go with the JEST trust arrangement.

Conclusion

With a JEST arrangement, married couples in non-community states have an expanded opportunity to achieve a stepped-up basis that comes with inheriting assets. While the tax law is not completely clear, the worst case scenario of implementing this strategy with the safeguards described above can be a much better result than not using the strategy at all. The second installment of this article, which will be published in an upcoming issue of ESTATE PLANNING, further describes the creation and funding of the JESTs and amelioration of risks that apply. ■

JOINT TRUST

JEST Offers Serious Estate Planning Plus for Spouses—Part 2

A joint exempt step-up trust (JEST) can be drafted to provide creditor protection as well as a full step-up in tax basis and use of a credit shelter trust.

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Couples living in community property states are generally in line to benefit more from the stepped-up basis available to inherited assets than are couples in non-community property states. Estate planners have, however, identified strategies to expand the favorable basis treatment to spouses living in non-community property states, and one such strategy involves use of a joint exempt step-up trust (JEST). As is explained in Part 1 of this article,[1] the JEST arrangement has not received clear approval from the IRS, but IRS guidance that is available does give positive indications. Furthermore, use of a JEST does not carry much downside risk, so many clients will be amenable to adopting the strategy in their estate plans. Part 2 of this article continues the analysis of the JEST.

JEST creation and funding

In implementing the JEST, the married couple first establishes a joint revocable trust. Each spouse has 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 can 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 that event, the trustee transfers the trust assets back to the spouses in equal shares.

The first dying spouse should also be given a testamentary general power of appointment over all trust assets. As described in Part 1 of this article, the first dying spouse's power can be limited to being exercisable in favor of the creditors of his or her estate, while still qualifying as a general power of appointment under Section 2041.[2]

If the IRS ever argues that a deemed gift was made from the surviving spouse to the first dying spouse immediately before the first dying spouse's death, it would be best to have the general power of appointment mirror the language in Section 2523(e), so that the gift tax marital deduction would apply to avoid use of the surviving spouse's estate tax exclusion. This appears to require that the first dying spouse would need to have the power to exercise such general power of appointment in favor of himself or herself, or his or her estate, alone or in all events. The law is not absolutely clear as to whether such a power of appointment can be limited to requiring the consent of one or more adverse parties and still facilitate qualification for the gift tax marital deduction. If estate tax avoidance is less important than concerns with respect to needing consent of one or more adverse parties, an adverse party approval clause can be included.

To address the concern that the first dying spouse could disrupt the intended disposition of assets by disinheriting the surviving spouse through the use of the testamentary general power of appointment, the trust can provide that the first dying spouse's power is only exercisable with the written consent of a non-adverse party. Although anyone who has a substantial interest in the trust property is typically deemed an adverse party,[3] there is authority for the proposition that a beneficiary of the trust, such as a child or grandchild, is a non-adverse party if he or she is acting as a trustee, or

1 Gassman, Denicolo, Hohnadell, "JEST Offers Serious Estate Planning Plus for Spouses—Part 1," 40 ETPL 3 (October 2013).

2 Section 2041(b)(1).

3 Section 2041(b)(1)(C)(ii) (stating that "[i]f the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent—such power shall not be deemed a general power of appointment").

otherwise in a fiduciary capacity.[4] The first dying spouse could also be given a limited power of appointment over trust assets, which then cascades into a general power of appointment to the extent it is not used.[5]

For pension and IRA planning purposes, the power can be further limited to being exercisable only in favor of creditors of the first dying spouse's estate who are younger than the oldest beneficiary of a given trust, which will often be the surviving spouse. When an IRA is payable to a properly designed trust, the life expectancy of the oldest beneficiary may be used to determine the required minimum distribution amounts in order to allow for distributions to be made over the life expectancy of the oldest beneficiary in lieu of the otherwise applicable five-year rule.[6]

As discussed above, the full stepped-up basis and full funding of a credit shelter trust may not occur without an IRS challenge, but will yield at least the equivalent of what a two-trust marital estate plan would provide, with significant upsides beyond that.

The following discussion reviews the risks described above, and how the JEST has been designed to reduce these risks significantly, while preserving all opportunities that would be offered by a two-trust or conventional joint trust arrangement.

Risk 1: Gift upon funding. Unequal funding of the JEST while both spouses are alive raises the possibility of a gift upon funding. A spouse who contributes more than 50% of the assets but has the power to get back only 50% in a unilateral termination has presumably made a completed gift of the difference to the other spouse. Transferring property held as tenancy by the entireties to the JEST could also result in such a gift because under the law of tenancy by the entireties, the tenancy can be severed by only joint action of the parties. Giving each spouse the power to unilaterally revoke the trust likely severs the tenancy upon funding. This severance may be considered to be a gift of differential value by the younger spouse, who has a higher actuarial interest in the property.[7]

In Ltr. Rul. 200101021, however, the IRS held that the contribution of tenants by the entireties assets to a joint trust was not a gift by either spouse where each of them retained the right, acting unilaterally, to revoke his or her transfer,and revest title in himself or herself, rendering the gift incomplete. As desirable as this result may be, it ignores the actuarial difference between the spouses' interests—a younger, healthier spouse is more likely to survive the other spouse, and therefore has an ownership interest in the trust that exceeds 50% of the value of the trust assets, according to Reg. 25.2511-2. The other rulings did not explicitly address the issue of a gift upon funding.

Estate tax planning attorney Michael Mulligan has also suggested that any gift upon funding may be considered incomplete and, therefore, not to have occurred until the first death, regardless of whether 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."[8]

If a gift on funding does occur, so long as both spouses are U.S. citizens, the gift tax marital deduction presumably would eliminate tax concerns. (If the spouse is a non-citizen, the marital deduction would not apply).

Risk 2: Loss of creditor protection for tenancy by the entireties assets. Mr. Mulligan's comment as to funding raises another issue. Holding properties as tenancy by the entireties, where state law permits, usually provides creditor protection because the properties can be reached by only creditors with a claim against both spouses. Tenancy by the entireties property that is transferred into a typical joint trust loses entireties status, and this creditor protection, unless either of the following occurs:

1 The joint trust satisfies all unities required by tenancy by the entireties law (which will not be the case with a JEST).

2 The governing law explicitly provides that trust assets can be designated by a married couple to be treated as tenancy by the entireties

4 See Estate of Vissering, 96 TC 749 (1991), *reversed on other grounds* 990 F.2d 578, 71 AFTR2d 93-2190 (CA-10, 1993) (stating "[t]he fact that a decedent holds the power in a fiduciary capacity as a trustee or that a decedent can only exercise the power jointly with another does not prevent the power from being a general power of appointment"). See also Blattmachr, Kamin, and Bergman, "Estate Planning's Most Powerful Tool: Powers of Appointment Refreshed, Redefined and Reexamined," 47 Real Prop. Tr. & Est. L.J. 529 (2013), where the authors discuss decanting as a fiduciary power. Estate of Jones, 56 TC 35 (1971); Miller, 387 F.2d 866, 21 AFTR2d 1592 (CA-3, 1968).

5 In LISI Newsletter #2080 (3/20/2013), Edwin P. Morrow recognized that this technique was upheld in the Tax Court case of Chisholm, 26 TC 253 (1956).

6 See Ltr. Rul. 201203033, discussing Reg. 1.401(a)(9)-5.

7 See Reg. 25.2511-2(c).

8 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. (9/18/2007).

property, even if the unities are not satisfied. Delaware, Virginia, Hawaii, and Illinois are examples of jurisdictions that have 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 the other attributable to the surviving spouse. The analysis that follows assumes that the first dying spouse has not exercised either his or her power to revoke the trust unilaterally, or the testamentary 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. If the first dying spouse's share exceeds his or her unused exemption, then the excess amount can be used to fund QTIP Trust A for the lifetime benefit of the surviving spouse.

Turning to the surviving spouse's share, if the first dying spouse's share is less than his or her remaining exemption amount, the surviving spouse's share is used to fund Credit Shelter Trust B. Like Credit Shelter Trust A, this trust can be created for the benefit of the surviving spouse and descendants, although including the surviving spouse as a beneficiary may imperil a basis step-up for these assets at the first death, as discussed below.

If assets remain in the surviving spouse's share after full funding of Credit Shelter Trust B, the remainder of the surviving spouse's assets will be used to fund QTIP 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 discussed below.

Credit Shelter Trust A

The assets of Credit Shelter Trust A are treated as coming from the first dying spouse. They are included in the first dying spouse's gross estate for estate tax purposes pursuant to 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 produces a stepped-up basis.[9]

A spendthrift provision in Credit Shelter Trust A provides creditor protection for the surviving spouse because the first dying spouse (rather than the surviving spouse) will be deemed to be the grantor/transferor of the trust. To increase creditor protection, it may be best to limit the surviving spouse's right to receive distributions in the discretion of the trustee according to an "ascertainable standard," that limits distributions to being 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.[10]

QTIP Trust A

Similarly, the assets of QTIP Trust A will also be included in the first dying spouse's estate under Section 2038. These assets will avoid estate tax on the first dying spouse's death because Section 2056(b)(7) permits an estate tax marital deduction for QTIP trust assets, so long as the surviving spouse has a qualifying income interest for life. These assets should also receive a stepped-up basis on the first dying spouse's death, unless the one-year rule under Section 1014(e) applies. Because the assets remaining in this trust 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 at that time.

Even with a spendthrift provision, QTIP Trust A cannot provide total creditor protection because the surviving spouse must have a right to income in order to qualify for the marital deduction. Therefore, creditors will be able to reach the income distributions after they are received by the spouse, if the trust has income. However, the principal can be 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 be-

9 Ltr. Ruls. 200101021 and 200210051; see also Mulligan, *supra* note 8 (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.

10 See e.g. Fla. Stat. 736.0504(3) (2012) (providing that "[i]f the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee").

cause of the surviving spouse's right to income.[11] However, although the surviving spouse may be able to require the trust to hold income-producing assets, there is no requirement that the trust produce a minimal amount of income.[12]

Credit Shelter Trust B

Now we will examine how the first death affects the trust or trust funded from the surviving spouse's share of the JEST.

Estate tax. Credit Shelter Trust B is designed to use up whatever is left of the first dying spouse's estate tax exemption after the funding of Credit Shelter Trust A. In order to make use of this remaining exemption amount, assets from the surviving spouse's share must be used to fund Credit Shelter Trust B after being included in the first dying spouse's estate for estate tax purposes.

By providing the first dying spouse with a testamentary general power of appointment over all of the trust assets, the assets of Credit Shelter Trust B are includable in the first dying spouse's estate under Section 2041, as was the case in most of the rulings.[13]

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

Risk 3: Inclusion of Credit Shelter B assets in surviving spouse's estate. Although the IRS rulings were favorable, they are not binding on the Service and cannot be cited as precedent. Therefore, the IRS could possibly reach a different conclusion on this issue 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 on 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 exercisable only in conjunction with the creator of the power, which would not be considered a general power of appointment under Section 2041(b)(1)(C)(i).[14]

Less than all of the first dying spouse's estate exemption amount would be used if the first dying spouse's testamentary power is not considered a general power of appointment. In that event, the surviving spouse may have the benefit of a portability allowance, and may use his or her exemption amount to fund Credit Shelter Trust B as a gift. The assets in Credit Shelter Trust B would then arguably be includable in the gross estate of the surviving spouse under Sections 2036 and 2038, unless special structuring is employed.

A 1935 court decision from the Ninth Circuit, in *Johnstone*[15] provides support for the argument that the testamentary power of appointment held by the first dying spouse is in fact a general power. In this case, the Ninth Circuit determined that the decedent who died before the grantor of a revocable trust had a testamentary general power of appointment over trust assets, even though the grantor had retained the power to alter or amend the trust during their joint lifetimes. Finding a general power, the court stated the following:

> [I]n trust C there was a reserved power in the donor, during her lifetime, to alter or modify the trust agreement, but not to revoke the same. These reserved powers, if exercised, might also have prevented the exercise by the decedent of the general power of appointment by will. However, these reserved powers were not exercised, and at the time of his death the decedent was entitled to exercise the general power of appointment under the terms of the trust agreements. *In trust C, although the decedent, the donee of the power, predeceased the donor, the power of the donor to alter or modify the trust agreement terminated with the death of the decedent at which time the trust, under the terms of the trust agreement, terminated. Thus at the time of his death the decedent had a general power of appointment over the property here involved.*

Although this case was decided under old law, it provides a strong argument that the first dying spouse has a general power over the joint trust assets, despite both spouses having the power to revoke the trust assets during their lifetimes.

11 Reg. 20.2056(b)-5(f)(4).

12 Reg. 20.2056(b)-5(f)(4) (stating that "a power to retain trust assets which consist substantially of unproductive property will not disqualify the interest if the applicable rules for the administration of the trust require, or permit the spouse to require, that the trustee either make the property productive or convert it within a reasonable time. Nor will such a power disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets").

13 The same conclusion was also reached in Ltr. Rul. 200210051, where each spouse had the power to withdraw all of the trust assets while both were living. This approach is not recommended 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 imperil only that spouse's share of the trust.

14 Mulligan, *supra* note 8.

15 76 F.2d 55, 15 AFTR 382 (CA-9, 1935).

Mr. Mulligan points out that the IRS could also determine that the assets of Credit Shelter Trust B are includable in the surviving spouse's estate under a "conduit" or "step transaction" analysis, whereby the IRS would view the separate transactions as one, ultimately determining that the surviving spouse is the actual contributor of the assets of Credit Shelter Trust B. Again, this will trigger Sections 2036 and 2038 rather than Section 2041. He cites cases in which 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.[16]

In the end, however, Mr. Mulligan points out that the lifetime QTIP rules justify ignoring these arguments where spouses are involved. Under the QTIP rules, Spouse A can set up a lifetime QTIP for Spouse B with Spouse A's assets, and the trust can benefit Spouse A after the death of Spouse B. 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 these assets. 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.[17] They note that the IRS could determine that the surviving spouse is the transferor of the Credit Shelter Trust B, causing inclusion in his or her estate under Section 2036 (if the surviving spouse had the right to receive income from Credit Shelter Trust B) or Section 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, by being merely a discretionary beneficiary, the IRS could include the assets in the surviving spouse's estate for one of two reasons:

1 The Service could find an "implied understanding" that the surviving spouse would receive distributions from the trust.

2 The Service could decide that, under state law, the trust is self-settled and the surviving spouse's creditors could therefore reach the assets.[18]

The risk of estate tax inclusion may be reduced through proper planning and trust management. Careful drafting and conduct may negate an "implied understanding." Further, drafting to avoid creditors (such as by setting up Credit Shelter Trust B in a jurisdiction that protects self-settled trusts) can be helpful both for tax and nontax reasons (the nontax reasons are discussed below).

In addition, an attempt could be made to structure the funding of the joint trust to minimize the need for a Credit Shelter Trust B created with the surviving spouse's assets. 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.

Messrs. Gans, Blattmacher, and Bramwell express concern that the IRS' reasoning in these rulings could invite abuse by taxpayers seeking to overcome the step-transaction doctrine in other contexts. Mr. Mulligan, however, seems to feel that the QTIP analogy will continue to support the IRS' favorable determinations. Planners forced to confront this issue and seeking certainty may consider getting IRS rulings of their own.

In determining whether Credit Shelter Trust B can be properly funded, planners should consider two questions:

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 fully use both exemptions anyway, what

16 Footnote 14 of Mr. Mulligan's article, *supra* note 8, supports this concept by citing the cases of Mahoney, 831 F. 2d 641, 60 AFTR2d 87-6152 (CA-6, 1987); Marshall Estate, 51 TC 696 (1969); Estate of Sinclaire, 13 TC 742 (1949); and Estate of Schwartz, 9 TC 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 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."

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."

17 Gans, Blattmachr, and 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).

18 *Id* (stating that "[i]n other words, if as a matter of state law the donor spouse is treated as having funded the trust and her creditors could therefore reach the trust's assets, the spouse's estate would include the assets under 2041 even though she is not deemed the transferor for estate tax purposes").

is the harm if that aspect of the joint trust arrangement does not work?

2 Can any harm caused by inclusion be minimized?

As to 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 accomplished 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 tax on the income remaining in the trust or distributed to other beneficiaries, and the tax payments would reduce his or her taxable estate without being considered gifts. Having Credit Shelter B treated as a defective grantor trust established and funded by the surviving spouse could actually save more estate tax than would otherwise be the case by having the surviving spouse's estate reduced by the income taxes paid by him or her on the trust income, assuming that the surviving spouse has no power of appointment or rights over the trust assets that would cause Credit Shelter Trust B to be included in his or her estate for estate tax purposes.

Marital deduction

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.[19] 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 the suggested arrangement, for both reasons). The rulings conclude that this completed gift by the surviving spouse would qualify for the estate tax marital deduction (assuming that the first dying spouse is a U.S. citizen).

Risk 4: The gift to first dying spouse may not qualify for the marital deduction. 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 do not go into detail on the marital deduction question, the Service had to reach two conclusions in order to determine that the marital deduction applied:

1 The gift occurred when the spouses were married.

2 The gift did not involve a nondeductible terminable interest.

While pointing out that this determination has been made in nonbinding rulings, the commentators have suggested that the IRS may later abandon these conclusions.[20] They point out that whether the gift was considered to be made when the spouses were married turns on exactly when the gift was made. If the surviving spouse is considered to have made the gift after the moment of the first dying spouse's death, the parties were not then married, and the marital deduction would not apply. However, if the surviving spouse is deemed to have made the gift before or at the moment of the first dying spouse's 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.[21] In that situation, it has been held that a gift occurs at the moment of death, rather than after death.[22] They note that "no policy justification exists for refusing to extend this rationale to the [joint trust] strategy."

Messrs. Blattmachr, Gans, and Bramwell also discuss the Ninth Circuit Court of Appeal's 1935 decision in *Johnstone*, 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* on this issue with inconsistent results. On the other hand, *Johnstone* did not involve a transfer between spouses, while the simultaneous death authorities involve interspousal transfers. In light of these authorities, the authors 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 may be 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

19 See Ltr. Ruls. 200101021, 200210051, and 200403094.

20 Mulligan, *supra* note 8; Gans, Blattmachr, and Bramwell, *supra* note 17.

21 Gans, Blattmachr, and Bramwell, *supra* note 17. The "common disaster" presumption applies only when there is no evidence as to the order of death. Reg. 20.2056(c)-2(e).

22 See Reg. 20.2056(c)-2(e); Estate of Bagley, 443 F.2d 1266 27 AFTR2d 71-1852 (CA-5, 1971). In Bagley, Mr. Bagley's will created a testamentary trust for his wife's benefit during her lifetime and gave her a general testamentary power of appointment over this trust. Mr. Bagley's will provided that this power of appointment could be exercised in his wife's will by specific reference to the power. His will also provided that in the event of a simultaneous death, his wife would be deemed the survivor. His wife's will made no reference to the power of appointment. Both spouses died in a car accident, and no evidence existed as to the order of their death. The court determined that "[t]he power of appointment given to Mrs. Bagley under her husband's will was created immediately upon the death of the husband, subject to later perfection by probate."

property to satisfy Section 2523(e): a right to receive lifetime income and a general power of appointment over the applicable interest.

In Ltr. Rul. 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 other rulings, the first spouse to die received only a testamentary general power of appointment with no particular income rights. Although the IRS allowed a marital deduction in these rulings, it did not provide any discussion of the terminable interest issue.

Messrs. Blattmachr, Gans, and Bramwell express concern about the fact that the surviving spouse was granted a "naked" testamentary general power of appointment (a power without an income interest) in the rulings. They caution that the Service may reexamine its position on this issue in the future, because a power of appointment without an income interest does not satisfy the non-terminable interest exception under Section 2523(e). They therefore suggest that the surviving spouse would have to rely on an exception created by case law, which allows a marital deduction when the spouse has the option to either accept or reject a gift within a reasonable time and ultimately accepts the gift. Finding acceptance here would seem to require that the surviving spouse actually exercise the testamentary power of appointment. Although one ruling did involve the exercise of the power,[23] the others did not. Further, these commentators feel that even exercising the power may not be enough, because the relevant cases all involve spouses who personally accept outright gifts rather than receiving a power of appointment.

The authors expect that the IRS will retain this favorable position on the marital deduction issue and eventually issue a definitive ruling. In the meantime, short of requesting a ruling for each joint trust we prepare, how can estate planners reduce the chance of a marital deduction problem if the IRS takes the position that the surviving spouse made a gift to the first dying spouse that would otherwise be taxable?

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

To help bring the gift within the statutory requirements of Section 2523(e), it may also be useful to include a provision in the trust that allows both spouses to withdraw principal from the trust while both are living, as found in Ltr. Rul. 200210051.[24]

If all else fails, a savings clause in the trust agreement could directly or indirectly provide that if the gift tax marital deduction does 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 do not 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, a description of the contingency could alert the Service to the marital deduction issue if it is not otherwise aware of it.

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 sitused in 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.

Creditor protection

The next risk to consider involves creditor protection concerns.

Risk 5: No creditor protection from the surviving spouse's creditors. Where an individual transfers assets to a trust for his or her own benefit, most states allow 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 to be the trans-

23 Ltr. Rul. 200403094.

24 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 Reg. 25.2523(e)-1(f)(6). Whether each spouse is comfortable with the other spouse having such a power is another question. In Ltr. Rul. 200210051, however, each spouse had the right to receive principal *and* income from the trust during their joint lifetime, which Mr. Mulligan believes to satisfy the requirements of Reg. 25.2523(e)-1(f)(8).

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feror of the assets for creditor protection purposes. This could allow creditors of the surviving spouse to reach the assets of Creditor Shelter Trust B if the surviving spouse is a beneficiary.

Note that estate tax and creditor protection 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 creditors would be to situate Credit Shelter Trust B in an "asset protection trust" jurisdiction such as Nevada, Alaska, Delaware, Ohio, 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 require the trustee to invest in a family LLC or limited partnership to obtain charging order protection so that the surviving spouse's creditors would have a more difficult time obtaining assets from Credit Shelter Trust B. But this would not prevent the IRS from concluding that the surviving spouse's creditors 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.

Stepped-up basis

In its rulings, the IRS determined that the assets in the surviving spouse's share of the joint trust could not obtain a stepped-up basis under Section 1014(a) on the first death, even though the assets are includable in the gross estate of the first dying spouse. The authors believe that the IRS is wrong and that a basis step-up should be available, particularly if the surviving spouse's rights in the trust assets are limited after the first death. Although the authors expect the Service to continue to take this position, there are ways to significantly increase the chances of a successful outcome.

In the rulings, the IRS asserted that the step-up was prohibited by 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. Section 1014(e), however, provides the following exception to this rule:

> [I]f 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.[25] [Emphasis added.]

For Section 1014(e) to apply, the property must be "acquired by" or "pass 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 possible benefit of the surviving spouse? In its rulings, the Service has concluded that this language precludes a basis step-up without providing any explanation. The authors share the belief of many others that the Service has stretched the literal language of the law in reaching this conclusion. "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; therefore, the less interest that the surviving spouse has in this trust, the more likely that the IRS will accept that Section 1014(e) should not bar a step-up.

For example, 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.[26] No rulings or cases explicitly confirm this conclusion, but it is difficult to say that property "passed to" or was "acquired by" a discretionary beneficiary, who by definition has no certain rights to the property.

QTIP Trust B

As mentioned above, QTIP Trust B is funded only if assets remain in the surviving spouse's share after funding Credit Shelter Trust B. Many of the same risks applicable to Credit Shelter Trust B, discussed above, are also applicable to QTIP Trust B; however, the QTIP nature of this trust creates a few important differences, which are discussed below.

Estate tax and marital deduction. The assets of QTIP Trust B will be includable in the first dying spouse's estate, but will not be sub-

25 Ltr. Ruls. 200101021 and 200210051.

26 See Barreira, "Proper Medicaid Planning May Permit Keeping the Home in the Family" 28 ETPL 177 (April 2001) (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").

ject to estate tax at the first death pursuant to the marital deduction. To qualify for the marital deduction, however, the surviving spouse must receive all income from this trust at least annually.[27] Estate tax will be deferred for QTIP Trust B assets until the surviving spouse's death. At that point, the assets of QTIP Trust B will be included in the surviving spouse's gross estate and be subject to estate tax, if the surviving spouse's personal assets and QTIP Trust B assets exceed the surviving spouse's remaining estate tax allowance.

Creditor protection. Unlike Credit Shelter Trust B, where the surviving spouse is not required to be an income beneficiary, the surviving spouse must receive all income (if any) from QTIP Trust B in order to meet the marital deduction requirements under Section 2056(b)(7). Accordingly, the surviving spouse's creditors can reach any income that is actually distributed to the surviving spouse. However, if the surviving spouse is only an income beneficiary, his or her creditors cannot reach the principal of QTIP Trust B, and the income can be minimized.

Stepped-up basis. As previously noted, the estate tax marital deduction requires that the surviving spouse be an income beneficiary of QTIP Trust B. Again, the authors and others feel that a stepped up basis should still occur notwithstanding that a surviving spouse who was considered to have gifted the assets involved to the first dying spouse would have the right to receive principal in the discretion of a trustee, an income interest, or a special power of appointment. The surviving spouse, however, will have a stronger argument for a step-up in basis if the spouse retains fewer rights in QTIP Trust B.

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 private letter rulings. Although not without uncertainty as to whether both a full stepped-up basis and full funding of a credit shelter trust will occur on the first death, many couples and their descendants will be better off for having used this arrangement for the reasons described above. While the IRS may not agree with all tax advantages described in this article, if the client would be no worse off having only the advantages the IRS might allow (one-half of a stepped up basis and one-half of a credit shelter trust funding) then it should be more than worthwhile to attempt to position the family in the best manner possible, and to monitor the tax law as it will eventually work itself out in the future.

Practitioners should invest time to understand these issues, and to understand and develop trust documents that take the above and many other considerations into account. Practitioners should also make sure that clients understand the risks and possible advantages of this system. Each client's situation merits special drafting that can save much in taxes while positively enhancing family and creditor protection planning.

Unequal funding of the trust while both spouses are alive raises the possibility of a gift upon funding.

To increase creditor protection, it may be best to limit the surviving spouse's right to receive distributions in the discretion of the trustee according to an "ascertainable standard."

It may also be useful to include a provision in the trust that allows both spouses to withdraw principal from the trust while both are living.

The less interest that the surviving spouse has in this trust, the more likely that the IRS will accept that Section 1014(e) should not bar a step-up.

If the surviving spouse is only an income beneficiary, his or her creditors cannot reach the principal of QTIP trust B, and the income can be minimized.

27 Section 2056(b)(7).