## TABLE OF CONTENTS

**Page**


I. Tax Policy and Marriage ..... 1

II. Treatment of Marriage for Estate Planning and Estate Tax Purposes ..... 2

III. Who is Considered Married for Tax Purposes and Eligible for the Marital Deduction ..... 6

IV. Standard Marital Estate Planning Approaches ..... 14

V. Analysis of Portability After Eleven Years of Use ..... 16

VI. Planning for Marriage . . . and Failure ..... 30

VII. Conclusions ..... 41

# LOVE AND MARRIAGE AND ESTATE PLANNING

**Thomas W. Abendroth**

Love and marriage, love and marriage
They go together like a horse and carriage
This I tell you brother
You can't have one without the other

from the song by Frank Sinatra
lyrics by Sammy Cahn and music by Jimmy Van Heusen

## I. Tax Policy and Marriage

A. At first blush, someone new to the world of taxes and financial planning might think that the topic of marriage and taxes would not receive much attention. It is in fact the subject of frequent commentary. Just google "marriage penalty" and that becomes obvious.

B. Federal and state tax rules in fact can have a significant impact on married individuals, and tax policy that that affects or modifies that impact can generate a great deal of attention. Over 1,000 federal laws exist in which benefits, rights, and privileges are contingent on marital status, or in which marital status is a factor; over 200 of those laws are tax laws in the Internal Revenue Code. Probably the most significant example of this is the last decade is United States v. Windsor, 133 S. Ct. 2675 (U.S. 2013), declaring unconstitutional Section 3 of the Defense of Marriage Act, which became law in 1996 and among other things defined marriage as "only a legal union between one man and one woman as husband and wife."

C. The inter-connectivity of marriage and taxes actually did not exist before 1948. Before 1948, there was no marriage penalty, or marital deduction. Every taxpayer filed a separate return.

1. The changes to the tax code in the Revenue Act of 1948 were not designed to penalize or benefit married couples in an intentional way. Rather they were in response to the disparate treatment of married couples in community property states as compared to separate property states.

2. The impact of state community property laws was recognized at the federal level. As a result half the income earned by one spouse in a community property state was treated as income of the other spouse. If one spouse earned $100,000, each spouse reported $50,000 of income on their separate tax returns and paid tax at lower bracket rates than a similarly situation couple in a separate property state.

3. There was also an impact in applying the federal estate and gift taxes. A decedent with a $600,000 estate in, for example, Illinois, had to report and

pay estate tax on the entire $600,000 at death. In a community property state like Texas, if the estate was attributable to community property earnings, only $300,000 was included in the decedent's estate for estate tax purposes. There were only very limited free transfers between a wife and husband, so a couple in a separate property state could not easily plan around this result by using lifetime gifts.

4. The 1948 legislation created the joint tax return. Initially the tax brackets for married filing jointly were set at double the brackets for a single taxpayer. It was other legislation over time that modified tax brackets and created qualification limits based on income for deductions and credits that created "marriage penalty" anomalies.

5. The largest impact, however, was social change - the emergence, and indeed now prevalence, of two-earner couples. Most married couples with one wage earner will not suffer an income tax marriage penalty. It is two-earner couples that suffer the penalty most often.

D. The Revenue Act of 1948 also introduced the estate and gift tax concept that, today, is so fundamental to the industry of estate planning that it is hard to imagine it once did not exist – the marital deduction.

II. Treatment of Marriage for Estate Planning and Estate Tax Purposes

A. The Revenue Act of 1948 also attempted to eliminate the disparities between community and separate property states in the transfer tax area by creating a marital deduction for estate tax and gift tax purposes under Code Sections 2056 and 2523. After enactment, a spouse in a non-community property state, or a community property resident with respect to non-community property, could claim a marital deduction for up to half his or her property by leaving it to the surviving spouse.

B. The Tax Reform Act of 1976 increased the maximum marital deduction for many taxpayers by setting the maximum allowable deduction at the greater of $250,000 or half the adjusted gross estate.

1. The 1976 Act also unified the federal estate and gift tax systems, and made them subject to a single tax rate table under which all lifetime taxable transfers and all taxable transfers at death are considered together.

2. It added Section 2010 to Code, creating a unified credit against the estate and gift taxes that exempts a certain amount of property from the tax. The credit is now identified in the Code as the applicable credit amount. The amount sheltered by the credit is the applicable exclusion amount. IRC § 2010(a), (c). A taxpayer could exempt property from gift tax or estate tax using the applicable exclusion amount.

C. The final major change to the marital deduction rules was in The Economic Recovery Tax Act of 1981. It brought us the system we have today, with an unlimited marital deduction. **This was a tax policy decision that decidedly gave married couples a benefit.** The policy underlying the 1981 tax act was that the federal government would require payment of estate tax, if at all, only once for a married couple. If the couple chose to defer estate tax until the death of the survivor, they always could do so, by leaving property at the death of the first spouse to die to the surviving spouse.

1. The Economic Recovery Tax Act of 1981 also made another important, marriage related, change to the Code. It created the Qualified Terminable Interest Property Trust, or QTIP Trust.

2. The decedent could now leave property in trust for her or his surviving spouse, qualify it for the marital deduction, and still maintain complete control over ultimate disposition of the property at the surviving spouse's death. Previously, any trust qualifying for the marital deduction had to give the spouse the ability to dictate where the property went at his or her death.

D. These two changes to the estate tax system left married couples with a choice. They could take the easy route, leave all property at the first death to the surviving spouse, and defer but not necessarily avoid or minimize estate tax. Or they could create a separate credit shelter trust to utilize the first spouse's exclusion amount to the extent it was available. Most couples with knowledgeable counsel chose the latter option. The A/B estate plan with an optimum marital deduction, as we know it today, became an integral part of estate planning.

E. The time period since 1977 also has witnessed a continual increase in the exclusion amount, very slowly at first with an exclusion amount at levels that resulted in a significant number of estates being potentially subject to estate, and then much more rapidly.

1. From 1977 to 2001, the applicable credit and effective exclusion amounts changed as follows:

| Year | Applicable Credit Amount | Applicable Exclusion Amount |
|---|---|---|
| 1977 | $30,000 | $131,000 |
| 1978 | 34,000 | 144,333 |
| 1979 | 38,000 | 157,666 |
| 1980 | 42,500 | 172,666 |
| 1981 | 47,000 | 187,666 |
| 1982 | 62,800 | 225,000 |
| 1983 | 79,300 | 275,000 |
| 1984 | 96,300 | 325,000 |

| Year | Applicable Credit Amount | Applicable Exclusion Amount |
|---|---|---|
| 1985 | 121,800 | 400,000 |
| 1986 | 155,800 | 500,000 |
| 1987-1997 | 192,800 | 600,000 |
| 1998 | 202,050 | 625,000 |
| 1999 | 211,300 | 650,000 |
| 2000-2001 | 220,550 | 675,000 |

2. The Economic Growth and Tax Relief Reconciliation Act of 2001 provided for a gradual increase of the applicable credit amount for estate taxes from $1,000,000 to $3,500,000, followed by suspension of the estate tax in 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 increased the exclusion amount to $5,000,000 and provided that it would be indexed for inflation beginning in 2012. The Tax Cut and Jobs Act of 2017 then doubled it. The history of estate exclusion amounts since 2001 is as follows:

| Applicable Year | Applicable Credit Amount | Applicable Exclusion Amount |
|---|---|---|
| 2002-2003 | $345,800 | $1,000,000 |
| 2004-2005 | $555,800 | $1,500,000 |
| 2006-2009 | $780,800 | $2,000,000 |
| 2009 | $1,455,800 | $3,500,000 |
| 2010 | No tax | No tax |
| 2011 | $1,730,800 | $5,000,000 |
| 2012 | $1,772,800 | $5,120,000 |
| 2013 | $2,045,800 | $5,250,000 |
| 2014 | $2,081,800 | $5,340,000 |
| 2015 | $2,117,800 | $5,430,000 |
| 2016 | $2,125,800 | $5,450,000 |
| 2017 | $2,141,800 | $5,490,000 |
| 2018 | $4,417,800 | $11,180,000 |
| 2019 | $4,505,800 | $11,400,000 |
| 2020 | $4,577,800 | $11,580,000 |
| 2021 | $4,625,000 | $11,700,000 |
| 2022 | $4,769,800 | $12,060,000 |

F. The estate and gift tax essentially became a flat tax. Under the current rate schedule, any amount above the applicable exclusion will be taxed at the top rate of 40%. These estate tax has become a tax that do not apply to, maybe not the

"99.8%" that Bernie Sanders likes to reference, but to at least 98% of taxpayers and their estates.

G. Except for increases in the exclusion, marital deduction estate planning largely remained unchanged until 2010. Then came "portability," the concept of being able to leave one's unused applicable exclusion amount to his or her surviving spouse. Section 2010 of the Code, as amended by Sections 302(a)(1) and 303(a) of the Tax Relief Act of 2010, created portability by introducing the concept of "deceased spousal unused exclusion amount" ("DSUE amount"). Section 2010(c)(2) defines the applicable exclusion amount as "the sum of (A) the basic exclusion amount, and (B) in the case of a surviving spouse, the deceased spousal unused exclusion amount."

H. Portability Provisions and Scope

1. Portability is available without regard to the size of the estate of the decedent or the reason for the decedent having unused exclusion amount.

   a. A 2022 decedent with an $8 million estate, all left in taxable form, leaves $4.06 million of DSUE amount (exclusion that is portable).

   b. A 2022 decedent with an $18 million estate, who leaves $6 million to his children and $12 million to his spouse and charity, leaves $6.06 million of DSUE amount.

2. The definition of applicable exclusion amount also applies for gift tax purposes. The 2010 Act amended Code Section 2505 (Unified Credit Against Gift Tax) to define the credit for gift tax purposes by reference to "the applicable credit amount in effect under section 2010(c) which would apply if the decedent died as of the end of the calendar year." Thus, a surviving spouse may use his or her enhanced applicable exclusion amount for gifts.

3. Portability does not apply to the GST exemption. Section 2631(c), as amended by the 2010 Act, defines the GST exemption amount as equal to "the basic exclusion amount under section 2010(c)."

4. While the basic exclusion amount is adjusted for inflation, the DSUE amount is not adjusted for inflation once transferred to the surviving spouse. If John as surviving spouse received $5 million of DUE amount, it will remain at $5 million for the remainder of his life.

5. By statute, portability must be elected by the deceased spouse's executor on a timely filed Form 706 for the deceased spouse. IRC § 2010(c)(5).

6. The statute limits the surviving spouse to use of the unused exclusion of his or her last deceased spouse. This limitation applies regardless of whether the last deceased spouse has any unused exclusion or whether the

last deceased spouse's executor makes or fails to make a timely election. Thus, an individual can lose DSUE amount if he or she remarries and his or her second spouse also dies first.

a. A surviving spouse can preserve DSUE amount by making taxable gifts. The gifts will use DSUE amount first, and that use is not lost if the spouse remarries and survives another spouse. Treas. Reg. § §25.2505-2(b), (c).

b. The JCT Technical Explanation that accompanied the regulations provided an example that illustrated this option. In the Example, Wife had exclusion of $7,000,000, consisting of her $5,000,000 basic exclusion amount and $2,000,000 DSUE amount from Husband 1. Wife makes a $3,000,000 taxable gift. She is assumed to use her DSUE amount first, so she has $4,000,000 of basic exclusion amount remaining after the gift. If Wife dies and leaves her entire estate to Husband 2, her executor can elect to pass her $4,000,000 of applicable exclusion to Husband 2. T.D. 9593, Explanation of Provisions.

c. These ordering rules clearly are a benefit to high net worth individuals. In estates of $5,000,000 to $10,000,000, the spouse may be less able, or willing, to make significant lifetime gifts.

I. Since the enactment of the portability provisions, the decision-making around marital deduction planning has changed. As will be discussed herein, the ability to preserve the use of both spouse's exclusions without creating a credit shelter trust brings into play a new set of tax and non-tax considerations.

1. Portability can allow couples to create simpler estate plans. But simpler is not necessarily better.

2. More importantly, portability allows couples to preserve the exclusion of the first spouse to die even if he or she did not own sufficient assets to fully use the exclusion at death.

3. But before discussing these impacts on planning, these materials discuss who is allowed to take advantage of the special estate and gift tax rules that exist for married couples.

## III. Who is Considered Married for Tax Purposes and Eligible for the Marital Deduction?

### A. Core Requirements for the Marital Deduction

1. There are two fundamental requirements for obtaining the marital deduction for a decedent's property.

a. The decedent must be married at the date of death.

b. The property passes to a surviving spouse, outright or in a qualifying trust.

2. One would thinking the requirement that there be a surviving spouse is simple to understand and not avoidable. But at least one taxpayer's estate thought it could be circumvented.

3. In Estate of Lee v. Commissioner, T.C. Memo. 2007-371, the decedent claimed a marital deduction for property passing to a spouse who predeceased the decedent.

a. Mr. and Mrs. Lee both suffered from terminal conditions disease when their estate planning documents were prepared. At the time that the planning was done, most of the assets were held in Mr. Lee's name. The joint assets and the assets titled in Mrs. Lee's name constituted a minimal portion of the combined estates. Mrs. Lee died on August 15, 2001. Mr. Lee died subsequently on September 30, 2001.

b. The executor interpreted Mr. Lee's will as providing that Mrs. Lee should be deemed to have survived Mr. Lee, if Mr. Lee died within six months after Mrs. Lee's death. In this way an A/B plan could be implemented with a credit shelter trust for Mrs. Lee and the children and an outright marital gift to Mrs. Lee.

c. After their deaths, Mr. and Mrs. Lee's separate estates were administered as if Mr. Lee had predeceased Mrs. Lee. A credit shelter trust was established for the benefit of Mrs. Lee and their children and the residue of Mr. Lee's estate was transferred to Mrs. Lee as if she were still alive. Mr. Lee's estate tax return claimed the marital deduction for the residue that was transferred to Mrs. Lee.

d. Upon audit, the IRS denied the marital deduction determined an estate deficiency of $1,020,000, and imposed an accuracy related penalty of $204,000 and an additional tax of $255,000 for an untimely filing.

e. The Tax Court, on a motion for summary judgment, found that the marital deduction requires an actual surviving spouse to meet the requirement in Code Section 2056(a) that the marital deduction is available for interests in property passing from the decedent to the surviving spouse. Because Mrs. Lee died 46 days before Mr. Lee, Mr. Lee left no surviving spouse. Consequently, Mr. Lee's estate was not entitled to benefit from the marital deduction. The wills of Mr. and Mrs. Lee could not operate to change the order of death.

f. The Tax Court also noted that the term "survivor" is not defined in the Internal Revenue Code. Consequently, it must be given its ordinary and customary meaning of one who outlives another. Moreover presumptions of death only apply when the actual order of death cannot be determined. Treas. Reg. § 202056(c)-2(e) provides that a presumption, whether supplied by local law, a decedent's will, or otherwise, may operate to determine the order of the deaths of spouses if the actual order of their deaths cannot be determined. This was not a case in which the actual order of deaths could not be determined.

B. State Law Governs what is Marriage (for the most part)

1. In general, state law determines the nature of a taxpayer's property interests and the person's status for property law purposes. Consistent with these principles, the determination whether a couple is married is governed by state law. See Estate of Goldwater v. Commissioner, 64 T.C. 540, 550 (1975) ("In our view the congressional intent in enacting section 2056 was that the term 'surviving spouse' refers to the same person who is the surviving spouse under the law of the State in which the decedent's estate is being administered."), aff'd, 539 F.2d 878 (2d Cir. 1976)

2. On occasion, however, the federal government will question a couple's marital status. The most recent example of this in the estate tax context is the entertaining case of Estate of Grossman v. Commissioner, T.C. Memo 2021-65

3. In Estate of Grossman, the Tax Court recognized a religious divorce and Israeli marriage, over the objection of the IRS, and allowed an estate tax marital deduction for property passing to surviving spouse.

a. This matter came before the court on cross motions for partial summary judgment. The issue was whether Ziona Grossman was the surviving spouse of Semone Grossman for purposes of the estate tax marital deduction. Semone and Ziona, both Jewish and residents of New York, celebrated their marriage in Israel in 1987 pursuant to Israeli laws after Semone obtained a religious divorce from his first wife Hilda, who was also Jewish and a New York resident. After their marriage, Semone and Ziona returned to New York, had two daughters, and lived together as husband and wife for twenty-seven years until Semone's death in 2014.

b. Semone and Hilda were married in 1955. In 1967, Semone began a new relationship with Katia, who was not Jewish, and obtained a divorce in Mexico in which Hilda neither appeared nor participated. In 1974, after Semone's and Katia's relationship had ended, Hilda challenged the validity of the Mexican divorce in

New York state court. The New York court declared that Hilda's marriage to Semone was not legally dissolved and that the marriage of Semone with Katia was null and void.

c. Later, Semone met Ziona. In 1986, before Semone married Ziona, Hilda agreed with Semone to him giving her a *get* which is a religious divorce under rabbinical law and which was granted. Hilda thereafter never claimed she was still married to Semone. In 1987, Semone and Hilda were married in Israel in an Orthodox Jewish religious ceremony and issued a marriage certificate by the Israeli Ministry of Religious Services.

d. After their marriage, Semone and Ziona filed joint income returns. When he died in 2014, Semone was buried in Israel alongside Ziona's parents. Semone in his will directed that any reference to "my wife" meant Ziona.

e. Semone had a large estate which was valued at approximately $87 million on a gross basis. The bulk of the estate ($79 million) was left to Ziona.

f. The IRS, in the audit of Semone's federal estate tax return, determined that Semone and Ziona were not married to each other for federal estate tax purposes and that the amounts left to Ziona failed to qualify for the estate tax marital deduction. The IRS asserted that Semone's estate owed an additional $35,497,032 in federal estate tax and imposed an accuracy related penalty under Section 6662 of $7,099,406.

g. The court ruled that Semone and Ziona were properly married. The court said that New York law would recognize Semone's and Ziona's marriage if it was lawful under the laws of the place in which marriage was celebrated which in this case was Israel. Israel had recognized the marriage as lawful.

h. The court quoted the oft-expressed concern that "Congress did not intend that the Commissioner in making tax determinations around marital status, or the courts in passing upon them, should set themselves up as domestic relations tribunals." Estate of Borax v. Commissioner, 349 F.2d 666, 676 (2d Cir. 1965) (Friendly, J. dissenting). It noted that the parties most interested in the status of Semone and Ziona's marriage, Semone, Ziona, and Hilda, did not challenge the marriage. No New York court (or any other court) found the marriage invalid. As a result, the court was not going to assume, based on the facts presented, that Semone and Ziona were not husband and wife under New York law. The court granted the

estate's motion for partial summary judgment and denied the IRS's motion for partial summary judgment.

C. Common Law Marriage

1. Common-law marriage is a marriage that takes legal effect without the prerequisites of a marriage license or participation in a marriage ceremony.

2. Only a minority of states have statutes that address common law marriage. Some, like Colorado (Colo. Stat. §14-2-109.5), explicitly recognize common law marriage as a marriage under state law. Others, like Iowa, recognize it only for purposes if specific statutes; in Iowa, the Support of Dependents Chapter (Iowa Code §252A.3) Otherwise it is not explicitly prohibited (Iowa Code §595.1A).

3. More information on the treatment of common law marriage under state law can be found at Common Law Marriage by State (ncsl.org) .

4. The IRS has long recognized common law marriage for federal tax purposes, consistent with the principle referred to above on looking to state law to define marriage. See Revenue Ruling 58-66, 1958-1 C.B. 60 (ruling that a couple would be treated as married for purposes of federal income tax filing status and personal exemptions if the couple entered into a common law marriage in a state that recognizes that relationship as a valid marriage).

5. Note that the applicable test is not whether the state in which the couple resides recognizes the common law marriage. It is the state in which the couple entered into the marriage.

D. Unmarried Couples and Married Couples with Limits on their Federal Rights

1. A couple that is not married but in a relationship cannot use the marital deduction. They must plan as any single person would plan. Transfers from one to the other can qualify for the annual exclusion but otherwise will use the applicable exclusion amount. There is no deferral of estate tax at the first death, and if trusts are not used in the planning, assets could be subject to estate tax at each death. Likewise the survivor of the couple had no statutory intestate inheritance rights, or a right to an elective share of the estate.

2. There are two instances where Congress determined that state law marriage does not count as a marriage for purposes of the marital deduction. Thankfully, one of these situations has been rectified, and it hopefully will stay that way. Each is discussed below.

E. Same-Sex Marriages

1. The Defense of Marriage Act ("DOMA") was passed by Congress, rather overwhelmingly, and signed into law by President Clinton, in 1996.

2. Section 2 of the Act absolved states from recognizing same-sex marriages from other jurisdictions:

   No State, territory, or possession of the United States, or Indian tribe, shall be required to give effect to any public act, record, or judicial proceeding of any other State, territory, possession, or tribe respecting a relationship between persons of the same sex that is treated as a marriage under the laws of such other State, territory, possession, or tribe, or as a right or claim arising from such relationship.

3. Section 3 defines "marriage" as "only a legal union of one man and one woman as husband and wife."

   In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

4. By end of the first decade or so of the 2000's, there were twenty-one states and Washington, D.C. that recognized various forms of legal, same-sex relationships. Fifteen jurisdictions fully recognized same-sex marriage, and same-sex civil unions were recognized in three states.

5. As a result of DOMA, many couples that were married for state law purposes could not avail themselves of federal tax laws that applied to married couples.

6. The constitutionality of Section 3 of DOMA was challenged in Windsor v. United States, 570 U.S. 744 (2013)

   a. The case concerned the marriage of Edith Windsor and Thea Spyer, who met in New York in 1963 and began a long-term relationship. In 1993 they registered in New York as domestic partners. Concerned about Thea's health, they married in Canada in 2007. New York recognized the marriage as valid for purposes of New York law. (New York allowed same-sex couples to marry in New York in 2011.)

   b. Thea died in 2009. She left her entire estate to Edith. Edith, as Thea's executor, claimed the marital deduction for this property. Because under Section 3 of DOMA their marriage was not recognized for purposes of federal law, the IRS concluded that Edith was not entitled to the marital deduction. Edith, as Thea's

executor, paid $363,000 of estate tax, then sought a refund in federal court.

c. Edith argued that Section 3 of DOMA violated the Equal Protection Clause of the Fifth Amendment of the United States Constitution, and was therefore unconstitutional.

d. In a 5–4 decision, the Court held that Section 3 of DOMA is "unconstitutional as a deprivation of the liberty of the person protected by the Fifth Amendment of the Constitution." The Court found that the definition of marriage was reserved to the states; it reasoned that "recognition of civil marriage is central to state domestic relations law," and its definition the "foundation of the State's broader authority to regulate the subject of domestic relations."

e. The dissents asserted that the Court did not have jurisdiction to decide the case, because the Attorney General's office refused to defend the statute. The dissents also expressed concern that, although the Court noted that it was not addressing the constitutionality of a state's refusal to recognize same-sex marriage, Windsor would be used to strike down state laws banning same-sex marriage.

7. Those challenges to state laws refusing to recognize same sex marriage did in fact occur. The issue came before the Supreme Court in Obergefell v. Hodges, 576 U.S. 644 (2015), in which the Supreme Court of the United States ruled that the fundamental right to marry is guaranteed to same-sex couples by both the Due Process Clause and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution.

8. In response to the decision in Windsor, the IRS issued Revenue Ruling 2013-17, 2013-38 IRB 20. Under this Revenue Ruling, the IRS holds that for federal tax purposes all references to married individuals, including gender-specific references, are deemed to include same-sex spouses. In addition, for purposes of the Internal Revenue Code, the terms "spouse," "husband and wife," "husband," "wife," and related terms include same-sex spouses who had been lawfully married in a jurisdiction that recognizes that marriage. These positions eventually were incorporated in regulations applicable to the estate, gift and generation-skipping taxes as well as income tax and other provisions.

9. Since the Supreme Court's decision in Dobbs v. Jackson Women's Health Organization, overturning Roe v. Wade, there has been concern that the current Court would be similarly willing to reconsider Obergefell.

a. In Dobbs, Justice Clarence Thomas wrote in a concurring opinion that the court should reconsider other "due process precedents."

b. Any developments in this area, should not automatically impact the decision in Windsor to allow a marital deduction for a state sanctioned marriage. As noted, Windsor was a Fifth Amendment Equal Protection case, not a due process case.

F. Marriage and Non-U.S. Citizens

1. In 1988, Congress decided that allowing the unlimited marital deduction for property passing to a non-U.S. citizen spouse created a tax avoidance problem. The property would pass tax-free to the spouse, who then could leave the United States and completely or largely avoid estate tax at her or his death.

2. As a result, effective for estates of decedents dying after November 10, 1988, property passing to a surviving spouse who is not a U.S. citizen will not qualify for the estate tax marital deduction unless the property passes in a qualified domestic trust (QDOT). IRC §§2056(d), 2056A.

3. A QDOT must meet the requirements for a life estate/general power of appointment trust or QTIP trust. It must have at least one trustee who is a citizen of the United States or a domestic corporation. The U.S. trustee must have the power to withhold sufficient trust principal to pay any estate tax owed on account of a distribution from the trust, or at the surviving spouse's death, as discussed below.

4. To qualify as a QDOT, the trust must meet the requirements set forth in Treasury Regulations.

a. If the trust assets exceed $2 million, valued at the deceased spouse's death, the QDOT must provide either (i) that at least one trustee be a U.S. bank or trust company, or (ii) that the trustee furnish a bond or letter of credit equal to 65 percent of the value of the trust assets at the deceased spouse's death. Treas. Reg. § 20.2056A-2(d)(1)(i).

b. If the trust assets do not exceed $2 million, either (i) the trust must comply with the requirements that apply to larger QDOTs, or (ii) the trust instrument must provide that no more than 35 percent of the trust assets, valued annually, may be invested in non-U.S. real estate. Treas. Reg. § 20.2056A-2(d)(1)(ii).

c. The required security provisions may be incorporated in the trust instrument by reference to the regulations. If it is desired to include the provisions in the trust instrument, the IRS has provided sample language in Rev. Proc. 96-54, 1996-2 C.B. 386.

d. The trustee must file an annual compliance statement with the IRS. Treas. Reg. § 20.2056A-2(d)(3).

5. If a trust is a QDOT, an estate tax will be imposed upon any principal distributions from the trust made at any time before the surviving spouse's death, as well as upon the value of the remaining trust property on the date of the surviving spouse's death. No estate tax is imposed on income distributions from a QDOT. The tax in all cases is equal to the tax that would have been imposed on the property had it been included in the first spouse's taxable estate. Therefore, the property will be taxed at the first spouse's highest marginal tax rate.

6. If a lifetime principal distribution is made to the spouse because of a hardship, the estate tax is not imposed. A distribution would be made on account of hardship if it is made in response to an immediate and substantial financial need relating to the surviving spouse's health, maintenance, or support or the health, maintenance, education, or support of any person that the surviving spouse is legally obligated to support. Treas. Reg. § 20.2056A-5(c)(1).

7. There are extensive rules on how to transfer property to a QDOT after the death of a spouse in order to take advantage of the special rules.

8. Lifetime gifts to a noncitizen spouse similarly do not qualify for the marital deduction. Instead of a QDOT exception, transfers of up to $100,000 per year will qualify for the gift tax annual exclusion under IRC § 2503(b), as long as the gifts are of present interests. All other transfers to the spouse will be fully taxable. IRC §2523(i). The $100,000 amount is inflation adjusted, and as of 2022 it is $164,000.

## IV. Standard Marital Estate Planning Approaches

A. The traditional advice regarding the federal estate tax marital deduction has been not to overuse it. Rather, the traditional plan was to use the optimum marital amount: to use the marital deduction only to the extent necessary to reduce taxes and avoid using it to the extent of the decedent's remaining applicable exclusion amount. Examples like the following have been included in educational materials about marital deduction planning since the 1980's.

> **EXAMPLE:** An individual with an estate of $8,490,000 dies in 2009 and leaves the entire amount to her husband. Her estate will pay no estate tax, because of the unlimited marital deduction. However, if at the husband's subsequent death in 2017 he has no estate other than the $8,490,000 he received from his wife, his estate will exceed his applicable exclusion amount of $5,490,000 by $3,000,000, which will generate total estate taxes of $1,200,000.

On the other hand, if, at the time of her death, the individual had left $3,500,000 (the 2009 exclusion amount) for the benefit of her husband in a nonmarital trust and had given the remaining $4,990,000 to him outright, her estate still would owe no estate tax. The $3,500,000 left in trust would be sheltered by her applicable credit amount and the $4,990,000 given outright to the husband would be sheltered by the marital deduction. Upon the husband's subsequent death, the trust would not be taxable and the $4,990,000 he received from his wife could be left to the children tax-free, by virtue of his applicable credit amount.

B. This kind of planning, employing a nonmarital trust and a marital gift or marital trust, was critically important in the early 2000's and before, because at that time any couple who had accumulated more than $1,000,000 of assets faced the possibility of estate tax. In order to avoid or minimize the estate tax, it was necessary to utilize the exclusion of the first spouse to die.

**EXAMPLE:** John dies in 2002 with an estate of $1,000,000. He leaves all the property to his wife, Jane. Jane has $500,000 of her own assets. Jane dies in 2003. Her $1,500,000 estate exceeds her $1,000,000 exclusion. Her estate owes estate tax of $210,000.

**EXAMPLE:** John dies in 2002 with an estate of $1,000,000. The property passes to a credit shelter trust for Jane. Jane has $500,000 of her own assets. Jane dies in 2003. Only her $500,000 of assets are included in her estate. No estate tax is due.

1. In separate property states, the retitling of assets in order to use the exclusion regardless of the order of deaths was part of planning. If John and Jane owned all their assets in joint tenancy, John's exclusion might not be used at the first death, even with a credit shelter trust.

2. Many clients are reluctant to retitle assets to accommodate future use of the exclusion. There are two overlapping challenges in convincing clients that a more equal division of assets is worthwhile.

   a. First, the spouse with the larger estate may not want to give assets to his or her spouse for personal reasons. These doubts may arise from concern over possible divorce, the spouse's spending habits, or for other reasons.

   b. Second, the couple may strongly oppose the administrative inconvenience of creating separate accounts.

C. With the enactment of portability, married couples now had an alternative to a marital/nonmarital estate plan. The first spouse to die could leave everything to or in trust for the surviving spouse and still preserve the federal estate tax exclusion of the first spouse. Has portability been beneficial? Yes, but maybe not in the ways that many estate planning professionals predicted.

V. Analysis of Portability After Eleven Years of Use

A. In the months after portability became available, practitioners and advisers discussed the following factors in weighing its value versus the value of traditional optimum marital deduction planning.

B. Advantages of Portability

1. Simplicity. One advantage of portability is simplicity. It allows a married couple to prepare a simple estate plan that leaves all property to the surviving spouse (in trust or outright), while still preserving the deceased spouse's applicable exclusion amount.

a. This is an advantage in particular for couples whose combined estates are well under the applicable exclusion amount. The couple also can avoid the administrative inconvenience of dividing assets between them, and retitling assets in order to preserve use of the exclusion amount.

b. Many couples whose estates are larger but still under twice the exclusion amount also might want to take advantage of this simplicity. There is the risk of losing the DSUE amount and incurring some estate tax if the surviving spouse remarries and the second spouse also predeceases him or her, but for many clients this risk is minimal.

2. Additional Basis Step-Up. One of the tax benefits of portability that received much attention early on was that assets passing to the surviving spouse will receive another step-up in basis at the surviving spouse's death, something not available for assets in a credit shelter trust.

a. In estates of couples that clearly will be less than twice the applicable exclusion amount, assuming the DSUE amount is not lost due to the last deceased spouse rule, there is no competing tax benefit and the basis step-up is a clear advantage.

**EXAMPLE:** John and Janet each have estates of $3,000,000. If John dies and leaves his $3,000,000 in a credit shelter trust for Jane, the trust assets will not receive a step-up in basis at Jane's death. Assume the assets grow to $5,000,000 and there is $1,400,000 of unrealized gain. Instead, if John left the $3,000,000 directly to Janet, and his executor elected portability the assets would be included in Janet's estate. All unrealized gain on the assets would be eliminated at Jane's death, avoiding potential federal capital gains tax of over $330,000.

b. In estates that are near or above twice the applicable exclusion amount, there may be a trade-off of income tax savings versus estate tax savings.

c. The spread between estate tax rates and capital gains tax rates has dropped significantly, a factor that many commentators noted, especially with clients in states with high income tax rates.

(i) In California, for example, the combined estate tax rate is 40% but the combined capital gains tax rate for a taxpayer in the highest bracket is 37.1%. In New York, the effective estate tax rate is 49.6% and the top LTCG rate is 36.5%

(ii) About ten years ago, the differential between estate tax rates and income tax rates is less than 10% in 5 states, and between 10% and 15% in another 20 states. See Lee, Paul S., "Paradigm Shift: The ATRA-Math," presentation by Bernstein Global Wealth Management (2013).

d. Commentators suggested that the small spread in rates meant that the second basis step up could be valuable even if portability resulted in some estate tax at the second death.

3. Use With Depreciating Assets. If the decedent's estate contains assets that likely will depreciate in value, such as promissory notes with imbedded income in respect of a decedent ("IRD"), then passing those assets to the surviving spouse may be preferable to using them to fund a credit shelter trust. If most of the decedent's estate consists of these assets, then portability may be a good option.

4. Retirement Accounts.

a. In many estates, a high proportion of the wealth is in retirement accounts. Because the assets are IRD, they will shrink by the income taxes incurred as distributed. In addition, the minimum distribution rules for retirement accounts can be less favorable when the account is allocated to a trust.

b. The preferred disposition for many married couples is to leave retirement assets to the surviving spouse. In the past, a typical beneficiary designation named the spouse as primary beneficiary and the participant's revocable trust as contingent beneficiary. The spouse then could disclaim a portion of the retirement assets if they were needed to fund the credit shelter trust and the spouse and his or her advisors decided that increasing the funding was worth foregoing the income advantages of rollover by the spouse.

c. With portability, the surviving spouse can avoid the choice between maximizing estate tax benefits and maximizing income tax benefits.

**EXAMPLE:** John dies in 2013 with a $5,000,000 estate, including $3,000,000 in rollover IRA accounts. John designates Janet as beneficiary of the IRA accounts. At his death, $2,000,000 passes to a credit shelter trust, and the remaining $3,000,000 of IRA accounts to Janet. John's executor elects portability. Janet dies with a separate estate of $6,000,000, including $2,500,000 remaining in the IRAs (a decrease due to minimum distributions and income tax on those distributions). She has her own basic applicable exclusion and $3,250,000 of DSUE amount from John.

C. Advantages of Credit Shelter Trust Planning

1. Shelter of Appreciation and Income. The DSUE amount is not indexed for inflation. A credit shelter trust creates the opportunity for future appreciation and income to increase the value of assets outside the estate.

**EXAMPLE:** Wife dies in 2013 with assets of $4,000,000, all of which are left to Husband. As Wife's executor, Husband elects portability and receives $5,250,000 of DSUE amount. Husband had $3,000,000 of assets of his own, so he has a total of $7,000,000 of assets and $10,500,000 of applicable exclusion amount. Husband invests half the assets in a new business. Ten years later it is worth $15,000,000. His other assets have appreciated to $5,000,000 so his total estate is $20,000,000. Assume that the current basic exclusion amount is reduced at the end of 2025 and Husband's basic exclusion amount is now $7,000,000. With the DSUE amount, which is not inflation adjusted, he can shelter $12,250,000 from estate tax.

If Wife had created a credit shelter trust with her $4,000,000 and Husband had used those funds for the business investment, all $15,000,000 would be sheltered from estate tax.

2. Generation-Skipping Tax Planning. There is no portability of GST exemption. A couple who wants to maximize the amount of property held in long-term trusts for descendants will want to use credit shelter planning.

a. Assuming the decedent's remaining applicable exclusion amount is being transferred to the surviving spouse through a portability election, the only way the decedent can take advantage of her remaining GST exemption is to use a reverse QTIP trust. IRC § 2642(a)(3).

b. All of the income of the QTIP trust is required to be distributed, so the value of the assets in the trust may not increase as rapidly as in a trust that can accumulate income.

c. In addition, if the reverse QTIP is the only QTIP created in the estate of the first spouse to die, or if the regular QTIP trust is not large or has been depleted, or, in worst case, if the regular QTIP trust is not obligated to pay the estate tax due on the reverse QTIP trust, the estate tax due at the death of the surviving spouse might have to be paid from the GST tax exempt assets in the trust. This will clearly reduce the effectiveness of the GST exemption allocation.

3. Impact of Remarriage. A major risk with portability is that the surviving spouse will lose some or all of the DSUE amount if he or she remarries and the second spouse also predeceases him or her. In addition, DSUE amount is not cumulative. By contrast, the surviving spouse's remarriage does not impact the benefits of a credit shelter trust and the surviving spouse can accumulate multiple credit shelter trusts.

**EXAMPLE:** John has survived Janet and is now a beneficiary with his children of a credit shelter trust holding $3,000,000. He also has $2,000,000 of DSUE amount from Janet. John marries Mary. Mary also predeceases John and leaves her entire estate, which exceeds the exclusion amount, to a trust for her family. John's DSUE amount becomes -0-. The credit shelter trust is unaffected.

**EXAMPLE:** Same facts as the preceding example except that Mary leaves $5,000,000 to a credit shelter trust for John and his children. John and his children are now beneficiaries of two credit shelter trusts funded initially with $8,000,000.

4. Avoiding Potential Audit Issues.

a. If the credit shelter trust is funded with non-publicly traded assets that are difficult to value, the family can avoid risk of audit with respect to those assets at the second death.

b. The credit shelter trust also allows a family that owns a closely-held business to isolate voting control outside the estate, or divide a controlling interest so voting control does not end up in the hands of the surviving spouse.

**EXAMPLE:** John owns a business that continues to do well and increase in value. Several years ago, John recapitalized the business and created classes of voting stock and nonvoting stock. He transferred 20% of the voting stock to an irrevocable trust and 40% to Janet. Janet dies. Her estate plan leaves her voting stock

to a credit shelter trust, of which John is trustee. At John's death, he is not considered to have voting control for estate tax purposes. See Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996).

D. Impact of Increasing Applicable Exclusion Amounts

1. Following the permanent adoption of the increase in the applicable exclusion to $5,000,000, adjusted for inflation, in the 2012 Tax Act, it was thought that more married couples would rely solely on portability, because the increased exclusion meant many more couples were safely under the threshold for paying federal estate tax.

2. The increased exclusion meant that more couple would simplify their estate plans, and do away with credit shelter trusts and marital trusts. Instead, they could leave property outright to the surviving spouse and rely on portability to pass the DSUE amount to the survivor, just in case her or his estate increased substantially.

3. The further increase in the exclusion in the 2017 Tax Act should have only accelerated this trend.

4. These predictions seem to be partially true. It certainly appears that the portability election is used a lot at the first death. But not necessarily because couple have rushed to simplify their estate plans. What has occurred as a result of the increased exclusion amount is many decedent's estate having unused exclusion, regardless of how the estate plan is structured.

   a. There clearly are many portability elections being made in estates that are below the federal filing threshold. Attorneys and other estate tax return preparers naturally are being cautious, and are advising executors not to forgo a possible benefit, even if the likelihood of the surviving spouse needed the DSUE amount to avoid federal estate tax is low.

   b. There of course is a cost to making the election, since it does require the filing of a federal estate tax return. However, the regulations have relaxed filing requirements for returns being filed solely to elect portability. This reduces the burden of preparing the return and the cost.

   c. Under Treas. Reg. § 25.2010-2(a)(7), the estate tax return must report property qualifying for the marital or charitable deduction only to the extent necessary to establish qualification for the deduction and the value only as necessary to establish the amount and value of the property passing to nonmarital or noncharitable beneficiaries. As a practical matter, this often means that items like tangible personal property passing to the surviving spouse,

property titled in joint tenancy with the surviving spouse, or retirement accounts passing to the surviving spouse do not have to be formally valued in accordance with IRS requirements.

d. Also, in states that still have a state estate tax, a state estate tax return might be required anyway, and those returns often require a completed federal return as part of the state filing. In those situations, the executor is preparing the federal return anyway, and might as well file it to elect portability.

e. The best statistical evidence that estates are frequently filing returns to make portability elections is the number of letter rulings seeking relief for a late portability election. A search in Bloomberg Tax shows a couple dozen rulings already in the first two months of 2022, and hundreds in recent years. One can assume that these represent a significant minority of the estates making the portability election; that most estates file timely or use Revenue Procedure 2017-34.

5. Portability also is being used in many larger estates because there are not enough assets to fully fund the credit shelter trust. This is the result of the larger applicable exclusion, but also due to the nature of the assets held by the decedent.

**EXAMPLE:** Douglas passes away with a traditional marital trust/credit shelter trust estate plan and a $14,500,000 estate in 2020. Douglas had made $1,500,000 of taxable gifts, so his available exclusion amount was $10,080,000. The estate consisted of marketable securities, private investments, $2,000,000 of joint tenancy assets with his surviving spouse, Marilyn, and $4,800,000 in retirement accounts payable to Marilyn. The assets available under Douglas' revocable trust to fund the credit shelter trust are $7,700,000. He had $2,380,000 of unused exclusion for which the estate elects portability.

6. Many real life examples follow a similar pattern. The much larger exclusion available in recent years is not being fully utilized at the first death.

7. Experience is indicating that the prediction that portability would allow clients to worry less about arranging asset ownership to fully fund the credit shelter trust was accurate. This is particularly the case with beneficiary designations for IRAs and other retirement accounts. The SECURE Act's changes to payout periods for inherited IRAs has made it even more advantageous to name the spouse as primary beneficiary of retirement accounts.

a. Before portability it was not uncommon to designate the decedent's revocable trust as beneficiary for part of all of the retirement accounts, in order to use them to fund the credit shelter trust. Doing so was not as favorable from an income tax standpoint as having the spouse as beneficiary, but it was possible to tie the RMDs to the spouse's life expectancy.

b. With the SECURE Act the required payout for the account now with a credit shelter trust would be within ten years.

E. Is Traditional Optimum Marital Deduction Planning Still Dominating?

1. Based on experience, with admittedly a limited data set, the answer appears to be yes, at least for larger estates. For both couples with estates that exceed twice the applicable exclusion and those with estates greater than one exclusion than less than two, it seems that the standard optimum marital deduction plan, with a credit shelter trust and a marital trust or marital gift is still the primary form of estate plan being used.

2. There are likely a number of reasons for this, starting with the familiarity and comfort that attorneys, and many clients, have with this form of estate plan. An optimum marital deduction plan with a credit shelter trust is time-tested, and it provides certainty that property will be set aside in a sheltered form at the first death.

a. Inertia is probably a factor too, and the related factor that many clients prefer to make changes to their estate plan only if absolutely necessary. If the clients don't have to revise their estate plan in response to tax law changes, they won't do it.

b. For high net worth clients, the benefit of using their remaining GST exemption on the credit shelter trust also is a factor.

c. In addition, many clients like the flexibility of a trust of which the spouse and descendants will be beneficiaries. It creates an easy way to get funds to family members during the surviving spouse's life.

3. An additional influence may be the effectiveness of attorneys and other advisers in selling the benefits of trusts. All the factors we have emphasized over the years are meaningful to many clients.

a. The traditional trust structure ensures that assets are available the couple's descendants, and reduces the chance that they might be used for a new spouse if the surviving spouse remarries, or for children of that second marriage.

b. The trusts of course provide creditor protection for the spouse, and help act as a deterrent against children who might pressure the surviving spouse for money.

c. The trusts help control the use of the funds, both by the spouse and the children, and provide a mechanism for professional asset management.

4. When portability first was enacted, commentators spent an inordinate amount of time focused on the possible income tax benefits of receiving a second step-up in basis on all the assets if portability was used and all the assets at the first death passed to the spouse, outright or in a marital trust. It's not clear that this factor is resonating with clients.

a. The certainty of sheltering assets from estate tax in a credit shelter trust often seems to outweigh the potential, and not fully quantifiable, benefit of a second basis step-up.

b. The examples that many commentators used in attempting to analyze the income tax benefit of portability generally did not reflect reality. Many appreciating assets in a credit shelter trust will incur capital gain regularly over time during the existence of the trust. Advisers will sell stocks in marketable securities portfolios. Many private venture capital investments will have a liquidation event when gain will be incurred. The business controlled by the family might be sold during the surviving spouse's life, in particular if the next generation does not prove up to the task of running it.

c. Many taxpayers rightfully perceive the capital gains tax as not as bad as an estate tax, and not just because of the differential in rates. The timing for incurring the tax often can be controlled, and its impact offset by losses, or through charitable planning. The tax is easier to pay, in the sense that it is due only after a liquidity event, when the taxpayer has received cash that can be set aside for payment of the tax.

d. It is probably too soon to judge at this point, but the recent proposals in Congress to eliminate the basis step-up also could be a factor in people's thinking going forward.

F. Traditional Planning and State Estate Tax

1. One final important reason that traditional estate plans still are being used frequently is the need to do so for state estate tax purposes. States that have a separate death tax or state estate tax tied to the old federal state death tax credit have not enacted portability for state tax purposes. Hawaii appears to be the only exception.

2. A couple will forego use of the sheltering benefit of the state exclusion at the first death if they are relying entirely on portability. This could result in more state estate tax at the second death.

   **EXAMPLE:** John and Janet are Illinois residents. Illinois has a $4,000,000 exclusion amount. John has $6,000,000 of assets and Janet has $3,000,000 of assets. They want their estate plan to be as simple as possible. Pursuant to their estate plan, all of John's assets pass to Janet at his death in 2013. His executor elects portability and passes John's $5,250,000 DSUE amount to Janet. At Janet's death, assume her estate is $9,000,000. It is sheltered from federal estate tax by her applicable exclusion amount, which includes the DSUE amount from John. However, Janet's estate is subject to Illinois estate tax of $801,049.

   Assume John's estate plan instead had created a $4,000,000 credit shelter trust, and left $2,000,000 outright to Janet. Assume portability was elected for the remaining $1,250,000 of John's exclusion. At Janet's subsequent death, her estate consists of the $2,000,000 from John and her separate $3,000,000. This is sheltered by her applicable exclusion amount and she owes no federal estate taxes. Her Illinois taxable estate is $5,000,000. The Illinois estate tax at her death is $285,714.

3. A typical plan in Illinois will have a credit shelter trust designed to receive the amount that will produce the "least possible federal and state estate tax." The excess will pass to a QTIP marital trust. Here portability becomes useful and adds a great deal of flexibility when combined with the QTIP trust.

   a. Illinois and a number of other states with a state estate tax allow for a state only QTIP election. The executor can choose to elect marital deduction for state and federal purposes for the QTIP trust, and use portability for the unused exclusion. Or the executor can have a QTIP trust, or severed portion of the QTIP, that is not marital deduction property for federal purposes but is for Illinois. In states with a state only QTIP election, a QTIP trust can be used to preserve the federal exclusion.

   b. For example, assume Jane, an Illinois resident, dies in 2022 with a $14,000,000 estate, and an optimum marital deduction estate plan. The credit shelter trust would receive $4,000,000, and the QTIP trust receives $10,000,000. The executor could elect marital deduction for all of the QTIP trust. Jane's DSUE amount is $8,060,000, which could be passed to her spouse. Or the executor could sever the QTIP trust into an $8,060,000 trust and a $1,940,000 trust. The larger trust would be an Illinois only QTIP and use Jane's remaining applicable exclusion at her death. This trust will be included in the estate of Jane's spouse for Illinois

purposes at his or her death, but excluded from estate tax for federal purposes. The $1,940,000 trust would be QTIP for federal and Illinois purposes.

c. It important to note that this same kind of planning is possible with a single-fund QTIP trust, discussed below, and no separate traditional credit shelter trust.

4. The possibility of a change of residence is a factor to consider with all clients. Assume a couple is living in a state that does not impose a state estate tax and they rely on portability at the death of the first spouse to die. However, several years later, the surviving spouse moves nearer to grandchildren in a state that does impose an estate tax. The assets that could have been protected from state estate tax in a credit shelter trust established at the death of the first spouse to die will be subject to state estate tax at the death of the surviving spouse.

G. Single-Fund QTIP Trust and Other Alternative Plans

1. There are several alternatives to a traditional estate plan that are simpler, and still create some flexibility in deciding to use, or not to use, a decedent's applicable exclusion at the first death.

2. Disclaimer plan. The estate plan leaves the assets of the first spouse to die outright or in a marital trust to the surviving spouse, but provides that if the surviving spouse disclaims, the assets will pass to a credit shelter trust. The credit shelter trust could be for the sole benefit of the surviving spouse or for spouse and descendants.

a. The danger with this option is that the surviving spouse fails to disclaim, even when it would be advantageous to do so.

b. The surviving spouse also could be disabled. An agent under a power of attorney, assuming he or she has the authority to disclaim on behalf of the spouse, may be reluctant to do so.

c. The attorney also needs to make sure the spouse does not take actions post-mortem that constitute acceptance of the decedent's property.

3. Single Fund QTIP. The far better alternative is to draft a plan that leaves all the assets to a QTIP trust for the surviving spouse. The executor for the deceased spouse then can choose to elect the marital deduction for the trust and rely on portability, or not to make the QTIP election for all or a portion of the trust.

a. The trustee of the QTIP trust usually is given the power to sever the trust into elected and non-elected portions.

b. This plan puts the decision in the hands of the executor, who may be best suited to make the decision. It allows for the decision to be made up to 15 months after the date of death, rather than nine months with a disclaimer.

c. In states with a state death tax and the state only QTIP option, the executor has the additional flexibility to treat part of the allocation to the QTIP trust as a state-only QTIP. The one QTIP trust in the terms of the decedent's will or revocable trust could end up with three or more trusts: (1) a non-marital trust, (2) a state-only QTIP trust, and (3) a traditional marital deduction QTIP trust, with the possibility that one or more of those trusts is further divided to create a reverse QTIP to which GST exemption can be allocated.

d. In addition to the QTIP trust, the estate plan can contain provisions for a credit shelter trust. If there is a non-elected portion of the QTIP trust, the trustee can elect to allocate it to the credit shelter trust, thereby creating a trust for spouse and descendants. This option is based on Estate of Clayton v. Comm., 976 F.2d 1486 (5th Cir. 1992), where the court invalidated a Treasury Regulation that stated that a trust would not qualify for QTIP treatment if the allocation of property to it was contingent on making the election. Other cases followed, and the Treasury changed the regulation to conform to the court ruling. See Treas. Reg. § 20.2056(b)-7.

(i) This option is superior to the disclaimer approach in that the surviving spouse can retain powers of appointment over the credit shelter trust. He or she cannot do that in a credit shelter trust funded by a disclaimer.

(ii) The decision to allocate the non-elected portion of the QTIP to another trust should not be made by the surviving spouse. If the spouse is executor or trustee, there should be provisions to allow an independent co-fiduciary to make the decision.

(iii) An estate plan that allocates the trust residue to a Clayton QTIP with a credit shelter trust option will look very much like a traditional A/B estate plan.

H. The Impact of No Inflation Adjustment for the DSUE Amount

1. One of the factors in favor of credit shelter trusts discussed above is that the assets set aside in a credit shelter trust at the first death will remain exempt from estate tax, and possibly GST tax, no matter how rapidly they appreciate. By contrast, the DSUE amount is not subject to an adjustment

for inflation. How impactful is this difference? The last eight years provides a useful trial, by simply looking at the equity markets.

2. The S&P 500 index was at 1,822.36 on January 1, 2014. It was at 2,823.81 on January 1, 2018, and stood at 4,515.55 on December 31, 2021. For the following examples, assume that the basket of marketable securities in the decedent's estate and the surviving spouse's separate estate grew at the rate similar to that of the S&P 500, reduced to take into account some capital gains tax incurred along the way and other factors such as distributions. Below are two hypotheticals:

**EXAMPLE 1:** Louise dies January 1, 2014 with an estate of $8,800,000, including a house worth $800,000 owned in joint tenancy with her husband, Walter. The remainder of the estate consists of marketable securities. Under option 1, Louise has an estate plan that passes everything to Walter and elects portability. Walter receives Louise's DSUE amount of $5,340,000. Walter has $2,000,000 of other assets, all in marketable securities. Under option 2, Louise has a traditional optimum marital deduction estate plan. The credit shelter trust created under her plan receives the applicable exclusion amount, and the rest passes as a marital gift to Walter. The trust funding occurs December 1, 2014, based on a fractional formula. At that time the $8,000,000 portfolio has increased in value to $8,830,720. The credit shelter trust receives $5,894,510 and the remaining $2,936,210 is distributed to Walter. Assume no change in value for the residence for Walter's life.

Walter dies December 31, 2021. Under option 1, his estate with a date of death value at Louise's death of $10,800,000 has more than doubled to $22,375,210. Under option 2, his separate estate of $5,736,210 is now worth $10,854,040, and the credit shelter trust holds $11,521,170. Walter has $11,700,000 of basic applicable exclusion plus, under option 1, $5,340,000 of DSUE amount from Louise.

| | **Option 1 Portability** | **Option 2 Credit Shelter** |
|---|---|---|
| 1. Walter's estate | $22,375,210 | $10,854,040 |
| 2. Exclusion amount | (17,040,000) | ($11,700,000) |
| 3. Taxable Amount | 5,332,210 | -0- |
| 4. Estate tax (40%) | 2,134,084 | -0- |
| 5. Credit Shelter Trust | -0- | 11,521,170 |
| Total to Children (1 - 4 + 5) | $20,241,126 | $22,375,210 |

3. The example shows that the use of a credit shelter trust can produce a better estate tax result in situations where assets appreciate significantly between the first and second deaths. But this benefit could be reduced at some point by the loss of a basis step-up for the credit shelter trust assets.

**EXAMPLE 2:** Louise dies January 1, 2018 with an estate of $12,000,000, including a house worth $1,000,000 owned in joint tenancy with her husband, Walter. The remainder of the estate consists of marketable securities. Under option 1, Louise has an estate plan that passes everything to Walter and elects portability. Walter receives Louise's DSUE amount of $11,180,000. Walter has $4,000,000 of other assets, all in marketable securities. Under option 2, Louise has a traditional optimum marital deduction estate plan. The credit shelter trust created under her plan receives the applicable exclusion amount, and the rest passes as a marital gift to Walter. The trust funding occurs December 1, 2018, based on a fractional formula. At that time the $11,000,000 portfolio has decreased in value to $10,012,640 (the market does go down sometimes). The credit shelter trust receives the entire amount. Assume no change in value for the residence for Walter's life.

Walter dies December 31, 2021. Under option 1, his separate estate is worth $23,406,100. Under option 2, his separate estate of is now worth $6,974,961, and the credit shelter trust holds $16,431,140. Walter has $11,700,000 of basic applicable exclusion plus, under option 1, $11,180,000 of DSUE amount from Louise.

| | **Option 1 Portability** | **Option 2 Credit Shelter** |
|---|---|---|
| 1. Walter's estate | $23,406,100 | $6,974,961 |
| 2. Exclusion amount | (22,880,000) | (11,180,000) |
| 3. Taxable Amount | 526,100 | -0- |
| 4. Estate tax (40%) | 210,440 | -0- |
| 5. Credit Shelter Trust | -0- | 16,431,140 |
| Total to Children (1 - 4 + 5) | $23,195,660 | $23,406,101 |

4. In this example, even in a period of significant asset appreciation, the choice of portability versus credit shelter trust made much less of a difference from an estate tax standpoint. The estate tax due under option 1 is less than 1% of the estate. And portability may have provided a better income tax result because of the basis step-up in Walter's estate. However, if Walter had lived until 2026, and the exclusion amount is reduced as it is currently scheduled to do, then the estate tax impact would have been much more significant in option 1. The credit shelter trust does provide a safer result from an estate tax standpoint in that the assets are taken out of the estate tax system regardless of the amount of appreciation between the first and second deaths.

I. Considerations with Non-standard Families

1. On final consideration is planning in situations involving married couples where there are children from a prior marriage, or other non-standard family situations. Here, portability remains a dangerous choice. The estate planning attorney needs to consider whether leaving an executor with discretion to use portability is even appropriate, and if it is, who the executor should be and how the estate tax burden should be allocated.

2. The problem with portability in non-standard families is that it allows the surviving spouse to use the DSUE amount personally, rather than for the beneficiaries of the first spouse to die. In effect, electing portability is like leaving assets outright to the spouse.

3. The regulations provide that, for a testate decedent, only the executor can make the portability election. Treas. Reg. § 20.2010-2 (a)(6). In these situations, the executor probably should not be a beneficiary under the estate plan, and/or should be directed as to a portability election.

   a. For example, if the estate is not large enough to independently require the filing of an estate tax return, an executor who is a child of a prior marriage may choose not to incur the expense of filing an estate tax return solely to make the portability election for the second spouse.

   b. Rather than have the parties disagree over the need for a return, or over covering the cost of its preparation, it is better to have the estate plan direct whether an estate tax return should be filed to elect portability, and, if so, who is responsible for the cost of the preparation and filing.

4. Often, in a complex family structure where a client has children from a prior marriage, a QTIP trust is used for the surviving spouse, with the trust assets eventually passing to the client's descendants. However, when a QTIP trust is combined with portability, the client's estate plan may not operate as intended.

   **EXAMPLE:** John marries Mary several years after his wife, Janet dies. John has three children from his marriage to Janet. John bequeaths most of his estate to a QTIP trust for Mary, remainder to his children. He names Mary as executor. At John's death, Mary elects QTIP treatment for the trust and portability. She then makes gifts of her own assets to her family using John's DSUE amount. Mary dies with an estate equal to her basic exclusion amount, which she also leaves to her family. The QTIP trust pays estate tax, and John's children receive no benefit from John's exclusion amount.

a. Even if Mary did not make gifts to her family, assuming that her estate was large enough to absorb most of her applicable exclusion amount (including the DSUE amount), the QTIP trust would have to contribute to cover the taxes attributed to it, unless the estate plan waives reimbursement.

b. Code Section 2207A requires reimbursement on a marginal not proportionate basis. Thus, the QTIP trust could bear most or all of the estate tax at the second spouse's death, while the second spouse's personal assets are sheltered in part by the deceased spouse's DSUE amount.

5. In cases such as these, the more prudent course of action may be to use traditional credit shelter/marital deduction planning. If there is DSUE amount available, then estate plan should direct whether it will be used and how the tax burden on the QTIP trust is handled.

6. These issues also could be addressed in a prenuptial or postnuptial agreement. For example, the parties could agree to permit the surviving spouse to have the use of any DSUE amount of the first spouse to die in return for an agreement that the surviving spouse would waive the right of reimbursement for tax due as a result of the inclusion of the QTIP trust in the surviving spouse's estate (or at least for that portion of the QTIP trust equal to the DSUE amount).

## VI. Planning for Marriage . . . and Failure

A. Of course not every couple goes into a marriage ready and willing to share all their assets and primarily benefit the other in their estate planning. Love does not always conquer all. Sometimes it has a dollar limit.

1. The most common situation where this is true is when one or both spouses have children from a prior marriage. The spouse wants to ensure, or maybe it is the children who want to ensure, that property is preserved for the children. The concern also arises in high net worth families who want to protect against someone joining the family "for the money."

2. Frequently, the concerns surrounding an impending marriage can be addressed by careful estate planning.

a. Trusts can be used to protect the trust corpus while still providing support for a surviving spouse.

b. A client who enters a marriage with significant property should be advised to keep that property separate, and not commingle it with earnings during the marriage. Separate, or nonmarital property includes both property brought to the marriage and property

received by the individual by inheritance or gift. For the most part, nonmarital property will not be subject to division in case of divorce. Of course, the law varies from state to state, and it does not always provide complete protection. This leads many who are contemplating marriage to consider a prenuptial agreement.

B. Prenuptial Agreements

1. One of the most effective ways to protect a person's assets in a marriage is to enter into a prenuptial, or premarital, agreement. A prenuptial agreement is an agreement between the parties to be married, entered into before the marriage, which determines their respective property rights. It can control their rights in case of death, in case of divorce, or in both cases. It can apply to all property or only to certain property interests.

2. Historically, prenuptial agreements were not favored by the courts. Courts often concluded that the agreements were against public policy and void, if they waived or reduced a duty of support.

   a. During that time period, it typically was a duty of the husband to support the wife after divorce; for example, in invalidating a prenuptial agreement in Warner v. Warner, 235 Ill. 448, 85 N.E. 630 (Ill. 1908), the Illinois Supreme Court said that it is the duty of a husband to support his wife and children "according to his ability and status in life."

   b. In most jurisdictions, prenuptial agreements are now valid, and in fact may even be specifically sanctioned by statute (in Illinois, the Uniform Premarital Agreement Act, 750 ILCS 10/1, et seq.); however, the historical animosity survives in the form of a judicial presumption that the agreements should be strictly and narrowly interpreted.

3. Within this context of strict interpretation a properly drafted agreement may alter or eliminate any of the rights that otherwise might exist as a result of the marriage, except one. Those rights include:

   a. The right to temporary or permanent maintenance;

   b. The categorization of property as marital property, or the exclusion of certain property from division upon divorce;

   c. The right to claim contribution to separate property or a right of reimbursement from separate property;

   d. The right to treat jointly owned property as marital property;

   e. The right to a homestead exemption;

f. The right to a spouse's award, an intestate share of the estate, or to renounce a spouse's will and take an elective share; and

g. The right to act as personal representative of the estate, or to designate the person who will act.

4. The one right that generally cannot be waived or altered is the right to child support. In Illinois, for example, the Illinois Uniform Premarital Agreement Act specifically states that a prenuptial agreement may not waive child support. 750 ILCS 10/4(b).

5. The validity of a prenuptial agreement is determined under the same rules that apply to contracts generally. However, as noted above, courts are generally more willing to exercise their equitable powers over prenuptial agreements for public policy reasons. The following requirements for valid prenuptial agreements are found in most jurisdictions:

   a. Written and signed. The agreement should be in writing and signed by both parties. Some courts have enforced an agreement against the one party who signed it, even if the other did not. However, it should never be the plan to have just one party sign.

   b. Voluntary. Clearly, there should be no question that each party is voluntarily entering into the contract. There can be no duress or coercion. These factors can arise more frequently in prenuptial agreements than in other contracts. This is understandable given the emotional and social pressures.

      (i) If the agreement is presented to one spouse shortly before the wedding, and/or delivered with an ultimatum that the wedding will not happen unless the agreement is signed, the stage is set for invalidating the agreement.

      (ii) To avoid this possibility, the agreement should be dealt with as far in advance of the wedding as possible. It should not be an afterthought.

   c. Consideration. Prenuptial agreements are somewhat unique in that no special consideration in the form of money or actions is needed to make them valid. The pending marriage is sufficient consideration.

      (i) As a result, the lack of equality in what is being promised or given up in the agreement does not impact the adequacy of consideration.

      (ii) Inequality may be a factor supporting invalidity on other grounds, such as duress or fairness, discussed below.

d. Fairness. Fairness is the catch-all that allows courts to exercise their equitable powers and not enforce an agreement that the court believes is fundamentally unjust. This is most likely to occur where the agreement leaves one spouse impoverished following the divorce. Courts have invalidated agreements that leave one spouse with a significantly lower standard of living than the couple enjoyed during the marriage. See, e.g. Warren v. Warren, 169 Ill. App.3d 226, 523 N.E.2d 680 (5th Dist. 1988).

(i) This is a critically important fact in counseling wealthy clients about premarital agreements. If they go too far in trying to protect their wealth, and do not provide some reasonable financial accommodation for the less wealthy spouse in case of divorce, they put the validity of the agreement at risk.

(ii) A variety of other factors may impact the fairness of the agreement, including the ages of the couple, their business and financial sophistication, and the amount of time they had to review and consider the agreement terms.

(iii) Under the laws of many states, it is not an absolute requirement that each party be represented by a lawyer. However, having separate legal representation for each spouse is the best way to deflect later attempts by one party to invalidate the agreement, based on claims of lack of fairness, coercion, or lack of understanding of the implications of the agreement.

e. Disclosure. One of the most important prerequisites for a prenuptial agreement is that there be full disclosure by each of the parties of their wealth and income. It is a factor that goes to the fairness of an agreement, and in some jurisdictions, it may constitute an independent requirement.

(i) The position of many courts is that a person cannot give up marital rights to property if he or she does not know the value of the rights being given up.

(ii) This does not necessarily mean that each spouse must provide a detailed, exhaustive list of his or her assets, although it is preferable to do so. It may be sufficient to provide general descriptions that give the other party an understanding of the nature and extent of the assets.

(iii) For example, for an individual with an interest in a family business, it may be sufficient to describe it as a "__%

interest with an estimated value in excess of $5 million." Whether the exact value is $5.2 million or $6 million may not be critical. (However, if its value is $15 million, the estimate may be insufficient.)

(iv) If the wealthier party conceals assets of meaningful value, he or she is giving the court an excellent reason to invalidate the agreement.

(v) The sophistication level of the parties, and the nature of the legal representation they receive are factors that may impact the level of disclosure required.

C. Planning Considerations with Prenuptial Agreements

1. With prenuptial agreements, one size does not fit all. The role an agreement will play in a person's financial planning will depend on the circumstances and the nature of the relationship with the future spouse.

2. For an older couple, each with separate assets and children from a prior marriage, an agreement that keeps all assets separate and in which they each waive all spousal rights might make sense. The goal for such a couple is often to preserve each one's own property for his or her own children and to minimize financial ties between the new spouse and children. They are in full agreement that it is best to start with the presumption that their assets will be separate. They can choose to place some property in joint ownership during the marriage, but this will not impact the treatment of their other property.

3. In the same situation, but where one spouse has significantly less assets and would not be able to support himself or herself following a divorce or death, the type of agreement described above could fail. A court might invalidate it as unfair. It is better to deal with the need to provide support for the less wealthy spouse head-on, and provide very specific terms in the agreement. That means less for the children from the first marriage, but more certainty. More certainty hopefully means less conflict.

4. Another common situation in which prenuptial agreements are used is for a young couple, first marriage, where the family of one of the couple has significant wealth.

a. If the wealth is tied up in a family owned business, one approach is to use the agreement only to protect the family business assets.

b. It may be that the primary goal of the agreement is to prevent the poorer spouse from claiming significant maintenance in the event of a divorce (especially after a shorter marriage) based on the much higher living standard of the wealthy family. Provisions

limiting the spouse's rights at death may not be necessary because the wealthier spouse intends to treat his or her spouse in the usual way if they are married at death. Instead, trusts can be used to protect the assets for children of the marriage or that spouse's collateral relatives.

5. In a marriage of two professionals, one may be giving up a career to start a family and be the stay-at-home parent. That person may be foregoing significant financial opportunity. She or he may be in a profession where there are barriers to re-entry after a few years off. If a prenuptial agreement is used in this situation, it needs to recognize this reality. A court will, and it will make sure the stay-at-home spouse receives adequate support in the event of a divorce. If the agreement goes too far in limiting the spouse's rights, there is a risk the court may invalidate it.

D. Trusts and Divorce

1. Although the trust property cannot be accessed by a divorcing spouse or the court, and while a court in Illinois probably would not ever contemplate seeking to do so, the court could take the trusts into account in the property division.

2. The trusts do represent a possible source of income for John, and, in the case of the family trust, a future expectancy of property. Therefore, they may be relevant in the division of property between John and his wife.

3. A divorcing spouse should not expect that the trusts will remain secret. Many state laws require extensive financial disclosure in divorce proceedings. In Illinois divorce proceedings, for example, mandatory disclosure of financial information is the norm. Although the rules differ from county to county and are based on local circuit court rules, almost all circuits in Illinois have some form of mandatory disclosure.

   a. In Cook County, each party is required to provide the other with a completed disclosure statement of income, expenses and assets, and with the last two years of filed tax returns. See Cook County Circuit Court Rules 13.3.1 and 13.3.2.

   b. The Disclosure Statement form includes a category for trust income, and a category for "All Other Property." Courts are liberal in granting discovery requests seeking information about trusts.

4. Income is given a broad definition in Illinois. Distributions from a trust would fall into the definition, regardless of their tax or accounting categorization.

5. If the spouse who is a beneficiary was receiving regular distributions from a family trust, it is likely that a court would presume those distributions will continue, and likely would take them into account in making an equitable division of marital property or an award of maintenance.

6. It also is possible that a court might set a time for reconsideration of the amount of a maintenance award if the time period when a trust might terminate is nearer. For example, if a trust for John lasted until he turned 48, a court could decide to revisit maintenance, especially if it had struggled with an equitable division satisfactory to it at the time of divorce.

7. Less likely, but probably arising on occasion is the question of rights of reimbursement or even transmutation of the property.

    a. For example, suppose the trust held real estate that the beneficiary actively managed, but for which he or she took a nominal salary. The court might order reimbursement for this activity, because it was "marital energies" that enhanced the properties' values.

    b. The reimbursement could not occur from the trust assets. The spendthrift rules would prevent this. But the court could require the beneficiary/spouse to make it out of other assets. This is an important issue to address in a prenuptial agreement, which can limit the circumstances in which reimbursement can be considered.

E. Treatment of Trusts in Divorce in Other Jurisdictions

1. It is important to remember that clients may not live in Illinois at the time of a divorce. The law governing the division of property in a divorce has developed in several jurisdictions in ways that threaten the long-standing traditional protection provided by trusts. In some states, courts treat trust interests as property that can be considered as part of the pool of assets to be divided.

2. There is no uniformity as to the types of trust interests that may be subject to division. In some jurisdictions, courts have determined that a trust remainder interest that will be distributed outright to the spouse if he or she reaches a certain age is property subject to division. An outright remainder interest contingent only upon the remainder beneficiary surviving the income beneficiary also may fall in this category.

3. The courts are not invalidating spendthrift statutes in taking these steps. In general, they do not, and cannot, order the trustee to distribute trust property or assign trust interests. Some courts also have included in the property settlement decree an obligation on the beneficiary spouse to transfer trust property to the other spouse when received.

4. The case law in divorce cases in other states should lead practitioners to consider several options to provide further protection for trust interests. For example, powers of appointment can provide several benefits in preventative planning in case of the divorce of a trust beneficiary. If the current income beneficiary has a power of appointment over the trust, this may prevent the trust property from being considered in a divorce of a remainder beneficiary.

   a. The power of appointment also can be used to alter a future beneficiary's interest in response to a pending or completed divorce proceeding.

   b. For example, if a client's father had a power of appointment over the family trust, he could exercise it to cause the share for the client to continue in trust for the client and his or her descendants, rather than terminate and distribute outright to at the father's death.

   c. The father could craft a provision that tries to directly address the impact of a divorce and any order in the divorce proceeding impacting the trust. This could be accomplished for example with a provision that would delay or cancel the otherwise designated termination date of a trust:

      "If the trustee determines that principal which is otherwise required to be distributed outright to a beneficiary could, after receipt by such beneficiary, be subject to claims of creditors, to claims for alimony, maintenance, or support, or to any involuntary transfer to a third party, whether or not such claims have been asserted or are then prospective, the trustee shall withhold such principal in accordance with this paragraph. The trustee shall retain any principal so withheld in a separate trust named for the beneficiary, and shall apply as much of the net income and principal of the trust as the trustee determines from time to time to be required for the best interests of the beneficiary, adding any undistributed net income to principal from time to time, as the trustee determines. The trustee shall make no distribution to satisfy any legal obligation of the beneficiary, including any obligation to support or educate any person. The trustee may invest the property of such trust in assets that will be held for the beneficiary's use rather than for investment purposes, including, but not limited to, automobiles, furniture and hobby equipment, and may pay directly any costs of taxes, insurance, maintenance, repairs and necessary improvements for such assets or other property owned by the beneficiary, if the trustee determines that such use is necessary for the beneficiary"s health, support, education and best interests. If the beneficiary dies before complete distribution of the trust, the trustee shall distribute the

remaining principal to such one or more persons or organizations (other than the beneficiary, his or her estate and the creditors of either) as the beneficiary may appoint by will, or, in default of effective appointment, to the beneficiary's then living descendants, per stirpes."

5. A discretionary spray trust that lasts for the child's lifetime, rather than terminates upon the parent's death is less likely to be treated as a divisible property interest in a divorce proceeding. At a minimum it would be treated as having a significantly reduced value in a property division. For example, practitioners have seen courts conclude that a broad spray trust for the child and the child's descendants is not a property interest of the child for divorce purposes.

   a. If the trust had made regular distributions to the child before the divorce, this may work against the child. At the very least, in most states the court is likely to assume that those distributions will continue and take that income into account in the division of the couple's property and/or awarding maintenance.

   b. Likewise, if the trust states that its primary purpose is to provide for the child, and the interests of other beneficiaries do not need to be considered in making distributions to the child, the court might not treat it as a true spray trust.

   c. On the other hand, if the trust is GST exempt, that would support the position that it should not be considered in the divorce.

6. Powers to alter the trust terms also could be vested in a trust protector or other third party. For example, the trust could allow a trust protector to suspend or take away a power of withdrawal that the beneficiary has. While that power could be tied to specific reasons (the beneficiary separates from her spouse), it is preferable to leave it general.

7. Decanting is another option available to trustees to protect a trust in case of a divorce. More than 25 states have enacted decanting statutes that allow a trustee, without court approval, to appoint trust assets in favor of another trust with new or modified terms.

   a. The 2017 case of Ferri v. Powell-Ferri (72 N.E. 3d 451, 476 Mass. 651 and 165 A.3d 1137, 326 Conn. 438), illustrates the use of decanting in the context of a divorce, as well as the possibility of litigation over its use when the stakes are high.

   b. The case arose in the context of a divorce action between a beneficiary, Paul John Ferri, Jr. ("Ferri"), and his wife, Nancy Powell-Ferri ("Powell-Ferri"). A trust was established in 1983 (the "1983 Trust"), and authorized the trustees to distribute income or

principal as the trustees "shall deem desirable for [Ferri's] benefit." Ferri could withdraw 1/4 of the trust principal at age 35, 1/2 at age 39, 3/4 at age 43, and the remainder at age 47. At the time of the action, Ferri could withdraw 3/4 of the trust assets. But while the action was pending, he became entitled to withdraw all of the trust assets.

c. The trustees decanted the 1983 Trust. Under the terms of the new trust (the "2011 Trust"), Ferri could not withdraw the trust assets; the trust was to exist for Ferri's life; and Ferri held a lifetime, limited power of appointment that could not be exercised in favor of his creditors or wife.

d. The trustees of the 1983 Trust commenced a declaratory judgment action in Connecticut court seeking a declaration that they validly transferred the assets to the 2011 Trust and that Nancy Powell-Ferri had no interest in the 2011 Trust. The Connecticut Supreme Court certified to the Supreme Judicial Court of Massachusetts the question of whether a trustee possesses the power to decant.

e. The Massachusetts Supreme Judicial Court held that the 1983 Trust granted the trustees the authority to decant based on the trustee's broad discretion to distribute assets to Ferri. The Court focused on two provisions in particular. First, the Court found that the trustees' authority to "segregate irrevocably" principal of the trust for the benefit of Ferri included the authority to transfer principal to a new trust. Second, the Court concluded that the trustees' authority to distribute principal for Ferri's "benefit" meant that the trustee could make distributions of principal to a new trust for Ferri's benefit. The Court also held that Ferri's right to withdraw principal at certain ages did not hinder the trustees' power to decant because until Ferri actually exercised the withdrawal power the trustees must continue to exercise their existing fiduciary duties, including the duty to make distributions as provided in the trust instrument.

f. On return to the Connecticut Supreme Court, Powell-Ferri asserted, inter alia, that (1) Ferri self-settled the 2011 Trust and that she was entitled to equitable division of 75 percent of the assets, (2) Ferri acquiesced in allowing the trustees of the 1983 Trust to dissipate marital assets in violation of Connecticut law, and (3) Ferri had a chose in action against the trustees for breach of fiduciary duty entitling Powell-Ferri to equitable division of all of the assets of the 1983 Trust

g. Regarding Powell-Ferri's first assertion, the Court held that because Ferri took no part in decanting the 1983 Trust to the 2011

Trust, Ferri was not the settlor. In fact, the trustees of the 1983 Trust did not even inform Ferri of their intent to decant the 1983 Trust. With respect to Powell-Ferri's second assertion, the Court held that Ferri did not dissipate marital assets merely by his inaction following the decanting. The Court noted that during the marriage the parties primarily used the assets of the 1983 Trust for investments and tax payments, not for basic support. Because Ferri did not need the assets for his support, he may have concluded they better served his interests retained in trust. Possessed with no reason to request a withdrawal from the trust, Ferri had no obligation to do so because Powell-Ferri desired a divorce. Finally, because Ferri had not yet exercised his right to request withdrawal of 75 percent of the assets of the 1983 Trust, he did not have a chose in action. That is because the trustees had no duty to act until Ferri instructed them to do so. Until Ferri issued a withdrawal instruction, the trustees had a duty to continue managing the trust in what they believed was Ferri's best interests.

8. It is important that state law be considered to determine the extent of the trustee's decanting power. State statutes vary significantly in the amount of discretion a trustee has to change trust terms depending on the terms of the existing trust. For example, in many states, a decanting cannot eliminate a mandatory income interest, and in many states, a decanting cannot be used to add beneficiaries (for example, to convert a single beneficiary trust into a broad spray trust).

9. It may be possible to use the decanting as part of a multi-step process. For example, the decanting could add a lifetime power of appointment, or a special trust protector power, which then could be exercised to achieve the desired change in terms.

10. As illustrated by the Powell-Ferri case, the best fact scenario is one where the trustee undertakes the decanting on its own accord and not at the request of the beneficiary. It will be even better if it occurs before any divorce action is commenced. In the more common situations, without these favorable facts, the decanting could be difficult to effectively pull off.

F. A new issue related to trust planning and divorce has emerged as a result of the 2017 Tax Act's repeal of Code Section 682. This was the section that caused grantor trust status for a trust created for a spouse to cease when the marriage ended.

1. This repeal brings to the forefront a question that Section 682 made irrelevant: do provisions of the grantor trust rules cause a trust to continue to have grantor trust status after the divorce? If so, the grantor would

continue to be responsible for the tax on trust income being paid to his or her ex-spouse.

2. This issue could apply to a trust set up to provide the spouse with income in contemplation of divorce, or to a pre-existing trust that will continue in place, such as a spousal limited access trust.

3. There are several tax code provisions that could continue to apply after a divorce. The big one is Section 672(e)(1)(A), which provides that when a grantor sets up a trust, he or she is treated as holding any power or interest held by that grantor's spouse at the time of the creation of such power or interest. The provision implies that the test for applying this spousal unity rule is when the trust is created, and later events do not impact it. Treasury seems to recognize this problem and has requested comments on it in Notice 2018-37, 2018-18 I.R.B. 392.

4. Until some clarity is provided, attorneys advising clients on the trust aspects of a divorce should make the client aware of it, and work with divorce counsel to see if it can be addressed as part of the property settlement.

## VII. Conclusions

A. From a transfer tax perspective, the policy of the federal government for the last 75 years has been to favor married couples. Since 1981, only married individuals can pass their entire estate, no matter what the size, to a family member (their spouse) entirely tax free.

B. This makes marital deduction planning a crucial component of estate planning. Strategic use of the marital deduction is key in any married couple's estates. As discussed herein, it is not as simple as just taking advantage of the marital deduction and leaving everything to the surviving spouse. It is coupling the benefits of the marital deduction with the other credits and exclusions available under the federal estate tax.

C. It is not evident yet that portability has fundamentally changed the way we approach marital deduction planning at the first death. The optimum marital deduction plan still works, and delivers all the estate tax benefits that it is designed to provide. It works equally well for clients with estates under $10 million, and may make sense in the view of the attorney and the clients for a couple of reasons.

1. At the moment, the prospect of a reduction in the estate exclusion at the end of 2025 would convert a lot of currently nontaxable estates into potentially taxable ones.

2. Younger clients may be confident that their net worth will increase significantly over the next 10 to 15 years, and they may want an estate plan they can grow into.

3. In either of these situations, a single fund QTIP trust plan will work too.

D. Regardless of the structure of the couple's estate plan, the real value of portability is that it provides and invaluable safety net, that can catch any exclusion that goes unused at the first spouse's death, either intentionally unused or because of the size, type and ownership of the assets, and pass that remaining exclusion to the surviving spouse as DSUE amount. This safety net so far has proven to be the most significant benefit of portability.

E. The wealth professional also should not lose sight of the non-tax aspects of planning for married couples, and for those soon-to-be married. The non-tax considerations often have a significant impact on the plan, and may dictate how best to use the marital deduction.