LESSON 4 - ADVANCED ESTATE PLANNING

THE UNLIMITED MARITAL DEDUCTION

- The Single Economic Unit
  - Under current law, an individual is generally permitted to leave an unlimited amount of property to his spouse at his death without incurring any estate tax.
  - Advantages of the Unlimited Marital Deduction include:

1. Defers estate taxes until the death of the surviving spouse.
2. May fund the applicable estate tax credit of the surviving spouse.
3. Ensures the surviving spouse has sufficient assets to support his lifestyle.

- Requirements of the Unlimited Marital Deduction
  - In order to claim a marital deduction, the decedent must have been married as of the date of his death and the surviving spouse must receive property through the estate.

Exam Question
Requirements of the Unlimited Marital Deduction

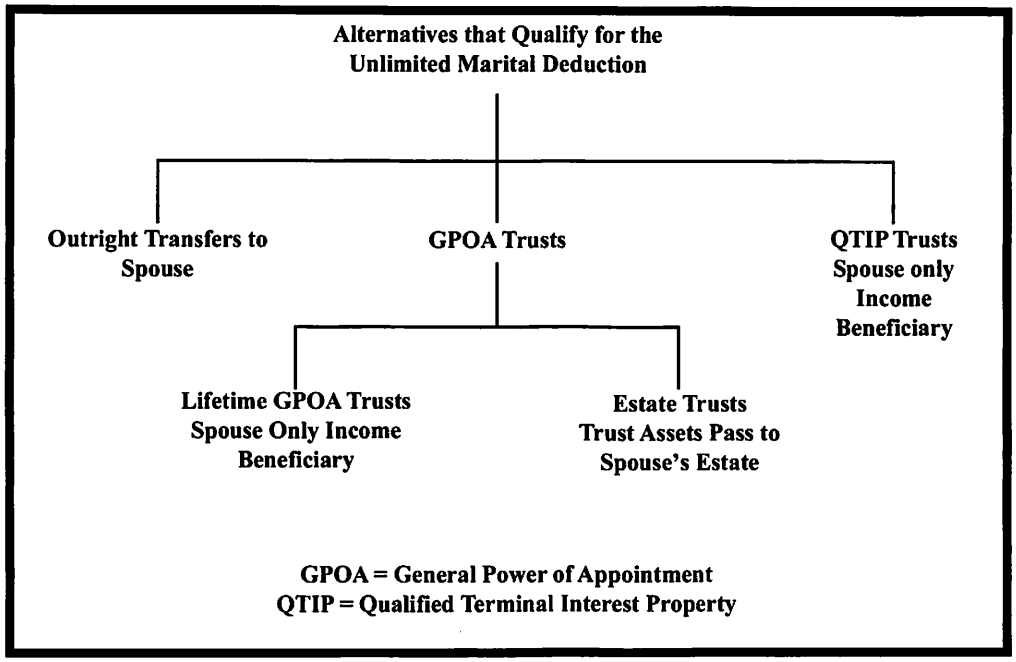
Which of the following is not a requirement of the unlimited marital deduction?

a) In order to claim a marital deduction, the decedent must have been married as of the date of his death.
b) The surviving spouse must receive property through the estate.
c) The surviving spouse must be a US citizen.
d) The gross value of qualifying property left to the surviving spouse is included in the marital deduction.

Answer: D
Answers A, B, and C are all requirements of the unlimited marital deduction. Answer D is incorrect because only the net value, not the gross value, of qualifying property left to the surviving spouse is included in the marital deduction. The term "net value" for marital deduction purposes equals the gross value of the qualifying property left to the surviving spouse less any taxes, debts, or estate administration expenses payable out of the spousal interest.

- Limitations of the Unlimited Marital Deduction
  - To prevent abuse, the unlimited marital deduction is limited in two ways: (1) the property passing to the spouse must qualify for the marital deduction, and (2) only the net value of qualifying property that is left to a surviving spouse can be included as the marital deduction.
    - The term "net value" for marital deduction purposes equals the gross value of the qualifying property left to the surviving spouse less any taxes, debts, or estate administration expenses payable out of the spousal interest.

- If property is not transferred to the surviving spouse outright, special qualification rules must be met for such property to qualify for the marital deduction. There are generally three ways to leave property to a spouse and qualify for the marital deduction. These are summarized in the following chart:



Qualification for the Marital Deduction

- For a transfer to qualify for the estate tax marital deduction, the property interest must meet three requirements.
  - First, the property must be included in the decedent's gross estate.
  - Second, the property must be transferred to the surviving spouse.
  - Third, the interest must not be a terminable interest unless it meets one of the exceptions.

- If the surviving spouse is not a US citizen, additional requirements must be met in order to qualify for the unlimited marital deduction.

- If property is not included in the gross estate of the decedent, the decedent will not be permitted to deduct the value of that property from the gross estate as a marital deduction.

- In order to qualify for the unlimited marital deduction, the property must pass from the decedent to, and for the benefit of, the surviving spouse.
  - If the property passes from someone other than the decedent to the surviving spouse, or if the property passed by the decedent goes to someone who is not his surviving spouse, the marital deduction will not be available.
  - If the decedent leaves property to his surviving spouse as trustee for some other individual, the surviving spouse does not have a beneficial interest in the property and the transfer will not qualify for the marital deduction.
  - Generally, property that is included in the decedent's gross estate and is transferred to the surviving spouse by any means will meet the "transferred to" requirement for the marital deduction, even if the decedent is not the person transferring the property.

- A terminable interest is any interest in property passing from a decedent to his surviving spouse where the surviving spouse's interest in that property will terminate at some point in the future.

- The terminable interest rule is based on the premise that a marital deduction should only be permitted when property passing from the decedent spouse to a surviving spouse will be included in the surviving spouse's gross estate.
  - There are situations, however, where property left to the surviving spouse will not be included in the surviving spouse's gross estate. For example, if the decedent leaves property in trust for the benefit of the surviving spouse, and the trust gives the spouse the right to receive all income, the right to receive distributions for health, education, maintenance, and support, and the right to demand the greater of $5,000 or five percent of the trust corpus each year, the spouse will not have a sufficient ownership interest in the property to require an inclusion in her estate. The terminable interest rule is designed to prevent the use of the unlimited marital deduction in circumstances where the surviving spouse will not have to include in his gross estate the value of property passing from the deceased spouse.
- A terminable interest, alone, will not prevent the use of the unlimited marital deduction for the transfer. The marital deduction will not be available if:
  - a terminable interest is transferred to a surviving spouse, and
  - another interest in the same property passes from the decedent to someone other than the surviving spouse (a third party) for less than full and adequate consideration in money or money's worth, and
  - the third party may possess or use any part of the property after the interest of the surviving spouse terminates.
- The terminable interest rule has one additional caveat. If the deceased spouse's will directs his executor to use property included in the gross estate to purchase terminable interest property for the surviving spouse, the unlimited marital deduction is not available for that property.
- The exceptions to the terminable interest rule include:

Exam Tip

Make a flashcard and know these exceptions!

  - A six-month survival contingency.
  - A terminable interest, either outright or in trust, over which the surviving spouse has a general power of appointment.
  - A Qualified Terminable Interest Property (QTIP) Trust.
  - A Charitable Remainder Trust (CRT) where a spouse is the only noncharitable beneficiary.
- In planning large estates, contingency clauses are often used to ensure that the combined estates of a married couple make full use of their available applicable estate tax credits and to provide for the orderly disposition of the client's wealth.

Exam Question
Terminable Interests

Which of the following is NOT a terminable interest?

a) An ownership interest in a life insurance policy.
b) A life estate in a home.
c) A interest in a patent.
d) An interest in property for a term equal to an individual's life.

Answer: A
The ownership interest of a life insurance policy is not a terminable interest. The ownership interest does not terminate. All of the other interests listed are terminable interests. A life estate is a terminable interest because the interest in the property terminates at the individual's death. An interest in a patent is a terminable interest because a patent right terminates after a certain period of time. Answer D describes a life estate, so it is also a terminable interest.

Exam Question
Property Qualifying for the Unlimited Marital Deduction

Anne recently died. Anne is survived by her husband, Edward, and daughter, Catherine. Which of the following would be a qualifying property transfer for the purposes of the unlimited marital deduction?

a) Anne leaves ownership of certain copyrights to Edward.
b) Property transferred to a credit shelter trust for the benefit of Catherine, with Edward as the trustee.
c) Anne leaves her beach house to Edward, subject to the condition that if Edward does not survive Anne's sister, Anne's sister will get the property.
d) The $1,000,000 life insurance policy on Anne's life owned by Edward.

Answer: A
Although copyrights are terminable interests, no person other than Edward has any interest in the property, since all rights were given to Edward. Therefore, the transfer of the copyrights to Edward will qualify for the marital deduction. Answer B does not qualify for the unlimited marital deduction because even though Edward is trustee, and has legal title to the property inside the trust, he does not have beneficial title to the property. Answer C does not qualify for the unlimited marital deduction because the transfer to Edward is a terminable interest. Answer D does not qualify for the unlimited marital deduction because the proceeds of a life insurance policy owned by Edward on Anne's life will not be included in Anne's gross estate.

Outright Bequests to the Spouse

- The simplest way to qualify the transfer of property for the unlimited marital deduction is to transfer property directly to the surviving spouse. Many individuals prefer this method, since the surviving spouse has complete control over the property during his lifetime.

- While an outright transfer to the surviving spouse is simple and gives the surviving spouse complete control over the property, it may be more appropriate to limit the surviving spouse's control over the property through the use of a trust.

- In situations where the surviving spouse is not capable of managing assets or may need protection from current and future creditors, a transfer in trust should be considered. Once a transfer to the surviving spouse is accomplished through the use of a trust, a terminable interest results, potentially disqualifying the transfer for the marital deduction. There are two types of trusts, General Power of Appointment Trusts and QTIP Trusts, which

can be created to protect property for a decedent's heirs and still qualify for the unlimited marital deduction. These trusts are addressed below.

General Power of Appointment (GPOA) Trusts

- A General Power of Appointment (GPOA) Trust, also known as an "A Trust," creates a terminable interest for a surviving spouse that will nevertheless require the unconsumed assets to be included in the surviving spouse's gross estate and thus qualify the transfer of the property to the trust for the unlimited marital deduction.

- To qualify for the marital deduction, the trust must grant to the surviving spouse a power to appoint the trust property to himself, his estate, his creditors, or the creditors of his estate.

- A general power of appointment trust that only grants the surviving spouse the power to appoint the property to his estate is referred to as an estate trust.
  - Unlike a normal power of appointment trust, an estate trust does not require the annual distribution of income to the surviving spouse. Note, however, that if income is accumulated in an estate trust, such accumulated income is included in the surviving spouse's gross estate in addition to the original principal of the trust.
  - For the trust to qualify, no one other than the surviving spouse can have a beneficial interest in the trust. Upon the surviving spouse's death, the trusts assets must pass to the spouse's estate. Estate trusts are useful for passing nonincome-producing property since there is no statutory requirement for the trust to produce income. The trustee controls the trust assets during the spouse's lifetime.

Qualified Terminable Interest Property (QTIP) Trusts

- Use of a Qualified Terminable Interest Property (QTIP) Trust, also known as a "C Trust," allows a decedent to qualify a transfer for the marital deduction at his death yet still control the ultimate disposition of the property.

- A QTIP Trust holds property for the benefit of a surviving spouse and makes income distributions to the surviving spouse at least annually. At the surviving spouse's death, the trust property will transfer to the remainder beneficiary as determined by the grantor of the QTIP Trust, the first-to-die spouse.

- In order to qualify as a QTIP Trust, the following requirements must be met:
  - The property transferred to the trust must qualify for the unlimited marital deduction. Consequently, it must be in the gross estate of the first-to-die spouse and must be transferred to the surviving spouse (in this case, in trust).
  - The surviving spouse is entitled to all of the trust income for her life and that income must be paid at least annually. If the trust earns income during the surviving spouse's lifetime that is not distributed as of the date of the surviving spouse's death, the trust must distribute this income to the surviving spouse's estate (this is referred to as "stub income").
  - The surviving spouse must have the authority to compel the trustee to sell nonincome-producing investments and reinvest those proceeds in income-producing investments.
  - During the surviving spouse's lifetime, no one can have the right to appoint the property to anyone other than the surviving spouse.
  - The transferor or his executor must file an election to treat the trust as a QTIP Trust on the transferor's gift tax return (Form 709) or the decedent's federal estate tax return (Form 706).

Planning for the Non-citizen Spouse

- The unlimited estate tax marital deduction is not available for an outright bequest to a surviving spouse if the surviving spouse is not a US citizen. For non-citizen spouses, there is a special annual exclusion amount of $159,000 (2021) available for lifetime transfers by a citizen spouse to a non-citizen spouse.

Exam Question
Transfers to Non-US Citizen Spouses

Amanda has been married to Javier for 25 years. Javier is a Honduran citizen. Amanda would like to make an inter vivos transfer to Javier. What is the maximum amount that Amanda can transfer to Javier without incurring transfer taxes or utilizing her applicable credit during 2021?

a) $0.
b) $15,000.
c) $159,000.
d) $250,000.

Answer: C
There is a special annual exclusion for non-citizen spouses of $159,000. A spouse can transfer up to $159,000 to her non-citizen spouse without incurring gift taxes.

Exam Question
Transfers to Non US Citizen Spouses

Miguel and Jane have been married for 45 years. Miguel is a citizen of Mexico, where the couple has lived for the past 25 years. Given the following list of separate property owned by Jane, and considering Jane's will leaves everything to Miguel outright, what amount would qualify for the unlimited marital deduction?

1. A California home valued at $1,000,000.
2. Mexican property valued at $450,000.
3. The contents of the California home valued at $100,000.
4. An investment account held at a New York City bank valued at $500,000.

a) $0.
b) $159,000.
c) $4,625,800.
d) $5,490,000.

Answer: A
Because the property is transferred outright to a non-citizen spouse, it does not qualify for the unlimited marital deduction.

- One remedy to this problem is having the non-US citizen surviving spouse become a US citizen before the due date of estate tax return and maintain residency in the United States following the death of the decedent-spouse. If both of these conditions are met, the transfer to the surviving spouse will qualify for the unlimited estate tax marital deduction. Upon the death of the surviving spouse, the US will be able to collect an estate tax on the value of the remaining assets.

- For individuals who do not wish to obtain US citizenship, the citizen-spouse, or the executor of the citizen-spouse's estate, can create a Qualified Domestic Trust (QDOT). A QDOT will allow the US government to subject remaining assets to estate taxation upon the death of the non-citizen surviving spouse. In order to qualify the QDOT for the unlimited marital deduction, the following requirements must be met:

- at least one of the QDOT trustees must be a US citizen or a US domestic corporation;
- the trust must prohibit a distribution of principal unless the US citizen trustee has the right to withhold estate tax on the distribution;
- the trustee must keep a sufficient amount of the trust assets in the United States to ensure the payment of federal estate taxes, or the trustee must have a minimum net worth sufficient to assure the payment of estate taxes upon the death of the non-citizen surviving spouse; and
- the executor of the citizen-spouse's estate must elect to have the marital deduction apply to the trust.

Exam Question
QDOTs

In which of the following situations would the use of a QDOT be appropriate?

a) Tom dies and is survived by his wife, Tina, who is not a US citizen.
b) Regina dies and is survived by her husband, Raul, who becomes a US citizen two months after Regina's death.
c) Harold dies and does not have a surviving spouse.
d) Franz, who is not a US citizen, dies and is survived by his wife, Francine, who is a US citizen.

Answer: A
Answer B does not describe a situation in which the use of a QDOT would be appropriate because Raul became a US citizen prior to the due date of the estate tax return and therefore, any property transfers to Raul would qualify for the unlimited marital deduction. Answer C is not correct because there is no reason to use a QDOT if Harold does not have a surviving spouse. Answer D is not correct because a QDOT is used when the *surviving* spouse is not a US citizen.

Alternatives to Qualification

- At first glance, the unlimited marital deduction appears to be a planning panacea once you qualify for the marital deduction, there is no estate tax on the value of the property at the death of the first spouse. Remember, however, that the marital deduction is only a deferral device; it is available in the first spouse's estate only if the assets transferred will be available to be taxed in the surviving spouse's gross estate.
- In estate planning, it is important to avoid qualifying too many assets for the marital deduction.
  - In 2021, an individual can pass up to $11,700,000 of assets to a nonspouse during their lifetime or at death without triggering federal transfer tax.
  - Prior to 2011, when an individual left his entire estate to the surviving spouse, the applicable estate tax credit equivalency was lost and could not be retrieved.
  - The Tax Relief, Unemployment Insurance, Reauthorization and Job Creation Act of 2010 implemented the applicable estate tax credit portability feature.
  - The exclusion amount is portable between spouses. This means that if one spouse dies and leaves all of their assets to the other spouse, the exclusion is not lost as was the case before. Now the surviving spouse is able to use any remaining exclusion not utilized by their last spouse to die.
  - When too many assets pass to a surviving spouse, resulting in an increase in overall estate taxes for the family when the surviving spouse dies, the unlimited marital deduction is said to be overqualified.

Example

Jack and Jill have been married for 43 years. They have simple "I love you" wills leaving all of their separate property to the surviving spouse. Jack dies earlier this year and leaves $7 million to Jill, who has an estate in her own right of $6 million. None of Jack's exclusion is applied at Jack's death since it is all estate tax free because of the marital deduction.

Now Jill's separate estate is $8 million and she passes away still having Jack's $7 million. Her exclusion is only $11,700,000. Under normal circumstances the remaining $3,300,000 would be subject to estate tax. However, Jack's unused credit of $4,625,800 may be used to offset the remaining amount, leaving nothing subject to estate tax.

Exam Question

Yana and Bill are married and in the process of establishing their estate plan. Currently they only have simple mutual wills in place. Yana's gross estate is worth $4 million and Bill's is $3 million. Bill has made a cumulative taxable gift to his children from his first marriage of $2 million in the current year. If Bill dies this year before completing their new estate plan, how much of Bill's unused applicable exclusion amount is available for Yana?

a) None
b) $2,000,000
c) $9,700,000
d) $11,700,000

Answer: C

Bill made taxable gifts of $2 million, which he paid no gift tax on due to the applicable exemption amount. Therefore, he has reduced his exemption amount from $11,700,000 to $9,700,000. His entire estate is then transferred to his wife so none of the remaining $3 million in his gross estate is taxable. So the total unused exclusion is $9,700,000.

- The portability feature is only applicable if both spouses die after December 31, 2010.
- The law of the estate exclusion states that the unused exclusion amount is that amount not utilized by the "last spouse" to die. Therefore, in the event that a surviving spouse remarries and is predeceased again, the unused exclusion amount from the first decedent spouse is wasted.

Exam Question

Joe and Holly are married and have a combined net worth of $8 million. Holly unexpectedly dies due to congestive heart failure leaving Joe $3 million of her $4 million gross estate. The other $1 million is split evenly between their two children. Five years pass and Joe is remarried to Chartreuse who inherited $2 million dollars from her father. Chartreuse has established her will leaving all of her assets to her children from a first marriage and excluding Joe, since she believes he has enough of his own assets. Chartreuse predeceases Joe due to a car accident. How much unused exclusion amount is available for Joe's estate to utilize if all the proper elections were made at Holly and Chartreuse's deaths?

a) $9,700,000
b) $10,700,000
c) $11,700,000
d) $13,300,000

Answer: A

The unused exclusion amount is based on the "last deceased spouse." Holly's unused exclusion does not matter. It was effectively wasted. Chartreuse has $2 million, which is left to her children, meaning $2 million of her $11,700,000 exclusion is being utilized. Therefore, Joe's estate may utilize her $9,700,000 unused exclusion.

Assume in this example that Joe wanted to be able to utilize Holly's exclusion. He could accomplish this by transferring assets to the children before Chartreuse's death. If he transfers $3 million to the children at any time before Chartreuse's death then he will first apply the unused exclusion that was ported over from Holly. He will retain his own exclusion. Then when Chartreuse dies he can also port over her unused exclusion.

Example

Vic and Valerie had been married for 35 years at the date of Vic's death in 2019. Vic and Valerie have three children. Valerie is the daughter of a southern business tycoon and has significant assets totaling $1,000,000 in her own name. In addition, Valerie expects to receive a substantial inheritance from her parents of $2,000,000. Vic's will leaves all of his assets, $9,500,000, to Valerie, and, if Valerie predeceased him, the assets are split between his children, in equal shares, per stirpes (typically referred to as an "I Love You" or "sweetheart" will). Assume funeral and administrative expenses are $100,000 for the first spouse to die, and $400,000 for the second spouse to die. Since Vic left all of his assets to Valerie outright, his entire estate qualifies for the marital deduction. Vic will not be able to use his applicable estate tax credit, since none of his property is passing to his children or anyone other than his wife. Vic's estate is overqualified for the marital deduction. Furthermore, Vic's assets will be added to Valerie's and will likely be subject to estate tax at the highest marginal rate at Valerie's death (Note that Vic dies before the portability feature was available).

Given the above information, the estate tax calculation for Vic's estate follows:

Vic's Gross Estate	$9,500,000
- Funeral & Admin Expenses (assumed)	($100,000)
- Debts	($0)
- Taxes due at death	($0)
Adjusted Gross Estate	$9,400,000
- Marital Deduction	($9,400,000)
- Charitable Deduction	($0)
Taxable Estate	$0
+ Post'76 Gifts	$0
Tentative Tax Base	$0
Tentative Estate Tax	$0
-Applicable Estate Tax Credit	($0)
Total Estate Tax Liability	$0

At Valerie's subsequent death in 2021, her estate tax calculation follows (assuming no growth in the value of the assets between deaths, also assumes that the exemption was not ported to Valerie):

Valerie's Assets	$3,000,000
Assets from Vic's Estate	$9,400,000
- Funeral & Admin Expenses (assumed)	($400,000)
- Debts	($0)
- Taxes due at death	($0)
Adjusted Gross Estate	$12,000,000
- Marital Deduction	($0)
- Charitable Deduction	($0)
Taxable Estate	$12,000,000
+ Post'76 Gifts	$0
Tentative Tax Base	$12,000,000
Tentative Estate Tax	$4,745,800
- Applicable Estate Tax Credit	($4,625,800)
Total Estate Tax Liability	$120,000

If Vic had left $9.4 million in a bypass trust for the benefit of Valerie, he would have been able to use his applicable estate tax credit amount. Furthermore, Valerie's gross estate would not include the $9.4 million in the bypass trust, resulting in an overall estate tax savings.

- In contrast, the unlimited marital deduction can also be underqualified. Underqualification means that too much of the decedent's property was subject to estate tax at the death of the first spouse due to a failure to make adequate use of the unlimited marital deduction.

> ***Example***
>
> Patty and John had been married for 40 years at the date of John's death in 2021. Patty and John have three children. The value of Patty's gross estate is $450,000, and the value of John's gross estate is $12,030,000. John's will leaves $11,820,000 to a bypass trust for the benefit of Patty and their children, and the rest of his estate outright to Patty. Since John's estate exceeds the applicable estate exemption amount of $11,700,000 (2021), estate tax will be due on the $120,000 ($11,820,000 - $11,700,000) excess. John has underqualified the marital deduction in his estate. If John had left $11,700,000 to the bypass trust and $330,000 (the $210,000 she was already receiving plus the $120,000 that was originally going to the bypass trust) to Patty, his estate would not have a federal estate tax liability. Since Patty's gross estate will be less than $11,700,000 (her assets of $450,000 plus the $330,000 she received from John's estate, assuming there is no growth in the value of the assets), Patty's estate would not have a federal estate tax liability, either. John's underqualification of the marital deduction causes $120,000 of assets to be subject to estate tax that would have passed tax free to the children at Patty's death had the appropriate marital deduction been used.

- A bypass trust (sometimes referred to as a credit shelter trust, or "B Trust") is used to ensure that an individual can make full use of his applicable estate tax credit amount.
  - Instead of overqualifying the marital deduction by leaving all property to the surviving spouse, a bypass trust is created to receive property with a fair market value equal to the decedent's remaining applicable estate tax exemption ($11,700,000 in 2021) from the decedent's gross estate, while the remainder of the property passes to the surviving spouse (either outright, or through the use of a GPOA Trust or QTIP Trust).

- A common testamentary trust arrangement includes the transfer of the remaining applicable estate tax exemption to a bypass trust, also known as a B Trust, the transfer of a certain amount to a General Power of Appointment Trust, also known as an A Trust, and the transfer of the remaining balance to a QTIP Trust, known as a C Trust. The arrangement is often referred to as an ABC Trust arrangement.
  - With such an arrangement, a decedent can accomplish several objectives.
    - First, the decedent can guarantee the full use of his applicable estate tax exemption with the transfer to the B Trust.
    - The decedent can also provide the necessary funds to his surviving spouse in several ways. The A Trust allows the spouse to receive income distributions as well as appoint the principal to herself. The B and C Trusts allows income distributions to the surviving spouse as well as the ability for the surviving spouse to receive principal distributions from the B and C Trusts for health, education, maintenance and support.
    - In addition, the A Trust and C Trust qualify the transfers for the unlimited marital deduction. A key difference, however, between the A and the C Trust is the selection of the ultimate beneficiaries of the trust property. Because the surviving spouse will have a GPOA over the trust property of the A Trust, the surviving spouse can choose the ultimate beneficiary of the trust property, whereas the decedent (grantor) will choose the remainder beneficiary of the C Trust.

Exam Question
Unlimited Marital Deduction

Which of the following statements is incorrect?

a) When a decedent's taxable estate is less than the applicable estate tax exemption, the estate is said to be overqualified.
b) When too few assets pass to a decedent's surviving spouse, and, as such, the decedent's taxable estate is greater than the applicable estate tax exemption, the decedent's estate is said to be underqualified.
c) An ABC Trust arrangement utilizes a General Power of Appointment Trust, a QTIP Trust, and a Bypass Trust to maximize the use of a decedent's applicable estate exemption.
d) The ultimate beneficiary of a QTIP Trust is chosen by the surviving spouse.

Answer: D
Answer D is incorrect because the ultimate beneficiary of a QTIP Trust is chosen by the grantor of the QTIP Trust. All of the other statements are correct.

- An individual who is uncomfortable placing a large amount of money in a bypass trust could leave all of his property to the surviving spouse but include a provision in the will stating that if the surviving spouse disclaims any or all of the bequest, the disclaimed property will be placed in a bypass trust, thus giving the surviving spouse an income interest in the trust as noted above.

- Provided that a client is comfortable with limiting the amount of property that is transferred outright to a spouse, several planning options emerge. One of the most powerful to emerge is the use of an Irrevocable Life Insurance Trust (ILIT) to provide for the surviving spouse, prevent property from being included in the gross estate of either spouse, and protect assets from the claims of the beneficiaries' creditors.
    - A properly drafted ILIT can accomplish all of these objectives. By allowing the trustee of the ILIT to apply for and purchase a life insurance policy on the life of the insured/grantor of the ILIT, the insured will possess no incidence of ownership in the policy thereby keeping the policy out of his gross estate. The grantor of the ILIT can then name his spouse as the primary beneficiary of the trust, granting the surviving spouse:
        - the right to income;
        - the right to receive distributions for health, education, maintenance, and support; and
        - the right to demand up to $5,000 or five percent of the trust corpus each year without subjecting the principal of the ILIT to estate taxation in the surviving spouse's gross estate.

Comprehensive Exam Question

- Mike has an estate valued at $12,500,000. In addition, there is a fully paid-up life insurance policy on Mike's life that has a $1,000,000 death benefit. Mike is married to Mary and has two children. Mike is expected to die before Mary, who is substantially younger than him. Mike and Mary have asked you to help them with their estate planning and would like you to consider the following three alternative scenarios.

- Assume for each scenario funeral and administrative expenses of $100,000.

- Scenario #1, assume that all of Mike's assets, including the death benefit on the life insurance policy he owns on his life, pass to Mary.

Question: When Mike dies January 1, 2021, what is his taxable estate?

Answer:

Mike's Gross Estate	$13,500,000	$12.5 million + $1 million
- Funeral & Admin. Expenses	($100,000)	
- Debts	($0)	
- Taxes due at death	($0)	
Adjusted Gross Estate	$13,400,000	
- Marital Deduction	($13,400,000)	
- Charitable Deduction	($0)	
Taxable Estate	$0	
+ Post'76 Gifts	$0	
Tentative Tax Base	$0	
Tentative Estate Tax	$0	
- Applicable Estate Tax Credit	($0)	
Total Estate Tax Liability	$0	

- Mike's gross estate includes the $12,500,000 in assets that he held at the date of his death, plus the $1,000,000 death benefit from the life insurance policy Mike owned on his life at the time of his death. Since all of Mike's assets, including the death benefit on the life insurance policy, pass to Mary, his estate qualifies for a $13,400,000 marital deduction, resulting in a taxable estate of $0. Note that Mike has not made use of his applicable estate tax credit.

Question: Assuming that Mary dies later the same year (November 1, 2021), and that Mary's only assets are those that she inherited from Mike, and that the value of the assets that she inherited did not change, what would be Mary's estate tax liability (assume that portability was elected)?

Answer:

Mary's Gross Estate	$0
Assets from Mike's Estate	$13,400,000
- Funeral & Admin Expenses	($100,000)
- Debts	($0)
- Taxes due at death	($0)
Adjusted Gross Estate	$13,300,000
- Marital Deduction	($0)
- Charitable Deduction	($0)
Taxable Estate	$13,300,000
+ Post'76 Gifts	$0
Tentative Tax Base	$13,300,000
Tentative Estate Tax	$5,265,800
- Applicable Estate Tax Credit*	($5,265,800)
Total Estate Tax Liability	$0

* Mary's credit is $4,625,800 plus Mike's unused credit of $4,625,800 since they both died after 2010 assuming a proper portability election was made.

- Limited to tentative tax, the net result of Scenario 1 is that Mike and Mary pay no federal estate taxes. Mike and Mary's heirs receive $13,300,000 ($13,500,000 - $200,000 administrative expenses) assuming that there is no additional tax levied by their state of residence.

- Without portability, the total estate tax liability for Mary would equal $615,000 since she is not allowed Mike's unused applicable estate tax credit.

- Scenario #2, Mike created an ILIT 5 years ago to own the life insurance on his life. For this scenario assume that Mike was able to fund the ILIT using annual exclusion gifts subject to a Crummey right of withdrawal.

Question: What is Mike's estate tax liability if he dies January 1, 2021?

Answer: In this case, the $1,000,000 death benefit is excluded from Mike's gross estate because he did not possess at his death (or in the three years immediately preceeding his death) any incident of ownership in the life insurance policy. Instead, the life insurance policy was owned by the trustee of the ILIT. The results of the estate planning of Scenario 2 are as follows:

- At Mike's death, the $1,000,000 life insurance proceeds are paid to the ILIT. The trust grants Mary the right to receive the trust income and the right to principal distributions for her health, education, maintenance, and support. Effectively, all of these assets are available for Mary in the event she will need them during her lifetime. At Mary's death, any amounts remaining in the ILIT are split equally among Mike and Mary's children. Mike's estate tax calculation is as follows:

Mike's Gross Estate	$12,500,000
- Funeral & Admin Expenses	($100,000)
- Debts	($0)
- Taxes due at death	($0)
Adjusted Gross Estate	$12,400,000
- Marital Deduction	($12,400,000)
- Charitable Deduction	($0)
Taxable Estate	$0
+ Post'76 Gifts	$0
Tentative Tax Base	$0
Tentative Estate Tax	$0
- Applicable Estate Tax Credit	($0)
Total Estate Tax Liability	$0

- Note that Mike's gross estate is $1,000,000 less than it was in Scenario 1 due to the exclusion of the life insurance proceeds. Again, however, Mike has failed to utilize his applicable estate tax credit in his estate planning process.

Question: Assuming that Mary dies November 1, 2021, and assuming that the assets that Mike bequeathed to Mary remained at the same value, and that these are the only assets included in Mary's gross estate, what would be Mary's estate tax liability?

Answer:

Mary's Gross Estate	$0
Assets from Mike's Estate	$12,400,000
- Funeral & Admin Expenses	($100,000)
- Debts	($0)
- Taxes due at death	($0)
Adjusted Gross Estate	$12,300,000
- Marital Deduction	($0)
- Charitable Deduction	($0)
Tentative Tax Base	$12,300,000
+ Post'76 Gifts	$0
Tentative Tax Base	$12,300,000
Tentative Estate Tax	$4,865,800
- Applicable Estate Tax Credit*	(4,865,800)
Total Estate Tax Liability	$0

* Mary's credit is $4,625,800 plus Mike's unused credit of $4,625,800, since they both died after 2010 assuming a proper portability election was made.

- Note that moving the life insurance to the ILIT does not save them any tax. However, the trust established for the life insurance may provide savings of estate administration, asset protection and professional management.

- Without portability, the total estate tax liability for Mary would equal $215,000 since she is not allowed Mike's unused applicable estate tax credit. A savings of $400,000 in relation to Scenario #1.

- Scenario #3, assume that 5 years ago Mike moves the life insurance policy into an ILIT so that the death benefit will remain outside of his estate, and that he makes full use of his applicable estate tax credit using a bypass trust. For this scenario, assume that Mike was able to fund the ILIT using annual exclusion gifts subject to a Crummey right of withdrawal.

  Question: What is Mike's estate tax liability?

  Answer: In this case, the $1,000,000 death benefit will be excluded from Mike's gross estate because he did not have any incidents of ownership in the life insurance policy at his death (or in the three years immediately preceeding his death). Instead, the life insurance policy was owned by the trustee of the ILIT.
  - At Mike's death, the $1,000,000 life insurance proceeds are paid to the ILIT. The trust grants Mary the right to receive the trust income and the right to principal distributions for her health, education, maintenance, and support. Effectively, all of these assets are available for Mary in the event that she needs them during her lifetime. At Mary's death, any amounts remaining in the trust are split equally among Mike and Mary's children.
  - Mike's will directs his executor to create a bypass trust and to fund it with the maximum amount that can be transferred without increasing Mike's estate tax. Since Mike has not made any taxable transfers during his lifetime, the full applicable estate tax exemption of $11,700,000 (2021) is available. Therefore, Mike's executor transfers $11,700,000 (2021) in assets to the bypass trust. During her lifetime, Mary will have the right to receive the trust income and the right to receive distributions of principal for her health, education, maintenance, and support. Similar to the ILIT, the assets of the bypass trust are available to Mary should she need them during her lifetime. At Mary's death, any amounts remaining in the bypass trust are split equally among Mike and Mary's children.

- Mike's estate tax calculation follows:

Mike's Gross Estate	$12,500,000
- Funeral & Admin Expenses	($100,000)
- Debts	($0)
- Taxes due at death	($0)
Adjusted Gross Estate	$12,400,000
- Marital Deduction	($700,000)
- Charitable Deduction	($0)
Taxable Estate	$11,700,000
+ Post'76 Gifts	$0
Tentative Tax Base	$11,700,000
Tentative Estate Tax	$4,625,800
- Applicable Estate Tax Credit	($4,625,800)
Total Estate Tax Liability	$0

- **Question:** Unlike Scenario 1 or Scenario 2, Mike has made full use of his applicable estate tax credit equivalency to reduce the overall estate taxes paid by Mike and Mary. Assuming that the assets that Mike bequeathed to Mary are the only assets included in Mary's gross estate, and they did not appreciate or depreciate, and that Mary died November 1, 2021, what is Mary's estate tax liability?

Answer:

Mary's Gross Estate	$0
Assets from Mike's Estate	$1,700,000
- Funeral & Admin Expenses	($100,000)
- Debts	($0)
- Taxes due at death	($0)
Adjusted Gross Estate (AGE)	$1,600,000
- Marital Deduction	($0)
- Charitable Deduction	($0)
Taxable Estate	$1,600,000
+ Post'76 Gifts	$0
Tentative Tax Base	$1,600,000
Tentative Estate Tax	$585,800
- Applicable Estate Tax Credit	($585,800)
Total Estate Tax Liability	$0