Will and Trust Drafting for Florida Attorneys
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I. Where to Begin? The Nuts and Bolts of Will Drafting.

In drafting a will for a client, advisors try to identify common patterns in the facts presented, to determine what type of will and/or other estate planning is necessary. The most significant factors are married v. unmarried, level of wealth, age, and family structure. A thirty year old single male with no children needs a completely different type of will than a married seventy year old on his second wife, with children from a previous marriage and with a significant taxable estate. The initial goal of the planner should be to try to winnow down the number of estate planning possibilities so that a limited number of choices can be presented to the client. Clients view their estate planners not merely as draftsman, but as advisors, as clients are looking for direction in trying to figure out what to do.

A. Initial Advice to the Client

The two most important parts of commencing the estate planning process are information gathering and determining the client's general intentions. The client should be made aware of the decisions that he or she will be called upon to make before a will can be drafted. Some of those decisions are as follows.

1. Who gets what assets.
2. Are assets distributed free of trust, or should trusts be created (for taxable and/or nontaxable purposes).
3. If trusts are created, what are the rules for mandatory and discretionary distributions from the trusts and trust termination.
4. Is the elective share a concern.
5. Who should be the personal representative.
6. Who should serve as trustee on any trusts created.

7. Should lifetime estate planning be done in conjunction with the will to reduce estate taxes.
8. Should incapacity planning be done in conjunction with the will.

Once the client has voiced some of these initial decisions, the type of will that needs to be drafted can be determined. The decision-making process, however, needs to be undertaken in conjunction with the information gathering process.

Estate planning can become difficult when it requires clients to deal with unpleasant family matters, the most common being estranged children, children addicted to drugs or alcohol, strained marriages, and children from multiple marriages. Clients look to their estate planner for advice on handling these sensitive matters in the context of the estate plan. Clients are typically interested to know how similar situations have been handled in the past and what the end results were.

B. Checklist for Gathering Client Information

Most estate planners use a questionnaire that they provide their clients to assist in the information gathering process. Some planners use an expansive questionnaire that they expect their clients to prepare prior to the first meeting. Others use a shorter version. The type of questionnaire to be used can also be dependent on the type of planning to be performed. For example, if the planning is likely to result in the creation of a living trust, followed by transfers of assets into the trust, extensive and detailed information on the assets will be required. For a younger family needing only wills, far less information would be required. For very busy professionals or business owners, a lengthy questionnaire can be a barrier to continuing with the estate planning project, and information might best be gathered in person and/or from that person’s other advisors.

Exhibit 1 is an example of an estate planning questionnaire for use with married clients who are likely to spend the time to fill out the form.

C. Designating Fiduciaries

The client’s choice of fiduciary is an inherently personal decision that can be one of the most important decisions the client will make in the estate planning process. The

size and the complexity of the estate and the client's family situation will all factor in the choice of fiduciary.

1. Legal Requirements to Serve as Personal Representative for Florida Estate. In selecting the personal representative, an initial threshold issue is qualifying the personal representative under Florida law. For an individual to serve as a personal representative, any resident of Florida may serve. FS 733.302. A person who is not a Florida resident may serve as the personal representative only if the person is (1) a legally adopted child or adoptive parent of the decedent; (2) related by lineal consanguinity to the decedent; (3) a spouse or a brother, sister, uncle, aunt, nephew, or niece of the decedent, or someone related by lineal consanguinity to any such person; or (4) the spouse of a person otherwise qualified. FS 733.304.

Notwithstanding a person's eligibility to serve as the personal representative under FS 733.302 and FS 733.304, a person is not eligible to serve as the personal representative if the person (1) has been convicted of a felony; (2) is mentally or physically unable to perform the duties; or (3) is under the age of 18 years. FS 733.303.

For an organization to serve as personal representative, the organization must be a trust company incorporated under the laws of Florida or a Florida or federally chartered banking corporation or savings and loan. FS 733.305.

2. Preference in Appointment.

When a will is probated, the probate statute provides for a preference in appointment of the personal representative, at FS 733.301. In testate estates, the order is as follows:

1. The person nominated in the will;
2. The person selected by a majority in interest of the persons entitled to the estate;
3. A devisee under the will. If more than one applies, the court shall select the most qualified person.

In intestate estates, the order is as follows:

1. The surviving spouse;

2. The person elected by a majority in interest of the heirs;

3. The heir nearest in degree. If more than one applies, the court shall select the most qualified person.

If no person applies to be the personal representative, the court may appoint a capable person to act as personal representative.

D. Complying With Statutory Requirements

To make a valid will under Florida law, several statutory requirements must be met. Any person of sound mind who is either 18 or more years of age or an emancipated minor may make a will. FS 732.501. Every will must be in writing and executed by the testator and at least two attesting witnesses. FS 732.502. The testator must sign a the end of the will, and the testator must sign in the presence of the witnesses or acknowledge that the testator previously signed the will or that another person did so on the testator's behalf. FS 732.502.

Any competent person may sign the will, and a will is not invalid because one of the witnesses has an interest in the will. FS 732.504.

Florida law allows a testator to prepare a list of specific devises of tangible personal property if referred to in the will. FS 732.515. The list need merely be signed by the testator and can be prepared before or after the will.

E. Using Disinheritance and No Contest Clauses: Will They Stand?

A disinheritance clause is often used to specifically remove an individual from an estate plan, typically a blood relation who would otherwise be expecting to inherit from the will. A typical disinheritance clause might be drafted as "I leave my son, Fred, nothing under this Last Will and Testament." Florida law contains no restrictions on the ability of a testator to disinherit natural heirs, other than a surviving spouse.

Practice Tip. A disinheritance clause is not effective to eliminate an heir who would take under the laws of intestacy if the will does not dispose of all of the decedent's property. This would be the case if a will does not contain a residuary bequest and the remaining portions of the will do not address certain of decedent's property. In such a case, where the will does not dispose of all the property, the undisposed of property is

distributed according to the laws of intestacy, even though the will has a clause that purports to disinherit an heir. See, for example, *Estate of Barker v. Broughton*, 448 So. 2d 28 (1st DCA 1984).

A no contest clause is clearly against public policy and will not be enforced under Florida law. "A provision in a will purporting to penalize any interested person for contesting the will or instituting other proceedings relating to the estate is unenforceable." FS 732.517. Florida Statute 737.207 provides the same rule for trusts.

II. How is a Trust Drafted and Executed?

A. Determining the Need for a Trust.

Trusts are wonderful vehicles for implementing a client's intentions regarding the management and distribution of assets. Trusts can allow a client to control the management and distribution of asset into the future, in some cases for generations. Trusts can also provide for asset protection, incapacity planning, estate tax reduction, gift tax reduction, federal income tax management, state income tax management, divorce planning, planning for special needs children, and many other purposes. With the scheduled increases in the estate tax exemption amount and the possibility of outright repeal of the estate tax, those areas of trust planning once considered secondary, such as asset protection and control, have moved to the forefront in importance for many planners and their clients.

There are many "types" of trusts in use, and some of the common types include a life insurance trust, or "ILIT" (Irrevocable Life Insurance Trust), living trust, grantor trust, defective grantor trust, bypass trust, credit shelter trust, dynasty trust, asset protection trust, qualified terminal interest property trust, or "QTIP," qualified personal residency trust, special needs trust, and grantor retained annuity trust. While these names are a useful starting point for a client discussion, they can oversimplify a complex area. Many trusts overlap multiple areas and accomplish several goals. For example, a trust created with *Crummey* powers to hold life insurance and other assets, the income of which will be taxable to the Settlor, which is intended to hold assets for several generations, has characteristics of a life insurance trust, a grantor trust, and a dynasty trust.

A sensible starting point is to determine a client's planning goals, in the areas of income tax, estate tax, family planning, asset protection, incapacity planning, and asset management, to see whether a trust can help a client satisfy a need in any of these areas. Sometimes the need for a trust is clear, and in other instances the complexity of a trust may not weigh favorably against the client's goals.

Although practitioners tend to focus on the more analytic and measurable goal of estate tax reduction, many clients tend to be far more focused on family dynamics issues. For example, many clients are hesitant about leaving assets in the hands of their children directly, with concerns about their children's responsibility, deadbeat spouses, and divorce. A trust will allow assets to be managed, controlled, and disbursed so that they are used solely for the beneficial and productive enjoyment of the client's children, and not for any other purpose. If the client is only interested in a will, a basic testamentary trust established by the will to manage asset for children for some period of time is an easy choice to make for a client.

If a client is expected to have a taxable estate, the client should be presented with some estate tax reduction techniques that can be achieved through the use of trusts. These techniques are discussed at length below.

Practice Tip. Trusts should not be used as a secret divorce planning tool. When an attorney is presented with one spouse and not the other, many attorneys believe they should make an inquiry into the health of the marriage, to protect the attorney from potential liability as well as the client from disastrous financial results, especially if the client seeks to engage in inter vivos estate planning techniques. The case of *Schneider v. Schneider*, 864 So.2d 1193 (4th DCA 2004), presents such an adverse outcome. In the case, the client directed that the sales proceeds from his medical practice be placed in trust for the benefit if this children, as part of a purported income tax savings plan and estate planning arrangement. The client did not discuss this diversion of funds into the trust, nor did he have a waiver from his wife regarding this action. In a subsequent marital dissolution action, during which the client's friend testified that the client told him that he was thinking about getting divorced after the sale of the medical practice, the court determined that the assets placed into the trust were marital assets that should be credited against the client in the equitable distribution process. The Court reasoned "[T]he wife should have had a voice in how the marital funds were allocated for the children. A party to dissolution cannot use the children as pawns to set up trusts or other stratagems to manipulate equitable distribution." Most of the family's assets therefore

went to the wife or were in trust for the children. This is certainly not what the client intended.

B. Standard Elements and Clauses in Trust Agreements

A trust has three principal parties: the settlor, the trustee, and the beneficiaries. The Settlor is the person establishing the trust and is typically the person who contributes all or a majority of the assets to the trust. The trustee is the individual or institution responsible for managing the trust's assets, making distributions of trust assets to the beneficiaries, and performing all other duties involved in administering a trust. The beneficiaries are those persons who will receive distributions from the trust. A trust can have different classifications of beneficiaries, including current beneficiaries, remainder beneficiaries, and contingent beneficiaries.

No matter how many articles or sections a trust may have, an effective trust needs only a select few elements to be effective under Florida law, namely the naming of a trustee, the naming of beneficiaries, and distribution rules. Florida law can be relied upon to flesh out the remainder of the operative provisions of a trust. In practice, however, must clients and draftsman will prefer to set forth precise rules and procedures to follow in place of the Florida default provisions.

1. Trustee Provisions. The initial trustee of a trust will be person or organization that takes initial custody of the trust corpus. One or more successor trustees will take over the position of trustee upon the resignation, removal, death, or disability of the prior trustee. A trust should have a succession procedure in the event that no named successor is available. For example, a commonly used trust provision permits all current income beneficiaries to collectively name the successor trustee if the successor is not named in the document.

Many trusts use a co-trustee arrangement in which two trusts administer a trust simultaneously. Such trusts should contain detailed decision-making procedures for handling situations where the trustees cannot agree on what action to take. A commonly used trust provision allows the two co-trustees to appoint a temporary trustee to make decisions in the case of deadlock. The co-trustees will implement the decisions of the

temporary trustee. This procedure is far more desirable than litigation, arbitration, or continued deadlock.

2. Beneficiary Provisions. The beneficiary provisions should address who is entitled to the trust corpus. There are two acceptable methods to identify beneficiaries: by specific name and by class. Most trusts incorporate elements of both methods. For example, a settlor may establish a trust for the settlor's children. If the settlor has children from multiple marriages and desires only to benefit his children from his current wife, the clause should name the specific children. If the trust corpus may also be used for the children of one of the settlor's children after such child dies, the second group of children could be designated by class, by including a clause that names the descendants of a named beneficiary as beneficiaries after the death of a named beneficiary.

3. Distribution Rules. The distribution rules are typically the core part of a trust, giving instruction for when, in what amounts, and how distributions are made to the beneficiaries.

4. Trustee Powers. Florida law provides an expansive list of trust powers at FS 737.402. A trustee has all powers conferred by FS 737.402 unless limited by the trust instrument. FS 737.401. In spite of Florida law granting expansive trustee powers, virtually every trust will be drafted with its own list of trustee powers, highly duplicative of the statutory powers. Other than tradition, there is no single answer why trusts are drafted with the exhaustive list of powers. Perhaps draftsmen are concerned about changes to the law that could eliminate a power, a change to the situs of the trust to a state without such a list of enumerated trustee powers, or that the list of enumerated powers does not set forth sufficient powers that the draftsman anticipates the trustee may need to properly administer the trust.

5. Spendthrift Provisions

Most trusts set up by a settlor for the benefit of others, whether by way of an inter vivo trust or a testamentary trust, contain a provision known as a spendthrift clause, to prevent trust assets from being used to pay the debts of the beneficiary. Florida has a

long history of recognizing the validity of spendthrift clauses in trusts. *Waterbury v. Munn*, 32 So.2d 603 (Fl. 1947).

Practice Tip. Florida law recognizes an important exception to the validity of spendthrift clauses, in the context of alimony and child support. If all other methods to collect alimony from a beneficiary have failed, a garnishment order is effective against the trust to collect the alimony. *Bacardi v. White*, 463 So.2d 218 (Fl. 1985).

In *Bacardi*, a trust was established for the benefit of the husband in the marriage by his father. The trust instrument contained a spendthrift clause which stated:

> No part of the interest of any beneficiary of this trust shall be subject in any event to sale, alienation, hypothecation, pledge, transfer or subject to any debt of said beneficiary or any judgment against said beneficiary or process in aid of execution of said judgment.

The husband refused to pay the court ordered alimony. In determining whether to allow the trust to be garnished for the unpaid alimony, the Court held that garnishment should only be allowed as a last resort. The Court also further limited the right of garnishment to disbursements that are due to be made or which are actually made from the trust, if, under the terms of the trust, a disbursement of corpus or income is due the debtor-beneficiary. If disbursements are wholly within the trustee's discretion, the court may not order the trustee to make such disbursements.

6. Trust Management Provisions

Florida has adopted the prudent investor rule for the management of trust assets. FS 518.11. The standard "requires the exercise of reasonable care and caution and is to be applied to investments not in isolation, but in the context of the investment portfolio as a whole and as a part of an overall investment strategy that should incorporate risk and return objectives reasonably suitable to the trust." The rule also requires diversification of assets, unless the purpose of the trust requires otherwise. FS 518.11(1)(b). The rule provides that the trustee should pursue an investment strategy that considers the reasonable production of income and safety of capital, consistent with the purpose of the trust. FS 518.11(1)(e).

Practice Tip. If the trust is going to hold anything other than a portfolio of marketable securities, it is critical that portions of the prudent investor rule be overridden by express direction in the trust. Express directions within a trust to eliminate or alter any portion of the prudent investor rule will be honored, and the fiduciary is not liable to any person for the fiduciary's reasonable reliance on those express provisions. FS 518.11(2).

If a trust is going to hold real estate or business assets, express elimination of some or all of the provisions of the prudent investor rule should be included. Otherwise, the trustee may decline to accept appointment, or the trustee may feel compelled to sell the assets that were intended to be held by the trust.

7. Settlor's Power Over the Trust. In any irrevocable trust, where it is desired to keep the trust assets out of the settlor's taxable estate, the settlor cannot be provided with any significant power to amend or revoke the trust, nor to access the trust corpus. If a trust is not clearly irrevocable, it may be included in the maker's taxable estate for federal estate tax purposes, primarily under Sections 2036 through 2038 of the Code. To keep the trust corpus out of the settlor's taxable estate, an irrevocable trust should have a provision similar to the following:

> The Trust hereby created is and shall be irrevocable by the Settlor, and the Settlor hereby expressly waives and relinquishes all rights and powers, whether alone or in conjunction with others, and regardless of when or from what source the Settlor may have acquired such rights or powers, to alter, amend, revoke or terminate this Trust Agreement, or any of the terms hereof, in whole or in part. The Settlor hereby renounces absolutely and forever, for the Settlor's estate, any power, whether alone, or in conjunction with others, to determine or control (by alteration, amendment, revocation, termination, or otherwise) the possession or beneficial enjoyment of the principal or income of the Trust. Any distribution to or for the benefit of any beneficiary is not intended to be, and shall not be, made in lieu of or in discharge of any obligation of, or for the pecuniary benefit of the Settlor or any Trustee. In addition, the Settlor hereby relinquishes all administrative powers over the Trust Estate and any power to control the beneficial enjoyment of the Trust Estate, and the Settlor hereby disclaims any interest in the Trust which may at any time be attributed to the Settlor.

For living trusts, because the assets are not intended to be kept out of the settlor's estate and are intended to benefit the settlor during the settlor's lifetime, the living trust will contain provisions allowing for the termination of the trust and the amendment of the trust by the settlor.

C. Types of Trusts and the Advantages of Each

The trust universe should initially be divided into testamentary and inter vivos trust. A testamentary trust is a trust that is neither formed nor funded until the death of the settlor. An inter vivos trust is a trust that is established and funded during the life of the settlor.

Inter vivos trusts can be broadly divided into two distinct categories of trusts: living trusts and irrevocable trust.

1. Living Trusts. The living trust, also known as a revocable trust, is primarily used as a will substitute and an incapacity planning device. In drafting such a trust document, the incapacity planning portions are typically in one section of the document, and the testamentary portions are in another.

2. Irrevocable Trusts. Irrevocable inter vivos trusts are typically established to reduce estate taxes.

a. Life Insurance Trust

A life insurance trust is created for the purpose of holding life insurance on the life of the settlor. Most life insurance trusts have a provision, known as a *Crummey* power, to allow the beneficiaries to withdraw specific amounts of contributions made to the trust, to avoid a taxable gift.

A life insurance trust will also typically give no powers or controls over the trust to the settlor, to avoid the risk of inclusion of the death benefit within the settlor's estate. Life insurance trusts are typically established as grantor trusts, to increase the amount of property in the trust due to the settlor's payment of any income tax liability generated by the trust's investments.

b. Grantor Retained Annuity Trust

A grantor retained annuity trust ("GRAT") is an estate tax reduction plan in which the settlor transfers money to a trust in exchange for an annuity for a fixed number of years. The settlor will be considered to have made a gift to the extent that the amount transferred to the trust exceeds the value of the annuity, as determined under IRS tables. If the settlor dies before the end of the annuity period, the value transferred to the trust is included in the settlor's gross estate.

The GRAT will be established as a grantor trust, and the beneficiary trust provisions can go established so that the trust lasts for as long as desired.

Because a GRAT is statutorily authorized, many practitioners feel that the use of GRATs should be making a comeback in light of the all out IRS assault on the use of family limited partnerships.

c. Family Investment Trust and Dynasty Trust

A trust that is not established to hold life insurance but will simply be used to hold family wealth is often known as a family investment trust or dynasty trust. There are several ways in which such a trust is typically funded. The settlor could allocate gift tax exemption to the trust and fund the trust with the maximum gift tax credit. This planning technique will transfer all appreciation in the property to the settlor's children, free of transfer tax. If the trust is established as a grantor trust, the amount of the tax-free wealth transfer increases.

The trust can also be established by the sale of property to the trust in exchange for an installment note. If the trust is a grantor trust, the technique is sometimes referred to as a sale to an "intentionally defective grantor trust," or IDGT. The sale of property to the trust, typically business assets or securities, does not trigger capital gains tax because the sale is considered not to have occurred for income tax purposes. If fractional business interests are transferred, such as a minority interest in a limited liability company, discounts can be taken which would serve to increase the amount of wealth transferred free of transfer tax.

If the trust is a nongrantor trust, the sale should be in exchange for a long term installment note, which should serve to postpone the payment of capital gains tax until principal payments are made on the note. The transfer tax-free amount is measured by the rate of appreciation of the property transferred over the interest rate of the note.

d. Inter Vivos Qualified Terminal Interest Property Trust

A transfer to a spouse qualifies for the gift tax marital deduction. A transfer to a trust for the benefit of a spouse only qualifies for the martial deduction if the trust qualifies as a qualified terminable interest property trust, or "QTIP." The requirements for a QTIP are set forth below, under Marital Deduction Planning, but the basic requirement is that the spouse be the only beneficiary of the trust during the spouse's life and be entitled to all income from the trust.

An inter vivos QTIP is used where large transfers of wealth to a spouse are desired during lifetime, possibly for asset protection planning or in the context of resolving a martial dispute, yet the settlor is not comfortable giving the spouse free and unfettered access to the funds.

e. Charitable Remainder Trusts

A charitable remainder trust ("CRT") is used to convert an asset into a stream of income, typically for life, with a current charitable deduction, and the remainder of the property transferred to a charity upon death.

Typically, the settlor will transfer property to the trust in exchange for an annuity payment, either a term of years or lifetime annuity. The charitable gift is determined based on the actuarial value of the annuity in relation to the value of the property transferred. The settlor is entitled to an income tax charitable deduction for the value of the charitable gift.

3. Testamentary Trusts. A testamentary trust is a trust established in a will or living trust that is funded upon the death of the settlor. Testamentary trusts do typically come in one several types: marital deduction trust, credit shelter trust, and family trust.

a. Marital Deduction Trust

A marital deduction trust, also known as a QTIP, is a trust that is eligible for the estate tax martial deduction. This type of trust is discussed at length below, under Martial Deduction Planning.

Including a QTIP trust in a testamentary estate plan, instead of an outright bequest to the surviving spouse, is often done for one of three reasons. First, any assets not consumed by the surviving spouse during life are transferred under the terms of the QTIP trust to an established list of beneficiaries, which prevents the surviving spouse from changing the estate plan after the death of the first spouse. This is often done when the couple has children from earlier marriages and such a change to the plan is a possibility. A second reason that a QTIP trust might be used is if the surviving spouse is financially unsophisticated, and leaving a large bequest to such person, free of any control, could work to the surviving spouse's disadvantage. A third reason is if the surviving spouse has need for his or her own asset protection. For example, if the surviving spouse is an obstetrician, leaving a large bequest to such person, free of trust, could subject the bequest to tort claims arising from the medical practice.

b. Credit Shelter Trust

A credit shelter trust is a cornerstone of estate planning for families with taxable estates. The credit shelter trust is funded at death with the amount that can be transferred free of estate tax. The remainder is typically transferred to the surviving spouse, directly or as a QTIP.

The credit shelter trust is used to preserve the applicable exemption amount of the first spouse to die, even if the assets will be primarily used for the surviving spouse. A simple example illustrates the idea. In a year where the exemption amount is $1.5 million, a married couple each has assets worth $2 million, and they have children together from their only marriage. If the husband were to die and leave his assets to his wife outright, upon her death, she would have a taxable estate of $4 million. If, instead, the husband funded a credit shelter trust with the exemption amount, $1.5 million, that amount will not be included in the surviving spouse's estate at her death, because the

transfer to the credit shelter trust is viewed as a completed transfer for wealth transfer tax purposes. On the death of the wife, her taxable estate is therefore only $2.5 million instead of the $4 million that it would be without the use of the trust. Note that the surviving spouse can be the only beneficiary of the trust during the spouse's life, and can even be the sole trustee of the trust. Alternatively, other family members can be beneficiaries, and the surviving spouse can even be excluded as a beneficiary. From a planning perspective, it is often desirable to draft the credit shelter trust so that the surviving spouse accesses the trust after other sources of income and assets are expended, because the amounts in the credit shelter trust will not be subject to the estate tax on the death of the surviving spouse. The assets of a QTIP trust, on the other hand, would be subject to full estate tax inclusion in the estate of the surviving spouse.

c. Family Trust

A family trust is a generic term that can be used to describe money transferred to trust that is not a credit shelter trust, either because there is not expected to be a taxable estate, or because the credit shelter trust has been fully funded and additional amounts are transferred to nonspouse family members.

Such an arrangement is used in preference to an outright bequest in situations where there are younger beneficiaries who are not ready to handle the receipt of a large amount of funds or beneficiaries who are not and may never be capable of managing a large some of money, and in situations where the settlor simply desires to control the investment and distribution of funds after death.

d. ***Trust for Care of Animal***. Many clients are particularly concerned about the well being of pets after the client's death. In 2002, Florida adopted a statutory framework to allow Florida residents to establish trusts for the care and protection of animals. FS 737.116.

D. Selecting the Trustee

For many clients, trustee selection can be the most difficult decision regarding the establishment of a trust, given that the client may be placing a lifetime of wealth accumulation into the custody and/or control of another person or institution.

In the case of living trusts, most clients properly insist on being sole trustee, or with a spouse or a child as a co-trustee. Because living trusts are best used as a tool for incapacity, the person named as trustee upon the incapacity of the settlor is the crucial decision. Again, while the client is alive, a relative is usually the most appropriate trustee, although the trend is towards naming an institutional trustee as a co-trustee upon incapacity if the settlor is concerned about the financial management skills of the relative.

For inter vivos trusts, the client's initial decision will be to appoint another person or organization as trustee, or the client himself or herself.

For testamentary and inter vivos trusts other than living trusts, the initial decision regarding trustee selection is whether to use an institutional trustee or an individual as trustee. Institutional trustees are often preferred for very large trusts, in situations where there may be conflict among different classes of beneficiaries, and for trusts that are expected to remain in place for many decades. Some clients view trustee fees quite unfavorably. Given the amount of work involved in properly managing a trust and the fiduciary exposure being accepted by a trustee, the standard fee schedule for a reputable and experienced trustee is often a small price to pay for professional management.

Individual trustees can be appropriate in many situations, particularly for smaller trusts, in situations where beneficiary conflict is remote, and in situations where a settlor is fortunate to have skilled financial managers as relatives or trusted advisors. In judging the appropriateness of an individual trustee, there are four factors that are often used, in decreasing order of importance: willingness, ability, relation, and geography. In addition, tax effects on trustee selection should also be considered.

Willingness must be the threshold test, because an unwilling trustee will either decline the assignment or do such a poor job that the trust arrangement may not accomplish the client's goals. Attorneys should be careful to educate clients and their trustees on the amount of work involved in being a trustee, especially if there are complex assets to manage and discretionary distribution provisions to manage.

Ability must also be a threshold test. No matter how eager the potential trustee, only a trustee with a proven track record of personal financial responsibility can be considered as a trustee.

Next in order of importance is whether the potential trustee is related to the client. Close relatives, such as siblings, are more likely to take great interest and care in administering a trust for that person's nieces and nephews than a stranger, for example. Siblings also may share the same values and may have the greatest knowledge about the family dynamics that are critical to successful operation of a trust. Of course not every client has a relative who is willing and capable, and in such cases, in the absence of a very close friend or trusted advisor, an institutional trustee must be considered.

If possible, the trustee should be geographically close to the beneficiaries, especially if the trust has discretionary distribution provisions that require monitoring of the beneficiaries activities. Given the dispersal of family members across the country and the mobility of many individuals, geographic proximity is probably best used as a tie breaking factor if there is more than one suitable trustee candidate.

The most difficult situation for trustee selection is where the trust might end up as the owner of an operating business or actively managed real estate. Although there are many publicized horror stories involving institutional trustees controlling operating businesses, there are likely just as many, less publicized, instances involving individual trustees. Bank department trustee are normally particularly ill suited to play an active role in an operating business. Family members and friends may also be particularly unqualified to step in as the owner of a business. Employees of the business, although possibly qualified to run the business, face an inherent conflict of interest in also serving as the owner representative. Many operating businesses often end up failing or being sold at a liquidation price after the sudden death of the principal owner/operator. The difficulty in finding an appropriate owner representative in most situations highlights the need for the owner/operator of a successful business to put in place a succession plan, to protect family members relying on the income from the business and those persons who earn their livelihood as employees of the business.

Practice Tip. An additional consideration should be given if the trustee is not a Florida resident or a Florida trust company. Some states, such as California, will apply California income tax to a trust in California if any of the trustees are California residents or California trust companies. Cal. Rev. & Tax Code Section 17742. For example, a trust with a Florida settlor holding Florida real estate will be subject to California state income taxes if the trustee is a resident of California. Because California's income tax rate is 9.3%, this could be a very important consideration in trustee selection. Therefore, whenever selecting trustees outside of Florida, an inquiry should be made to determine whether the appointment of the out of state trustee will create a new state income tax liability.

E. Effective Drafting Strategies

Good drafting requires adherence to the client's intentions, eliminating ambiguity, and making sure that key provisions of the Internal Revenue Code and state law are respected by the instruments.

One area that has not received enough attention is ambiguity, both internal to a document and externally. Internal ambiguity arises when provisions are not sufficiently clear to cover all potential situations. The most dangerous internal ambiguities are those determining who is a beneficiary. For example, some estate planning documents will identify a testator's children by name, and then leave bequests to "my children, in equal shares." How are children handled who are not identified by name? What was the client's true intention?

Practice Tip. For joint living trusts, in which typically a married couple contributes their assets jointly to the living trust, care must be taken in drafting the termination and amendment clauses. At least one Florida Court of Appeals case has held that a living trust could not be modified after the death of the first spouse.

In *L'Argent v. Barnett Bank*, 730 So.2d 395 (2nd DCA 1999), a husband and wife executed an inter vivos revocable trust funded with significant assets, naming three individuals as beneficiaries upon the death of both the husband and wife. The husband died and the wife subsequently amended the trust to remove one of the beneficiaries. The

trust contained a standard revocation and amendment clause, which provided that during "the life of the Settlors, this trust may be amended, altered, revoked, or terminated, in whole or in part, or any provision hereof, by an instrument in writing signed by the Settlors and delivered to the trustees." The Court reasoned that to be valid, the amendment had to be signed by both settlors, during their lives, based on the unambiguous language of the amendment clause. The court also reasoned that "Our conclusion is reinforced by the absence of a specific reserved power granting the surviving settlor the power to amend. While it is possible that the omission of such language was an oversight, we conclude that [the amendment clause] was intended to preserve the settlors' joint intention. Those persons enumerated as beneficiaries were to remain beneficiaries unless both settlors agreed to the amendment."

In drafting amendment and revocation clauses in joint living trusts, care should be given to providing specific guidance on the ability of the surviving spouse to amend or revoke the trust.

External ambiguity arises in several contexts. The most common is where a distribution provision requires that distribution be made for the "health, education, maintenance and support" of the beneficiary, with no additional rules setting forth how the "support" of a beneficiary is to be determined. Are the beneficiary's other sources of income and assets to be considered, and must those be spent before the beneficiary is entitled to a distribution? What about support from a spouse? Is the beneficiary permitted to quit work and live off the trust?

Practice Tip. Another area of ambiguity is the coordination of multiple trusts. If more than one trust is capable of making distributions for the health, education, maintenance and support of a beneficiary, and the trusts do not have the same trustees, conflict between the trustees is possible of there is not a coordinating provision in the trust documents. Even if the trustee is the same, some guidance would seem to be required if, for example, the remaindermen of the trusts are different. A coordination clause is thus desirable and could say, for example, that "all discretionary distributions are to be made from this trust in preference to all other previously created trusts."

F. Executing the Trust

The testamentary aspects of a trust are invalid unless the trust instrument is executed by the grantor with the formalities required for the execution of a will. FS 737.111. Therefore, a trust should be signed by the settlor and two witnesses.

G. How Early Termination is Handled

A properly drafted trust will set forth the conditions under which the trust shall terminate. Nevertheless, conditions may arise under which it may be appropriate to terminate the trust early.

Florida Statute 737.402(3) is the "small trust" termination provision pursuant to which a trustee may terminate a trust if the market value of the trust assets is less than $50,000, and, relative to the cost of administering the trust, continuation of the trust pursuant to its existing terms will defeat or substantially impair the purpose of the trust. If the trustee makes the determination that the trust should be terminated, the trustee is required to distribute the trust corpus to the beneficiaries in a manner which conforms, as nearly as possible, to the intention of the settlor. The statute specifically provides that this termination provisions is effective even if the trust contains spendthrift or similar provisions. Only an express direction in a trust that the trustee may not terminate the trust under this statute is effective to prevent its use.

Florida Statute 737.4031 is the judicial modification of trust statute and permits the court to terminate a trust early if "the purposes of a trust have been fulfilled or have become illegal or impossible to fulfill, if because of circumstances not know to or anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust or, if a material purpose of the trust no longer exists."

Florida Statute 737.4032 is the nonjudicial modification of trust statute and permits a trust to be terminated at any time after the settlor's death upon the unanimous agreement of the trustee and all beneficiaries.

Although judicial or nonjudicial early termination of a trust seems to be an easy and convenient way for the beneficiaries to access a trust according to their own plans

rather than that of the settlor, in practice such terminations can be difficult to achieve. The terms of the judicial modification statute are fairly strict, and the required showing not easy to make. Although nonjudicial termination may seem the more preferred route, if there are unborn potential beneficiaries, protecting their interests can be difficult, and of the trustee consents to termination without properly taking into account the interests of such unborn beneficiaries, the trustee could conceivably face liability in the future.

H. Trust Protectors and How to Draft for Flexibility

A trust protector acts as an intermediary between the settlor and the trustee. The trust protector can provide a number of functions, based in large measure on the location and purpose of the trust. The powers of the protector can be formulated in various ways, such as an affirmative power to direct the trustee, provisions requiring prior consent, or the power to revoke a decision of the trustee. Although trust protectors are most commonly used with offshore trustees, not subject to the jurisdiction of the courts of the United States, a protector could certainly have some purpose overseeing a domestic trust in limited situations. For a trust designed to keep assets out of the estate of the settlor, caution should be exercised in allowing the settlor to serve as protector.

III What are the Tax Issues to be Considered in Estate Planning

A. Tax Issues When Drafting Various Trusts.

1. <u>Income Tax Issues</u>. How to handle the income tax effects of a trust should be carefully considered in the drafting of every trust. Trust income is potentially taxable to the settlor, the trust, or the beneficiaries of the trust, depending on the desires of the client and the type of trust used.

a. *Grantor v. Nongrantor Status*. A trust will be taxable for income tax purposes to the settlor if the trust qualifies as a grantor trust under Subchapter J of the Internal Revenue Code. Subchapter J enumerates several criteria for determining whether a trust is a grantor trust. Any power of the settlor to revoke the trust or have unfettered access to trust assets will cause the trust to be a grantor trust. All revocable or living trusts are therefore grantor trusts and taxable to the settlor.

Many trusts will be irrevocable and restrict the ability of the settlor to have access or control over trust assets, to avoid inclusion of the trust corpus in the settlor's estate. In such cases, the draftsman can often control whether the irrevocable trust will be a grantor trust or a nongrantor trust. There are several powers that can be given to a settlor to trigger grantor status that will not cause inclusion of the trust corpus in the settlor's estate. Those powers include the ability of the settlor to substitute trust assets for different assets in a nonfiduciary capacity.

Why would a trust settlor want to be taxed in the income of a trust? One reason would be to make additional gifts to the trust without estate or gift tax issues. By paying the tax liability generated by trust income, the settlor is, in effect transferring additional sums for the benefit of the trust. Another reason might be to reduce the overall tax liability of an arrangement if the settlor will not be in the top income tax bracket and the trust would be. Although the income tax rates for trusts are the same as for individuals, the brackets are "compressed" such that the top 35% rate starts at $9,750 for the 2005 taxable year. If the combined tax liability of the settlor and the trust would be less than the threshold for the top bracket, grantor trust status will usually reduce the tax liability of the overall arrangement.

The Internal Revenue Service has ruled that the payment of the tax liability created by a trust's grantor status by the settlor of the trust is not a taxable gift to the trust, presumably because when a settlor pays such tax liability, the settlor/grantor is paying the tax imposed by the Internal Revenue Code on the settlor/grantor himself.

Practice Tip. The Internal Revenue Service has also ruled that a provision in a trust to give the trustee the option to pay the settlor/grantor tax liability arising from trust income is acceptable from an estate tax perspective. Rev. Rul. 2004-64. By including this clause in a trust, the situation where the income tax liability becomes excessive, perhaps due to much better-than-expected investment performance or an increase in income tax rates, will not become an unexpected and unwanted liability of the settlor/grantor.

b. ***Nongrantor Trust Income Tax Rules***. A nongrantor trust will be taxed according to the complex rules of Subchapter J.

Subchapter J is a hybrid approach to taxation, in that the trust is treated as a taxable entity but can pass through items of income and deductions to the beneficiaries. A trust is taxed similarly to an individual, with the major difference being that the trust is entitled to deduct most distributions made to the trust's beneficiaries, to the extent of the trust's taxable income. This deduction, in substance, makes the trust a pass-through entity to the extent of such distributions.

Subchapter J creates a unique income tax concept which forms the core of trust taxation – distributable net income (DNI). DNI is trust income that is distributable to the beneficiaries, net of expenses and deductions, and is the basic determination of the amount of income that can be passed through to the beneficiaries.

To the compute the tax consequences of trust income, the starting point is gross income. In general, the gross income of a trust is computed in the same fashion as determining the gross income of an individual. Against gross income are applied the above-the-line deductions, which are taken into account for purposes of computing adjusted gross income, and below-the-line deductions, such as itemized deductions. The

taxable income of the trust is the difference between gross income and deductions, just as for an individual.

One issue that has generated considerable litigation is whether the cost of investment advice paid by a trust is subject to the 2% floor on itemized deductions. The Sixth Circuit has held that such expenses are not subject to the 2% floor, while the Tax Court, Federal Circuit, and Fourth Circuits have held that such expenses are subject to the limitation.

The primary difference between individual taxation and trust taxation is the allowance to a trust of a deduction for a distribution of DNI. In its simplest form, if a trust earns ordinary taxable income and the trust distributes out all such income to an income beneficiary, the trust will deduct the entire distribution, transferring the tax liability to the beneficiary receiving such distribution.

DNI is generally the taxable income of the trust, computed, without the distribution deduction, less net capital gains, and plus tax exempt income. The treatment of capital gains is subject to a number of exceptions and is continually evolving. The Treasury Regulations were recently amended to update the capital gain rules to be more consistent with modern portfolio management and as a result there will be more situations where capital gains are included in DNI.

The following example from the regulation illustrates a simple example of the computation of DNI. (Treas. Reg. Section 1.643(d)-2.)

Example. (1) Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to corpus and all expenses are charges against corpus. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations......	$ 30,000
Extraordinary dividends allocated to corpus by the trustee in good faith............	20,000
Taxable interest....	10,000

Tax-exempt interest	10,000
Long-term capital gains	10,000
Trustee's commissions and miscellaneous expenses allocable to corpus	5,000

(2) The “income” of the trust determined under section 643(b) which is currently distributable to W is $50,000 consisting of dividends of $30,000, taxable interest of $10,000, and tax-exempt interest of $10,000. The trustee's commissions and miscellaneous expenses allocable to tax-exempt interest amount to $1,000 (10,000/50,000 × $5,000).

(3) The “distributable net income” determined under section 643(a) amounts to $45,000, computed as follows:

Dividends from domestic corporations		$ 30,000
Taxable interest		10,000
Nontaxable interest	$ 10,000	
Less: Expenses allocable thereto	1,000	
		9,000
Total		49,000
Less: Expenses ($5,000 less $1,000 allocable to tax-exempt interest)		4,000
Distributable net income		45,000

In determining the distributable net income of $45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains allocable to corpus are excluded and the deduction allowable under section 1202 is not taken into account (section 643(a)(3)): the extraordinary dividends allocated to corpus by the trustee in good faith are excluded (sections 643(a)(4)); and the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 are included (section 643(a)(5) and (7)).

A trust is classified as either a simple trust or a complex trust. This classification is made on a year-by-year basis, based upon what distributions or accumulations a trust

may make and what it actually makes. A trust is a simple trust for a taxable year if it satisfies three statutory requirements. A trust that does not qualify as a simple trust is a complex trust.

Internal Revenue Code Section 651 sets forth three requirements for a trust to be considered a simple trust. First, the terms of the trust require that all Fiduciary Accounting Income (FAI) be distributed during the current taxable year, second, that the trust not provide for any charitable purposes, and third that the trust not distribute any amount during the current year other than income required to be currently distributed. In most instances, a trust will be complex if it accumulates income or distributes principal.

A simple trust has one tier of beneficiaries and a complex trust has more than one tier of beneficiaries. The simple trust’s single tier of beneficiaries are those beneficiaries entitled to receive the trust's FAI.

A complex trust can have up to three categories of bequests. In the first are gifts or bequests of specific sums of money or property payable in no more than three installments. These distributions are excluded from income and do not carry out DNI of a trust.

The second category consists of distributions of FAI required to be distributed currently. These distributions are the first distributions to be taxed to beneficiaries (first-tier beneficiaries). These carry out DNI first, dollar for dollar. First-tier beneficiaries include annuity distributions to the extent there is FAI available to satisfy the distribution. In the third category are all other distributions: mandatory distributions of principal or accumulated income, discretionary distributions of income or principal, and mandatory annuity distributions paid out of principal or required to be paid out of principal. These carry out any DNI remaining after the first-tier distributions. If second-tier distributions exceed the remaining DNI, the DNI is allocated pro rata among the second-tier beneficiaries based on the respective amounts received.

One distinction between a simple trust and a complex trust is that a simple trust cannot receive a distribution deduction for required distributions of principal that are not

made, while a complex trust will receive such deduction (and the beneficiary will include such amount in income, if taxable).

Another difference is that DNI may be computed differently. In a complex trust, extraordinary dividends and taxable stock dividends are included in DNI, even if allocated to principal. In addition, capital gains allocated to principal may be included in DNI if actually distributed. By contrast, in a simple trust, extraordinary dividends, taxable stock dividends, and capital gains are included in DNI only if allocated to income.

The tiers are important only if distributions exceed DNI. If the total distributions do not exceed DNI, the tiers are irrelevant, and all amounts distributed carry out DNI dollar for dollar, each reflecting its proportionate share of the items of income and deductions in DNI, except to the extent of any special allocations. The remaining DNI is essentially taxed to the trust.

If the distributions exceed DNI, the tier of a distribution is crucial in determining the tax consequences to the beneficiary. Beneficiaries of first-tier distributions carry out DNI first. To the extent DNI exceeds the first-tier distribution, second-tier distributions are allocated their pro rata share of DNI.

2. Gift Tax Issues.

Funding the irrevocable trust presents a gift tax issue that must be considered in every situation. Whenever a settlor makes an irrevocable transfer to a trust, the potential for a taxable gift arises. If the trust qualifies for the marital exemption because it qualifies as an inter vivos QTIP trust, no gift tax issue arises.

In a non QTIP situation, the settlor has the option to use a portion of the settlor's lifetime gift exemption amount. The settlor also has the ability to use the annual $11,000 exclusion amount for gifts made to trust, so long as the gift is not a "gift of future interests in property." IRC Section 2503(b)(1). A simple transfer of property to a trust where the beneficiary of the trust will be allowed to enjoy the property at some future date is a gift of a future interest in property and thus not eligible for the gift tax exclusion.

In order to circumvent this restriction on gifts of future interests, trusts are often granted giving each beneficiary the power to withdraw amounts contributed to the trust

each year. This power, known as a *Crummey* power, after the seminal case to approve of this technique, is used in situations where a trust will be funded on a regular basis by the settlor, often in the context of a life insurance trust. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968). For each beneficiary of the trust given a withdrawal right, $11,000 of gift tax exclusion can be used. Just who qualifies as a beneficiary for this purpose (as opposed to individuals simply granted withdrawal rights to increase the number of transferees for gift tax purposes) as been the subject of litigation. Contingent beneficiaries were permitted as *Crummey* beneficiaries, who could each be counted toward the $11,000 per year transferee exclusion, in *Cristofani v. Commissioner*, 97 T.C. 74 (1991), acq. in result only 1992-1 C.B. 1, 1996-2 C.B. 1. In *Cristofani*, the beneficiaries at issue were grandchildren who could take from the trust only upon the death of a parent.

3. Estate Tax Issues.

The goal of drafting most intervivos trusts is to exclude the trust corpus from the settlor's estate. In order to be excluded from the estate, the settlor must not have any of the enumerated rights and powers that would cause the corpus to be included.

There are three primary Code sections under which property in trust may be included in the settlor's gross estate. A transfer made without adequate consideration in which the settlor retains the right of possession or enjoyment of the property or the income from the property, or the right to control who possesses, enjoys or receives the income from the property will be included. IRC Section 2036(a). A transfer taking effect at death of the settlor if the settlor retained a reversionary interest in excess of five percent of the value of the property is included. IRC Section 2037. A power to revoke a transfer or change who may enjoy the property is also included. IRC Section 2038(a)(1).

4. Special Tax Considerations for Life Insurance Trusts.

The tax goal of a life insurance trust are to keep the death benefit out of the settlor's estate and to ensure that the death benefit is not subject to income taxes.

For life insurance that is transferred into a life insurance trust, if such transfer occurs less than three years before the death of the insured, the death benefit will be

included in the settlor's gross taxable estate. IRC Section 2035(a). For policies held longer than three years after transfer and those policies owned by the trust from inception, the death benefit will be excluded from the insured's estate so long as the trust would otherwise be excludable from the insured's estate under the general principals of Internal Revenue Code Sections 2036 through 2038, and the arrangement does not run afoul of Section 2042.

Internal Revenue Code Section 2042 sets forth a special estate inclusion rule for life insurance policies. The death benefit will be includible in the insured's gross estate under Section 2042(2) if the insured has an incident of ownership in the policy at death. Although neither the statute nor Treasury regulations give a comprehensive definition of incidents of ownership, the term has included the power to surrender or cancel the policy, change the beneficiary, assign or pledge the policy, or change how the death benefit will be received.

B. Estate Tax Exemptions and Marital Deduction Planning

1. Estate Tax Exemptions

The federal estate tax applies only to clients whose estates, when aggregated with cumulative lifetime taxable gifts, exceed the exemption equivalent of the unified credit. The unified credit for decedents dieing in 2005 is $555,800. The exemption equivalent of this unified credit is $1.5 million, and this amount is currently scheduled to increase to $3.5 million in 2009.

2. Marital Deduction Planning

The unlimited marital deduction is the cornerstone of estate planning for married couples. All property bequeathed outright to the surviving spouse qualifies for the marital deduction, and partial interests in property qualifies if the property is qualified terminal interest property ("QTIP").

a. Qualifying a Trust as a QTIP

Qualified terminal interest property, known as a "QTIP," is typically a trust under which the surviving spouse receives a "qualifying income interest" in the trust for life, and the surviving spouse makes an election to have the property qualify for QTIP

treatment. A "qualifying income interest" is an interest pursuant to which the surviving spouse is entitled to all income from the property annually or at more frequent intervals, and no person has the power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's lifetime. IRC Section 2523(f)(3).

Neither the Code nor Florida law requires that the trustee be required to make unproductive property productive. The Internal Revenue Service has issued some guidance, in the form of TAM 9717005, that the QTIP income requirement is not met if the property is unproductive and the surviving spouse could not require that the property be made productive.

Practice Tip. In computing the elective share under Florida law, amounts left in trust for the surviving spouse will count toward the property received by the surviving spouse if the trust qualifies as an Elective Share Trust. FS 732.2095(2)(b). An Elective Share Trust is a trust under which the surviving spouse is entitled to all income from the trust for life, payable at least annually, and the surviving spouse has the power, under the terms of the trust or applicable state law, to require the trustee to convert the property to productive property. FS 732.2025(2). Therefore, if the client has any elective share concerns, the trust instrument should include a provision allowing the spouse to require the trustee to make the trust corpus productive.

b. Funding the Marital Bequest.

There are three ways in which to handle a marital deduction bequest within an estate plan: a specific formula, a disclaimer, or a Clayton QTIP.

i. Specific Formula. The most definitive, yet least flexible, method for funding the marital deduction portion of the estate is through the use of a specific formula. There are two types of formulas, a pecuniary formula, in which a fixed amount is transferred to either the marital or nonmarital share, and a fractional share formula, in which a fractional portion of the estate is transferred to the martial or nonmarital share. There are several variants of each type of formula, although most planners typically use only one or two formulas in all of their drafting.

An example of a pecuniary funding formula is as follows:

> I give the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death.
>
> The following is an example of a basic fractional share formula:
>
> a fraction of the trust property of which (a) the numerator is the smallest amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death, and (b) the denominator is the value as finally determined for federal estate tax purposes of the property that became, or the proceeds of sale, investment, or reinvestment of which became, trust property.

ii. Disclaimer. In a disclaimer marital deduction arrangement, the estate is left to the surviving spouse, and the will provides that any amount disclaimed by the surviving spouse will be placed into a nonmarital trust for the benefit of other family members. The flexibility of this arrangement is unmatched in terms of being able to allow the estate to be administered in the most tax efficient manner possible given the estate tax laws in place at the time of the death of the first spouse. This arrangement is advisable only when the surviving spouse can be relied upon to disclaim an appropriate amount into the nonmarital trust. In cases where there are multiple marriages and children from different marriages, or the family is quite young and the possibility of subsequent remarriage would be high, the disclaimer approach is probably not advisable.

iii. Clayton QTIP. In a Clayton QTIP arrangement, assets fund a QTIP trust only to the extent that the personal representative elects to qualify a portion of the QTIP trust with a QTIP election. The portion of the QTIP trust that the personal representative does not make the QTIP election is used to fund a non-QTIP trust, which will not qualify for the martial deduction. This other trust may have different beneficiaries and completely different terms that the QTIP trust. This type of planning arrangement is named after the first Tax Court case to sustain the use of this arrangement. *Clayton v. Commissioner,* 976 F2d 1486 (5th Cir. 1992), rev'g and remanding 97 TC 327 (1991).

The advantage of the Clayton QTIP is that a fixed formula is not used, thereby allowing flexibility in the context of an ever changing estate tax environment. Instead of relying on a surviving spouse to make the disclaimer determination, the personal representative will be relied upon to allocate between the surviving spouse and a nonmarital trust, which may include other family members.

C. Calculating Estate and Gift Tax.

Estate and gift taxes are imposed based on the same graduated rate schedule, starting at 18%, with the highest bracket presently at 47%. Prior to the enactment of EGRRA, the gift and estate tax shared a "unified credit" of a single amount. The portion of the credit not used during life was used at death.

Under current law, the applicable credit amount for gift tax purposes is fixed at the amount determined as of the applicable exclusion amount were $1 million. IRC Section 2505(a)(1). The applicable credit amount for estate tax purposes is scheduled to increase over time, over and above the amount available for gift tax purposes. The gift tax and estate tax applicable exclusion amounts are still unified in the sense that any gift tax applicable credit amount that was used during the decedent's lifetime reduces the amount of the applicable exclusion amount available to offset the estate tax.

1. **Calculating the Gift Tax**.

a. Gift Tax Exclusions

In determining the amount of taxable gifts made by a donor each year, the first $11,000 gifted by the donor to each donee is excluded from the amount of taxable gift made during the year. The $11,000 is indexed annually to inflation, in $1,000 increments.

In order to qualify for the annual gift tax exclusion, the gift must qualify as a "present interest." An outright gift of property, or the gift of an immediate income interest would qualify as a present interest. A gift of a "future interest" does not qualify for the annual exclusion. Examples of future interests include a gift of a remainder interest and other interests that will commence in use, possession, or enjoyment at some future date. Treas. Reg. Section 25.3503-3(a).

Most gifts to a trust contain at least a partial gift of a future interest. For example, the funding of a life insurance trust that will not pay out to beneficiaries until the death of the settlor is entirely a gift of a future interest. A gift to a trust that will pay one beneficiary an income interest, with the remainder to another beneficiary, is a part present interest and a part future interest. Only a portion of the gift would qualify for the annual exclusion, computed based on actuarial factors. Treas. Reg. Section 25.2503-4.

Contribution to a qualified tuition program, such as a "529 plan" qualify for the annual gift exclusion even though such a gift would certainly not be a gift of a present interest. IRC Section 529(c)(2)(A). The donor is permitted to make a contribution in a single year and take the gift into account ratably over five years. For example, if a grandparent makes a contribution of $55,000 to a 529 plan for the benefit of a grandchild, that $55,000 is taken into account ratably over five years, resulting in an annual gift of $11,000 and therefore a taxable gift has not been made (assuming no other gifts during the time frame).

Amounts paid directly to an educational organization for tuition qualify for an exclusion from the gift tax. Note that the payment must be made directly from the donor to the institution, and that amounts paid for room and board and incidentals do not qualify for the educational expense exclusion.

An exclusion is also available for the payment of a person's qualifying medical expenses, such as the payment for the diagnosis, cure, and treatment of disease. The donor must make the payment directly to the health care provider to qualify the gift for this exclusion.

Gift splitting is a process by which a non-donating spouse agrees that all gifts made during the year by the other spouse shall be treated as having been made equally by both spouses, so as to allow the $11,000 annual exclusions of both spouses to be used during the year. This process allows the wealthier spouse to use up to $22,000 of exclusion each year for each donee.

b. Amount of the Taxable Gift

The gift tax is imposed on the fair market value of the property transferred as of the date of the gift. IRC Section 2512(a). Fair market value is defined as the price that a willing buyer would pay a willing seller for the property, neither being under compulsion to by or sell. Treas. Reg. Section 25.2512-1.

If a liability is attached to a gift of property and that liability will only be paid out of the property or by the donee, the liability reduces the amount of the taxable gift. If the amount of the debt exceeds the donor's basis in the property and the donee assumes the debt, the transaction is part gift and part sale.

The valuation of publicly traded securities and most real estate is fairly straightforward. The valuation of closely held businesses and minority interests in partnerships and corporations has been the subject of decades of litigation. The process of fractionalizing a unitary interest in the hands of the senior generation through gifting smaller pieces of the interest to heirs is a cornerstone of estate planning for affluent clients. For example, if an entire closely held business is worth $2 million sold in the market, a gift of a 20% interest to a member of the second generation might only be valued at $300,000, to reflect the lack of control and lack of marketability that such interest carries with it.

Revenue Procedure 59-60 gives extensive guidance on the valuation of property for estate and gift tax purposes.

c. Gift Tax and the Credit

The gift tax is computed based on the value of the gift made. Any remaining applicable exemption amount credit is applied against the gift tax to arrive at the net gift tax owed. Form 709 is required to by filed with the year's income tax return if any non excluded or non exempt gifts are made during the year. Failure to file a return leaves the statute of limitation open indefinitely.

2. Calculating the Estate Tax.

a. Calculating the Gross Estate

The federal estate tax is based on the taxable estate, an amount starting with the gross estate, reduced the allowable deductions and increased by the adjusted taxable gifts. The gross estate consists of all of decedent's property real and personal, wherever situated. In makes no difference whether the assets are included within the decedent's probate estate or inside a living trust at the time of death. Most assets are clearly inside or outside a decedent's estate, so it is the unusual situations that require the most analysis.

*i. Joint Tenancie*s. The full value of property owned by a decedent and one or more other persons as joint tenants with right if survivorship is included in the decedent's gross estate. IRC Section 2040(a). If the other joint tenants provided some or all of the consideration for the acquisition of the property, the portion of the value to be included in the decedent's estate is based on the portion of the purchase price provided by the decedent. Treas. Reg. Section 20.2040-1(a)(2).

ii. Lifetime Transfers With Retained Rights or Interests. If the decedent transferred property to another during the decedent's life, but retained the right to the income from the property for life or for a period not ascertainable without reference to the decedent's death, or retained the right to designate who shall possess or enjoy the property of the income therefrom, the value of the entire property is included in the decedent's gross estate. IRC Section 2036(a). The statute has generated considerable litigation over the last five years, so is reproduced.

> **(a) General rule.**
> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

> **(1)** the possession or enjoyment of, or the right to the income from, the property, or
>
> **(2)** the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Recent litigation has focused on Internal Revenue Code Section 2036(a)(1) in the context of family limited partnerships. In many reported cases, an individual or couple transfers assets to a partnership in exchange for a limited partnership interest. Other family members typically contribute a small percentage of assets in exchange for a general partnership interest. When the transferor dies, the estate tax computation is made using high discounts on the retained limited partnership interest, based on lack of marketability and lack of control.

In a series of recent IRS victories, the taxpayers transferred almost all of the their interests to the family limited partnership, had an implied agreement to use partnership assets and income for living expenses, commingled personal and partnership assets, and in general failed to respect the form of the partnership. The courts have had no difficulty viewing the decedent as having retained the right to the possession, enjoyment, and income of the property allegedly transferred, and has included the full, undiscounted value of the partnership assets in the decedent's gross estate. See, e.g., *Estate of Korby Commissioner*, TC Memo 2005-102; *Estate Of Abraham v. Commissioner*, 408 F.3d 26 (1st Cir. 2005).

Taxpayers have structured family limited partnerships by attempting to rely on the bona fide sale exception contained in Internal Revenue Code Section 2036(a), by having the taxpayer sell an interest in the family limited partnership to other family members at severely discounted values, in exchange for notes or other consideration. A recent string if IRS victories has relied on absence of adherence to form and the lack of a nontax business purpose. See, e.g., *Estate of Bongard v. Commissioner* , 124 TC No 8 (2005).

iii. Life Insurance Death Benefit. The gross estate includes the value of all death benefit on the life of the decedent payable to the executor of the decedent's estate. The gross estate also includes the death benefit of life insurance

on the life of the decedent, payable to anyone, if the decedent held any incidents of ownership at the time of the decedent's death, including the power to change the beneficiary, the power to borrow against the policy, the power to surrender or cancel the policy, or any other right to the economic benefit of the policy. If all of the incidents of ownership are irrevocably transferred away to other parties, the inclusion of the death benefit in the decedent's gross estate can be avoided after the passage of three years from the last transfer of incident of ownership. Gift tax consequences can result from such transfers. Therefore, it is almost always advantageous to have life insurance on the decedent acquired from inception by a third party or an irrevocable life insurance trust.

iv. *Adjusted Taxable Gifts.* Adjusted taxable gifts are added to the gross estate to determine the tentative estate tax. The adjusted taxable gifts are all gifts made by the decedent, other than those excluded from the gift tax, such as the $11,000 annual exclusion or the educational and medical exclusion, made after December 31, 1976. The fact that applicable credit was allocated to the gift to eliminate the payment of gift tax does not matter in this portion of the estate tax calculations. It is considered in another part of the calculation. The result of this methodology is that the computation of the gift tax payable on post-1976 gifts uses the rate schedule in effect as of the date of the decedent's death, rather than the actual amount of gift tax paid with respect to the gift transfer in the prior period.

v. *Powers of Appointment*. The gross estate includes any general power of appointment that the decedent held over any property at the time of the decedent's death. A general power of appointment is "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." IRC Section 2041(b)(1). A power of appointment is created when the owner of the property gives the power to dispose of the property to another, which become the power holder.

b. Estate Deductions

To compute the taxable estate, the allowable deductions are subtracted from the gross estate. The Internal Revenue Code and the Treasury Regulations enumerate the allowable deductions. Some expenses are deductible against the gross estate, some

expenses should be claimed on the fiduciary return as an offset against the estate's income, and some expenses can be claimed in either place. The most important of the expenses eligible for deduction from the gross estate are as follows.

i. *Funeral Expenses.* Funeral expenses may be deducted if the expense is actually expended by the personal representative out of assets subject to the claims of creditors, properly paid out of decedent's estate, and do not exceed the value of decedent's probate property plus the value of all funeral expenses paid prior to the due date for the federal estate tax return out of property no subject to the clams of creditors.

ii. *Expenses of Administration.* Administration expenses that may be deducted from the gross estate include the personal representative's fee, attorney's fees, the expenses of other professionals in administering the estate, and all other expenses incurred to administer the estate.

iii. *Debts and Claims.* The decedent's debts are deductible from the gross estate, including the unpaid principal balance on mortgages if the value of the property is included in the gross estate.

iv. *Medical Expenses.* Medical expenses unpaid at the time of decedent's death are deductible from the gross estate.

v. *Marital Deduction.* There is an unlimited deduction for the value of all property passing from the decedent to the decedent's spouse if the transfer is a bequest of property outright or is in the form of a certain type of trust or other arrangement– qualified terminable interest property. Property left to a surviving spouse in trust that does not qualify as a qualified terminal interest property trust will not qualify for the unlimited marital deduction.

Qualified terminal interest property, known as a "QTIP," is typically a trust under which the surviving spouse receives a "qualifying income interest" in the trust for life, and the surviving spouse makes an election to have the property qualify for QTIP treatment. A "qualifying income interest" is an interest pursuant to which the surviving spouse is entitled to all income from the property annually or at more frequent intervals,

and no person has the power to appoint any part of the property to any person other than the surviving spouse during the surviving spouse's lifetime. IRC Section 2523(f)(3).

vi. *Charitable Deduction.* An unlimited amount may be deducted from the gross estate that is left to a qualified charitable organization. Qualified charitable organizations include organizations qualified as tax exempt under Internal Revenue Code Section 501(c)(3) of the Internal Revenue Code, as well as certain types of fraternal orders, veterans organizations, and employee stock ownership plans in certain limited circumstances. The amount of the charitable bequest must be ascertainable at the time of the decedent's death.

Certain transfers of property are classified as a "split interest transfer," where both a qualified charitable organization and a non charitable beneficiary receive an interest in the same property. If the transfer meets certain statutory requirements, the portion of the bequest made to the charitable beneficiary will qualify for the charitable deduction, using certain valuation tables promulgated by the IRS.

vii. *State Death Tax Deduction*. For decedent's dying after December 31, 2004, the state death tax credit has been eliminated. Instead, a state death tax deduction is allowable for state death, inheritance, estate, and similar taxes if such taxes are actually paid.

c. Estate Tax and Credit

To compute the estate tax, the allowable estate deductions are subtracted from the gross estate to arrive at the tentative taxable estate. The state death tax deduction is added to this amount to arrive at the taxable estate. Gifts made by the decedent after 1976 are then added to the taxable estate. This amount is then used to determine the tentative tax, based on the rate schedule in effect during the year of death.

The rate schedule in effect for 2005 is as follows:

Unified Gift and Estate Tax Rate Schedule for 2005

(A) Amount subject to tentative tax . . . exceeding	(B) but not exceeding	(C) Tax on amount in Column A*	(D) Tax rate on excess over amounts in Column A* Percent
$ ---	$ 10,000	$ ---	18
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	---	780,800	47

The gift tax payable is subtracted from the tentative tax to arrive at the gross estate tax. The applicable credit amount, which is $555,800 for 2005, is applied against the gross estate tax to arrive at the net estate tax. GST tax is added to the net estate tax to arrive at the total transfer tax amount.

D. The Impact of Income Tax.

Income tax considerations in estate planning should be an important consideration in the choice of assets to distribute to each beneficiary.

In planning an estate, the planner should advise the client as to which assets will have their tax basis stepped up at death and which will not, as well as which assets will subject to tax an ordinary income rates. If a client intends to leave a $500,000 annuity to one child (with no tax basis left in the annuity), via a beneficiary designation, and $500,000 of securities, via a will, the client should be advised that the recipient of the annuity is faced with ordinary income tax rates of up to 35% on distributions, while the recipient of the securities will be subject to a 15% capital gains tax only on the post-death appreciation of the securities and, if qualified for the reduced tax on dividends, the

income distributed on the securities will be taxed at a 15% tax rate. The client may therefore want to adjust the bequests to account for these different income tax results.

If a client has charitable intentions, the client should be advised that charitable bequests should be made with ordinary income assets, such as annuities, IRA's, and similar assets that would be subject to ordinary income rates in the hands of individuals, but which qualified nonprofits can access without payment of any tax.

E. Rules Governing the Generation-Skipping Tax

Property passing from a grandparent to a child, directly or indirectly, is subject to an additional layer of tax, known as the Generation Skipping Transfer ("GST") tax. The GST tax is essentially an additional layer of the estate tax, imposed at the top estate tax rate, and with the same exemption amounts as the regular estate tax. The tax is imposed when all uncertainty is removed that a property transfer will made to a member of a skip generation. The two principal issues for GST tax are when the tax will be imposed, and determining the amount of the tax. The tax is imposed in one of the three situations: a "direct skip," a "taxable termination," and a "taxable distribution."

1. Direct Skip.

A "direct skip" is the transfer of property to a skip person that is subject to estate or gift tax. IRC Section 2612(c)(1). A "skip person" is a person of a generation two or more generations below the generation of the transferor. IRC Section 2613(a)(1). In addition to grandchildren, the GST tax applies to individuals other than lineal descendants born more than 37 ½ years after the transferor.

The GST tax regime contains an important exception where the parent of a direct descendant is deceased, known as the predeceased child exception. The grandchild in such a situation is treated as the child for GST tax purposes. IRC Section 2651(e).

A trust is a "skip person" if all beneficiaries of the trust are skip persons.

2. Taxable Termination.

A taxable termination arises when an amount was previously transferred to a trust with skip persons and non skip persons as beneficiaries, will be distributed only to skip persons as a result of the termination of the interests of the non skip person, by way of

death, release of a power, or specific provisions within the trust terminating the interests of the non skip persons. For example, if the grandparent establishes and funds a trust providing for income for life to the child, with the remainder payable to the grandchildren, a taxable termination occurs upon the death of the child, requiring the payment of the GST tax at that time.

3. Taxable Distribution.

Money held in trust that has not previously been subject to the GST tax, because it was not a direct skip at the time of funding and a taxable termination has not occurred, is considered a "taxable distribution" subject to the GST tax when distributed to a skip person. For example, a trust with discretionary distribution provisions permitting distributions to the settlor's children and grandchildren will cause a taxable distribution on every distribution to one of the grandchildren.

4. GST Tax Exemption.

The GST tax exemption tracks the estate tax exemption amount. The exemption is $1.5 million in 2005, $2 million for the years 2006 through 2008, and $3.5 million for 2009.

GST exemption may be allocated during lifetime or at death, by the personal representative. For lifetime allocations, GST exemption is automatically allocated to lifetime direct skips. IRC Section 2632(b). GST exemption is also automatically allocated to lifetime trust transfers if the transfer is an "indirect skip." An indirect skip is a transfer to a GST trust, which is a trust that could have a GST tax imposed on the trust, unless more than 25 percent of the trust might be transferred to non skip persons according to a complex system for making such determination. IRC Section 2632(c)(3)(B). Rather than determining whether a transfer to a trust qualifies as an indirect skip to a GST trust under these complex rules, which would automatically consume GST exemption, practitioners should decide whether or not to allow the allocation to be made, by filing a gift tax return and electing out of the automatic allocation or making an affirmative GST allocation on the return. Case management best

practice would require that an affirmative GST allocation or opt out be made on a timely filed gift tax return for every irrevocable trust established.

GST exemption can be allocated retroactively during life to a trust in the situation where a non skip direct descendent dies before the settlor dies, and GST tax would therefore be payable because distributions would subsequently be made to a skip person. To avoid the payment of GST tax, the settlor can allocate GST exemption to all previous transfers made to the trust, by filing a gift tax return for the year during which the non skip person died.

Upon death, the personal representative is allowed to allocate GST exemption. If the personal representative fails to make such allocation, the GST exemption is automatically allocated to the estate bequests, first, pro rata to direct skips, and second, pro rata to trusts that will either make GST taxable distributions or which will undergo a GST taxable termination.

5. How the GST Tax Is Computed.

For a GST taxable direct skip, the transferor is liable for the payment of the GST tax. The amount of the GST tax is not added to the amount of the taxable gift.

For GST taxable trusts, the starting point is the inclusion ratio, which is a number from zero to one which signifies the portion of the trust that is GST taxable. The inclusion ration is one minus the applicable fraction, which is the amount of GST allocation made to trust transfer divided by the value of property transferred to the trust. If $1 million is transferred to a trust and $1 million of GST allocation is made to the trust, the inclusion ration will be zero, and the trust will bear no GST tax liability (unless subsequent transfers are made to the trust without GST exemption being allocated to the transfer). If $1 million is transferred to a trust and $600,000 of GST exemption is allocated, the applicable fraction will be 0.6, and the inclusion ratio will be 0.4.

The GST tax is determined by multiplying the taxable amount of the transfer by the applicable rate. The applicable rate is the maximum estate tax rate multiplied by the inclusion ratio. If the trust has an inclusion ratio of 0.4 and the highest estate tax rate is 47% (as it is for 2005), the applicable rate would be 18.8%. The taxable amount, for a

taxable distribution, is the value of the property received by the transferee, increased by the amount of GST tax if paid by the trust. For a taxable termination, the taxable amount is the value of trust assets, reduced by deductible expenses, for a taxable termination. In the case of a 2005 taxable distribution of $100,000 from a trust with an inclusion ratio of 0.4, the GST tax would be $18,800 if paid by transferee.

6. GST Planning

The best practice for GST exemption planning is to create trusts that have inclusion ratios of zero or one, to delay the payment of any GST tax for as long as possible. In a simple example, if a client wishes to transfer $3 million in trust for the benefit of children and grandchildren, the client could establish one trust, allocate his entire $1.5 million GST exemption to the trust, and the trust would have an inclusion ration of 0.5. Every taxable distribution to a grandchild would be subject to GST tax, at a rate of 23.5% for 2005 (0.5 * 47% top estate tax rate). Instead, if the client created two trusts, each with $1.5 million, one trust could be allocated all of the $1.5 million GST exemption, and the other trust none, so that one trust has an inclusion ration of zero, and the other trust an inclusion ration of one. If the trusts are drafted so that the trustees are directed to make distributions first out of trusts that will not incur any GST tax, the trustees could distribute all assets from the trust with the zero inclusion ratio first, without the payment of any GST tax. After the first trust is consumed, only then would taxable distributions be made out of the trust that would incur GST tax. In this manner, the assets of both trusts could be invested and grow for as long as possible before the payment of any GST tax.

F. Dealing with Post-Mortem Income Tax Issues

There is an election to treat a revocable trust as part of the decedent’s estate for income tax purposes. The primary benefit of so doing is to allow the deduction of losses for depreciated property used to fund a pecuniary bequest.

A medical expense incurred by the decedent but not paid before his death (1) may be deducted under Internal Revenue Code Section 2053(a) as a debt on the decedent's estate tax return, or (2) may be deducted as a medical expense on the decedent's income

tax return for the year in which the medical expense was incurred pursuant to Internal Revenue Code Section 213(c), if the expense is paid by the estate within one year of death. For a small estate, deducting medical expenses on the estate tax return may provide little or no benefit.

If at the time of his death the decedent was married, and if his spouse did not remarry during the balance of the year, a joint return can be filed. The joint return will include the decedent's income for the period ending on the date of his death and the surviving spouse's income for the entire year. If both spouses die in the same year, a joint return can be filed which includes the income of each for the period covered by his or her last return.

Ordinarily the assessment of a federal income tax deficiency must by made by the Internal Revenue Service within three years after the return is filed. Under Internal Revenue Code Section 6501(d), however, the executor can request that the assessment of any deficiency be made within 18 months after the request is made. Thus, if the request is made when the return is filed, the statute of limitations is reduced by half. The right to request a prompt assessment has several limitations. For example, it does not shorten the statutory period for assessment of a deficiency if no return was filed or if there was a substantial omission of income.

If any distribution attributable to an employee is paid to the employee's spouse after the employee's death, the rules for rollover treatment applicable to the employee apply to the spouse, except that the spouse may only roll over the distribution to an IRA, a qualified trust or a Section 403(a) annuity plan. A surviving spouse may also elect to treat the IRA of the deceased spouse as his or her own IRA. Following a rollover, taxation of benefits and earnings thereon is postponed until distributed from the spouse's IRA, a qualified plan, or Section 403(a) annuity plan. Distributions are not required to commence until the spouse reaches age 70 ½.

G. The Economic Growth and Tax Relief Reconciliation Act of 2001

The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) makes significant changes to the estate, gift, and GST rates and exemptions. The most

surprising aspect of EGTRRA is that it repeals the estate and GST tax for 2010, followed by full reinstatement of the estate and GST tax to their 2001 rates and exemptions. EGTRRA also changes the relationship between the federal government and the states regarding the imposition of death and estate taxes, by repealing the state death tax credit in favor of a deduction. EGTRRA also makes significant changes to the basis step up at death rules.

1. The New Scheduled Rates and Exemptions Under EGTRRA

The scheduled rates and exemptions are as follows

Year	Top Gift & Estate Tax Rate	Gift Tax Exemption Amount	Applicable Exclusion Amount	GST Tax Rate	GST Exemption Amount
2005	47%	$1 million	$1.5 million	47%	$1.5 million
2006	46%	$1 million	$2 million	46%	$2 million
2007	45%	$1 million	$2 million	45%	$2 million
2008	45%	$1 million	$2 million	45%	$2 million
2009	45%	$1 million	$3.5 million	45%	$3.5 million
2010	0 estate tax / 35% gift tax	$1 million	N/A	0	N/A
2011 and beyond	55%	$1 million	$1 million	55%	$1 million (inflation adjusted)

Planning in this environment is challenging. Although most commentators believe that a comprise package of new rates and exemptions will be enacted prior to the 2010 repeal and 2011 re-enactment of the estate tax, until that occurs, we must plan for the rules as currently in effect.

Perhaps the largest planning challenge is for those estates in the $5 million to $10 million range (for married couples). Should the client engage in complex estate planning

today through the use of GRATS, family limited partnerships, and the purchase of expensive permanent life insurance policies? If we are going to have only a combined $2 million estate tax exemption, perhaps the answer is yes. If we are going to have a combined exemption in the $6 million to $10 million range, perhaps such planning would be unnecessarily expensive and complex. For smaller estates, the use of disclaimers should be adequate to avoid the necessity of aggressive lifetime gifting. For estate over $10 million, aggressive planning should still be explored, as not even the most optimistic commentator believes that the exemptions will be increased to over $5 million per person.

2. State Estate Tax Considerations

One of the most challenging planning aspects of EGTRRA is addressing state estate tax issues. Prior to EGTRRA, a credit against the federal estate tax liability was allowed for state inheritance, estate or other death taxes actually paid by the decedent's estate. IRC Section 2011(a). The credit was capped by the Internal Revenue Code at a specific percentage of the taxable estate, but generally worked out to be about one third of the federal tax liability. Because almost all states used as their state estate tax an amount equal to the maximum federal credit, in effect, this combined federal and state estate tax system charged as the combined federal and state estate tax an amount equal to the federal tax, with an allocation of two thirds to the federal estate tax and one third to the state death tax.

Under EGTRAA, for decedents dying after December 31, 2004, the state death tax credit is eliminated. Instead, a death tax deduction is allowed. This change has caused the states to go down one of two paths. The first path is known as "decoupling," in which the state bases its state death tax not on the state death tax credit allowable under current law, but on some other standard, such as the credit that would have been allowable prior to EGTRRA, or some other standard. For those states that have decoupled and now allow a state death tax, estates could see an increase in the overall combined state and federal liability, as well as a considerable increase in the complexity

of estate planning. If EGTRAA is not amended, in 2010, many estates will pay only a state death tax.

Other states, such as Florida, have left their state death tax equal to the maximum federal credit, which means, in effect, that they presently have no state death tax. Florida is apparently constitutionally limited to only having a state death tax that is fully credited against a federal estate tax.

For Florida clients without any real estate or other property located in a state that maintains a state death tax, EGTRAA has no net effect on the total amount of estate and death tax due. All simply goes to the federal government.

For Florida clients with property in a state that maintains a state death tax, the client is faced with current and testamentary decisions to make. The following states with the most relevance for Florida estate planners maintain a state death tax or state estate tax after the enactment of EGTRRA: New York, Massachusetts, New Jersey, Pennsylvania, and Ohio.

New York, for example, imposes an estate tax based on the state death tax credit available in 1998. To determine the amount of credit that would have been available in 1998, the federal applicable exclusion amount is deemed to remain at $1 million. Many Florida residents could easily own New York real estate valued in excess of $1 million, thereby exposing such clients to the New York estate tax.

Practice Tip. Planning around the new state death tax regimes can be easily accomplished for Florida residents. Most states, including New York, do not apply the estate tax against intangibles owned by out of state residents. Therefore, an easy way to avoid the imposition of New York's state estate tax on real estate is to transfer such real estate into a Florida partnership. The avoidance of New York state probate on New York real estate transferred into an entity is another advantage of implementing this type of planning.

3. Modification of Basis Step Up Rules

Under Internal Revenue Code Section 1014, the income tax basis of property is increased to fair market value as of the date of decedent's death. Under new Section

1022, for decedents dying in the year 2010 and thereafter, the tax basis in the hands of the transferee will be the lesser of the decedent's adjusted basis or the fair market value of the property.

Under Internal Revenue Code Section 1022(b), an aggregate basis increase of up to $1.3 million may be allocated to property acquired from a decedent, indexed for inflation in $100,000 increments. The Section 1022(b) amount is increased by (i) and capital loss carryover and net operating loss that could have been carried over from decedent's last taxable year to a subsequent taxable year, plus the sum of any losses that would have been incurred if such property had been sold at fair market value immediately prior to the decedent's death.

In addition to the Internal Revenue Code Section 1022(b) basis increase, new Section 1022(c) allows a $3 million spousal property basis increase for property transferred to a surviving spouse, either directly or in the form of qualified terminal interest property.

H. Modifying Existing Estate Planning Documents After the 2001 Tax Act.

With the changes in the scheduled estate tax rates and exemption amounts, flexibility must be built into estate planning documents wherever possible. The current trend seems to be using disclaimer marital deduction trusts.

If a disclaimer marital deduction cannot be used, and a formula marital deduction will be used instead, a cap on the nonmarital portion must be used, especially if the spouse is not the only current income beneficiary of the arrangement. The following is an example of a nonmarital pecuniary formula with a pecuniary cap.

> **Family Share.** The "Family Share" shall be a pecuniary sum, equal to the lesser of:
>
> **(1)** The largest value of my Residuary Estate that can pass free of federal estate tax by reason of the unified credit allowable to my estate. This value shall be determined after being reduced by reason of my adjusted taxable gifts, all other dispositions of property included in my gross estate for which no deduction is allowed in computing my federal estate tax, and administration

expenses and other charges to principal that are not claimed and allowed as federal estate tax deductions; or

(2) Two Million Dollars.

This formula will serve to cap the nonmarital share at an amount the client finds appropriate, instead of potentially leaving too much of the estate to the nonspousal heirs as the credit amount increases under the current schedule. Although this method may leave some of the first decedent's credit unused, such a result may be more palatable than leaving too little in assets to the surviving spouse.