The Estate Planner

By Lewis J. Saret

Easy Ways to Use the $5 Million Estate and Gift Tax Exemption While You Still Can

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Introduction

Generally

Virtually all estate planners agree that the estate, gift and GST transfer tax provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010"), and especially the $5 million ($5.12 million in 2012) gift tax exemption provided by TRA 2010 (sometimes referred to herein as the "unified credit"), offer an unprecedented opportunity to reduce their client's transfer tax exposure. Unfortunately, many clients are reluctant to move forward with estate planning to take advantage of TRA 2010's favorable transfer tax provisions. This frequently results from two key causes. First, clients hate the added complexity that is frequently associated with the most effective estate planning techniques as well as the techniques. Second, and of greater importance to most clients, clients (including those who are extraordinarily wealthy by any measure) are highly reluctant to make gifts, which are an integral component of most estate planning techniques, because of the fear that they may need the gifted assets themselves at some point in the future.

This column discusses some techniques that are less complicated than many others and which address the fear that clients may have that they may need the gifted assets themselves in the future.

Key Objectives of Estate Planning

Before discussing specific estate planning techniques, it is important to understand the key objectives of estate planning, which fall into two basic categories: (1) tax-driven objectives, and (2) non–tax-driven objectives.

Tax-Driven Objectives[1]

The primary tax objectives of estate planning are threefold:

- Minimize estate, GST and gift taxes imposed on clients.
- Defer the payment of any estate, gift or GST taxes imposed on clients.
- Ensure there will be sufficient liquidity to pay estate taxes when they become due, especially for estates containing large illiquid assets, such as closely held businesses.

There are of course various ancillary tax objectives, such as minimizing income taxation of beneficiaries, *etc.*

Non–Tax-Driven Objectives

Generally, clients do not engage in estate planning solely to save taxes; they generally do so to accomplish various nontax objectives for the benefit of people they care about, including themselves. Having said this, tax planning is obviously important to clients because it significantly impacts the nontax planning objectives.

More specifically, clients engage in estate planning for the following reasons, among others:

- **To increase and preserve client property during clients' lifetimes.** This includes planning for the clients' liquidity needs and retirement planning, and minimizing lifetime income taxation. This could also include protecting the clients' assets from potential claims of creditors, generally referred to as asset protection.
- **Providing for beneficiaries in a manner suited to their needs.** This may include establishing trusts for children who lack financial maturity or are disabled, selecting guardians for minors, *etc.*
- **Providing for the potential incapacity of the clients.**

One of the most important nontax objectives of virtually all clients is addressing this fear of poverty. There is an old saying that rings true: There are two things worse than taxes—poverty and fear of poverty.[2] In the estate planning context, this fear manifests itself in clients' reluctance to make gifts because of the fear that they may subsequently need gifted assets for themselves in order to support their lifestyles.

Therefore, the primary goal that motivates clients to engage in estate planning is to provide for the people that they care about, which typically includes spouses, lineal descendants, sometimes ancestors and other relatives, and almost always the clients themselves.

Giving–Tax and Other Aspects

As noted above, gifts are an integral component of most estate planning techniques. In this regard, the gift tax system is integrated with the estate tax system. Gifts made during lifetime are added to the assets included in the donor's estate at death to arrive at the donor's adjusted taxable estate. A tentative estate tax is calculated based on the donor's adjusted taxable estate, after adding back lifetime gifts, and then any gift tax paid on such gifts is subtracted from the estate tax due, and the unified credit (unreduced for any unified credit used during the donor's lifetime for lifetime gifts) is subtracted from the estate tax, to result in the net estate tax due.

Planning Pointer. Mathematically, the key elements discussed above can be shown as follows, with references to lines on page 1 of the Estate Tax Return. Form 706, *United States Estate (and Generation-Skipping Transfer)* Tax Return (Rev. August 2011) is included in Exhibit 1 for purposes of reference.

Exhibit 1.

Part 2, Tax Computation, Line No.		Description
3c	+	Taxable estate (*i.e.,* gross estate less allowable deductions)
4	+	Adjusted taxable gifts made by decedent after December 31, 1976, other than gifts already includible in decedent's gross estate
5	=	Adjusted taxable estate.
6	+	Tentative estate tax based on amount (*i.e.,* adjusted taxable estate amount) shown on line 5
7	-	Total gift tax paid/payable with respect to adjusted taxable gifts made by decedent after December 31, 1976, shown on line 4, to the extent the decedent was the donor of such gifts and such gifts were includible in the decedent's gross estate
8	=	Gross estate tax
9	+	Unified Credit
10–14	+	Adjustments to Unified Credit and Other Credits
15	=	Total Credits
16	+8-15	Net estate tax

It should be noted that one of the primary tax objec-

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tives of estate planning is to minimize, to the greatest extent possible, the net estate tax amount reflected on line 16, taking into consideration any gift tax paid.

It should also be noted that as a result of the foregoing calculation, lifetime gifts are advantageous from an estate planning perspective for two reasons and possibly an additional third reason.

Post-Gift Appreciation Escapes Transfer Tax System

First, for gifted assets that appreciate in value, appreciation that occurs after the date of the gift escapes the transfer tax system.

Example 1. Zach Markburg founds an Internet startup, *Yearbook.com,* which grows rapidly. Zach makes a gift to his son, Sonny, of 1,000 shares of *Yearbook.com* stock with a $3 million fair market value on January 1, 2011, and when the gift and estate tax exemption amount is $5 million. As a result, Zach pays no gift tax upon the gift. *Yearbook.com* goes public in an IPO on July 1, 2012, and the value of the stock gifted to Sonny grows to $300 million in value as of December 31, 2012. Zach retains another 1,000 shares of *Yearbook.com* stock.

Zach dies on December 31, 2012, when the gift and estate tax exemption amount is $5.12 million. Zach's only asset at his death is his own 1,000 shares of *Yearbook.com* stock, which as noted is worth $300 million.

Here, as shown in Exhibit 2, Zach's estate will pay an estate tax, assuming no state estate tax, of $104,300,000.

Example 2. Same facts, except that Zach does not make a gift to Sonny, and retains 2,000 shares of *Yearbook.com.* Here, as shown in Exhibit 3, Zach's estate will pay an estate tax of $208,208,000, or in other words, Zach's

Exhibit 2.

Part 2, Tax Computation, Line No.		Description	
3c	+	Taxable estate (*i.e.,* gross estate less allowable deductions)	$300,000,000.
4	+	Adjusted taxable gifts made by decedent after December 31, 1976, other than gifts already includible in decedent's gross estate	3,000,000
5	=	Adjusted taxable estate	303,000,000
6	+	Tentative estate tax based on amount (*i.e.,* adjusted taxable estate amount) shown on line 5	106,030,800
7	-	Total gift tax paid/payable with respect to adjusted taxable gifts made by decedent after December 31, 1976, shown on line 4, to the extent the decedent was the donor of such gifts and such gifts were includible in the decedent's gross estate	0
8	=	Gross estate tax	106,030,800
9	+	Unified Credit	1,772,800
10–14	+	Adjustments to Unified Credit and Other Credits	
15	=	Total Credits	1,772,800
16	+8-15	Net estate tax	$104,258,000

Exhibit 3.

Part 2, Tax Computation, Line No.		Description	
3c	+	Taxable estate (*i.e.,* gross estate less allowable deductions)	$600,000,000.
4	+	Adjusted taxable gifts made by decedent after December 31, 1976, other than gifts already includible in decedent's gross estate	
5	=	Adjusted taxable estate	600,000,000
6	+	Tentative estate tax based on amount (*i.e.,* adjusted taxable estate amount) shown on line 5	209,980,800
7	-	Total gift tax paid/payable with respect to adjusted taxable gifts made by decedent after December 31, 1976, shown on line 4, to the extent the decedent was the donor of such gifts and such gifts were includible in the decedent's gross estate	0
8	=	Gross estate tax	209,980,800
9	+	Unified Credit	1,772,800
10–14	+	Adjustments to Unified Credit and Other Credits	
15	=	Total Credits	1,772,800
16	+8-15	Net estate tax	$208,208,000

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Exhibit 4.

Part 2, Tax Computation, Line No.		Description	
3c	+	Taxable estate (*i.e.*, gross estate less allowable deductions)	$32,626,700
4	+	Adjusted taxable gifts made by decedent after December 31, 1976, other than gifts already includible in decedent's gross estate	
5	=	Adjusted taxable estate	32,626,700
6	+	Tentative estate tax based on amount (*i.e.*, adjusted taxable estate amount) shown on line 5	1,400,445
7	-	Total gift tax paid/payable with respect to adjusted taxable gifts made by decedent after December 31, 1976, shown on line 4, to the extent the decedent was the donor of such gifts and such gifts were includible in the decedent's gross estate	0
8	=	Gross estate tax	1,400,445
9	+	Unified Credit	1,772,800
10–14	+	Adjustments to Unified Credit and Other Credits	
15	=	Total Credits	1,772,800
16	+8-15	Net estate tax	$9,627,345

Exhibit 5.

Part 2, Tax Computation, Line No.		Description	
3c	+	Taxable estate (*i.e.*, gross estate less allowable deductions)	$16,313,350
4	+	Adjusted taxable gifts made by decedent after December 31, 1976, other than gifts already includible in decedent's gross estate	3,500,000
5	=	Adjusted taxable estate	19,813,350
6	+	Tentative estate tax based on amount (i.e., adjusted taxable estate amount) shown on line 5	6,915,473
7	-	Total gift tax paid/payable with respect to adjusted taxable gifts made by decedent after December 31, 1976, shown on line 4, to the extent the decedent was the donor of such gifts and such gifts were includible in the decedent's gross estate	0
8	=	Gross estate tax	6,915,473
9	+	Unified Credit	1,772,800
10–14	+	Adjustments to Unified Credit and Other Credits	
15	=	Total Credits	1,772,800
16	+8-15	Net estate tax	$5,142,673

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estate pays $103,950,000 more than in Example 1. In other words, by making a gift during 2011, Zach could save over $100 million in transfer taxes.

Example 3. Harold Professional, a successful professional, lives frugally and has accumulated $7 million of assets as of January 1, 2012. Harold's assets grow at an eight-percent rate after taxes for 20 years at which point Harold dies in 2032 owning assets with a fair market value of $32,626,700. Harold's assets pass to his daughter, Dolly. Assuming that the estate tax is exactly the same in 2032 as in 2012, Harold's estate tax would be $9,627,345, as shown in Exhibit 4.

Example 4. Same facts as Example 3, except that Harold makes a gift of $3.5 million to a trust for Dolly's benefit in 2012. Here, at Harold's death, as shown in Exhibit 5, Harold's estate yields an estate tax of $5,142,673. Therefore, by making a gift of $3.5 million to Dolly, Harold saves $4,448,672 in estate taxes, which flows through entirely to Dolly rather than to the government.

As the foregoing examples illustrate, when clients make gifts during lifetime, all appreciation on the gifted assets escape estate taxation and can result in substantial savings for the family unit.

Assets Used to Pay Gift Taxes* Not Subject *to Estate Tax;* *Assets Used to Pay Estate Tax* Are Subject *to Estate Tax

Second, if clients make gifts that result in a taxable gift then the amount of funds used to pay gift tax further reduce the donor's taxable estate and further reduce the transfer taxes that apply to the family unit.

Example 5. Same facts as Example 4, except that Harold makes a gift of $6 million in 2012 to a trust for Dolly's

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benefit. Here, Harold would have to pay a gift tax in 2012 of $308,000, which would reduce Harold's taxable estate. The result would be that his assets at his death in 2032 would equal $3,225,382, which would result in estate tax of $1,128,884, as shown in Exhibit 6. Therefore, in this Example, Harold's total transfer tax exposure is $1,436,884, as opposed to $5,184,673 in Example 4, and $9,627,345 in Example 3.

Exhibit 6.

Part 2, Tax Computation, Line No.		Description	
3c	+	Taxable estate (*i.e.,* gross estate less allowable deductions)	$3,225,382
4	+	Adjusted taxable gifts made by decedent after December 31, 1976, other than gifts already includible in decedent's gross estate	6,000,000
5	=	Adjusted taxable estate	9,225,382
6	+	Tentative estate tax based on amount (*i.e.,* adjusted taxable estate amount) shown on line 5	3,209,684
7	-	Total gift tax paid/payable with respect to adjusted taxable gifts made by decedent after December 31, 1976, shown on line 4, to the extent the decedent was the donor of such gifts and such gifts were includible in the decedent's gross estate	308,000
8	=	Gross estate tax	2,901,684
9	+	Unified Credit	1,772,800
10–14	+	Adjustments to Unified Credit and Other Credits	
15	=	Total Credits	1,772,800
16	+8-15	Net estate tax	$1,128,884

Clawback or No Clawback

As noted above, upon death, lifetime gifts made after 1976 are added to the decedent's estate, using the values as of the date of gift, to arrive at an adjusted taxable estate amount, upon which the estate tax is based. As also noted, post gift appreciation of assets that the decedent/donor gifted during lifetime is not added to estate. Therefore, post-gift appreciation escapes transfer taxation with respect to the decedent/donor.

One open issue is whether, if the $5 million ($5.12 million for 2012) gift tax exemption is reduced after December 31, 2012, to some amount less than $5 million ($5.12 million for 2012), gifts made during 2012 that exceed the exemption at death but did not exceed the exemption amount in 2012 must be added to the decedent's taxable estate as of date of death. In other words, if the estate and gift tax exemption is reduced below $5 million ($5.12 million for 2012) in the future (and under current law, the exemption is scheduled to decline after December 31, 2012, to $1 million), any amounts transferred during life may be "clawed back" into the estate and gift transfer tax system without the protection of the $5 million ($5.12 million for 2012) exemption amount.[3]

Many commentators believe that if the exemption amount is reduced, that a clawback would be inconsistent with congressional intent and, therefore, is unlikely to occur. If this view prevails and there is no clawback, any gifts during 2012 that exceed any future reduced exemption amount will permanently escape transfer taxation with respect to the donor and possibly future generations.

If there is a clawback, then the donor will generally be in no worse transfer tax position than if the donor had not made a gift, with one key exception. That exception is the need to plan for sufficient liquidity in the donor's estate to satisfy any estate taxes that result from any potential clawback with respect to the gifted assets, which necessarily would not then be directly available in the donor's estate to use to satisfy the associated estate tax liability.

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Caution. It is important to clearly explain the issue of the potential clawback to clients. Some commentators have expressed the opinion, based on conversations with Congressional staffers, that there will be no clawback. Notwithstanding such opinions, there is no guarantee that a clawback will not occur. Therefore, it is important for practitioners to discuss the risk of such a clawback and the impact of such possibility with clients.

Summary of Client Objectives Regarding Estate Planning

At the end of the day, clients are motivated to engage in estate planning because they want to provide for their loved ones and to preserve and protect family businesses. Although nobody likes paying taxes, taxes are not, in and of themselves, typically a direct motivating factor. Instead, tax planning is indirectly important because funds used to pay taxes cannot be left for the benefit of loved ones and requires planning to ensure that there are sufficient funds to cover estate taxes to avoid the need to dispose of liquid assets, such as family-owned businesses. The importance of this distinction is that many clients deeply resent and dislike what they perceive to be complicated estate planning techniques, which they think unnecessarily complicates their lives and the way that they run their businesses. In turn, this increases the reluctance of some clients to engage in more sophisticated estate planning.

As we have seen, lifetime gifts result in greater tax savings than transfers of assets at death. On the other hand, clients generally are reluctant to make *inter vivos* gifts because of the fear that they may need such assets for themselves during their lifetimes.[4]

Furthermore, advisors have a professional obligation to advise their clients about how to take advantage of the $5 million ($5.12 million for 2012) exemption. How should they proceed?

With the foregoing in ming, some clients who are resistant to sophisticated estate planning techniques may be more receptive to the following estate planning techniques, which allow them to take advantage of the $5 million ($5.12 million for 2012) exemption while avoiding most of the complexity of more sophisticated estate planning techniques:

- Spousal Limited Access Trusts (SLATs)
- *Inter vivos* Credit Shelter Trusts
- Nonreciprocal SLATs and Nonreciprocal Inter vivos Credit Shelter Trusts

SLATs

One easy way for clients to make gifts that will remove the gifted property from their estates is to make gifts to a SLAT. In essence a SLAT is simply an irrevocable trust established by one spouse for the benefit of the other spouse. The key benefit of a SLAT is that the assets gifted to the SLAT are removed from the donor's taxable estate but at the same time such gifted property remains available to the family unit through the spousal beneficiary.

SLAT Structure

Separate Property

First, the SLAT grantor must use separate property to fund the SLAT. Failure to use separate property when funding SLATs will cause the SLAT assets to be included in the nongrantor spouse's taxable estate under Code Sec. 2036.

Planning Pointer. Planners should clearly document the origin of funds used to create and fund SLATs to avoid any issue in the future.

Standard of Payment

Some commentators have raised an issue concerning the standard used for making distributions to the spouse/beneficiary and whether an ascertainable standard applied to such payments may accidentally cause estate inclusion of some or all of the trust assets in the spouse/beneficiary's estate.[5]

Specifically, Reg. §20.2036-1(b)(2) provides as follows:

> The "use, possession, right to the income, or other enjoyment of the transferred property" is considered as having been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit. The term "legal obligation" includes a legal obligation to support a dependent during the decedent's lifetime.

Essentially, Reg. §20.2036-1(b)(2) provides that there is estate inclusion of trust assets if such assets are to be used to discharge the grantor's support or other legal obligations, which could include the grantor's legal obligation to support his/her spouse.

In interpreting Reg. §20.2036-1(b)(2), courts have set forth the following key principals:[6]

- **Mandatory distributions.** If the trust instrument mandates distributions for grantor's spouse for purposes of providing support, then there is estate inclusion under Code Sec. 2036.[7]
- **Discretionary Distributions.** If the trustee has discretion to make distributions for support purposes, there is estate inclusion if the grantor is the trustee[8] but no inclusion if there is an independent trustee.[9]
- **Support Standard.** If the trust instrument does not have a support standard then there is no Code Sec. 2036 inclusion regardless of whether distributions to the spouse are discretionary or mandatory.[10] However, if the spouse is trustee, then lack of an ascertainable standard will result in inclusion in the spouse's estate under Code Sec. 2041.

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Planning Pointer. Prudent planners will include language in their trust agreements that prohibit distributions to the grantor's spouse that discharge the grantor's legal obligation of support. However, an independent trustee can be appointed to distribute income or principal to the spouse for any purpose.

Trustee

To avoid Code Sec. 2036 inclusion, planners should use someone other than the grantor as trustee. Although the grantor's spouse can serve as trustee if his/her ability to distribute is subject to an ascertainable standard, it is preferable to use an independent trustee as either sole trustee or co-trustee.

Dispository Structure

Unlike certain other estate planning techniques, such as GRATs and charitable remainder trusts (CRTs), which are well defined under the Code, SLATs apparently arose as a marketing concept and are not defined under the Code. As a result, the concept of a SLAT is somewhat vague. Commentators have described SLATs as having characteristics ranging from characteristics virtually identical to a qualified terminal interest property (QTIP) marital trust to characteristics virtually identical to a credit shelter trust that includes the spouse as a beneficiary. The two things in common to all descriptions of a SLAT are that (1) the spouse is a beneficiary, and (2) the SLAT is structured to ensure that it is not included in the taxable estates of either the grantor or the spouse.[11]

Advantages of SLAT

First, the primary benefit of a SLAT is that it can be used to mitigate the donor's estate tax exposure by allowing the grantor to make a completed gift to the SLAT with the gifted assets removed from the donor's estate and with such assets excluded from the spouse's estate.[12]

Second, SLATs allow the assets contained in the SLAT to be available to the family unit because the spouse is a SLAT beneficiary and may serve as either a sole or co-trustee.[13] This addresses in large part the concern of most clients that they may need assets, which they are contemplating using to make a gift, in the future.

Third, SLATs generally protect the assets in the SLAT from creditors of both spouses assuming that the transfer into the SLAT is not a fraudulent conveyance by the grantor. A fraudulent conveyance is generally a transfer of property intended to hinder, delay or defraud creditors. Although a full discussion of fraudulent conveyances is beyond the scope of this column, if the funding of the SLAT is not intended to defraud creditors and does not leave the grantor insolvent, then the transfer should not constitute a fraudulent conveyance.

Example 6. Kristin, a successful high-tech entrepreneur, creates a SLAT for her husband, Sam, and transfers into a SLAT $5 million in stock in her latest venture, Startup Inc. in 2011. The transfer uses up Kristin's full $5 million exemption. The stock placed into the SLAT sells for $10 million, which remains in the SLAT.

In 2016 Kristin founds a new startup, Second Act, Inc., which fails spectacularly in 2017. Kristin is sued and a judgment in the amount of $10 million is entered against Kristin, forcing her into bankruptcy in 2018. Here, the assets in the SLAT should not be exposed to creditors.

Example 7. Same facts as Example 6 except that it is Sam who founds Second Act, Inc., and who is forced into bankruptcy in 2018. The result should be the same. Namely, the assets in the SLAT should not be exposed to Sam's creditors.

Disadvantages of SLAT

First, one obvious disadvantage of a SLAT is that if the spouse predeceases the grantor, the grantor loses his indirect access to the trust assets.

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Planning Pointer. One easy solution to the issue of the grantor losing indirect access to SLAT assets through the spousal beneficiary is to have the spouse create an irrevocable life insurance trust for the benefit of the grantor of the SLAT for the purpose of replacing the access to the assets transferred into the SLAT.

Second, the grantor's access to SLAT assets is contingent on the quality of the marriage. In a worst-case scenario, if the spouse's divorce, the grantor's indirect access to SLAT assets terminates. Therefore, for clients with unstable marriages, SLATs are not an appropriate estate planning vehicle.

Planning Pointer. To mitigate the risk of divorce, planners should consider including in the SLAT instrument a provision either (1) defining the SLAT beneficiary as the grantor's then current spouse, which would not include a spouse after divorce; or (2) terminating the SLAT upon divorce with SLAT assets then dropping down into trusts for lineal descendants.

Inter vivos Credit Shelter Trust

Generally

A variation on the above described SLAT strategy is to create an *inter vivos* credit shelter trust for the benefit of the grantor's spouse and lineal descendants. This generally has the same benefits as those described above for SLATs (*i.e.,* removal of assets from the estate of the grantor and the estate of the grantor's spouse; indirect access to the trust assets through the spousal beneficiary; and protection of trust assets from creditors of both spouses). However, *inter vivos* credit shelter trusts have an additional benefit. Because most married clients have estate plans that incorporate credit shelter trusts, clients generally will be more familiar with such trusts than other estate planning vehicles and may be more receptive to lifetime planning with such trusts.

Structure

An *inter vivos* credit shelter trust generally would be structured using terms that are very similar to those contained in testamentary credit shelter trusts. Generally, they are created for the benefit of the grantor's spouse and lineal descendants. Among other things, the grantor's spouse can:

- be a discretionary beneficiary of the trust.
- be a trustee, either a sole trustee as long as distributions are subject to an ascertainable standard, or a co-trustee along with an independent trustee.
- have a limited power of appointment over trust assets.

Planning Pointer. As noted, the grantor can give the spouse a limited power of appointment. Such a limited power of appointment could be broad enough to encompass virtually anyone other than the spouse, the spouse's creditors, or the creditors of the spouse's estate and still be excluded from the spouse's estate for estate tax purposes.[14] Therefore, the spouse could even be given a limited power of appointment that would be sufficiently broad enough to appoint trust assets back to the grantor as long as it can be shown that there was no prearrangement with the spouse to so exercise the power of appointment. Also it should be noted that even if the grantor is successful from a transfer tax standpoint in appointing property back to the grantor in trust with such appointed assets excluded from the estates of the grantor and the spouse, such an exercise could expose the appointed assets to the claims of the grantor's creditors.

Advantages and Disadvantages of *Inter vivos* Credit Shelter Trust

Generally, the advantages and disadvantages of an *inter vivos* credit shelter trust are the same as for a SLAT. However, as noted above, one additional benefit of an *inter vivos* credit shelter trust is that because most estate planning clients have already been exposed to credit shelter trusts in their existing estate plans, such clients may be more receptive to using *inter vivos* credit shelters to lock in the expanded unified credit in 2012.

Nonreciprocal SLATs and Nonreciprocal *Inter vivos* Credit Shelter Trusts

Generally

Some clients may desire to establish not just one but two trusts, one for each spouse in order to take advantage of each spouse's unified credit. Here, the issue presented is whether the reciprocal trust doctrine would apply and cause each spouse to be treated as the grantor of the other spouse's trust and thereby potentially causing estate inclusion.[15]

Generally, the reciprocal trust doctrine is a judicially created doctrine that may apply when two grantors create virtually identical trusts at the same time, and there is a crossing of beneficial interests or powers. Here, the IRS may try to uncross the transfers and thereby include the principal of one Grantor's trust in the other Grantor's estate.

Example 8. Oscar and Yuri are brothers. Each is married with children. Oscar creates and funds a trust that pays all income to Yuri for Yuri's life and, at Yuri's death, pays the remainder to Yuri's lineal descendants. Yuri creases an identical trust for Oscar and his descendants. Here, absent the reciprocal-trust doctrine, neither trust would be included in the estates of either Oscar or Yuri because neither brother has retained any interest or powers over the property that they have transferred to the trust for the other brother. However,

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if Oscar had created and funded a trust that paid income to himself for life with the remainder to his descendants, then this trust would be included in his estate under Code Sec. 2036. Therefore, absent the reciprocal trust doctrine, by creating such trusts for each other, Oscar and Yuri would be able to avoid estate taxes on assets transferred to such trusts.[16]

Test

Generally

The basic test for whether the reciprocal trust doctrine applies, which is a two-part test, is as follows:

- The trust must be interrelated.
- The trust arrangement, to the extent of mutual value, must leave grantors in approximately the same economic position as they would have been in had they created the trusts naming themselves as the life beneficiaries.[17]

Test for Interrelatedness

The interrelated test does not depend on either a *quid pro quo* or a tax-avoidance motive. Instead, courts look at various factors, including the following:[18]

- Contemporaneousness of the creation of the trusts
- Whether the trust provisions are substantially identical
- Identity of beneficiaries and trustees
- Relationship of grantors
- Corpus of the trusts
- Whether the creation of the trusts was part of one design

Test for Mutual Economic Value

In *Grace Est.,* the Court described the test for mutual economic value as requiring that "the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."

Courts have interpreted this test in two different ways. The Sixth Circuit, in *J. Green Est.,*[19] held that the test for mutual economic value requires that the Grantor have an economic interest in the trust of which he/she is not the grantor, making that trust includible under Code Sec. 2036(a)(1) if that party were deemed to be the grantor. However, *Green* concluded that a retained power that would render a trust includible under Code Sec. 2036(a)(2) would not satisfy this prong of the two-part reciprocal trust doctrine test under the *Grace* test.

Jurisdictions other than the Sixth Circuit have taken a broader view. Under this view, if trusts are interrelated and then, when uncrossed, there is a basis for taxation (*e.g.,* under Code Sec. 2036(a)(2)), then the reciprocal trust doctrine applies.[20]

Planning Pointer. To avoid application of the reciprocal trust doctrine, planners must either (1) ensure the trusts will not be interrelated; or (2) ensure that if the trusts are uncrossed, that there is no power or interest that would provide a basis for taxation.

Conclusion

Many clients are resistant to implementing any planning to take advantage of the $5 million ($5.12 million in 2012) gift tax exemption provided for under TRA 2010. The reasons may vary but typically include a desire to avoid additional complexity in their lives as well as a fear that they may need any gifted assets in the future for themselves. Two techniques that clients may be more receptive to include *inter vivos* credit shelter trusts and spousal limited access trusts, sometimes referred to as SLATs. In particular, credit shelter trusts are incorporated into the estate plans of virtually all married clients. Therefore, they may be more receptive to using a lifetime or *inter vivos* credit shelter trust because, in effect, this is essentially accelerating part of their existing estate plan with a goal of locking in the enhanced unified credit amount provided for under TRA 2010 for 2012 and still allows indirect access of trust assets to the marital unit while simultaneously removing such assets from the taxable estates of the marital unit.

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Endnotes

1 For practitioners with limited transfer tax experience, the transfer tax system may be summarized as follows (and it should be noted that this is a gross oversimplification of the transfer tax system).

First, the Code imposes an estate tax upon the gross estates of decedents, which is determined by valuing assets owned (or effectively deemed to be owned) at death by the decedent at the fair market value as of date of death or the alternate valuation date, which is generally six months after date of death.

Second, the Code imposes a gift tax that applies to gratuitous lifetime transfers and which applies to the fair market value of the assets as of the date of gift.

Third, the Code provides for an unlimited marital deduction for *inter vivos* or testamentary transfers to U.S. citizen spouses. To illustrate, if a billionaire leaves his entire $25 billion estate to his/her U.S. citizen spouse at death, and the spouse dies three months later, there is an offsetting marital deduction that eliminates the estate for the first spouse to pass away. However, unless the surviving spouse has remarried or has some other offsetting deduction, the $25 billion will be included in the estate of the surviving spouse. Therefore, the marital deduction is essentially a transfer tax deferral mechanism rather than a transfer tax avoidance technique.

Fourth, there is an exemption amount that applies to the estate and gift tax. Before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the estate and gift tax exemption was $675,000 per person for both estate and gift tax purposes and was referred to as the unified credit because the credit amount was the same (*i.e.,* unified) for estate and gift tax purposes. EGTRRA increased the gift tax exemption to $1 million, where it remained through 2010. EGTRRA increased the estate tax exemption to the following amounts in the following years:

2002: $1 million.
2003: $1 million.
2004: $1.5 million.
2005: $1.5 million.
2006: $2 million.
2007: $2 million.
2008: $2 million.
2009: $3.5 million.

TRA 2010 reunified the estate and gift tax exemption and increased it to $5 million per person for 2011 and 2012. TRA 2010 also added a portability provision so that if one spouse dies without fully using his/her exemption amount, the surviving spouse with certain limitations can use the unused exemption. However, the transfer tax provisions of TRA 2010 lapse at the end of 2012 and the estate and gift tax exemption revert to the amounts that would have been in existence without either EGTRRA or TRA 2010, which would be a $1 million estate and gift tax exemption with no portability. For a more detailed discussion of TRA 2010's provisions, *see* Lewis J. Saret, The Estate Planner, *Estate Tax Planning During 2012,* TAXES, Mar. 2012, at 21.

Fifth, there are certain gift tax exclusions that do not use up any of the donor's exemption. These include the annual exclusion, which is $13,000 per donee for 2012 gratuitous transfers and which is indexed for inflation, and exclusions for certain medical and educational tuition expenses.

Sixth, at death, gifts are added back to assets owned at death to the taxable estate of a decedent to result in adjusted taxable estate amount. However, the amount added back is the value of gift as of the time of gift, not the value of the asset gifted as of the date of death. To illustrate, if pre-IPO stock is gifted and increases 100-fold by the death of the donor, the pre-IPO value is added back to the decedent's estate and all appreciation escapes transfer tax.

[2] Mark B. Edwards, "The Place of the Gift Tax in An Estate Tax Dominated World," *Estate Planning for the Family Business Owner* (ALI-ABA Course No. SP001, 2008).

[3] For a detailed discussion of the clawback issue, *see* David L. Starbuck, MECHANICS OF THE "CLAWBACK," IS A $5,000,000 GIFT REALLY A $5,000,000 GIFT? (Materials for presentation to the Madison Group, Mar. 2, 2011).

[4] One solution to this type of fear is the use of Alaska/Delaware type self-settled trusts. However, because this column focuses on the easiest and simplest estate planning techniques, such trusts are not discussed here.

[5] *See generally* Mark Merric and Rod Goodwin, *The Good, Bad and Ugly of Spousal Access Trusts—Part III,* LISI ESTATE PLANNING, Dec. 2, 2008, at *www.leimbergservices.com;* Mark Merric and Rod Goodwin, The Good, Bad and Ugly of Spousal Access Trusts—Part II, LISI ESTATE PLANNING, Nov. 11, 2008, *www.leimbergservices.com;* Mark Merric and Rod Goodwin, The Good, Bad and Ugly of Spousal Access Trusts—Part III, LISI ESTATE PLANNING, Oct. 14, 2008, at *www.leimbergservices.com;* Mark Merric and Rod Goodwin, The Good, Bad and Ugly of Spousal Access Trusts—Part I, LISI ESTATE PLANNING, Aug. 20, 2008, at *www.leimbergservices.com;* Mitchell Gans and Jonathan Blattmachr, Another Look At Spousal Lifetime Access Trusts, LISI ESTATE PLANNING, Dec. 18, 2008, at *www.leimbergservices.com.*

[6] *See generally* Mitchell Gans and Jonathan Blattmachr, *Another Look At Spousal Lifetime Access Trusts*, LISI ESTATE PLANNING, Dec. 18, 2008, at *www.leimbergservices.com.*

[7] *See generally* Gans & Blattmachr, *supra* note 5, *citing to L.S. Richards,* CA-10, 67-1 USTC ¶12,463, 375 F2d 997 (1967).

[8] *See generally* Gans & Blattmachr, *supra* note 5, *citing to V.C. Sullivan Est.,* 66 TCM 1329, Dec. 49,401(M), TC Memo. 1993-531.

[9] *See generally* Gans & Blattmachr, *supra* note 5, *citing to A.W. Mitchell Est.,* 55 TC 576, Dec. 30,478 (1976), *acq.* 1971-2 CB 3; Rev. Rul. 2004-64, IRB 2004-27, 7.

[10] *See generally* Gans & Blattmachr, *supra* note 5, *citing to Sullivan, supra* note 8.

[11] *See, e.g.,* LTR 199903040 (Oct. 14, 1998) (IRS ruled that trust was not QTIP trust because no QTIP election was made and therefore trust was excluded from surviving spouse's estate where the donor created an irrevocable trust to which he contributed his separate funds, the trustee was directed to distribute net income at least quarterly to the spouse during her lifetime, and to distribute to her as much principal as the trustee deemed necessary for the spouse's support, maintenance and medical care, and the trust terminated at spouse's death with undistributed income paid to her estate and principal paid to the grantor's descendants).

[12] *See, e.g.,* LTR 199903040, *supra* note 11.

[13] As discussed above, if the spouse serves as sole trustee of a SLAT, the distribution standard must be limited by an ascertainable standard to avoid inclusion of the SLAT assets in the spouse's estate under Code Sec. 2041.

[14] Reg. §20.2041-1(c).

[15] For a detailed discussion of the reciprocal-trust doctrine, *see* Paul Van Horn, *Reciprocal Trusts Revisited,* PRACTICAL TAX LAW., Summer 2005; Mitchell M. Gans, Jonathan G. Blattmachr and Diana S. C. Zeydel, *Supercharged Credit Shelter Trust*, PROB. & PROP., July/Aug. 2007, at 52, 57–60.

[16] *A.S. Lehman,* CA-2, 40-1 USTC ¶9198, 109 F2d 99, *cert. denied,* 310 US 637 (1940).

[17] *Grace Est.,* SCt, 310 US 637 (1940).

[18] *Id.*

[19] *J. Green Est.,* CA-6, 95-2 USTC ¶60,216, 68 F3d 151 (1995).

[20] *B. Bischoff Est.,* 69 TC 32, Dec. 34,702 (1977).

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