

GONNELLA GEITTMANN, PC

Carol H. Gonnella
Admitted in WY & WA
carol@jhestatelaw.com

Attorneys and Counselors
575 South Willow Street,
Post Office Box 1226
Jackson, Wyoming 83001
(307) 733-5890 *voice*
(307) 734-0544 *facsimile*
www.jhestatelaw.com

Clay D. Geittmann
Admitted in WY
clay@jhestatelaw.com

Planning for a Spouse

Overview

In this article, we will discuss the various techniques to plan for a spouse, and the many strategies to be utilized to provide for a spouse, save taxes and maintain control.

In our many years of estate planning, we have found that most of our married clients have as their primary goal providing for each other, and thereafter to provide for their family and then for their community. It is of great importance that after the first death, the surviving spouse is financially able to continue to pursue his or her normal and customary standard of living.

Often our new clients bring in their existing planning documents, asking us to review them. Many times these documents include a will that distributes everything owned by the deceased spouse to the surviving spouse, outright. This simple will is often called an "I Love You" will. It satisfies the goal of leaving everything to the survivor, but provides little else in the way of planning.

One of our mandates as estate planners is to educate our clients on the various techniques available in planning for spouses that not only allows the survivor to have access to the assets of the decedent, but also achieves many other estate planning goals. Only after a client is educated about these techniques can he or she make an informed decision as to what strategies best meet his or her planning needs and objectives.

Transfers can be made to a spouse during lifetime, called lifetime transfers, or to a surviving spouse upon the first death, called testamentary transfers. Transfers can be made for tax and non-tax reasons. These concepts shall be addressed in this outline.

Why Plan for a Spouse?

Preparing an "I Love You" will and giving all of a client's assets to the surviving spouse outright may satisfy the primary goal of providing for the survivor, but it fails to satisfy other planning goals. In your client meetings, it is important to determine if the following objectives are important.

Is the client concerned about reducing federal and/or state gift and estate tax?

Would your client like to creditor proof the assets transferred to his/her spouse?

Is your client concerned about a remarriage, and would like to protect his/her assets in such an event?

Would your client like to make assets available for the use of the surviving spouse, but to insure that upon the survivor's death, the remainder will be distributed pursuant to your client's desires?

Basic planning can address all of the above in a myriad of ways, depending on what the client wants to do. The reason most people do not plan for their spouse is simple: they were not educated about the options available. As a planner, it is your duty to educate to motivate them to consider the flexible planning tools available for spousal planning.

Tax Reasons to Plan for a Spouse

Proper planning can significantly reduce federal and state gift and /or estate taxes. To appreciate how this can best be accomplished, it is important to understand some basic tax concepts.

The Unlimited Marital Deduction

In 1981, the unlimited marital deduction was added to the gift and estate tax law. This deduction treats married couples as a single unit, allowing spouses to make transfers to each other gift an estate tax free. With this marital deduction, no estate tax is imposed upon an estate, regardless of its size, until the death of the surviving spouse. Thus it is not an avoidance of the tax, but a deferral. The transferee spouse must be a citizen of the United States to make complete use this deduction.

The Annual Gifting Exclusion

Under federal law, an individual can give up to \$11,000 per year to any person or persons free from any gift tax or use of the unified credit amount (see below). It is a use it or lose it exemption, and is lost if not the gift is not given by December 31 of a particular year. This gift must be one of a present interest to qualify for the exclusion.

It is wise to check state law of gifting, as state statutes may differ in their requirements regarding gifts.

The Lifetime Exemption Amount

Presently, a person can transfer to another person, other than a spouse, up to \$1,000,000 either during life or upon death without the payment of any estate tax. This exemption is called the Lifetime exemption.

In May 2001, Congress passed the "EGTRRA 2001, modifying this lifetime exemption amount, the top estate tax rates and the top gift tax rates as follows:

<u>Year</u>	<u>Estate/GSTT Exemption</u>	<u>Top Estate Rate</u>	<u>Top Gift Rates</u>
2002	\$1 Million	50%	50%
2003	\$1 Million	49%	49%
2004	\$1.5 Million	48%	48%
2005	\$1.5 Million	47%	47%
2006	\$2 Million	46%	46%
2007	\$2 Million	45%	45%
2008	\$2 Million	45%	45%
2009	\$3.5 Million	45%	45%
2010	Estate /GSTT Repealed	0%	35%

If the lifetime exemption is not properly used, it is lost. Thus, if a client transfers all of his assets to his spouse using the unlimited marital deduction, the lifetime exemption is cannot thereafter be used, subjecting all the assets given to the surviving spouse to tax upon the survivor's death. (Remember, the unlimited marital deduction only defers the tax, does not avoid the tax).

After 2010, there will be a modified carryover basis plan. An estate will be permitted to have an asset base of \$1.3 million that will be stepped up to fair market value. Transfers to a spouse will entitle the spouse to an additional stepped-up basis of \$3 million. This basis step-up will be allocable to specific assets within the estate.

It should be noted that there is a sunset provision to the repeal of the estate tax. It is possible that that if Congress does not affirmatively vote to retain the repeal, the imposition of estate tax will be automatically reinstated after 2010 pursuant to the laws as they existed before the enactment of EGTRRA 2001.

Gift Tax Rates

As can be seen from the above table, the gift tax rates remain uniform with the estate tax rates until the estate tax is repealed in the year 2010. In 2010, the gift tax rate will mirror the then existing top income tax rate, which under the new law will be 35% in that year. This retention is for the purpose of discouraging transfers to lower income beneficiaries to minimize capital gain taxes.

Using the above techniques, a client can reduce federal gift and estate taxes while giving a surviving spouse use and access to all of the property. The sections that follow address the techniques to plan using these tax benefits afforded all persons (subject to the U.S. citizen rules) under to Internal Revenue Code.

Non-Tax Reasons to Plan for a Spouse

Taxes aside, there are many non-tax reasons to plan for a spouse. Proper planning can afford the following benefits for a spouse.

Avoidance of Death Probate

The use of trusts in planning can avoid a probate at the death of both the first spouse to die and upon the death of the surviving spouse. The avoidance of probate provides privacy, efficiency and saves in probate costs and fees.

Avoidance of Living Probate

The use of trusts in planning can avoid a living probate, also known as a guardianship or conservatorship, if the surviving spouse is unable to manage his or her financial affairs. The avoidance of living probate provides privacy, efficiency and saves in probate costs and fees.

Creditor Protection

A properly structured trust drafted for the surviving spouse will protect the assets within the trust from creditor claims of the spouse. The trust must be crafted to insure the spouse would not have too much control over the assets. This drafting generally uses ascertainable standards for distribution and either no power of appointment or a limited power of appointment held by the spouse.

Remarriage Protection

For those clients concerned by a subsequent remarriage by the surviving spouse, a remarriage clause can be placed into the trust documents, limiting the spouse's access to the trust assets in the event of his or her remarriage, or in some cases in the event of his or her cohabitation with a person of the opposite sex.

Control over Ultimate Distribution

If a client wishes to have control over the distribution of the assets upon the death of the surviving spouse, a general power of appointment over the assets will not be given to the surviving spouse. Thus the spouse has the ability to use the assets during life, but upon his or her death, the remaining assets in the trust are distributed by the trustee pursuant to the client's instructions. When using the unlimited marital deduction, this type of trust is known as a qualified terminal interest property trust, also known as a QTIP. This type of trust is described in greater detail below.

Utilization of the Lifetime Exemption and the Unlimited Marital Deduction

The majority of married clients plan by creating a joint revocable living trust or two separate revocable living trusts to hold their assets during life. Upon the first death, the assets of the decedent are then transferred pursuant to the instructions of his/her revocable living trust into

two irrevocable subtrusts, one to hold the lifetime exemption property and the other to hold the unlimited marital deduction property. The trust funded with the lifetime exemption property is often called the family trust, the “B” trust, the credit shelter trust or the bypass trust. In this outline, it will be called the family trust. A sufficient amount of the decedent’s assets are carved from his/her estate to fund the family trust from the decedent’s then remaining lifetime exemption. We say “the then remaining balance” because some or all of this exemption amount may be used during life. After determining the amount to be transferred into the family trust, the remaining balance of the decedent’s property is transferred into the marital trust and qualifies for the unlimited marital deduction. Thus there is no estate tax upon the first death regardless of the size of the estate.

The Family Trust

This trust funded with the lifetime exemption amount may or may not be made available for use and benefit of the surviving spouse. Generally our clients name the spouse as beneficiary of this trust with or without naming other beneficiaries. The client has great flexibility over this trust, in both distribution scheme and termination of the spouse’s interest before his or her death, based upon any number of factors, including remarriage. The surviving spouse may not have discretion in the distribution of income or principal of the trust and may not have a general power of appointment upon his or her death. This limitation on the spouse’s powers over the trust keeps it out of his or her estate upon death. All the appreciation within the trust is also free from taxation upon the death of the surviving spouse. If the trust distribution scheme is subject to ascertainable standards, the surviving spouse may be the trustee of the trust.

The client has many options as to who is the beneficiary of the family trust, and has the right to exclude the spouse completely. Often clients name both the spouse and children as beneficiaries, giving the trustee the power to “spray or sprinkle” income and/or principal to the named beneficiaries. If desired, the trust document may say that the spouse is to be given primary consideration when making distributions. The spouse may be the only named beneficiary of the family trust.

The Marital Trust

The marital trust is funded with the remaining balance of the decedent’s assets. These assets will be included in the surviving spouse’s estate upon his/her death and will be subject to estate tax at that time. The only permissible beneficiary of the marital trust is the spouse, and the trust must specify two important conditions: 1) the spouse is entitled to all of the income of the trust, which must be paid to the spouse at least annually and 2) the spouse must be entitled to convert non-income producing property into income producing property.

Once those conditions are satisfied, the client has numerous options when planning how the spouse may access and use the assets in the marital trust. The most flexible option is to allow the spouse to withdraw principal whenever the spouse wants to make a withdrawal. Thus the spouse has the right to deplete the trust of its assets at any time. In addition, the spouse can have a general power of appointment over the trust. That means

the spouse has the power to direct where the assets will be distributed upon his/her death, and may have them go to anyone or any entity he or she desires. This would include giving the assets to a new spouse and the ability to disinherit the children or other loved ones of the client. If the client desires more control of the assets than with these provisions, a QTIP trust, as described below, should be considered.

The Qualified Terminal Interest Trust—A Special Type of Marital Trust

A qualified terminal interest trust, also known as a “QTIP” trust, is a type of marital trust allowed in the Internal Revenue Code. It allows the use of the unlimited marital deduction while providing a spouse with full rights to the income of the trust and limited rights to the principal or the direction of the assets upon the death of the spouse. An examination of the QTIP’s name reveals a lot about what it does. “Qualified” means that the assets fall within the marital deduction rules and qualify for the unlimited marital deduction. “Terminal interest” means that the surviving spouse’s interest will terminate upon his/her death. The trust document, not the surviving spouse, will dictate who receives the assets upon the surviving spouse’s death. This feature ensures that the client’s intended heirs, usually the children, are protected. If a surviving spouse remarries, a provision can be included to preclude the spouse from the principal of the trust. Just as with the more flexible marital trust, the surviving spouse must have a right to all the income and must be able to convert non-income producing property into income producing property.

The specific terms of a QTIP trust may include the following:

- Pay all of the income to my surviving spouse for the rest of his or her lifetime.
- My trustee has the discretion to make the principal available to my surviving spouse if my spouse needs it for health, education, maintenance and support. (These four words are known as the “ascertainable standards” under the Internal Revenue Code).
- If my spouse remarries or cohabitates with a person of the opposite sex, he or she will continue to receive the income from the trust, but will lose all right to principal during the period of the remarriage.
- If my spouse is no longer remarried, due to divorce or death, he or she is again entitled to principal in the trustee’s discretion for health, education, maintenance and support.
- On my spouse’s subsequent death, my children will receive the trust property remaining in the trust in equal shares.

The last bullet is giving the spouse no power of appointment, or ability to direct the trust assets to beneficiaries upon his or her death. An alternative to this approach is to give the surviving spouse a limited power of appointment to a certain class of beneficiaries. With

this directive, the surviving spouse has the power to direct the distribution of the trust assets only to certain people or entities specifically mandated by the client. Such a direction may include the following:

- My spouse has the limited power to appoint the property remaining in this trust to my children, in equal or unequal shares, and/or to any charitable organization deemed to be a qualified charitable organization under the Internal Revenue Code.

QTIPs are frequently used in second marriages. In the classic example, the client desires to take care of his spouse by remarriage, but also wants to ensure that the children from his/her first marriage will ultimately inherit the assets of the trust. The QTIP will achieve the planning objectives of the client.

QTIPs are wonderful creditor protection trusts. Because the surviving spouse does not have unfettered access to the trust assets, a creditor of the spouse is unable to attach the assets of the trust. If a client has creditor protection as a planning goal, a QTIP trust for the surviving spouse should always be considered.

The Lifetime QTIP Trust

The discussions above regarding the family trust, the marital trust and the QTIP trust assume that the client created those subtrusts in his/her trust or will documents, to become effective upon the death of the client. Thus they are deemed to be testamentary trusts. Clients may also utilize the benefits of a QTIP trust during life by using the gift tax unlimited marital deduction. Generally, for a gift to a spouse not to be subject to the gift tax, it must be a gift with no strings attached. However, there is an exception to this rule wherein a donor spouse may make a gift to a donee spouse into a lifetime QTIP trust. The donee spouse has the use and benefit of the trust but he or she has less than complete control of the assets of the trust. These trusts are generally used when one spouse has the majority of the assets and there is a desire to equalize the asset base or a desire to give the “poorer” spouse sufficient assets to fully utilize the lifetime exemption upon the spouse’s death.

The lifetime QTIP trust is similar to the testamentary QTIP trust in that the minimum rights which the trust must provide to the donee spouse are that the spouse, and only the spouse, is entitled to all the trust income, at least annually. The donee spouse must have the right to require the trustee to make the property income producing property. The donor spouse may specify to whom the trust property can be distributed upon the death of the donee spouse, and it may include the donor spouse as a beneficiary if properly drafted.

The property given to the trust is considered a gift to the spouse, so it will be excluded from the donor spouse’s estate and included in the donee spouse’s estate. Thus the donee spouse’s lifetime exemption amount will be applied to this property as well as any other property he or she owns. This maximizes the lifetime exemptions of both spouses, regardless of which spouse is the first to die.

Two considerations must be given to lifetime QTIP planning. This trust must last for the lifetime of the donee spouse. In the event the parties divorce, the trust continues in full force for such spouse's benefit. Thus a lifetime QTIP is often only created when the marriage is of long duration or in marriages with large estates, where only a small fraction of the total estate is transferred into the lifetime QTIP trust. Secondly, a lifetime QTIP cannot be used for the benefit of a noncitizen spouse with the use of the gift tax unlimited marital deduction.

Conclusion

As you can see there are a myriad of different planning opportunities that can be used to take care of one's spouse. In order to ascertain which strategy is best for your particular situation, we recommend that you meet with your estate planning advisor and discuss the issues relevant to your particular situation. Following this conference, your legal advisor should be in a much better position to recommend which strategy or combination of strategies is right for you.