POST-MORTEM ESTATE PLANNING: DISCLAIMERS, ELECTIONS, AND OTHER TAX CONSIDERATIONS IN ESTATE ADMINISTRATION

by
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Despite the historically high basic exclusion amount ("estate tax credit"), many taxpayers are still concerned about post-mortem planning issues related to matters other than the estate tax. For example, baby boomers who are inheriting assets from their parents may wish to transfer wealth to their children, especially if the assets will produce taxable income (e.g., IRAs). The surviving spouse of a decedent may not have a credit shelter trust to preserve the deceased spouse's unused exclusion amount, and may be faced with electing portability on the deceased spouse's estate tax return (Form 706). Even during the difficult time when family and loved ones are grieving, consideration should be given to post-mortem planning. The purpose of this material is to provide a brief overview of some items to consider.

I. <u>DISCLAIMERS</u>: Dad dies and leaves his estate to Son, who is well off and has a taxable estate of his own. Son does not want to accept some of the assets in Dad's estate, but already makes taxable gifts to his daughter, Granddaughter, and does not want to make a taxable gift of Dad's estate. What can Son do to make a non-taxable transfer of Dad's estate to Granddaughter? He might consider a qualified disclaimer. What if one of the assets in Dad's estate is an IRA?

A. <u>FEDERAL REQUIREMENTS</u>: Federal requirements for a qualified disclaimer are outlined in IRC §2518(b).

In general, a qualified disclaimer must be:

* Irrevocable
* Written
* Delivered to the appropriate person
* Within nine (9) months of death
* Transferee must not have accepted any benefit or interest
* Transferee must not direct where disclaimed interest passes
* Disclaimed interest must pass to someone other than disclaiming party (unless spouse)

If a disclaimed asset is not a "qualified" disclaimer under §2518(b), it is generally treated as a taxable gift under §2503.

B. <u>STATE REQUIREMENTS</u>: The requirements listed above are for federal purposes only, and it is imperative that applicable state laws be reviewed to determine whether or not the state may have additional or different statutory requirements for a qualified disclaimer.

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C. SPECIAL CONSIDERATIONS:

i. **IRAs: Qualified Retirement Accounts: A Beneficiary Can Disclaim Retirement Plan Assets.**

a. Partial Disclaimers. In some cases, a beneficiary can disclaim a portion of the retirement benefits. However, the partial disclaimer must meet certain requirements. For example, a beneficiary can generally disclaim a fraction of a benefit if the plan permits.

b. Disclaimers Can be by Formula. For example, a beneficiary can disclaim the amount of the benefit that exceeds the decedent's applicable exclusion amount (or "estate tax credit" equivalent amount).

c. Contingent Beneficiaries Should be Named. If a contingent beneficiary is named, then the contingent beneficiary becomes the designated beneficiary after a disclaimer.

ii. September 30 Deadline: (of year following year of death) for determining "designated beneficiary".

a. Disclaimers must comply with federal and state law.

b. Can Still Cash Out (by September 30 of year following year of death)

c. Determine Designated Beneficiaries by September 30 following year of death, but can divide IRA (if allowed) later (up until December 31 of year following year of death).

II. ELECTIONS:

A. PORTABILITY: COMPARING PORTABILITY VERSUS TRADITIONAL CREDIT SHELTER TRUST PLANNING. General Overview: Portability is available to decedents who were married at death, and who died in or after 2011. "DSUE" is the last deceased spouse's unused exclusion amount, which may be used by the surviving spouse (even if he or she remarries, so long as his or her new spouse has not yet died). Surprisingly, remarriage alone does not negate the DSUE. Only the new spouse's death will "undue" the surviving spouse's unused DSUE. Reg. §20.2010-(d)(5).

In order to elect portability, an estate tax return (Form 706) must be filed. **Advisors should always consider recommending that a surviving spouse file a return, regardless of the size of the estate**. The surviving spouse may marry a second spouse who has a large estate of his/her own. At that point, the question may be raised as to why a return was not filed, preserving portability.

However, the question arises as to who will be responsible for paying for the estate tax return. If the personal representative is someone other than the spouse, can the spouse force the personal representative to file? *In re Matter of the Estate of Anne S. Vose v. Lee*, ___ P.3d ___, 2017 WL 167587 (Okla. 2017), an Oklahoma Supreme Court case which discusses this question is discussed in more detail below, in these materials.

Miscellaneous Considerations: GST exemption is not portable. DSUE is fixed at the year of the deceased spouse's death, and is not indexed for inflation. Therefore, DSUE does not "cover" growth and appreciation of the assets, and does afford GST planning.

B. BENEFITS OF TRADITIONAL PLANNING: Benefits of a Traditional B Trust/Credit Shelter Trust Over Relying on Portability: Before portability, most married individuals left the estate tax-exempt amount to a Credit Shelter Trust so that the assets would be available for the benefit of the surviving spouse but would not be included in the surviving spouse's estate for estate tax purposes. While portability eliminated the need for a Credit Shelter Trust for this particular estate tax purpose, there are still a number of other benefits to including a Credit Shelter Trust in an estate plan.

For example, since portability is not indexed for inflation, the Credit Shelter Trust can protect not only the exempt amount, but also the asset's growth and appreciation during the surviving spouse's lifetime. The Credit Shelter Trust also typically provides asset/creditor protection for the deceased spouse's assets, so that if the surviving spouse remarries, he or she cannot gift the deceased spouse's assets in the Credit Shelter Trust to the new spouse. Also, the assets will preserve any GST exemption allocated to the Credit Shelter Trust, including growth and appreciation. This means that the assets, including growth and appreciation, will "skip" the estate taxes at the death of the child, and pass transfer tax free to the grandchildren or more remote beneficiaries.

Another important non-tax related reason for using a Credit Shelter Trust might be to provide fiduciary oversight. If the surviving spouse has poor financial investment skills, or is simply disinterested, the Trustee can provide proper management. Similarly, the assets can be protected from other creditors and predators (e.g., a spendthrift child, "service provider", neighbor, charity, etc.).

C. BENEFITS OF PORTABILITY: Benefits of Relying on Portability and Not Using the Credit Shelter Trust: Many clients prefer to not use a Credit Shelter Trust now, because of the complexity and professional fees related to maintaining an irrevocable trust after a grantor dies. In addition to simplicity of administration, another advantage of relying on portability and foregoing the Credit Shelter Trust is the stepped-up basis that will occur (under current law) for assets owned by the surviving spouse individually, for income tax purposes (Code Section 1014(a)(1)). In other words, the basis in all assets the surviving spouse owns (other than certain assets such as qualified retirement accounts), will receive a new basis equal to the date of death value when the surviving spouse dies. If the assets are instead owned by the Credit Shelter Trust, there will be no stepped-up basis at the surviving spouse's death. When the assets are later sold, there may well be a significant income tax cost.

It is perhaps important to note that limiting or eliminating the stepped-up basis has been an item Congress has discussed in the past for purposes of raising revenue.

Another benefit of relying on portability applies to retirement accounts. Under current law, when a decedent leaves retirement benefits to a surviving spouse, the surviving spouse can take advantage of the income tax benefits of the rollover provisions under IRC §§ 402(c) and 408(d)(3)(A). These provisions allow eligible distributions from a qualified retirement plan or IRA that are paid into an IRA for the benefit of the surviving spouse of the qualified retirement plan participant or IRA owner within sixty days of the distribution date (a "spousal rollover") to be excluded from gross income under IRC § 72. Such spousal rollovers are very important, because they allow the surviving spouse to take distributions over his or her own life expectancy, redetermined annually using the Uniform Table, and also to name his or her own beneficiary, who in turn can take distributions over that beneficiary's life expectancy.

By electing portability, the surviving spouse can receive the benefit of the DSUE amount and also take advantage of the income tax benefits of the rollover.. The surviving spouse might also convert the traditional IRA later to a Roth IRA, which might result in income tax planning opportunities that outweigh the fact that portability is not indexed for inflation and is not available for purposes of the GST tax.

There are situations, however, where leaving all of the retirement benefits outright to the spouse may not be appropriate. For example, in a second marriage situation, or where the surviving spouse is a spendthrift, use of a trust can provide security to the decedent that his retirement assets will be protected and held for his intended beneficiaries.

To summarize, even clients with estates below the exclusion amount need to consider the benefits and disadvantages of electing portability versus using a Credit

Shelter Trust when establishing an estate plan. The Credit Shelter Trust allows for control over the assets and their ultimate distribution, asset protection and spendthrift protection, the guaranteed use of both spouse's exemptions and protection from transfer tax on the growth and appreciation of the assets. However, portability allows for a step up in basis of appreciated assets, lower income tax rates and the benefit of the use of the DSUE amount (the deceased spouse's unused exclusion amount)..

D. <u>FIDUCIARY DUTY TO ELECT PORTABILITY? Vose Case:</u> State courts may be called upon to determine whether or not a surviving spouse has the right to elect portability when the first spouse dies. See for example, *Estate of Anne S. Vose v. Lee*, ___ P.3d ___, 2017 WL 167587 (Okla. 2017). In *Vose*, the Supreme Court of Oklahoma held that the Personal Representative had to make a portability election, despite the fact that the decedent and her spouse had entered into a premarital agreement wherein her spouse waived all rights to decedent's spouse.

The Court in this case provided that the Personal Representative had a fiduciary duty to safeguard the decedent's spouse's interest in the DSUE. In essence, the Court here treated DSUE as an asset of the estate.

III. <u>OTHER CONSIDERATIONS</u>:

A. <u>AMENDING/REVOKING THE IRREVOCABLE TRUST</u>

i. <u>Is it possible to revoke or amend an "irrevocable trust"? If so, under what authority is it possible?</u> Please note: For purposes of this section, the citations are to New Mexico's Uniform Trust Code. However, in most instances New Mexico's adoption of the Uniform Trust Code is similar to the statutes that the Uniform Law Commissioners have proposed (and thus may be similar to many states' laws).

a. <u>Historically: Beneficiaries' Consent or Changed Circumstances.</u>

Historically, irrevocable trusts could be amended if (i) all of the beneficiaries consented to the modification, if the modification did not change a material purpose of the settlor or (ii) there were changed circumstances that were not anticipated by the settlor that would impair or defeat the purposes of the trust (the equitable deviation doctrine) (see, e.g., Wills, Trusts, and Estates, Dukeminer and Sitkoff, Ninth Edition, 2013, p.717, et. seq.). In general, both case law and statutory provisions provide more discretion for modification of administrative provisions of a trust agreement rather than the dispositive terms of a trust agreement (which by definition presumably reflect the settlor's intentions in establishing the trust to begin with).

b. <u>Beneficiaries' Consent: Not Enough if Proposed Change Violates a Material Purpose.</u>

The Claflin Doctrine (Claflin v. Claflin, 20 N.E. 454 (Mass.1889)) provides that even with all of the beneficiaries' consents, a trust cannot be modified if it would be contrary to a material purpose of the settlor. Similarly, beneficiaries cannot compel a modification or termination if it would be contrary to a material purpose of the settlor.

What is a material purpose? As provided in the highly regarded Dukeminer and Sitkoff text (cited above, p. 719), generally, a trust cannot be terminated if (i) it is a spendthrift trust; (ii) the trust delays distribution of the principal to the beneficiary until a stated age, date, or event (iii) distributions are at the discretion of the Trustee; or (iv) is a support trust.

B. <u>Uniform Trust Code</u>. The common law of trusts and principles of equity supplement the Uniform Trust Code ("UTC") except to the extent specifically modified by statute (see §46A-1-106). With respect to modification of trusts, the UTC closely follows the common law, as above described. Specifically, pursuant to the UTC, the court has wide discretion to modify or terminate a trust, so long as the settlor is available and the settlor and all beneficiaries consent. If the settlor is not available, the court may modify a trust so long as the modification does not violate a material purpose of the trust. A "Nonjudicial Settlement Agreement" is also available in some instances.

i. <u>Beneficiaries and Settlor All Consent Modification or Termination Allowed, Even if Against a Material Purpose of Trust</u>: The Uniform Trust Code §411 (2000, rev. 2004) (§46A-4-411(A) NMSA 1978) ("Modification or Termination of Noncharitable Irrevocable Trust by Consent") provides that a noncharitable irrevocable trust may be modified or terminated upon the consent of the settlor and all beneficiaries, even if the change is inconsistent with a material purpose of the trust, with court approval. The Settlor must be alive and available (or a substitute agent, such as an agent specifically authorized on a Power of Attorney, or a conservator specifically authorized by the court) to consent.

ii. <u>Court Concludes the Trust is No Longer Necessary to Achieve a Material Purpose of the Trust</u>. The court may *terminate* a non-charitable trust if it determines that it is no longer necessary to achieve ANY material purpose of the trust (emphasis added §46A-4-411(B)). The court may *modify* a non-charitable irrevocable trust upon the consent of all beneficiaries (but settlor not required), if the court concludes that modification is not inconsistent with a material purpose of the trust.

iii. <u>Is Spendthrift Protection a "Material Purpose" for the Creation of a Trust?</u> Interestingly, New Mexico statutes deviate from the UTC and provide that a spendthrift provision is not presumed to constitute either a material or immaterial provision of the trust. §46A-4-411C NMSA 1978). The UTC draft language provides that spendthrift provision is not presumed to create a material purpose of the trust. New Mexico's adaption appears to give the discretion to the Court to determine whether or not the settlor intended the spendthrift provision to be a material reason for the use of the trust.

iv. <u>Unanticipated Circumstances or Inability to Administer Trust Effectively</u>. Section 46A-4-412 authorizes the Court to modify the administrative or dispositive terms of a trust if there is clear and convincing evidence that there are circumstances not anticipated by the settlor and the modification or termination will further the purposes of the trust.

- Administrative OR Dispositive Modifications
- Clear and convincing evidence
- Circumstances not anticipated by settlor
- Modification will further purposes of the trust
- Court order

v. <u>Administrative Terms</u>. The court may modify the administrative terms of a trust if continuation of the trust as it exists would be impracticable or wasteful or impair the trust's administration. §46A-4-412.

vi. <u>Tax Objectives</u>. The court may modify the terms of a trust that is not contrary to the settlor's probable intention of necessary to achieve the settlor's tax objective. §46A-4-416. The modification may be retroactive. (Query: Is the IRS obligated to honor the modification? What if it was not a contested matter heard by the highest state court?)

vii. <u>Nonjudicial Settlement Agreement</u>. Section 46A-1-111 also allows interested parties to enter into a nonjudicial settlement agreement in some instances. Specifically, "qualified beneficiaries" need to consent (a distributee or permissible distributee of income or principal, and one who would be the next permissible distributee if the current interest terminated) (§46A-1-103)

The Nonjudicial Settlement Agreement may not violate a material purpose of the trust, and is valid only to the extent it only includes terms and conditions that could be properly approved by the court pursuant to the UTC and applicable law. (§46A-1-111).

Pursuant to §46A-1-111 (NMSA 1978) Nonjudicial Settlement Agreements may address:

- Interpretation or construction of the terms of the trust agreement
- Approval of Trustee's Report or Accounting
- Direction to a Trustee to refrain from performing a particular act or grant to a Trustee of a desirable power
- Resignation or appointment of a Trustee and the determination of the Trustee's compensation
- Transfer of a trust's principal place of administration;
- Liability of a Trustee for an action relating to a Trust.

Any interested party may request court approval for a Nonjudicial Settlement Agreement. §46A-1-111.

Query: In what ways and to what extent can a trust be modified under (i) the common law, and/or (ii) the UTC that differ from the Uniform Decanting Statute?

How would the practitioner approach a modification that is deemed to be "dispositive" differently from a modification that is deemed to be "administrative"? Does the answer to this question help frame whether or not a change affects a "material purpose" or might be due to an unanticipated circumstance?

How would your advice differ about trust modification or termination if you were representing a fiduciary or a beneficiary?

IV. <u>CONCLUSION.</u> Even though the basic exclusion amount (or "estate tax credit" amount) is currently $5,490,000 per taxpayer (with portability available for the surviving spouse), careful attention must still be paid to post-mortem planning. This includes considering disclaimers, elections, and judicial and non-judicial modification in some instances.

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