THE MARING LAW FIRM
ATTORNEYS AT LAW
456 MONTGOMERY STREET
Suite 1300
SAN FRANCISCO, CALIFORNIA 94104

HARRY B. MARING
Attorney at Law
Principal

TELEPHONE: (415) 989-8406
FACSIMILE: (415) 989-8409
E-MAIL: Hmaring@maringlawfirm.com

SAN FRANCISCO PARALEGAL ASSOCIATION

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Estate Planning for the Blended Family

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Family Fact Pattern

HARVEY - 65 WYNONA - 45

Joint Children
Sean - 5
Sally - 2

Children From Prior Relationships

Charles - 45
Charlotte - 42
Chris - 40

Fannie - 15

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INTRODUCTION

Estate planners have heard it before:

> (1) The children of the blended family cry - "That" woman stole my daddy's money!!! or "Biff the Body Builder is taking my mother to the cleaners!!!"; or,
>
> (2) The greedy child wails - "I want my money and I want it NOW!"; or,

It all leads to the same place - people with unmet expectations are mad and they want to sue somebody.

Anticipation of litigation

There is a presumption that there will be tension among family members which may lead to litigation. While it does not occur in every situation, the prevailing air of anticipated, if not real, animosity certainly establishes the environment where we need to plan as if litigation will in fact occur.

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Conflict of Interest for professional advisors

We, as planners, need to recognize that with this hostility, we may have a professional conflict of interest when representing multiple parties with different agendas. While the attorney needs to have a signed written agreement waiving any real or potential conflicts of interest, the Estate planner needs to think about disclosure of risks to each party.

Basic Family Patterns

As a general proposition, estate planning clients typically come in 5 groups:

TRADITIONAL: This is usually a homogenous, one marriage couple with joint children. It could be a long term second marriage with all children being adopted and no children from a prior marriage that have not been adopted. In most cases, this is the most simple family to plan for.

BLENDED: This is usually the older/younger spouse scenario where the younger spouse is the same age as the children from the older spouse's prior marriage. There is conflict between spouses because of a typical property and wealth differential or conflict between the second spouse and children from the prior marriage. The older spouse could also have conflict with his/her own kids who resent the second spouse.

NONTRADITIONAL: This typically is a same sex couple that are either (1) co-habiting, (2) a registered domestic partnership or (3) married under California or another state's or country's laws which is recognized in California. It could be a conflict similar to the blended family and also, conflict from each partner's family who do not support the relationship. This could also include co-habiting heterosexual couples since certain federal tax benefits and deductions do not apply to co-habiting heterosexual couples.

NOTE: With Windsor v. United States, 570 U.S. _______, (2013), 133 S. Ct. 2675, 186 L. Ed. 2d 808, Hollingsworth v. Perry , 570 U.S. (2013), 133 S. Ct. 2652, 186 L. Ed. 2d 768, and Obergefell V. Hodges 576 U.S. ______(2015), we now have same sex marriages treated on a par with heterosexual marriages.

DYSFUNCTIONAL: This could be a traditional, blended or nontraditional family that has one or more children who are at odds with the family, the parents or the siblings or the child is at odds with himself/herself - nothing will please him or her.

SINGLE: This could be a single person who has no children and has never been married, who has a few specific bequests but generally leaves his/her estate to siblings, nieces, nephews, friends and charity. Or it could be a single person with a prior spouse or partner with children which may put him/her in the blended, dysfunctional or nontraditional group. Since this client has substantial crossover issues with other groups, he/she should be considered a member of the appropriate group depending upon the circumstances and will not be specifically dealt with as such in the following discussion.

In this outline, we will refer to the Dysfunctional, Blended or Nontraditional family as "a

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blended family" but will reference a specific group where appropriate.

Each group generally has its own set of unique issues but each group also has a variety of crossover issues that are common to all groups. Thus, if you are aware of the issues facing one group, you may very well see similar issues facing another group.

In all of these instances, conflict abounds and each client has a different idea of what they should be doing for each family member and each family member has a different idea of what they expect to receive from daddy and mommie. If the heirs have one idea and the client has another, the heir has unmet expectations, blames the siblings who may have exercised undue influence over the parents and wants to sue. Or worse, the heir attacks the lawyer, accountant, or financial advisor.

The point is to anticipate the areas and points of litigation, plan and draft around them, communicate these issues to the client and encourage them to communicate with their heirs. Additionally, plain old, vanilla drafting may inadvertently create problems that would not normally arise in the traditional family context where most kids assume that the surviving spouse will have use of all of the assets for their lifetime and then on the second death, the kids get their share. In the blended family, these are not the normal expectations and thus, when an heir doesn't get what they think should be coming to them - boom!

PSYCHOLOGIES OF THE PLAYERS

Fundamental reasons that these conflicts occur include:

Poor or no communication.

Many people do not like to think about their mortality - stop for a second...do you think about what will happen if/when you die?

Parents do not want to share their thoughts with their children.

Parents do not want to share their assets while they are still living - Parents are scared that they will run out of money and may have to ask their kids for money to support themselves.

Parents do not think their kids can manage property - Parents think kids act the same way they acted when the child was 3...The parents always remember the time when you did...(something really stupid)?

Or, the parents do not want the child's spouse to have access to the money.

Children of wealthy parents think they deserve it now - the children grew up with all of the benefits, privileges and standard of living bestowed on them by their well to do parents and now that they are on their own, they feel entitled to the same benefits regardless of whether they are earning that level of support or not.

Siblings feel that Mom & Dad treated them differently during lifetime and there is

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lingering animosity between the kids, particularly in unequal distribution scenarios such as one child getting more that the others, the family business going to one child or one child feeling like they should have gotten a particular asset and did not get it.

TANGIBLE PERSONAL PROPERTY - your “stuff” - If you don’t specify who gets the jewelry, furniture and yes, even the knick knacks, sibling rivalry will end in a fight.

Families do not accept nontraditional couples.

Kids resent new spouse - that woman stole daddy’s money.

Misunderstanding or lack of knowledge of what is community property under California law - once you get married, everything you owned before marriage does not automatically become community property.

Your personal touch

Our best tools are our own experiences - think about your own family and personal relationships, the conflicts that exist, what caused the conflicts and how you have resolved these conflicts or avoided the issue. What was the real issue in the last argument that you had with your parents, your spouse or significant other, your children, your siblings, your friends - from your perspective, what was really going on?

Once you can really articulate how you feel about something, you can then see how effective your communication skills are and then be able to appreciate, see or anticipate your client’s perspective.

Finally, keep in mind that in some of the discussions that follow, both clients, husband and wife, are in the same room at the same time...the advisor must understand the sensitive nature of the discussion regarding death, taxes, unequal wealth, support, inheritance, family relations and dynamics, and be attuned to the individual needs of each client while still maintaining a position of objectivity and clarity of thought.

Draw on your own personal experiences.

OVERALL THOUGHTS TO KEEP IN MIND

Remember that the second spouse could very well be the same age as the children from the first marriage.

Remember that the children of the second marriage could be the same age as the grandchildren of the first marriage.

In the traditional family estate plan, we usually have the surviving spouse enjoying the money for his or her lifetime either outright or in a bypass/QTIP arrangement, and then upon their death, the kids from the traditional marriage get the assets.

With the basic blended family situation, we will assume that the moneyed spouse wants to provide for the surviving spouse during his or her lifetime and upon the second

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death, the assets are divided partially (or all) to children of the first marriage and/or children of the second marriage.

Thus, if this is the case, we will normally be providing for the establishment of two trusts upon the first death, the bypass trust and the QTIP marital trust.

Thus, we will usually have the three trust (Bypass, QTIP and Survivor's) arrangement as our starting construct.

ZERO TAX MARITAL DEDUCTION FORMULA

Once we know that we are going to establish a bypass share and a marital deduction share, we will want to normally achieve a zero estate tax on the death of the first spouse.

But, how does the document actually accomplish this and what are the pitfalls surrounding this?

We want to make sure that we have zero tax on the first death but how do we actually allocate the real dollars and assets to the bypass trust and the marital share?

Let's take a $12 million estate that is all community property – each spouse has an estate of $6 million. Assuming that we have a revocable trust, the decedent's share of the estate is being divided into the bypass share and the marital deduction share and the surviving spouse's share is going to the survivor's trust.

And assume a $5M exclusion amount (it is actually $5,450,000 for 2016 and $5,490,000 for 2017).

If the bypass exclusion amount is $5M, on the first death, our trust language could say that 5/6 of the estate goes to the bypass and 1/6 goes to the marital share. That may work if the value of the estate does not fluctuate. If we did say 5/6 and 1/6 and when the first to die passes away, suppose the estate has grown to $7 million. 5/6 of $7 million is $5,833,333 and since we can only put $5 million in the bypass trust tax free, we have over funded the bypass by $833,333 and created a tax on the first death - not good.

Alternatively, we could say that a specific asset goes to the bypass share and another asset goes to the marital share or say that $X dollars goes to the bypass and $Y dollars goes to the marital share but again, if values fluctuate or the asset is not in the estate at the time of death, those allocations may not give us a zero tax result.

So, we must come up with a way to create a zero tax - and the only way to do that is with a formula, .i.e., a zero - tax formula.

While some practitioners avoid this issue by just picking a form that contains a marital deduction formula clause and just going with it, the choice of formula can have a real impact on the beneficiaries.

Thus, the choice of which zero tax formula to use presents itself in EVERY estate plan involving a married couple where you will be setting up a bypass share and a marital share.

Then, once the formula is determined, we must decide which method to use in actually valuing and transferring the assets to the various trusts. This is called the funding method.

Also remember that we are talking with a client today who may die in 10 or 20 years and his/her asset values may fluctuate wildly in that period of time. Additionally, we are talking about increases or decreases during the period of administration - if you have a short administration period, the problems are very limited. But with a long administration period because of difficult assets or litigation or other factors, and a wildly fluctuating marketplace, the problems get exacerbated.

Zero tax formula to use - pecuniary v. fractional

With the choice of formula, the goal is to end up with a zero tax estate on the first death. We want to allocate monies to the bypass share and we want to allocate monies to the marital deduction share and after this is done, we want the decedent's estate to not pay any estate tax.

And once this allocation is done, we have to actually distribute assets to each bequest in order to fund the bequest.

So, this process has two parts, (1) allocation of assets according to the zero tax formula and (2) actual distributions of assets to fund the bequests.

Allocation according to the zero tax formula

Keep in mind that we value the estate at date of death values but when we fund the bequests, we generally must use date of distribution values. See Revenue Procedure 64-19. And when distribution occurs many months or even years after date of death, the values of the assets may have fluctuated greatly and then the issue becomes who enjoys/bears the benefits/burdens of appreciation/depreciation of assets between the date of death and the date of actual funding of the bequest?

For example, if we have a $12 million estate, all of which is community property, the decedent's assets are $6 million at date of death. If we have a $5 million applicable exclusion amount, we want to make sure that the bypass gets $5 million and the marital gets $1 million. But what happens if at the date of distribution, the total assets of the first to die have grown to $7 million? Who gets the extra $1 million? Or if the estate has decreased to $5M, who suffers the $1M loss?

And, if we have a blended family where the bypass is going to the kids of the first marriage and the marital is being held for the benefit of the surviving spouse, the allocation of the post death appreciation or depreciation has a real dollar impact on the economic benefit or detriment one of the players enjoys or suffers.

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And this allocation formula must be decided at the time the estate plan is drafted, even though it is implemented many years after the date of signing. Note that this decision must be made in drafting every estate plan for a married couple where there is a bypass bequest – do you want the bypass to be the pecuniary bequest or do you want the marital to be the pecuniary bequest? And note that whichever bequest is the pecuniary bequest, then the other bequest is the residual bequest.

Pecuniary formula

Pecuniary means fixed dollar amount.

The formula that we use designates one share as the pecuniary share - a specified dollar value that is fixed and determined based on date of death values. It never fluctuates in value - it will always be this dollar amount.

The other share is the residual share which fluctuates in value from date of death to date of funding.

Thus, the pecuniary bequest is fixed at the time of death, is funded first and all appreciation and depreciation in assets from date of death to date of distribution is borne by the residual bequest.

We can have a pecuniary marital bequest or a pecuniary bypass trust - the key is to determine which is the pecuniary bequest – the marital or the bypass.

The pecuniary bequest insures that that bequest gets this dollar amount, no more and no less. But by doing so, since the fluctuation in value affects the residual bequest (non-pecuniary bequest), then the residual bequest could be over funded if the values rise after death or it could be under funded if the values decrease after death.

If we have a **PECUNIARY MARITAL BEQUEST**, the formula says that we give to the surviving spouse as a marital deduction, an AMOUNT which, when added to all property the spouse gets outside of the documents, is the smallest amount necessary when taking into account the applicable exclusion amount, that will reduce the deceased spouse's estate tax to zero. All other assets are paid to the bypass share. Thus, since here the fluctuation occurs to the bypass share, these are code words to say where post death appreciation and loss is allocated - to the bypass share.

With the $6M estate rising to $7M during administration, if we have a pecuniary marital formula, since the pecuniary amount is fixed at date of death values, then the extra $1M is allocated to the bypass trust. If we had a **PECUNIARY BYPASS FORMULA**, then the marital will be allocated the excess $1 million.

With the blended family, this could have a serious negative effect. The pecuniary bequest is fixed at date of death values and the residual bequest fluctuates in value, either up or down. If we have a pecuniary bypass and a residual marital and values go down substantially, this will create a reduction in the value of the marital share and will probably have a major economic impact on the surviving spouse's lifestyle. Conversely, if values go up, the kids who are the beneficiaries of the pecuniary bypass share will be

wondering why “that woman” or “Biff” got all of the appreciation in value.

In summary, in order to determine how much goes to the marital bequest and how much goes to the bypass trust, we can have a pecuniary marital bequest with a residual bypass bequest or, we can have a pecuniary bypass with a residual marital. Whichever is the pecuniary bequest has a value at date of distribution that is fixed as of date of death and the residual bequest, whether bypass or marital, is affected by fluctuations in value.

We will discuss later how you choose which formula, depending on your facts.

Funding and the capital gains tax issue

But now that we have defined the value of the decedent’s assets that goes to the pecuniary bequest and the value that goes to the residual bequest, what assets do we actually use to satisfy and fund the bequests?

This is called funding.

The main issue here is about appreciation/depreciation between the date of death and the date of funding.

This is the same appreciation or depreciation we discussed above with the zero tax formula and the pecuniary amount, but here, when we actually fund the distribution, since we have a pecuniary bequest, then we may have a capital gains tax issue on funding with appreciated assets! See Kenan v. Commissioner, 114 F.2d 217. (2nd Cir.1940).

Keep in mind that all assets in the decedent’s estate get a step up in basis to fair market value at date of death - with community property, both sides get the step up in basis.

Now suppose the pecuniary bequest is the bypass trust ($5M) and the assets we choose to fund this amount have a cost basis of fair market value at date of DEATH equal to $4M but a fair market value at date of FUNDING equal to $5M - These assets rose in value from date of death to date of funding by $1M.

If we fund the pecuniary bypass bequest with these appreciated assets that have a fair market value in excess of basis at the date of funding, the IRS treats those assets as having been sold on the day of funding and if there is any gain associated with those assets, then the estate must pay a capital gains tax. Thus, in the example in the preceding paragraph, we would have a deemed $1M capital gain on funding the pecuniary bypass trust and the residual estate would have an additional income tax liability.

If we had a pecuniary marital share and used this same asset to fund the pecuniary bequest, we would still have the same capital gains tax issue.

On the other hand, the residual bequest, be it the bypass or the marital, does not have

this capital gains tax issue on funding.

So, in a blended family context, if we have a pecuniary marital that is locked in value as of date of death and all assets have gone up in value since date of death, then the surviving spouse may be pretty angry in that he/she gets a value of assets that are fixed at date of death…but the bypass bequest is usually allocated the burden to pay any capital gains taxes that accrue and that are used to pay the pecuniary marital bequest - so the kids from the first marriage will ask why are they paying capital gains taxes on money they did not receive (appreciated assets were allocated to the marital share) even thought they did enjoy the increase in overall value to the estate by reason of it being the residual bequest.

On the other hand, if the bypass is the pecuniary bequest, then we have the reverse with the increase in value going to the marital bequest.

Actually choosing which formula

As an overall concept, it may be wise to use the pecuniary bypass when the marital amount will far exceed the bypass amount so that the bypass will be the smaller portion of the decedent's estate and therefore, attract less capital gains tax. But by picking the bypass as the pecuniary bequest, if there is vast appreciation in the assets after date of death, then that appreciation goes to the marital bequest which, if not spent, will ultimately be taxed in the surviving spouse's estate.

When the marital share is expected to be the smaller of the two, then it makes sense to have the marital as the pecuniary bequest – it will attract the least amount of capital gains on funding and all of the post death appreciation will be allocated to the residual bypass bequest which does not attract capital gains and also escapes estate taxation in both estates.

But in the blended family context, where a dollar going in one direction is a dollar not going in the other direction, the recipient of the residual bequest will naturally be thankful for the increase while the pecuniary recipient will not be happy at all - as can readily be seen, the choice of formula in the blended family context is an art, not science. And conversely, in a declining market, the recipient of the residual bequest will be upset that they bore the brunt of the decline.

But at least we now have the tools to show that we made a decision based upon knowledge of the law as applied to the facts, not just an answer like "That is the way I always do it" or "I don't know - that is what my form says"!

Ultimately, the best idea is to try to fund as soon as possible after death to minimize the capital gains tax issue and the allocation of appreciation and depreciation.

Also, check your documents to see if you have the ability to distribute in kind on a pro rata or nonprorata basis - most documents allow for this and California Probate Code 16247 provides for this as well - if your documents do provide for non-pro rata distributions, then you can pick and choose which assets go to fund which bequest and hopefully allocate assets with little or no post death appreciation to the pecuniary

bequest. This is called a pick and choose provision.

Additionally, we need to be careful with naming a trust as a beneficiary of a retirement account or IRA. If the retirement benefits are payable to a pecuniary bequest, then the IRS takes the position that it is income in respect of a decedent (IRD), it is treated as distributed and the income tax on the amount in the account is due immediately - another reason to be careful with pecuniary bequests.

On the flip side of the coin, if we have assets that go down in value from date of death to date of funding, IRC Section 267 disallows a loss deduction between related parties but the trust can make an election under IRC Section 645 to treat the trust as an estate for income tax purposes. If so, then under IRC 267(b)(13), funding a pecuniary bequest with loss assets where the trust is treated as an estate for income tax purposes allows the estate to take a deduction for the income tax loss on funding the pecuniary bequest.

One last thing: Assume that the decedent's estate was $5M at date of death and she had an exclusion of $5,450,000. The formula called for a pecuniary bypass and a residual marital. The value of the pecuniary bequest is fixed at $5M on date of death but let's say that the assets rose in value to $6M at date of funding. Assuming that you can fund the bypass with assets having a basis and fair market value of $5M so you avoid the Kenan gain but now you have an extra $1M that must go to the marital share. The first $450,000 can be sheltered from estate taxes but now you have $550,000 included in the surviving spouse's estate.

If you had picked the pecuniary marital formula, the marital bequest would have been zero and the extra $1M would have gone to the bypass share and you would have avoided this problem.

Fractional share formula

Now, all of the gyrations above may be a bit more than the planner wants to deal with.

Instead of using the pecuniary formula, the planner has the ability to use what is called the fractional share formula in order to achieve a zero tax estate.

The fractional share formula requires that the bypass share and the martial deduction share each have a proportional fractional interest in each asset to which the formula applies.

While that treats each bequest equitably, it can also create undivided interests in non-readily marketable assets (e.g., real estate, closely held stock).

In a blended family context, that could be disastrous - the family home, for example could be partially owned by the spouse and partially owned by the children from the first marriage!

The usual formula will say to distribute assets based upon a fraction, the numerator of which is the exemption amount and the denominator is the total estate. Or, the numerator is the marital bequest and the denominator is the total estate. This has

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nothing to do with the pecuniary/residual formula but still should achieve a zero estate tax.

The appreciation/deprecation, increase/decrease issues go away since each share gets a proportionate portion of the increase/decease of each asset.

Typically, each share will receive a proportional undivided interest in each and every asset and thus, the funding and capital gains tax issues mentioned with the pecuniary bequests do not exist since we do not have a true pecuniary bequest. Fractional share formulas are usually funded on date of distribution values.

The fractional share formula is more difficult to administer because if we have fluctuating values, each portion participates in realized and unrealized increases and decreases, and with distributions that may be ongoing as well as changes in tax payments, we are constantly updating values to make sure that we comply with the terms of the formula.

Normally, it is assumed that you must distribute a fraction of each and every asset to the bypass share and to the marital share but language allowing for non-prorata distributions can be inserted to give a pick and choose fractional bequest. Thus, the issue of tenants in common in a single asset between fighting parties can be avoided.

However, if you use the fraction of each and every asset, it will minimize disputes as to discretionary distributions but may result in adverse parties being co-owners of property which may be more deleterious.

As a bottom line, where you have (1) a blended family, (2) a large enough estate with enough complications that administration may take a long time and (3) assets that may have the potential for a wide swing in values from date of death to date of funding, the mere fact that the fractional formula is more difficult to administer may not overshadow the infinite fairness that it achieves with all parties in this context.

Investment objectives

From an investment perspective, with the bypass and the marital bequests, we naturally want to assess where you want to have growth assets and where you want to have income producing assets. Normally, you would want to put your growth assets in the bypass trust since these assets will not be included in the surviving spouse's estate while income producing assets may be more appropriate for the marital trust since all income must be paid out annually. That is the investment side of the equation.

However, the investment and tax analysis does not always rule in the blended family context. Where you have competing beneficiaries, each wanting to maximize their return, it may be better to try to invest for the benefit of each player, knowing that the surviving spouse has the right to demand that the assets in the marital trust be made productive.

Additionally, with a marital unitrust, as discussed below, we also remove discretion, allowing the trustee to invest for the total return of the portfolio.

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Thus, it could be said that with a factional share formula and unitrust payments to the surviving spouse, we can eliminate a lot of the litigation issues surrounding discretionary distributions.

DRAFTING AND ADMINISTRATIVE ISSUES

Drafting for the traditional, non-dysfunctional, family is fairly straightforward in that the children assume that the surviving parent will be using all of the assets and only upon the second death will the children hope to receive access to assets.

But in the blended family context, the overall theme is that the children of the first marriage and the surviving spouse are in opposing positions. Remember that with the blended family, issues similar to those found in the blended family context could also involve the Traditional, Dysfunctional, Nontraditional, and the single client.

Additionally, we need to keep in mind that the paramount rule is the intent of the parties and how the documents reflect that intent.

Spouses want each other to be taken care of and we need to look at our planning to see how it actually operates in real life. Does it take care of the surviving spouse, minor children and children from the prior marriage? How does the plan operate in real time upon the first death and until the second death? Do we have enough flexibility built into the plan as reflected by the documents to meet the current, anticipated and future needs of the parties as well as have provisions for unexpected contingencies?

Planning for children and grandchildren

We need to pay particular attention to the provisions for the children of the prior relationships of each of the parties as well as the joint children. Look at the relative ages and needs of each of them and have an honest discussion of what would happen on the first death of a parent and then on the second death and again, in reverse order.

Make sure that you consider whether a pot trust (where all of the assets are kept together in one pot which is then divided into shares upon the attainment of a certain age by the youngest child) is appropriate when considering the ages of all of the children, which could vary widely. The pot trust makes sure that all assets are available for all of the children, usually at least to get the youngest child through college. On the other hand, dividing out shares immediately on the first death for the children goes a long way in lessening the tension caused by the pot trust but then, if one child has a greater need than the others, such as a medical issue, once they run through their share, the trustee can not dip into the other shares to assist that child in need.

Grandchildren need to be considered as well, particularly where they are children of the kids from the first marriage and are very likely the same age as the client's children from their second marriage. If we continue to have a pot trust and one of the first marriage children dies and their children step in, then the remaining first children may have to wait a long time with a pot trust to see any distribution.

Spouse as Trustee

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Where the surviving spouse is the trustee and lifetime beneficiary of the bypass trust and the marital trust and the ultimate beneficiaries are people other than the surviving spouse's family, great care is necessary in order to (1) adequately provide for the surviving spouse, (2) not allow the surviving spouse to spend all of it for non-trust purposes and (3) to avoid litigation if the remaindermen (children of the first marriage who inherit after the death of the second spouse) want to sue the surviving spouse for paying out too much money to himself or herself.

Also be aware that the surviving spouse is often the same age as the children of the first marriage. If you use the typical bypass and QTIP trusts where the surviving spouse enjoys all of the assets of the bypass and the QTIP trust for life, then the children from the first marriage may very well die before the death of the second spouse. If that is the case, the children from the first marriage may never see any money from their parent's estate and thus, they will be most unhappy.

It is important to keep this in mind when you are actually looking at the mechanics of your planning to see if it makes sense from the ground level.

Bypass trust

With any trust, other than the QTIP trust, we have the choice as to whether to pay out income or not, and if we do pay out income, what determines how much is paid out. Additionally, we must also decide if the beneficiary is entitled to any distributions of principal, and if so, what guidelines do the trustee look at to determine when and how much those distributions will be.

Finally, depending upon the facts and circumstances of your particular case, if the settlor wants to be extra cautious to make sure that the beneficiary has access to at least a minium amount of money, regardless of the determination of the trustee, the trust can provide that the beneficiary is allowed to demand each year an amount equal to the greater of $5,000 or 5% of the trust corpus – this is the 5 & 5 withdrawal power under IRC Section 2041.

So let's look at the three points of distribution under the bypass trust - (1) income, (2) principal and (3) 5 & 5 - and put them into a blended family context.

Note as an aside, that the choice of trustee in the blended family context is extremely important – if the second spouse is the trustee, then we would certainly have to consider conflicts with the children of the first marriage!

As to income distributions, let's say the surviving spouse is the beneficiary. A major question is who is the trustee? If there is an independent third party trustee, then the income distribution can be:

1. all income or a unitrust payout;
2. income for health, education, maintenance and support (HEMS) or
3. income for comfort, welfare and happiness.

If the surviving spouse is the trustee, then great caution must be exercised - the point is

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for this trust to bypass the estate of the surviving spouse for estate tax purposes but still have the surviving spouse enjoy the money. So, we want to make sure that we do not have language that defeats this objective.

The issue presented is if the spouse is the trustee AND the beneficiary, does he or she possess such power over the assets in the bypass trust that the IRS will say is tantamount to outright ownership, thereby causing the assets of the bypass trust to be included in the surviving spouse's estate?

If the surviving spouse has no discretion in making distributions or there is an IRS code section that defines what distributions the surviving spouse as trustee can make to themselves, then we have succeeded in keeping the bypass trust out of the surviving spouse's estate.

On the other hand, if we give the surviving spouse too much power, then we have an estate tax disaster.

If the spouse is the trustee and the trust provides for all income or a unitrust amount, then we are O.K. since there is no discretion exercised. The spouse as trustee invests the money, the income is earned and then all income or the unitrust amount is distributed annually to the spouse, no questions asked, so to speak.

If the surviving spouse is the trustee and the beneficiary and there is any discretion as to the distribution of income or of principal, that discretion must be limited by what is known an "Ascertainable Standard" in order for the bypass trust to not be included in the surviving spouse's estate.

The Ascertainable Standard is under IRC Section 2041 and says that if a power to distribute money for the benefit of oneself as beneficiary is limited by an ascertainable standard relating to health, education, maintenance and support (HEMS), then the power is called a "limited power of appointment" and not a general power of appointment. The limited power of appointment under the HEMS standard is the IRS approved wording which keeps the assets of the bypass trust out of the surviving spouse's estate when the surviving spouse is trustee and beneficiary.

Now, on the other hand, we can also give the trustee the power to distribute assets to the beneficiary according to a standard that is broader than HEMS, such as comfort, welfare and happiness. This standard is most often seen where the settlor has appointed a very close friend or personal financial advisor as trustee and the surviving spouse is NOT the trustee at all or does not participate in any discretionary distribution decisions. Since this language is not HEMS, this is outside the IRS approved language for distribution. Here, since the trustee is distributing for the benefit of someone else, there is no risk to the trustee since they are not a beneficiary. HOWEVER, if the trustee is the surviving spouse, then this language amounts to a general power of appointment held by the surviving spouse as trustee for the benefit of themselves and causes the assets of the bypass trust to be included in the surviving spouse's estate!

Thus, with any estate plan that contains a bypass trust, it is imperative to look at who the trustee is, look at who the beneficiary is and then look at the standard for

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distribution to see if there is a problem.

As to the PRINCIPAL distribution provision, if the trust provides that the trustee shall distribute, say, $5,000 per month to the beneficiary, then there is no discretion and the spouse as trustee and beneficiary seems to be O.K.

As for discretionary principal distributions, the same discussion relating to the income distribution provisions pursuant to the HEMS standard and the spouse's comfort, welfare and happiness apply equally here as well.

Another point to be aware of in the bypass trust, regardless of the blended family issue, would be the situation where the surviving spouse also has the ability to sprinkle income and/or principal to himself/herself or to his/her children or even just to the children. If the trust provides that the surviving spouse can distribute for support, then this would allow him/her to discharge a legal obligation of support which he or she has regarding minor children, and would cause the principal to be included in the surviving spouse's estate. Most trusts do include a clause (called an Upjohn clause) prohibiting the trustee from using trust funds to discharge a legal obligation of support but just be aware of this.

As to the last point of distribution in the bypass trust called the 5&5 power under IRC Section 2041, in addition to the income and principal distributions, the beneficiary can also be given the right to withdraw the greater of $5,000 or 5% of the trust principal for any reason. Thus, if the income and principal distributions based on the HEMS standard or any other standard set out in the document are not enough, then the surviving spouse can also get the 5&5 amount at any time with no restrictions, as long as this is allowed under the trust document. And, the 5&5 is specifically excluded from being deemed a general power of appointment.

However, caution should be exercised in giving a 5&5 power over the bypass trust - to the extent that the power is not exercised and lapses in the year of death of the surviving spouse, the amount subject to the power will be included in the surviving spouse's estate regardless of whether he/she exercises the power. Thus, say the bypass trust is $3.5M and the 5&5 power lapses in the year of death, an extra $175,000 (5% of $3.5M) is included in the surviving spouse's estate unnecessarily. The better practice is to allow the withdrawal, if at all, only for a specified period of time, such as during the month of December of each year – that way, there is no inclusion problem unless the surviving spouse dies during that month.

Additionally, the California legislature has provided a savings statute just in case the lawyer has the wrong distribution standard with the wrong trustee – California Probate Code Section 16081(c) provides that when the beneficiary is the trustee of a trust, unless a specific reference is made to this section, the trustee can only distribute property for his or her HEMS within the meaning of section 2041 of the IRC. Thus, the Probate Code basically rewrites the terms of a poorly worded trust where the trustee is the beneficiary unless a specific reference is made in the trust that 16081(c) does not apply. But the better practice is to draft the trust properly from the outset and not rely on a statutory savings clause.

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DISCRETIONARY DISTRIBUTIONS FROM THE BYPASS AND QTIP TRUSTS

With the basic blended family situation, we will assume that the moneyed spouse wants to provide for the surviving spouse during his or her lifetime and upon the second death, the assets are divided partially (or all) to children of the first marriage and/or children of the second marriage.

Thus, if this is the case, we will normally be providing for the establishment of two trusts upon the first death, the bypass trust and the QTIP marital trust. Keep in mind that we would have chosen the zero-tax formula that works best, pecuniary or fractional, and we would have funded each trust as soon as practicable after the first death.

Now that we have the bypass trust and the marital QTIP trust established, what terms do we actually put into each trust - what language do we use to determine who gets a distribution and how?

Let's look at our six points of distribution from the trust estate, 3 points from each trust:

A. Bypass Trust

1. Income
   - -All Income to surviving spouse
   - -Income to surviving spouse for HEMS if spouse is trustee
   - -Income for comfort, welfare and happiness, depending on trustee
   - -Unitrust distribution to the surviving spouse.

2. Principal

   -HEMS if spouse is trustee, or,
   -Comfort, welfare and happiness if third party is trustee

3. Bypass 5&5 withdrawal of principal

B. QTIP Trust

1. Income

   -All income to the surviving spouse is mandatory under IRC Section 2056.
   -Unitrust - we can also use, as an alterative to the "all income" distribution, a unitrust distribution to the surviving spouse.

2. Principal

   -HEMS, or,
   -Comfort, welfare and happiness

3. QTIP 5&5 withdrawal of principal

Remember that HEMS stands for health, education, support and maintenance.

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Choice of language

Assuming that the clients feel that principal distributions should be made from the various trusts, how do you go about deciding what language to use to tell the trustee when and how much to distribute.

Read the forms

It is important to know and read the trust documents and see not only what language is used, but to also understand how such language is interpreted by the courts. Then, you can take their particular facts and apply your knowledge in drafting to address some of the issues we are addressing here.

For the estate planner, it is important to understand how estate plans are set up, what points of discussion or argument can exist and then, knowing the facts as well, make sure that you are aware of the various issues that need to be addressed in the drafting and that the forms actually address these issues.

It is very important to read the language in the client's documents in light of whether you have (1) a surviving spouse, (2) an adult beneficiary for whom the trust is established, (3) a child who is the beneficiary and (4) if that child is a minor or an adult - the context here is that the individuals will be fighting and they will squeeze every dime out for their position or, the standard language may not apply depending upon who the beneficiary is.

The HEMS standard may work very well for minor children but does the surviving spouse and/or adult children really need money for education...most documents have a definition of education that may be totally inappropriate depending on who the beneficiary is - it may be more appropriate to have one distribution standard for minor children, one for surviving spouses and a different standard for adult children from the first marriage.

Mandatory or Discretionary Distributions and Standard to Apply

When drafting trust distribution provisions, we can have (1) mandatory distributions such as all income, (2) discretionary distributions such as for HEMS or (3) we can have beneficiary elective distributions or withdrawals such as the 5 & 5 withdrawal we discussed above.

The question here is what provisions do we actually have in the trust to allow for the particular distribution to the specific beneficiary?

The grantor of the trust needs to be interviewed and an assessment of his or her desires determined but in most cases, they may just say, I want my spouse taken care of and then the assets to go to my children.

At that point, we need to press a little bit further to discuss the full extent of "my spouse taken care of", particularly in the blended or dysfunctional family setting.

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We want to analyze exactly what discretion we want to give to the trustee, and to whom and for how much they can make a distribution.

As we discussed above, in each trust, we have the 6 points of distribution - income in each trust, principal in each trust and the 5 & 5 withdrawal in each trust. We have already addressed the 5 & 5 withdrawal provisions which, if included in either trust, allow for the beneficiary to exercise the withdrawal right and thus, the trustee has no discretion in this - either the beneficiary withdraws or the beneficiary allows the withdrawal right to lapse.

In the blended family context, the surviving spouse will most likely exercise this withdrawal right every year and there are no protections against this. With a bypass amount of $5,450,000, 5% equals $272,500 each and every year in addition to the income provisions and any discretionary principal distributions. This may not be the intent of the settlor so make sure you ask the question. Plus, if the surviving spouse does not spend the money, it has been taken from a tax free environment and put into a taxable environment!

Additionally, the all income and unitrust (see below) distribution provisions allow for no discretion as the trust instrument requires the trustee to distribute this amount. Remember that all income is required to be distributed from the QTIP trust to the surviving spouse each year in order to get the marital deduction in the first estate.

As we have eliminated for the purposes of this discussion the income of the QTIP and the 5 & 5 of the QTIP and the bypass, we are left with 3 points of distribution: (1) the income of the bypass (2) the principal of the bypass and (3) the principal of the QTIP. And let's just assume that the distribution standard for all three points is HEMS.

Each of these is called a discretionary distribution provision as the trustee has the discretion to either make or not make a distribution and the discretion to determine how much.

A typical provision in a bypass trust (the QTIP trust will contain a similar provision but only as it relates to principal - see note below) provides:

> Discretionary Payment of Income and Principal by Trustee. At any time or times, the trustee shall pay to or apply for the benefit of the surviving settlor so much of the net income and principal of the trust as the trustee deems proper to pay the reasonable expenses of the surviving settlor for his or her health, education, support, and maintenance. In exercising discretion, the trustee shall give the consideration that the trustee deems proper to all other income and resources that are then known to the trustee and that are readily available to the surviving settlor for use for these purposes. All decisions of the trustee regarding payments under this subsection, if any, are within the trustee's discretion and shall be final and incontestable by anyone. The trustee shall accumulate and add to principal any net income not distributed.

Let's dissect this, paying particular attention to the bolded language:

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At any time or times, the trustee
-shall
pay to or apply for the benefit of the surviving settlor so much of the net income and principal of the trust as the trustee deems proper to pay the reasonable expenses of the surviving settlor for his or her
-health, education, support, and maintenance.
In exercising discretion, the trustee shall give the consideration that the trustee deems proper to
-all other income and resources that are then known to the trustee and
-that are readily available to the surviving settlor for use for these purposes.
All decisions of the trustee regarding payments under this subsection, if any, are within the trustee's discretion and shall
-be final and incontestable by anyone.
The trustee shall accumulate and add to principal any net income not distributed.

NOTE: The principal distribution provision of the QTIP will say exactly the same thing except that the words “net income” are deleted from the “net income and principal” sentence above - the law requires that all income or the unitrust amount be paid in order to qualify for the marital deduction with a QTIP trust and thus, the only discretionary payment relates to the principal to be paid out of the QTIP trust.

In our review, what we are looking for in the language of the trust distribution provisions is the following:

> Does the trust say that the Trustee SHALL make a distribution or that the trustee MAY make a distribution?
>
> If the trust says that the trustee MAY make a distribution, what is the extent of the trustee’s discretion that can be exercised - simple discretion or absolute discretion and why does it matter?
>
> Do we look at other resources of the beneficiary to determine if a distribution is in order and if so, what resources and in what form are we looking for?
>
> Health, Education, Maintenance and Support (HEMS) - how are these terms defined under the document or under California law?
>
> Does the trustee look to a standard of living as of the date of the decedent’s death in order to determine what payments for reasonable expenses are appropriate?
>
> Who is the beneficiary (surviving spouse, minor child or adult child) and how do the above issues affect him/her?

Always, the governing rule is the intent of the testator/settlor and that any ambiguity is determined in favor of the beneficiary.

SHALL v. MAY

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The first decision to be made when drafting an invasion power is whether to use the mandatory “TRUSTEE SHALL DISTRIBUTE”or the discretionary TRUSTEE MAY DISTRIBUTE.

And, as we all know, each word in a document should be given meaning.

So, what is the difference between using SHALL and using MAY?

CONTROL

In the discussion of MAY v. SHALL, the inquiry is really who controls the determination of the distribution, the trustee (MAY) or the beneficiary (SHALL).

Yes, depending upon what the document says in conjunction with the case law interpreting the language used, the traditional notion that the trustee totally controls the distribution is not entirely accurate. Where the trust instrument says that the trustee SHALL make a distribution, the case law indicates that the Beneficiary can control the distribution. On the other hand, if the trustee MAY make a distribution, this language, coupled with words giving the trustee the sole and absolute discretion to make a distribution, could give the ultimate control back to the Trustee.

SHALL

In the case of <u>In Re Miller's Estate</u>, (41 Cal Rptr 410 1964), Mrs. Miller left her money equally to her 3 daughters. She had one daughter who was an ophthalmologist but who was also an alcoholic. Her share was left in trust. The disbursement provision in the trust for income and principal stated: “The trustee SHALL distribute to the beneficiary such sums, as my trustee, in his sole discretion, shall determine as necessary to provide for her support and maintenance." (Emphasis added).

The trustee gave out little money and the beneficiary sued him.

The court indicated that:

> “[W]here the trust provision directs the trustee to disburse portions of the principal for a given purpose, the trustee's authority to pay is not discretionary but is merely conditional upon the existence of a reasonable necessity for the disbursement. Upon proof of the necessity, a court will compel the trustee to make the disbursement and usually will direct him as to the amount to be paid. The question of necessity, as well as what it calls for to comply with the condition, is a judicial question.”

The court also indicated that the trustee had a duty to pay monies out for the beneficiary’s support and maintenance and that he failed in his duty - the trustee paid out only $50.00 in a two year period.

Thus, the court is saying that with the SHALL language, the trustee must distribute something out - as long as the beneficiary shows a reasonable necessity, then the trustee must make a distribution. This seems to place a great deal of control in the

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hands of the beneficiary - if they can make a reasonable showing of necessity, the trustee must make a distribution.

Trustee's Psychology

Keep in mind that if the trustee withholds payment and the beneficiary sues to compel distribution, then the trustee's downside is the litigation. On the other hand, if the trustee is liberal and over distributes, the remaindermen may sue long after the distribution has been made and there may be no funds from which to make a recovery. Thus there is a bias on the part of the trustee to be conservative and not to over distribute assets, unless of course, it is the surviving spouse who is making distributions to themselves.

MAY

If we changed the SHALL to a MAY distribution, what does that do?

In re Greenleaf's Estate, 101 Cal.App.2d 658, 225 P.2d 945 (1951), the court, quoting Bogert on Trusts, stated:

> "[I]t is the general rule that if the power of the trustee is discretionary and the trustee is fairly employing his judgment to advance or not to advance, the court will not control his action merely because it disagrees with him, but it must find some abuse of discretion or bad faith before it will interfere. The court should not be burdened with the duty of administration, nor required, nor permitted, to substitute its judgment and discretion for that of the trustee so long as it acts within proper limits; nor in any event until there is an entire failure or refusal on the part of the trustee to perform its duty."

Thus, the court lays the basic framework for review of a trustee's actions - where we have: 'the trustee, in the trustee's discretion..." it appears that the court must find some abuse of discretion or bad faith in order to modify or control the trustee's actions. Thus, where we have the MAY language, the control shifts back to the trustee unless the court finds an abuse of discretion.

The fact that there is a true distinction in drafting between the words SHALL and MAY is confirmed in California Probate Code Section 12 which provides that "shall" is mandatory and "may" is permissive.

Discretion

Assuming that we have the trustee MAY make a distribution, what type of discretion has been granted by the settlor of the trust to the trustee? Is it a simple standard such as "the trustee, in the trustee's discretion" may make a distribution or is it a more formal grant such as "the trustee may, in the trustee's sole and absolute discretion, make a distribution"?

Probate Code section 16080 provides some statutory framework for the distinction:

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> "Except as provided in Section 16081, a discretionary power conferred upon a trustee is not left to the trustee's arbitrary discretion, but shall be exercised reasonably."

Thus, where the trust just uses the words “the trustee, in the trustee’s discretion”, then the trustee must act reasonably...i.e., the trustee can not act unreasonably. If the trustee acts unreasonably, which is a somewhat low threshold, then the beneficiary can petition the court under Probate Code Section 17200, show that the trustee is acting unreasonably, and perhaps get a larger payout from the trust estate.

Sole and absolute discretion

If, on the other hand, the trust provides that “the trustee may, in the trustee’s sole and absolute discretion, make a distribution” or, as set out in the form trust language above, the trustee’s exercise of discretion “shall be final and incontestable by anyone”, does this language add anything to the mix?

The court in Coberly v. Superior Court of Los Angeles County, 231 Cal. App. 2d 685, 42 Cal. Rptr. 64 (1965) stated:

> What standards must be met by a trustee which has been given absolute discretion in the administration of a trust? A grant of absolute discretion to a trustee to administer assets does not mean it can do as it pleases, but rather that the grantor has waived the requirement that the conduct of the trustee at all times satisfy the standard of judgment and care exercised by a reasonable, prudent man. As summarized in Restatement Second of Trusts, section 187, **words of absolute discretion in a trust are not interpreted literally but are ordinarily construed as merely dispensing with the standard of reasonableness.** The trustee is still required to avoid arbitrary action and to use its best judgment. A grant of absolute discretion in dealing with trust assets may entitle a trustee to speculate, concentrate, buy and sell for appreciation, assume large risks. It does not authorize a trustee to neglect its trust or abdicate its judgment. (Emphasis added.)

This elimination of the requirement that the trustee act reasonably is confirmed in Probate Code Section 16081(a) which provides that: [I]f a trust instrument confers "absolute", "sole" or "uncontrolled" discretion on a trustee, the trustee shall act in accordance with fiduciary principles and shall not act in bad faith or in disregard of the purposes of the trust."

However, note the distinction: with simple discretion, Probate Code Section 16080 requires that the trustee act reasonably. But with sole and absolute discretion, Coberly and Probate Code Section 16081(a) require only that the trustee not act in bad faith.

This suggests that with sole and absolute discretion, the trustee can act unreasonably, as long as it is not in bad faith.

Keep in mind that the showing of “bad faith” is a huge barrier for the beneficiary to overcome - the beneficiary must probably show some negative intentional act and/or

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thought process that the trustee is engaging in before the court will ignore and/or supplant the discretionary power of the trustee.

Thus, with this stronger discretionary language of uncontrolled, final, incontestable, or sole and absolute, the grantor of the trust can give the strongest amount of control back to the trustee to decide what distributions to make in exercising this discretion.

However, just because ultimate control can be shifted to the trustee, an analysis should be made as to whether the drafter should give this degree of control to the trustee. Depending upon who the trustee is, who the beneficiary is and who the ultimate remainder beneficiaries are, the grantor may want to have control in a particular place. For example, where there are no appropriate individual trustees and the grantor names a bank as trustee, then the grantor may want to use the SHALL language to make sure that the surviving spouse can show proof of a reasonable necessity. If the spouse is a total spendthrift, then the grantor may want to put more control in the hands of the trustee and would use the MAY language. If the beneficiary is the recalcitrant child, then the grantor may want the MAY language coupled with the sole and absolute discretion language to give the ultimate amount of control to the trustee.

Caution must be exercised when we have a trustee who is also the beneficiary and this trustee/beneficiary has the sole and absolute discretion to distribute income and principal to himself. If he can distribute to himself unreasonably, the IRS can take the position that the exercise of the power is not subject to an ascertainable standard and there a general power of appointment. See <u>Estate of Friedman</u>, (1979) 156 Cal.Rptr. 597, 94 Cal. App. 3d 667 where the court found the beneficiary's right to invade principal for his HEMS in his uncontrolled discretion was a general power of appointment. Thus, a trustee/beneficiary with sole and absolute discretion may hold a general power of appointment over the assets thereby causing inclusion in the beneficiary's estate.

However, again, the California Legislature has given us some relief under Probate Code Section 16081(b) which provides in pertinent, and paraphrased, part that:

> [A] person who is a beneficiary and who as trustee holds a power to make discretionary distributions to himself pursuant to a standard, shall exercise that power reasonably and in accordance with that standard.

As a final word for control purposes in a discretionary trust, pay particular attention to the MAY/SHALL language and see what type of discretion the trustee is required to exercise.

Using the Distribution Standard Relating to HEALTH, EDUCATION, MAINTENANCE and SUPPORT (HEMS)

As discussed above, this is the ascertainable standard language under IRC Section 2041. The prior initial discussion focused on using the ascertainable standard when naming the spouse as the trustee for the bypass trust - this language kept the assets of the bypass trust out of the estate of the surviving spouse who was trustee and beneficiary while still giving the surviving spouse the right to enjoy, according to the

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HEMS standard, the assets of the bypass trust.

But here, we are now talking about using the ascertainable standard of HEMS to actually define the amount of the distribution that the beneficiary is entitled to.

Trustee Guidance

In addition to using the ascertainable standard to protect the assets of the bypass trust from inclusion in the surviving spouse's estate when they are serving as trustee/beneficiary, this standard also gives some guidance to trustees in that we can somewhat define what the individual items of HEMS look like, to some degree, at least much more so than comfort, welfare and happiness. Even though individual trustees do not have quite as much of an issue with comfort, welfare and happiness as the distribution standard, most corporate trustees do have an issue with this as it will leave them wide open for litigation - how much will make the beneficiary happy? Thus, as it is probably prudent to assume that in some cases, you may have to turn to a corporate trustee as a last resort, you may want to consider having the ascertainable standard language in the document from the beginning.

Malpractice Issue

Of course, the lawyer has had those days where a client calls the day before the client takes their vacation to sunny downtown Bagdad and needs to update their estate planning documents. The lawyer is obviously rushed but wants to help out so they think, I just did the Smith documents last week and their fact pattern is the same as this client so why not just do a search and replace, change the names for the players and the client will think you are a hero!

However, the lawyer forgot that the Smith bypass trust had a comfort, welfare and happiness standard for distribution and that it had a family friend as the trustee...here, in the rushed situation, we have the surviving spouse as the trustee - whoops, surviving spouse as trustee and beneficiary with a standard for distribution of comfort, welfare and happiness.

Don't look now but Mr. Malpractice may come knocking at the door!

The better practice is to continue to use the HEMS standard in all cases unless the circumstances clearly suggest a different standard for distribution - it is generally advisable for practitioners to never have a comfort, welfare or happiness standard in their form repertoire so that they will never make this mistake.

NOTE: The California Legislature has again been kind to California attorneys - Probate Code Section 16081(c) has a savings clause that provides that where the beneficiary is the trustee, unless a specific reference is made to this section, the trustee can only distribute property for his HEMS within the meaning of section 2041 of the IRC.

Thus, even if the attorney uses the wrong standard with the spouse as trustee, unless the attorney specifically states that he or she is drafting around IRC 2041 under Probate Code 16081(c), Probate Code Section 16081(c) will rewrite the trust so that it

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conforms to IRC 2041 and HEMS.

But, again, do you want to rely on a savings statute or just draft it right from the beginning?

DEFINITIONS OF HEALTH, EDUCATION, SUPPORT AND MAINTENANCE (HEMS)

We all know the definition of HEMS, don't we? Or, at the very least, we know it when we see it!

In the traditional family, where we usually have the surviving spouse enjoying the money for his or her lifetime and then upon their death, the kids from the traditional marriage get the assets, we normally do not pay a lot of attention to exactly how much money Mom or Dad is drawing out of the marital or bypass trust. We know that the parents want the survivor to be supported and after the second death, that is the time when the kids get their shares.

But with the blended family, to the extent that a dollar goes to the surviving spouse, the ultimate beneficiaries do not get that dollar and thus, they are concerned with EVERY dollar that is spent by the surviving spouse. And, on the flip side, the second spouse may not really care if the children from the first marriage get any money or not - the surviving spouse is probably going to draw out EVERY dollar they can for their own HEMS!

Thus, we need to plan and draft our documents in light of who is the beneficiary - spouse, minor child or adult child - and think about what type of document needs to be drafted.

Remember that the surviving spouse will probably be looking for every dime they can get and the children of the first marriage are looking to deny every dime they can from the surviving spouse.

The IRS regulations give us a starting point for HEMS: Reg. Section 20.2041-1(c)(2) provides that a power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). The words ``support'' and ``maintenance'' are synonymous and their meaning is not limited to the bare necessities of life. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's ``support,'' ``support in reasonable comfort,'' ``maintenance in health and reasonable comfort,'' ``support in his accustomed manner of living,'' ``education, including college and professional education,'' ``health,'' and ``medical, dental, hospital and nursing expenses and expenses of invalidism.''

The above regulation section tells us what the standard is and pursuant to Rev Rul. 76-502, we look to state law for the actual definitions of the individual items of HEMS. Thus, remember that the definition of HEMS may vary, to some degree, from state to

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state.

Health:

The IRS Regulations include medical, dental, hospital, nursing and expenses of being an invalid as being a part of health.

However, say that a surviving spouse is the beneficiary of a trust with health as part of the standard - does health include elective surgery such as cosmetic surgery?
The trust departments of some of the banks in San Francisco, when asked about elective procedures such as upper body work and face work, were somewhat non-committal but indicated that elective procedures may be more questionable. Thus, while most form documents do not include a definition of health, the settlor may want to think about a limitation so that elective procedures may be curtailed, to some degree.

Support and maintenance:

As noted above, the Regulations under 2041 state that support and maintenance are the same and they are not limited to the bare necessities of life. The standard measurement is similar to that enjoyed when the trust was set up or during the settlor's lifetime as the regulation uses the phrase “support in the accustomed manner of living”.

Since health is reasonably definable, except for the elective procedures, the support and maintenance standard will be the main point of contention between the parties - what is paid out currently and what is retained for the remainder beneficiaries.

In Re Miller's Estate (1964) - The case with the alcoholic daughter from above. The disbursement provision for income and principal gave to the beneficiary "such sums, as my trustee, in his sole discretion, shall determine as necessary to supplement any other income or sources of funds she may have, to provide for her support and maintenance."

The court inferred the intent of Mrs. Miller to provide for the support and maintenance of her daughter.

The court also inferred that the daughter should live in the same manner and style as the Miller Family had lived prior to the death of Mrs. Miller.

In ordering a distribution for support and maintenance, the court included the following in the distribution for the benefit of the daughter:

1. The fees to have her reinstated as an ophthalmologist (she was now sober and was reinstated by the state board)
2. The attorney’s fees she paid for assistance to have her reinstated
3. Her federal income taxes
4. The funeral bill of her deceased husband
5. Personal rent
6. Food

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7. Telephone expense
8. Laundry and cleaning
9. Clothing expense
10. Insurance
11. Casual entertaining
12. Possible medical bills
13. Purchase medical equipment to open up a new ophthalmology practice
14. Malpractice insurance
15. Medical society assessments
16. Office rent
17. Office telephone service and answering service
18. Office laundry
19. Wages for a nurse
20. Office drugs
21. Stationary
22 Stamps

Thus, if we take a modern situation, say the surviving spouse wants to set up some type of business (like an ophthalmology practice, assuming he or she has the degree) or he or she wants to set up an art galley or a technology startup, under the Miller standard of support and maintenance, would the trustee, if we had a SHALL distribution standard, have to distribute for items similar to the Miller daughter as long as the surviving spouse shows reasonable necessity?

A greedy surviving spouse could stretch beyond comprehension the Miller guidelines and perhaps get distributions far in excess of what the grantor intended as support distributions.

Section 811 of the well cited treatise on the subject of Trusts and Trustees by George Bogert is quoted with approval by the Miller court:

> A trustee has been held entitled to include under the term "support" the education of the beneficiary, the maintenance of his family, the purchasing of life insurance on the beneficiary's life, a vacation, nursing and medical care and the payment of debts.

Thus, let's assume that the second, younger surviving spouse who is despised by the children of the first marriage, remarries and of course, this new other spouse is now also despised by the children of the first marriage.

Bogert, as quoted by the Miller case, indicates that the support of the beneficiary's new family could be included in the term "support". Do we think that the deceased first spouse actually intended for the bypass or marital trust to be used to support the surviving spouse, their new spouse and new minor children of the surviving spouse?

Some type of discussion of the intent of the settlor should be had to see if any limitations of the support and maintenance would be in order.

And, a question arises as to whether the payments to support the beneficiary are to be

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made despite the legal obligation of a spouse to support - such as a remarriage.

Education

It is important to specify what type of education is intended by the grantor.

The IRS Regulations at Section 20.2041-1(c)(2) refer to college and professional school.

Case law is instructive on this point. Where a minor beneficiary was involved, the court in In Re Kessler's Estate, (261 P.2d 27 1953) was dealing with a trust that was established for the daughter's care, maintenance and education until she was age 30. The trustee paid out very little money and the court stated that “[W]hat Karen needs during these formative years is not the prospect of an enlarged estate when she is thirty but increased opportunity for education, training, and development which will prepare her to achieve a successful life as well as to earn a living and to take her place as a responsible and capable member of society."

It is quite evident that with minors and young adults, the courts will recognize the need for nurturing and development in looking at what should be distributed for education purposes.

However, many form books just use the blanket HEMS for all beneficiaries, regardless of age, position or family dynamics. And, the definition of education is misplaced to some degree, depending upon who the beneficiary is.

And, most trust documents already contain a definition of education. One leading California resource contains the following:

> Definition of Education. As used in this instrument, the term "education" refers to the following:
>
> (a) Education at public or private elementary, junior high, middle, or high schools, including boarding schools;
> (b) Undergraduate, graduate, and postgraduate study in any field, whether or not of a professional character, in colleges, universities, or other institutions of higher learning;
> (c) Specialized formal or informal training in music, the stage, the handicrafts, or the arts, whether by private instruction or otherwise; and
> (d) Formal or informal vocational or technical training, whether through programs or institutions devoted solely to vocational or technical training, or otherwise.

Another California resource provides:

> Education shall include vocational, undergraduate and post graduate study at an institution of the beneficiary's choice. In determining payments to be made to the beneficiary for education, the trustee shall consider the beneficiary's reasonable related living and traveling expenses.

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But the one that takes the cake is:

> Education shall include worldwide travel whether or not as part of a formal program of academic education...

Let's say that we have a surviving spouse as the beneficiary of a trust that provides that the trustee SHALL distribute income and principal for the spouse's HEMS.

The above definitions are entirely appropriate for minor children and perhaps, young adults. However, if education is included in HEMS for the despised second spouse, let's see how far we can stretch this.

Education is defined to include worldwide travel. The surviving spouse wants to take an around the world cruise for a year - was this contemplated by the grantor? And if the spouse has remarried and has additional children, under the Miller case, support includes maintaining the beneficiary's family and education includes worldwide travel.

Under the right circumstances, the marital and bypass trusts may be paying for a year long vacation for the surviving spouse and their new family.

With the "SHALL" distribution language, all the surviving spouse needs to show is a reasonable necessity for the education expense and thus may be able to force the trustee to distribute for this reason.

The point here is that HEMS may not be entirely appropriate for a surviving spouse...perhaps, HEMS without the education (HMS) would be more appropriate unless it is contemplated that the surviving spouse will need or want more education.

As there is probably no love lost between the lifetime beneficiary and the remainder beneficiary, then each will have their own definition of what amounts are proper - the life beneficiary will say all and the remainder beneficiary will say none!

Also, a careful reading of the definition of education is necessary depending upon your facts and beneficiaries to see if the form language is appropriate.

A standard HEMS might be entirely appropriate for a minor child but as that child reaches adulthood, the definition could be adjusted.

Additionally, you could have a different definition for each beneficiary or class of beneficiaries.

Discretionary consideration of other resources

When the trustee makes discretionary distributions, the question arises as to whether he should consider other resources available to the beneficiary to determine the amount of the current distribution. The instrument will control if there is language that addresses this issue, typically, such as:

> The trustee shall give the consideration that the trustee deems proper to all other

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income and resources that are then known to the trustee and that are readily available to the surviving settlor (or to the beneficiary) for use for these purposes.

Look closely at your language and see if the trustee should look to other sources of:

-Income or non-income producing assets
-Assets in general, growth assets, unproductive assets, or illiquid assets
-Should the beneficiary have to sell the residence or not.

In most documents, you will see where the surviving spouse must exhaust the survivor's trust and/or the marital trust before getting principal out of the bypass trust - this makes sense as the survivor's trust and the marital/QTIP trusts are taxable in the estate of the surviving spouse and the bypass trust is not. You would want the surviving spouse to exhaust the taxable assets first before dipping into the non-taxable bypass assets.

But what happens if you have allocated the residence and the IRA to the surviving spouse in the survivor's trust and other liquid assets to the bypass and marital trust. If the surviving spouse is young, he or she may want to take full advantage of the IRA minimum required distributions and wait until they are 70 ½ before drawing out any money from the IRA. If the house is on the surviving spouse's side in order to preserve the IRC Section 280A $250,000 non-recognition of gain, then the surviving spouse may not have any liquid assets to draw from. If the trustee looks to other resources, liquid and illiquid, taxable and nontaxable, then there is an argument that the remaindermen will make that the surviving spouse must draw down the IRA and sell the house before any principal can be distributed from the marital or bypass trusts.

If the trust is silent as to whether to look to other resources, the court in <u>In Ferrall V. Bank of America</u>, 41 Cal 2d 166, 258 P2d 1009, 1953, indicated that unless there is a clear intent not to look at other resources, then the trustee should consider other income and resources available to the beneficiary. This result was confirmed in <u>Thomas v. Gustafson</u>, 141 Cal.App.4th 34, 45 Cal.Rptr.3d 639 (2006) wherein the court cited with approval <u>Estate of Miller</u>, <u>Estate of Greenleaf</u> and <u>Ferrall</u> in holding that the trustee should look to other resources of the beneficiary unless the trust instrument specifically provides otherwise.

It may be that the settlor's intent is not that the beneficiary must liquidate all illiquid assets before a principal distribution can be made, such as a residence, so make sure that the language is flexible enough to provide for changed circumstances.

And it has been suggested that the trustee obtain a copy of the beneficiary's tax return to verify income and resources.

And, should the trustee look to the beneficiaries' ability to work?

The point is to cut down on ambiguity and potential litigation.

MARITAL UNITRUST

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As noted above, the QTIP rules require that "all income" from the QTIP Trust must be paid to the surviving spouse in order to qualify for the marital deduction.

And as we all know, the investment of the trust assets is a very important consideration for the trustee. Pursuant to California Probate Code Section 16003, the trustee generally has a duty to be impartial between the income beneficiary and the remainder beneficiary in decisions regarding the investment of trust assets.

Where there is an "all income" requirement, the trustee is likely to invest in high yielding instruments such as bonds in order to avoid being sued by the income beneficiary for not producing high enough yields. In fact, under the QTIP trust, it is a requirement of the trust in order to qualify for the marital deduction that the spouse must also have the right to demand that the trustee make unproductive assets productive. Thus, the surviving spouse could demand that the trustee sell non-income producing or low income producing assets and invest in higher yielding vehicles. This ignores the fact that the assets may be rapidly appreciating but do not throw off any income. That benefits the remainder beneficiaries but does nothing for the income beneficiary.

Therefore, the remainder beneficiaries may want to sue.

This puts the trustee in a bind and most will invest 50/50 in bonds and stock...this approach however, may not give as good a return overall to the trust as a whole where the trustee is trying to maximize return, income and gain, for the benefit of the trust in its entirety in order to make it the most beneficial to all parties.

The unitrust provides that the trust must pay out a percentage of the trust estate as it is revalued annually, without regard to the income earned or the gains and losses in the performance of the trust assets. In this case, the trustee is trying to maximize return for the entire trust which benefits the income beneficiary and the remainder beneficiary.

These trusts are sometimes referred to as "Total Return Unitrusts" as the trustee invests for both income and appreciation which hopefully benefits both the life beneficiary and the remainder beneficiary, whereas with the all income trust, the assets may be invested to the detriment of the remainder beneficiary or in the discretionary trust, it may be to the advantage or detriment of either beneficiary.

These trusts also remove the trustee's discretion from the equation altogether. Thus, the fight over SHALL, MAY, control and the definition of HEMS goes away.

However, certain risks are associated with unitrusts such as the necessity to sell assets in a poor market in order to make the annuity payment in the event that the trust is not very liquid.

Generally, you will want to participate in the decisions as to allocation of assets to fund the marital and residual bequests, depending upon the terms of distribution for each of them. With the unitrust, we would want to try to steer away from illiquid or hard to value/sell assets, keeping in mind that the unitrust amount needs to be paid each and every year based upon the value of the assets that year.

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A closely held business may not be the best choice to fund a unitrust as it may not produce the best income as well as the expense and difficulty in valuing it each year.

With a bypass trust, the unitrust may not be the best distribution tool as the unitrust percentage must be paid out each year. If it is paid to the surviving spouse who may not need that amount of money, then we are moving assets from the bypass trust which is estate tax free on the second death to the surviving spouse's estate, and perhaps creating an unnecessary estate tax liability.

Another issue with the unitrust is that the percentage payout may not be enough for the beneficiary's needs. If that is the case, the trustee can also be given a limited discretionary power to distribute more than the unitrust amount, but we may end up in the same fight as we have discussed before between the income beneficiary and the remainder beneficiary.

California's unitrust statute probate Code Section 16336.5 allows an existing trust to convert to a unitrust. The default rate is 4% while under certain circumstances, the rate can be between 3% and 5%.

Remember that under the QTIP rules, all income must be paid out annually to the surviving spouse. Thus, the marital unitrust would provide that the trustee would pay out the unitrust amount or all of the income, whichever is greater.

Special Trustee

The use of a special trustee should also be considered in the blended family context. If we want the surviving spouse to be involved in the trust administration process so they don't feel like they have to beg for every dollar they receive, we can appoint a special trustee to exercise discretion in making the HEMS distribution to the surviving spouse. This may go to alleviate the tension between the income and remainder beneficiaries, particularly if the special trustee is truly independent and respected by all beneficiaries.

The special trustee can be called upon to decide sensitive issues and can also be appointed to manage difficult assets such as illiquid investments or a going concern business. Where the special trustee is an institution, a review process can be outlined so that all beneficiaries have a voice in the process of discretionary distributions or other decisions of the special trustee. Finally, the special trustee could be a group of advisors that would gather periodically to discuss the issues presented to them as well as arbitrate any disputes.

Dispute resolution

Mediation and arbitration should be considered as effective dispute resolution procedures to draft into any blended family estate plan, with due regard for any no contest provisions. The special trustee could act as an ad hoc dispute resolution mechanism or a more formal process could be established.

TANGIBLE PERSONAL PROPERTY

Our “stuff” that we have accumulated over the years generally has very little monetary value but it is a toxic asset in the blended family context. When the parent is deceased, the only tangible thing that some family members can hold on to is Dad or Mom’s ______ (fill in the blank). Most wills and trusts say that the tangible personal property goes to the surviving spouse without much thought as to what this really represents. These are tangible representations of the memories of your life which probably have little or no value to a surviving spouse - it may just be clutter that all they want to do is get rid of it. Not only does this destroy the object and memory for the person who values it, this also creates more tension between the child and the surviving spouse as they have destroyed an object that holds very real value for that child.

It would be wise to consider the disposition of the personal property as a matter in the estate planning process that is equally as important as the distribution of the financial assets.

PORTABILITY

The American Taxpayer Relief Act of 2012 (ATRA) made permanent the $5 million estate tax exemption which, after indexing for inflation, equals $5,450,000 per person in 2014. Additionally, the ability for the surviving spouse to use part or all of a deceased spouse's unused exclusion amount (DSUE) on their own gift and estate tax return (portability) was made permanent.

Thus, married couples can shelter as much as $10,900,000 of assets from estate tax without a huge amount of planning other than making sure that the deceased spouse’s assets go to the surviving spouse. All that is necessary would be a simple will or trust leaving everything to the surviving spouse (or all assets passing to the surviving spouse by joint tenancy or beneficiary designation) and filing an estate tax return. The surviving spouse can only use the DSUE of his or her last deceased spouse - you can not add the DSUE of any prior deceased spouses, other than that of the last one.

With the larger exemption and portability, fewer estates will be subject to estate tax and as a result, the use of the bypass trust (sometimes also called the credit shelter trust or exemption trust) could be reduced drastically.

Additionally, by eliminating the bypass trust, clients may be able to reduce the cost of drafting estate planning documents, avoid the compressed income tax rates associated with undistributed income from a trust and also avoid the loss of a step up in basis in the trust assets upon the second death.

However, bypass trusts may still be of benefit with high net worth clients because the generation skipping transfer tax exemption is not portable to the surviving spouse. Also, there are a number of non-tax reasons for the bypass trust such as control, staggered distributions for other family members, as well as potential protection of assets in a divorce proceeding and from creditors and in the blended family context, the control issue is a serious concern.

Under prior law, the deceased spouse either had to use their estate tax exemption on death or it was lost forever.

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Assume that HARVEY and WYNONA had an $8M estate ($4M each) and each has a $5M estate tax exemption. HARVEY dies and leaves all of his estate to WYNONA. HARVEY has an unlimited marital deduction on his death such that all assets going to WYNONA get a deduction in his estate resulting in zero tax on HARVEY's death. However, WYNONA now has an $8M estate but only $5M of exemption - under the old law, since HARVEY did not use his exemption on his death, WYNONA could not "port" HARVEY's exemption for her own use and thus, HARVEY's exemption was lost and WYNONA's estate has $3M of assets subject to estate tax at a tax rate of 40%.

(Remember that, assuming that all of the assets were community property in California, these assets would have received a new cost basis for future income tax purposes equal to fair market value on the date of HARVEY's death - this is called a "step up in basis". Additionally, upon WYNONA's later death, all of the assets in her estate would have also received a cost basis as of the date of her death. But the cost to get this second step up in basis would be inclusion of the assets in WYNONA's estate at a huge estate tax cost).

Under the old law before 2010, in order to remedy the cost of the extra estate tax in WYNONA's estate, HARVEY would have set up a bypass trust for the benefit of WYNONA, to which he would allocate his $4M of assets. WYNONA would be trustee and have the right to income and principal according to an ascertainable standard of health, support, maintenance and education and upon her death, the assets would be distributed according to the terms of the trust. Structured in this manner, the bypass trust assets would not be included in WYNONA's estate.

As a result of using the bypass trust, HARVEY's estate would apply $4M of his exemption to offset estate taxes for the bypass trust and WYNONA's estate would now only have $4M of assets which could be sheltered from estate tax by her own $5M exemption. Unfortunately, under the old law, the remaining $1M of HARVEY's exemption would be lost.

(Again, remember that, assuming that all of the assets were community property in California, these assets would have received a new cost basis for future income tax purposes equal to fair market value on the date of HARVEY's death - this is called a "step up in basis". However, upon WYNONA's later death, even though all of the assets in her estate would have also received a cost basis as of the date of her death, the assets in the bypass trust do not get a new cost basis upon WYNONA's death. The loss of this second step up in basis means that upon a later sale of the assets in the bypass trust, there could be some capital gains taxes due - but these assets could have been subject to estate tax in WYNONA's estate on her death so the trade off may be worth it).

Also, the estate tax is based on 100% of the value of the taxable estate while the capital gains tax is based only upon the gain when the assets is sold.

But under the new law, with portability, HARVEY can leave his entire $4M to WYNONA under the unlimited marital deduction and there would be no estate tax on his death. WYNONA can file an estate tax return for HARVEY's assets and elect to "port" HARVEY's unused exemption to herself, giving her a $10,900,000 gift and estate tax

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exemption. By the time WYNONA dies, if her estate is less than the total of HARVEY's unused exemption and WYNONA's exemption at the time of her death, there would be no estate tax on WYNONA's death as well. Also, since all of the assets are included in WYNONA's estate, her estate gets this second step up in basis. If her assets are below the estate tax threshold and they get a new cost basis at her death, her heirs can sell all of these assets at the time of WYNONA's death and presumably pay no capital gains taxes...and they have also received these assets estate tax free.

As a side note, if a bypass trust is established, the trustee is usually required to file an annual Form 1041 income tax return and pay tax on any taxable income generated by the trust's assets that isn't distributed to the beneficiaries. The trust gets into the highest tax bracket sooner that an individual does so it may be disadvantageous to retain income in the bypass trust.

Continued use of the Bypass trust

In our example, if HARVEY leaves everything to WYNONA under the unlimited marital deduction and WYNONA files an estate tax return to elect portability, WYNONA now has an estate of $8M. HARVEY's exemption of $5,450,000 is NOT indexed with inflation so it will remain fixed at $5,450,000 while WYNONA's exemption will continue to be indexed for inflation. If, by the time of WYNONA's death, the assets have grown to say $12,000,000, WYNONA will have her current exemption which has risen with inflation to add to HARVEY's $5,4500,000 exemption which has not risen with inflation. It could be that since ALL of the assets are in WYNONA's estate and are hopefully growing in value, that an estate tax may be generated at her death.

On the other hand, if HARVEY had left his $4M to the bypass trust, these assets can grow to whatever value and they will not be included in WYNONA's estate for estate tax purposes but these assets will not get a step up in basis on WYNONA's death.

WYNONA's $4M in assets will now grow but she has her exemption indexed for inflation along with the remaining $1M of HARVEY's exemption...in essence, half of the assets are not in WYNONA's estate and the growth on these assets are also excluded from her estate.

The only downside in using the bypass trust is the loss of the step up in basis, the additional income tax returns and a possible increase in the income tax rate.

But, use of the bypass trust can preserve HARVEY's generation skipping transfer tax exemption.

Portability Examples 2016

Assume a joint estate of $10,900,000 in 2016 with an estate tax exemption amount of $5,450,000 each.

Example one: On the first death, we allocate $5,450,000 to the bypass and $5,450,000 to the surviving spouse in the survivor's trust. Assets grow to $20M by the time of the second spouse's death - there would be $10M in the bypass trust and $10M in the

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survivor's trust.

Example two: Alternatively, on the first death, we allocate all assets to the surviving spouse under the unlimited marital deduction, portability is elected to move the deceased spouse's DSUE of $5,450,000 to the surviving spouse and the assets grow to $20M by the time of the surviving spouse's death. All $20M is included in the surviving spouse's estate.

Bypass pro	Bypass con	Portability pro	Portability con
Unlimited future growth is protected from estate tax on death of second spouse		Surviving spouse's estate tax exemption continues to rise with inflation	DSUE from deceased spouse does not rise with inflation and all of future growth of deceased spouse's assets plus surviving spouse's assets are subject to tax in second estate. Also, surviving spouse is limited to DSUE of their last deceased spouse
	No step up in basis to fair market value on death of second spouse of bypass assets	Step up in basis to fair market value on all assets on second death	
Preserve and allocate GST exemption of first spouse to die			GST exemption of first spouse to die is not portable and is lost
	Estate Tax Return is due within 9 months from date of death of first spouse if deceased spouse's estate is over $5,450,000		Estate Tax Return is due within 9 months from date of death of first spouse and must elect portability of DSUE; Note, extension available under Revenue Procedure 2014-18

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Bypass pro	Bypass con	Portability pro	Portability con
	Must establish separate accounts for bypass trust assets and get separate tax ID number	No separate accounts or accountings are necessary and no new tax ID number is required	
Could provide for professional management of assets with corporate or professional trustee	A Trustee is required which could be surviving spouse but there could be trustee's fees if a professional or corporate trustee was appointed	Surviving spouse controls all of the assets and they could hire professional manager for investment of assets	
With a third party trustee, there could be limitations on the rights of the surviving spouse to access income and principal to protect this from third parties for the benefit of children of the deceased spouse. Remainder beneficiaries after surviving spouse's death are generally locked in at the time of the deceased spouse's death.	Distributions of income and principal may be limited to health, support, maintenance and education and there is the possibility that the remainder beneficiaries object to some of the discretionary distributions to surviving spouse. Remainder beneficiaries after surviving spouse's death are generally locked in at the time of the deceased spouse's death unless there is a limited power of appointment.	There are no limits on distributions of income and principal to surviving spouse and there is no remainder beneficiary oversight of discretionary distributions to surviving spouse	Surviving spouse can leave all of these assets to anybody they choose

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Bypass pro	Bypass con	Portability pro	Portability con
Possible asset protection from creditors, divorce and spendthrift and assets may be protected from second spouse for benefit of children from first marriage			No asset protection from creditors, divorce and spendthrift and assets are not protected from second spouse for benefit of children from first marriage
	An annual income tax return is usually required and unless distributed, retained income is taxed at a higher rate than on the same income in the hands of an individual	No additional income tax returns - all income is taxed on surviving spouse's personal income tax return	

PORTABILITY IN THE BLENDED FAMILY CONTEXT

As a general concept, with estates of several million dollars less than $10M, you would probably use portability with all assets going to the surviving spouse - you would get a step up in basis on the second death and have an easier administration process.

With estates getting close to $10M and the possibility of an estate tax on the second death, you should consider using the traditional Bypass Trust with no portability election. There would be no step up on the second death but these assets would not be included in the second estate.

With estates greater than $10M, you would most likely use the traditional Bypass Trust with no portability election.

In a blended family fact pattern, if the portability election is made by the surviving spouse, she has the ability to make gifts to her children from the prior marriage using the decedent's DSUE and not have any of the decedent's DSUE available for the decedent's children from the prior marriage. For example, if the assets are in a QTIP trust and the decedent thinks that the surviving spouse will use portability to shelter the QTIP trust from taxes on her death, she could instead use the DSUE of decedent to give her assets to her children - the rules say when you make taxable gifts, you use the DSUE of the prior deceased spouse first and then you use your exemption. Thus, there could possibly be no DSUE of the deceased spouse left to shelter estate taxes on assets going to the children of the first marriage that are in the QTIP trust. Also, IRC 2207A says that since the QTIP trust is included in the surviving spouse's estate, the

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QTIP trust pays its own taxes at the highest rates. Taxes are calculated on the surviving spouse's entire estate and then calculated on the surviving spouse's estate excluding the QTIP assets. The difference is what the QTIP trust pays. Thus, the surviving spouse's assets get the use of her exemption and if she has used all of the DSUE with gifts of her assets to her own children, then the kids from the first marriage never get the benefit of the decedent's exemption amount...they would have been better off if decedent had set up a bypass trust and used his exemption on his death to shelter these assets from estate taxes on the surviving spouse's death.

Care must be taken that the executor who is perhaps independent, have the ability to make the correct elections.

Also, in a blended family situation, assume that the husband's first wife died and he elected portability. Then, he marries wife number two. He can still use the DSUE of his first wife at any time until wife number two dies at which time he is limited to wife number two's DSUE.

The prevailing view is that you use the DSUE of the prior spouse as soon as you can to make sure that you can take advantage of that benefit. In essence, if wife number one dies, husband can use her DSUE to make gifts of his assets, then remarry and if wife number two dies, husband can use her DSUE as well.

Should surviving spouse have the power to file the portability election or not...

The law requires that portability be elected on a timely filed Estate Tax Return except that relief for late filing was given on January 29, 2014 by Revenue Procedure 2014-18 to December 31, 2014 if you meet the stated prerequisites.

But assuming that you do use portability and assets have passed to the surviving spouse, note that it has been suggested that the surviving spouse can use the DSUE of the decedent to make gifts to a grantor trust for the benefit of the children which gives a better result to the beneficiaries than the Bypass Trust. The assets are out of the estate of the surviving spouse, all income earned stays with the grantor trust and ultimately, the beneficiary, and the income taxes are paid by the surviving spouse which is like an additional tax free gift because the beneficiary is relieved of the burden of paying the income taxes but gets the full economic benefits of the income.

Also note that bequests of all assets to the surviving spouse may waste deceased's parent's $1M parent child exclusion for Prop 13 purposes. But if the property is in a Bypass trust or a QTIP trust, the decedent is the transferor for Prop 13 purposes and property passing to children, either outright or in trust, could qualify for the residence or the $1M parent child exclusion.

Basis Step up on Second Death

Wouldn't it be nice in a blended family context that after the first death, you could fund a trust with all of the decedent's assets and then have 15 months to make the QTIP election which would give you the ability to either have the assets stepped up again on the surviving spouse's death or just let the assets stay on the decedent's side in the

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Bypass trust and use his exemption to shelter the assets from estate taxes on his death.

Normally, in the traditional Bypass trust and QTIP trust arrangement, you would fund the Bypass trust with the exemption amount and the excess would go to the QTIP. However, in the smaller estates, you would still want the control afforded by a trust since it is a blended family but you would love to get the step up in basis on the second spouse's death.

If you wanted the second step up in basis, you could just have an all to survivor trust and have the surviving spouse disclaim back to a disclaimer trust that would qualify as a QTIP trust for which you could make the QTIP election but how can you be assured that the second spouse in a blended family will disclaim?

Additionally, the disclaimer trust has to qualify as a QTIP trust but if you don't elect, you may not want all of the income payable annually so you would also have to disclaim the income interest in the disclaimer trust so as not to erode principal.

That is a lot of disclaiming!

And you must disclaim within 9 months after date of death.

Along comes Estate of Clayton v Commissioner (5th Cir 1992) 976 F2d 1486, followed by Treas Reg §20.2056(b)-7(d)(3) that allows a trust to be established that qualifies as a QTIP trust but to the extent that the QTIP election is not made with respect to some of the property in the QTIP trust, the non-QTIP property passes to a discretionary Bypass Trust.

Thus you are assured of the control in a blended family situation but you could take advantage of the second step up for assets in the QTIP trust.

And, you have 15 months, with extensions, in which to make the QTIP election.

Note, however, that Rev. Proc. 2001-38 2001-1 C.B. 1335 does cast some doubt on this "Clayton Election" technique and says that the IRS will disregard a QTIP election if it will not save estate taxes but most commentators suggest that this is a savings procedure for erroneous QTIP elections.

But in any event, it is advisable to use an independent trustee to make the Clayton election to avoid an argument by the IRS that the surviving spouse has made a gift of the non-elected assets to the remainder beneficiaries.

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