Spousal Access Trust Makes Use of Enlarged Gift Tax Exemption

Properly drafted mutual trusts let couples take advantage of the $5.12 million gift tax exemption before it expires, without relinquishing access to their property.

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Under current law, the $5.12 million federal estate and gift tax exemptions are due to expire on 12/31/2012, and these exemptions will revert to $1 million. A significant loss of tax benefits may result for taxpayers fortunate enough to survive into 2013—although with proper tax planning, those savings can be retained. To claim the benefit of the current $5.12 million estate and gift tax exemptions before they expire, gifts can be made before year end. If a married couple wish to make use of their $5.12 million gift tax exemptions, but are concerned about providing for themselves, each can create a spousal access trust (SAT) for the benefit of each other. Below is a description of major considerations bearing upon the creation of SATs in the current legislative and economic environment.

Background

In December 2010, the Bush tax cuts were unexpectedly extended for two years with additional estate and gift tax benefits. [1] The top rate of federal estate and gift tax was reduced to 35%, [2] and the federal estate and gift tax exemptions were increased to $5 million per person. [3] Indexed for inflation, the exemptions have increased to $5.12 million in 2012. [4] But, under the Tax Relief Act of 2010, these favorable provisions expire as of 12/31/2012, and the estate tax reverts to its 2001 levels: a top rate of 55% and an exemption of $1 million.

As we enter the 2012 election season, Congress has demonstrated limited political willingness to conduct the country's business on a consensus basis. The prospects for Congress to address the estate tax prior to the election are negligible, and before year end, not much greater. At this time, the end of the Bush tax cuts has to be considered a significant possibility.

What will happen to federal estate and gift tax rates and exemptions is uncertain. A reasonable range of possibilities includes an exemption amount between $1 million and $5 million, and a top rate between 55% and 35%. For a married couple having combined assets of $10.24 million, changes within these parameters will result in additional estate taxes that may be projected to range from $1,134,000 to $4,532,000 (see Exhibit 1).

Exhibit 1. Projected Additional Estate Taxes If Bush Tax Cuts Expire and Are Replaced With Lower Exemptions and Higher Rates

	Top estate tax rate				
Exemption reduced from $5.12 million to...	35% (no state death tax)	45.4% (35% plus state death tax of 16% deductible	45% (no state death tax)	53.8% (45% plus state death tax of 16% deductible	55% (EGGTRA repealed and Section 2011 retored)

		under		under	
		Section 2058)		Section 2058)	
		One spouse			
$3.5 million	$ 567,000	$ 735,480	$ 729,000	$ 871,560	$ 891,000
$2 million	$1,092,000	$1,416,480	$1,404,000	$1,678,560	$1,716,000
$1 million	$1,442,000	$1,870,480	$1,854,000	$2,216,560	$2,266,000
		Two spouses			
$3.5 million	$1,134,000	$1,470,960	$1,458,000	$1,743,120	$1,782,000
$2 million	$2,184,000	$2,832,960	$2,808,000	$3,357,120	$3,432,000
$1 million	$2,884,000	$3,740,960	$3,708,000	$4,433,120	$4,532,000

The prospect of losing the current tax benefits poses a simple question: How can the $5.12 million exemption amount be used before it is reduced? The simple answer is to make gifts before year-end that use the exemption.

Practical gift-giving issues

When high net worth couples wish to use the current exemption amount and retain access to the gift property to provide for their own needs, four basic issues need to be considered:

(1) How much needs to be gifted to obtain the desired benefits?
(2) How may SATs be structured to avoid IRS scrutiny?
(3) What assets are available to be transferred as gifts, and what are their tax attributes?
(4) What is the tax risk of estate tax inclusion?

Gift planning threshold

Gifts to use the $5.12 million exemption prior to its expiration have a specific hurdle to cross. To benefit from the current high exemption for federal estate tax purposes, the gift has to be greater than what the estate tax exemption is reduced to in the future.

For example, if a gift of $2 million is made in 2012, when the estate tax exemption is $5.12 million, and the estate tax exemption is reduced to $2 million in the year of death, the benefit of the current high exemption will be lost: When the estate tax return is filed, the $2 million of lifetime gifts will use the $2 million of estate tax exemption available at death, and the balance of the decedent's assets will be subject to the estate tax at the rates then in effect.

This reality creates a high hurdle for making gifts. It is not enough to make modest gifts. Rather, the planning target is a gift upwards of the full current federal estate and gift tax exemption, $5.12 million.

Avoiding the reciprocal trust doctrine

This high hurdle raises another common concern in making gifts: whether the donors will need the property to provide for themselves. In their planning, two spouses typically wish to provide for one another before providing for other beneficiaries. By creating SATs for the mutual benefit of one another, spouses can accomplish this goal, basically creating during their lifetimes the same “credit shelter” type trusts he or she would create for the survivor at the first death. If the terms of the trusts are sufficiently different from one another, each spouse can use the gift tax exemption up to the full $5.12 million, and avoid triggering estate tax inclusion under the “reciprocal trust” doctrine.

Simply stated, the “reciprocal trust” doctrine holds that when each of two people create a separate trust, each for the benefit of the other, which trusts leave each in the same economic position, each person is treated as having created the trust for his or her own benefit for estate tax purposes. Consequently, each person will have included in his or her estate the trust for his or her benefit. [5]

While the IRS has imposed the reciprocal trust doctrine on several occasions to collect estate taxes, it has also recognized instances when the doctrine does not apply. If the terms of the trust that each spouse creates for the other are sufficiently different from one another, the reciprocal trust rule will not apply. Whether the trusts are sufficiently different from one another is a factual issue, which depends on the provisions of each trust agreement and the governing law of the state in which it is formed. A distinguishing feature may be the creation of the trusts at two different times, for example, at least three months apart. Also, if one trust is more liberal in its distribution provisions for the beneficiary spouse, and the other trust more restrictive, then the two trusts may be recognized as sufficiently different to avoid the reciprocal trust doctrine.

Estate of Levy [6] is the leading example. In that case, the trust created by the husband for the wife's benefit gave the wife a broad power of appointment over the trust for her benefit, exercisable during life or at death in favor of anyone other than herself, her estate, her creditors, or the creditors of her estate. Otherwise the trust for her benefit was the same as the trust she created for her husband. The two trusts were found by the court to be sufficiently different to avoid the reciprocal trust doctrine.

Another example is presented by **Ltr. Rul. 200426008**, where each spouse created a trust to hold insurance on his or her life, for the benefit of the other spouse and their children, including a child who was apparently disabled. The trusts were largely similar, but the trust for the wife gave her certain rights to withdraw up to 5% of the trust principal each year, while the trust for the husband limited distributions to times when his net worth and income from personal services fell below specific levels. The ruling found that the differences were sufficient to avoid the application of the reciprocal trust doctrine. The ruling cites the *Levy* decision and reaches a conclusion consistent with that case. Nonetheless, IRS policy limits the ruling to the taxpayers who requested it and provides that it may not be cited as precedent.

A third example is presented by **Ltr. Rul. 9643013**, where the wife created a trust just for issue, while the husband created a trust for the benefit of the wife and issue. The ruling found that the differences between the two trusts avoided the reciprocal trust doctrine.

Asset analysis

When evaluating use of the mutual trust strategy to benefit from the current exemption amount, first the assets need to be reviewed and summarized, to determine what assets are available for gifting. For instance, retirement assets cannot be transferred without incurring the deferred income tax, making them inappropriate for SAT planning. Other assets may be more appropriate, including cash and securities, and business interests.

While residential real estate and life insurance may also be appropriate for the SAT planning, these assets invite consideration of other planning opportunities, including QPRTs and insurance trust planning. Income tax basis information should also be collected, to confirm that the gifts are not likely to create an income tax liability greater that the estate tax. [7]

If the assets available do not provide each spouse with upwards of $5.12 million to gift, consider having just one spouse create a trust for the benefit of the other. A single trust may claim the benefit of the current high exemption for at least one of two spouses, without creating any concern over the reciprocal trust doctrine.

Structuring SATs

Once the assets have been identified, the two different trusts need to be outlined. One trust will have broader distribution provisions than the other. For instance, consistent with the *Estate of Levy* decision, one spouse should be given a broad lifetime power of appointment in favor of anyone other than himself or herself, his or her estate, his or her creditors, and the creditors of his or her estate, while the other spouse is provided with more limited powers over the trust for his or her benefit.

Consistent with **Ltr. Rul. 200426008**, one spouse may also be given the ability to withdraw principal, while distributions to the other spouse may be subject to consideration of the other resources available to him or her. Additional differences between the two SATs strengthens the argument that they are not subject to the reciprocal trust doctrine.

Exhibit 2 contains an outline of the way in which the two trusts may differ from one another. Which provisions are more appropriate for a particular spouse depend on the circumstances, including which spouse has a greater life expectancy (e.g., wives are three times more likely to be the surviving spouse than husbands), [8] and which spouse owns more substantial assets in his or her name.

Exhibit 2. Ways in Which Spousal Trusts May Differ From Each Other

	Trust for Spouse A, created by Spouse B	Trust for Spouse B, created by Spouse A
Income	Non-spouse trustee may sprinkle for Spouse A and issue or accumulate.	Pay only to Spouse B or accumulate.
Principal	Non-spouse trustee may distribute for HEMS or best interests, taking into account other resources available. Non-spouse trustee may also invade for other beneficiaries. Spouse may appoint during lifetime for issue, or if none, then anyone other than self, estate, creditors, or creditors of estate.	Spouse B has discretionary power of withdrawal for HEMS or 5&5 (which may be exercised by only spouse personally). Independent trustee may invade for best interests of Spouse B.
Remainder subject to	Spouse A given a broad limited power of appointment among	Spouse B given a narrow limited testamentary power of appointment

power of appointment	anyone other than self, estate, creditors, or creditors of estate.	among issue, or if none, then anyone other than self, estate, creditors, or creditors of estate.
Remainder in default of appointment	Remainder limited to children.	Remainder limited to children.
Remote contingency	Siblings of Spouse B and their issue. Charity.	Siblings of Spouse A and their issue. Different charity.
Trustees	Third party trustee with Spouse A. Spouse B can remove and replace within standards providing for independent trustee. (Rev. Rul. 95-58, 1995-2 CB 191.)	Spouse B as sole trustee, with power to appoint independent trustee Spouse B to name his or her own successors (other than Spouse A).
Assets	Different.	Different.
Time of creation	Create first, preferably by three months.	Create second.

Estate tax exclusion—other concerns

Other limitations should be built into the SATs in order to avoid estate tax inclusion. Each trust should state that distributions may not be made that will satisfy any person's obligation of support. Most states impose on spouses the obligation to support one another. If the distributions to the beneficiary spouse may be made to satisfy the donor spouse's obligation of support, the trust may then be included in the estate of the donor spouse. [9]

The power of appointment that each spouse holds over the trust for his or her own benefit may be broad enough to include the spouse that created the trust. However, if the first spouse to die exercises the power of appointment to make the surviving spouse the beneficiary of a trust that the surviving spouse originally created, the trust may be included in the surviving spouse's estate under **Section 2036**, since the surviving spouse may then be viewed as the beneficiary of a trust he or she created. No clear authority exists to avoid this result for a credit shelter type trust, in contrast to the treatment of a marital trust subject to a QTIP election. [10] No assurances can be provided that the power of appointment over a SAT may be used to benefit the donor spouse and avoid inclusion in his or her estate. For this reason, each spouse should be comfortable that the trust for his or her benefit, together with the other assets he or she owns, will be adequate to provide for him or her without regard to the trust for the other spouse.

Estate tax inclusion—Section 2001(b)

When gifted property is included in the donor's estate, the taxpayer is often in the same position as if the gift had not been made. The inclusion rule results in a reduction of the decedent's “adjusted taxable gifts” for purposes of determining the estate tax. [11] Exemption is restored in the amount of the gift, and the estate is increased by the value at death of the gifted property.

Estate tax inclusion does not necessarily create an adverse tax result. No regulations illustrate how the inclusion rule **Section 2001(b)** operates. **Section 2001(f)** does require that post-1997 adjusted taxable gifts be valued at their value as finally determined for gift tax purposes. Presumably, this same rule would apply to the reduction in “adjusted taxable gifts” resulting from an inclusion in the estate.

The Instructions to Form 706 appear to confirm this approach, but they raise another issue. In order for a gift to be taken out of “adjusted taxable gifts,” the instructions anticipate that it be reported on Schedule G of Form 706. To get reported on Schedule G, the taxable gift would appear to have to remain in trust form until the donor spouse's death. In contrast, **Rev. Rul. 84-25** [12] provides for a reduction to “adjusted taxable gifts” without any such requirement of inclusion on Schedule G of the return. The Form 706 instructions provide a worksheet, the sense of which indicates that the gift gets taken out of “adjusted taxable gifts” at its gift tax value, and not at the value at which it is included in the estate, consistent with **Rev. Rul. 84-25**.

If this result is correct, then the inclusion of a trust that has decreased in value from when it was created may provide a transfer tax benefit, because it may restore exemption by reducing the adjusted taxable gifts by more than the estate tax inclusion. This mechanical result does not appear to have previously been a common event, perhaps because the gift tax exemption was never previously high enough to permit gifts large enough for the pattern to occur with any great frequency.

Other tax concerns

For income tax purposes, each trust will be a grantor trust during the lifetime of the spouse that created it, under the rule that attributes to a grantor any power or interest held by his or her spouse. [13] The items of income, gain, and deduction will continue to be reported on the joint income tax returns the spouses file. Upon the death of the grantor spouse, that trust becomes a separate taxpayer, while the trust created by the surviving spouse may continue to be a grantor trust, if it contains other common grantor trust provisions, such as the power to substitute assets. [14] To avoid unwanted tax burdens at a time when the funds available to pay them may be limited, the trusts can give a third-party trustee the discretion to make distributions to pay income taxes. [15]

For income tax purposes, the gifts also result in carryover basis for determining capital gains and losses. [16] As noted above, the potential income tax costs of the gifts should be considered if the property to be transferred is highly appreciated.

For federal generation-skipping transfer (GST) tax purposes, exemption may be allocated to SATs, so that the assets remain free of estate, gift, and GST taxes as they pass from the children's to the grandchildren's generation.

Once each spousal trust is created, as a practical matter it is likely to need to remain in existence until the assets are distributed to the next generation. If assets beyond those needed for ordinary support are distributed to either of the spouses during his or her lifetime and held outside of the trust arrangement, they may be subject to estate taxes without the benefit of any reduction in “adjusted taxable gifts” as indicated by the Instructions to Form 706. But see **Rev. Rul. 84-25**, discussed above, which permitted the adjustment under **Section 2001** for assets included in an estate without regard to the existence of a trust.

Consideration should also be given to the more amorphous theories that the Service may apply to assert estate tax inclusion, including the step-transaction doctrine and the allegations of an implied agreement between the spouses to benefit whoever survives through the exercise of the power of appointment. Factors that may avoid these arguments include:

(1) Creating the trusts at different times from one another, such as three or more months apart.
(2) Retaining sufficient assets in the name of each spouse to provide for his or her needs independently from the trusts.

Broader planning concerns

The urgency of SAT planning should be considered in light of what is known about the likely course of the estate and gift tax. As described at the beginning of this article, the range of possibilities includes reversion to the 2001 levels of estate tax: an exemption of $1 million and a top rate of 55%. Two scenarios need to be considered, with one being more important.

The first scenario is the failure of Congress to take any action on the Bush tax cuts prior to the election in November, and then prior to the new congressional session in 2013, so that the Bush tax cuts actually lapse as of 1/1/2013, and the estate tax system reverts to the $1 million exemption and 55% top rate. Given the conduct of current political leadership to date, even the most casual observer may readily conclude that this result is highly likely.

The second scenario is the more important. Once the new congressional session begins, how likely is Congress to address the continuation or revision of the Bush tax cuts within the first six months of 2013? The more significant planning issue is not what the exemption may go down to on 1/1/2013, but what it is likely to be at one's death.

Consider the respective positions of the political leadership. Obama's 2012 Greenbook proposal for the federal estate tax is an exemption of $3.5 million and a top rate of 45%, which were the levels in 2009, and for the federal gift tax is an exemption of $1 million. [17] In the 2010 compromise, the Republican leadership pushed for the $5 million exemption and 35% top rate. Many Republicans continue to favor estate tax repeal.

Conclusion

Due to political uncertainty, couples may wish to create SATs to lock in the use and benefit of the current $5.12 million exemption. SATs provide a useful vehicle to claim the benefit of the $5.12 federal estate and gift tax exemptions before they expire at the end of the year. As the year progresses, and the potential loss of the Bush tax cuts approaches, the creation of SATs as a once-in-a-lifetime opportunity to preserve family wealth will become increasingly compelling.

[1] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010), Pub. L. 111-312 (2010).

[2] **Sections 2001(c)** and **2502(a)(2)**.

[3] **Sections 2010(c)** and **2505(a)**.

[4] **Rev. Proc. 2011-52, 2011-45 IRB 701**.

[5] The leading cases establishing the reciprocal trust doctrine are Estate of Grace, **23 AFTR 2d 69-1954**, 395 US 316, 23 L Ed 2d 332, 69-1 USTC ¶12609, 1969-2 CB 173 (1969), and Lehman, **24 AFTR 198**, 109 F2d 99, 40-1 USTC ¶9198 (CA-2, 1940), *cert. den.* 310 U.S. 637 (1940).

[6] **TC Memo 1983-453**, PH TCM ¶83453, 46 CCH TCM 910 .

[7] As a result of TRA 2010, income tax rates and estate tax rates are closer to one another than at any other time in recent memory. For an analysis of how income tax burdens can offset estate tax savings, see Mahon, "The „TEA‟ Factor: How Much Appreciation Must Occur for a Gift to Provide Estate Tax Savings Greater Than Income Tax Costs," 150 Trusts & Estates 46 (August 2011).

[8] By way of example, IRS statistics for estate tax returns filed in 2007 show that 75% of the male decedents left a surviving spouse, while only 32% of the female decedents did so. These statistics can be found at http://www.irs.gov/taxstats/index.html.

[9] **Reg. 20.2036-1(b)(2)**.

[10] See **Reg. 25.2523(f)-1(f)**. Example 11.

[11] **Section 2001(b)**, last sentence.

[12] 1984-1 CB 191.

[13] **Section 672(e)**.

[14] **Section 675(4)**.

[15] **Rev. Rul. 2004-64, 2004-2 CB 7**.

[16] **Section 1015**.

[17] http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf. See pages 75-76.