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W. Birch Douglass III

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ESTATE PLANNING FOR SPOUSES

W. BIRCH DOUGLASS, III

Introduction

For this presentation it is assumed the spouse for whom we are doing our planning is the less wealthy spouse and the one who is (or will be) the surviving spouse. For simplification and ease of reference, this spouse is assumed to be the wife.

Before the Tax Reform Act of 1976 most of us gave little, if any, attention to true estate planning for the wives of our clients unless such wives had substantial assets of their own. At best, we simply made sure the wife had a properly drafted will that did not conflict with the husband's will.

After 1976 we began seeing more wives with larger estates because of the 100% marital deduction available for the first \$100,000 of interspousal transfers during lifetime. Then, with The Economic Recovery Tax Act of 1981 and its provisions for the unlimited marital deduction, qualified terminable interest property trusts (QTIPS) and the new rules for qualified joint interests, the number of wives with six-figure estates has increased dramatically.

Frequently, the wife is not aware she even has what one could call an "estate." New York Life Insurance Company has recently publicized this in an advertisement that has appeared in many national publications. The advertisement shows a picture of a wife saying "Estate planning? Why me? Everything's in Harry's name."

As a tax practitioner and estate planner, I see the "wholesale" use of the unlimited marital deduction and QTIPs in the husband's estate plan as providing tremendous post-mortem opportunities and flexibilities. However, I also see these techniques as forcing the wife and her advisors to confront a multitude of complex issues in planning her own estate, both during the life of the husband and after his death. Let us now explore a few of these issues as well as certain other points to be considered by the wife's advisors.

Gifts to Children

Gifts by the wife to the children may impair her future financial security if the husband's estate proves to be smaller than anticipated or the husband does not provide adequately for the wife in his will. Generally, this is not a problem where the husband has substantially more wealth than the wife. He will want to make all of the gifts to the children, with the wife simply joining in the split-gift election.

As long as the gifts over which the split-gift election is made by the wife do not exceed the available annual exclusions for the unified credit, there is really no disadvantage to the wife in joining in the husband's gifts. However, it should be kept in mind that if the husband

is making sizable gifts of interests in a closely-held business in such a manner as to utilize his and his wife's unified credits, the wife could later find herself receiving a substantial tax bill from the Internal Revenue Service if on audit any significant adjustment is made in the gift tax value of the stock. Should the husband have died in the interim, the wife may not have adequate financial resources at her disposal to pay the taxes and interest on her half of the gifts. A similar situation, but perhaps worse, could be faced by the wife if the husband and wife are divorced before the gift tax returns are audited. Unless this potential tax liability is covered in the property settlement agreement, it is unlikely the husband would voluntarily provide the tax dollars to his ex-wife, particularly if they exceeded the \$10,000 gift tax annual exclusion since he might well incur current gift taxes on the dollars provided to pay the earlier gift taxes.

Although prenuptial and postnuptial agreements are normally thought of in second marriage situations, they may at times be appropriate in first marriages to provide the wife with certain protections before she embarks on or participates in a gift-giving program or otherwise disposes of or encumbers her properties as part of the couple's overall estate plan. In order for such an agreement to be enforceable, the agreement should contain the criteria outlined in *Batleman v. Rubin*, 199 Va. 156, 98 S.E.2d 519 (1957). Caution should be exercised if the agreement covers what happens in the event of a divorce, as the entire agreement may be void as contrary to public policy under *Cumming v. Cumming*, 127 Va. 16, 102 S.E. 572 (1920).

Ownership of Insurance on Husband's Life

Before the unlimited marital deduction and the popularity of "Crummey trusts" and "supertrusts," the common advice given by most practitioners was to have the insurance on the husband's life owned by the wife. Now, it appears many clients and advisors are placing much too great an emphasis on keeping the proceeds out of the gross estates of both the husband and the wife without giving adequate attention to the wife's desires or the irrevocable nature of the insurance trust.

I find far too many clients in their 30's and 40's coming to me for irrevocable life insurance trusts as a panacea for their estate tax problems. Frequently, they have been "brainwashed" by articles in trade publications, by insurance advisors and by friends into believing that it is almost unpatriotic not to have a Crummey-type trust. These clients are generally not aware that such a trust is irrevocable, that the Internal Revenue Service will no longer rule favorably on most insurance trusts because of Rev. Proc. 81-37, 1981-2 C.B. 592, or that by creating the trust they will no longer be able to pledge the insurance as collateral for personal or business loans.

From the wife's standpoint, however, an irrevocable life insurance trust created by the husband may be very beneficial. The trust further insulates the proceeds from creditors, avoids the wife's being faced with decisions on how to dispose of the proceeds to avoid taxability in her

estate at her subsequent death and also to a certain degree may, depending upon how the trust is drafted, protect the wife from being cut out of the dispositive scheme if there is a deterioration in the marital relationship.

For the wife's own protection and financial security it might be appropriate for the wife to own a certain amount of insurance on the husband's life outright and free of trust.

In those situations where the husband and wife have purchased a "second-to-die" insurance policy as a means of providing dollars for estate taxes at the second death, consideration should be given to how and from what source the wife will pay the premiums (if any) due after the husband's death.

Checklist For Wife's Will

If the wife's estate is (or may be through appreciation or inheritances) close to the unified credit exemption equivalent, she should consider a typical two-trust marital deduction will to minimize taxes in the event the wife should predecease. It is not wise to rely on the husband's ability to disclaim (for example, because of incapacity).

If the wife's estate is of moderate size but less than the unified credit exemption equivalent (and an outright bequest to the husband would unnecessarily increase the size of his estate), the wife should consider a credit shelter trust for the husband. The trust should be designed as a QTIP to permit a partial election if the wife's estate should exceed the unified credit equivalent.

If the wife's estate is small (but not nominal), the wife should consider an outright bequest to the husband with a provision that if he disclaims the assets are to pass into a credit shelter trust for him. A "double disclaimer" by the husband could pass the assets to the children if he decides he does not need the income from the assets. Caution should be used to make sure the husband as trustee or beneficiary is not given any powers that would prevent a qualified disclaimer. For example, the proposed regulations under I.R.C. Section 2518 disallow qualified disclaimer treatment if the husband retains a special power of appointment or as trustee can exercise his fiduciary discretion in such manner as to affect the beneficial enjoyment of the trust's income or corpus.

Any insurance owned by the wife on the husband's life should normally be left outright or in trust to the children (either by will or by contingent ownership provisions) as opposed to having the policies pass to the husband. If the policies are left to a trust, the husband should not be the trustee because possession of incidents of ownership in a fiduciary capacity may cause inclusion in the husband's gross estate under Rev. Rul. 76-261, 1976-2 C.B. 276. In spite of the position of the Internal Revenue Service, it should be noted that the courts are split on this issue. The most recent case in this area is *Estate of Bloch*, 78 T.C. 850 (1982), in which the taxpayer won.

Unless there are disclaimer provisions in the wife's will specifying the takers of disclaimed property, the wife's will should not "pour over" to the husband's inter vivos trust. The reason is that if the husband survives he may not be able to make a qualified disclaimer, as the disclaimed assets would pass to a trust over which he has the power to revoke. It can, however, be argued that the disclaimer in such event would constitute an incorporation by reference in the wife's will of those trust provisions in effect at the wife's death, but this may require a court order.

In many situations the most difficult assets to deal with in the wife's will are tangibles such as jewelry, silver and antiques. The wife may not want to leave these items to the husband for fear they may find their way into the hands of a second wife. If the children are minors, it may not be appropriate for the items to pass to the children at that time. Also, a bequest of the items to the children could subject the items to death taxes in certain situations (for example, if the wife has made substantial lifetime gifts or made split-gift elections using her unified credit). One solution may be to give the husband a life estate in the tangibles with instructions to the executor to make the QTIP election to avoid current estate taxes. Although life estates in tangibles are frequently viewed as administrative nightmares (unless the will contains specific authorization permitting the husband to give a receipt which will be deemed a sufficient voucher in the executor's accounts and relieves the executor of a duty to see that the tangibles ultimately pass to the remaindermen), the arrangement does at least give some assurance that the items will ultimately pass to the desired beneficiaries. However, there are certain pitfalls with this arrangement. The husband, having a life estate, could of course allow a second wife to use the items during his lifetime. To the extent the items appreciate in value and a QTIP election has been made, the items will likely be subject to greater taxes at the husband's death. If the husband decides to give the items to the children during his lifetime by releasing his remaining life estate, taxable gifts may result.

Planning Techniques Before the Husband's Death

Much post-mortem planning for the husband's estate can be commenced before the husband dies. In view of the great concern many terminally ill clients and their families have to get their affairs in order and to minimize estate taxes, it is no longer viewed as morbid to suggest tax planning techniques for the wife in conjunction with revisions in the estate plan of the dying husband.

One technique that may be of interest is one I call the "gift, bequest back." If the husband is expected to live at least a year, the wife can step up her basis in an asset by giving it to the husband who then wills it back to the wife tax-free under the unlimited marital deduction. (Because of I.R.C. Section 1014(e), there is no basis step up if one year does not elapse between the gift and the bequest.) Instead of an

outright gift, the wife could create a QTIP for the husband, retaining the reversionary interest for herself, and it appears the tax result would be the same. Even if the husband is not expected to live at least a year, it may still be possible to use the technique if the husband has a typical two-trust marital deduction will so that the assets given by the wife to the husband can be allocated to the credit shelter trust created under the husband's will. In this situation, the wife has merely traded one asset for another (a larger marital trust), with the added advantage of securing a basis step up in both assets. These techniques are particularly attractive where the wife has low basis, low yield assets she would probably sell after the husband's death in order to reinvest for a higher yield. Substantially depreciated rental property is another asset to consider in this situation.

A variation is a technique I call the "gift, bequest over." The idea here is to use the husband as a conduit to permit the wife to give certain of her assets to the children with a stepped-up instead of a carryover basis. Recently, I have encountered a number of wives who have interests in farm land or other real estate acquired by gift or inheritance years ago with little or no tax basis, and assets such as these are ideal for this technique.

Caution must be exercised in using both of these techniques to avoid increasing the husband's estate to the point where it might fail to qualify for favorable treatment under I.R.C. Sections 303, 2032A and 6166. Also, other possible disadvantages (for example, increased administration expense) should be considered before employing one of these techniques.

With respect to jointly owned property, it may be desirable to sever the survivorship provision to eliminate half of the appreciation after the husband's death from the wife's gross estate. Instead of simply severing survivorship provisions, it might be preferable to retitle the property 100% in the husband's name, with a provision in the husband's will leaving the property to the wife or in trust for her benefit. This will provide a basis step up in the entire property unless the one-year rule mentioned before applies.

Qualified retirement plan beneficiary designations and settlement options should be carefully reviewed, particularly in view of the recent amendment to I.R.C. Section 2039 placing a \$100,000 ceiling on the amount of plan benefits that qualify for the estate tax exclusion. If the wife expects to have adequate income from other sources, she may want a spousal rollover into an individual retirement account. The rollover can be made only if the wife (and not a trust) is the beneficiary and if the benefits are payable in a lump sum.

Items to Consider Immediately After the Husband's Death

If the wife is named as a fiduciary under the husband's will, the provisions of the will should be carefully checked to determine whether there are reasons the wife should decline to qualify as a fiduciary. For

example, if the wife and a bank are named as co-trustees for a credit shelter trust which permits invasions of principal for the wife not limited by an ascertainable standard, I.R.C. Section 2041 treats the wife as having a general power of appointment over the credit shelter trust even though she cannot make the invasions alone.

In order to have a qualified disclaimer, one of the key requirements is that the wife must not have accepted the benefits of the property to be disclaimed. Thus, if there is any likelihood the wife may make a disclaimer, she should be cautioned not to accept the benefits of the property. This requirement is most likely to be "violated" with respect to joint accounts, principal and secondary residences, income producing properties and life insurance proceeds. If there has been a prior acceptance of benefits (perhaps unknown to the attorney involved unless he makes certain inquiries), the attempted disclaimer may result in a taxable gift, as the disclaimer would still be effective under Virginia law to transfer ownership of the property.

QTIP Election

One of the most difficult decisions that will face wives as time goes on is whether and to what extent the QTIP election may be desirable in the husband's estate. To a large degree the husband's executors will defer this decision to the wife who will rely on us for advice in this area. Among the many factors to be considered are:

- (1) The wife's age, apparent health and projected gross estate.
- (2) The anticipated investment yield and appreciation until the wife's death on the assets taxable in the husband's estate if the QTIP election is not made.
- (3) The wife's income and other resources without the income that would be produced by the husband's assets that will be used to pay death taxes if the QTIP election is not made.
- (4) Whether wasting assets are likely to be allocated to the marital trust.
- (5) Whether deferral under I.R.C. Section 6166 or special use valuation under I.R.C. Section 2032A will be more beneficial than the QTIP election.
- (6) Likelihood of the wife's death within a short period of time and whether the credit for tax on prior transfers under I.R.C. Section 2013 may be more valuable than the QTIP election.

Replanning the Wife's Estate

The following checklist should be of assistance to the wife's advisors in replanning the wife's estate after the husband's death:

- (1) Determine whether to exercise powers of appointment to direct specific assets to particular beneficiaries (for example, stock in the family corporation to a child in the business).
- (2) Review the persons named as the wife's executors and trustees.

(3) If the wife is a fiduciary and has the right to name her successor, consider exercising the right.

(4) Consider the need for additional insurance on the wife's life.

(5) Depending upon the wife's financial security, implement (or continue) a gift-giving program to take advantage of the \$10,000 per donee annual exclusion. Payment of tuition and medical expenses for grandchildren are not gifts for tax purposes.

(6) If the benefits of I.R.C. Sections 303, 2032A and 6166 are desired, take such steps as may be necessary to assure the availability of the benefits.

(7) The tax clause in the wife's will should be reviewed carefully, with particular attention given to the source of the payment of death taxes on nonprobate assets such as marital deduction trusts (QTIPs or otherwise).

(8) Be alert to any grandfathered generation-skipping provisions.

(9) If the wife or the marital trust established by the husband receives common stock in closely-held businesses, consider a recapitalization to minimize growth in the wife's estate.

(10) Assets likely to appreciate may be sold to the children in exchange for notes as a means of freezing the wife's estate.

Income Tax Planning

This area should not be overlooked, as frequently the wife is in a higher income tax bracket after the husband's death because of the receipt of insurance proceeds, retirement plan benefits and trust income.

Arrangements to shift income to lower bracket taxpayers should be explored. These may include gifts to children and grandchildren, outright or in trust. The popularity of interest-free demand loans as a means of shifting income to lower bracket taxpayers may be more risky now in view of the recent decision in *Dickman v. Commissioner*, 11th Cir. No. 81-5297 (November 1, 1982), where it was held that interest-free demand loans to family members resulted in taxable gifts since, in the court's view, the right to use money is the transfer of a property right subject to the gift tax.

In conclusion, we should keep in mind that most widows, particularly elderly ones, are unable to cope with the management of investment assets even though their paramount concern may be financial security. We can be of great assistance to our clients by guiding them in the right direction. Alternatives include durable powers of attorney, portfolio management accounts, trusts (either funded or "standby" ones), custody and agency accounts and financial counseling services.