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Integrating Income Taxes in Modern Estate Planning Decisions — A Case Study

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INTRODUCTION

After a decade of uncertainty, the last five years in the estate planning world have been relatively stable. High exemption amounts — the amount that can be protected from estate tax — mean few people are subject to estate tax. On the other hand, increasing income tax rates result in more people paying more income tax. The consequence is that, for most people, tax planning for the inevitability of death has been turned on its head, with high asset values for a step-up in basis to avoid income tax trumping low asset values to avoid or reduce estate tax.

Of course, non-tax objectives remain essential to an estate plan. For example, probate avoidance, protecting a surviving spouse from losing his or her assets and protecting a child's inheritance from divorce or a lawsuit, remain paramount. Although the tools to accomplish these non-tax objectives remain trusts, how trusts are used in view of the new tax paradigm has changed.

This article first sets forth the current estate planning landscape. It next outlines why the traditional planning under prior law no longer applies for many. Finally, it utilizes three case studies to illustrate the practical ramifications of implementing an estate plan in this new environment. The focus is on U.S. citizens worth less than $5 million.

ESTATE PLANNING LANDSCAPE TODAY

Much has been written about the impending death knell of traditional estate planning in light of recent law changes that impact estate planning. A few items in particular have remarkably altered the focus of estate planning: (1) the significant increase in the amount of the estate tax exemption; (2) the ''portability'' of the estate tax exemption amount between spouses; and (3) the increase in federal individual income tax rates.

Changes in the Estate Tax

The first major law change occurred with the enactment of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the ''2010 Act'').[1] The 2010 Act increased the basic estate tax exemption amount to $5 million for 2010 and 2011, and also enacted ''portability'' for married spouses, which generally allowed a decedent spouse's unused exemption to be transferred to the surviving spouse. Thus, where the first-to-die spouse died without using the full $5 million exemption, the surviving spouse could subsequently utilize this unused exemption upon his or her death.

Although the 2010 Act was only temporary in effect — scheduled to sunset on December 31, 2012 — the American Taxpayer Relief Act of 2012 (the ''2012

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[1] Pub. L. No. 111-312.

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Act'')[2] was not. Instead, the 2012 Act made portability a permanent mainstay of the Internal Revenue Code and also indexed the estate exemption amount to inflation. The effect of this large, inflation-adjusted exemption amount was to shield more property from estate taxes at death. Still further, the combination of the increased exemption amount with the enactment of portability had the effect of rendering over $10 million exempt from estate and gift tax for a married couple, an amount which is well beyond the net worth of the vast majority of married couples.

In sum, whereas the estate exemption amount for decedents dying in 2002 was a mere $1 million, for 2017 the inflation-adjusted estate tax exemption is $5.49 million.[3] Thus, over the past 15 years, the basic exemption amount has increased over five-fold. The increase in the estate exemption enacted in 2010 has significantly decreased the number of estates that are ultimately liable for the estate tax. Indeed, the Joint Committee on Taxation reports that, for 2013, less than two of every 1,000 estates were required to pay estate tax.[4] As discussed further below, the changes have significantly altered the approach to estate planning.

Changes in the Income Tax

While the reach of the estate tax has diminished with the higher estate exemption amounts and the enactment of portability, individual ordinary income tax rates have generally increased over the same timeframe, particularly for individuals in the higher income tax brackets. Although the 2012 Act made permanent many of the income tax cuts made during the Bush administration, the 2012 Act effectively increased the tax rates on higher income earners. In particular, the 2012 Act imposed a 39.6% ordinary income tax rate on income above $400,000 for single taxpayers or $450,000 for taxpayers that are married filing jointly.

Along with the increase in ordinary income tax rates, the 2012 Act generally phased out the personal exemption when adjusted gross income is over $250,000 for single taxpayers, and $300,000 for taxpayers that are married filing jointly. The 2012 Act also brought back the ''Pease'' limitation on itemized deductions for adjusted gross income over $250,000 for single taxpayers, and $300,000 for taxpayers that are married filing jointly. For high-income earners, the resuscitation of the Pease limitation effectively raises the federal income tax rate by 1.2% for a taxpayer that is married filing jointly.

With respect to capital gains tax rates, the 2012 Act also increased the top long-term capital gain tax rate of 20% for taxpayers in the 39.6% ordinary income tax bracket, and preserved the 15% long-term capital gain tax rate for taxpayers in the 25%, 28%, 33%, and 35% ordinary income tax brackets. For taxpayers in the 10% and 15% ordinary income tax brackets, there generally is no capital gains tax on long-term gains for most assets.

Taken altogether, the increase in the estate tax exemption, the portability of the estate tax exemption to surviving spouses, along with the concurrent increase in federal individual income taxes, have reshaped the focus of estate planning in a number of important ways.

EFFECT OF LAW CHANGES

Prior to the law changes discussed above,[5] it was frequently common for each individual of a married couple with a modest level of assets to create a revocable trust to help shield the assets from estate tax. Upon the death of the first spouse, the revocable trust would commonly bifurcate the decedent's assets into two trusts: a credit shelter trust and a marital trust.

[2] Pub. L. No. 112-240.

[3] §2010(a). Rev. Proc. 2016-55, 2016-45 I.R.B. 707, §3.35. All section references herein are to the Internal Revenue Code, as amended, and the regulations promulgated thereunder, unless otherwise stated.

[4] Joint Committee on Taxation, ''History, Present Law, and Analysis of the Federal Wealth Transfer Tax System'' (JCX-52-15) (Mar. 16, 2015).

[5] Whereas this portion of the article discusses the decrease in utility of a traditional credit shelter trust for the vast majority of estates, there remain a number of instances where the credit shelter trust maintains its traditional role in forming an estate plan. Although beyond the scope of this article, a few such instances include:

1. Estate plans for married couples that have accumulated significant value, such that the basic exemption amount and portability do not maximally shield the combined estates from estate tax.

2. Estate plans where there is a likelihood that trust assets may significantly appreciate in value between the deaths of the predeceased spouse and surviving spouse, and/or where there is a significant difference in age between spouses, such that the basic exemption amount and portability do not maximally shield the combined estates from estate tax.

3. For split family situations (e.g., where a spouse has children from a previous relationship or marriage), a credit shelter trust may provide clarity as to the disposition of assets upon the surviving spouse's death.

4. For Generation-Skipping Transfer Tax purposes. As the exemption available under the Generation-Skipping Transfer Tax is not portable under present law, a credit shelter trust is a mainstay to shelter the predeceased spouse's exemption from Generation-Skipping Transfer Tax.

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Under prior law, the basic exemption amount for each spouse of a married couple was structured as a ''use it or lose it.'' Therefore, the purpose of the credit shelter trust was to fully utilize the basic exemption amount so as not to ''lose it,'' thereby ensuring that the decedent maximized the estate tax benefit provided under the basic exemption.

To achieve this result, the revocable trust would generally utilize a formulaic approach, whereby upon the death of the first spouse, the trustee was directed to allocate so much of the trust property to the credit shelter trust to fully utilize the exemption under §2010(c), with the remainder of the trust property being allocated to the marital trust, which would in turn qualify for the marital deduction.[6] In effect, then, the credit shelter trust would allow married individuals to shelter assets from the estate tax by placing assets in the trust in an amount equal to the estate tax exemption.

Further, the credit shelter trust is often structured to give the surviving spouse access to the decedent's assets during his or her life. Typically, the credit shelter trust grants the surviving spouse an interest in the income and principal of the credit shelter trust for life (in effect, a life estate), subject to an ascertainable standard (e.g., health, education, maintenance and support). At the death of the surviving spouse, the remainder would go to the children of the decedent and surviving spouse. Because the credit shelter trust is funded up to the applicable exemption amount, the estate of the first-to-die spouse would generally bear no estate tax at the death of the surviving spouse; instead, the trust will bypass the surviving spouse's estate.

It is important to note that, if a credit shelter trust were not used, there would still be no estate tax at the first spouse's death because of the marital deduction; however, in the absence of the credit shelter trust, the estate of the second spouse to die would be subject to an increased estate tax liability because the property that passed by way of the marital deduction would be included in the surviving spouse's estate upon his or her death. However, with the use of a credit shelter trust, this same amount would not be included in the surviving spouse's estate, providing a real value in decrease estate tax liability.

Today, the underlying rationale for using the credit shelter trust has much less force, and may even produce tax consequences that ultimately are adverse to the intentions of the grantor, the estate and the ultimate beneficiaries. This generally obtains for three reasons.

First, present law allows for the portability of the estate exemption to the surviving spouse. The basic exemption is no longer a ''use it or lose it'' system with respect to the first spouse to die. Before portability came into effect, each spouse was forced to use his or her lifetime exemption either before or after his or her death; it was a ''use it or lose it'' for each spouse. Now, the exemption is portable to the surviving spouse, and therefore can also be used when the surviving spouse dies. Portability of the estate exemption from one spouse to another has thus decreased the utility of a credit shelter trust for a significant portion of estates of married couples.

Second, as discussed, the basic estate exemption has increased significantly over the past 15 years, with a present exemption of $5.49 million. The vast majority of individuals do not amass estates that approach the estate exemption amount. Thus, the estates for such individuals generally may not need to utilize a credit shelter trust to avert being subject to estate taxes.

Third, given today's law there can potentially be adverse income tax consequences where a credit shelter trust is used. At death, a decedent's property generally receives a stepped-up basis, meaning that the property is valued as the fair market value on the date of the decedent's death.[7] The stepped-up basis can be of significant value, as it shields from income tax any appreciation on the estate's value between the time the decedent acquired the property and the decedent's date of death.

However, where a credit shelter trust is used, the assets placed into the credit shelter trust receive a ''step-up'' in basis to the fair market value at the time of death for the first spouse to die.[8] However, because assets that are placed in a credit shelter trust aren't included in the surviving spouse's estate, no second ''step-up'' in basis occurs upon the death of the surviving spouse for the assets in the credit shelter trust. Given the increased individual income tax rates, this may result in the loss of a very significant benefit to the estate, particularly where the assets had appreciated in value since the time the first spouse had died.

NEW PARADIGM FOR ESTATE PLANNING

With significant changes in estate planning, and increased impact of income tax consequences, where does that leave the estate planner today?

Not surprisingly, the focus for the estate planner has changed. First, whereas the need for the use of revocable trusts in estate planning remains unabated, the underlying rationale has taken a different shape.

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[6] §2056(a).

[7] §1014.

[8] *Id.*

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Second, from a tax perspective, given the increase in the basic exemption amount, the enactment of portability, and the increase in individual income tax and capital gain tax rates, the tax focus has generally shifted from averting estate tax consequences (e.g., through the use of a credit shelter trust) to planning for a step-up in basis for assets upon the death of the surviving spouse. Finally, the estate planner is now regularly confronted with post-mortem estate planning problems that exist due to the significant law changes that have occurred over the past 15 years.

This section emphasizes three main points as a result of the changes in law:

1. Notwithstanding the changes, the need for ''traditional'' estate planning remains as vital as ever. Under such estate planning, there continue to be significant reasons for the vast majority of individuals to create revocable trusts.

2. The substantive focus of the estate plan has been altered as a result of the law changes. As fewer estates are subject to estate tax due to changes in law, the aims commonly center on income tax as well as non-tax considerations.

3. Many decedents have estate plans that fail to address the change in focus. As such, there is renewed focus on the post-mortem rectification of estate plans that were reasonable when executed, but do not make sense in light of current law.

Although the analysis in this article pertains primarily to *federal* estate and income taxes, *state* estate and income taxes should also be considered. At last count, 15 states still impose a state estate tax. Thus, without a state estate tax in most states, the shift in the estate planning paradigm, where income tax trumps the estate tax, is even more pronounced. Further, considering state income tax rates, which can approximate or exceed 10% in states such as California, the income tax effects within an estate plan become even more consequential. The bottom line: attaining a step-up in basis upon death to offset income tax becomes even more important for an estate plan when state income taxes are considered.

Consider three examples to illustrate how the paradigm has shifted for estate planning today.

A Traditional Estate Plan

Consider the first example, which illustrates how, although the underlying rationale for a traditional estate plan has changed, there are nonetheless significant reasons to execute revocable trusts.

Example 1

Ozzie and Harriet have been happily married for 30 years. They have two grown children, both of whom are successful lawyers. Ozzie and Harriet have recently retired and entered their twilight years. Ozzie and Harriet's combined net worth is $4 million. Upon the first of the two to die, they intend to leave the entire estate to the surviving spouse, and at the death of the second spouse, they intend to leave the balance of their estate to their two children in equal shares. Based on these facts, how should an estate planner approach Ozzie and Harriet's fact pattern?

For an estate size less than the basic exemption amount, the underlying tax motive has shifted from one with an estate tax focus to one with an income tax focus. Upon the death of Ozzie and Harriet, the assets will receive a stepped up basis to fair market value. However, the estate will not be subject to estate tax due to the increase in the basic exemption amount. Thus, due to the increased estate exemption amount, $5.49 million, and the portability of the decedent's exemption to the surviving spouse, there ostensibly is no reason to create a traditional by-pass credit shelter that would absorb the estate tax liability, and mitigate exposure for the second to die.

However, on balance, there are still significant non-tax reasons for Ozzie and Harriet to execute revocable trusts given the present facts.

First, by creating and funding their trusts, Ozzie and Harriet will be able to avoid probate. Probate may be a very costly process, both in terms of economic costs as well as a drain on time and energy. Where an estate must be probated, fees for services may be due to the personal representative, estate planning and administration attorneys, accountants, and frequently, appraisers and other professionals. Although the rules vary by state and locality, estates will generally incur additional costs for probate tax, filing fees, and other ancillary administrative fees. Even worse, probate can frequently take a significant emotional toll on the loved ones of the decedent, and the private details of families generally become part of the public record as a result of probate.

Therefore, it remains advisable for Ozzie and Harriet to execute wills that pour over all of their assets into their respective revocable trusts. In doing so, provided their trusts are appropriately funded, their estates can avoid substantial probate costs at death.

Second, basic estate planning can provide significant asset protection for Ozzie's and Harriet's assets following death, which ultimately inures to the benefit of their children. Thus, their estate planning may be structured so as to protect the assets from a failed marriage and a barrier to creditors of the beneficiaries of the trust. With U.S. divorce rates hovering around nearly one out of every two marriages, their children may have a marriage that ends with divorce, or other

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claims may arise. By maintaining the assets in trusts, Ozzie and Harriet can help protect their assets from a divorce and a barrier to other claimants. For example, Ozzie and Harriet might provide in their revocable trusts that, upon the second death, each child could serve as trustee of their own trust upon attaining a specified age (e.g., 35 years old), effectively giving the children control over the assets in their respective trusts, while simultaneously shielding those assets from prospective claimants adverse to the children. As the sole Trustee, a child has control over distributions that the child can receive.

Finally, Ozzie and Harriet may consider granting their children a testamentary limited power of appointment, so that each child may appoint the trust property to beneficiaries of their choice, such as a long-time spouse or a child with special needs. The result is that Ozzie and Harriet can exercise a measured amount of control to help ensure that the assets are preserved for their children, as well as for future generations.

Therefore, irrespective of the changes in the estate planning tax rules, there remain significant reasons for Ozzie and Harriet to each create a revocable trust and appropriate trusts for their children upon their deaths.

What's the Basis of Your Estate Plan?

A second common feature of estate planning today relates to a shifted focus from estate tax planning to income tax planning. Consider a second example with Ozzie and Harriet.

> *Example 2*
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> Ozzie and Harriet have been happily married for 30 years. They have two grown children, both of whom are successful lawyers. Ozzie and Harriet have recently retired and have entered their golden twilight years. Ozzie and Harriet's combined net worth is $4 million. Upon the first of the two to die, they intend to leave the entire estate to the surviving spouse. At the death of the second spouse, they intend to leave the balance of their estate to their two children in equal shares.
>
> However, recently Ozzie has begun to have anxieties that Harriet may soon suffer from dementia or Alzheimer's disease. He fears that, if he were to die before Harriet, she may unwittingly succumb to the fancies of the pool boy and give everything away to him, leaving nothing for their two beloved children.
>
> Harriet, on the other hand, has concerns that, if she were to die before Ozzie, he may become victim to the aggressive paramour in the nursing home. The paramour may entice Ozzie to forget his previous happy wife and happy life from the past 30 years, convincing him to leave it all behind and abscond with the estate, thereby leaving nothing for their beloved kids.
>
> Based on these facts, how might we approach Ozzie and Harriet's fact pattern?

First, note that similar to the first example, the rationale for having trusts remains. Properly structured, revocable trusts can provide a significant level of asset protection to the decedent's assets, and, where the trust is funded, can assist in circumventing the onerous requirements of probate. Further, because the total value of their estate, $4 million, it is likely unnecessary to provide for a credit shelter trust. Lastly, upon the first to die, the executor for the decedent spouse's estate may make the portability election to transport the unused credit to the surviving spouse, bringing the total exemption for the unused credit to $10.98 million.

However, in this scenario, the estate planner is confronted with a different issue. How can the first-to-die spouse maintain a level of control over the assets after his or her death, where there are concerns that the surviving spouse, in light of various hypotheticals, may squander the assets to the detriment of the estate's other beneficiaries?

Grant a General Power of Appointment

One viable idea is to create trusts that concomitantly utilize a "power of appointment." A power of appointment may be given by an owner of property ("the donor") to another person who holds the power (the donee). The donee may then appoint the property to an "appointee." Alternatively, where the power is not exercised, there generally is a designated default, called the "taker in default."

The Code distinguishes broadly between two types of power of appointment: a general power of appointment and a limited (sometimes called a "special") power of appointment. Under §2041(b)(1), a general power of appointment is generally a "power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." A limited power of appointment, on the other hand, is simply any power that allows the donee to appoint property, that is not a general power of appointment.

For estate planning purposes, the difference between a general power of appointment and a limited power of appointment is significant. Whereas property subject to a limited power of appointment is not included in the donee's estate, §2041(a)(2) requires inclusion in a decedent's gross estate of any property for which the decedent has, at the time of death, a gen-

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eral power of appointment. If the decedent has a general power of appointment over trust property, the property will be included in the decedent's estate and, importantly, receive a step-up in basis to fair market value for income tax purposes under §1014. On the other hand, where the decedent only held a limited power of appointment over trust property, such property would not be included in the decedent's estate, and there would be no step-up in basis for income tax purposes.

Returning to Ozzie and Harriet, how might Ozzie and Harriet utilize a power of appointment to achieve their estate planning goals and to allay their worst case scenario anxieties?

For purposes of this analysis, let us assume that Ozzie is the first to die. At his death, all assets owned by Ozzie will generally receive a step-up in basis to fair market value under §1014. Assume further that, in Ozzie's pourover will, he grants Harriet a power of appointment over all of his trust property, allowing her to appoint his trust property to any of the creditors of her estate. Because the power of appointment is exercisable in favor of the creditors of her estate, it is a general power of appointment. What is the result?

First, note that, given the facts under present law, the inclusion of a testamentary general power of appointment would have no estate tax impact on Ozzie. The property he owns will be in his estate at death and, irrespective of whether he grants a general power of appointment to Harriet, will not be subject to estate tax at his death. The real impact comes into play when Harriet, the surviving spouse, subsequently dies. Because she has a general power of appointment over Ozzie's trust, all of the property in his trust will also be included in her estate. However, because such property is only appointable to a creditor of her estate, it is highly unlikely that Harriet would in fact exercise the power of appointment.

Thus, at Harriet's death, the property over which she had a general power of appointment would be included in her estate. Further, because Ozzie's trust property is included in Harriet's estate, it will receive a step-up in basis for income tax purposes under §1014. In the event that the assets in Ozzie's estate appreciate in value between Ozzie's and Harriet's death, the step-up in basis can create significant value to the beneficiaries of the estate, in this case Ozzie's and Harriet's children. However, because the combined value of their estates is approximately $4 million, there will be no adverse estate tax impact under present law due to the general power of appointment. Thus, a good result for income tax purposes has no adverse impact for estate tax purposes.

However, there may be a concern that, with a general power of appointment, the surviving spouse has too much control over the ultimate fate of the estate's assets. Recall, Ozzie fears that Harriet may succumb to Alzheimer's or dementia, whereas Harriet's concern is that Ozzie may give way to an aggressive paramour. Wouldn't the inclusion of a testamentary general power of appointment ultimately create exposure regarding the ultimate disposition of the estate assets? For example, assume that Ozzie passes away, and his estate plan disposes of all assets to Harriet, and consider further that Ozzie grants Harriet a testamentary general power of appointment. What if Harriet forgets her past life and becomes enamored with the pool boy, and as a result exercises the general power of appointment by appointing all assets to him?

Appoint an Independent Co-Trustee

Recall that the general power of appointment is only appointable to a creditor of Harriet's estate. Because the pool boy is not a creditor of the estate, she would not be able to appoint the assets to him. That notwithstanding, the primary concern here is that Ozzie wants to maintain a relative amount of control over the assets, and Harriet may be able to squander the assets in other ways that are not consistent with his intent. That is, even if Ozzie's trust sets forth an ascertainable standard that a distribution may only be made when they pertain to a beneficiary's health, education, maintenance, and support, Harriet, by virtue of being the sole trustee, could stretch the meaning of the ascertainable standard, as no one is watching her.

To mitigate the concern that the surviving spouse may prove fickle with regard to the estate, or otherwise squander the estate by virtue of being sole trustee of the trust, one consideration is to appoint an independent successor trustee to serve as a co-trustee along with the surviving spouse at the death of the first-to-die spouse. An independent trustee can help resolve conflicts of interest that might arise, and can also ensure that the estate's assets are administered in a manner consistent with the grantor's (decedent spouse's) intent. Thus, the independent trustee will ensure monitoring of the trust assets and distributions, which can help address Ozzie's concerns.

However, there are additional factors that should be considered when using an independent trustee. First, an independent trustee is generally a professional or institution and, therefore, must be compensated for serving as trustee, thereby using trust resources on trust administration. Further, the surviving spouse may feel restricted regarding asset distributions because of the needed approval of the unrelated trustee. However, these additional considerations may be overshadowed by the significant benefit of maintaining a greater level of control over the ultimate disposition of the assets by using an independent trustee.

Taken altogether, the use of a general testamentary power of appointment in an estate plan may result in

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a second step-up in basis upon the death of the second-to-die spouse, which may produce a significant tax benefit to the ultimate beneficiaries of the estate plan. Where there is a concomitant concern that the surviving spouse, as sole trustee of the trust, may control and expend trust assets in a manner inconsistent with the grantor's intention, it may be advisable to appoint a successor co-trustee.

Post-Mortem Planning: Rectifying What Once Made Sense

A third common issue that estate planners confront today is a post-mortem problem. The scenario is this: a husband and wife reasonably created revocable trusts with a credit shelter trust under former law when the basic exemption was much lower; however, when the law changed, the couple failed to update their estate plans. Subsequently, the husband or wife dies. What can be done to rectify the estate plan post-mortem, since it no longer makes sense given present law?

Let us return to Ozzie and Harriet.

> *Example 3*
>
> In 2002, the estate exemption was $1 million and there was no portability of the basic exemption between spouses. At that time, Ozzie and Harriet, with assets approximating $4 million, shrewdly consult with an estate planning attorney and each create revocable trusts. Under the revocable trusts, upon death, the trustee is directed to create a credit shelter trust up to the exemption amount, with the remaining assets going to the marital trust. The credit shelter trust is to be held for the benefit of the surviving spouse and their two adult children. Each revocable trust appoints the surviving spouse as the successor trustee. The revocable trust directs the trustee to distribute as much of the net income and principal of the credit shelter trust as the trustee, in his or her sole and absolute discretion, shall consider necessary for the health, education, maintenance and support of the beneficiaries of the credit shelter trust. At the time the trust was created, each spouse intended for the credit shelter trust to be excluded from the surviving spouse's estate upon their death.
>
> Ozzie subsequently dies in 2017 with this estate plan in place, at which point the basic estate exemption amount is $5.49 million, and there is portability of the estate exemption amount between spouses. Harriet becomes trustee. Upon review, Harriet and the children do not believe that the estate plan makes sense. However, what are they to do?

When Ozzie made his estate plan in 2002, Ozzie created an estate plan that made sense given the laws then in effect. However, when several significant law changes occurred over the subsequent years, Ozzie failed to update his estate plan to reflect the updated law changes. Thus, upon his death, the trust directs the trustee to fund a credit shelter trust with an amount up to the estate exemption. Given Ozzie and Harriet's combined net worth is $4 million, that means that all of the assets in Ozzie's estate will be funded to the credit shelter trust.

However, the estate plan may not be consistent with an efficient plan that would be put in place today. First, the credit shelter trust will require a separate tax return, which will result in the estate incurring superfluous administrative costs. The second, and perhaps more significant, issue relates to the step-up in tax basis. Although the assets will receive a step-up in basis to fair market value upon Ozzie's death, if they are funded to the credit shelter trust, they will not become part of Harriet's estate. If they are not part of Harriet's estate when she dies, then they will not get a second step-up in basis to fair market value at that time, which may have significant and detrimental consequences to the assets of the estate.

One post-mortem idea to address the problem may be to modify the terms of the credit shelter trust through a nonjudicial settlement agreement. Following the Uniform Trust Code's lead, many states now have enacted laws that provide that an irrevocable trust can be modified upon consent of the ''interested persons'' outside of court through the execution of a nonjudicial settlement agreement. Under the Uniform Trust Code, a nonjudicial settlement agreement is generally valid only to the extent it does not violate a material purpose of the trust. Although defined variously under state law, interested persons often encompass beneficiaries and the trustee.

Thus, in a state that allows for a nonjudicial settlement agreement, there may be an opportunity for Harriet and the children to execute an agreement that allows the credit shelter trust to be distributed to Harriet's revocable trust. By bringing the assets from the credit shelter trust into her revocable trust, the assets would presumably be included in her estate upon her death, and therefore would be entitled to a second step-up in basis at that time.

A second possible idea to address the problem may be through the process of decanting. Decanting is the exercise of a trustee's power to distribute assets from the trust to another trust, subject to certain limitations. Decanting would similarly require the trustee and beneficiaries to acknowledge the risks involved. If state law does not allow for non-judicial settlement

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agreement or for decanting the irrevocable credit shelter trust, there may be an opportunity to domesticate the trust to a state that has more favorable governing provisions (e.g., to Nevada or Delaware).

The final and simplest idea may be to just distribute the balance of the credit shelter trust into the surviving spouse's revocable trust. Assume that Ozzie's trust provided that, upon his death, Harriet is to serve as sole trustee of the trust. Ozzie's trust further provides that distributions may be made to a beneficiary (Harriet, or the two children) pursuant to an ascertainable standard of health, education, maintenance and support. Upon Ozzie's death, Harriet, as sole trustee, could simply distribute the balance of the credit shelter trust to her own revocable trust under the pretext that it satisfied the ascertainable standard. In such case, it would be advisable to have the interested parties (i.e., Harriett and the children) of the credit shelter trust sign a consent to the distribution, acknowledging the risks involved. Also, if the law changed reducing the exemption, assets in the credit shelter trust, formerly out of Harriet's estate, are now in her estate.

These three options — executing a nonjudicial settlement agreement, decanting, or simply distributing the credit shelter trust to the surviving spouse's revocable trust — are to bring the assets into Harriet's estate, such that when she dies, there would be a second step-up in basis. One concern is that the surviving spouse will then have unfettered control of all assets, and is also able to change the terms of the trust during her lifetime. For example, after decanting or executing a nonjudicial settlement agreement, Harriet could completely change the beneficiaries, such that the initial takers (i.e., the kids) do not receive a share upon her death. Thus, for any such post-mortem planning, it is of utmost importance that the beneficiaries are well-advised and acknowledge the risks involved.

CONCLUSION

After the election, with a Republican President and Congress, the premise of this article remains the same, and perhaps even more so: Namely, high exemption amounts offset the need for most people to do creative estate tax planning. Rather, income tax concerns to ensure a step-up in basis at the second death trumps estate tax issues. Although traditional credit shelter trusts will no longer be required for tax purposes, revocable trusts and trusts for the surviving spouse and descendants will remain critical for most clients.

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