I SHOULD HAVE DONE WHAT?
AVOIDING SPOUSAL PORTABILITY AND
TRUST ADMINISTRATION MALPRACTICE TRAPS

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INTRODUCTION

There are a number of issues that can be easily overlooked by professionals who do not primarily practice in the estate and trust practice areas, but who perform various functions as executors, trustees (or advisors to such persons) or assist in the preparation of various documents and filings with respect to estates and trusts. The purpose of this discussion is to highlight some of the more problematic areas in estate and trust administration and provide information on how to avoid such traps when assisting clients.

DISCUSSION

I. **Spousal Portability Traps for the Unwary**. With the enactment of the 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (the "2010 Tax Act"), Congress granted predeceasing spouses the opportunity to transfer their unused applicable exclusion amount to their surviving spouse without the aid of traditional estate tax planning techniques.[1] Despite Congress's apparent goal to simplify estate planning for married couples, however, spousal portability is plagued with uncertainty and obscure requirements, frustrating the purpose behind portability and giving rise to potential malpractice liability.

a. **General Background on Spousal Estate Planning Prior to 2011**. Prior to the enactment of the 2010 Tax Act, married couples seeking to transfer the maximum amount of assets estate tax free had to implement certain estate planning techniques to cause each spouse to transfer assets at his or her death in a manner that would fully utilize such spouse's remaining federal estate tax applicable exclusion amount. Generally, such estate planning techniques involved the creation of a credit shelter trust upon the death of the first spouse to ensure that he or she fully utilized his or her respective applicable exclusion amount. Burdens associated with this technique included (i) re-titling assets into the individual names of each spouse to equalize

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[1] See Section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Relief Act"); I.R.C. § 2010(c)(2).

their estates, and (ii) relying on formula clauses to properly fund a credit shelter trust to fully utilize each spouse's applicable exclusion amount.

b. **Spousal Portability Under the 2010 Tax Act**. With the passage of the 2010 Tax Act, however, spouses are presented with a deceptively simple approach to making full use of each spouse's applicable exclusion amount. In general, the 2010 Tax Act allows the surviving spouse of a decedent dying after 2010 to use the decedent spouse's unused exclusion amount in addition to the surviving spouse's own applicable exclusion amount.[2] This concept, frequently referred to as "portability," effectively allows the decedent-spouse to transfer the unused portion of his or her applicable exclusion amount to his or her surviving spouse. With the current $5 million federal estate tax exclusion amount, married couples can effectively use a total exclusion of $10 million entirely in the estate of the surviving spouse without engaging in traditional credit shelter estate planning.[3] There are, however, several easily overlooked requirements that must be met for the surviving spouse to take advantage of his or her deceased spouse's unused exclusion amount.

c. **Calculation of Applicable Exclusion Amount**. The 2010 Tax Act defines a decedent's "applicable exclusion amount" as the sum of –

i. the "basic exclusion amount" (currently $5 million, subject to an adjustment for inflation for estates of decedents dying after 2011), and

ii. the "deceased spousal unused exclusion amount" (defined as the lesser of (a) the "basic exclusion amount," or (b) the excess of the <u>basic exclusion amount</u> [4]of the <u>last deceased spouse</u> of such surviving spouse, over the amount of the tentative tax on the estate of such deceased spouse, determined under the estate tax rate schedule).[5]

Thus, a surviving spouse may use his or her deceased spousesal unused exclusion amount in addition to such surviving spouse's own exclusion amount for taxable transfers made during life or at death. Notably, however, the new legislation limits the deceased spousal unused exclusion amount to that of the "last deceased spouse."[6] Thus, a surviving spouse *could* lose the unused exclusion of his or her deceased spouse. For instance, there is the potential that a surviving spouse could lose the ability to take advantage of any unused exclusion if the surviving spouse remarries and also survives his or her second spouse who has an unused exclusion less than the prior deceased spouse (or no unused exclusion at all).

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[2] I.R.C. § 2010(c)(2).
[3] Assumes both spouses die in 2011, a proper and timely election is made on the first death, and the surviving spouse is not predeceased by a spouse from a subsequent marriage.
[4] The Joint Committee on Taxation noted that the a technical correction may be necessary to replace the 2010 Tax Act's reference to the "basic exclusion amount of the last deceased spouse of the surviving spouse" with the "applicable exclusion amount of such last decease spouse." Joint Committee on Taxation, 111th Cong., 2d Sess., "ERRATA – 'General Explanation of Tax Legislation Enacted in the 111th Congress'" p. 1 (March 23, 2011).
[5] I.R.C. § 2010(c)(2)(A), (B).
[6] I.R.C. § 2010(c)(4).

d. **Spousal Portability Election Must Be Made**. Despite Congress's intent to simplify spousal estate planning and ensure that unused exclusion amounts are not wasted, spousal portability is not automatic. Instead, portability must be elected at the time of the first-spouse's death.[7] Internal Revenue Service Notice 2011-82 states that to elect portability, "the executor [of the predeceasing spouse's estate] is required to file a Form 706 [United States Estate (and Generation-Skipping Transfer) Tax Return] for the decedent's estate, <u>even if the executor is not otherwise obligated to file a Form 706</u>."[8] This means that an estate tax return must be filed even though no estate tax is owed and even though the estate tax rules do not otherwise require one to be filed. The Form 706 released in August 2011, however, makes no mention of portability. Instead of checking a box or attaching an affirmative election statement, portability is elected by virtue of timely filing a properly-prepared and complete Form 706.[9] On the other hand, executors obligated to file a Form 706 but choosing *not* to elect portability must follow the instructions on Form 706 to avoid making the election.[10] While Form 706 will eventually be revised to expressly address portability and the computation of the deceased spousal unused exclusion amount, there is no indication of when the revised form will be published.

e. **Complications in Deciding Whether to Elect Portability**. Failing to file a Form 706 electing portability where spouses did not engage in traditional estate tax planning during their lifetimes can have significant estate tax consequences on the surviving spouse's estate.[11] Thus, the consequences of failing to file Form 706, which, under current law, amounts to a waiving portability, raise a legitimate question about an executor's (and their advisors) responsibility to file a Form 706 for *every* estate. Filing an estate tax return, however, is not a simple or inexpensive process. The following are a few of the factors to consider when deciding whether an election should be made:

i. <u>Burden of Election versus Likelihood of Benefit</u>. Depending on the composition of the estate, the cost of preparing a Form 706 to elect portability and potentially defend the return in the event of audit may exceed the benefit, if any, of making the election. While the burden and expense of filing a return for the estate of a high net worth individual not otherwise obligated to file a Form 706 may be warranted, the benefit of making the election is not as easy to ascertain for modest, small or even insolvent estates. For instance, although it may seem unlikely that a given surviving spouse would ever be in an estate tax situation, if portability is waived and the surviving spouse subsequently wins the lottery, wins a large lawsuit, receives a large inheritance, marries well or the estate tax exclusion amount declines, he or she *could* have a taxable estate - it will just be too late to make the portability election. While the safest course of action is to File a 706 in every estate where there is a surviving spouse, the reality is that many surviving spouses and beneficiaries will not find the upfront costs of making the election worth the uncertain availability of what will be in most cases an unlikely benefit.

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[7] I.R.C. § 2010(c)(5).

[8] IRS Notice 2011-82 (emphasis added).

[9] <u>Id.</u>

[10] I.R.S. Notice 2011-82.

[11] As much as $1,750,000 ($5 million times 35% rate) of estate tax could be owed at the second death that would have otherwise been avoided by making the portability election at the first death.

ii. Predeceased Spouse's Estate Open to Limited Examination Indefinitely. Despite the Section 6501 statute of limitations for assessing estate or gift tax on a decedent spouse, the Form 706 of a decedent spouse is subject to indefinite examination by the Treasury secretary.[12] The scope of the extended examination, however, appears to be limited to the determination of the deceased spousal unused exclusion amount.[13] Thus, the Treasury secretary should not be able to assess estate taxes against the predeceasing spouse's estate beyond the expiration of the Section 6501 statute of limitations. More importantly, however, filing an unnecessary Form 706 risks drawing the Service's attention to matters that would have otherwise gone unreported, potentially generating adverse tax consequences.

iii. Conflicts between Surviving Spouse and Children From a Prior Marriage. Since spousal portability inures to the benefit of the surviving spouse's estate, and therefore the surviving spouse's beneficiaries, a potential conflict may arise between the surviving spouse and other beneficiaries at the time of the first death. This situation would most likely occur where the predeceasing spouse intentionally disinherits his or her surviving spouse in favor of a third party that is unlikely to be a beneficiary under the surviving spouse's estate plan (i.e., second marriage situation where there are children from a prior marriage and a prenuptial agreement is in place). Under such circumstances, the third party would likely oppose using property of the estate to file a Form 706 solely to preserve the surviving spouse's right to portability. Thus, the issue becomes – to whom does the executor owe a duty, if any, with respect to making the portability election? The North Carolina General Statutes provide that "[the executor] shall use the authority and powers conferred upon him [. . .] for the best interests of all persons interested in the estate, and with due regard for their respective rights."[14] At this time, it is unclear whether a surviving spouse could force the executor to make the election.

iv. Portability is Temporary. The 2010 Tax Act expires on December 31, 2012.[15] Absent congressional action, both spouses must die before the end of 2012 to take advantage of portability. Thus, added to the uncertainty of whether a surviving spouse would even benefit from having his or her predeceased spouse's unused exclusion amount is the risk that Congress will not extend portability beyond December 31, 2012, making the expense of a filing Form 706 solely to elect portability a wasted effort (at least in hindsight).

v. Portability Lost if Survivor Remarries and Next Spouse Also Predeceases. As discussed above, a surviving spouse's applicable exclusion amount only takes into account the unused exclusion amount of his or her last deceased spouse. Accordingly, only the estate tax exclusion amount of the immediately predeceased spouse is portable. This requirement will only be implicated if the surviving spouse remarries and then survives his or her new spouse, wasting the unused exclusion amount of the original

[12] I.R.C. §2010(c)(5)(B).
[13] Id.
[14] N.C. Gen. Stat. §28A-13-2 (2011) (emphasis added).
[15] See §101(a) of the 2010 Tax Act.

predeceased spouse. Again, this requirement increases the risk that filing Form 706 solely to elect portability will be a wasted effort.

f. **Shifting Portability Election Decision to Interested Parties**. Although the weight of the factors discussed above suggest that electing portability isn't likely to benefit a majority of estates, from a professional liability risk management standpoint, however, it is prudent to file a Form 706 in *every* estate where there is a surviving spouse. At a minimum, advisors should fully explain to the executor and other interested parties the consequences of not electing portability and recommend that a complete Form 706 be filed. Thereafter, the advisor should shift the burden and risk associated with the portability decision to the executor and/or those who would ultimately stand to benefit from such election. One means of protecting oneself from the spousal portability election trap is to fully disclose, in writing, the issues and consequences associated with the portability election and document the executor and/or interested parties decision with respect to the election, preferably by a signed statement that portability will or will not be elected. For the purposes of illustration, an example of our standard language is set forth in <u>Exhibit A</u>.

g. **Conclusion**. Spousal Portability is fraught with uncertainty but can be a benefit to a surviving spouse's estate under certain circumstances if the interested parties are aware of and follow the portability requirements. For every estate where there is a surviving spouse, the executor should arguably make the portability election. Since current law requires the filing of a timely-filed complete Form 706 to make the election, the costs will frequently outweigh the uncertain benefit of making the election. Accordingly, to limit malpractice liability, advisors should: (i) fully explain to the executor and other interested parties the consequences of not electing portability, (ii) recommend that a complete Form 706 be filed and (iii) obtain the written direction of the interested parties with their decision regarding the election.

II. **<u>Trust Administration Issues</u>**: The accountant is often called upon to render advice in estate planning. While accountants may not prepare trust documents for their clients, the accountant may be relied on for rendering advice and explaining the tax implications of certain trust provisions. Trustee selection, asset ownership and investment responsibility delegation are areas commonly overlooked that deserve attention early-on in the trust administration process.

a. **Choosing a Trustee**. It is not uncommon for clients to seek the counsel of their accountants in deciding who to name as successor trustee under their living trust. In fact, clients occasionally designate their accountants as successor trustee. Whether you are advising a client about trustee selection or are already designated as trustee or successor trustee, there are several often overlooked issues that require some consideration.

i. <u>Successor Trustee in the Event that the Trust is Silent</u>. The North Carolina General Statutes provide a procedure for filling a trustee vacancy.[16] In the absence of the trust instrument effectively designating a successor trustee, the trusteeship of a noncharitable trust is filled by:

[16] N.C. Gen. Stat. § 36C-7-704.

1. The person selected by unanimous agreement of all of the qualified beneficiaries;[17] or

2. If the qualified beneficiaries fail to make an appointment, then a person appointed by the court.[18]

Neither statutory appointment method is ideal. Unanimous agreement among qualified beneficiaries may be difficult to obtain and court appointment is burdened with uncertainty, delay and expense. As a result, it is clearly the best practice for the terms of the trust to expressly set forth names of successor trustees and the procedure for filling vacancies if all of the names successors fail or cease to serve.

ii. Spouse as Successor Trustee. The surviving spouse is commonly named as the successor trustee under his or her spouse's living trust. While this may be appropriate in many circumstances, advisors should exercise caution in always recommending that the surviving spouse serve as successor trustee. Important considerations include:

1. *Incidents of Ownership* – If the trust owns a second-to-die life insurance policy on the life of the surviving spouse, who serves as trustee, the policy may be includible in the surviving spouse's estate. Specifically, to the extent that a person controls the disposition of death benefits payable under a life insurance policy, the death benefit is includible in that person's estate.[19] Control over the policy, commonly referred to as "incidents of ownership," includes the powers to change the beneficiary, surrender or cancel, assign, revoke, pledge or borrow against the policy. Since trustees often have powers that fall within the scope of "incidents of ownership," if the trust owns a second-to-die life insurance policy on the surviving spouse's life, the surviving spouse, as trustee, should be restricted from exercising any incidents of ownership over the policy.

2. *Distribution Standards* – There may be negative tax implications where the surviving spouse has a beneficial interest in a trust and distributions are not subject to an ascertainable standard. For instance, if a beneficiary-trustee has the power to withdraw assets, not limited by an ascertainable standard, he or she must include the assets in his or her estate.[20] In addition, if the beneficiary-trustee transfers trust property to another trust beneficiary, the transfer may be deemed a taxable transfer by the beneficiary-trustee if such transfer was not made under an

[17] A qualified beneficiary is generally any living beneficiary who is a permissible distributee of trust income or principal, together with the first-line remaindermen (i.e., the beneficiaries who would be eligible to receive distributions if the current beneficiary's interest terminated or if the trust were to terminate on the date in question. N.C. Gen. Stat. § 36C-1-103(15).
[18] Id. § 36C-7-704(c).
[19] I.R.C. § 2042.
[20] I.R.C. § 2041.

ascertainable standard.[21] Thus, if the surviving spouse will serve as a trustee and also be a beneficiary of the trust, the trust should restrict the distributions to an ascertainable standard.[22]

3. *Legal Support Obligations* – A trustee granted with the authority to distribute trust property in any manner to satisfy any of his or her legal support obligations is deemed to have a general power of appointment.[23] Thus, if the surviving spouse's minor child has a beneficial interest in a trust, the trust should restrict the surviving spouse, as trustee, from using the trust property to satisfy his or her support obligation.

iii. Beneficiary as Trustee. The same concerns discussed above associated with a spouse serving as successor trustee are implicated when a beneficiary serves as trustee.

iv. Foreign Trustee. Even where clients are not engaging in international estate planning, advisors should be aware that naming a non-United States citizen as a fiduciary can raise some precarious issues under the United States foreign income tax rules.[24] Specifically, a trust may inadvertently become a "foreign trust" if the successor trustee is not a United States citizen. Under the Internal Revenue Code, a trust is treated as a "foreign trust" if (i) no United States court is able to exercise primary jurisdiction over the administration of the trust, or (ii) if a non-United States citizen has the authority to control any substantial decision of the trust (the "Control Test").[25] Thus, a domestic trust can inadvertently become a foreign trust, subject to foreign trust reporting requirements and tax consequences,[26] if the trust designates a non-United States citizen as trustee, which would arguably cause the trust to fail the Control Test The Treasury Regulations do, however, provide a twelve month safe harbor to cure the inadvertent migration of a domestic trust to a foreign trust where the "death, incapacity, resignation, change in residency or other change with respect to a person that has a power to make a substantial decision of the trust" would cause the trust to fail the Control Test.[27] Thus, if a client names a non-United States citizen as a fiduciary under a trust, they should do so only after being made aware of the issues that may arise if that person serves as trustee.

v. Corporations as trustee. The North Carolina General Statutes prohibit a company from engaging in "unauthorized trust activity," which includes engaging in trust business (i.e., serving as a fiduciary), unless such company falls within an exception.[28] Generally, the exceptions to this rule are for banks and trust companies that register with the NC Commissioner of Banks. Thus, not just any company has the authority to serve as

[21] Treas. Reg. § 25.2511-1(g)(2).
[22] Distributions for health, education, maintenance and support generally constitute an ascertainable standard. Treas. Reg. § 20.2041-1(c)(2).
[23] Treas. Reg. § 20.2041-1(c)(1).
[24] I.R.C. § 6048
[25] I.R.C. §§ 7701(a)(30)(E) and 7701)(a)(31)(B); see also Treas. Reg. § 301.7701-7.
[26] I.R.C. § 6048.
[27] Treas. Reg. § 301.7701-7(d)(2)(ii).
[28] N.C. Gen. Stat. § 53-303.

trustee under North Carolina law. This means that if the client wishes to designate an accountant as trustee, the trust should list the name of the accountant and not the name of the accountant's company. Where a company engages in unauthorized trust activity, the NC Commissioner of Banks may order the company to stop acting as trustee under the enforcement provisions of Chapter 53 of the North Carolina General Statutes.[29] Moreover, the attorney general and/or the shareholders of the company could bring an ultra vires action.[30] At this time, the North Carolina statutes do not appear to address whether the actions of an unauthorized trustee are valid, void or voidable.

b. **Funding Revocable Trusts**. Clients are increasingly likely to ask about "living trusts" to avoid probate in large part due to a lot of aggressive marketing about the "horrors" of probate in recent years. While the purpose of this discussion is not to review the merits of probate avoidance planning, our focus is on what must be done after a living trust is established in order to avoid probate.

A living trust's probate avoidance benefits are realized only if the decedent transferred his or her probate assets to his or her living trust prior to death. Essentially, since the decedent dies with no probate assets in his or her name, there are no assets subject to probate and therefore no probate fees owed. Unfortunately, probate assets are not always retitled in the name of the trust. Thus, great care should not only be taken in designing an estate plan, but also in ensuring that assets are properly titled once the plan is in place.

c. **Investment Delegation**. While accountants often are comfortable with handling the administrative responsibilities of a trustee, they generally do not hold themselves out as investment managers or wish to accept responsibility for the investment performance of the trust property. Fortunately, North Carolina law provides that a trustee has the power to "delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances."[31] This being the case, the accountant typically relies on the expertise of a financial services professional in investing trust assets. When trust investments perform poorly, however, beneficiaries may look to the trustee in placing the blame. As a result, it is prudent for trustees choosing not to personally invest trust assets to formally shift investment responsibility to a third party by documenting the investment delegation, with the informed consent of the beneficiaries. The following steps should be considered in delegating investment authority:

i. Choose an Agent Wisely. The trustee cannot simply delegate investment responsibility to anyone and disclaim responsibility if investments perform poorly. Instead, the trustee must exercise "reasonable care, skill, and caution" in selecting an agent and defining the scope of the agency. [32] North Carolina law provides that fiduciaries are permitted to employ agents without liability for any neglect, omission, misconduct or default of the agent if such agent was retained with due care.[33]

[29] Id. § 53-369 (a violation of an order results in monetary penalties).
[30] Id. § 55-3-04.
[31] Id. § 36C-8-807(a).
[32] Id.
[33] Id. § 32-27(24).

ii. Obtain Beneficiary's Release. A beneficiary may prospectively or retrospectively release the trustee from liability for any breach of trust unless the release was induced by improper conduct of the trustee; or at the time of the release "the beneficiary did not have knowledge of the beneficiary's rights or of the material facts relating to the breach."[34] Presumably, this means that beneficiaries can relieve the trustee from liability regarding the trustee's investment management. The beneficiaries, of course, are not obligated to release the trustee from liability.

iii. Monitor Agent's Performance. The trustee's investment responsibilities do not end once the investment authority is delegated. The trustee is still obligated to exercise "reasonable care, skill, and caution" in periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the delegation agreement.[35]

d. **Conclusion**. There are traps for the unwary in selecting successor trustees, structuring assets to avoid probate and delegating investment authority. An accountant who recognizes these issues and discusses them on the early-on with his or her clients will be in a much better position to avoid malpractice liability.

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[34] Id. § 36C-10-1009.
[35] Id. § 36C-8-807(a)(3).

<u>EXHIBIT A</u>

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[Date]

PLEASE SEE THE CIRCULAR 230 NOTICE AT THE BOTTOM OF THIS LETTER

____[Executor]____, Executor
Estate of ____[Decedent]____
____
____

Dear ___________,

As we have discussed, as Executor of ____[Decedent]_____'s estate (the "<u>Estate</u>"), you must decide whether the Estate should make an election to make ____[Decedent]_____'s unused federal estate tax exclusion amount available to _____[Surviving Spouse]_____. This concept, known as "spousal portability," was part of the changes made to the tax law under the 2010 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (the "<u>2010 Tax Act</u>"). Essentially, spousal portability allows the surviving spouse of a decedent-spouse dying after 2010 to use the decedent-spouse's unused federal estate tax exclusion amount in addition to his or her own federal estate tax exclusion amount for taxable transfers made during life or at death. Under prior law, the unused exclusion of the first spouse to die would be lost if not used.

In order to take advantage of the portability benefits, certain actions are required. Most notably, the 2010 Tax Act requires that a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (the "<u>Estate Tax Return</u>") must be completed and timely filed with the Internal Revenue Service for the estate of the first spouse to die (<u>even</u> if the estate is under the filing threshold). If the Estate Tax Return is not properly filed, the surviving spouse cannot use the exemption of the first spouse.

In addition, properly filing the Estate Tax Return does *not* guarantee that the portability benefits will be available to the surviving spouse. Whether the portable exclusion amount will benefit the surviving spouse depends on:

1. *<u>Size of Surviving Spouse's Estate</u>*. Portability only benefits the surviving spouse if his or her estate exceeds his or her unused federal estate tax exclusion amount. Thus, whether the surviving spouse will benefit from the portability election depends on (i) the value of the surviving spouse's estate, and (ii) the surviving spouse's remaining

federal estate tax exclusion amount at the time of the surviving spouse's death. As a point of reference, the federal estate tax exclusion amount is currently $5 million per individual, and in 2012, the exclusion amount will be indexed for inflation. In 2013, the federal estate tax exclusion amount is set to drop down to $1 million absent congressional action.

2. *Changes in Surviving Spouse's Marital Status*. The surviving spouse can only receive the portable exclusion amount of his or her *last deceased spouse*. Thus, a surviving spouse will lose the portable exclusion of his or her original deceased-spouse if he or she remarries and survives his or her subsequent spouse.

3. *Portability is Temporary*. Portability is set to expire on December 31, 2012, absent congressional action to extend the law. Thus, under current law, both spouses must die before the end of 2012 to take advantage of portability.

As Executor of the Estate, you are responsible for filing any Estate Tax Return. As we have discussed, the value of the Estate is such that the Estate is not obligated to file an Estate Tax Return. Thus, the Estate Tax Return need only be filed to potentially preserve the portable exclusion amount for use by _____[Surviving Spouse]_____. Filing an Estate Tax Return, however, is not a simple or inexpensive process, and is generally a cost charged to the estate. It is quite possible that the cost of preparing an Estate Tax Return to elect portability and potentially defend the return in the event of audit will exceed the benefit, if any, of making the election.

We recommend that you file an Estate Tax Return for the Estate despite the burden and expense of such process. We make this recommendation in light of the potential significant estate tax consequences of failing to elect portability if the surviving spouse has a taxable estate. While _____[Surviving Spouse]_____ may not currently have a taxable estate and it may seem unlikely that _[he/she]__ will have a taxable estate at death, there is a chance that the _[he/she]__ could be in an estate tax situation in the future if _[he/she]__ comes into a large sum of money. For instance, if _____[Surviving Spouse]_____ wins the lottery, wins a large lawsuit, receives a large inheritance, or if the estate tax exclusion amount declines, _____[Surviving Spouse]_____ *could* have a taxable estate - it will just be too late to make the portability election. Thus, the safest course of action is to file an Estate Tax Return making the portability election.

We understand the you may find that the expense of preserving portability for _____[Surviving Spouse]_____ is not worth what may be an unlikely benefit. In addition, we recognize that you may decide not to file an Estate Tax Return despite our recommendation. In making your decision, however, you should discuss with _____[Surviving Spouse]_____ and the other beneficiaries of the Estate the benefits of preserving portability along with the drawbacks of making the election. We will be happy to answer any question that they may have regarding the election.

After consultation with _____[Surviving Spouse]_____ and the other beneficiaries of the Estate, please indicate whether you wish to file the Estate Tax Return for the Estate to elect portability by checking the appropriate space and signing this letter and returning it to me in the enclosed pre-addressed envelope.

Please note that in order to elect portability the Estate Tax Return must be filed no later than nine months after the date of death. Accordingly, please be sure to make your decision as soon as possible.

If you have any questions, please call me.

Very truly yours,

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___________ I wish to file the Estate Tax Return for the Estate to elect portability; I understand that filing the Estate Tax Return to elect portability does *not* guarantee any benefit to the surviving spouse or his or her estate.

___________ I do not wish to file the Estate Tax Return and hereby choose to *waive* portability; I understand that by not filing the Estate Tax Return, the surviving spouse will not have any right to the unused exclusion amount of the decedent's estate.

____
_________________________, Executor

IRS CIRCULAR 230 NOTICE

Please note that, due to requirements recently imposed by the IRS, called the Circular 230 Notice Rules, we must inform you that, unless specifically indicated otherwise, any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax related penalties or promoting, marketing or recommending to another party any tax related matter addressed herein.

I Should Have Done What?

Avoiding Spousal Portability & Trust Administration Malpractice Traps

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Trap #1 – Spousal Portability

- Claude and Bertha are married and homeless, each with a $1 estate; Claude dies in 2011 and leaves his $1 to Bertha; No estate tax return is filed; Bertha buys a lottery ticket and wins $10 million; Bertha dies in 2012 with a $10 million estate.
  - Does spousal portability provide any benefit?
    - No, Claude's $5 million exemption is wasted.
    - Had Claude's executor elected portability, Bertha's estate could have saved ~$1.75 million in estate taxes.

Trap #1 - Spousal Portability (cont.)

- Spousal portability's impact on post-2010 estate planning:
  - Portability permits a surviving spouse to use his or her <u>last predeceased spouse's</u> unused exclusion amount *without* a credit shelter trust.
  - A surviving spouse can potentially transfer up to $10 million of assets at death free of federal estate tax.
  - For now, only applies if both spouses die in 2011 or 2012.

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Trap #1 - Spousal Portability (cont.)

- Pros:
  - Relatively simple.
  - Protects against wasting exemption.
  - Benefits couples with assets difficult to transfer between spouses, such as IRAs or stock options.

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Trap #1 - Spousal Portability (cont.)

- Cons:
  - No GST exemption portability.
  - For now, only temporary (both spouses must die in 2011 -2012).
  - First estate open to indefinite examination.
  - <u>*Not*</u> automatic – requires a timely filed and complete estate tax return.
    - EVEN IF THE ESTATE IS LESS THAN THE FILING THRESHOLD

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Trap #1 - Spousal Portability (cont.)

- Would you make the portability election?
  - *Scenario 1:*
    - Claude and Bertha are married with a combined $5 million estate; If Claude dies in 2011 leaving everything to Bertha, should Claude's executor make the portability election?
  - *Scenario 2:*
    - Same as Scenario 1, but the combined estate is $2 million?
  - *Scenario 3* :
    - Same as Scenario 1, but the combined estate is under $1 million?

Trap #1 - Spousal Portability (cont.)

- Factors to consider when deciding to elect portability:
  - Burden of election:
    - Costs of completing a Form 706.
    - Costs of defending the estate in the event of audit.
  - Likelihood of benefit:
    - Surviving spouse's unused exclusion amount.
    - Size of surviving spouse's estate.
      - **Inheritances, lawsuit/ settlement proceeds, subsequent wealthy spouse, lottery winnings**

Trap #1 - Spousal Portability (cont.)

- Factors to consider when deciding to elect portability (cont.):
  - Audit concerns:
    - Risks associated with drawing the IRS's attention to what would otherwise be unreported matters.
    - Estate is subject to indefinite examination to determine the deceased spousal unused exemption amount.

Trap #1 - Spousal Portability (cont.)

- Factors to consider when deciding to elect portability (cont.):
  - Conflicts between surviving spouse and beneficiaries:
    - Claude and Bertha are married; Each have children from prior marriages; A premarital agreement waives spousal rights in each other's estate; Claude dies in 2011 leaving everything to his children from a prior marriage; Bertha wants the executor to file an otherwise unnecessary estate tax return to elect portability; Claude's kids do not want their inheritance to be reduced by the cost of filing the estate tax return.

Trap #1 - Spousal Portability (cont.)

- Factors to consider when deciding to elect portability (cont.):
  - Portability is temporary:
    - Expires December 31, 2012, absent congressional action.
    - Both spouses must die before the end of 2012.
  - Portability can be lost due to remarriage:
    - Only the unused estate tax exclusion of the immediately predeceased spouse is portable.
    - Portability is wasted if the surviving spouse remarries and is predeceased by the subsequent spouse.

Trap #1 - Spousal Portability (cont.)

- Last deceased spouse :
  - Claude and Bertha are married with a $5 million estate; Claude dies and leaves everything to Bertha; Claude's estate elects portability; Bertha marries Darnell, who has no remaining estate tax exemption; Darnell dies; Bertha dies with a $10 million estate.
  - Can Bertha's estate take advantage of portability?
    - No, Darnell, Bertha's last deceased spouse, had no unused exemption transferrable to Bertha.

Trap #1 - Spousal Portability (cont.)

- Portability election and professional responsibility:
  - Failure to file an estate tax return = portability waiver.
  - File a return for *every* estate where there is a surviving spouse?
- Our policy:
  - Disclose portability requirements, benefits, and burdens in writing.
  - Recommend filing a return.
  - Obtain direction from the interested parties, in writing.
    - See sample letter in materials.

Trap #1 - Spousal Portability (cont.)

- Conclusion:
  - Spousal portability is not automatic, a complete Form 706 *must* be timely filed.
  - The upfront costs will frequently exceed any benefit.
  - Despite the costs and burdens of making the election, the consequences of waiving portability pose a significant risk.
  - Recommend electing portability in *every* estate where there is a surviving spouse.
  - Disclose portability requirements, benefits, and burdens in writing and obtain written direction from interested parties regarding whether the election will or will not be made.

Trust Administration Issues

Trap #2 – Successor Trustees

- Claude and Bertha are married; They each designate themselves followed by each other as trustee under their respective trusts; Claude and Bertha die in a common accident; Claude and Bertha are survived by minor children.

- Who serves as Trustee?
  - The trust is silent.
  - Look to the default successor trustee appointment procedure under N.C.G.S. § 36C-7-704.

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Trap #2 – Successor Trustees (cont.)

- Under N.C.G.S § 36C-7-704, where the trust is silent, the successor trustee becomes:
  - The person unanimously selected by all of the qualified beneficiaries; or
  - If the qualified beneficiaries fail to unanimously appoint a person, then a person appointed by the court.
- The statutory appointment method is rarely ideal.

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Trap #2 – Successor Trustees (cont.)

- Who should be named as successor trustee?
  - Spouse?
    - "Incidents of ownership" over life insurance policies on the spouse's life can cause inclusion of the policy in the spouse's estate.
    - Distribution authority not tied to an ascertainable standard can be construed as a general power of appointment.
    - If the spouse's children are beneficiaries, the spouse can be construed to have a general power of appointment because of the spouse's legal support obligations.
  - Beneficiary?
    - Similar issues to spouse (see above).

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Trap #2 – Successor Trustees (cont.)

- Who should be named as successor trustee (cont.)?
  - Foreign trustee?
  - If a non-U.S. citizen has the authority to control any "substantial decision" of a trust, the trust is considered a "foreign trust" and is subject to foreign trust income tax and reporting requirements.
  - *Example*: Claude designates Edgar, a Canadian citizen, as successor trustee; Claude dies and Edgar accepts the trusteeship; Does the trust become a foreign trust?
    - Treas. Reg. 301.7701-7 provides a 12 month safe harbor to correct an inadvertent conversion.

Trap #2 – Successor Trustees (cont.)

- Who should be named as successor trustee (cont.)?
  - Corporation as trustee?
    - Generally, only banks and trust companies registered with the NC Commissioner of Banks can serve in such capacity.
    - *Example*: Claude designates his accountant's firm as successor trustee under his revocable trust; Claude dies; Can the firm serve as trustee?

Trap #2 – Successor Trustees (cont.)

- Conclusion:
  - When clients seek input regarding successor trustee selection, use caution when responding.
  - If a spouse, beneficiary, foreign trustee or corporation is named as beneficiary, due care should be given to the appropriateness of such designation and the inclusion of any additional trust provisions to prevent the trust and the trustee from inadvertent adverse estate and income tax consequences.

Trap #3 – Revocable Trust Funding

- Claude, single, establishes a revocable trust for probate avoidance purposes; After signing the trust, however, Claude fails to retitle his $1 million brokerage account into the name of his revocable trust; Claude dies.
- Is Claude's brokerage account subject to probate?
  - Yes, unless it passed by beneficiary designation or payable on death designation to another person.
  - Had Claude properly titled the brokerage account into the name of his revocable trust, Claude's estate would have saved ~$4,000 in probate fees.

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Trap #3 – Revocable Trust Funding (cont.)

- Assets held in trust at death are generally not subject to probate fees.
- A revocable trust may decrease the costs of administering an estate <u>to the extent that the assets are transferred to the revocable trust prior to death</u>.
- Probate fees in North Carolina are assessed at a rate of $4.00 for every $1,000 of probate assets in your estate, with a cap of $6,000 in probate fees.

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Trap #3 – Revocable Trust Funding (cont.)

- Conclusion:
  - A client with a revocable trust established for probate avoidance purposes does not avoid probate if the trust is not properly funded during life.
  - Great care should be taken in not only designing the estate plan, but also in making sure that the assets are properly titled once the plan is in place.

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Trap #4 – Investment Delegation

- Claude and his children are beneficiaries of a $10 million trust holding marketable securities; Gerald, CPA, serves as Trustee; Gerald handles the administrative responsibilities but lets Harlan, Claude's long-standing investment advisor, invest the trust property; The value of the trust declines 90%; Claude and his children bring a breach of fiduciary duty claim against Gerald for mismanagement of the trust property.
- Is Gerald responsible for the investment decline?
  - It depends!

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Trap #4 – Investment Delegation (cont.)

- The Trustee is typically responsible for managing and investing the trust property.
- Where appropriate, some Trustees choose to delegate the Trustee's investment responsibilities to a third-party agent.
- While delegation is permissible under North Carolina law, the Trustee should take certain steps to protect him or herself from the poor performance of the third-party agent.

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Trap #4 – Investment Delegation (cont.)

- Steps:
  - Choose a money manager wisely:
    - "Reasonable, care, skill and caution."
    - "Due care."
  - Obtain beneficiary's release:
    - Prospective or retrospective.
    - Release cannot be induced by improper conduct.
    - Knowledge of rights and the material facts.
  - Monitor money manager's performance:
    - "Reasonable, care, skill and caution."
    - Periodic review to monitor agent's performance and compliance with the delegation agreement.

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Trap #4 – Investment Delegation (cont.)

- Conclusion
  - Investment delegation is generally permissible.
  - If you delegate investment responsibility, to avoid liability for investment performance:
    - Choose the money manager wisely.
    - Get a written release from the beneficiaries.
    - Periodically monitor the money manger's performance.