



**Why Married
Couples Must Act
Now To Review
Their Estate Plan**



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SPECIAL REPORT

WHY MARRIED COUPLES MUST ACT NOW TO REVIEW THEIR ESTATE PLAN

By Michelle C. Lerman



I'm happy to provide you with this Special Report. To find out more about us, please visit us at www.myestateplancenter.com. You'll read the amazing, heartfelt testimonials from just a few of our "family members" whose lives have been changed through the peace and comfort that estate planning brings. I don't call them "clients" because we treat those we help like family, giving them the special attention of me and our dedicated staff. If you have any questions about anything in this Special Report, please feel free to call me at the number below or email me at michelle@lermanlaw.com.

Attorney Michelle C. Lerman, certified by the California Board of Legal Specialization of the State Bar of California as a Legal Specialist in Estate Planning, Trust and Probate Law, specializes in custom legacy planning for the unique needs of individuals and families. Ms. Lerman was selected for inclusion in the 2009 and 2010 California Super Lawyers. Only 5% of the lawyers in the state were so selected. Ms. Lerman was also voted the #1 Favorite Lawyer for Marin/Sonoma by the "J. Weekly" Newsmagazine Readers' Choice Award 2007. She obtained her Degree of Bachelor of Arts magna cum laude from the University of California at Los Angeles in 1980 and her Degree of Juris Doctor from the University of Southern California in 1983.

Ms. Lerman founded Lerman Law Partners, LLP with her husband, Jeffrey H. Lerman, former President of the Marin County Bar Association. The Firm now represents clients throughout California, with offices in Century City, San Mateo, Santa Clara, and San Rafael (the Lerman Law Building.) Known as the "Real Estate Investor's Lawyers", Lerman Law Partners, LLP, in addition to Probate and Estate Planning, assists clients with loan work outs, real estate transactions, litigation and business succession. Michelle Lerman and her husband of 32 years live in Marin County, California and have four children.

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Why Married Couples Must Act Now To Review Their Estate Plan

In 1983, when I first became a lawyer, transfers over \$275,000 were subject to a transfer tax, meaning a “gift tax” for assets transferred during life and an “estate tax” upon a death, and the highest tax rate was 60%, so most people needed an estate plan to minimize estate tax at death. Married couples would create a Living Trust that provided for the deceased spouse’s Exclusion amount to be transferred into an Irrevocable Trust called a Bypass Trust, allowing the assets to pass free of estate tax when the surviving spouse later died.

Now the law is different. Unlike prior estate tax law, which kept changing every year, the current law is “permanent” in that there is no set expiration date—the tax rate and the Exclusion amount that can pass free of transfer tax stay the same each year, except for annual cost of living adjustments. The Taxpayer Relief Act now simplifies the ability to minimize *estate tax* for about 99% of the population. Because most people don’t have millions of dollars, they no longer have to worry about estate tax. But keep reading! Even if you’re part of that 99%, you still need a well-crafted estate plan to focus on all your other *non-estate tax* goals. Further, as explained below, the wrong estate plan may *increase income tax*.

The Three Big Changes You Must Understand

Under the current “permanent” law, you can now take the necessary action to protect your family and safeguard your assets—as long as you understand the three biggest changes created by the Taxpayer Relief Act and how it affects your estate plan.

1. **EXCLUSION IS HIGHER:** You can now transfer more assets without transfer tax. Under the current law, \$5 million, plus an amount indexed annually for inflation, passes “exempt” or free from transfer tax. With the indexed increase, a U.S. citizen or resident can gift \$5.43 million in 2015 (or die with that amount) free of transfer tax.
2. **FLAT TRANSFER TAX RATE IS LOWER:** Each dollar over the Exclusion that is either gifted during life or left at death is now taxed at a flat rate of 40%—a decrease from the 55% maximum tax rate of prior years. While *income tax* rates have been increasing, *estate tax* rates have been decreasing.
3. **EXCLUSION OF ONE SPOUSE IS PORTABLE TO THE SURVIVING SPOUSE:** Portability allows couples to use each other’s unused Exclusion without having to create complicated trusts. Unlike the prior “use it or lose it” rule, a spouse who dies with assets under the Exclusion can now port, or transfer, the unused Exclusion to the surviving spouse if the surviving spouse files a timely estate tax return electing portability, and if certain other criteria are met.

For example, if one spouse has \$2 million of assets and never made any lifetime gifts that used his Exclusion, under 2015 law that spouse won’t use all of his Exclusion. Of the \$5.43 million Exclusion, for example, he will have \$3.43 million of unused Exclusion (\$5.43 million minus \$2 million).

The \$3.43 million of unused Exclusion can be ported to the surviving spouse. If ported, the surviving spouse potentially can use her own Exclusion PLUS the Exclusion that the deceased spouse did not use, so long as the surviving spouse dies with the deceased spouse as her last spouse (meaning that the surviving spouse didn't re-marry someone who also predeceased her) and certain other criteria are met. Great news: The surviving spouse could then transfer her Exclusion plus her deceased spouse's \$3.43 million of unused Exclusion free of transfer tax, opening the gateway to some very creative planning!

Before portability, the surviving spouse needed to fund an Irrevocable Trust (i.e., a Bypass Trust or a Disclaimer Trust) to retain the benefit of the assets and the deceased spouse's Exclusion. Portability now enables the surviving spouse to capture the tax benefit of the deceased spouse's Exclusion without funding Irrevocable Trusts that require ongoing annual tax returns and administration.

Shift of Focus Away from Estate Tax Avoidance

Although a Living Trust is still critical to avoid probate court, Living Trusts appropriately crafted before the Taxpayer Relief Act to decrease estate tax may increase another type of tax—income tax. Therefore, not all Living Trusts should be drafted to minimize estate tax. Essentially, under current law—with the higher Exclusion, lower estate tax rates, and portability of the Exclusion—people can transfer more wealth transfer tax-free without a Living Trust that requires assets to be funded after death in Irrevocable Trusts like the Bypass Trust.

Thus, after the Taxpayer Relief Act, some couples must focus less on estate tax and more on income tax (including capital gains tax), property tax and safeguarding assets for children. Married couples should review their plan to assess the pitfalls of relying solely on portability, why they still may want their

Living Trust to create an Irrevocable Trust after the first spouse dies, and other options they should consider to avoid the adverse income tax consequences of traditional Bypass Trusts that were drafted in the era before the Taxpayer Relief Act.

The Shifting Role of the Bypass Trust

With the Exclusion now higher and portable, married couples should evaluate whether to bypass the Bypass Trust. If the Bypass Trust does not save estate tax, but potentially increases income tax, married couples may want to steer clear.

In addition, rising income tax rates are changing the focus of estate planning. In California, Proposition 30, approved by voters in November 2012, increased state income tax through 2018, making California's top income tax rate the highest of any state in the nation. Long term capital gains tax rates have also climbed. Rather than focusing on estate tax, most people should focus on estate planning strategies to minimize income tax.

The Devil's in the Details; A Deeper Look into the Bypass Trust—the Good, the Bad and the Ugly

Because the current high estate tax Exclusion has no set expiration date, married couples need to gain a deeper understanding of Bypass Trusts to determine whether to include one in their Living Trust. What are the other options? Should the surviving spouse file an estate tax return after the death of the first spouse and elect portability as an alternative to the Bypass Trust? The following discussion will enable couples to make the right decision when planning their estate.

The good news about Bypass Trusts: In addition to being harder for creditors to reach, all assets transferred into the Bypass Trust when one spouse dies, *including any increase in value from the date of the first spouse's death until the surviving spouse's death*, will avoid all estate tax when the surviving

spouse dies. In effect, the assets transferred into the Bypass Trust are grandfathered in and can grow an unlimited amount without being subject to estate tax when the surviving spouse dies. Even if the Exclusion is lower than the value of the Bypass Trust assets, all the assets pass *estate tax* free!

The surviving spouse can also maintain tremendous control over the assets in the Bypass Trust. The assets can be used by the surviving spouse for support and can be sold and re-invested at the discretion of the surviving spouse, assuming she is appointed Trustee. Better yet, the spouse who dies first has the peace of mind knowing that the beneficiaries named in the Living Trust will get the remaining funds in the Bypass Trust, not a new spouse (who might be a floozy!).

The bad news about Bypass Trusts: Although all Bypass Trust assets pass to the named beneficiaries free of estate tax, when appreciated assets in the Bypass Trust are sold after the surviving spouse dies, the remainder beneficiaries typically will pay income tax (capital gains tax) on all the gain. For example, if the \$3 million of assets put into the Bypass Trust appreciated to \$5 million during the surviving spouse's lifetime, the beneficiaries will pay capital gains tax on the \$2 million of gain when the beneficiaries sell those assets after the surviving spouse dies.

Had all the assets been distributed to the surviving spouse and not to the Bypass Trust, the beneficiaries could have avoided all capital gains tax. Putting assets into the Bypass Trust resulted in more tax, not less, because the beneficiaries will pay capital gains tax when they sell appreciated assets in the Bypass Trust after the surviving spouse dies.

And the ugly: The bad news gets even worse if the surviving spouse would have had enough Exclusion to shelter all the assets without the Bypass Trust. For example, if the couple did not need to fund the Bypass Trust to save estate tax as in the example above, but doing so resulted in higher income tax, the

beneficiaries are not going to be happy campers. In this new era of estate planning post Taxpayer Relief Act, because couples can port the unused Exclusion, the Bypass Trust may not minimize estate tax but may increase *income tax*. That's pretty ugly!

Now that we've covered the good, the bad and the ugly of the Bypass Trust, let's explore another type of Living Trust, the stepsister of the Bypass Trust.

The Stepsister Becomes Cinderella; the "All to Spouse Plan with Optional Disclaimer Trust"—a Flexible Alternative to the Bypass Trust

Unlike the Living Trust that *requires* the Trustee to fund assets into an Irrevocable Bypass Trust, some Living Trusts offer the surviving spouse the *option* to fund an Irrevocable Trust. The "All to Spouse Plan with Optional Disclaimer Trust" allows the surviving spouse to do just that.

The Living Trust with an "All to Spouse Plan" instructs the Trustee to transfer all the assets to the surviving spouse, providing her an option that would allow the Trustee to fund some or all of the deceased spouse's assets into an Irrevocable Trust. The Trustee would then fund assets into an Irrevocable Disclaimer Trust rather than an Irrevocable Bypass Trust. While the Bypass Trust and her stepsister Disclaimer Trust both protect assets, the Bypass Trust must be funded, while funding of the Disclaimer Trust is optional, allowing the surviving spouse to wait and see.

To exercise the option to disclaim under the All to Spouse Plan with Optional Disclaimer Trust, the surviving spouse needs to follow certain rules, including signing a written document, referred to as a Qualified Disclaimer, within nine months after the death of the first spouse and before receiving any benefit of the assets being disclaimed. If the surviving spouse wants the estate tax or creditor protection of a trust similar to the Bypass Trust, the surviving spouse would disclaim some or all of the assets of

the deceased spouse. Then, those assets disclaimed would be re-titled into an Irrevocable Trust called a Disclaimer Trust, while those assets not disclaimed would be held in a very flexible ongoing trust. Both trusts will benefit the surviving spouse, but the Disclaimer Trust is designed to protect the assets from creditors and to allow the assets to pass free of estate tax when the surviving spouse dies.

Like a Bypass Trust, the assets in the Disclaimer Trust *and all appreciation on those assets* pass free of estate tax when the surviving spouse dies. On the downside, like the Bypass Trust, the Disclaimer Trust will require annual accountings (unless waived) and tax returns. More significantly, as with the Bypass Trust, putting assets in the Disclaimer Trust will usually subject appreciated assets to capital gains tax upon sale after the surviving spouse dies.

While couples use the Bypass Trust for *pre-death planning* (the Living Trust mandates transfer of the deceased spouse's assets valued up to the unused Exclusion into the Bypass Trust), couples use the All to Spouse Plan with Optional Disclaimer Trust for *post-death planning* (the surviving spouse decides whether and how much to disclaim, which the Trustee will then place into the Disclaimer Trust). Similar to the Bypass Trust, the Disclaimer Trust:

- Protects assets from estate tax, irrespective whether the surviving spouse remarries.
- Allows assets to grow in value without being subject to estate tax.
- Allows assets to transfer to grandchildren transfer-tax free.
- Protects assets from creditors.

The All to Spouse Plan with an Optional Disclaimer Trust is superior to the Bypass Trust *in certain situations* because it gives the surviving spouse more flexibility. The surviving spouse makes the decision after one spouse dies, not while drafting the estate plan. Unless the surviving spouse disclaims,

he or she doesn't have to file separate tax returns every year, which means he or she has very little reporting and administrative burdens while still being able to use the assets for support.

Before giving it a standing ovation, understand the downside of the All to Spouse Plan with Optional Disclaimer Trust—the spouse who dies first loses all control; the surviving spouse can leave all the assets to a new spouse, unless the surviving spouse disclaims. Further, if the surviving spouse disclaims assets, she can't even make minor changes to the beneficiary list. The surviving spouse can use the assets in the Disclaimer Trust for support, but has zero ability to change the final distribution of the remaining assets.

Instructions in the Living Trust, which may have been written 20 years before the surviving spouse dies, will control what happens when the surviving spouse dies. If a child becomes addicted to drugs, for example, the surviving spouse would not be able to remove the child from the Disclaimer Trust. If a child becomes irresponsible or gets divorced, the surviving spouse cannot revise the terms of any trust that may have been created for that child. In other words, the surviving spouse who disclaims cannot later decide who gets the assets after the survivor dies.

The surviving spouse would only disclaim after determining that the potential estate tax and creditor protection benefits of the Disclaimer Trust will offset the disadvantages: the need to file annual tax returns and produce periodic accountings, the potential capital gains tax on the sale of appreciated assets after the surviving spouse's death, and the inability to tweak the final distribution of the Disclaimer Trust assets. The All to Spouse Plan with Optional Disclaimer Trust allows the surviving spouse to weigh the pros and the cons of getting all the assets versus disclaiming, making an informed decision in light of the facts and circumstances after the death of the first spouse.

An Alternative Plan for Married Couples to Consider- the “QTIP-Protection Trust”

While traditionally we either created a Living Trust with the Bypass Trust or the All to Spouse Plan with Optional Disclaimer for a married couple, after passage of the Taxpayer Relief Act we now consider a third option—a Bypass Trust that can be converted into an Irrevocable Trust after one spouse dies, referred to in this special report as a “QTIP-Protection Trust.” Basically, after the conversion, the Bypass Trust becomes what legal experts call a QTIP Trust, an Irrevocable Trust that protects the assets without the adverse income tax consequences of a Bypass Trust.

Basically, this type of trust is a Bypass Trust drafted to allow the surviving spouse to make a simple tax election (which your tax advisor will call a “Q-tip Election”) that will eliminate the income tax bill that might be created with the Bypass Trust. If the surviving spouse makes a timely Q-tip Election (within 15 months after the first spouse’s death assuming an Application for Extension of Time to File a Return is filed), the election in effect converts the Bypass Trust to a QTIP-Protection Trust. As the name implies, the QTIP-Protection Trust protects the trust assets from creditors, from Sexy Sue and Don Juan, and from potential capital gains on the sale of appreciated assets after the surviving spouse dies.

The QTIP-Protection Trust allows the surviving spouse to decide after the first death whether estate tax protection is necessary. If so, the survivor will keep the assets in the Bypass Trust without making a Q-tip Election. If not, the surviving spouse would make the Q-tip Election.

The QTIP-Protection Trust is perfect for the couple who may need estate tax protection, but who also want the protection against creditors or a future spouse. What if the surviving spouse falls in love with Sexy Sue or a charming Don Juan and is lured into relinquishing all the assets? What if creditors, like

someone who falls in your home or a disgruntled employee, attack the assets, leaving nothing for the children or other ultimate beneficiaries?

The QTIP-Protection Trust can prevent the trust assets from going to Sexy Sue and Don Juan without the adverse income tax consequence of a Bypass Trust. Certain provisions in the Living Trust are drafted to allow the surviving spouse to file a tax return making a “Q-tip Election.” Abracadabra—the Bypass Trust will become an Irrevocable Trust with the protection of the traditional Bypass Trust but without the potential adverse income tax consequences.

One Size Fits All? No—the Size of the Estate Often Dictates the Type of Living Trust

Estates, like people, come in all shapes and sizes. You need to know your size before you shop for clothing, and you need to know the size of your estate (meaning your net worth) before you determine what kind of estate plan you need.

While there are no hard and fast rules, typically, couples with a small estate of less than \$5 million of assets may want to consider the All to Spouse Plan with Optional Disclaimer Trust, couples with a medium estate of between \$5 million and \$10 million of assets, may want to consider either an All to Spouse plan or a QTIP Protection Trust, and couples with a large estate of over \$10 million of assets may be best served by the traditional Bypass Trust. However, many other factors will go into your decision. Be sure to discuss all your options with an attorney before making a final decision about how to create your best legacy.

[Click here](#) to buy my new book, Create Your Best Legacy, and start creating yours today!

Having worked for large firms and preferring the personal attention that a small firm can offer, 18 years ago Jeff and Michelle Lerman created a Firm that gives clients what they want and deserve. They meet their clients at their home away from home, the Lerman Law Building in Central San Rafael, a warm and inviting office with staff that really cares. They listen to your goals and help you implement them. They believe that you want and deserve personal attention.

Instead of cookie-cutter trusts that many attorneys prepare, they create customized plans that are lasting legacies for your family. And unlike other firms, once your plan is signed, you have peace of mind knowing that you keep control of the original documents. Plus, you will have a computer disk with copies of your executed documents so that you can easily transmit your signed documents by email to your family and advisors without wasting paper and the natural resources of our Earth. And since your entire file is saved electronically rather than by hard paper copy, they can instantaneously access your records to answer any future issues, without the delay of retrieving dusty files from storage.

Yes, Michelle is a Certified Specialist, in the select group of “Super Lawyers”, and prepares custom estate plans, but many clients talk about how much she cares. Someone once said, “It doesn’t matter how much you know until others know how much you care.” At our Firm, we care, and we look forward to providing you with the personal attention that you want and deserve.

We welcome the opportunity to help you!

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