*SAME-SEX MARRIED COUPLES*

# A SWAN SONG: ESTATE PLANNING IN LIGHT OF STATES' MARRIAGE EQUALITY LAWS

*Same-sex married couples should take advantage of estate planning techniques available to them, while avoiding DOMA drawbacks.*

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During the last year, New York, Washington, and Maryland became the latest states to permit marriage between same-sex couples. In addition to these states, Connecticut, Iowa, Massachusetts, New Hampshire, and Vermont allow for marriages between same-sex couples.[1] also recognize marriages between same-sex couples.

While these states afford same-sex married couples the same benefits, and burdens, as opposite-sex married couples, the federal government is not as welcoming. The federal Defense of Marriage Act (the DOMA) defines “marriage” as the legal union between one man and one woman and “spouse” as a person of the opposite sex, prohibiting federal agencies from recognizing the marriage of a same-sex couple. As a result, married couples of the same sex in these states presently receive only those benefits and burdens of marriage imposed under state law.

Ironically, same-sex couples can take advantage of several interesting estate planning techniques stemming from the disconnect between the DOMA and state family law. The federal government's unwillingness to recognize same-sex marriages actually creates certain tax opportunities that are unavailable to opposite-sex married couples.

## Navigating the roadblocks

Before considering some of the interesting estate planning opportunities afforded to spouses who are not recognized (SWANs) as a result of the DOMA, a planner must have a clear understanding of the many benefits the DOMA puts out of reach.

## Gift tax.

Each person can make annual gifts of property of up to $13,000 to an unlimited number of individuals without using any portion of his or her unified federal gift and estate tax exemption. This annual amount is known as the gift tax annual exclusion.

Independent of the annual exclusion, spouses whose marriage is recognized for federal purposes qualify for a marital deduction from the gift tax permitting them to make unlimited gifts to (or, in certain types of trusts, for the benefit of) each other without incurring a federal gift tax. Conversely, SWANs do not qualify for that marital deduction and cannot transfer assets between one another in excess of the annual exclusion without creating federal gift tax consequences. Unfortunately, they can quickly run into unintentional gift tax exposure. While opposite-sex spouses do not have to worry about which account is used to pay expenses or how large birthday or anniversary gifts can be, SWANs must carefully plan for any significant transfer of value. Even if no gift tax is due, if the transfer exceeds $13,000, a federal gift tax return will be required, and the gift will use up a portion of the couple's respective available lifetime gift tax exemptions. As long as the lifetime exemption remains at the $5 million level, this may be less of an issue for many couples, but if the exemption drops to only $1 million on 1/1/13, it becomes a substantial concern, especially when considering how the couple's residence will be titled.

Opposite-sex couples can also elect to “split” gifts. Gift-splitting allows the couple to give $26,000 annually to an unlimited number of individuals without having to worry about which spouse actually funds the gift. SWANs cannot gift-split. Such spouses can individually give $13,000 from their respective individual assets, but one spouse cannot make a gift of $26,000 without being exposed to the federal gift tax. As a result, SWANs embarking on an annual gift program for their children (or any other beneficiary) must pay close attention to all aspects of the transfer since drawing from the wrong account by accident could have a disastrous effect.

## Flexibility.

In the event SWANs later divorce, in addition to the pain and financial consequences inherent in any divorce, gift taxes may also be triggered. **Section 2516** states that if a couple enters into a written agreement relative to their marital and property rights at the time of their divorce, any transfers of property pursuant to such agreement will be deemed made for full and adequate consideration, effectively eliminating gift tax concerns. This benefit is simply not available to SWANs: any transfers pursuant to a

property settlement agreement will be subject to gift tax or consume their lifetime gift tax exemptions unless a separate exemption applies to the specific circumstances.

To address the estate tax consequences of their marriage not being recognized, as well as the potential for an eventual repeal of the DOMA, SWANs should have a flexible estate plan. At the most basic level, the plan should create two trusts at the first death. The first trust would be funded with the full amount of the state estate tax exemption (e.g. $1 million in New York). The second trust would be funded with assets up to the amount of the federal estate tax exemption. The second trust would be designed to qualify for the marital deduction (most commonly a must-pay income, qualified terminable interest property (QTIP) trust), whereas the first could be a trust that accumulates its income (often referred to as a “credit shelter” or “bypass” trust). Structuring the second trust to qualify for the marital deduction allows the plan to adapt in the event the DOMA is repealed. In large estates, it may make sense to not make that election, maximizing the federal estate tax benefit.

If it is clear from the outset that a QTIP treatment would not be desired even if the election were available, the second trust could be drafted as an accumulation trust. The first trust will be sheltered from New York estate tax upon the death of the second spouse, and the New York estate tax on the assets funding the second trust can be deferred until the death of the surviving spouse if the executor so elects. For federal purposes, no marital deduction will be allowed for the second trust. Any assets in excess of the federal estate tax exemption can pass outright to the surviving spouse if desired.

Assume a couple has combined assets of $11 million, and the first spouse to die has $9 million of assets in his or her name. $1 million would fund the first trust, $4 million would fund the second trust, and the balance would pass outright to the surviving spouse. At the death of the second spouse, the $1 million trust would pass free of New York estate tax to the couple's children or other remainder beneficiaries. Depending on the election made by the first spouse's executor, New York estate tax on the $4 million trust may be deferred until the death of the second spouse. If the estate makes the election, $10 million will be potentially subject to estate tax at the second death, less any assets the second spouse used during his or her lifetime. The New York estate tax exemption will also shelter $1 million of the second spouse's assets, thereby leaving a $9 million taxable estate for New York estate tax purposes. Importantly, New York allows the surviving spouse to have these assets available for his or her support during his or her remaining lifetime.

The federal estate tax is not so kind. No part of the first spouse's estate will qualify for the federal marital deduction. Depending on the amount of the federal estate tax exemption in the year of death, an estate tax may be due to the IRS. Assuming the federal exemption is $5 million (2012), $4 million will be subject to federal estate tax at the first death. If the federal exemption is $1 million (2013), $8 million will be subject to federal estate tax at the first death. Simplifying the analysis by applying a 35% estate tax rate for 2012 and a 50% rate thereafter, the surviving spouse of a same-sex marriage must pay federal estate taxes of $1.4 million (2012) or $4 million (2013), whereas the surviving spouse of an opposite-sex marriage would pay no federal estate tax at all.

It is critical for same-sex couples considering marriage to update their existing estate plans (or implement a plan if one is not currently in place) as they move forward.

## Recognizing opportunities

Although the DOMA stacks the deck strongly against SWANs, there are some opportunities that also become available as a result of its effects.

## Grantor retained income trusts.

One of the more powerful opportunities available to SWANs is the grantor retained income trust (GRIT). A GRIT is a “freeze” technique, allowing an individual to pass the capital appreciation of an asset to another at a reduced gift tax cost. The grantor of the GRIT reserves the right to receive the trust's net income for a fixed number of years after he or she transfers property to the trust. At the end of that period, the assets remaining in the GRIT pass to the remainder beneficiary (or beneficiaries), either outright or in trust. That remainder interest bears with it all of the assets' appreciation during the fixed term of years.

The value of the grantor's gift will be reduced by the value of his or her retained interest in the GRIT. That retained interest must be valued by applying the IRS tables and the applicable interest rate under **Section 7520**. Those tables assume a certain rate of return for the income interest, but they have no bearing on how the assets are actually invested. For example, the GRIT can be invested entirely for growth, ensuring that the remainder beneficiary receives as much as possible from the GRIT upon the expiration of the term of years. This actuarial discounting effect is the key benefit of the GRIT and the main reason why its availability was sharply curtailed in favor of grantor retained annuity trusts and grantor retained unitrusts, in which the amounts payable to the grantor are more stringently regulated.

Just as importantly, the actuarial discounting can be enhanced by other valuation adjustments that may apply to the underlying asset itself (i.e. for a tenants-in-common interest, lack of control, etc.).

*Example 1:* To use a simple example, assume the grantor contributed 12,500 shares of Apple stock worth $40 a share ($500,000) to a GRIT in July 2005 and selected a GRIT term of six years. Based on the IRS tables, the grantor's retained interest is worth approximately $120,000, which means his taxable gift is $380,000.[2] No gift tax was due since the amount of the gift was covered by the grantor's lifetime gift tax exemption. When the GRIT term expired in 2011, the stock was worth $400 per share. Because the stock bears no dividend, no income was earned, and the grantor received no payments from the GRIT. Upon the GRIT's termination, a trust for the remainder beneficiary received $5,000,000. As a result, $4,620,000 passed free of gift and estate tax from the grantor to his intended beneficiary.

The result is even more astounding if, instead of contributing the stock directly, the grantor contributed nonvoting units in an LLC or LP holding the stock. As discussed below, depending on the terms of the agreement, those LLC or LP units would be worth substantially less than the underlying value of the Apple stock itself, further reducing the value of the grantor's gift.

Clearly the technique can be quite compelling, so much so that in order to address perceived abuses of this type of transaction, the Code provides that the remainder beneficiary of a GRIT cannot be the grantor, the grantor's spouse, or a lineal descendant of the grantor or the grantor's spouse. Because a SWAN is not a spouse for federal purposes, that prohibition does not apply here.

The assets remaining in the GRIT at the end of the term of years may be held in a trust for the spouse's benefit and will not be includable in his or her estate upon his or her death. By transferring assets to a GRIT, the grantor is able to move assets out of his or her estate for the benefit of his or her non-recognized spouse without having those assets subject to estate tax at the recipient spouse's death. The grantor also has the security of knowing that the assets can be available later through the spouse/beneficiary, as long as their marriage continues.

The downside to a GRIT is that if the grantor does not survive the term of years, the trust's assets will be includable in the grantor's estate at their fair market value as of the date of the grantor's death. However, the end result is no worse than if the grantor had never created the GRIT. Note that assets transferred to a GRIT will not receive a stepped-up basis at the grantor's death, so funding such a trust with low-basis assets is not the best strategy if there are other choices available.

If the value of the assets transferred to the GRIT (taking into account the actuarial tables) is below the grantor's available federal gift tax exemption, no gift tax will be due, but the grantor must file a federal gift tax return (Form 709) reporting the gift, explaining the valuation methods applied, and reconciling the use of his or her exemption. If the value is greater than the grantor's remaining lifetime exemption, a gift tax would be due along with the return. New York does not impose a gift tax, so there is no requirement to file a gift tax return for New York purposes.

## Split interest charitable trusts.

SWANs with charitable goals may also benefit from establishing a charitable remainder trust (CRT) or a charitable lead trust (CLT). For either of these techniques, the charitable organization can be a donor-advised fund or a family foundation, ensuring that the gift advances the grantor's specific philanthropic wishes. The difference between a CRT and a CLT concerns whether the charitable portion is the "lead" interest (measured by a set term of years or a person's lifetime) or the remainder interest. In a CRT, the grantor retains the lead interest with the remainder passing to charity. A CLT is the direct opposite—one or more charities receive the lead interest, at the end of which the remainder interest passes to one or more individuals. Under present law, the lead interest must be either a fixed annuity or a "unitrust" interest (a variable annuity based on a fixed percentage of the trust's assets each year). Use of a raw "income" interest (along the same lines of the GRIT discussed above) is prohibited by the Code regardless of marital status.

Using a CRT or CLT provides an estate with a charitable deduction for estate tax purposes for the actuarial value of the portion (lead or remainder) passing to charity. Just as for a GRIT, IRS tables determine life expectancy for this purpose, and prevailing federal interest rates also affect the calculation. CRTs are most effective in a high interest rate environment, though the trust can still work in today's market in the right situation. Using a CRT, one spouse could provide for a lifetime stream of payments to the other spouse while at the same time reducing the overall estate tax.

*Example 2:* Assume that the married couple in our test case from the example above wishes to provide for one another, and at the second death would be pleased to have all of their remaining assets pass to charity. The first spouse dies in December 2011 with $9 million in assets. At the time of his death, his husband is 75 years old. Instead of creating discretionary trusts (with access to principal), the deceased spouse leaves $500,000 to his husband outright and places $8,500,000 into a fixed annuity CRT (often referred to as a "CRAT") paying $461,380 to his husband annually (exactly 5.428% of the date-of-death

value of the assets). Funding a CRAT in December 2011 with $8,500,000 for the benefit of an individual at age 75 produces a charitable deduction of $3,967,357 for the remainder interest, leaving a lead interest of $4,532,643 subject to tax. In this example, the $500,000 bequest and the value of the surviving husband's lead interest are covered by the federal estate tax exemption and other de minimis deductions. The decedent's husband is left with, in addition to his own assets, $500,000 in cash and an annuity paying him $461,380 annually. At his death, a favored charity receives several million dollars (depending on the trust's investment performance, anywhere from $3,0000,000 with zero growth net of expenses to over $15,000,000 if the annualized return is 10%) with no federal estate tax. The result is even better if a CRT is funded with an IRA or qualified plan, preserving the income tax deferral as long as possible. The downside is that the survivor does not have access to trust principal. This is an extreme example, however. Taxes aside, for this type of plan it is of the utmost importance to set the charitable interest at a level where the surviving spouse is comfortable with both the outright portion and the annuity.

These techniques can also be used for lifetime planning. For example, one spouse can create a CRT, reserving for herself and her spouse the lifetime interest. Creating a lifetime CRT can also defer recognition of capital gains since the CRT itself is exempt from federal income taxation, with the holder of the lead interest picking up the income slowly over time. However, just like any other gift, any part of the lead interest passing from one spouse to the other would be subject to gift tax as a result of the DOMA.

To get around this limitation, it is possible to structure a fixed annuity CLT (often referred to as a “CLAT”) so the actuarial value of the non-charitable remainder interest is close to zero. Using this method, one spouse can create a trust in which an annuity is paid to a charitable organization for a set number of years. If the time frame is long enough, a zeroed-out CLAT can effectively transfer assets to a SWAN at the end of the lead term without any transfer tax.

*Example 3:* Assume the richer of the two spouses wishes to transfer assets to her wife without causing a gift tax or using her lifetime gift tax exemption. If she contributes $2,000,000 to a ten-year CLAT in December 2011, with annual payments to charity of $215,740, there will be virtually no taxable gift. At the end of ten years, the couple's family foundation will have received over $2,150,000, and the beneficiary spouse will receive a payment of almost $1,750,000 if the annualized return over the lead period is 10% per year. Using an annualized return of 8%, almost $1,200,000 would be distributed at the end of ten years. If, instead, the lead term of the trust is 15 years, the annual charitable payment is just under $150,000, and the grantor's wife receives over $3,600,000 at 10%, or $2,300,000 at 8%. A zeroed-out

CLAT works best in a low-interest-rate environment and with a long lead term, so this technique favors younger beneficiaries who can wait for the remainder interest to mature while the assets are held for the benefit of the charity. At the same time, the beneficiary can also participate in the decision-making for which causes the family foundation (or donor-advised fund) will support. The grantor should be screened from administering the funds received by the private foundation from the CLT as part of the internal governance of the foundation.

## Family investment entities.

A family limited investment entity (an "FIE," most commonly a limited partnership or a limited liability company), is another estate planning technique that, if properly implemented and administered, can afford SWANs more flexibility than opposite sex couples. An FIE is an organization formed among family members that is created for the common investment of assets. An FIE allows for economies of scale in investing and provides for unified management of the underlying assets. Often, an FIE contains restrictions limiting the transfer of interests in the entity to individuals who are members of the family group. These restrictions provide for a measure of protection from creditors while still allowing an owner to make gifts of interests in the FIE to members of the family. An FIE can also be designed so that there are voting and nonvoting interests, allowing an owner to make gifts of the equity without giving any portion of voting control to the recipient.

A byproduct of these structures is their effect on the value of interests in the FIE. In determining the value of an FIE interest for gift tax purposes, an appraiser will apply valuation adjustments (discounts) that take into account the lack of marketability due to the restrictions on transfer, the lack of control inherent in nonvoting interests, and minority interests when a member does not have enough voting units to control the entity. These valuation adjustments can allow a member to transfer his or her nonvoting interests to another member of his or her family at a substantially reduced gift tax cost. If a member dies holding interests, the same valuation adjustments apply when determining the value of the FIE interests in his or her estate.

Although under current law voting interests of an FIE held by spouses in a federally recognized marriage are not per se aggregated for federal estate and gift tax purposes, the IRS has in some instances restricted the amount of discounts that apply when it can show an implied understanding among family members.[3] The IRS position is essentially that if one family member owns a 35% voting interest in the FIE and the other family member owns a 30% voting interest, their interests should be combined (i.e.

65% controlling interest owned by each of them). The end result of this theory is to reduce the discount applicable to the minority interest.

Because SWANs are not considered to be family members for this purpose, when determining voting control in an FIE their ownership should not be aggregated under this argument. As unrelated parties for purposes of the tax system, they should be in a position to make gifts of compressed assets without risk of disrupting any of the valuation discounts that otherwise would apply, even if together their combined voting interests control the FIE. It is important to note that an FIE need not be, and in many cases should not be, a stand-alone technique. For example, funding a GRIT with interests in an FIE “supercharges” a GRIT's success by compounding the actuarial discounts that apply to the GRIT.

## Trustee control.

In addition to the powerful estate planning benefits GRITs can offer, SWANs also have increased flexibility with respect to the removal and replacement of trustees of trusts created for their benefit. In order to avoid the inclusion of trust assets in his or her estate, a beneficiary must not have the ability to participate in the discretionary distribution of principal to such beneficiary beyond the limitations of an ascertainable standard (i.e., health, education, maintenance, and support). Only a trustee (or co-trustee) other than the beneficiary may have the discretion to make distributions beyond such a standard (i.e. best interests). In many situations, a beneficiary will have the ability to appoint and remove trustees. However, there are limits on who the beneficiary can appoint to succeed a trustee he or she removes. To avoid estate tax inclusion, the beneficiary cannot be granted the power to replace a trustee he or she removes with a successor who is related or subordinate to him or her. **Section 672(c)** defines the term “related or subordinate” to include a spouse. As long as the DOMA remains in effect, SWANs have no such spousal limitation. This means that the beneficiary may be granted the power to remove any existing trustee and replace that individual with his or her spouse (provided that such spouse is not the grantor of the trust) at any time. The beneficiary's spouse, acting as a trustee, could then make purely discretionary distributions of principal to the beneficiary while still avoiding the inclusion of the trust assets in the beneficiary's estate. Of course, better drafting would still impose the **Section 672(c)** limitation to allow for protection upon the DOMA's repeal.

## Conclusion

If and when the DOMA is repealed, which seems likely given recent constitutional changes and proposed legislation, SWANs will be afforded the same treatment under federal law as, and the protections that are currently afforded to, married couples of the opposite sex. Conversely, with the repeal of DOMA the unique estate planning opportunities currently available to SWANs will disappear. Same-sex couples who are considering marriage should consult with their estate planning attorney so that they can take advantage of the estate planning techniques currently available to them as a result of their non-recognition status before the techniques expire, while at the same time navigating the many pitfalls that the DOMA presently puts in their way.

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Washington, D.C. also permits same-sex marriage, as do several Indian tribes in Oregon and Washington State. California Proposition 8 was recently held unconstitutional by a three judge panel of the 9th Circuit Court of Appeals, paving the way for marriage for same-sex couples to be reinstated in California. It is unclear at this time if or when marriages may resume in California given the potential for further appeals. Civil Unions and Domestic Partnerships offering varying degrees of success in approximating marriage are presently permitted in the states of California, Delaware, Hawaii, Illinois, Maine, Nevada, New Jersey, and Oregon.

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[2]

These numbers are rounded to streamline the example.

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[3]

See Griffin, **89 AFTR2d 2002-954**, 42 F. Supp. 2d 700 (DC Tex., 1998). See also **TAM 9436005**.

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