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YOGA FOR ESTATE PLANNERS:

DRAFTING FLEXIBLE DOCUMENTS THAT CAN BEND AND STRETCH

(by Marvin E. Blum)

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Certain defined terms are used through this presentation. In the interest of brevity, such defined terms will be indicated as such by the use of initial capital letters, and their associated meanings will be set forth in the attached Exhibit A.

I. <u>THE NEED FOR DEVELOPING FLEXIBLE ESTATE PLANS IN A TIME OF CHANGES AND UNCERTAINTY</u>

The evolving nature of the transfer tax system and associated inherent uncertainties are important elements of the estate planning process. Over the past few years, a combination of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act"), other federal transfer tax developments, and state law changes have resulted in a significant restructuring of the traditional estate planning approach.

A. <u>2001 Tax Act</u>

1. <u>Estate Tax/Generation-Skipping Transfer Tax</u>

Under the 2001 Tax Act, the estate and generation-skipping transfer ("GST) tax exemptions are both equal to $2,000,000 in 2006 through 2008 and will both increase to $3,500,000 in 2009. Both taxes will be repealed for decedents dying/generation-skipping transfers occurring in 2010. However, absent extension of the 2001 Tax Act or further legislative changes, both taxes will return in 2011 under the "sun setting" provisions required by the Congressional

Budget Act of 1974 with an associated exemption for each equal to $1,000,000 (although the GST exemption will remain adjusted for inflation).

For the year 2006, the value of an estate in excess of the $2,000,000 exemption amount is taxed at a flat 46% rate. For the years 2007 through 2009 that tax rate drops to 45%. Transfers subject to GST will be taxed at a rate of 46% in 2006 and at a rate of 45% for years 2007-2009. The highest estate tax rate and the flat GST rate both return to 55% in 2011 (absent extension of the 2001 Tax Act provisions or further legislative relief), with a 5% surcharge on estates exceeding $10,000,000.

2. <u>Gift Tax</u>

The gift tax was not repealed under the 2001 Tax Act, and its associated exemption amount remains at $1,000,000, without adjustment for inflation. The top marginal rate for gifts is 46% for 2006, decreases to 45% for years 2007-2009, and will be equal to 35% in 2010, reverting back to 55% in 2011, absent extension of the 2001 Tax Act or further legislative changes.

3. <u>Income Tax Basis Adjustment</u>

IRC 1014 continues to provide for an adjustment to fair market value for the income tax basis of assets belonging to a decedent dying prior to January 1, 2010, with the valuation date being either the date of the decedent's death or the alternate valuation date established under IRC 2032, as applicable. For decedents dying in 2010, a modified carryover basis system will apply. Generally, a beneficiary of an estate will receive an income tax basis in an acquired asset equal to the <u>lesser of</u> the decedent's basis in the asset or its fair market value at the decedent's death. However, a decedent will have a $3,000,000 basis adjustment allocable to property transferred to the Surviving Spouse either outright or via a QTIP Trust and an <u>additional</u> $1,300,000 basis adjustment for property transferred to any beneficiary (including the Surviving Spouse).

Typically, a donee of a gift will take a carryover basis in the asset gifted (plus an adjustment for any gift taxes paid attributable to unrealized gains) unless the asset's fair market value is lower, in which case that value will become the donee's basis in the asset received for determining loss. These rules did not change under the 2001 Tax Act.

B. <u>Possible Changes in the Tax Laws</u>

There is a general belief that the system as it is currently structured will be changed. The unknown is what that change will be and how the system will be structured after it is implemented. At the time this presentation was prepared, it appeared that the two most likely possibilities were as follows:

1. <u>Scenario #1: the Bush Administration's and Congressional Republicans' Wish List</u>

The Bush Administration and the majority of Republicans in Congress would like to see a permanent repeal of the estate and GST taxes for years after 2009, with a retention of the gift tax (and an associated exemption of $1,000,000), and an income tax adjustment that includes the loss of the basis adjustment at death to fair market value (subject to a limited adjustment allowance, if any).

Scenario #2: the Congressional Democrats' Wish List

In contrast, a majority of the Congressional Democrats would like to see a retention of the estate tax and GST, with an increase in the exemption amount for each (e.g. $4,000,000 +) and a reduction in the tax rates. Some Republicans have indicated they would be amenable to this compromise and think passage of a variation of this proposal would be possible.

2. The Practical Reality

Despite Congressional assurances of significant legislative changes to the 2001 Tax Act, we are still to a large extent living in tax limbo. Some practitioners have interpreted a recent formal announcement by the IRS of its intent to reduce significantly the number of Estate and Gift Tax attorneys as an indication of the Administration's exertion of its influence behind the scenes and as a "de facto repeal" of the estate and GST taxes. These measures have caused some practitioners to doubt whether we will receive any significant legislative transfer tax relief any time soon.

Most of us who have closely monitored Congressional developments on this front for the past several years are doubtful that we will receive any definitive answers to these questions in the near future. Some estate planners have adopted a "wait and see" approach for many clients without an apparent urgent need for updated estate planning documents based upon a well meaning desire to minimize inconveniences and fees for their clients. However, this strategy may not be sound considering the possibility of an unforeseen and untimely death or prolonged incapacity. Consequently, the wise estate planner should forgo adopting a "wait and see" approach and should instead incorporate as much flexibility as possible into his/her estate planning documents so that a client's estate plan may adapt as necessary to future developments in both the law and the client's own family circumstances.

II. POTENTIAL TRAPS FOR THE UNWARY IN EXISTING DOCUMENTS AND POSSIBLE SOLUTIONS

A. Bequests Tied to the Estate Tax Exemption Amount or the Generation-Skipping Transfer Tax Exemption Amount

Some clients, particularly those with significant wealth and/or children from a prior marriage, may have existing estate plans providing for a bequest of the estate tax exemption amount under IRC 2010 to be made directly to the children at death (or trusts for them), even if there is a Surviving Spouse.

Clients previously adopting this approach should be advised of the consequences of such a bequest in light of scheduled increases in the estate tax exemption amount, the potential for even higher exemption amounts to be legislated, and the full repeal of the estate tax in 2010. The prudent attorney will want to specifically help those clients to assess whether their objectives would be better served by providing for a cap on the gift to the children (as illustrated in the Example below), especially if there is a concern that a Surviving Spouse might be otherwise insufficiently provided for under the current plan.

If the client ultimately determines a cap would be preferable, the remaining portion of the estate tax exemption amount should pass to a Bypass Trust benefitting the Surviving Spouse. If appropriate given the family dynamics, the children and grandchildren might be permitted to receive distributions as well, provided the Bypass Trust's continuing ability to provide for the Surviving Spouse's support would not otherwise be impaired in the process.

> **<u>Example</u>: If an issue of mine survives me by at least ninety (90) days, I bequeath, per stirpes, to those of my issue who so survive me property equal in value to <u>the lesser of</u> the Exemption Pecuniary Bequest Amount or One Million Dollars ($1,000,000). Each share of property so allocated shall be held in a separate trust created for and named after the issue of mine to whom such share is allocated, to be held, administered, and disposed of in accordance with the terms and provisions of Article _____. If any portion of the Exemption Pecuniary Bequest Amount remains after satisfaction of the aforementioned bequest, I bequeath property equal in value to such remaining portion of the Exemption Pecuniary Bequest Amount to the Trustee of the Bypass Trust, to be held, administered, and disposed of in accordance with the terms and provisions of Article ____.**
>
> **My executor shall have the power and the sole discretion to satisfy each share of the bequest provided for pursuant to this Section ____ allocated to a trust for an issue of mine (and the bequest provided for the Bypass Trust, if applicable) in cash or in kind or partly in cash and partly in kind and to select the assets which shall constitute each such share of such bequest (and which shall constitute the bequest provided for the Bypass Trust, as the case may be), provided that my executor shall value such assets at their respective fair market values as of the date or dates of their distribution in satisfaction of the aforementioned bequest. Each share of the bequest provided for pursuant to this Section ____ allocated to a trust for an issue of mine (and the bequest provided for the Bypass Trust, if applicable) shall carry with it, as income and not as principal, its proportionate part of all net income attributable to assets of my estate from the date of my death until the date or dates of distribution of the property to the Trustee of the Trust provided hereunder to receive such. No compensating adjustments between net income or principal or in the amount of any distribution under this Will shall be made as a result of any decisions made by my executor in funding any such bequest provided for pursuant to the preceding.** [Note: See Exhibit A for definitions of defined terms.]

Note that similar concerns may apply with regard to a gift of the GST exemption amount to trusts for grandchildren, even if the gift is only provided for at the Surviving Spouse's death, since it could result in the bulk of the clients' combined estates bypassing their children, potentially frustrating the clients' objectives.

B. Selection of Pecuniary Bequest in A "Zero Estate Tax Plan"

1. Selection of a Pecuniary Amount Designed to Minimize or Avoid Estate Taxes at the Death of the First Spouse to Die (the "Deceased Spouse")

A typical estate plan for a married couple provides for the maximum amount that can pass free of transfer taxes at the Deceased Spouse's death to pass to a trust designed to provide the Surviving Spouse with distributions to maintain his/her lifestyle but be excluded from his/her estate at death (a "Bypass Trust"). The balance of the Deceased Spouse's estate is then directed to pass either outright to the Surviving Spouse, or more commonly for wealthier clients, a trust designed to qualify for the marital deduction (typically, a "QTIP Trust"), which defers the estate taxation of those assets until they are included in the Surviving Spouse's estate for estate tax purposes at his/her death. The preceding may either be implemented through a pecuniary bequest to the Bypass Trust and a residuary bequest to the QTIP Trust or alternatively through a pecuniary bequest to the QTIP Trust and a residuary bequest to the Bypass Trust.

2. Approaches for Funding a Pecuniary Bequest

The IRS issued Revenue Procedure 64-19 in order to prevent the funding of a pecuniary marital deduction gift with assets reflecting a level of depreciation or minimal appreciation uncharacteristic of the valuation changes experienced by estate assets as a whole, since the IRS viewed such action as an attempt to "stuff" the Bypass Trust disproportionately with appreciated assets. As a result, a pecuniary bequest to a Bypass Trust, or alternatively to a QTIP Trust, under a Zero Estate Tax Plan is typically required to be funded with assets either (i) valued at their respective values as of the date or dates of funding (a "Date of Distribution Bequest") or (ii) valued based upon their adjusted estate tax values, provided the assets selected are fairly representative of the total appreciation/depreciation in the value of all property available for use in satisfying the bequest, as measured during the period after the date of death through the date or dates of funding (a "Fairly Representative Funding Bequest")(although other less common means of funding a pecuniary bequest are available). Often, the former funding approach is selected because it requires that only the selected assets be valued twice, as opposed to the latter, which requires that all estate assets available for distribution in satisfaction of the pecuniary bequest be revalued in order to ensure the assets selected for funding reflect a level of appreciation/depreciation representative of that enjoyed by the pool of available assets.

3. Recognition of Capital Gain/Loss in Funding a Pecuniary Bequest

The two conventional approaches for funding a pecuniary bequest described above yield different income tax consequences for the Estate. (It is assumed for purposes of this discussion that an election will be made pursuant to IRC Section 645 to treat any "Qualified Revocable Trusts" as part of the Estate for income tax purposes.)

a. Date of Distribution Bequest

i. Non Income in Respect of a Decedent (“IRD”) Items

In funding a Date of Distribution Bequest, the Estate is deemed for income tax purposes to have sold the distributed assets in exchange for consideration equal to the pecuniary bequest. As a result, if appreciated assets are used to fund a Date of Distribution Bequest, the difference between each distributed asset’s income tax basis (typically, its estate tax value) and its value as of its distribution date will be treated as capital gains. The nature of the distributed asset will dictate the taxation of the resulting capital gain (e.g., to the extent the gain was considered recapture income, it would be taxed as ordinary income).

Similarly, capital losses may be incurred if depreciated property is used to fund a Date of Distribution Bequest. (A capital loss in such event would not be disallowed under IRC 267.) Capital losses not otherwise used by the Estate may be carried forward, and to the extent ultimately unused by the Estate, distributed to the residuary beneficiaries in the year the Estate terminates. (Capital losses are generally excluded from distributable net income and are therefore not available for distribution to the Estate’s beneficiaries until the year of the Estate’s termination.)

The Trust funded with the pecuniary bequest will then take an income tax basis in each distributed asset equal to the Estate’s basis in the asset immediately prior to its distribution in satisfaction of the pecuniary amount, plus an adjustment for any capital gain/loss recognized upon distribution (i.e., typically, the Trust will take an income tax basis in the distributed asset equal to its fair market value as of the distribution date unless the Estate’s income tax basis had been adjusted post-date of death for depletion, depreciation, etc).

ii. IRD Items

An Estate will be required to recognize any deferred income associated with property considered IRD used to fund a Date of Distribution Bequest.

b. Fairly Representative Bequest

In contrast, an Estate is not automatically treated for income tax purposes as having sold assets used to fund a Fairly Representative Bequest. However, the Estate may elect such treatment in funding a pecuniary bequest, in which event the election must be applied to all distributions made by the Estate during the affected year rather than allow the executor to pick and choose which distributed assets are to be treated as having been sold. This election will, however, not apply with respect to bequests of a specific sum of money, a bequest of property payable in three or fewer installments, or charitable bequests.

4. Selection of Trust to Fund With Pecuniary Bequest

Typically, two factors affect the decision concerning which of the Bypass Trust and the QTIP Trust to fund with a pecuniary bequest.

a. Goal #1: Allocate Anticipated Post-Death Income to the Bypass Trust

On the one hand, conventional wisdom dictates that the residuary bequest be made to the Bypass Trust if the Estate assets are expected to generate significant income prior to funding the two Trusts since the residuary beneficiary typically is entitled to Estate income, barring a contrary Will provision or state statute requiring interest payments on pecuniary bequests after a prescribed period of time. In so providing, the Bypass Trust will facilitate the tax-free transfer of that income at the Surviving Spouse's death (and thereafter, if GST is allocated to the Bypass Trust), whereas if the QTIP Trust were the residuary beneficiary, that income would ultimately be subject to estate taxes in the Surviving Spouse's estate. Note that Treasury Regulation 20.2056(b)-5(f)(9) provides that the funding of a marital deduction bequest without any entitlement to Estate income may be postponed for a reasonable period of administration without affecting the qualification of the accompanying marital deduction under IRC 2056 (although the valuation of such may be affected).

Note, however, that if a pecuniary bequest to the QTIP Trust/residuary bequest to the Bypass Trust approach is adopted, it may in any event be preferable to provide for the QTIP Trust to share in the post-death income due to the need to ensure an efficient allocation of GST exemption to the residuary bequest to the Bypass Trust (as discussed in more detail below). If so, the importance of Goal #1, and the argument in favor of selecting the Bypass Trust as the residuary beneficiary, is weakened.

As background, assets used to fund a residuary bequest may be valued differently for purposes of an accompanying allocation of GST exemption, depending upon the requirements pertaining to the funding of the initial pecuniary bequest. (For purposes of this discussion, it is assumed that the pecuniary bequest will be either a Fairly Representative Bequest or a Date of Distribution Bequest.) The denominator of the applicable fraction with respect to a residuary bequest may be either (i) the collective estate tax value of all assets available for funding the pecuniary bequest, less the actual pecuniary bequest amount or (ii) the collective estate tax value of all assets available for funding the pecuniary bequest, reduced by the present value of the pecuniary bequest, calculated as of the decedent's date of death by taking into account the date the pecuniary bequest is actually satisfied and the Section 7520 rate applicable at the decedent's date of death. (See Treasury Regulation 26.2642-2(b)(3)) Because result (i) yields a lower value for the denominator in the applicable fraction with respect to a residuary bequest, it presents a greater opportunity for achieving an inclusion ratio equal to or as close as possible to 0 for assets funding the residuary bequest and is, therefore, the preferable result.

The availability of result (i) depends upon the applicable requirements for funding the pecuniary amount, which again is assumed to be either a Date of Distribution Bequest or a Fairly Representative Bequest (either of which is satisfiable in kind). The following must apply in order for result (i) to be applicable: the pecuniary bequest to the QTIP Trust must (1) carry "appropriate interest" under Treasury Regulation 26.2642-2(b)(4), (2) be set aside/funded within 15 months of the decedent's death, or (3) be allocated (under state law or the governing instrument) a proportionate share of any income earned by the Estate assets available for distribution in satisfaction of the pecuniary bequest from the date of death until the date the pecuniary bequest is funded.

Typically, the cautious estate planning attorney will provide in the governing document for either approach (1) or approach (3) to apply in order to ensure that the more favorable means of allocating GST exemption to the Bypass Trust (as the residuary beneficiary) is secured rather than rely on approach (2) to be achieved. As a result, Goal #1 is somewhat frustrated in the process and, consequently, the argument in favor of providing for a residuary bequest to the Bypass Trust is weakened.

b. Goal #2: Minimize Recognition of Capital Gains in Funding the Pecuniary Bequest

A. Date of Distribution vs. Fairly Representative Funding

Conventional wisdom also dictates that income taxes be minimized in funding a pecuniary bequest. As previously noted, such a result can be achieved by providing for a Fairly Representative Bequest, regardless of the identity of the recipient Trust. However, as also noted, a Fairly Representative Bequest requires that all estate assets available for use in funding the bequest be valued twice - once at date of death (or the alternate valuation date) and subsequently upon actually funding the bequest. For that reason, many practitioners prefer a Date of Distribution Bequest and rely on funding the bequest either prior to any significant appreciation occurring or by carefully selecting assets that have experienced little or no significant post-death appreciation.

B. Date of Distribution Funding of Smaller Bequest

However, in order to hedge their bets, many of those practitioners still attempt to provide for the smaller of the (i) estate tax exemption amount or (ii) the marital deduction gift to be the pecuniary bequest in order to minimize both the income taxes incurred upon funding and the number of assets required to be revalued in the process. Consequently, for smaller estates, it is often preferable to provide for the pecuniary bequest to be made to the QTIP Trust so that the larger portion of the estate (the estate tax exemption amount) will constitute the residuary bequest, which can be funded without incurring income taxes or requiring revaluation of the selected assets. Correspondingly, in larger estates, it is often preferable for the pecuniary bequest to be made to the Bypass Trust so that the larger portion of the estate (the marital deduction gift) will constitute the residuary bequest, which can pass to the QTIP Trust without incurring income taxes or requiring revaluation of the selected assets.

C. Evolving Identity of the "Smaller Bequest"

As the estate tax exemption amount increases, many practitioners are finding that a significant number of their clients are "out growing" the funding approach adopted in their existing Zero Estate Tax Plan. In other words, many clients who were previously well served by a pecuniary bequest to the Bypass Trust at a time when the estate tax exemption amount represented the smaller portion of their estate would be better served now by a pecuniary bequest to the QTIP Trust since the marital deduction gift has become the smaller portion.

To further complicate matters, the practitioner must also consider the possibility of additional legislative increases to the estate tax exemption amount and their possible effect in this regard.

As an additional concern, clients often "out grow" the funding approach adopted in their existing documents due to economic factors. The value of a client's estate may either increase or decrease significantly to the point where he/she would be better served by adopting the alternative funding approach.

D. A Possible Solution

Query: Could a Will be drafted to postpone selecting the Trust to be funded with the pecuniary bequest until after the client's death so that the client's wealth and available estate tax exemption amount could then dictate which approach would be preferable?

Example: If my spouse survives me, I hereby direct that my Executor calculate the Exemption Pecuniary Bequest Amount and the Marital Deduction Pecuniary Bequest Amount and distribute the lesser of such amounts as follows:

(1) If the lesser of such amounts is the Exemption Pecuniary Bequest Amount, I hereby bequeath (i) property equal in value to the Exemption Pecuniary Bequest Amount to the Trustee of the Bypass Trust, to be held, administered, and disposed of in accordance with the terms and provisions of Article ____ and (ii) the rest, residue and remainder of all property of every kind and character, wherever situated, that I shall own at my death (including any lapsed or disclaimed devise or bequest made pursuant to any preceding Section of this Will) to the Trustee of the Marital Trust, to be held, administered, and disposed of in accordance with the terms and provisions of Article ___. In funding the Bypass Trust pursuant to (i) above, assets may be distributed in cash or in kind or partly in cash and partly in kind, and any assets distributed in kind for such purpose shall be valued for such purpose at their fair market values determined as of the dates of their respective transfers.

(2) If the lesser of such amounts is the Marital Deduction Pecuniary Bequest Amount, I hereby bequeath (i) property equal in value to the Marital Deduction Pecuniary Bequest Amount to the Trustee of the Marital Trust, to be held, administered, and disposed of in accordance with the terms and provisions of Article ____ and (ii) the rest, residue and remainder of all property of

every kind and character, wherever situated, that I shall own at my death (including any lapsed or disclaimed devise or bequest made pursuant to any preceding Section of this Will) to the Trustee of the Bypass Trust, to be held, administered, and disposed of in accordance with the terms and provisions of Article _____. In funding the Marital Trust pursuant to (i) above, assets may be distributed in cash or in kind or partly in cash and partly in kind, and any assets distributed in kind for such purpose shall be valued for such purpose at their fair market values determined as of the dates of their respective transfers. [Note: See Exhibit A for definition of defined terms.]

Presumably, the discretion an executor is typically allowed to exercise in determining the Exemption Pecuniary Bequest Amount or the Marital Deduction Pecuniary Bequest Amount, as applicable, under a conventional estate plan should be safely exercisable under an approach requiring the comparison of the two amounts and the selection of the lesser without endangering the marital deduction. (E.g., Typically, an executor can decide whether to deduct an administration expense on (i) the estate tax return and thereby cause the QTIP Trust funded with the residuary estate to bear the expense or (ii) the estate's Form 1040 and thereby require that the expense be borne by the Bypass Trust funded with assets equal to the decedent's remaining estate tax exemption amount.) This would also seem to be the correct answer given that the amount ultimately passing to each of the two trusts should theoretically be the same under either approach for transfer tax purposes, although the income tax consequences obviously differ. However, if caution is sought, it should in any event be permissible for the selected funding approach to be dictated by the value of the client's gross estate at death and his/her available estate tax exemption amount since those values are objectively determined at the moment of death.

To the presenter's knowledge, this technique has not been discussed in any detail in other commentaries, nor has the IRS indicated how it might view such an approach. If the accompanying flexibility is sufficiently attractive to a client, consider obtaining a private letter ruling confirming the desired tax results. As a caveat, the IRS has previously indicated its reluctance to issue rulings on "hypothetical matters" (See Rev. Proc. 2006-1, 2006-1 I.R.B., January 3, 2006). Consequently, the wise practitioner will want to contact personnel in the Internal Revenue Service National Office prior to incurring the time and expense of preparing a letter ruling request on this issue in order to determine whether the IRS would be willing to issue a ruling in advance of the technique's implementation.

III. EMPOWERING BENEFICIARIES TO ADAPT AN ESTATE PLAN THROUGH POWERS OF APPOINTMENT

A. The Basics

1. Elements of an Appointment Power

The donee of a power of appointment may be permitted to exercise the power during life (an "inter vivos power of appointment") and/or at death (a "testamentary power of appointment"). To the extent a donee does not exercise the power, the remaining property will pass to the persons designated under the instrument to receive the subject property (the "takers in default") in the manner prescribed by the client.

The client may define the persons and/or organizations who may benefit from the donee's exercise of the power of appointment (the "objects" of the power) as broadly or as narrowly as the client considers appropriate. Note that even if the client wishes to defer entirely to the donee's judgment by authorizing him/her to pass the property subject to the appointment power to anyone or any organization, a narrow restriction on the donee's discretion may be appropriate if the client wishes to protect the affected property from the donee's creditors and/or from inclusion in the donee's estate for estate tax purposes. In that event, the donee should be prohibited from appointing the property to the donee, the donee's creditors, the donee's estate, or the creditors of the donee's estate. Absent those restrictions, the donee would have a "general power of appointment," which as discussed below might be preferable for purposes of minimizing the overall transfer taxes otherwise assessed on the affected property at the donee's death (if not exempt from GST). If those restrictions are the only limitations imposed on the donee's appointment authority, then the donee is considered to have a "broad special power of appointment." (Note the preceding terminology reflects that used for transfer tax purposes. However, the definition of a "general power of appointment," "limited power of appointment," or "special power of appointment" under state law may vary by jurisdiction and in the context of income taxation.)

2. Reasons For Granting a Power of Appointment

a. Special Powers of Appointment

A client might consider providing the Surviving Spouse and issue (each, a "donee") with a "special power of appointment" in order to empower each of them to adapt (without estate tax consequences to the donee) how assets remaining in his/her trust at death are to pass (if a testamentary power of appointment) and/or during his/her lifetime (if an inter vivos power) as appropriate to accommodate changes in circumstances and/or further the beneficiary's own objectives, if inconsistent with the default provisions of the plan.

b. General Powers of Appointment

i. Provision of Power to Beneficiary in the Governing Instrument

A client may also provide a beneficiary with a general power of appointment (as discussed above), the exercise of which is conditional upon the assets remaining in the donee's Trust at death otherwise being slated under the default terms to pass to "skip persons" (as determined at the time of the donee's death) and therefore resulting in a "taxable termination." If those circumstances apply, the existence of the exercisable general power of appointment (even if not exercised) should cause the affected assets to be subject to inclusion in the donee's own estate for estate tax purposes rather than be subjected to the typically higher GST. In effect, the overall transfer taxes assessed on the assets at the donee's death should be minimized since the donee's own tax attributes (estate tax exemption amount, "bracket run up," etc.) would be available for such purpose. Trust assets would be used to pay the estate taxes caused by inclusion of the assets in the donee's estate.

ii. Empower a Trust Protector to Provide a Beneficiary With a General Power of Appointment

Alternatively, an independent fiduciary (a "trust protector") may be given the discretion to convert a donee's special power of appointment into a general power of appointment (or grant the donee the ability to direct assets to the donee's creditors at death, if no special appointment power is otherwise given). In theory, the trust protector is expected to convert (or grant) the general power of appointment and cause the trust assets to be included in the donee's estate at death only if the assets would otherwise pass to a "skip person" and result in a taxable termination subject to the typically higher GST. Again, in doing so, the beneficiary's own tax attributes would be available for use in minimizing the overall transfer taxes due. Trust assets could be used to pay the estate taxes caused by inclusion of the assets in the donee's estate. Of course, this approach only works if the power is actually converted (or granted) prior to the donee's death.

Query: Does the trust protector have a fiduciary duty to monitor the donee's and the Trust's financial circumstances in order to make an informed decision as to whether to convert the power? Can the trust protector shift that burden to the beneficiary by requiring him/her to keep the trust protector apprised of any changes in circumstances reasonably expected to affect the trust protector's decision to convert the appointment power? Is the trust protector liable if his/her action or inaction ultimately causes more tax to be owed? Can the governing instrument sufficiently absolve the trust protector from such a duty to monitor, if otherwise applicable?

B. Reasons for Exercising a Power of Appointment

There are many reasons why a donee might wish to exercise a power of appointment, including:

- to override an otherwise equal allocation of any assets remaining at the donee's death among his/her children in light of those children's disproportionate wealth (e.g., the donee might want to provide disproportionately for a child employed as a public school teacher if the donee's other children are successful entrepreneurs who have no children of their own and are satisfied to receive a reduced share of their parents' combined estate);

- to provide for a wealthy child's share of the estate to be transferred directly from the donee at death to trusts for that child's own children;

- to modify the default terms of a conventional trust otherwise to be created at the donee's death for a child with special needs in order to ensure the provisions for the child under the modified trust will not disqualify him/her from continuing to receive federal financial assistance;

- to provide for the share otherwise to be set aside for a conventional trust for a child with an addiction problem to be transferred directly from the donee at death to trusts for that child's own children rather than be used by the addict-child as the means for furthering the addiction since he/she could potentially force distributions to be made pursuant to an ascertainable standard not otherwise limited by provisions designed to authorize the trustee to withhold distributions in such a situation;

- to override the default provisions providing for the assets to continue in trust for the donee's own children in order to provide those children with part or all of the assets free of trust, assuming there are no creditor protection or estate tax exposure issues for the recipient(s); and/or

- to override default provisions providing for the assets to pass to trusts for the donee's children designed to terminate in stages so the assets will pass instead to dynastic trusts.

C. Mechanics of Providing For and Exercising a Power of Appointment

1. Creation of Powers of Appointment

The creator of the power of appointment must first decide whether to provide the donee with an inter vivos power of appointment, a testamentary power of appointment (and whether to provide a special or general power of appointment), or both.

a. Testamentary Powers of Appointment

The following illustrates sample language for use in creating the referenced type of appointment power. Note the need to ensure the Rule Against Perpetuities savings clause provides the proper limitation on the duration of any trusts created as a result of an exercise of the originally provided appointment power or a subsequently granted appointment power (unless Delaware Tax Trap application is sought, as discussed below).

i. **<u>Example: Broad Special Power of Appointment</u>: Upon the death of the Beneficiary, he or she shall by a clause in his or her Last Will and Testament which refers specifically to this special testamentary power of appointment and in which he or she exercises this special power of appointment, have the power, exercisable by such Beneficiary alone and in all events, to appoint part or all of the assets then held in the Beneficiary's Trust, including undistributed net income therefrom, outright or in trust to any persons or entities (<u>other than</u> such Beneficiary, such Beneficiary's estate, such Beneficiary's creditors or the creditors of such Beneficiary's estate) in such shares, proportions, and amounts as he or she may determine, and upon such trusts and for such estates as he or she may determine; provided, however, that this special power of appointment shall not be exercised or exercisable in any manner that may cause any of the Trust estate to be included in the Beneficiary's estate for federal estate tax purposes. To the extent such Beneficiary fails to exercise the special testamentary power of appointment described above, the assets held in his or her Trust upon his or her death shall pass in the manner set forth in Section ____ (referencing the provisions made for the takers in default).**

ii. **<u>Example: Special Power of Appointment Limited to the Creator's Issue</u>: Upon the death of the Beneficiary, he or she shall by a clause in his or her Last Will and Testament which refers specifically to this special testamentary power of appointment and in which he or she exercises this special power of appointment, have the power, exercisable by such Beneficiary alone and in all events, to appoint part or all of the assets then held in the Beneficiary's Trust, including undistributed net income therefrom, outright or in trust to any one or more of my issue (<u>other than</u> such Beneficiary) in such shares, proportions, and amounts as he or she may determine, and upon such trusts and for such estates as he or she may**

determine; provided, however, that this special power of appointment shall not be exercised or exercisable in any manner that may cause any of the Trust estate to be included in the Beneficiary's estate for federal estate tax purposes. To the extent such Beneficiary fails to exercise the special testamentary power of appointment described above, the assets held in his or her Trust upon his or her death shall pass in the manner set forth in Section _____ (referencing the provisions made for the takers in default).

iii. <u>Example: General Power of Appointment Exercisable With Respect to a Trust With a GST Inclusion Ratio of One</u>: Notwithstanding what is otherwise stated in Subsection _____ above [referencing the provisions made for the takers in default] and Subsection ______ [referencing a testamentary special power of appointment, if otherwise granted], if (i) part or all of the assets held in the Beneficiary's Trust upon his or her death would otherwise pass to a "skip person" (as defined in Code Section 2613(a)) and (ii) the generation-skipping transfer tax is in effect at the Beneficiary's date of death, then such Beneficiary, by a clause in his or her Last Will and Testament which refers specifically to this power of appointment and in which he or she exercises this power of appointment, shall have the power, exercisable by him or her alone and in all events, to appoint part or all of such assets otherwise passing to one or more skip persons, including undistributed net income therefrom, in fee simple and free of Trust to his or her estate or to any other persons or entities, in such shares, proportions, and amounts as he or she may determine, and upon such trusts and for such estates as he or she may determine. In default of the exercise of the foregoing general power of appointment by a Beneficiary, such assets otherwise passing to one or more skip persons shall pass as otherwise provided in Subsection _____ above [referencing the provisions made for the takers in default], subject to a contrary disposition pursuant to Subsection ______ [referencing a testamentary special power of appointment, if otherwise granted]. Any administrative expenses and taxes attributable to the general power of appointment granted to the Beneficiary pursuant to this Section (if any) shall be apportioned pro rata to and so paid by the recipients of the assets of this Trust subject to such general power of appointment upon

the Beneficiary's death, and the Trustee may, if the Trustee deems it necessary to protect the interests of the estate of the Beneficiary, withhold from any distribution otherwise provided hereunder to any such recipient of such assets of this Trust assets equal to such recipient's proportionate share of the aforementioned administrative expenses and taxes. [Note the permitted object of the general power of appointment can be limited to **creditors of the Beneficiary's estate** if the objective is to minimize the overall transfer taxes due at the Beneficiary's death by causing them to be included in his/her estate, but the creator is reluctant to provide the donee with any greater discretion over the disposition of the Trust assets.]

b. <u>Inter Vivos Special Power of Appointment</u>

<u>**Example:**</u> **After the Beneficiary has attained the age of [insert appropriate age], he or she shall have the power, exercisable by such Beneficiary alone and in all events, to appoint part or all of the assets then held in the Beneficiary's Trust, including undistributed net income therefrom, outright or in trust to any one or more of the Beneficiary's issue, in such shares, proportions, and amounts as he or she may determine, and upon such trusts and for such estates as he or she may determine; provided, however, that this special power of appointment shall not be exercised or exercisable in any manner that may cause any of the Trust estate to be included in the Beneficiary's estate for federal estate tax purposes. Any exercise of this special power of appointment shall be set forth in a written instrument specifically referencing this Section of this instrument, signed by the Beneficiary and delivered to Trustee, with the exercise of such special power of appointment to take effect upon the later to occur of (i) the effective date of such exercise set forth in such written instrument or (ii) the date upon which such written instrument is delivered to the Trustee.** [If a reciprocal trust challenge by the IRS is of concern (as discussed below) and the objects included the <u>creator's</u> issue, consider prohibiting the donee from exercising the appointment power in favor of a related beneficiary of a similar Trust holding a similar appointment power.]

c. <u>Coordination with Rule Against Perpetuities ("RAP") Savings Clause</u>

Generally, a RAP savings clause should restrict the donee of a power of appointment granted under the instrument from exercising it to create a Trust with a term extending beyond the prescribed savings clause period (or from giving any subsequent donee of a resulting power of appointment a similar ability). Not only could such an exercise result in a trust that violates the RAP, it could also run afoul of the "Delaware Tax Trap" and cause unintended estate tax inclusion in the power-holder's estate. However, while the "Delaware Tax Trap" may be a trap for the unwary, it can also be used by sophisticated planners as a technique in which the creator deliberately gives his/her child a power of appointment that can be exercised to provide a subsequent donee with a power of appointment exercisable without regard to the RAP limitations period. If the child-donee exercises the appointment power to create such a subsequent power of appointment, he/she will be deemed to have made a taxable gift or a taxable estate transfer. If he/she elects not to exercise the power, the Trust assets will be subject to the GST provisions instead. Although this approach offers another avenue to convert from a higher GST tax to a potentially lower estate or gift tax, the technique is hyper-technical and can be difficult for clients (and even planners) to operate properly. Accordingly, this presenter prefers the approach described in Example iii above.

2. <u>Exercise of Powers of Appointment</u>

a. <u>Exercise of Testamentary Power of Appointment in the Donee's Last Will and Testament</u>

<u>Example</u>: I hereby expressly exercise the power of appointment provided to me in Article ___, Paragraph ___ of the Last Will and Testament of Jane B. Smith, dated August 22, 1998, by directing that all of the assets of the Jennifer B. Smith Trust created thereunder for my benefit on hand as of my date of death be allocated, per stirpes, among those of my issue who survive me by at least ninety (90) days, with each share so allocated to be held, administered, and disposed of in a separate trust named for the issue of mine to whom such share is allocated, in accordance with the terms and provisions of Article ___ below; provided, however, that notwithstanding any other provision of this instrument to the contrary, no trust created pursuant to the preceding or pursuant to the exercise of a power of appointment granted with respect thereto shall endure longer than [reference original RAP savings clause period defined in the Last Will and Testament of Jane B. Smith]. Should any trust endure so long, it shall immediately terminate at the end of that period, and the corpus of the trust then on hand shall be paid over and delivered, free of trust, to the then income beneficiary of such Trust.

b. <u>Exercise of an Inter Vivos Power of Appointment</u>

<u>Example:</u> I hereby expressly exercise the power of appointment provided to me in Article ____, Paragraph ____ of the Last Will and Testament of Jane B. Smith,

dated August 22, 1998, by directing that Ten Thousand Dollars ($10,000), in cash, be distributed from the Jennifer B. Smith Trust created thereunder for my benefit to my son, Steve Smith, upon the delivery of this instrument to the Trustee of such Trust. [signed and dated by the donee]

<u>Caveat</u>: Consider the IRS' previously asserted position that (i) a similar inter vivos power exercisable by a related donee with respect to his/her own similar trust may create a "reciprocal trust doctrine" application (see Private Letter Ruling 9235025) and (ii) an exercise of an inter vivos special power of appointment by the donee may effect a gift (see Private Letter Rulings 8535020 and 9451049). While the respective arguments have been widely criticized, the planner wishing to adopt a conservative approach may wish to address concern (i) by providing in the governing instrument that a donee is prohibited from exercising the appointment power during his/her lifetime in favor of a donee of a similar Trust with a similar appointment power. To the presenter's knowledge, concern (ii) cannot be addressed to the IRS' satisfaction in the governing instrument if the donee is entitled to distributions under a traditional health, education, maintenance, and support ("HEMS") Standard or is entitled to mandatory distributions of income. However, the concern should be inapplicable if a purely discretionary distribution standard is utilized and, consequently, applied by an independent trustee or trust protector. If a HEMS Standard is applicable and an exercise of an inter vivos special power of appointment is contemplated, the cautious planner should address with the client the potential for the IRS to treat the exercise as effecting a gift (presumably valued in accordance with the suspect methodology described in Rev. Rul. 75-550, 1975-2 C. B. 357). Again, neither of the IRS' concerns should be applicable with respect to a testamentary exercise of an appointment power in the donee's Will.

IV. DISCLAIMERS

Disclaimers present the opportunity for flexibility in post-death estate planning as well.

A. The Basics

If done properly, a beneficiary may disclaim any interest (including a power of appointment) otherwise passing to him/her at death by bequest and, consequently, be treated as having predeceased the transferor. (Gifts made during a donor's lifetime may also be disclaimed, but that situation is not addressed for purposes of this presentation.) As a result, the disclaimant will not be treated as having made a taxable gift to the resulting recipient of the disclaimed asset, the identity of which is dictated by the provisions of the governing instrument applicable in the event of a disclaimer (if specified) or otherwise in the event of the disclaimant's death. Careful drafting should anticipate the desired disposition of a potentially disclaimed asset and provide accordingly for such disposition, since a disclaimant cannot direct the disposition of the disclaimed asset pursuant to a "qualified disclaimer."

Note that a disclaimant is not treated as having predeceased the transferor for purposes of the "predeceased ancestor rule" under IRC 2651(e). Consequently, if the disclaimed asset passes by default under the terms of the governing instrument (or under the intestacy statutes) to an individual considered a "skip person" with respect to the transferor, a direct skip will be deemed to have occurred requiring either an equivalent allocation of the transferor's GST exemption amount or payment of GST, as the case may be.

B. The Requirements for a "Qualified Disclaimer"

The requirements for a qualified disclaimer under IRC 2518 include the following:

- a written instrument that (i) sets out the disclaimant's irrevocable and unconditional refusal of acceptance of the subject property, (ii) sufficiently identifies the interest to be disclaimed, and (iii) is signed by the disclaimant or his/her legal representative (e.g., an agent under a durable power of attorney vesting the agent with disclaiming authority, or an executor of a deceased beneficiary's estate if authorized under the governing instrument or governing law to make such a disclaimer on behalf of the deceased beneficiary);

- delivery of the above described written instrument to the transferor of the interest, the transferor's legal representative, or the holder of legal title to/person in possession of the disclaimed property, as the case may be, within 9 months of (i) the date on which the transfer creating the interest in such disclaimant is made or (ii) the disclaimant's 21^{st} birthday, whichever is later (a disclaimer post marked within the 9-month period is treated as delivered in a timely manner if the requirements set forth in Treasury Regulation 25.2518-2 are otherwise met);

- the disclaimer must be silent on the disposition of the disclaimed asset, although a disclaimant can serve as trustee of a trust acquiring the disclaimed asset and thereafter distribute the disclaimed assets to the beneficiaries of the recipient trust, provided the disclaimant's ability to direct distributions of the disclaimed property is limited to an ascertainable distribution standard;

- the disclaimant cannot have accepted any benefit from the disclaimed asset prior to disclaiming it;

- the disclaimant cannot accept any benefit from the disclaimed asset at any point after the disclaimer, <u>unless he/she is the Surviving Spouse</u> and is a beneficiary of a trust receiving the disclaimed asset by virtue of the default provisions of the governing instrument (but again, he/she cannot have any ability to control distributions of the property beyond an ascertainable standard <u>and cannot hold a power of appointment</u> over the disclaimed assets held by the trust)[In other words, if the disclaimant is not a Surviving Spouse, the disclaimed asset cannot pass to a trust for the benefit of the disclaimant. If the disclaimant is a Surviving Spouse, the disclaimed assets may pass to a trust for the Surviving Spouse's benefit, but the Surviving Spouse cannot hold any power of appointment over the trust assets.];

- the disclaimer cannot be made in exchange for any consideration;

- if a formula disclaimer is made, the amount disclaimed and any income attributable to that amount earned prior to and after the disclaimer must be separated from the portion of the bequest that is not disclaimed and income attributable to those assets; and

- the options for setting aside the disclaimed assets defined by a pecuniary formula must comport with procedures similar for funding a marital gift (i.e. a Date of Distribution Funding or a Fairly Representative Funding).

State law requirements for a disclaimer may vary and should be investigated to ensure compliance. Due to differences in such requirements, the presenter has opted to include only examples of instruments effecting disclaimers that meet the Texas law requirements. See Exhibits B and C for details.

C. <u>Introducing Tax Planning Into a Simple Estate Plan at the Deceased Spouse's Death Through the Surviving Spouse's Disclaimer</u>

1. <u>Creation of a Disclaimer Trust to Receive any Assets Disclaimed By the Surviving Spouse</u>

In the current environment of increasing estate tax exemption amounts, married clients who (i) have a combined estate less than or nominally in excess of the current estate tax exemption amount, or (ii) have the confidence that they will both live long enough to benefit from anticipated increases in the estate tax exemption amount and achieve such a status, may opt for a simplified estate plan providing for all of the Deceased Spouse's estate to pass outright to the Surviving Spouse. The wise planner will attempt to (i) explain the asset protection benefits of the trust form and (ii) point out the possibility of the "sun setting" of the higher estate tax exemption amounts and a return to a $1,000,000 exemption in an effort to encourage clients to incorporate at least a Bypass Trust funded with the Deceased Spouse's estate tax exemption amount.

Despite our best efforts, some clients will persist in their determination to opt for the simplified plan. However, the wise planner will nevertheless incorporate the means for the Surviving Spouse to revisit this decision at the Deceased Spouse's death and, if considered appropriate at that time, to introduce tax planning through a formula disclaimer of assets equal in value up to the Deceased Spouse's estate tax exemption amount in favor of a Disclaimer Trust. (If appropriate, the Surviving Spouse could also disclaim assets equal in value up to the Deceased Spouse's GST exemption amount or, if greater, assets with a collective value projected to equalize the spouses' estates and thereby minimize the overall estate taxes.) The Disclaimer Trust can provide the Surviving Spouse and issue (if appropriate) with distributions under a HEMS Standard and permit the Surviving Spouse to serve as trustee. However, the Surviving Spouse <u>cannot</u> be given a power of appointment over the Disclaimer Trust assets.

2. <u>Determining Whether (and to What Extent) the Surviving Spouse Should Disclaim Part or All of the Assets Otherwise Passing Directly to Him/Her From the Deceased Spouse</u>

Of course, many factors must be considered in deciding whether the Surviving Spouse should disclaim part or all of the assets otherwise passing to him/her from the Deceased Spouse, including:

- a financial review of the spouses' combined estate as of the Deceased Spouse's death and financial projections developed in order to determine the likelihood of their combined estate exceeding the estate tax exemption amount likely to be in effect at the Surviving Spouse's death (obviously, if there is likely to be estate tax owing at the Surviving Spouse's death, he/she should strongly consider a disclaimer of assets in an amount to reduce the Surviving Spouse's projected estate to a level below the anticipated estate tax exemption amount, but the disclaimed amount should not exceed the Deceased Spouse's estate tax exemption amount);

- the administrative time and expense associated with holding assets in trust form and the Surviving Spouse's willingness to accept those consequences, keeping in mind he/she can always decline to serve as Trustee and thereby avoid being directly responsible for administering the Trust;

- income is generally taxed at higher rates if <u>retained</u> in a trust due to the compressed rate structure applicable with respect to trusts, although distributions to the Surviving Spouse and/or issue may alleviate this concern;

- the disclaimed assets will belong to the Disclaimer Trust and cannot be managed and spent by the Surviving Spouse as "freely" as they could be if owned directly by him/her. The former concern can be alleviated to a large extent through provisions in the governing instrument providing the Trustee with broad investment and management discretion and including an exculpatory clause as generous as that allowed under the applicable state law. The latter concern can be addressed in part by the appointment of an independent party as the trust protector (a concept discussed below) of the Disclaimer Trust and the provision to him/her of the discretion to distribute assets to the Surviving Spouse for reasons unrelated to his/her health, education, maintenance, and support, cautioning the Surviving Spouse to consider that the trust protector can always decline to make such a distribution;

- the Surviving Spouse cannot dictate how any assets remaining in the Disclaimer Trust at his/her death are to pass and must accept the default provisions contained in the governing instrument;

- the benefits/costs of disclaiming assets equal in value up to the Deceased Spouse's GST exemption amount or, if greater, assets with a collective value projected to equalize the spouses' estates (and thereby obtain the benefit of each spouse's "run up through the brackets");

- if the Surviving Spouse survives long enough to be entitled to a bequest provided by the Deceased Spouse but ultimately dies within the 9-month disclaimer period, then the tax consequences for the spouses' combined estate become the only relevant factors and, accordingly, a disclaimer by the Surviving Spouse's executor in favor of the Disclaimer Trust should be considered if such would accomplish one or more of the following: (i) use of each spouse's estate tax exemption amount and possible equalization of the estates and obtaining the benefit of each spouse's "run up through the brackets," (ii) enable either or both estates to qualify for relief under certain IRC Sections whose application is conditioned upon the nature of the assets comprising the applicable spouse's estate (e.g., IRC 6166 long term payout of estate taxes and/or IRC 2032A special use valuation), and/or (iii) generation of some estate tax for the Deceased Spouse's estate so alternate valuation under IRC 2032 and/or the PTP (previously taxed property) credit under IRC 2013 (also referred to sometimes as the "TPT Credit") may be available for the Surviving Spouse's estate and thereby result in the overall estate taxes assessed on the spouses' combined estate being minimized. (For purposes of calculating the PTP credit for the Surviving Spouse's estate, see Rev. Rul. 75-550, 1975-2 C. B. 357 for an illustration of the methodology used by the IRS in valuing a Surviving Spouse's entitlement to distributions from a trust created by the Deceased Spouse under what it considered to be an ascertainable standard.)

3. <u>Sample Contingent Provisions Included in the Governing Instrument in Anticipation of a Disclaimer by the Surviving Spouse</u>

A. Should my spouse survive me and my spouse or the executor or administrator of my spouse's estate disclaim all or any portion of my interest in (i) property passing outright from me to my spouse at my death pursuant to a beneficiary designation providing for such result (e.g., with respect to a policy insuring my life or benefits payable with respect to a pension, profit sharing, and/or stock bonus plan that is "qualified" under Code Section 401(a), or benefits payable with respect to an individual retirement account created under Code Section 408) and should the terms of the beneficiary designation therefor direct that such disclaimed property consequently become an asset of the "Disclaimer Trust" created hereunder or (ii) property passing from me to my spouse outright and free of trust pursuant to Article ___ hereunder, then the Trustee shall allocate all of the property subject to such a disclaimer to the Trustee of a separate Trust created hereunder and named the Disclaimer Trust, which shall be administered in accordance with the terms and provisions of Subsection B below. Should my spouse survive me and my spouse or the executor or administrator of my spouse's estate disclaim all or any portion of my spouse's interest in the Disclaimer Trust, then the Trustee shall distribute all property subject to such a disclaimer from the Disclaimer Trust in accordance with the terms and provisions below governing the distribution of my estate at my death in the event my spouse fails to survive me, determined as though my spouse had not survived me, and my spouse's death had occurred immediately prior to my death. My spouse shall remain eligible to serve as a fiduciary with respect to any property my spouse disclaims pursuant to the foregoing, but, notwithstanding any other provision of this Will to the contrary, in no event shall my spouse have the ability as fiduciary to direct the beneficial enjoyment of the disclaimed property in a manner other than for the health, education, maintenance, and support of the permitted beneficiaries, nor shall my spouse possess any power of appointment or other kind of power or powers which would invalidate a disclaimer under Section 2518 of the Code or which would cause such disclaimed property to be includible as part of my spouse's estate for federal estate tax purposes.

B. <u>Disclaimer Trust Terms and Provisions</u>. The trustee shall hold, administer and dispose of any property passing to the Disclaimer Trust in a separate Trust in accordance with the following terms and provisions:

1. <u>Distributions During Lifetime of My Spouse</u>. The primary purpose of this Trust is to provide for the health, education, maintenance, and support of my spouse during my spouse's lifetime.

The Trustee shall distribute, at such intervals as the Trustee may determine, to my spouse during my spouse's lifetime, such amounts of the net income of the Trust as are necessary for the health, education, maintenance, and support of my spouse. Any net income not so distributed shall be added to principal. In addition, the Trustee may at any time and from time to time pay to, or apply for the benefit of, my spouse such amounts of principal of the Trust as are necessary for the health, education, maintenance, and support of my spouse. In making any distribution as provided above, the Trustee shall consider all other resources available to my spouse. [Note the governing instrument could also allow for the distributions of income and/or principal to issue, if appropriate.]

2. <u>**Distribution of Trust Assets Upon Death of My Spouse**</u>**. Upon the death of my spouse, the assets of the Disclaimer Trust then on hand shall be distributed as follows: [reference appropriate dispositive provisions, noting the Surviving Spouse cannot be given any appointment power].**

D. <u>Benefits of a Disclaimer by the Surviving Spouse in Conjunction With an Existing "Zero Estate Tax Plan"</u>

1. <u>The Basics</u>

Even if the Deceased Spouse has provided for a "Zero Estate Tax Plan," it may still make sense for the Surviving Spouse to consider disclaiming part (or all, as appropriate) of the assets otherwise passing outright to him/her and/or to the QTIP Trust in favor of a Disclaimer Trust to (i) achieve a tax-efficient usage of the Deceased Spouse's GST exemption amount, (ii) equalize the spouses' estates and thereby minimize the overall estate taxes assessed by taking advantage of each spouse's "bracket run up" and possibly avoid the surcharge under IRC 2001(c)(3), if such should become applicable again (returns after the sun setting of the 2001 Tax Act provisions), (iii) generate some estate tax for the Deceased Spouse's estate so alternative valuation may be elected and thereby minimize the overall estate taxes assessed on the spouses' combined estates, and/or (iv) generate some estate tax for the Deceased Spouse's estate so the PTP credit under IRC 2013 (based upon the value of the Surviving Spouse's entitlement to distributions under the HEMS Standard) may be available for the Surviving Spouse's estate (if he/she should die within 10 years).

Many of these same objectives could be achieved by foregoing the QTIP election entirely, making a reverse QTIP election, or making only a partial QTIP election at the Deceased Spouse's death, as appropriate for the desired objective. However, the Disclaimer Trust is often considered preferable to the QTIP-eligible Trust for which no QTIP election is made because the Disclaimer Trust need not provide for the <u>mandatory</u> distribution of income (a requirement for the QTIP-eligible Trust) that is otherwise GST exempt (if applicable) or at least eligible to pass free of estate tax and GST at the Surviving Spouse's death to trusts for the children.

2. The Mechanics

The language set forth in Subsections A and B of Section 3 above should continue to be used with the insertion of the following text following option (ii) in Subsection A: **"or (iii) property passing to the Marital Trust pursuant to Section ___."**

It should also be clarified in the governing instrument that the calculation of the amount to be used to fund the Bypass Trust should be computed without consideration of any disclaimer by the Surviving Spouse of other bequests (e.g., assets passing to the QTIP Trust) otherwise made for him/her by the Deceased Spouse pursuant to other provisions of the instrument. See the relevant language in the definition of the "Exemption Pecuniary Bequest Amount " contained in Exhibit A.

The apportionment of any estate tax generated by a Surviving Spouse's disclaimer of assets otherwise passing either outright to the Surviving Spouse or to a QTIP Trust should be addressed in the governing instrument. Typically, the resulting estate tax should be borne by the assets passing to the Disclaimer Trust (with the amount disclaimed allowing for such result), if the full benefit of the bequest to the Bypass Trust is to be maintained.

E. Disclaimers by Issue

1. Reasons for Disclaiming

There are many reasons why a child (or other issue) might wish to disclaim part or all of any assets bequeathed to him/her at a parent's death, including:

- to pass unneeded wealth directly from the deceased parent to trusts for the disclaiming child's own children without tax consequence to the child. Again, the wealthy child's disclaimer of part or all of his/her share of the estate will be considered to have effected a "direct skip" by the deceased parent to the grandchildren's trusts since the predeceased ancestor exception set forth in IRC 2651(e) only applies if the child actually predeceases the parent (or fails to survive the prescribed survival period conditioning entitlement to the bequeathed amount), but does not apply in a "deemed" death effected through a disclaimer. Consequently, the governing instrument should, in fairness, provide that any GST incurred as a result of a direct skip caused by a disclaimer be borne by the property passing pursuant to the direct skip;

- to ensure a special needs child who is receiving federal financial assistance will not be disqualified from receiving future assistance; or

- if an outright bequest would otherwise be made to a child with creditor issues, to allow the bequeathed amount to pass to the child's own children so as to maintain the family group's share of the estate, keeping in mind that the disclaiming child cannot have an "understanding" with his/her children that the disclaimed property will ultimately be available for his/her benefit, since such an agreement would be inconsistent with a legally binding disclaimer. Before such a disclaimer, state law should be researched to determine if such a disclaimer would constitute a fraudulent transfer. As a caveat, disclaimed property can be reached by the federal government in order to satisfy the disclaimant's federal tax liens.

2. The Mechanics

Inclusion of the following language should facilitate the fulfillment of the desired objective(s) described above:

Example: If an issue of mine disclaims all or any portion of an interest in property otherwise passing to or for the benefit of such person under this Will, the interest that is the subject of such a disclaimer shall pass as if the person disclaiming had predeceased me, and a future interest that would otherwise take effect in possession or enjoyment after the termination of the estate or interest that is disclaimed shall take effect as if the disclaiming beneficiary had predeceased me. A person who disclaims property otherwise passing to or for the benefit of such person under this Will shall remain eligible to serve as a fiduciary with respect to such property, but, notwithstanding any other provision of this Will to the contrary, in no event shall the disclaimant have the ability as fiduciary to direct the beneficial enjoyment of the disclaimed property in a manner other than for the health, education, maintenance, and support of the permitted beneficiaries, nor shall the disclaimant possess any power of appointment or other power or powers which would invalidate a disclaimer under Section 2518 of the Code or which would cause such disclaimed property to be includible as part of his or her estate for federal estate tax purposes.

Note that the preceding allows for the disclaiming child to act as trustee of any trusts created for his/her own children to receive the assets he/she disclaims. If that is the desired result, the governing instrument should be drafted to clarify as such.

V. TRUST PROTECTORS

It may be prudent to empower an independent party (often referred to as a "trust protector" or "trust terminator," the former term being used subsequently in this outline to describe such an individual) to exercise certain discretions with respect to a trust that cannot be exercised by a beneficiary or the grantor (if a trust is inter vivos) without negative tax and/or asset protection consequences. For such purpose, the trust protector should be someone other than the (i) grantor, (ii) a beneficiary of the subject Trust, or (iii) an individual or entity related or subordinate (within the meaning of IRC Section 672(c)) to the grantor or any beneficiary of the Trust.

Depending upon the objectives to be served, the trust protector may be empowered to perform one or more of the following:

- to distribute income/principal to a beneficiary for reasons unrelated to the beneficiary's health, education, maintenance, or support at a time when a beneficiary or the grantor is serving as trustee (note certain language included in an "incentive trust" distribution standard may create an unascertainable standard, requiring administration of its terms by an independent party, such as a trust protector);

- to terminate a trust entirely without reference to an ascertainable standard, generally provided to ensure a trust can be terminated if the estate tax is repealed or the estate tax exemption amount is raised to a level sufficient to ensure the assets, if distributed free of trust, would not cause the beneficiary to have an estate tax exposure in his/her own right;

- to extend the term of a trust that would otherwise terminate during a beneficiary's lifetime and result in a distribution of any assets on hand to the beneficiary;

- to provide a beneficiary of a trust with a testamentary general power of appointment in order to subject the trust assets remaining at death to inclusion in the beneficiary's estate for estate tax purposes and thereby avoid the otherwise higher GST (assuming the beneficiary's death would otherwise be considered a taxable termination) and utilize the beneficiary's own tax attributes (estate tax exemption amount, "bracket run up," etc.) in order to minimize overall transfer taxes;

- to exercise the discretion to make modifications to the terms of a trust that affect the economic interests of the beneficiaries and as such would be considered either a general power of appointment if exercisable by a beneficiary or would otherwise be considered a prohibited retained interest if exercised by the grantor; and/or

- to exercise any other discretion over a trust that could not be exercised by the beneficiary/grantor without <u>adverse</u> tax consequences.

It is fairly well settled that trust protectors are considered to be fiduciaries and, consequently, persons who owe a fiduciary duty to the beneficiaries. However, there is little guidance in domestic statutes and case law defining what those duties are, although certain foreign jurisdictions commonly considered to be "tax havens" for offshore planning have legislatively defined the trust protector's role.

Certain questions are raised in this regard. To what extent does a trust protector have a duty to monitor the donee's and the Trust's financial circumstances in order to be in the position to assess whether certain discretions reserved to the trust protector should be exercised (e.g., whether distributions beyond support should be made, whether to give the beneficiary a general power of appointment in order to minimize transfer taxes at death, etc.)? Can, and should, the client absolve the trust protector of any such duty to monitor in the governing instrument? Presumably, the cautious and informed candidate for the trust protector role will want, at the very least, for the governing instrument to limit liability exposure to the greatest extent legally permitted and to provide an assurance of indemnification in the event of a challenge to the exercise (or failure to exercise) of his/her authority.

VI. GST EXEMPTION PLANNING

A. Need for Flexibility in Governing Instruments Creating Inter Vivos Trusts

Commonly, a transferor (upon the advice of his/her attorney) will have already decided whether to allocate GST exemption to gifts to an inter vivos trust when it is created. Consequently, the trust agreement will be drafted to accommodate the grantor's decision in that regard. For example, if the grantor's gifts to a trust are to be allocated GST exemption, the trust will typically be designed to last for the beneficiary's lifetime and (absent a contrary exercise of an appointment power by a beneficiary) will provide for assets to continue to pass to dynastic trusts for future generations for as long as allowed under state law.

However, unforeseen circumstances may necessitate a late allocation of GST exemption to a trust with regard to which the grantor initially elected to withhold an allocation of exemption (e.g., a trust which the grantor anticipates the child-beneficiary will exhaust during his/her lifetime). This might happen, for example, if a trust were created for a child who subsequently dies during the grantor's lifetime. In that event, the grantor might wish to make a retroactive allocation of GST exemption to the trust pursuant to Code Section 2632(d) so that the child's death will not result in a "taxable termination" for GST purposes resulting in GST being owed. Additionally, a transferor might have GST exemption remaining at his/her death, even after part of the exemption has been sufficiently allocated to cause all testamentary trusts created to have an inclusion ratio of zero. In that event, the executor of the transferor's estate may elect to allocate the remaining GST exemption to an inter vivos trust previously subject to GST, or such an allocation may be accomplished under the automatic allocation rules set forth in the Internal Revenue Code applicable at an individual's death.

The governing instrument should be drafted to accommodate such a change in a trust's GST status so that its administration will always be tailored to its GST status. Consequently, it would be wise to consider including the following provisions:

1. Severance Authority.

The trustee should be authorized to sever any partially GST exempt trust created as a result of a subsequent allocation of GST exemption into newly created GST exempt and nonexempt trusts. The trustee should be encouraged to make distributions to non-skip persons from the newly created nonexempt trust prior to making such distributions from the newly created exempt trust. Correspondingly, the trustee should be encouraged to make distributions to skip persons from the newly created exempt trust prior to making such distributions from the newly created nonexempt trust.

Example (Non-Marital Deduction Trusts): The Trustee may divide any Trust into two (2) or more separate Trusts if, in the Trustee's sole discretion, such division is advisable. Any such division may be made at any time and shall be evidenced by a written instrument filed with the Trust records. In dividing a Trust, the Trustee shall comply with all applicable provisions of Texas State Law (including, under current law, Texas Trust Code Section 112.057) so that the division is effective and valid for state law purposes. In dividing a Trust for Generation-Skipping Transfer Tax purposes, such Trust shall be divided (i) on a fractional basis so that each resulting Trust has either an Inclusion Ratio of one (1) or an Inclusion Ratio of zero (0) and (ii) in compliance with Code Section 2642 and the regulations promulgated thereunder. The written instrument evidencing the division shall specify how such Trust property is to be allocated among the separate Trusts. If a Trust is divided, the terms governing the newly-divided separate Trusts shall be identical to the terms of the original, undivided Trust, but the separate Trusts may be administered independently of one another, including the making of disproportionate distributions from the separate Trusts. I suggest but do not require that the following apply:

(1) Any discretionary distributions to be made to persons who are classified as non-skip persons for federal Generation-Skipping Transfer Tax purposes shall generally be made first from the non-exempt Trust, in order to avoid to the maximum extent possible any such distributions from the exempt Trust.

(2) Any discretionary distributions to be made to persons who are classified as skip persons for federal Generation-Skipping Transfer Tax purposes shall generally be made first from the exempt Trust, in order to avoid to the maximum extent possible any such distributions from the non-exempt Trust.

2. Trust Protector's Authority to Grant a Beneficiary a Testamentary General Power of Appointment to Minimize Transfer Taxes Assessed at the Beneficiary's Death.

A trust protector should be authorized to provide the primary beneficiary of a GST nonexempt inter vivos trust created as a result of a qualified severance with a testamentary general power of appointment if the trust assets would otherwise pass at the beneficiary's death to a "skip person" so that the inclusion of the trust assets in the beneficiary's estate at death will cause the assets to be subject to estate taxes and thereby avoid the assets being subject at that point to the typically higher GST.

Example (Non-Marital Deduction Trusts): With respect to any Trust created hereunder that has an inclusion ratio (as defined in IRC 2642) greater than zero (0), (such a Trust, a "Nonexempt Trust") the trust protector of such Trust shall have the authority, in his, her, or its, as the case may be, sole discretion, with

respect to all or any portion of the corpus of such Trust (including a pecuniary amount), to do one or more of the following:

(1) to convert the special power of appointment granted to the Beneficiary of such Trust pursuant to Subsection _____ into a testamentary general power of appointment, so that such Beneficiary shall have the right, by a clause in his or her Last Will and Testament which refers specifically to such converted testamentary general power of appointment and in which he or she exercises such converted testamentary general power of appointment, exercisable by him or her alone and in all events, to appoint all of such corpus (or any part thereof, as the Beneficiary shall elect) subject to such converted power of appointment, in fee simple and free of Trust to his or her estate or to any other persons or entities, in such shares, proportions, and amounts as he or she may determine, and upon such trusts and for such estates as he or she may determine. In default of the exercise of the foregoing general power of appointment by the Beneficiary, such corpus subject to such converted power of appointment shall pass as otherwise provided in Subsection ________ above [referencing the default dispositive provisions], subject to a contrary disposition pursuant to Subsection _________ [referencing a special power of appointment, if any, exercisable in any event]. Any administrative expenses and taxes attributable to the converted testamentary general power of appointment granted to the Beneficiary pursuant to this Section (if any) shall be apportioned pro rata to and so paid by the recipients of the corpus of this Trust subject to such general power of appointment upon the Beneficiary's death, and the Trustee may, if the Trustee deems it necessary to protect the interests of the estate of the Beneficiary, withhold from any distribution otherwise provided hereunder to any such recipients assets equal to such recipient's proportionate share of the aforementioned administrative expenses and taxes. [Note the permitted objects of the general power of appointment can be limited **to creditors of the Beneficiary's estate** if the objective is to minimize the overall transfer taxes due at the Beneficiary's death by causing them to be included in his/her estate but the grantor is reluctant to provide the donee with any greater discretion over the disposition of the Trust assets.];

(2) to revoke the conversion of a power that has been converted as provided in Subsection (1) above for all or any part of the property of the trust to which such conversion had previously applied;

(3) to convert such power as provided in Subsection (1) above, and irrevocably to release the right to revoke such conversion; and

(4) After conversion of a power of appointment as provided in Subsection (1) above with respect to a part of the trust property, to divide the trust property into two fractional shares based upon the portion of the trust as constituted prior to such division that would be includible in the gross estate of the Beneficiary pursuant to IRC Section 2041 if he or she died immediately before such division (in which case the power of appointment that has been

converted as provided in Subsection (1) above shall be exercisable over the entire share which holds the portion of the trust that would be includible in the Beneficiary's estate, and over no part of the other share), and to hold, administer and dispose of each such share in a separate trust; provided, however, that the trust protector of such Trusts shall have the right to recombine the two Trusts so created, in such trust protector's sole discretion.

In authorizing such conversion, it is my request, but not direction, that the trust protector convert the special power of appointment granted to the Beneficiary pursuant to Section _______ into a general power of appointment when the trust protector believes that inclusion of the property affected thereby in the gross estate of the Beneficiary may achieve a significant savings in transfer taxes by having an estate tax (rather than a generation-skipping transfer tax) imposed on property subject to such general power, or that such conversion may permit a greater use of the exemption from generation-skipping transfer tax set forth in IRC Section 2631 allowed to the Beneficiary or his or her spouse. Any purported exercise of a converted power of appointment shall not be valid unless the trust protector has converted such power prior to its exercise as described in Subsection (1) above.

The trust protector of a Nonexempt Trust shall exercise (if applicable) his or her power to (i) convert the special power of appointment granted to the Beneficiary pursuant to Section_______ into a testamentary general power of appointment pursuant to Subsection (1) above, (ii) revoke the conversion of such testamentary general power of appointment, or (iii) release the right to revoke the conversion of such testamentary general power of appointment only by written instrument, signed and acknowledged by the trust protector, delivered to the Beneficiary during his or her lifetime, and clearly expressing the trust protector's conversion, revocation of conversion or release of the right to revoke the conversion of such power, as the case may be, by referring explicitly to this Section __________. A copy of each such instrument of conversion, revocation or release shall be kept with the trust records.

B. <u>Need for Flexibility in Governing Instruments Creating Testamentary Trusts</u>

Some practitioners may choose to draft their governing instruments so that assets to which either spouse has allocated GST exemption are automatically directed to a set of trusts designed to hold only GST exempt assets, with the remaining assets subject to GST being automatically directed to a separate set of nonexempt trusts that either (i) provide the beneficiary with a testamentary general power of appointment exercisable only if (and to the extent that) a taxable termination would otherwise occur at the beneficiary's death or (ii) provide a trust protector with the discretion to give the beneficiary such a power, as appropriate. Since the circumstances will not be known until the Deceased Spouse's death, such an approach entails including provisions for four separate trusts, to wit: Exempt Bypass, Nonexempt Bypass, Exempt QTIP, and Nonexempt QTIP. The inclusion of these multiple trusts in a Will can frustrate a client trying to decipher the estate plan.

Other practitioners who may prefer a more economical drafting approach with fewer trusts may prefer to send all assets remaining after the estate administration has been completed (and any transfer taxes paid) to a single Bypass Trust and a single QTIP Trust, and then rely on the trustee's authority to allocate GST exemption as appropriate and thereafter <u>sever</u> a partially GST exempt trust created in the process into separate GST exempt and nonexempt trusts, as necessary. If this approach is adopted, provisions similar to those set forth in Sections VI.A.1 and VI.A.2 above should be included, along with the following specific provisions designed to allow for the division of a QTIP Trust into an Exempt QTIP (created through a reverse QTIP election under IRC Section 2652(a)(3)) and a Nonexempt QTIP:

> **<u>Example</u>: Notwithstanding any provision of this will to the contrary, if (i) a valid election is made to qualify all or a part of the Marital Trust for the marital deduction under IRC Section 2056(b)(7) and (ii) my personal representative makes a valid election to treat me as the "transferor" of part (but not all) of Marital Trust for generation-skipping transfer tax purposes pursuant to IRC Section 2652(a)(3), then my executor shall divide (on a fractional share basis) the property that would otherwise be used to fund the Marital Trust into separate Trusts, each of which shall be administered in accordance with the terms and provisions of Article ___. One of such Trusts so created shall be named the "Exempt Marital Trust" and shall be funded with the property to which I have allocated all or any part of the generation-skipping transfer tax exemption given to me pursuant to IRC Section 2631. The other of such Trust so created shall be named the "Nonexempt Marital Trust" and shall be funded with the property to which I have not allocated any such exemption. Notwithstanding the foregoing, if any tax, including interest and penalties thereon, is imposed on property includable in the gross estate of my spouse by reason of IRC Section 2044 or a similar provision of any state law, except as provided in the following sentence, the Trustee may recover the tax attributable to that property from the person or entity in possession of or receiving the property as provided in Code Section 2207A or a similar provision of state law. Unless failure to do so will result in a person other than me being treated for federal Generation-Skipping Transfer Tax purposes as the transferor with respect to some portion of the Exempt Marital Trust, the Trustee shall not seek contribution for any taxes imposed by reason of the death of my spouse as a result of the inclusion in my spouse's gross estate of the trust estate of the Exempt Marital Trust, it being my direction that any such taxes shall instead be charged, to the extent possible, to Nonexempt Marital Trust.** [A trust protector should be given the discretion to convert any special power of appointment given to the Beneficiary of a GST nonexempt Trust ultimately funded with assets from the Nonexempt Marital Trust (and not subsequently allocated any of the Surviving Spouse's GST exemption at his/her death) into a general power of appointment.]

EXHIBIT A

DEFINED TERMS

A "Bypass Trust" shall mean a Trust created pursuant to a Zero Estate Tax Plan that is designed to (i) be funded with a bequest from the Deceased Spouse of property equal in value up to his/her estate tax exemption amount (if any, with appropriate allowances for other taxable transfers at death and any expenses properly borne by the assets), (ii) exist for the benefit of the Surviving Spouse (and issue, if appropriate) during his/her lifetime, but (iii) ultimately be excluded from the Surviving Spouse's estate at death.

A "Date of Distribution Bequest" shall mean a pecuniary bequest satisfiable in cash or in kind, or partially in cash and partially in kind, subject to the requirement that any assets used to fund the bequest be valued at their respective values as of the date or dates of funding.

The "Deceased Spouse" shall mean the first spouse to die when discussing the estate plan of a married couple.

The "Exemption Pecuniary Bequest Amount" shall mean, except as provided in the sentence following this one, (A) the maximum amount which, when added to my adjusted taxable gifts, if any, would result in no federal estate tax payable by my estate, if such tax were computed by giving effect to (i) all relevant tax credits (including but not limited to the unified credit available to my estate pursuant to Section 2010 of the Internal Revenue Code, the credit for state death taxes provided by Section 2011 of the Internal Revenue Code (if applicable), and any credit or reduction in adjusted taxable gifts provided by chapter 14 of the Internal Revenue Code) and (ii) the deduction for state death taxes pursuant to Code Section 2058 (if applicable); provided, however, that consideration for such purpose shall be given to the credit or deduction for state death taxes, as the case may be, only to the extent that such consideration does not increase the amount of state succession taxes otherwise payable by reason of my death, reduced by (B) (i) the value of all items in my gross estate for federal estate tax purposes which pass or have passed to a beneficiary otherwise than under this Section and which do not qualify for the federal estate tax marital or charitable deduction, (ii) the amount of any death taxes (including any interest or penalties thereon) payable by reason of my death to any jurisdiction other than the federal government of the United States, expenses, or charges payable out of the principal of my estate for which no deduction is taken for federal estate tax purposes; provided, however, that no reduction shall be made for estate management expenses attributable to and actually paid from the marital share (as defined in Treas. Reg. § 20.2056(b)-4(d)). However, if at my death, I own a qualified family-owned business interest, as defined in Section 2057 of the Internal Revenue Code or any successor provision, and if an election has been made for the application of Section 2057 of the Internal Revenue Code (if applicable) and the agreement required by Section 2057(h) Internal Revenue Code has been filed, then the amount calculated under (A) above shall instead be the sum of the amount deducted from my gross estate under Section 2057 plus the maximum amount which, when added to my adjusted taxable gifts, if any, would result in no federal estate tax payable by my estate, if such tax were computed in the aforementioned manner. In determining the amount of the Exemption Pecuniary Bequest Amount, values as finally determined for federal estate tax purposes shall be used. The Exemption Pecuniary Bequest Amount may be satisfied in cash or in kind, or partially in cash and partially in kind. This bequest shall carry with it, as income and not as principal, its proportionate part of all net income attributable to assets of my estate from the date of my death until the date or dates of distribution of the property to the Trustee of the Bypass Trust in satisfaction of this bequest. No compensating adjustments between net income or principal or in the amount of any distribution under this Will shall be made as a result of any decisions made by my executor in funding this bequest. **[include corresponding text accommodating desired funding approach]** If my spouse disclaims any property passing to my spouse in any manner by reason of my death, the Exemption Pecuniary Bequest Amount shall be computed as if such disclaimer had not been made. Further, for purposes of computing the Exemption Pecuniary Bequest Amount, any properties passing to any trust for which a qualified terminable interest property election could be made by my executor shall be treated as if such election had been made (even if no such election has actually been made or only a partial election has been made).

A "Fairly Representative Bequest" shall mean a pecuniary bequest satisfiable in cash or in kind, or partially in cash and partially in kind, subject to the requirement that any assets used to fund the bequest be valued based upon their adjusted estate tax values, provided the assets selected reflect an overall appreciation/depreciation in value fairly representative of the total appreciation/depreciation in the value of all property available for use in satisfying the bequest subsequent to the decedent's date of death through the date or dates of funding.

A "HEMS Standard" shall mean a distribution standard providing the beneficiary with distributions of income and principal for his/her health, education, maintenance, and support.

The "Marital Deduction Pecuniary Bequest Amount" shall mean an amount of property equal in value to the smallest pecuniary amount which, if allowed as a federal estate tax marital deduction in my estate, would eliminate (or reduce to the smallest amount possible) any federal estate tax payable by reason of my death, after considering (i) all deductions taken by my estate (other than a marital deduction for the bequest made by this Section), including but not limited to the deduction for state death taxes pursuant to Code Section 2058 (if applicable), (ii) the credit for state death taxes pursuant to Code Section 2011 (if applicable), (iii) the applicable credit amount available to my estate pursuant to Code Section 2010, and (iv) all other factors pertinent to the computation of the federal estate tax in my estate; provided, however, that consideration for such purpose shall be given to the credit or deduction for state death taxes, as the case may be, only to the extent that such consideration does not increase the amount of state succession taxes otherwise payable by reason of my death. In computing the amount of this marital deduction gift, values as finally determined for federal estate tax purposes shall be used. If no federal estate tax would be payable by my estate even if no bequest were made by this Section, this marital deduction gift shall not be made. This marital deduction gift shall be satisfied only with property (in cash or in kind, or partly in cash and partly in kind) of a character which qualifies for the marital deduction. This bequest shall carry with it, as income and not as principal, its proportionate part of all net income attributable to assets of my estate from the date of my death until the date or dates of distribution of the property to the Trustee of the Marital Trust in satisfaction of this bequest. No compensating adjustments between net income or principal or in the amount of any distribution under this Will shall be made as a result of any decisions made by my executor in funding this marital deduction gift. **[include corresponding text accommodating desired funding approach]**

A "Marital Deduction Trust," or alternatively, a "QTIP Trust," shall mean a Trust created pursuant to a Zero Estate Tax Plan designed to qualify for the estate tax marital deduction under IRC 2056 and, consequently, be funded with a bequest from the Deceased Spouse of property calculated to eliminate or minimize any estate taxes otherwise owing on the Deceased Spouse's estate so that estate taxation of those assets can be deferred until they are included in the Surviving Spouse's estate for estate tax purposes at his/her death.

The "<u>Surviving Spouse</u>" shall mean the survivor of the two spouses in the estate plan of a married couple.

A "<u>Zero Estate Tax Plan</u>" shall mean an estate plan in which the first spouse to die provides (whether it be pursuant to a pecuniary bequest or a residuary bequest) for assets equal to his/her remaining estate tax exemption amount (if any, with appropriate allowances for other taxable transfers at death and any expenses properly borne by the assets) to pass to a Bypass Trust for the Surviving Spouse (and issue, if appropriate) and a bequest of the remaining assets to a QTIP Trust so that any estate tax otherwise due on the assets passing to the QTIP Trust will be deferred until the Surviving Spouse's death.

EXHIBIT B

FORM DISCLAIMER FOR USE IN DISCLAIMING PROPERTY BEQUEATHED TO THE SURVIVING SPOUSE UNDER A WILL

NO. __________

IN RE: ESTATE OF	§	IN PROBATE COURT
	§	
[DECEDENT],	§	NUMBER ____OF
	§	
DECEASED	§	_____________ COUNTY, TEXAS

DISCLAIMER

STATE OF TEXAS	§	
	§	KNOW ALL MEN BY THESE PRESENTS
COUNTY OF _______	§	

I, [AFFIANT], in accordance with the provisions of Section 37A of the Texas Probate Code, hereby make the following disclaimer:

•

I am the surviving spouse of [DECEDENT], who died on ______________, 200__.

•

I hereby disclaim any and all interest in any property which I may be entitled to receive by inheritance, under Last Will and Testament (and all Codicils thereto) of [DECEDENT], or otherwise from the Estate of [DECEDENT] or by virtue of the death of [DECEDENT], except that I do not disclaim any interest in the ________________ and the ________________ (provide specific description of any property with respect to which the Surviving Spouse wishes to retain the interest bequeathed to him/her by the Deceased Spouse, including (if applicable) the Surviving Spouse's interest in the Disclaimer Trust created under the governing instrument to receive property disclaimed by him/her absent an additional disclaimer of his/her interest in such Trust). This Disclaimer is an unqualified refusal to accept the aforementioned disclaimed property and is irrevocable.

DATED this ______ day of ___________________, 2006.

____
[AFFIANT]

STATE OF TEXAS §
§
COUNTY OF _________ §

This instrument was acknowledged before me on _______________, 2006, by [AFFIANT].

{SEAL}

____
Notary Public in and for
The State of Texas

EXHIBIT C

FORM DISCLAIMER FOR USE IN DISCLAIMING PROPERTY BEQUEATHED UNDER A WILL TO A DISCLAIMANT WHO IS NOT THE SURVIVING SPOUSE

NO. ______________

IN RE: ESTATE OF	§	IN PROBATE COURT
	§	
[DECEDENT],	§	NUMBER ____ OF
	§	
DECEASED	§	_____________ COUNTY, TEXAS

DISCLAIMER

STATE OF TEXAS	§	
	§	KNOW ALL MEN BY THESE PRESENTS
COUNTY OF _____________	§	

I, [AFFIANT], in accordance with the provisions of Section 37A of the Texas Probate Code, hereby make the following disclaimer:

I hereby disclaim any and all interest in any property which I may be entitled to receive by inheritance, under Last Will and Testament (and all Codicils thereto) of [DECEDENT], or otherwise from the Estate of [DECEDENT] or by virtue of the death of [DECEDENT], except that I do not disclaim any interest in the _________________ (provide specific description of any property with respect to which the Disclaimant wishes to retain the interest bequeathed to him/her). This

Disclaimer is an unqualified refusal to accept the aforementioned disclaimed property and is irrevocable.

DATED this ______ day of _________________, 200__.

____
[AFFIANT]

STATE OF TEXAS §
§
COUNTY OF _______ §

This instrument was acknowledged before me on _____________, 200__, by [AFFIANT].

{SEAL}

____
Notary Public in and for
The State of Texas