

## WHAT TO DO ON THE SECOND DEATH WHEN NOTHING WAS DONE ON THE FIRST DEATH?

### I Introduction

#### a. The Problem

- i. Estate plans for married couples typically employ a revocable living trust to dispose of assets.
- ii. Typically in older plans, on the death of the first spouse, no estate tax is usually due because the revocable living trust is directed to be divided into a "Credit Trust" (holding the amount of the first-to-die's unified credit) and the "Marital Trust" (holding the balance of the first-to-die's assets in a trust that qualifies for the marital deduction.). IN community property states, where "joint" revocable trusts are created, the surviving spouse's assets are directed to be administered as the "Survivor's Trust" (a revocable trust intended to avoid probate on the survivor's assets when the survivor dies). This plan is typically referred to as an "A/B/C estate plan". (We will discuss planning strategies further that can avoid this issue later on).
- iii. The primary tax advantage of an A/B/C estate plan is to set aside the amount of the first-to-die's unified credit. A death in 2017 results in \$5,490,000 as part of the Credit Trust. Assuming a 40% estate tax rate, the establishment of the Credit Trust saves at minimum \$2,180,000 when the second spouse dies. If the Credit Trust appreciates between deaths, estate tax on that additional appreciation is avoided as well.
- iv. Though planners advise their clients to contact them when the first spouse dies, the survivor may be too unsophisticated, too incompetent, or too mournful to remember to do so. If the survivor has access to funds (either accounts outside the revocable trust or those in the revocable trust that the bank allows the survivor to access on his or her signature alone, or perhaps social security and pension funds deposited directly to the survivor's account), he or she may not have any reason to contact an attorney.
- v. As a result, no one does what they are supposed to do at the first spouse's death. When the second spouse dies, the children are left to figure it out. They come to the planner to ask: "What do we don on the second death when no one did what they were supposed to do on the first death?"

#### b. Topics to Be Discussed

- i. There are five issues that the estate planners must address when faced with the situation discussed:
  1. How is sub-trust funding that was supposed to be accomplished when the first spouse died completed at the surviving spouse's death?
  2. How are tax returns that were supposed to be filed at the first spouse's death filed when the second spouse dies?

3. What steps must be taken regarding the first-to-die spouse's retirement plan assets?
  4. What "clean up" must be done regarding the first-to-die's affairs?
  5. What concerns arise with specific gifts that didn't get made when they were supposed to at the first spouse's death?
- ii. In addition, we will discuss "preventative steps" that a planner might take to avoid having this problem.
- II How is Sub-Trust Funding that was Supposed to be Accomplished when the First Spouse Died Completed at the Surviving Spouse's Death?
- a. Formula Clauses
    - i. If the Credit Trust isn't funded as a result of the first spouse's death, and it was supposed to be funded, significant estate tax savings may be lost. Under current law, tax savings of at least \$2,000,000 can be lost. As a result, it is very important to fund the Credit Trust as it was supposed to be funded at the first spouse's death.
    - ii. Credit and Marital Trust funding is accomplished based on the formula clause in the document. The type of clause the governing will or trust document includes is essential as to whether or not only \$5,450,000 can be used to fund the Credit Trust, or as would be most likely preferred, whether a late-funded Credit Trust can include asset appreciation.
    - iii. Trust funding with formula clauses takes three steps:
      1. First, date of death values for decedent's assets must be determined (this could be the alternate value date if that is what was used on an estate tax return).
      2. Second, the formula is applied to determine the amount used to fund the Credit Trust and the Marital Trust.
        - a. If the formula is a "pecuniary credit" formula, the amount of the decedent's unified credit is determined and assets equal in value to that amount (based on date of death or alternate valuation date values, depending on what was used on the Form 706) are used to fund the Credit Trust. The rest of the decedent's assets are used to fund the Marital Trust.
          - i. Example: (with a \$10,000,000 estate) the amount of the unified credit is \$5,490,000, and the Credit trust is funded with the \$5.49 million. The balance of the decedent's assets pass to the Marital Trust.
        - b. If the formula is a "pecuniary marital" formula, the value of assets (based on date of death or alternate valuation date values, based on the Form 706) needed to fund the Marital Trust in order to reduce the decedent's estate tax to zero taking into account decedent's available unified credit is used to determine the value of assets that will

fund the Marital Trust. The rest of decedent's assets are used to fund the Credit Trust.

- i. Example: (with a \$10,000,000 estate) to reduce the decedent's estate tax to zero, \$4,510,000 is allocated to the Marital Trust. The balance of decedent's assets pass to the Credit Trust.
  - c. If the formula is a "fractional share" formula, the percentage of each of decedent's assets needed to fund the Credit Trust with the amount of the unified credit (based on date of death or alternate valuation on the 706) is determined. That percentage is subtracted from 100%, and the difference is the percentage of each of decedent's assets used to fund the Marital Trust. After the percentages are determined, each of decedent's assets are split between the Credit Trust and the Marital Trust based on those percentages.
    - i. Example: (with a \$10,000,000 estate) the unified credit, on a fractional basis, represents  $\$5,490,000/\$10,000,000$  of decedent's assets, or 54.9%. Therefore, 54.9% of each of decedent's assets will be used to fund the Credit Trust.  $100\% - 54.9\% = 45.1\%$ , so 45.1% of each of decedent's assets will be used to fund the Marital Trust.
- 3. Third, the funding is done using assets based on date of distribution values. This factor, based on which formula clause is to be used, determines whether appreciation that occurred after the first spouse died can be captured by the Credit Trust. The examples below will assume that the estate appreciated from \$10,000,000 to \$13,000,000 upon the death of the second spouse.
  - a. Pecuniary Credit Formula. \$5,490,000 is to be used to fund the Credit Trust, and the rest of decedent's assets are to be used to fund the Marital Trust. Funding is based on DATE OF DISTRIBUTION VALUES. Therefore, \$5,490,000 is allocated to the Credit Trust and \$7,510,000 is allocated to the Marital Trust. Due to this format, all of the appreciation from the death of the first spouse to the date of funding after the second spouse dies becomes part of the Marital Trust.
  - b. Pecuniary Marital Formula. \$4,510,000 is to be used to fund the Marital Trust, and the rest of decedent's assets are to be used to fund the Credit Trust. Funding is based on date of distribution values. Therefore, \$4,510,000 is allocated to the Marital Trust and \$8,490,000 is allocated

to the Credit Trust. All appreciation from the death of the first spouse to the date of funding after the second spouse dies becomes part of the Credit Trust.

- c. Fractional Share Formula. 54.9% of each asset is to be used to fund the Credit Trust and 45.1% of each asset is to be used to fund the Marital Trust.  $54.9\% \times \$13,000,000 = \$7,137,000$ . This is the amount allocated to the Credit Trust.  $45.1\% \times \$13,000,000 = \$5,863,000$ , and this is the amount allocated to the marital trust. In this circumstance, 54.9% of the appreciation from the death of the first spouse to the date of funding after the second spouse dies becomes part of the Credit Trust.

4. Practitioner's Note: if assets drop in value between the date of the first spouse's death and the date the trusts are properly funded after the second spouse dies, the pecuniary credit formula will result in the full amount of decedent's unified credit being used to fund the Credit Trust. If a pecuniary marital formula is used, the Credit Trust will be "shorted" that entire decline. If a fractional share formula is being used, the decline will be shared based on the percentage of each asset to be allocated to the Credit Trust and the Marital Trust.

b. Should the Sub-Trusts be "Physically Funded" on the Second Death?

- i. Short Answer: Yes. If for no other reason than to create discounts for estate tax purposes when the survivor's form 706 is filed. Also, for paper trail purposes, it is important.
  1. Example: if a rental property is divided into separate trusts due to one of the formulas listed above, this would create discounts that can be used on the estate tax.

III How are Tax Returns that Were Supposed to be Filed at the First Spouse's Death Filed When the Second Spouse Dies?

a. Discussion Points:

- i. When meeting with the children on the death of the survivor of their parents, the planner must inform the children that certain tax returns are due.
- ii. Returns may include:
  1. The first to die's form 706 (and related forms and schedules);
  2. First to die's state form if in a state that requires this;
  3. First to die's final income tax returns (both Federal and State); and
  4. Income tax returns (both Federal and State) for the "administrative trust".
- iii. In depth look at Form 706 of first-to-die
  1. 706 is due 9-months after death. This will be filed late.
  2. With most estate plans, there will be no estate tax needed to be paid, so there will be no late fees charged.

3. This will lock in values of assets.
  4. S Corporation Status: Though not an election or allocation on the Form 706 itself, protecting the S election for S stock owned by the first-to-die is an important issue for the planner to address. Only certain trusts are permitted to hold S corporation stock without causing the S Corporation to lose its S election:
    - a. A revocable living Trust is one such trust (IRC Section 1361(c)(2)(A)(i).
    - b. Qualified subchapter S trusts ("QSSTs") (IRC Section 1361(d)) and electing small business trusts ("ESBTs") (IRC Section 1361(c)(2)(A)(v)) may also hold S stock.
    - c. Grantor trust may continue to hold S Stock for two years after the grantor dies without causing the corporation to forfeit the S election (IRC Section 1361(c)(2)(A)(ii). As a result, if nothing was done at the death of the first-to-die and two years have passed, the corporation may have lost its S status. In that circumstance, consider applying for a letter ruling under IR 1362(d) and Treasury Regulations 301.9100 for permission to allow the corporation's S status to remain uninterrupted.
  5. Valuation of property at the first death is curial for purposes of determining basis for tax purposes.
  6. Form 8971 must be filed and Schedule A mailed to beneficiaries 30 days after the filing of a Form 706. So this will need to be done.
  7. Portability cannot be filed on a late return.
- iv. State Inheritance Tax
    1. Check to see if the state requires this.
  - v. Final Income Tax Returns for the First-to-Die
    1. Typically these returns are filed with the Decedent's accountant.
    2. In the event these were not filed, it is important to file late returns as quickly as possible.
    3. Late income tax returns for the trust may be required as well. The trustee may choose to report all the "trust accounting income" as having been distributed to the surviving spouse, with the income tax thereon properly reported and paid by the survivor. Since the survivor likely paid income tax on the trust accounting income, this aspect of filling the late returns for the administrative trust should cause no additional tax, penalty or interest.

IV What steps must be Taken Regarding the First-to-Die Spouses Retirement Plan Assets?

- a. Check the plan. Typically clients will stay on top of this portion of the decedent's estate plan.

V What Clean up must be done regarding the First-to-Die's Affairs?

- a. Is a probate of the Assets of the First-to-die Necessary?
    - i. Check to see if there were any assets left in the name of the first to die spouse. If so, and depending on the time frame you may still be able to probate the will, or if three years have lapsed in Utah, you will need to do an informal probate.
    - ii. Creditor's claims on the first death of the decedent could most likely be barred if a year has passed since death of decedent.
  - b. Specific gifts?
  - c. Non-Probate Assets?
- VI Avoiding the Problem
- a. Educating Your Clients – And Their Children
    - i. Remind them the importance of speaking with an attorney upon the death of the first spouse.
  - b. Title Assets Properly
    - i. Get assets into the trust
  - c. Marital Step Up Trust
    - i. Reverse-engineer the A/B/C trust format to leave everything to the spouse and give the spouse the power to make the most informed decision upon their death.