EXECUTIVE SUMMARY

Non-Reciprocal Spousal Trusts

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Non-Reciprocal Spousal Trusts

Until 2026, a unique opportunity exists for clients to shift up to $22 million from their taxable estates.[1]

A husband and wife can each establish a new irrevocable trust (also known as an "intentionally defective irrevocable trust," or "IDIT") for the benefit of one another and possibly children.[2]

- Each spouse can then gift up to $11 million to the trust they create.[3]
- The beneficiary-spouse can serve as the trustee of the trust established for his or her benefit; however, they may wish to serve with an independent trustee.
- The trust assets will be available until death, and the trust should escape estate taxes at each spouse's death.
- Life insurance could be purchased inside each trust to hedge against one spouse prematurely dying.

This technique is an opportunity for all clients regardless of their net worth.

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[1] The actual amount will depend on the balance of the donor's lifetime gift tax exemption and generation-skipping transfer tax exemption.
[2] Clients must take certain steps to avoid the trusts being treated as reciprocal trusts by the IRS.
[3] The actual amount will depend on the balance of the donor's lifetime gift tax exemption and generation-skipping transfer tax exemption.

NON-RECIPROCAL SPOUSAL TRUSTS

HUSBAND

Contributes $11MM of separate property to IDIT for the benefit of spouse

$11MM

WIFE

Contributes $11MM of separate property to IDIT for the benefit of spouse

$11MM

HER IDIT

Grantor: Husband
Trustee: Wife and/or Independent Trustee
Beneficiary: Wife and/or Children

ASSETS

- -Up to $11MM* contributed from Grantor
- -Life Insurance Policy on Husband

HIS IDIT

Grantor: Wife
Trustee: Husband and/or Independent Trustee
Beneficiary: Husband and/or Children

ASSETS

- -Up to $11MM* contributed from Grantor
- -Life Insurance Policy on Wife

ADVANTAGES

Taxes
No estate tax on trust assets (or appreciation)

Asset Protection
Assets inside the trust are no longer owned by Grantor

Potential Benefit
One spouse can be a beneficiary potentially receiving distributions if needed

"Once in a Lifetime" Opportunity?
Estate/gift tax exemptions scheduled to fall to $5MM in 2026.

RISKS

Death
If spouse dies, remaining assets in trust pass to beneficiary (e.g. – children)

Divorce
Assets gifted away cannot be reacquired

Reciprocal Trust Doctrine
Trust must leave Grantors in different economic position or IRS could unwind the trust

RISK MANAGEMENT SOLUTIONS

Death
Life Insurance on Grantor is used to create liquidity/asset replacement in IDITS

Divorce
Depending on length of marriage, may be a non-issue

"Spouse" can be defined as a current spouse, not a specific person

Divorce can "cut off" former spouse's interest as a beneficiary

Can give Third Party power to alter beneficiaries or appoint back

Reciprocal Trust Doctrine
Add children to one trust as permissible beneficiaries, vary lifetime powers, vary trustees, vary special trustee, etc.

*Technique can be leveraged if spouses gift assets that qualify for a valuation discount; however, this may involve additional gift tax risk and an estate and gift tax attorney should be consulted.

Non-Reciprocal Spousal Trusts: Creating an Intentionally Defective Irrevocable Trust (IDIT) and Gifting Assets to the IDIT

On December 22, 2017, President Trump signed into law the *Tax Cuts and Job Act of 2017* (the "Act"). In general, the Act provides tax relief for gift, estate and generation-skipping transfer (GST) tax purposes by increasing tax exemptions.

Key Changes are as follows:

- Until 2026, the gift, estate and GST tax exemptions are $11 Million per person, or $22 Million for married couples.
- All exemptions are scheduled to "sunset" after 2025. $5 million gift, estate and GST exemptions could return in 2026 (GST exemption is indexed to inflation).

The Act provides unique planning opportunity until 2026 or sooner change by Congress. In light of these changes, you should consider creating an Intentionally Defective Irrevocable Trust ("IDIT") and gifting assets to the IDIT to fully utilize your increased gift tax exemption. Below is a brief summary of the IDIT concept and the potential benefits of this type of planning.

Description of an IDIT and its Potential Benefits

Brief Description of an IDIT

- An IDIT is an irrevocable trust drafted so that assets transferred to the IDIT should not be subject to estate taxes upon the death of the grantor.
- The assets of the IDIT should not be subject to creditor or divorce claims of a beneficiary.
- An IDIT is designed to receive gifts from you or to borrow funds from you to make investments on behalf of your descendants. The Trustee will use the trust assets for the benefit of the beneficiaries during their lifetime.
- An IDIT contains special provisions that qualify it as a "grantor trust" for income tax purposes without causing its assets to be included in your taxable estate at death. This is why it is described as "defective:" it is not treated separately from you for income tax purposes.
- As a result, although assets transferred to the IDIT, and all appreciation of those assets, will be removed from your estate for estate tax purposes, you will still be taxed on the income generated by the IDIT's assets.

Potential Benefits of an IDIT

- Assets of the IDIT Appreciate Outside of Your Estate on an After-Tax Basis.
  - **Note:** Appreciating assets are attractive candidates to be gifted to an IDIT. The assets transferred and

all appreciation of those assets should pass free of transfer taxes.

- In addition, the Trustee can use the IDIT and cash generated by the assets transferred to it (or funds lent to the IDIT by you in the future) to make investments in new ventures for your descendants.

➢ **Spouse May be Beneficiary of IDIT.** Depending on the assets transferred to the IDIT, the non-grantor spouse may be a beneficiary of the IDIT. The non-grantor spouse may also serve as the Trustee or Co-Trustee of the IDIT, so long as distributions are restricted to those needed for the spouse's health, education, maintenance and support for his or her accustomed manner of living.

➢ **Spouse May Create Similar IDIT.** In addition to an IDIT established for the benefit of your spouse and descendants, your spouse may create a similar IDIT for the benefit of you and your descendants and fund this IDIT with a portion of his or her remaining gift tax exemption.

- Many clients prefer to establish two IDITs (one for each spouse). This structure allows each spouse access of his or her respective IDIT while providing the benefits explained in this memorandum.

➢ **Coordinate with Revocable Trust.** The IDIT can be drafted with provisions to match or complement your Revocable Trust.

➢ **Income Tax Payments Should Not Constitute Gifts.** As the "grantor" of the IDIT for income tax purposes, you pay the income taxes related to the income generated by the assets of the IDIT. Your income tax payments:

- Should not constitute gifts by you for gift tax purposes; and
- Should reduce the amount of wealth subject to estate tax when you die.

➢ **Grantor Trust Status May be "Turned Off."** A "Special Trustee" may be given the power to amend the IDIT so that you are no longer taxed on the income from the assets of the IDIT.

➢ **Note:** The Special Trustee provisions also provide flexibility to accommodate certain changes in the tax laws and family circumstances.

Risks of Using an IDIT

There are several risks you should be aware of while contemplating this planning technique. These include the following:

➢ **An IDIT is an irrevocable trust,** and as such, any gift to it is irrevocable.

➢ **Divorce.** Gifts to the IDIT generally cannot be reacquired.[4]

➢ **Death.** When a spouse dies, that spouse's trust would become for the benefit of the children (or other named remainder beneficiaries).

[4] However, a "spouse" can be defined as a current spouse rather than a particular individual allowing continued access upon remarriage and/or a special power of appointment may be given to a third party or child to redirect trust assets back to a trust for the benefit of the spouse who initially created the trust, though this may impact the creditor protection of the trust.

- To hedge against this and to provide additional liquidity for the surviving spouse, life insurance could be purchased on the non-beneficiary spouse to create an infusion of cash at the first death.

  Example: Husband establishes trust for the benefit of wife and wife establishes trust for the benefit of husband. They each transfer $11 million of assets to the respective trusts. Inside the trust for the benefit of the wife, a $11 million policy is purchased on the life of the husband (and vice versa). If the husband were to prematurely die, wife's trust would have the original $11 million of assets (plus any appreciation) and would also receive $11 million of cash.

- **Reciprocal Trusts.** It is important to avoid creating trusts that violate the "reciprocal trust" doctrine. Under this rule, the trusts must not be mirror images of one another and must have differences demonstrating that your economic positions were different before and after the gifts.

Example

Assumptions. For purposes of this example, we have made the following assumptions:

- Husband and wife each create an IDIT for the benefit of the other spouse (and possibly children) and make a gift of $11,000,000 of separate property to their respective IDIT.

- The assets gifted to the IDITs appreciate at 5.00% compounded annually.

- The assets gifted to the IDITs generate annual income of 2.00% of their undiscounted value.

- The IDIT is not responsible for the income taxes on any of this income.

- Both live 20 years and die at a time when the federal estate tax rate is 40% (this is the current estate tax rate but it is uncertain what it will be at that time).

Potential Results at Time of Second Death

The assets of the IDITs would be worth $85,133,058. Income taxes have not been included in calculating this total (in other words, husband and wife paid the income taxes on the income earned by the IDITs from other assets outside of the IDITs, allowing the assets of the IDIT to appreciate on an income tax-free basis).

Potential Results Without IDIT Planning

If the husband and wife did not transfer assets to new IDITs as described above, at the time of the second death, these same assets would be worth $51,079,835, after payment of estate taxes.

Thus, under the assumptions set forth above, gift of assets to the IDIT could result in estate tax savings and additional wealth retained by the family of $34,053,223, plus further appreciation.

Planning Considerations

Creating an IDIT and transferring assets to it involves complex financial, legal, tax, and other considerations. You should consult with your tax and legal counsel before proceeding.

In addition, an IDIT is an irrevocable trust and, therefore, cannot be changed or revoked by you after it is created.

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