VIII. PLANNING FOR THE MARITAL DEDUCTION

A. Introduction and History

1. Introduction

The federal estate tax marital deduction defers federal estate taxation until the death of the last to die of an individual and his or her spouse. Internal Revenue Code ("IRC") § 2056 allows for an unlimited federal estate tax marital deduction for qualified interests that pass to a decedent's surviving spouse. Therefore, the estate tax marital deduction may eliminate any estate tax on transfers between spouses at the death of the first spouse. IRC § 2523 allows for an unlimited federal gift tax marital deduction for transfers between spouses during their lifetime, and such gift tax marital deduction will be discussed at the end of this Chapter.

Upon a client's death, a client may leave property directly to his or her spouse and obtain a marital deduction for such property. Outright transfers of property to the surviving spouse result in the decedent's loss of control over the use of the property during the lifetime of the surviving spouse and the ultimate disposition of the property at the surviving spouse's death. Such transfers allow the surviving spouse to use and distribute the property as the surviving spouse chooses as opposed to how the decedent desired. By giving property to a marital trust, a client may obtain the marital deduction and also retain control over the ultimate use and disposition of the property after the client's death. The client's estate planning documents may contain a marital deduction formula that gives the marital trust the optimal amount of property to defer and minimize federal estate tax upon the death of the client or his or her spouse, whichever comes first; this is referred to as the "optimal marital deduction."

This Chapter will discuss the following issues relating to the marital deduction, the use of trusts and formulae for funding such trusts:

- Basic marital deduction planning
- Qualifying for the marital deduction
- Terminable interest rule and its exceptions
- Selecting marital deduction trusts – QTIP v. GPOA
- Common marital deduction formula provisions
- General guidelines for selecting a marital deduction formula
- Selected funding and drafting issues
- Funding examples
- Post-Mortem planning
- The gift tax marital deduction

2. History of the Marital Deduction

At the inception of the federal estate tax in 1916, estates of decedents owning community property and estates owning non-community property were not treated equally. The inequitable treatment occurred in both the transfer tax (gift and estate) and the income tax arenas. In 1948, Congress sought to equalize the treatment of decedents in community and non-community property states. Decedents in non-community property states were allowed to deduct up to 50% of the non-community property which was transferred to a surviving spouse as long as the surviving spouse's interest in the property was sufficient to cause such property to be included in the surviving spouse's gross estate. Congress also provided for gift-splitting between spouses and the filing of joint tax returns for income tax purposes.

In 1976, Congress allowed for a deduction in the amount of $250,000 or 50% of the adjusted gross estate, whichever was larger. This deduction eliminated estate taxes in modest estates. In 1981, Congress removed the dollar limit and allowed a deduction for the full amount of property passing to the surviving spouse, whether during lifetime or at death. The deduction was allowable only if the property passing to the surviving spouse was includible in the surviving spouse's gross estate unless such property was consumed during the surviving spouse's lifetime. The 1981 act also introduced the qualified terminable interest property (QTIP) trust and the elective basis for the QTIP. There is more flexibility in post-mortem planning when a QTIP trust is involved.

3. Definitions

The following terms will be used throughout this Chapter and an understanding of them is recommended before moving forward:

- "Funding" is the selection of assets, whether cash, property or sales proceeds, to satisfy a gift or bequest under a will or trust.
- A "formula" gift or bequest is one whose size, composition or value is determined with reference to some external criteria.

  <u>EXAMPLE</u>: "I bequeath my son an amount equal to the value of 100 shares of IBM stock."

  <u>EXAMPLE</u>: "I give my son an amount equal to the value of all the gifts I made to my daughter during my lifetime."

- A "lead" gift or bequest is a formula bequest that is calculated first, that is, before the residuary gift or bequest.
- "residuary" gift or bequest is a disposition of the balance of the assets of the estate after all the lead gifts or bequests, taxes, debts and expenses have been paid.
- A "marital deduction formula" is a formula gift or bequest that is determined with reference to the maximum available marital deduction under the Internal Revenue Code, (usually) after taking into account other available estate tax deductions and credits.
- An "applicable exclusion formula" is a formula gift or bequest determined with reference to the largest amount that may be transferred free of federal estate tax by reason of the applicable exclusion amount – also called the unified credit. IRC § 2010(c).

4. Pecuniary, Fractional Share, Residuary and Hybrid Gifts and Bequests

The characterization of a bequest or gift is critical to a determination of the nature and extent of a beneficiary's entitlement. It is necessary to determine whether a gift or bequest is pecuniary, fractional or residuary in nature to determine whether the gift or bequest: (a) shares in income during administration; (b) can be satisfied in kind without the recognition of capital gain or the revaluation of assets; (c) will participate in gains and losses during administration; or (d) will share in the burden of taxes, debts, claims and expenses during administration. The following discussion of different types of gifts and bequests does not involve marital deduction formula clauses but explains how to characterize a gift or bequest. Marital deduction formula clauses, discussed further below, follow the same rules, although they can be more difficult to analyze, are generally more complex and are invariably more intimidating.

a. Pecuniary Gifts and Bequests. A gift or bequest is referred to as pecuniary if it is of a sum certain, that is, equal to a specified dollar value that can readily be determined as of the date of death of a decedent. A few examples of pecuniary gifts will assist in understanding the characteristics and concepts of such gifts:

> **EXAMPLE:** "I give my wife the sum of $100,000." "I give to the Trustees of the Family Trust the sum of $1,000,000."

The primary characteristics of a gift or bequest of a pecuniary amount are:

- All post-death appreciation (and depreciation) in the estate benefits the residuary beneficiaries.
- Pecuniary amounts may or may not share in income earned during the period of administration. This depends on the specific provisions of state law and the trust instrument.
- Capital gains will be incurred if appreciated assets are sold to raise the cash needed to satisfy the gift or bequest. The same result is obtained if the gift or bequest is satisfied by the distribution of specific assets in kind that have appreciated in value between the date of death and the date of funding.
- The distribution of assets in kind to satisfy a pecuniary bequest requires the revaluation of the assets at the time of distribution.
- Any taxes incurred during the "funding" process are generally paid out of the residuary share, along with expenses of administration, taxes, debts and claims.
- In general, the executor or trustee has broad latitude to select the assets to sell or distribute in order to pay the gift or bequest.

b. Fractional Share. A gift or bequest is referred to as fractional if it is expressed either as a percentage or as a fractional portion of the assets available for distribution.

> **EXAMPLE:** "I give my son one-half of my estate."

The primary characteristics of a gift or bequest of a fractional share are:

- The satisfaction of fractional share gifts and bequests generally does not give rise to capital gains, unless assets are actually sold. As discussed further below, no capital gains are realized if assets are distributed pursuant to the formula in kind, as long as the assets are divided proportionately.
- In general, costs, expenses, debts, claims, taxes, appreciation, depreciation, and trust accounting income are shared ratably among fractional shares.
- Any non-pro rata distribution of available assets must comply with fiduciary standards of impartiality and fair dealing. Unless non-pro rata distributions are authorized either by (i) the governing instrument or (ii) state law, the Internal Revenue Service ("IRS") will treat a non-pro rata distribution made in satisfaction of a fractional share bequest as a taxable event for income tax purposes. The Uniform Trust Code ("UTC") § 816(22) provides trustees with the power to allocate particular assets in proportionate or disproportionate shares among beneficiaries, to value the trust property for these purposes and to adjust for resulting differences in value. Thus, in states that have enacted this provision of the UTC, a trustee can make non-pro rata distributions without tax consequences, provided the trust instrument does not prohibit non-pro rata distributions.
- Assets that are divided proportionately and distributed in kind to fund fractional shares do not require revaluation at the time of distribution.

c. **Residuary**. A residuary gift or bequest is a gift or bequest of property not otherwise disposed of under the terms of a will or trust.

> **EXAMPLE:** "I give my daughter the sum of $100,000, and I give the balance of my estate to my spouse." The "balance of my estate" is a residuary bequest.

The primary characteristics of a residuary gift or bequest are:

- Any appreciation or depreciation during the administration of the estate benefits the residuary beneficiaries.
- No capital gains are realized if assets are distributed in kind to satisfy the residuary gift or bequest.
- Revaluation of the assets is not necessary when satisfying a residuary gift or bequest.
- Taxes, debts, claims and expenses of administration are satisfied with property from the residuary share.

d. **Hybrid**. Sometimes it is difficult to determine whether a formula is pecuniary or fractional because characteristics of both appear to be present. These are referred to as hybrid formulae. When first examining the following gifts, some appear the same, but upon a closer examination the differences can be distinguished.

- "I give my son the sum of $100,000, not to exceed, however, 10% of my estate." The "sum of $100,000" is a pecuniary gift. The limitation of 10% does not change the classification of the gift, although it may change the size of the gift.
- "I give my son the sum of $100,000; provided, however, that if the value of my estate is less than $1,000,000, I give my son 10% of my estate." The provision that if the estate is less than the stated amount the son will receive "10% of my estate" *changes* the bequest from a pecuniary amount to a fractional share *if* the condition is met.
- "I give my son an amount equal to the lesser of (a) the sum of $100,000 and (b) 10% of the value of my estate." The language "an amount equal to" generally creates a pecuniary bequest, even when the amount is measured with reference to a percentage, because a percentage "of the value of my estate" is still an amount, and therefore, considered to be pecuniary.
- "I give my son 10% of my estate, not to exceed, however, the sum of $100,000." The language "10% of my estate" creates a fractional share of the estate, subject to a limitation.
- "I give my son 10% of my estate; provided, however, that if the value of my estate is more than $1,000,000, I give my son the sum of $100,000."

  This example illustrates a fractional share that *changes* to a pecuniary gift *if* a specified condition is met.
- "I give my son a share of my estate equal to the lesser of (a) 10% of my estate and (b) $100,000." The language "a share of my estate" generally creates a fractional share. In the absence of language denoting an amount, the limitation probably does not change the character of the gift.

B. Basic Marital Deduction Planning

1. Outright Disposition

An outright transfer or distribution of an interest in property by a decedent to a surviving spouse will qualify for the marital deduction. An outright transfer not only includes property devised to the surviving spouse but also includes property jointly owned with a surviving spouse with rights of survivorship and spousal beneficiary designations. The policy reason behind allowing direct transfers to the spouse to qualify for the marital deduction is that the interest in property will be included in the surviving spouse's gross estate for federal estate tax purposes unless such property is consumed during the lifetime of the surviving spouse.

2. Disposition to Trust

Property interests transferred to trusts where the surviving spouse has an interest in such trust may qualify for the marital deduction if certain requirements are met. IRC § 2056(b) allows for a power of appointment trust, a QTIP trust, or an estate trust. Each of these trusts will be examined in detail later in this Chapter.

3. Deferring Tax

The estate tax marital deduction essentially defers estate tax until the death of the surviving spouse. This is advantageous because of the increasing applicable exclusion amount available to the surviving spouse, and because the surviving spouse, with careful planning, may reduce the size of his or her taxable estate after the death of his or her spouse.

At a minimum, when federal estate taxes are applicable, the utilization by each spouse of their applicable exclusion amount and the deferral of tax by use of the marital deduction should be considered.

Deferring taxes has several benefits in addition to the obvious benefit of not paying taxes upon the death of the first spouse. Assets will not need to be liquidated in order to pay estate taxes, thereby avoiding the payment of taxes on capital gains for such liquidation and allowing more assets to be available to support the surviving spouse during his or her lifetime. By splitting interests between a marital share and an applicable exclusion amount share, fractional interests in property may be created allowing a discount to be taken when valuing the property in the surviving spouse's estate.

Deferring taxes, however, may have some disadvantages. Assets retained by the spouse or a marital trust may appreciate during the surviving spouse's lifetime thereby increasing the federal estate tax at the death of the surviving spouse. Depending upon the age and health of both spouses, it may be more advantageous to pay some tax at the death of the first spouse at lower estate tax rates than to have property taxed in the surviving spouse's estate at higher estate tax rates, although this becomes less significant as the estate tax brackets become more compressed.

4. Basis Considerations

a. <u>Current Law</u>. In 2010, recipients of inherited property will receive a carryover basis equal to the lesser of the decedent's adjusted basis and the fair market value of the property on the decedent's date of death. The decedent's executor can allocate up to $1,300,000 in basis increase among the decedent's assets. In addition, the executor can allocate an additional $3,000,000 of basis increase among the decedent's assets that pass to a surviving spouse outright or in a QTIP trust (together referred to as "qualified spousal property"). The basis of any asset, however, may not exceed its fair market value as of the date of death. There are a number of assets that are not eligible for the step-up in basis, including property acquired by gift within 3 years of death from a person other than the decedent's surviving spouse and property that would constitute a right to receive income in respect of a decedent under IRC § 691. Under current law, IRC § 1022 will be repea1led after 2010. IRC § 1022.

b. <u>Future Years</u>. In 2011 and thereafter, the basis of property acquired from a decedent is the property's fair market value on decedent's date of death or on the alternate valuation date, whichever is used on the federal estate tax return filed by decedent's executor. IRC § 1014. This is sometimes called the "step-up in basis" rule and is to be contrasted with the "carryover basis" rule applicable to property acquired by gift. Property is considered "acquired" from the decedent when the property is acquired by bequest, gift or inheritance, when the property is transferred from a revocable trust created by decedent during the decedent's lifetime, and when the property is transferred as a result of the exercise of a general power of appointment. IRC § 1014(b). Some property, however, is not afforded a step-up in basis. This includes the following:

- Property received from the decedent during decedent's lifetime, but disposed of before decedent's death. IRC § 1014(a).
- A right to receive an item of income in respect of a decedent ("IRD") from decedent. IRC § 1014(c). For further discussion of IRD, see Section H.1 below.
- Property passing to a beneficiary if the decedent acquired the property by gift from such beneficiary within one year of decedent's death. IRC § 1014(e).
- Property purchased by an executor with funds obtained by selling property acquired from the decedent. Treas. Reg. § 1.1014-3(c).

C. Qualifying for the Marital Deduction

In general, a marital deduction is allowed for the value of any property interest which *passes* from the decedent to his or her surviving spouse if the interest is a *deductible interest*. The executor has the burden to establish that the decedent was survived by a spouse, the interest passed to the spouse, the interest is deductible and the value of the interest in property. Treas. Reg. § 20.2056(a)-1(b)(i).

1. Interest Must be Includible in Decedent's Gross Estate

In order for an interest in property to qualify for the marital deduction, the asset must be includible in the decedent's gross estate for federal estate tax purposes.

2. Decedent is Survived by a Surviving Spouse Who is a U.S. Citizen

If the surviving spouse is not a U.S. citizen, the marital deduction is only available for transfers to a qualified domestic trust (QDOT) under IRC § 2056A, or if the non-U.S. citizen surviving spouse, who was a resident of the U.S. at decedent's date of death, becomes a U.S. citizen before the date the federal estate tax return for the decedent is timely filed.

3. Interest Must "Pass" to the Surviving Spouse

Under IRC § 2056(c), an interest in property "passes" to the surviving spouse if it passes to the surviving spouse by bequest or devise, inheritance, dower or curtesy, inter vivos transfer, joint tenancy with right of survivorship, the exercise or nonexercise of a power of appointment, or beneficiary designation of a life insurance policy. Treas. Reg. § 20.2056(c)-1.

4. Interest Must be Deductible

The regulations describe a "deductible interest" as an interest that is not a "nondeductible interest." A nondeductible interest is defined as a property interest that: (a) is not included in the decedent's gross estate; (b) generates deductions under IRC § 2053 or 2054; or (c) in general, is a terminable interest. Reg. § 20.2056(a)-2(b). A terminable interest, as will be described more thoroughly below, is a nondeductible interest unless it meets the requirements of IRC § 2056(b).

5. Value of Property Interest

Once the requirements listed above are met, the value of the property interest must be determined. The property interest is valued as of the decedent's date of death, unless the executor elects the alternate valuation date under IRC § 2032. The alternate valuation election may be used only if the election will reduce the value of the gross estate and reduce the sum of the estate tax and generation-skipping transfer ("GST") tax liability (reduced by credits allowable against these taxes). IRC § 2032(c). The marital deduction is allowed only to the extent of the net value of any deductible interest. If a decedent passes a property interest to his or her surviving spouse and such interest is subject to an encumbrance or obligation, the value of the interest, for purposes of determining the amount of the marital deduction allowable with respect to such interest, must be reduced by the amount of the encumbrance or obligation. Treas. Reg. § 20.2056(b)-4(b). If the executor is required to discharge the encumbrance or obligation, however, the discharge is considered an interest passing to the surviving spouse and is therefore deductible.

> **EXAMPLE:** Decedent devised property valued at $100,000 to her surviving spouse, and such property was subject to a $50,000 debt. If all other requirements for a marital deduction were met, the marital deduction would be $100,000 if the executor was required to discharge such debt, and $50,000 if the executor was *not* required to discharge the debt.

D. Terminable Interest Rule and Its Exceptions

The terminable interest rule provides that the marital deduction is not permitted for interests that terminate or fail upon a lapse of time or the occurrence or nonoccurrence of an event if a person other than the surviving spouse receives the property after the termination of the surviving spouse's interest, unless one of the exceptions to such rule are met. Treas. Reg. § 20.2056(b)-1(b). Examples of terminable interests include life estates, terms for years, annuities, patents, and copyrights. The following are exceptions to the terminable interest rule.

1. Limited Survivorship Exception

IRC § 2056(b)(3) provides that the marital deduction is available for transfers to a surviving spouse with a limited survivorship requirement. Specifically, a terminable interest is deductible if: (a) the only condition under which the interest will terminate is the death of the surviving spouse within six months after the decedent's death, or if the surviving spouse's death is a result of a common disaster that also resulted in decedent's death; and (b) the condition does not in fact occur. Treas. Reg. §20.2056(b)-3(a).

> **EXAMPLE:** Decedent bequeathed his estate to his spouse on the condition that she survive him by 6 months. If she did not survive the decedent by 6 months, such property was to be distributed to the decedent's child. If the spouse died within the 6 month period such interest would be a nondeductible interest as it passed to a person other than the surviving spouse. If the spouse survived the decedent by 6

months, the conditions of IRC § 2056(b)(3) have been met, and such interest is deductible.

<u>EXAMPLE</u>: A decedent bequeathed her estate to her husband if he was living on the date of distribution. Even if the distribution occurred within six months of the decedent's death, the interest would still be a nondeductible interest as the distribution *could have* occurred after the 6 month period. Therefore, the marital deduction is not allowed.

2. General Power of Appointment Trust

Use of general power of appointment marital trusts, also referred to as a life estate with power of appointment, has declined since the Economic Recovery Tax Act of 1981, in part because of the larger degree of control that a property owner may exert through the use of one or more QTIP trusts. Under IRC § 2056(b)(5) and the regulations thereunder, a marital deduction is allowed for an interest that passes to a surviving spouse in trust if all the following conditions are met:

- The surviving spouse is entitled for life to all the income from the entire interest, or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest;
- The income payable to the surviving spouse must be payable at least annually;
- The surviving spouse must have the power to appoint the entire interest or a specific portion of the entire interest to himself or herself or to his or her estate;
- The power must be exercisable by the surviving spouse alone and in all events;
- The entire interest or specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse; and
- The surviving spouse must have the right to require the trustee to make unproductive property productive or to convert such unproductive property within a reasonable amount of time. Alternatively, applicable rules for administration of the trust must require the trustee to use the degree of judgment and care in the exercise of a power to retain unproductive property which a prudent man would use if he were the owner of the trust assets. Treas. Reg. § 20.2056(b)-5(f)(4).

If the right to income or the power of appointment is limited to a specific portion of the property interest, the marital deduction is allowed only to the extent that the rights in the surviving spouse meet the requirements listed above. Treas. Reg. § 20.2056(b)-5(b). The right to income and the power of appointment do not need to be in the same proportion; however, the marital deduction is limited to the smaller amount.

<u>EXAMPLE</u>: The surviving spouse is entitled to receive all the income from the property, but the surviving spouse's power of appointment only extends to one-half of the property. The marital deduction is limited to one-half of the value of such property.

A surviving spouse who is a beneficiary of a general power of appointment marital trust can possess a number of rights and powers which would be inconsistent with the concept of, or would be impermissible in, a QTIP trust:

- An unlimited right to withdraw any or all of the principal of the marital trust during the life of the surviving spouse;
- The right, as sole trustee or co-trustee, to participate in discretionary principal distribution decisions under a non-ascertainable standard; and
- A lifetime power of appointment exercisable in favor of third parties.

3. Life Insurance or Annuity Payments with General Power of Appointment

It is possible for an interest that consists of proceeds from an annuity, endowment or life insurance policy that are to be paid in installments or held by the insurer under an agreement to pay interest, to qualify for the marital deduction. Under IRC § 2056(b)(6), a marital deduction is allowed for such interests passing to a surviving spouse if the following conditions are met:

- The proceeds, or a specific portion of the proceeds, must be held by the insurer under an agreement to pay the entire proceeds or a specific portion of the proceeds in installments or to pay interest. Such payments must be payable only to the surviving spouse during the surviving spouse's lifetime;
- The installment or interest payments must be payable to the surviving spouse at least annually, and such payments must begin no later than 13 months after the decedent's death;
- The surviving spouse must have the power to appoint the entire interest or a specific portion of the entire interest to either the surviving spouse or the surviving spouse's estate;
- The power must be exercisable by the surviving spouse alone and in all events; and
- The entire interest or specific portion must not be subject to a power in any other person to appoint any part to any person other than the surviving spouse.

4. Estate Trust

An estate marital trust allows the trustee broad discretion to distribute any, all or none of the income to the surviving spouse. Undistributed income is added to principal. Principal may be distributed to the surviving spouse pursuant to whatever standard the deceased spouse wishes to provide in the governing instrument. At the death of the surviving spouse, the entire trust, including accrued and accumulated income, must be distributed to the surviving spouse's estate.

➔ **Planning Point:** This lack of control over the ultimate disposition of the trust at the death of the surviving spouse is one of the disadvantages of the estate trust for many individuals. In addition, the distribution to the surviving spouse's estate creates a probate estate that can be avoided by use of a QTIP trust or a general power of appointment marital trust.

➔ **Planning Point:** If an estate consists of a business interest which is not income producing and which the decedent does not want to be sold, the decedent may want to use an estate trust because an estate trust is not subject to the productivity standards of Treas. Reg. § 20.2056(b)-5(f)(4).

The ability of the trustee to accumulate income of an estate trust during the life of the surviving spouse and the ability to hold unproductive property are among the advantages of an estate trust. See Rev. Rul. 68-554, 1968-2 C.B. 412; PLR 9634020.

5. Qualified Terminable Interest Property Trust

Under IRC § 2056(b)(7), a marital deduction is allowed for an interest that passes to a surviving spouse even if the interest is a terminable interest. The Qualified Terminable Interest Property ("QTIP") Trust is a vehicle which allows a decedent to provide for a surviving spouse yet retain control of the ultimate disposition of the decedent's property. If the QTIP requirements are met, the subject property is treated as property passing to the surviving spouse and as not passing to any person other than the surviving spouse. Treas. Reg. § 20.2056(b)-7(a).

a. Requirements. A marital deduction is allowed for a terminable interest that passes to the surviving spouse if all of the following requirements are met:

- The surviving spouse is entitled to all the income from the property for life;
- No person, including the surviving spouse, may possess a power to appoint any part of such property to, or for the benefit of, any person other than the surviving spouse;
- The property passes from the decedent;
- The income payable to the surviving spouse must be payable at least annually; and
- An election must be made on the decedent's estate tax return with respect to a portion or all of the trust.

b. Dispositive Provisions of a QTIP Trust.

(1) Income. The spouse must receive all the income from the QTIP trust for his or her lifetime. IRC § 2056(b)(7)(B)(ii)(I); see also Treas. Reg. § 20.2056(b)-5(f). Some clients may wish the surviving spouse to receive the greater of the income from the QTIP trust or a unitrust amount, defined as a fixed percent of the trust determined annually.

Notwithstanding the client's desire to limit the surviving spouse's rights under the QTIP trust, the attorney, in drafting QTIP provisions, should not attempt to limit the spouse's income right by granting the Trustee discretion in determining when to distribute income. For example, the entire net income requirement will not be met if the Trustee is given the discretion to distribute all the income "as the trustee, in the trustee's reasonable discretion, shall determine to be proper for the health, education, support, maintenance, comfort and welfare of the grantor's surviving spouse in accordance with the surviving spouse's accustomed manner of living." *Estate of Davis v. Comm'r*, 394 F.3d 1294 (9th Cir.), *aff'g* T.C. Memo. 2003-55. Also, the IRS has ruled privately that the net income requirement is not met when the trust instrument provides that a corporate Trustee shall have the discretion to distribute the net income "in such amounts and at such times as my wife, in her sole discretion but in consultation with the Trustee, shall desire for her maintenance, education, health or support commensurate with her station in life." TAM 200505022.

➔ **Planning Point:** One risk of providing too many limitations on the surviving spouse's benefits from and/or control of a QTIP trust is to increase the risk of the surviving spouse's opting for the elective share. An incentive to elect may arise, for example, when utilizing the common marital deduction formula that minimizes the marital disposition while maximizing the property distributed to the nonmarital trust, if the surviving spouse has an insufficient or no beneficial interest in the nonmarital trust. Thus, when the client wishes to limit marital rights, the attorney should review the applicable elective share statute in detail, including whether the elective share may be satisfied or reduced by the surviving spouse's interest in the trust.

(2) Principal. Principal of a QTIP trust may not be distributable to anyone other than the surviving spouse during the surviving spouse's lifetime without disqualifying the trust for the marital deduction. IRC § 2056(b)(7)(B)(ii)(II); Treas. Reg. § 20.2056(b)-7(d)(1). Principal may be distributed to the spouse pursuant to an ascertainable standard relating to health, education, support and maintenance or pursuant to a broad standard such as best interests. If a non-ascertainable distribution standard is used and the spouse is a trustee, the spouse will have a general power of appointment over all of the QTIP trust, which will cause inclusion in the gross estate of the spouse under IRC § 2041(a)(2) in addition to IRC § 2044. The inevitability of such inclusion would make effectively impossible a partial QTIP election when the marital trust is created.

A broad principal distribution standard may be used if a third party serves as sole trustee of a QTIP trust. In addition, a broad principal distribution standard can be used when the spouse is serving as a co-trustee of the QTIP trust if the governing instrument precludes the spouse as co-trustee from participating in discretionary principal distribution decisions or if the governing instrument limits the spouse's right to participate in discretionary distribution decisions to the narrower ascertainable standard and allows the third party trustee to make principal distributions pursuant to a broader standard.

One useful technique that practitioners can use in appropriate circumstances to add flexibility to a QTIP trust is to designate a nonspouse individual and/or a corporate fiduciary as a Co-Trustee or as sole trustee, provide for principal distributions to the surviving spouse (subject to an ascertainable standard to the extent the spouse is involved in deciding whether to make such distributions) and also provide that the right to receive principal distributions will be removed upon the surviving spouse's remarriage or cohabitation. Because IRC § 2056(b)(7) does not require the trust to distribute any principal to the surviving spouse, the trust instrument should be able to provide for the making of principal distributions and cancel the Trustee's right to make such distributions upon the occurrence of certain events (such as the surviving spouse's remarriage or cohabitation) without jeopardizing the marital deduction. Precise drafting is absolutely necessary in this situation to ensure that the trust instrument cannot be interpreted to mean that the surviving spouse can ever forfeit any part of his or her income interest under the QTIP trust. A principal distribution forfeiture provision in the QTIP trust could be accompanied by a similar provision in the family trust that would both remove the surviving spouse's income interest in the family trust, as well as his or her principal interest, upon remarriage, cohabitation or other event.

(3) **Withdrawal Right**. A QTIP trust may contain a lifetime withdrawal right exercisable by the surviving spouse, but such withdrawal right should be limited both in terms of the amount withdrawable as well as the time within which it can be exercised. IRC § 2056(b)(7)(B)(ii)(II); Treas. Reg. § 20.2056(b)-7(d)(1)&(6). Such a withdrawal right is often limited to the greater of $5,000 or 5% of the value of the trust assets (a "5 or 5" standard). See IRC §§ 2514(e) & 2041(b)(2). Such a limited right of withdrawal does not cause a QTIP trust to be classified as an IRC § 2056(b)(5) general power of appointment marital deduction trust. This power allows the surviving spouse to withdraw trust property for his or her own benefit or to make gifts to the remainder beneficiaries or other individuals or entities.

➔ **Planning Point:** As stated above, no one, including the surviving spouse, can be given a lifetime power of appointment without disqualifying the QTIP trust for the marital deduction. Furthermore, under IRC § 2519, if a surviving spouse assigns all or part of his or her income interest in a QTIP trust, the surviving spouse is treated as making a gift of the entire remainder interest in the QTIP trust. This deemed gift of the remainder interest is in addition to the gift associated with the assignment of the income interest under IRC § 2511. Thus, the spouse's ability to benefit other people is limited. If the client wants the surviving spouse to have the ability to benefit others during his or her life, the spouse must have the power to receive principal distributions or exercise withdrawal rights for the purpose of making gifts.

In addition, if a spouse holds a withdrawal power with respect to a QTIP trust in excess of the "5 or 5" standard, a lapse of that power during the spouse's life that exceeds the "5 or 5" safe harbor may result in the spouse's making a taxable gift of the value of the withdrawable property in excess of the greater of $5,000.00 or 5%. IRC § 2514(e); Treas. Reg. § 25.2514-3(c)(4). Furthermore, there is a potential grantor trust issue under IRC §§ 677 & 678 regarding lapsing rights of withdrawal (i.e., the spouse may be treated as the grantor, for income tax purposes, with respect to part or all of the principal of the trust).

If a spouse is given an unlimited right, as opposed to a "5 or 5" standard, to withdraw the principal of the QTIP trust, the unlimited right assures that the benefits of a partial QTIP election will be unavailable because the value of the entire QTIP trust property will be included in the gross estate of the surviving spouse, regardless of whether a QTIP election is made. This result also will occur if the surviving spouse, as a Trustee of the QTIP trust, has a discretionary power to distribute trust property to him or herself. Unless the exercise of such power is subject to an "ascertainable standard," the surviving spouse will be considered to hold a general power of appointment over QTIP trust property, and the value of the entire QTIP trust property will be included in the surviving spouse's gross estate. IRC § 2041.

In *Estate of Manscill v. Comm'r*, 98 T.C. 413 (1992), *op. suppl.*, T.C. Memo. 1992-571, the decedent's Will named his daughter as Trustee of a marital trust. The trust instrument provided that the Trustee, with the surviving spouse's approval, could make principal distributions from the marital trust for the support of the daughter/Trustee. The court held that, despite the required approval by the surviving spouse, the power to distribute principal from the marital trust caused the surviving spouse not to have a qualifying income interest for life. However, distributions of principal to children of the surviving spouse may be permissible if such distributions are made only to the extent the surviving spouse has a legal obligation to support such children. Treas. Reg. § 20.2056(b)-5(j); see also TAM 8913003; TAM 9005002.

➔ **Planning Point:** Many clients choose the QTIP trust as the primary testamentary marital transfer because it allows the first spouse to die to ensure that property in the QTIP trust will be available for the client's remainder beneficiaries. Thus, many clients will wish to limit the surviving spouse's ability to withdraw QTIP trust principal for his or her own benefit.

(4) Powers Over Property Held in QTIP Trust. An interest is a qualifying income interest for purposes of the marital deduction only if no one, including the surviving spouse, has a power to appoint the underlying property to anyone other than the surviving spouse during the surviving spouse's lifetime. IRC § 2056(b)(7)(B)(ii)(II); Treas. Reg. § 20.2056(b)-7(d)(1)&(6); -7(h), Ex. 4. Thus, a lifetime power held by the surviving spouse to appoint trust property to the decedent's descendants will prevent the QTIP trust from qualifying for marital deduction. The IRS has rejected the argument that a savings provision, discussed below, in the trust instrument will negate this impermissible power. TAM 200234017. However, as discussed above, there is no restriction on the Trustee's making invasions of the principal during the spouse's lifetime as long as the invasion is only for surviving spouse's benefit, IRC § 2056(b)(7)(B)(ii)(II); Treas. Reg. § 20.2056(b)-7(d)(1)&(6), and the invasion power is allowed regardless of whether it is subject to a standard. Additionally, the IRS has ruled that the surviving spouse can be given the right to appoint property pursuant to a "5 or 5" power to any third party, provided the class of permissible appointees includes the surviving spouse. TAM 8943005.

The regulations provide that the restriction against a power to appoint trust property to someone other than the surviving spouse is violated if the surviving spouse is legally bound to transfer to a third person, without adequate and full consideration, property that had been distributed out of the trust to the spouse. Treas. Reg. § 20.2056(b)-7(d)(6); see also PLR 9606008 (allowing a marital deduction when a third party had the ability to purchase property from a trust because the third party was required to pay fair market value for the property); *Estate of Manscill,* supra.

A surviving spouse may disclaim a disqualifying power so that trust property qualifies for

QTIP treatment. IRC § 2518; Treas. Reg. § 20.2056(b)-7(h), Ex. 4. The IRS has previously ruled that a disclaimer can be used to convert a life estate in a general power of appointment trust to a QTIP trust by having the spouse disclaim the right to appoint the property. PLR 8622018. Similarly, the IRS has ruled that third parties can disclaim interests under IRC § 2518 so that the surviving spouse has a qualifying income interest in the disclaimed property. See, e.g., PLR 8725063.

(5) **Limited Testamentary Power of Appointment**. A limited testamentary power of appointment can be given to the spouse over the QTIP trust to allow the spouse to appoint the marital trust property among a class of beneficiaries defined and limited by the testator or settlor, such as his or her descendants, their spouses and charities. This permits the spouse to take a second look at the family's estate plan after the death of the testator or settlor of the trust and adjust for events and circumstances that have occurred subsequent to his or her death.

Although broadly-drafted limited powers of appointment can maximize flexibility while retaining the tax advantages of a trust, there is always the potential for the powerholder to appoint assets to individuals of whom the testator or settlor would not approve. This is especially true if the powerholder can appoint trust assets to a new trust with different trust terms. One option to deal with too much flexibility (short of simply removing such flexibility) is to provide that a particularly broad limited power of appointment is exercisable only upon the prior written approval of an independent Trustee, trust protector or other third party.

➔ **Planning Point:** As illustrated above, when providing advice with regard to the marital deduction, attorneys should not automatically consider QTIP trusts as inflexible devices that foreclose the possibility of planning for the surviving spouse's death. However, care should be taken when drafting QTIP trust language to address the client's particular concerns, needs and objectives and to preserve flexibility to address effectively unanticipated and/or unforeseen developments. At the same time, the attorney must be mindful of, and be prepared to implement, the desires of a client who wishes to use a QTIP trust disposition precisely because it can be designed to minimize spousal control while still enabling use of the martial deduction. Such intent would make many of the planning opportunities discussed above inappropriate.

c. **QTIP Election**. The QTIP election is made by the executor. IRC §§ 2056(b)(7)(B)(v) & 2203. If the decedent has a revocable trust agreement and pour-over will, the QTIP election is made by the legal representative of the estate, or, if none, by the trustee of the revocable trust. Treas. Reg. § 20.2056(b)-7(b)(3). The governing instrument may direct the fiduciary to elect to qualify all of the QTIP trust for the marital deduction. While such direction limits the flexibility to make a partial QTIP election (discussed below), it may be desirable when the interests of the surviving spouse and the remainder beneficiaries may conflict (e.g., second spouse and children of first marriage).

d. **Allocation of Property to the QTIP Trust.** The main reason why many clients prefer a QTIP trust over other available marital deduction dispositions is that, if the client is the first spouse to die, the QTIP provides the highest degree of control over assets that are transferred through a marital gift. The surviving spouse has no power to modify the distribution of the property during his or her life. To take maximum advantage of this feature, the Executor may allocate trust assets so that the marital trust holds assets over which the client wishes to maintain control, such as a closely-held business interest.

However, if the trust instrument contains a provision stating that the Trustee must hold only income-producing property in the QTIP trust, the closely-held business interest that has not been income-producing may not be an appropriate asset to place in the QTIP trust. Instead, the trust instrument should contain an alternative, but equally valid, provision stating that the surviving spouse can force the Trustee to sell QTIP trust assets that are not income-producing. Treas. Reg. §§ 20.2056(b)-7(d)(2); 20.2056(b)-5(f)(4); PLR 200339003. Thus, the Trustee could keep the interest in the QTIP trust if the surviving spouse did not mind keeping it in the trust. Of course, if the surviving spouse would seek to maximize income by seeking to compel a sale of the closely-held business interest, the QTIP trust should not hold such an asset if at all possible.

There are some additional issues relating to this form of marital disposition. First, the titling of assets becomes an issue, as jointly-owned property, life insurance, retirement plan assets, etc., will still pass outright to the designated beneficiary of these vehicles. Second, the surviving spouse will be restricted in using QTIP trust assets in his or her own estate planning after the death of the first spouse to die. Giving the surviving spouse more flexibility in this regard may be beneficial to the remainder beneficiaries. Third, the surviving spouse cannot appoint QTIP principal to the children while the surviving spouse is living, and, if the surviving spouse is not allowed or refuses to make gifts of the trust property, the children may be very elderly before the remainder benefits them.

e. <u>**Income Accrued or Undistributed at Death**</u>. Income accrued or undistributed at the death of the surviving spouse can be paid to the spouse's probate estate or can be added to the principal of the QTIP trust or paid to the next income beneficiary of the trust.

- Treas. Reg. § 20.2056(b)-7(d)(4) permits such income to be paid to someone other than the spouse or the spouse's estate without jeopardizing the qualification of the QTIP trust for the marital deduction. Such income can also be subject to a testamentary limited power of appointment exercisable by the surviving spouse.
- If the accrued or undistributed income is not distributed to the estate of the spouse, it nevertheless must be included in the gross estate of the surviving spouse, and will constitute IRC § 691(a) income in respect of a decedent. Treas. Reg. § 20.2044-1(d)(2).
- In *Estate of Rose Howard v. Comm'r*, 91 T.C. 923 (1988), the Tax Court ignored the predecessor proposed regulation and disallowed the marital deduction for a QTIP trust that did not pay the accrued or undistributed income to the spouse's estate or make it subject to a general power of appointment by the spouse. The *Howard* case was reversed on appeal, *Estate of Howard v. Comm'r*, 910 F.2d 633 (9th Cir. 1990), but some attorneys still exercise caution and comply with the Tax Court's *Howard* decision even though the Treasury Regulations were amended years ago to reflect the decision of the Ninth Circuit Court of Appeals.
- In *Estate of Lucille Shelfer*, 103 T.C. 10 (1994), the Tax Court followed its decision

in *Howard*. It held that a marital trust that did not pay the accrued and undistributed income to the spouse was not a QTIP trust, and thus its value was not included in the gross estate of the surviving spouse at her death under IRC § 2044, even though a marital deduction had previously been claimed (and allowed) for the trust in her husband's estate. A dissenting opinion noted that the taxpayers had "whipsawed" the IRS. The Court of Appeals for the Eleventh Circuit agreed with the dissent and reversed the Tax Court. *Estate of Lucille Shelfer v. Comm'r*, 96-2 USTC ¶ 60,238 (11th Cir. 1996); see also *Talman v. U.S.*, 37 Fed Cl. 741 (1997).

f. Definition of Income Under IRC § 643(b). The IRS has promulgated regulations to amend the regulations governing marital deduction treatment for transfers to a trust in both the gift and estate tax contexts. A trust may qualify for the gift or estate tax marital deduction even if the trust operates under a state law that allows a reasonable allocation of the trust's total return between the income and remainder beneficiaries. A spouse will be treated as entitled to receive all the net income from a trust, as required for the trust to qualify as QTIP for purposes of the gift or estate tax marital deductions, if the trust is administered under applicable state law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of Treas. Reg. § 1.643(b)-1. Furthermore, the QTIP election requirements under Treas. Reg. § 20.2056(b)-7 state that a power under applicable local law permitting the trustee to adjust between income and principal that fulfills the trustee's duty of impartiality and that meets the requirements of Treas. Reg. § 1.643(b)-1 will not be considered a power to appoint trust property to a person other than the surviving spouse

It is not sufficient that the trust agreement alone authorize the unitrust payment; state law must allow payment of a unitrust amount as income. The deduction will not be jeopardized if in some years trust income as traditionally defined will exceed the unitrust amount.

g. Partial Election.

(1) Single Fund Marital Trust. If a partial QTIP election is made, the QTIP trust may be held as a single fund marital trust with an elected share (which qualifies for the marital deduction) and a non-elected share (which does not so qualify). IRC § 2056(b)(7)(B)(iv).

- The trust instrument may provide that principal payments to the surviving spouse are to be charged against the elected share first, thereby reducing the portion that will later be included in the surviving spouse's gross estate for federal estate tax purposes. Treas. Reg. §§ 20.2044-1(d)(3) and (e), Ex. 4. The current fair market values of the elected share and the non-elected share are calculated immediately before the principal distribution. The principal distribution is then made solely from the elected portion of the single fund marital trust. The amount of the principal distribution is then reflected by an adjustment based on current value to both the elected portion and the non-elected portion of the marital trust, thereby reducing the fraction or percentage of the marital trust consisting of property that will be subject to estate tax at the death of the surviving spouse.

- A single fund marital trust with a rolling fraction can present some administrative difficulties and so must be used with care.
- The specific portion for which QTIP treatment is elected may be expressed within the deceased settlor or testator's estate tax return as a fraction or percentage of the QTIP trust, or may be defined by means of a formula provision similar to that used in drafting a pecuniary or fractional marital deduction formula, as further discussed below. Treas. Reg. § 20.2056(b)-7(b)(2)(i). Using such a formula would ensure that any change in valuation of the deceased grantor's assets upon audit or any decision regarding taking deductions on the estate tax return versus the income tax return would not cause imposition of or an increase in estate tax if the formula clause were designed to reduce the estate tax to the lowest possible amount. Treas. Reg. § 20.2056(b)-7(h), Exs. 7 and 8; see also PLR 9043015.
- A single fund marital trust for which a partial QTIP election is to be made can also be used in lieu of a marital trust/family trust estate plan without wasting the applicable exclusion amount of the first spouse to die. In addition, the non- elected portion clearly will qualify for the credit for tax on prior transfers should the surviving spouse die within 10 years of the deceased spouse whose governing instrument created the QTIP trust for which the partial QTIP election is made. IRC § 2013(a).

(2) Elected and Non-Elected Marital Trusts. With a partial QTIP election, the governing instrument can provide that the QTIP trust may be severed into two separate trusts, one elected and the other non-elected, that are held under the same dispositive terms and that principal payments shall be made to the spouse from the elected marital trust first. See Treas. Reg. § 20.2056(b)-(7)(b)(2)(ii); -7(h), Ex. 9. A trust can be divided in this manner if the severance is authorized under the governing instrument or local law. The division of a marital trust to reflect a partial QTIP election must be done on a fractional or percentage basis. However, the funding of the separate trusts so created need not be done by transferring a pro rata share of each of the assets in the marital trust before division into elected and non-elected trusts. Treas. Reg. §§ 20.2056(b)-7(b)(2)(ii)(B); 20.2056(b)-7(h), Ex. 14. No gain or loss will be recognized for income tax purposes when the two trusts are funded. This is true even where funding is accomplished not by transferring a pro rata share of each and every asset to the separate trusts, but by selecting particular assets to fund one trust or the other, if the governing instrument or local law explicitly authorizes non pro rata distributions. Having separate elected and non-elected trusts avoids the need to revalue elected and non-elected portions of a single QTIP trust each time principal is distributed from the elected portion to the surviving spouse.

When a partial QTIP election is made, the non-QTIP portion is not taxed again at the surviving spouse's death. For example, assume a 50% QTIP election is made and no principal distributions are made (or such distributions are made one-half from the elected portion and one-half from the non-elected portion). In the absence of a separate non-QTIP trust, on the death of the surviving spouse, 50% of all of the assets in the marital trust will be subject to estate tax. If a separate non-QTIP trust were created (which could have the same provisions as the QTIP trust), it would be funded with 50% of the assets in the marital trust and, most importantly, it could be funded with those assets most likely to appreciate. Thus, on the surviving spouse's death, less estate tax may be due on the separate QTIP trust than would have been the case had a 50% partial

QTIP election been made with respect to the single, non-severed marital trust hypothesized above. In addition, during the surviving spouse's lifetime, principal payments could be made from the elected trust first, thereby reducing the value of the assets that will be taxed at the surviving spouse's death. Treas. Reg. § 20.2056(b)-7(h), Ex. 9. This technique also avoids the need to revalue the QTIP trust each time principal is distributed to the spouse and reduces the assets that will be included in the gross estate of the spouse when principal distributions are made from the elected portion. No gain or loss will be recognized for income tax purposes when the two trusts are funded.

➔ **Planning Point:** If the governing instrument is silent on a trustee's right to divide a QTIP trust into two separate trusts, state law may allow the fiduciary to sever the marital trust.

Using separate elected and non-elected marital trusts is not without its disadvantages. The two trusts for the benefit of the surviving spouse will be identical. Both will require distribution of all of the income from the trusts to the surviving spouse, which may not fit the testator's plan and may unnecessarily subject to estate tax in the estate of the surviving spouse income generated in the non-elected trust but not consumed by the surviving spouse. This problem can be partially alleviated by investing the non-elected trust for growth rather than income. Such an investment strategy, however, reduces the investment flexibility of the non- elected trust, as compared to a typical family trust in which the income need not be paid to the surviving spouse. Another disadvantage is that the decedent's children cannot be included as income beneficiaries of a QTIP trust or a trust that could have been a QTIP trust but with respect to which the requisite election was not made.

➔ **Planning Point:** Utilizing a QTIP trust for which a partial election can be made provides more flexibility than use of alternative marital formulae (*e.g.*, "50% of adjusted gross estate" formula, equalizer formula based on *Estate of Smith v. Comm'r*, 565 F.2d 455 (7th Cir. 1977), and Rev. Rul. 82-23, 1982-1 C.B. 139).

➔ **Planning Point:** The governing instrument needs to address the burden of any federal and state estate taxes generated by the partial QTIP election.

(3) Portion of Family Trust to Qualify for Marital Deduction. In limited circumstances, the executor may wish to qualify a portion of the family trust for the marital deduction, including planning for a decedent who did not revise his or her estate planning documents after the Economic Recovery Tax Act of 1981 ("ERTA").

- If the decedent dies with a pre-1981 document that uses a "maximum marital deduction" formula, funding of the marital trust may be limited to 50% of the adjusted gross estate under the unlimited marital deduction transitional rule of the ERTA. P.L. 97-34, § 403(a)(1)(A).
- The executor may elect to have part of the family trust qualify for the marital deduction as qualified terminable interest property. Disclaimers and related post-mortem planning may be necessary to enable the family trust to meet the requirements of a QTIP trust discussed above.

- A partial QTIP election must be a fractional or percentage share of the QTIP trust and may be defined by means of a formula. Treas. Reg. § 20.2056(b)-7(b)(2)(i). A formula election is advisable, since it automatically adjusts in case the values of estate assets or the amount of deductions are changed on audit by the IRS.

  EXAMPLE: Decedent dies with a pre-1981 document subject to the ERTA transitional rule. The executor may elect to qualify a fractional share of the family trust for the marital deduction as QTIP, of which (i) the numerator is the smallest marital deduction amount which will result in no federal estate tax payable by reason of testator's death, and (ii) the denominator is the federal estate tax value of the assets included in testator's gross estate which became (or the proceeds, investments or reinvestments of which became) a part of the family trust after payment of all taxes and expenses.

h. Contingent ("Clayton") QTIP. An alternative to the "traditional" partial QTIP election described above is the contingent QTIP election (also called a *Clayton* QTIP). Under this strategy, the terms of a QTIP trust provide that the portion of the trust with respect to which the executor does not make the QTIP election will pass to the family trust, the beneficiaries of which may include the surviving spouse and descendants. The decedent's executor determines the fractional or percentage amount of the marital deduction desired relative to the residue of the decedent's estate as with a traditional partial QTIP election. In addition, the executor is essentially empowered to change the disposition of the potential QTIP property based on the extent to which a QTIP election is made. Treas. Reg. §§ 20.2056(b)-7(d)(3) and -7(h), Ex. 6, allows this technique without disallowing the marital deduction.

Furthermore, because the decedent's executor can determine the appropriate amount of the marital deduction and the corresponding amount for the family trust, a marital deduction formula, whether a reduce-to-zero, equalization or any other formula, is unnecessary. Although utilizing a contingent QTIP does not require the use of a formula, the estate plan could direct that the family trust be funded first with the decedent's remaining estate tax applicable exclusion amount and then that the residue be transferred to a trust that would be available for a QTIP election. Any assets composing the portion of the marital trust for which the marital deduction was not elected (or any assets that do not qualify for the marital deduction) can be directed to pass outright to nonspouse beneficiaries or to another trust for the benefit of the surviving spouse and other beneficiaries.

➔ **Planning Point:** The provisions applicable to the contingent QTIP trust must be drafted carefully so that, if the predeceasing spouse dies in 2010 when the federal estate tax is not applicable and when, therefore, there would be no QTIP election, a mechanism exists to shift property out of the marital trust to the alternative dispositions.

➔ **Planning Point:** As with a partial QTIP election, it might be preferable for an executor who is not the surviving spouse and is independent to have this power because that person would be more likely to make an objective decision. Further, in the contingent QTIP context, a surviving spouse, as sole executor, could be considered to have made a transfer within the meaning of IRC § 2036 to the extent he or she does not make the full available QTIP election.

As with a partial QTIP election, the executor generally has up to 15 months (nine-month due date for filing the decedent's Form 706 plus a six-month extension) after the decedent's death to assess the current situation and determine the appropriate QTIP election approach. Because of the 15-month post-death window period available to the executor to determine how much trust property should be elected for the QTIP marital deduction, there is no need for a six- month survival requirement clause in the decedent's governing instrument.

The surviving spouse has a mandatory income interest only in the portion of the marital share for which a QTIP election is made. This is an advantage over the traditional partial QTIP election strategy, which requires that both the elected and non-elected portions confer on the surviving spouse a mandatory income interest.

On the other hand, by not requiring the income from the trust holding non-elected property to be paid to the surviving spouse, the opportunity to obtain the credit for tax on prior transfers (the "TPT credit") under IRC § 2013 if the surviving spouse dies within ten years may be forfeited. This is because a trust that does not require that its income be distributed to the surviving spouse (or which permits distributions to other people) may not give the surviving spouse an interest in the trust that is capable of being valued actuarially. The TPT credit is further discussed below in Section K.1.

➔ **<u>Planning Point</u>:** Whenever a contingent or partial QTIP marital deduction trust is used, provisions must be added to the trust instrument concerning the apportionment of federal and state estate taxes attributable to the property that is not elected for the marital deduction. Care must be taken to ensure that estate taxes attributable to non-elected QTIP are not apportioned against the elected property. Many estate tax apportionment clauses (and default rules under state law) apportion estate taxes to the residue of the grantor's estate. Such a provision could decrease the marital deduction (to the extent of the estate taxes apportioned against property qualifying for the marital deduction). The practitioner should specifically apportion to the non-elected property the burden of any federal estate taxes and non-deductible state estate taxes attributable to that property. The client's estate planning documents should make clear that in no event will any property that qualifies for the marital deduction bear the burden of any non-deductible estate tax.

i. **<u>Generation-Skipping Transfer Tax Planning</u>**. The generation-skipping transfer ("GST") tax is imposed on any transfer of property from an individual to persons who are more than one generation younger than the transferor (*e.g.*, transfers to grandchildren, great-grandchildren, grand nieces and nephews), and to non-relatives who are more than 37-1/2 years younger than the transferor. The tax applies whether the transfer is an outright gift or bequest, a distribution of current income or principal from a trust, or a distribution on termination of a trust.

The tax is imposed at a flat rate, which is equal to the highest estate tax rate on the largest of estates. It is assessed *in addition to* any gift or estate tax that may be incurred by reason of the transfer.

In 2010, the GST tax is not in effect. Thus, no GST exemption can be allocated. Under current law, in 2011 the tax is re-instituted and an individual can transfer up to $1,000,000 or the amount of his or her unused GST exemption (whichever is lower) free of the GST tax. Beginning in 2011, the GST exemption may be adjusted annually for inflation.

An individual (or his or her executor) may allocate the GST exemption to transfers made during life or at death. The GST exemption is cumulative during life and at death. In addition to the GST exemption, the following transfers are excluded from application of the GST tax: (1) outright gifts qualifying for the gift tax annual exclusion; (2) gifts in trust that qualify for the gift tax annual exclusion if certain requirements are met (*e.g.,* generally, annual exclusion gifts made to an irrevocable life insurance trust are not exempt from GST tax); (3) medical and tuition payments that are exempt from gift tax; (4) pre-September 26, 1985 irrevocable trusts, which are "grandfathered" from GST tax if there are no additions or substantial changes in the trust provisions; and (5) gifts or bequests to a grandchild if the grandchild's parent was a child of the transferor and is deceased at the time of the gift or bequest.

(1) **QTIP Trust**. A QTIP trust enables some married individuals to use their GST exemption fully to the extent it is not otherwise used during life or at death. IRC §§ 2631(a), (c).

- Under current law, when the GST tax returns in 2011, an individual could create a lifetime generation-skipping trust, fully fund it with $1,000,000 of assets and incur no GST or gift tax. If his or her spouse consented to split gift treatment, $2,000,000 of assets could be set aside in a generation-skipping trust during life, without incurring gift or GST tax.
- Alternatively, the individual could establish a $1,000,000 generation-skipping trust at his or her death. Under current law, if the individual died in 2011, no estate tax will be incurred if the decedent still has his or her $1,000,000 applicable exclusion at his or her death.
- Many married individuals are unwilling to incur gift or estate tax any earlier than absolutely necessary and therefore do not want to create a trust to utilize their GST exemption until the death of both spouses.

(2) **GST Exempt and Non-Exempt Trusts**. Accordingly, many married individuals who want to use their full $1,000,000 GST exemption and defer all gift and estate taxes until the death of the surviving spouse will create one or two trusts at the first death:

- A family trust that uses the applicable exclusion amount (also called the credit shelter amount) and GST exemption, which are both $1,000,000 for 2011.
- The balance will pass either outright to the surviving spouse or in a marital trust.

If the taxpayer has eroded his or her GST exemption but has kept his or her entire applicable exclusion amount intact, the taxpayer's estate plan can create an exempt family trust that will be funded with the remaining GST exemption and a non-exempt family trust that will be funded with the taxpayer's applicable exclusion amount minus the remaining GST exemption. The balance will pass either outright to the surviving spouse or in a non-exempt marital trust.

Conversely, if the taxpayer has eroded his or her applicable exclusion amount but has kept the entire GST exemption intact, the taxpayer's estate plan can create a family trust that will be funded with the remaining applicable exclusion amount and an exempt QTIP marital trust that will be funded with the amount of the GST exemption minus the remaining applicable exclusion amount. The balance will pass either outright to the surviving spouse or in a non-exempt marital trust. As to the exempt marital trust, the executor will make a "reverse QTIP election" for generation-skipping transfer tax purposes under IRC § 2652(a)(3) so that the decedent remains the transferor for GST tax purposes of this trust after the death of the surviving spouse even though the trust is includible in the surviving spouse's gross estate.

> **EXAMPLE:** Decedent dies in 2011 with an estate of $2,300,000. Decedent's GST exemption was unused at Decedent's death, but his applicable exclusion amount had been reduced to $500,000. To fully utilize Decedent's GST exemption, Decedent's estate plan created a family trust funded with $500,000, an exempt QTIP trust funded with $500,000 and a separate non-exempt QTIP trust funded with the remaining $1,300,000. Decedent's executor allocated $500,000 of Decedent's GST exemption to the family trust and $500,000 to the exempt QTIP trust for which the executor also made a reverse QTIP election. This estate plan fully allocates Decedent's GST exemption and defers estate taxes until the death of the surviving spouse.

➔ **Planning Point:** A partial reverse QTIP election is not allowed. Therefore, the election must be made for the entire value of the trust to which the reverse QTIP election applies.

(3) Drafting Non-GST Exempt Marital Trusts. The non-GST exempt marital trust can be either a QTIP trust or a general power of appointment trust. This non-GST exempt trust often will provide that, at the death of the surviving spouse, the federal and state estate taxes payable by reason of the inclusion of the GST exempt QTIP trust and the non-exempt marital trust in the gross estate of the surviving spouse will be paid from the non- exempt marital trust so that the exempt QTIP trust will not be reduced by estate taxes.

➔ **Planning Point:** The non-exempt marital trust also can provide for the use of the surviving spouse's GST exemption. To do so, an amount or fraction of the non-exempt marital trust equal to the unused GST exemption of the surviving spouse would be added to the family trust and the exempt QTIP trust, to pass directly to or in trust ultimately for the benefit of one or more skip persons.

(4) **Other Options**. If a client's estate plan does not contain distributions to or in trust for skip persons, the estate plan can incorporate other, less complex provisions regarding the GST exemption, including the following:

- In order to provide for an unusual order of deaths or other unplanned distributions to skip persons, the governing instrument can (i) provide for a QTIP trust and (ii) give the trustee the power to divide a trust into exempt and non-exempt trusts for GST tax purposes or
- The trustee can use the above administrative power to divide a QTIP trust into two separate trusts, a GST exempt QTIP trust and a non-GST exempt QTIP trust. At the death of the surviving spouse, the administrative power could authorize the trustee to (i) pay death taxes solely from the non-exempt QTIP trust and (ii) allocate to the exempt QTIP trust distributions that are more likely to be to skip persons or generation-skipping trusts.

➔ **Planning Point:** The election to allocate the unused portion of a decedent's GST exemption must be made within the time allowed to file the federal estate tax return, including extensions. Such allocation is irrevocable. If a timely election was not made, the executor may request an extension of time within which to make the election. Treas. Reg. § 301.9100-1.

6. Non-U.S. Citizen Surviving Spouse

Generally, the estate tax marital deduction is not allowed for transfers to a surviving spouse who is a non-U.S. citizen whether it is an outright distribution or a transfer to trust. IRC § 2056(d). The rationale for such rule is to make sure the property for which the marital deduction is allowed will later be subject to federal estate tax in the surviving spouse's estate. When the IRS is certain the assets will be subjected to federal estate tax in the surviving spouse's estate, the IRS permits an exception to the above rule.

a. Resident Spouse Becomes a Citizen Prior to Due Date of Estate Tax Return. The estate tax marital deduction is allowed if the non-U.S. citizen surviving spouse was a U.S. resident at all times after the decedent's death and before becoming a U.S. citizen, and if the surviving spouse becomes a U.S. citizen before the estate tax return is filed.

➔ **Planning Point:** Practitioners should include a question on their estate planning questionnaires regarding citizenship. Although the IRS allows the marital deduction if a surviving spouse becomes a U.S. citizen before the estate tax return is due, as a practical matter, it is extremely difficult to complete the citizenship requirements within that time frame. Therefore, citizenship issues should be dealt with before the death of the first spouse.

b. Qualified Domestic Trust. A qualified domestic trust ("QDOT") is not a separate type of marital deduction trust. Rather, a QDOT is a marital deduction trust which has additional requirements imposed upon it because the surviving spouse is not a U.S. citizen. IRC

§ 2056A provides that a trust is a qualified domestic trust and qualifies for the estate tax marital deduction if the following requirements are met:

- At least one trustee of the trust must be a U.S. citizen or a domestic corporation;
- No distribution (other than income) may be made from the trust unless the trustee who is a U.S. citizen or domestic corporation has the right to withhold from the distribution the tax imposed by IRC § 2056A on such distributions;
- The trust must satisfy requirements detailed in the regulations to ensure the collection of estate tax from the trust, including use of a U.S. bank, bond or letter of credit if the fair market value of the assets passing to the QDOT exceeds $2,000,000 at the decedent's date of death or the alternate valuation date. Treas. Reg. § 20.2056A-2(d)(1)(i)(A), (B), or (C);
- The decedent's executor makes an irrevocable election on the decedent's estate tax return to treat the trust as a QDOT; and
- The trust meets the requirements of IRC § 2056(b) (*e.g.,* a general power of appointment trust or QTIP trust).

(1) **Tax on Distributions from QDOT**. Certain distributions from a QDOT (other than income or hardship distributions) before the surviving spouse's death, and certain distributions of any remaining property in the QDOT at the surviving spouse's death, are subjected to estate tax at the rate described in IRC § 2056A(b)(2).

(2) **QDOT May Be Created by the Decedent or Surviving Spouse**. If a surviving spouse who is not a U.S. citizen receives a bequest or trust distribution by reason of the death of his or her spouse, the surviving spouse may transfer that property to a QDOT before the filing date for the federal estate tax return, and the transfer will be treated as a transfer from the decedent to a QDOT that qualifies for the federal estate tax marital deduction. IRC § 2056(d)(2)(B).

➔ **Planning Point:** The ability of the surviving spouse to add assets to a QDOT is helpful where the spouse receives property from the decedent outright, either through the client's probate estate or outside of probate (*e.g.*, joint tenancy property, life insurance proceeds, individual retirement accounts).

(3) **Individual Retirement Accounts**. One of the decedent's largest investment assets may be an individual retirement account (IRA). If the surviving spouse is not a U.S. citizen, the question arises as to how the decedent's interest in the IRA can qualify for the marital deduction.

- If the beneficiary of the IRA is a QTIP marital trust, the solution is straightforward. The QTIP trust simply is drafted to satisfy the QDOT requirements.
- If the beneficiary of the IRA is the surviving spouse outright, the spouse probably will withdraw the property in the IRA and roll it over to his or her own

IRA account, titled in the name of the surviving spouse. The surviving spouse's IRA account should have a domestic corporation as trustee. It will satisfy the requirements of a general power of appointment marital trust (IRC § 2056(b)(5)) because the spouse may withdraw any part or all of the income and principal of the IRA trust at any time. The spouse and the IRA trustee can amend the IRA trust to satisfy all of the QDOT requirements. Thus, the spouse's IRA trust serves as the qualified domestic trust.

➔ **Planning Point:** An appropriate IRA trustee is needed. With the spousal rollover approach, the financial institution that serves as IRA trustee must be knowledgeable about estate tax and trusts. Many financial institutions (*e.g.*, mutual funds, brokerage firms, savings and loan associations) may not completely understand the rules applicable to a QDOT. Also, the qualified domestic trust amendments to the financial institution's IRA trust form should be handled in such a manner that they do not jeopardize the favorable IRS determination letter issued to the prototype IRA trust.

E. Selecting Marital Deduction Trusts – QTIP v. GPOA

1. Advantages of a QTIP Trust over a GPOA Trust

As discussed earlier, the QTIP trust was created by the Economic Recovery Tax Act of 1981, and it has since become the predominant marital deduction trust. The QTIP marital trust has significant advantages over the traditional general power of appointment (GPOA) marital trust.

a. **Control**. The testator or settlor can determine how much or little control to give the surviving spouse over the QTIP trust. In order to qualify for the gift and estate tax marital deduction, the spouse is required to have only an income interest for life. On the other hand, many individuals wish to give the spouse broad control over and benefits from a QTIP trust (*e.g.*, generous principal distribution provisions, "5 or 5" annual withdrawal rights, limited testamentary power of appointment, and spouse as sole trustee or as co-trustee). With a GPOA trust, the spouse must have a power to appoint the entire trust, and the deceased spouse has no control over such power.

b. **Protection Against Remarriage of Surviving Spouse**. A QTIP trust can be drafted to preclude a spouse who remarries from appointing the marital trust at death to his or her second spouse or children of the spouse's second marriage. In addition, principal distributions can be eliminated upon the surviving spouse's remarriage or cohabitation. However, with a GPOA trust, the power to appoint must be unlimited.

c. **Post-Mortem Planning**. Use of a QTIP trust facilitates post-mortem marital deduction planning, including a partial QTIP election and division of the marital trust into elected and non-elected portions or adding the non-elected portion to the family trust. The GPOA trust is not as flexible as the QTIP trust.

d. **Minimizing Generation-Skipping Transfer Tax**. A QTIP trust can facilitate planning for minimizing the generation-skipping transfer tax by allowing the testator or settlor to create a marital trust for which the reverse QTIP election is made under IRC § 2652(a)(3).

The GPOA trust does not allow for the ability to minimize generation-skipping transfer tax.

e. **Valuation Discounts**. Use of a QTIP trust can facilitate obtaining valuation discounts at the death of the surviving spouse. Following the Fifth Circuit decision in *Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996), the Tax Court has held in three separate cases that the assets of a QTIP marital trust includible in the gross estate of the surviving spouse under IRC § 2044 are not aggregated with other assets includible in the surviving spouse's gross estate under IRC § 2033 (outright ownership) or IRC §§ 2036 and 2038 (the surviving spouse's revocable trust) for purposes of valuing the assets of the QTIP trust. *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999), *acq*. AOD 99-006, 1999-35 I.R.B. 314; *Estate of Nowell v. Comm'r*, T.C. Memo. 1999-15; *Estate of Lopes v. Comm'r*, T.C. Memo. 1999-225. Because such interests are not aggregated, a valuation discount may be obtained for each of the separate interests in the gross estate of the surviving spouse, thereby reducing the federal estate tax obligation of the surviving spouse.

2. Advantages of a GPOA Trust over a QTIP Trust

Even though the QTIP trust is used more frequently, there are some advantages to the general power of appointment trust.

a. **Spouse as Trustee**. A surviving spouse may serve as the sole trustee of a GPOA trust, and the trust may have broad discretionary principal distribution provisions. Adverse tax consequences are possible if a QTIP trust has such provisions.

b. **Unlimited Right to Withdraw**. The surviving spouse has an unlimited right to withdraw any or all of the principal of a GPOA trust during the surviving spouse's lifetime. Such right may allow the surviving spouse the ability to make inter vivos gifts to third parties from the trust property. A decedent may grant this power to the surviving spouse to allow more flexibility to the surviving spouse to reduce the amount subject to taxation in the estate of the surviving spouse and to shift income during the surviving spouse's lifetime.

c. **Elective Share**. With a QTIP trust, a surviving spouse may be more likely to exercise the spouse's elective share rights as the surviving spouse does not have control over the use or ultimate distribution of the trust's assets. Whereas with a GPOA trust, the surviving spouse controls the ultimate distribution of the trust assets, and may have a lifetime general power of appointment.

d. **Assignment of Income**. For a surviving spouse who may be in the higher income tax brackets, the use of a GPOA trust may allow the spouse to assign income to a beneficiary who is in a lower tax bracket. The surviving spouse is permitted to have a lifetime general power of appointment under the GPOA trust, and the spouse may use that power to distribute income to the beneficiary in the lower tax bracket.

F. Common Marital Deduction Formula Provisions

1. Unlimited Marital Deduction Formula Clauses

The marital deduction formula determines how much property will be distributed to the surviving spouse or to a marital trust for the benefit of the surviving spouse and how that distribution is to be funded. An optimal marital deduction formula automatically adjusts the amount of the marital disposition so that generally no federal or state estate tax is payable at the death of the first spouse and all estate tax is deferred until the death of the surviving spouse.

The most common marital deduction formulae that are discussed in this Chapter are:

- True pecuniary marital formula
- Fractional share marital formula – pro rata and pick and choose
- Fairly representative pecuniary marital formula
- Reverse pecuniary formula
- Minimum worth pecuniary marital formula

2. True Pecuniary Marital Deduction Formula

A true pecuniary marital deduction formula is one in which the marital distribution is a ***dollar amount*** determined and satisfied in cash or in kind. When satisfied in kind, assets are ***valued on the date of distribution***. This type of marital funding provision is also sometimes called a *true worth funding* because the marital distribution consists of cash or other assets that on the date of funding have a value exactly equal to the pecuniary amount of the marital distribution.

> **<u>EXAMPLE</u>:** An example of a true pecuniary marital deduction formula is as follows:
>
> "If my spouse survives me, the trustee shall set aside, to be administered as provided in the Marital Trust, the minimum amount that, if allowed as a marital deduction in determining the federal estate tax on my estate, will cause my estate to incur no, or the least, such tax.
>
> In computing such amount, the asset values, deductions and credits as finally determined in the federal estate tax proceedings in my estate shall control, and, among available credits, only the unified credit shall be used.
>
> In funding such amount, only assets for which a marital deduction is allowable shall be used, and all assets used shall be set aside at then current fair market values. I recognize that the amount described in this Article may be affected by the exercise of, or failure to exercise, certain tax elections. I also acknowledge the possibility that no property will be set aside under this Article.
>
> Despite any other provision in this instrument, the amount described in this Article shall be computed after considering payments made or to be made to pay for my debts, the administration expenses of my estate, my funeral expenses, the expenses of my last illness and death taxes that are deducted for estate tax purposes. The property set aside or to be set aside under this Article shall not be reduced, however, by the amount of any

such payments.

If my spouse survives me, the balance of the Residuary Trust (and any other property that, but for the making of a qualified disclaimer by my spouse, would be set aside under the preceding provisions of this Article) shall be administered as provided in the Family Trust."

See also PLR 8447003 (a trust that was to distribute "an amount equal to one-fourth of the principal of the trust" was ruled a fractional share marital formula).

a. **Advantages of a True Pecuniary Marital Deduction Formula**. The advantages of a true pecuniary marital deduction formula include the following:

- The executor or trustee can pick and choose the assets with which to fund the marital deduction.

➔ **Planning Point:** Assets having the greatest potential for appreciation can be used to fund the family trust, and assets that are expected to appreciate more slowly or decline in value can be used to fund the marital distribution or trust. Similarly, in a rising market, the marital deduction distribution can be funded later and with less property since date of distribution values are used, which increases the amount of property in the family trust and decreases the estate tax at the death of the surviving spouse.

- A true pecuniary marital funding provision is generally considered to be the simplest to compute and to fund.

➔ **Planning Point:** Commentators suggest that a true pecuniary marital deduction formula should be used if the estate contains real property subject to special use valuation under IRC § 2032A.

b. **Disadvantages of a True Pecuniary Marital Deduction Formula**. There are a number of disadvantages of a true pecuniary marital deduction formula that may or may not offset its flexibility and simplicity, including the following:

- Capital gains will be generated if the marital distribution is funded with assets that have appreciated between the date of death (or alternate valuation date) and date of distribution because a fixed dollar obligation is being satisfied and the funding is treated as a sale or exchange. Treas. Reg. § 1.1014-4(a)(3); *Suisman v. Comm'r*, 15 F. Supp. 113 (D.C. Conn. 1935), *aff'd*, 83 F.2d 1019 (2d Cir. 1936); *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir. 1940); see Treas. Reg. § 1.661(a)-2(f).

➔ **Planning Point:** Capital gains are realized by the estate or trust that funds the pecuniary marital distribution. See Rev. Rul. 60-87, 1960-1 C.B. 286. The tax in effect is borne by the non-pecuniary family trust since distributions to pay income taxes will reduce the amount of the residue.

- Capital losses would be realized where an executor funds a true pecuniary marital distribution with assets that had depreciated between the date of death (or alternate valuation date) and the date of distribution.

➔ **<u>Planning Point</u>:** In general, only $3,000 of capital losses may be taken in any year. IRC § 1211(b).

➔ **<u>Planning Point</u>:** Capital losses incurred by a trustee of a revocable trust in funding a marital trust pursuant to a pecuniary formula cannot be recognized. IRC §§ 267(a)(1), (b)(5). This problem can be avoided by the trustee selling the depreciated assets to recognize the loss before funding and then distributing cash in satisfaction of the distribution to the marital trust.

The Tax Reform Act of 1997 amended IRC § 267 by adding a paragraph that generally disallows the recognition of loss on a sale or exchange of property between an executor of an estate and a beneficiary of such estate "[e]xcept in the case of a sale or exchange in satisfaction of a pecuniary bequest…." IRC § 267(a)(1), (b)(13) as amended by TRA '97 § 1308(a), effective for tax years beginning after August 5, 1997.

Hence, it appears that a loss that is realized in funding a true pecuniary marital distribution under a will still can be recognized subject to the $3,000 per year limitation.

- Another disadvantage of a true pecuniary funding formula, whether for the marital or family trust, is that funding such a distribution with the right to receive income in respect of a decedent ("IRD"), *e.g.*, individual retirement accounts, a professional entitled to receive substantial contractual death benefits, or a real estate developer with installment sales contracts, is a transfer that accelerates the taxability of the IRD. IRC § 691(a)(2); Treas. Reg. § 1.691(a)-4; *Noel v. Comm'r*, 50 T.C. 702 (1968).

➔ **<u>Planning Point</u>:** This can be a significant issue in the case of a decedent whose estate consists mostly of IRD. This problem can be minimized by making the pecuniary trust the smaller of the two trusts. The problem can also be minimized by making a specific bequest of the item of IRD of a decedent either to the residuary trust or to the marital trust (as circumstances require), or by using a fractional share marital formula.

- A true pecuniary marital distribution requires the executor or trustee to revalue the assets being distributed on the date or dates of distribution.

➔ **<u>Planning Point</u>:** With interests in real estate, closely-held businesses or valuable artwork, a true pecuniary marital deduction provision creates a substantial added expense. However, a non-pro rata fractional share marital formula (discussed below) would also require a revaluation of the assets.

- In a falling market, the executor or trustee will be under pressure to fund the pecuniary amount trust early because any decline in the overall value of the assets will reduce the residuary family trust. If the marital disposition is funded early, the estate loses the advantage (admittedly nominal with compressed income tax brackets) of being a separate taxpayer with respect to the assets distributed in satisfaction of the marital gift. Early funding may also result in decisions being made before all of the variables, such as the amount of the marital deduction, death taxes and cash requirements, are known.

> **EXAMPLE:** Decedent's estate is valued at $5,000,000 on the date of death. Pursuant to Decedent's estate plan utilizing a true pecuniary marital deduction formula, the marital disposition is to receive $4,000,000, and the nonmarital disposition is funded with the residue ($1,000,000 based on date of death values). During administration, the estate declines 20% in value to $4,000,000. At funding, the marital trust receives $4,000,000 (the pecuniary amount), and the nonmarital disposition receives zero. Unhappy beneficiaries of the nonmarital disposition may sue the fiduciary. To protect itself, the executor or trustee may fund the marital disposition shortly after death to ensure the nonmarital disposition is not eliminated if the value of the estate declines between the date of death and the date of funding. If the marital disposition is funded shortly after death with $4,000,000 and all assets passing under the estate plan then decline in value by 20%, the nonmarital disposition would eventually receive $800,000, while the marital disposition would eventually decline in value to $3,200,000.

Similarly, if the estate appreciates substantially in value after death, the spouse may sue the fiduciary, arguing that it should have funded the marital disposition shortly after death with assets that later increased in value. See, e.g., *Smail v. Smail*, 617 S.W.2d 889 (Tenn. 1981); *In re Estate of Marks*, 211 Ill. App. 3d 53 (2nd Dist. 1991).

- The holding period for long-term capital gains purposes begins on the date of satisfaction of the pecuniary distribution rather than on the earlier date of death.
- All excess deductions on termination of the estate will be allocated to the residuary nonmarital disposition, which may not have sufficient income to utilize the deductions. See IRC § 642(h).
- In the second marriage situation, where the children of the first marriage are the beneficiaries of the residuary nonmarital disposition, there may be conflicts of interest if the surviving spouse is the executor with the authority to allocate the most desirable assets to the pecuniary marital distribution.

➔ **Planning Point:** A true pecuniary marital formula may not be appropriate where beneficiaries of the marital trust and the family trust are contentious (*e.g.*, second spouse and children by first marriage), regardless of whether the surviving spouse is named as the fiduciary.

- Funding a pecuniary formula distribution will carry out distributable net income from the estate or trust even though the distribution is in satisfaction of a pecuniary amount. Treas. Reg. § 1.663(a)-1(b)(1).

3. Fractional Share Marital Formula

The marital disposition may be computed as a fractional share of the residue of the estate or trust.

> **EXAMPLE:** An example of a fractional share marital formula is as follows:
>
> "If my spouse survives me, the trustee shall set aside, to be administered as provided in the Marital Trust, a fraction of the Residuary Trust. The numerator of such fraction shall equal the minimum amount that, if allowed as a marital deduction in determining the federal estate tax on my estate, will cause my estate to incur no, or the least, such tax. The denominator of such fraction shall equal the value of the Residuary Trust.
>
> In computing such fraction, the asset values, deductions and credits as finally determined in the federal estate tax proceedings in my estate shall control, and, among available credits, only the unified credit shall be used.
>
> In funding such fraction, only assets for which a marital deduction is allowable shall be used. I recognize that the numerator of the fraction described in this Article may be affected by the exercise of, or failure to exercise, certain tax elections. I also acknowledge the possibility that no property will be set aside under this Article. Despite any other provision in this instrument, the numerator of the fraction described in this Article shall be computed after considering payments made or to be made to pay for my debts, the administration expenses of my estate, my funeral expenses, the expenses of my last illness and death taxes that are deducted for estate tax purposes. The property set aside or to be set aside under this Article shall not be reduced, however, by the amount of any such payments.
>
> If my spouse survives me, the balance of the Residuary Trust (and any other property that, but for the making of a qualified disclaimer by my spouse, would be set aside under the preceding provisions of this Article) shall be administered as provided in the Family Trust."

a. The Minimum Amount Marital Distribution. The marital formula set forth above involves a *minimum amount* marital distribution. This marital formula gives the marital trust a share measured by "the minimum amount that … will cause my estate to incur no, or the least, such tax." In most cases, the "… no, or the least, such tax." will be zero. This formula is a *reduce estate tax to zero* formula. It gives the marital trust a share measured by the optimal marital deduction amount allowed by the unlimited marital deduction used in conjunction with the applicable exclusion amount.

- The concept is not to fund the marital trust with any more assets than required to reduce the federal estate tax to zero. The *minimum amount* requirement keeps the marital trust as small as possible.
- The *minimum amount* formula will automatically adjust the amount of the marital trust to obtain the optimal marital deduction. The formula automatically considers expenses and other legacies which affect the optimal marital amount, so that the governing instrument need not expressly mention those items. The formula also automatically adjusts for yearly increases in the applicable exclusion amount.

<u>EXAMPLE</u>: The *minimum amount* formula is illustrated in the following simplified example. Assume the testator dies in 2011 and has a gross estate of $2,500,000.

$2,500,000	Gross estate
(70,000)	Administration expenses deducted on Form 1041
(30,000)	Cash legacies to children
$2,400,000	Balance

The marital trust will be funded with $1,500,000, which is the smallest marital deduction amount that will result in no federal estate tax being payable. The remaining $1,000,000 is allocated to the family trust. Note that part of the client's $1,000,000 applicable exclusion amount is used up by payments ($70,000) and bequests ($30,000) that are not deductible for federal estate tax purposes.

If the $70,000 of administration expenses were deducted on the federal estate tax return (Form 706), the marital trust would be funded with only $1,430,000, because that amount would be the smallest marital deduction that would result in no federal estate tax being payable. The family trust would be funded with $1,070,000, and $100,000 of that amount would then be used to pay the expenses and legacies.

The marital formula set forth above provides that "the numerator of the fraction… shall be computed after considering payments made or to be made to pay for my debts, the administration expenses of my estate, my funeral expenses, the expenses of my last illness and death taxes that are deducted for estate tax purposes." This ensures that the marital deduction distribution is not inadvertently diminished. The will and revocable trust agreement (if any) should also contain coordinated tax and expense clauses that specify which assets or portion of the estate and trust bear the burden of death taxes and expenses.

➔ **Planning Point:** The practitioner should always obtain copies of any estate planning documents that the client has executed. The tax clauses must be reviewed, and it must be determined who should bear the burden of paying the taxes on the assets which will be includible in the client's gross estate for federal estate tax purposes.

The phrase "only assets for which a marital deduction is allowable shall be used" is included in the marital deduction formula because this funding provision may be used with a QTIP marital trust.

- Not all of the QTIP trust may be qualified for the marital deduction. The executor may make only a partial QTIP election. Regardless of the election actually made, however, the marital trust should be funded with sufficient assets so that, if all of the trust did qualify for the marital deduction, the optimal marital deduction would be obtained taking into account the applicable exclusion amount.
- In calculating the distribution to the marital trust, it is assumed that all of the assets passing to the trust will qualify for the marital deduction, regardless of any partial QTIP election or disclaimer.

b. Advantages of a Fractional Share Marital Formula. Advantages of a fractional share marital funding formula include the following:

- As discussed further below, generally, no capital gain taxes are incurred in funding either the marital or nonmarital disposition.
- Both the marital and nonmarital shares bear a proportionate amount of any increase or decrease in value of the estate between date of death and date of funding.
- There is no acceleration of income in respect of a decedent ("IRD") in funding the marital and non-marital shares, and no need to make a specific gift of items of IRD. See Treas. Reg. § 1.691(a)-4(b).
- There is no need to revalue the assets on date of distribution unless non-pro rata distributions are made.
- Excess deductions on termination of an estate are allocated proportionately to the marital and non-marital distributions.
- There is no pressure to fund early because the date of funding does not alter the share of appreciation or depreciation borne by the marital and non-marital shares. The estate can be used longer as a separate income tax entity.
- In a second marriage situation or in others where absolute fairness is more important than saving taxes at the death of the surviving spouse, a fractional share marital formula is often used to avoid family conflicts and other difficulties.

c. Disadvantages of the Fractional Share Marital Formula. The disadvantages of a fractional share marital formula include the following:

- If the assets of the estate or trust increase in value from the date of death to the date of funding, more assets are used to fund the marital share than would be used with a true pecuniary marital deduction formula using date of distribution funding language. If a true pecuniary marital deduction formula were used, all the appreciation would be allocated to the family trust.
- If an allocation between the marital and nonmarital shares is made on a non-pro rata basis and there is no specific authority in the governing instrument or under state law for making such distributions, the transaction will be treated as a sale or exchange between the marital and nonmarital trusts causing recognition of gain on any appreciation in the allocated assets from the date of death or alternate valuation date until the date of funding. See Rev. Rul. 69-486, 1969-2 C.B. 159; Treas. Reg. §§ 1.661(a)-2(f); 1.1014-4(a)(3). If the governing instrument gives the executor or trustee the authority to make a non-pro rata allocation between the marital and nonmarital shares such that the executor or trustee can choose the assets in funding the two trusts, many - probably most - commentators believe that no capital gain will be recognized in these circumstances. See *In re Fiedler's Estate*, 151 A.2d 201 (N.J. Super. 1959); Rev. Rul. 69-486, 1969-2 C.B. 159. However, marital and nonmarital dispositions funded on a non-pro rata basis would have to be revalued and issues of fairness and impartiality might arise.

➔ **Planning Point:** UTC § 816(22) provides trustees with the power to allocate particular assets in proportionate or disproportionate shares among beneficiaries, to value the trust property for these purposes and to adjust for resulting differences in value. Thus, in states that have enacted this provision of the UTC, a trustee can make non-pro rata distributions without tax consequences, provided the trust instrument does not prohibit non-pro rata distributions.

- A fractional share marital formula is generally considered to be more inflexible and difficult to administer than a true pecuniary marital deduction formula.
- A fractional formula is generally believed to require the executor or trustee to fractionalize each asset in funding the marital and non-marital shares, except for de minimis amounts.

➔ **Planning Point:** Fractionalizing some assets (e.g., round lots of listed securities, investment real estate and closely-held business interests) may reduce the value of the assets, or may be simply impossible.

- The fraction must be recomputed if there is a partial distribution that is non-pro rata, or if the federal estate tax values are changed on audit, or if administration expenses are different than the amount estimated when the fraction is computed.

d. **Pro Rata Fractional Share Funding**. Pro rata funding of a fractional share marital formula involves the executor dividing each and every asset according to the fraction determined using the formula. For example, if the formula created a fraction of 1,000,000/3,000,000, each asset would be allocated 33.33% to the marital trust and 66.67% to the family trust.

The advantages of the pro rata fractional share funding include no gain or loss on funding of the marital trust and family trust shares, the depreciation and appreciation are ratably apportioned between the two trusts avoiding any problems with Rev. Proc. 64-19 (discussed below), and revaluation of the assets is not required when funding. However, the pro rata fractional share funding does have several significant disadvantages:

- Because the appreciation and depreciation are ratably apportioned, the marital trust may be overfunded or underfunded depending on the date of distribution values;
- The trustee has no discretion when selecting which assets to use to fund the trusts;
- As explained further above, if non-pro rata distributions are made, capital gains are incurred; and
- A pro rata fractional share funding formula is difficult to administer.

e. **Pick and Choose Fractional Share Funding**. A pick and choose fractional share funding formula utilizes the same fractional formula; however, it allows the trustee to pick and choose, as the name implies, which assets should be distributed in kind when funding the marital bequest. The advantages are maximum flexibility, no Rev. Proc. 64-19 issues (discussed below), and favorable income tax treatment. Disadvantages include the fact that a revaluation of the assets must be performed upon each distribution in satisfaction of the fractional bequest, and uncertainty exists as the pick and choose method is not well established.

4. Fairly Representative Pecuniary Marital Formula

A fairly representative pecuniary marital formula (also referred to as a Rev. Proc. 64-19 marital formula) provides that the amount of the marital distribution is determined as a ***dollar amount*** that is satisfied in cash or in kind, with assets which are distributed in kind ***valued at their federal estate tax values*** (or income tax basis if acquired after death) rather than using date of distribution values in determining the amount of the marital distribution. This clause is based on the requirements of Rev. Proc. 64-19, 1964-1 C.B. 682. This is a pecuniary formula that seeks to avoid the capital gain on funding issue that is present with the true pecuniary marital deduction formula using date of distribution values, as discussed above.

> **EXAMPLE:** An example of a fairly representative pecuniary marital formula provision is as follows:
>
> "If my spouse survives me, the trustee shall set aside, to be administered as provided in the Marital Trust, the minimum amount that, if allowed as a marital deduction in determining the federal estate tax on my estate, will cause my estate to incur no, or the least, such tax.

In computing such amount, the asset values, deductions and credits as finally determined in the federal estate tax proceedings in my estate shall control, and, among available credits, only the unified credit shall be used.

In funding such amount, only assets for which a marital deduction is allowable shall be used, and all assets used shall be set aside at the value as finally determined for federal estate tax purposes, except any property purchased after my death shall be valued at its cost. ***The assets, including cash, so distributed shall be fairly representative of the appreciation or depreciation in the value to the date or dates of distribution of all property available for distribution in satisfaction of such devise***. I recognize that the amount described in this Article may be affected by the exercise of, or failure to exercise, certain tax elections. I also acknowledge the possibility that no property will be set aside under this Article.

Despite any other provision in this instrument, the amount described in this Article shall be computed after considering payments made or to be made to pay for my debts, the administration expenses of my estate, my funeral expenses, the expenses of my last illness and death taxes that are deducted for estate tax purposes. The property set aside or to be set aside under this Article shall not be reduced, however, by the amount of any such payments.

If my spouse survives me, the balance of the Residuary Trust (and any other property that, but for the making of a qualified disclaimer by my spouse, would be set aside under the preceding provisions of this Article) shall be administered as provided in the Family Trust."

a. <u>Advantages of a Fairly Representative Pecuniary Marital Formula Funding Provision</u>. The advantages of a fairly representative pecuniary marital formula funding provision are as follows:

- A fairly representative pecuniary marital funding formula avoids capital gain on funding of the marital trust by using federal estate tax values (or cost for property purchased after death) in determining the amount distributed to the marital disposition;
- Unlike the fractional share marital formula, the executor or trustee can pick and choose the assets for distribution to the marital trust and need not fractionalize each asset, although when a marital trust is funded at federal estate tax values instead of date of distribution values, Rev. Proc. 64-19 requires that funding be implemented with assets (including cash) that are fairly representative of the post-death appreciation or depreciation in value of all assets that are available to fund the marital trust. Hence, the name "fairly representative."

➔ **<u>Planning Point</u>:** Rev. Proc. 64-19 does not prevent the executor or trustee from distributing to the nonmarital disposition those assets that such fiduciary believes have the greatest potential for future appreciation and distributing the other assets to the marital trust so long as appreciation or depreciation to the date of distribution is fairly allocated to the marital trust.

- Both the marital disposition and the nonmarital disposition are treated fairly in that both share in appreciation and depreciation to the date of funding on an equal basis.
- There is less pressure to fund early as compared with a true pecuniary marital formula, and the estate can be used as a separate income tax entity for a longer period.

b. <u>Disadvantages of a Fairly Representative Pecuniary Marital Formula Funding Provision</u>. The disadvantages of a fairly representative pecuniary marital formula funding provision are as follows:

- The assets must be revalued at date of distribution to demonstrate that the marital share has received a fairly representative amount of appreciation and depreciation during administration of the estate;
- If the assets of the estate or trust appreciate during the period of administration, the marital share is greater than it would be if a true pecuniary marital provision were used;
- A fairly representative pecuniary marital funding formula probably would be treated as a pecuniary formula with respect to both the acceleration of IRD issue and the allocation of excess expenses on termination issues discussed above as disadvantages of true pecuniary deduction formulas; and
- Proving that the marital share has received a fairly representative amount of appreciation and depreciation during estate administration is administratively difficult unless either the assets are revalued and careful records are kept on funding or the assets are fractionalized.

5. Reverse Pecuniary Marital Deduction Formula

When it is clear that the marital disposition will exceed the applicable exclusion amount, the amount of the applicable exclusion is sometimes stated as a pecuniary amount using date of distribution values. The marital disposition is the residue of the estate or trust. This type of funding is also sometimes referred to as a "credit shelter lead formula" and was created in response to the unlimited marital deduction brought about by the Economic Recovery Tax Act of 1981. <u>See</u> Richard B. Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* (U.S. Trust Company, 1997), page 25.

> **<u>EXAMPLE</u>:** An example of a reverse pecuniary formula is as follows:
>
> "If my spouse survives me, the trustee shall set aside, to be administered as provided in the Family Trust, the maximum amount that, if not allowed as a marital deduction in determining the federal estate tax on my estate, will cause my estate to incur no such tax.

In computing such amount, the asset values, deductions and credits as finally determined in the federal estate tax proceedings in my estate shall control. Despite the preceding sentence, all property passing under the following Article with respect to which my spouse has made a qualified disclaimer, or of which treatment as qualified terminable interest property is not effectively elected, shall be considered property for which a marital deduction is allowed. In computing such amount, among available credits, only the unified credit shall be used.

In funding such amount, assets for which a marital deduction is allowable shall be used only to the extent other assets are not available, and all assets used shall be set aside at then current fair market values. I recognize that the amount described in this Paragraph may be affected by the exercise of, or failure to exercise, certain tax elections. I also acknowledge the possibility that no property will be set aside under this Article.

Despite any other provision in this instrument, the amount described in this Paragraph shall be computed after considering payments made or to be made to pay for my debts, the administration expenses of my estate, my funeral expenses, the expenses of my last illness and death taxes that are not deducted for estate tax purposes. The property set aside or to be set aside under this Article shall not be reduced, however, by the amount of any such payments.

If my spouse survives me, the balance of the Residuary Trust shall be administered as provided in the Marital Trust. Despite the preceding sentence, any property directed in this Article to be administered as provided in the Marital Trust with respect to which my spouse has made a qualified disclaimer and any assets for which a marital deduction is not allowable shall be administered as provided in the Family Trust."

a. Advantages of a Reverse Pecuniary Marital Deduction Formula. The advantages of a reverse pecuniary marital deduction formula are as follows.

- As with the true pecuniary marital deduction formula, this type of funding provision is generally considered to be the simplest to compute and to fund.
- The executor or trustee may pick and choose the assets with which to fund the distribution. Assets having the greatest potential for appreciation can be used to fund the nonmarital disposition, and assets that are expected to appreciate more slowly or decline in value can be used to fund the marital disposition.
- Because the residuary marital disposition bears all risk of depreciation in value during administration of the estate, the nonmarital disposition will not be reduced by depreciation during the period of administration. This risk of depreciation does not jeopardize the marital deduction. In Rev. Rul. 90-3, 1990-

1 C.B. 174, the IRS held that, if a pecuniary bequest of the then applicable exclusion amount of $600,000 is required to be paid with assets valued at the date of distribution, the possibility of post-death fluctuations in the value of the residuary bequest to the surviving spouse does not cause the residuary bequest to be a nondeductible terminable interest for purposes of IRC § 2056(b).

- Since the pecuniary gift to the nonmarital disposition is the smaller amount in a larger estate situation, using a reverse pecuniary marital deduction formula will minimize potential capital gain on funding as compared with a true pecuniary marital deduction formula.

b. <u>Disadvantages of a Reverse Pecuniary Marital Deduction Formula</u>. The reverse pecuniary marital deduction formula in general has the same disadvantages as the true pecuniary marital deduction formula. In addition, if there is appreciation during the administration period, it all accrues to the residuary marital disposition, which will have the effect of increasing estate taxes at the surviving spouse's death.

6. Minimum Worth Marital Deduction Formula

Another variation of the pecuniary marital funding language is the minimum worth marital deduction formula, which directs funding of the marital disposition at the ***lower of*** (a) federal estate tax values or (b) date of distribution values. There are two variations of the minimum worth marital deduction formula: the individual asset variation and the aggregate asset variation.

> **<u>EXAMPLE</u>:** An example of the *aggregate asset variation*, which is specifically mentioned in Rev. Proc. 64-19 as an acceptable form of a marital deduction formula, is as follows:
>
> "If my spouse survives me, the trustee shall set aside, to be administered as provided in the Marital Trust, the minimum amount that, if allowed as a marital deduction in determining the federal estate tax on my estate, will cause my estate to incur no, or the least, such tax.
>
> In computing such amount, the asset values, deductions and credits as finally determined in the federal estate tax proceedings in my estate shall control, and, among available credits, only the unified credit shall be used.
>
> ***In funding such amount, only assets for which a marital deduction is allowable shall be used, and all assets used shall be set aside at the value as finally determined for federal estate tax purposes, except any property purchased after my death shall be valued at its cost. The assets, including cash, so distributed shall have an aggregate fair market value on the date or dates of distribution amounting to no less than the amount of this bequest***. I recognize that the amount described in this Article may be affected by the exercise of, or failure

to exercise, certain tax elections. I also acknowledge the possibility that no property will be set aside under this Article.

Despite any other provision in this instrument, the amount described in this Article shall be computed after considering payments made or to be made to pay for my debts, the administration expenses of my estate, my funeral expenses, the expenses of my last illness and death taxes that are deducted for estate tax purposes. The property set aside or to be set aside under this Article shall not be reduced, however, by the amount of any such payments.

If my spouse survives me, the balance of the Residuary Trust (and any other property that, but for the making of a qualified disclaimer by my spouse, would be set aside under the preceding provisions of this Article) shall be administered as provided in the Family Trust."

<u>EXAMPLE</u>: An example of the *individual asset variation* would be to change the bolded language in the above example as follows:

"In funding such amount, only assets for which a marital deduction is allowable shall be used, and the value of each asset shall be the lower of (a) the value finally determined for federal estate tax purposes (or cost, if it was purchased after my death) or (b) the value on the date of distribution."

The individual asset variation is generally assumed to qualify for the marital deduction although not specifically mentioned in Rev. Proc. 64-19 since, if federal estate tax values are lower, all funding is at federal estate tax values, and, if date of distribution values are lower, the marital trust will have to receive more assets in order for it to be fully funded.

a. <u>Advantages of the Minimum Worth Marital Deduction Formula</u>. The advantages of the minimum worth marital deduction formula are as follows:

- Capital gain on funding is avoided because appreciation in the value of assets is not "used" by the executor to meet the obligation to fund the pecuniary amount; and
- The minimum worth marital deduction formula grants the fiduciary substantial flexibility in selecting assets for the marital disposition.

b. <u>Disadvantages of the Minimum Worth Marital Deduction Formula</u>. The disadvantages of the minimum worth marital deduction formula are as follows:

- If values increase during post-death administration, the marital disposition will be overfunded (<u>i.e.</u>, it will receive more value than that for which a marital deduction was claimed);
- In the case of a decline in values from the date of death or alternate valuation date to the date of funding, the minimum worth marital deduction formula

reduces the value of the nonmarital disposition;

- A minimum worth marital deduction formula may not be appropriate in a second marriage situation or other circumstances where the beneficiaries of marital and nonmarital trusts are different; and
- Some commentators have suggested that use of a minimum marital deduction worth formula is inappropriate where a charitable deduction is being made from the residuary estate on the theory that the charitable deduction may fail because the amount is unascertainable at the date of death or alternate valuation date. See, e.g., Steve R. Akers, "An Overview of Post-Mortem Tax Planning Strategies," 34th Annual Philip E. Heckerling Ins. on Est. Plan. (2000).

7. Double Pecuniary Drafting

In the last several years, the option of utilizing a double pecuniary formula has been receiving more attention. The purpose is to limit the exposure of a residuary family trust to reduction by reason of a decline in the value of the assets in an estate or funded revocable trust between the date of death and the date of funding. Several articles have been published regarding the double pecuniary drafting. Two of such articles include: D. Keith Bilter, "Marital Deduction and Generation-Skipping Formula Clauses: How to Get More Bang For Your Buck," *35th Annual Philip E. Heckerling Inst. on Est. Plan.* (2001); and Max Gutierrez, Jr., ACTEC 1999 Summer Meeting.

Mr. Gutierrez suggested that attorneys consider using a traditional pecuniary marital lead formula together with two other family trusts. The first family trust would be funded with a pecuniary amount equal to a large percentage of the remaining applicable exclusion amount (*e.g.*, 80% of $1,000,000), and the second family trust would be funded with the residue of the estate or revocable trust.

- If there is an increase in value during the period between death and funding, the residuary family trust would get the benefit, just as with a more traditional two trust pecuniary marital lead formula.
- In the event of a decline in value between death and funding, the double pecuniary formula suggested by Mr. Gutierrez would result first in reduction of the residuary family trust and then in pro rata abatement of both the pecuniary family trust and the pecuniary marital gift (provided that state law or the governing instrument provided for pro rata abatement).

Mr. Bilter suggests the use of true pecuniary formulas for the marital and family trust followed by a gift of the residue. Under this arrangement, the entire residue would be disposed of through the use of pecuniary gifts and the residue would be extinguished after payment of the decedent's debts, expenses and taxes. The use of the two "lead" pecuniary gifts would maximize the use of the applicable exclusion amount (and the GST exemption) if the estate appreciates in value and the applicable exclusion is protected if the estate depreciates in value. Under this approach, appreciation or depreciation from date of death until date of funding is dealt with as follows:

- If the estate appreciates in value, the appreciation passes under the residuary clause; and
- If the estate depreciates in value, the marital and family trusts are reduced pro rata under the abatement provisions.

G. General Guidelines for Selecting a Marital Deduction Formula

1. Pecuniary Marital Formula

It is recommended to use a pecuniary amount formula if possible. The pecuniary amount formula allows for selection of assets to fund the disposition, is inherently flexible and understandable, and is easiest to administer.

➔ **__Planning Point__:** If the nonmarital disposition will be larger than the marital disposition, the true pecuniary marital deduction formula may be preferred. If the marital disposition will be the larger, use of a reverse pecuniary marital deduction formula with a residuary marital disposition may be better if there is concern about declining values.

2. Fractional Share Marital Formula

The fractional share marital formula is the best single, "all purpose" formula. It operates satisfactorily in both small and large estates. The fractional share marital formula also is the best formula for certain specific situations (*e.g.*, no recognition of IRD or capital gains on funding, treats contentious beneficiaries equitably, avoids need to revalue assets). It can, however, be difficult to understand and implement.

3. Optimal Marital Deduction with the Applicable Exclusion Amount

Using the optimal marital deduction in conjunction with the applicable exclusion amount may not be appropriate for some clients. For example, the client may desire to have his or her children receive a significant amount of property at the client's death. This often is especially important in second marriage situations. In other situations, it may be advantageous to equalize the value of the estates of husband and wife, which would cause tax to be incurred at the death of the first spouse to die but reduce aggregate estate tax over the two deaths.

4. Planning Points When Not Using the Optimal Marital Deduction

The practitioner may decide not to use optimal marital deduction estate planning in certain situations as discussed in the previous paragraph. The following estate planning techniques should be considered in such circumstances:

- The use of a QTIP marital trust in first marriage situations will facilitate post-mortem tax planning and allow the fiduciary to evaluate all the facts after the death of the testator or settlor;
- A simple percentage marital formula may provide for a marital disposition equal to a percentage of the client's adjusted gross estate. Alternatively,

the governing instrument could provide that the marital disposition and nonmarital disposition are to be funded with specified fractions or percentages of the client's net residuary estate;

- The will or revocable trust instrument can provide fixed pecuniary gifts to children, either outright or in trust (e.g., $300,000 to each child);
- The client might provide a fixed pecuniary gift to a marital trust and leave the residue to a nonmarital trust (e.g., $500,000 to marital trust; residue to nonmarital trust); and
- The governing instrument could contain a specific bequest of assets that are expected to appreciate substantially in value (*e.g.*, closely held stock) to the nonmarital trust or a separate QTIP trust for which a partial or no election might be made.

➔ **Planning Point:** In all of the situations discussed above, it is critical that the governing instrument clearly specify which distributions bear the burden of the estate tax. The source of payment of the estate tax may drastically affect the dispositive provisions in an estate plan.

H. Selected Funding and Drafting Issues

1. Adverse Impact of the Suspension of the Estate and Generation-Skipping Transfer Tax on Marital Deduction Allocation Formulas

a. In General. Certain formula gifts under a decedent's estate plan may result in unintended consequences, and likely litigation, in 2010. As discussed above, some formulas provide that, at the decedent's death, the executor will allocate to a marital trust for the sole benefit of the surviving spouse or outright to the surviving spouse the minimum amount necessary to reduce estate tax to zero. Other formulas allocate an amount equal to the decedent's remaining estate tax applicable exemption amount to a trust for the benefit of, or in an outright disposition to, individuals other than the surviving spouse. If the federal estate tax regime does not exist, depending on the specific language of the formula, it is quite possible that no property will be distributed under the formula, and the estate plan may be badly distorted. For example, with a formula stating that the marital disposition is to be funded with the minimum amount necessary to reduce federal estate tax to zero, the marital disposition almost certainly would not be funded. Similarly, if the formula states that the credit shelter disposition is to be funded with the decedent's unused estate tax applicable exemption amount, the credit shelter trust would not be funded. State courts may be able to resolve the ambiguity in the document in the taxpayer's favor, but the IRS would not be bound by a lower court's decision. *Comm'r v. Bosch*, 387 U.S. 456 (1967). This same issue arises with regard to formula gifts that allocate an amount equal to the decedent's unused GST exemption to a generation-skipping disposition.

b. Structuring Documents to Address Uncertainty. Commentators have suggested preparing estate planning documents (wills and revocable trust instruments) to provide that the distribution or allocation of property passing by reason of death will change if the estate tax is reenacted effective as of a date that post-dates completion of the estate plan and pre-dates the decedent's death. As before the temporary repeal, setting in place a mechanism allowing an executor to elect to treat less than all of a marital deduction disposition as QTIP can enable the executor to decide the amount of the marital deduction that should be claimed if the estate tax is in effect at the time of the decedent's death. As discussed further below, combining a QTIP arrangement with a structure mandating that non-elected QTIP shall pass to a credit shelter-type trust or outright to descendants, *per stirpes*, may further enhance flexibility if the estate tax is in place at the death of the first spouse to die. *See Estate of Clayton v. Comm'r*, 976 F.2d 1486 (5th Cir., 1992); Treas. Reg. § 20.2056(b)-7(d)(3); Treas. Reg. § 20.2056(b)-7(h) Ex. 6. Alternatively, leaving all property in a marital deduction disposition and putting the surviving spouse in a position to disclaim some, all or none of such property may prove valuable under a reenacted estate tax system. Moreover, even if the estate tax is not in effect at the death of the first spouse to die, the surviving spouse, by disclaiming, can cause property to pass to a credit shelter-type trust and/or to be enjoyed currently by children and grandchildren and not be subject to estate tax at the surviving spouse's death regardless of whether the surviving spouse survives to 2011 or beyond.

With regard to minimizing GST tax, an estate planning instrument may initially direct that certain property to be distributed to grandchildren but then may state that such property will instead be distributed to children if the GST tax is then in effect. Similarly, a formula may initially provide for the division of property passing in trust between GST exempt and GST non- exempt shares but then may provide that such division will be contingent on whether the GST tax is in effect at the decedent's death. Formula provisions mandating generation-skipping transfers may be preceded by a marital deduction disposition, thereby enabling the surviving spouse to control (by judicious disclaimer planning) the extent to which property will pass at the death of the predeceased spouse to GST exempt and GST non-exempt shares for descendants.

2. Income in Respect of a Decedent

Some clients may have substantial amounts of income in respect of a decedent ("IRD"). Some kinds of IRD may involve payments over an extended period of time (*e.g.*, individual retirement accounts, qualified employee benefit plans, deferred compensation, installment sale contracts, royalties and insurance renewal commissions). This long-term IRD may cause funding problems for the estate.

An estate generally includes IRD in its gross income only when it receives the IRD. IRC § 691(a)(1)(A). If the estate transfers the right to receive IRD, however, the IRD is prematurely realized and is taxed at that time. IRC § 691(a)(2). A transfer includes a sale, exchange or other disposition of the IRD, but it does not include a transfer to a person by bequest from a decedent.

If an estate satisfies a pecuniary amount legacy with IRD, the transfer will cause immediate realization (and taxation) of the IRD. The legatee is entitled to a pecuniary amount of property, and the estate's transfer of the IRD in satisfaction of the pecuniary amount is treated as a sale. IRC § 691(a)(2); Treas. Reg. § 1.691(a)-4; *Noel v. Comm'r*, 50 T.C. 702 (1968). Thus, if a will or trust instrument contemplates equal distributions of property to beneficiaries, but one or more of the beneficiaries receive IRD assets while other beneficiaries do not, all the beneficiaries may receive assets with the same value, but, because of the income tax burden caused by the IRD, the beneficiaries could actually receive disproportionate economic amounts. In addition, in the context of estate administration, the "sale" is often between related parties under IRC § 267 so that gain, but not loss, is recognized.

➔ **Planning Point:** IRD is not prematurely realized when the estate transfers it to a specific or residuary legatee, including allocation of the IRD among residuary trusts. See Treas. Reg. § 1.691(a)-4(b)(2).

EXAMPLE: Your client's revocable trust instrument provides that, at her death, an amount equal to the largest amount that can be transferred free of federal estate tax will be allocated to the Family Trust, and the balance of the trust property will be allocated to the Marital Trust. Your client's estate consists of a $3,000,000 IRA, payable to the revocable trust. The client's available applicable exclusion amount is $1,000,000. After the client's death, the trustee allocates $1,000,000 of the IRA to the Family Trust and $2,000,000 of the IRA to the Marital Trust. The revocable trust will have $1,000,000 of ordinary income in the applicable taxable year as a result of using part of the IRA to fund the pecuniary amount to which the Family Trust is entitled. The transfer of the IRA in satisfaction of a pecuniary formula gift is a "sale," and a sale is a "transfer" under IRC § 691(a)(2), resulting in the immediate recognition of income.

EXAMPLE: Your client's revocable trust instrument provides that at her death, a fractional share of the trust property will be allocated to a Family Trust, and the balance of the trust property will be allocated to the Marital Trust. The numerator of the fraction to be allocated to the Family Trust is equal to the largest amount that can be transferred free of federal estate tax. The denominator of the fraction is the value of the trust property. Your client's estate consists of a $2,500,000 IRA, payable to the revocable trust. The client's available applicable exclusion amount is $1,000,000. This produces a fraction (in this case) of 40% ($1,000,000/$2,500,000). After the client's death, the trustee allocates 40% of the IRA, or $1,000,000, to the Family Trust and 60% of the IRA, or $1,500,000, to the Marital Trust. The revocable trust will not recognize any income in the applicable taxable year as a result of using part of the IRA to fund the fractional amount to which the Family Trust is entitled. The transfer of the IRA is *not* in satisfaction of a pecuniary formula gift, so it is *not* a "sale." Because it is not a sale, it is not a "transfer" under IRC § 691(a)(2). Instead, it is a non-taxable transfer to the Family Trust.

➔ **Planning Point:** To avoid premature realization of IRD, the client's estate should be planned so that IRD is not used to fund a pecuniary amount legacy, including a pecuniary marital deduction formula or a reverse pecuniary formula.

EXAMPLE: If a client has a multi-million dollar estate comprised mainly of IRD, a pecuniary funding formula would not be appropriate.

Note that the IRD is realized even if assets distributed in kind to satisfy the pecuniary amount marital trust are valued at their federal estate tax values.

A fractional share marital formula avoids the IRD problem entirely because it does not involve a pecuniary amount. It also has flexibility, since a fiduciary who is authorized to make non-pro rata distributions may allocate the IRD to the marital trust, the family trust or partly to each, depending on which allocation produces the most favorable overall income and estate tax result.

➔ **Planning Point:** In large estates, a residuary marital disposition of IRD is generally a good solution, since the IRD would be allocated to the spouse or the residuary marital trust along with most of the estate.

To minimize federal estate tax at the death of the client's surviving spouse, many attorneys recommend that IRD be distributed to the spouse or to a marital trust. IRD is a shrinking asset, since the income tax which it generates is paid to the IRS and thus reduces the surviving spouse's gross estate. For purposes of the marital deduction funding, however, IRD is not discounted because of its built-in income tax liability. See Rev. Rul. 66-348, 1966-2 C.B. 433. If IRD is distributed to the marital share, this enables the fiduciary to allocate to the family disposition other assets that do not have built-in income tax liability.

3. IRC § 691(c) Deduction

If IRD was included in a decedent's gross estate for federal estate tax purposes, the recipient includes the IRD in gross income and is allowed an income tax deduction for the incremental amount of federal estate tax attributable to the IRD. IRC § 691(c).

Prior to the enactment of the Economic Recovery Tax Act of 1981 allowing an unlimited marital deduction beginning in 1982, practitioners carefully drafted wills to preserve all of the IRC § 691(c) deduction that was created by paying estate tax on the death of the first spouse to die. Because Treas. Reg. § 1.691(c)-1(a)(2) reduced the amount of the IRC § 691(c) deduction if the IRD had been allowed as a marital deduction, wills often directed that all IRD be allocated to the non-marital family trust. See also Rev. Rul. 67-242, 1967-2 C.B. 227.

With the unlimited marital deduction, drafting for the IRC § 691(c) deduction is simplified. At the first death, no federal estate tax is payable because of the unlimited marital deduction, so no IRC § 691(c) deduction is created.

In some estates, federal estate tax will be incurred on the death of the first spouse to die. In most cases the client's governing instruments utilize the unlimited marital deduction, so estate tax is incurred at the first death either because (a) a partial election is made in a QTIP marital trust or (b) the surviving spouse disclaims part or all of the marital distribution. In some situations, a married couple may intentionally incur federal estate tax at the first death (*e.g.*, client bequeaths $3,000,000 to children even if spouse survives).

➔ **Planning Point:** If a married client does incur federal estate tax, the fiduciary might allocate IRD away from the marital distribution in order to preserve fully the IRC § 691(c) deduction.

In *Estate of Kincaid v. Comm'r*, 85 T.C. 25 (1985), however, the Tax Court stated that when an estate's marital deduction is determined by a formula, the allocation of IRD to the marital or non-marital share is irrelevant in determining the IRC § 691(c) deduction.

If the fiduciary relies on *Kincaid*, it can allocate IRD to the marital trust, receive a full IRC § 691(c) deduction, and obtain the estate tax benefit of having the marital trust funded with a shrinking asset due to the built-in income tax liability of the IRD. See also TAM 9219006.

4. Income Earned During Administration

Trust accounting income earned during the period of estate administration is generally allocated among testamentary trusts in proportion to their respective interests from time to time unpaid or undistributed in the principal of the estate. See, e.g., § 6(b)(2) of the Illinois Principal and Income Act, 760 ILCS 15/6(b)(2). The executor determines the relative sizes of the marital trust and the family trust and allocates the income of the estate between them proportionately. Each trust receives its portion or fraction of the accounting income of the estate. This fraction can change during the administration of the estate.

Disproportionate partial funding of testamentary trusts can change the fraction of the accounting income of the estate to which each trust is entitled.

EXAMPLE: In a $3,000,000 estate, the executor may fund half of the marital trust, so its interest in the estate is reduced from $1,000,000 to $500,000:

Before partial funding:

Marital Trust	$1,000,000
Family Trust	$2,000,000

After partial funding:

Marital Trust	$ 500,000
Family Trust	$2,000,000

The marital trust is entitled to 33.3% of the income of the estate earned before the partial funding, but it is entitled to only 20% of the income of the estate earned after the funding.

The fraction of income of the estate to which each trust is entitled can change when taxes or expenses are paid out of the family trust.

EXAMPLE: Assume that the executor of a $2,500,000 estate elects to qualify none of the true pecuniary QTIP marital trust for the marital deduction because the surviving spouse has cancer and may die soon. The will provides that the federal estate tax of $230,000 is paid from the residue of the estate, *i.e.*, the Family Trust.

Before payment of estate tax:

Marital Trust	$500,000
Family Trust	$2,000,000

After payment of estate tax:

Marital Trust	$500,000
Family Trust	$1,770,000

The family trust receives 80% of the income of the estate earned before the payment of estate tax, even though it is entitled to only 78% (1,770,000/2,270,000) of the income earned after the tax payment.

➔ **Planning Point:** The adjustment to the fraction is especially significant when the marital trust and family trust have different income beneficiaries and the adjustment (or lack thereof) affects a substantial amount of income of the estate.

5. ***Estate of Hubert***

a. **Introduction and Summary of Decision**. The U.S. Supreme Court's decision in *Comm'r v. Estate of Hubert*, 520 U.S. 93 (1997), created opportunities in funding marital trusts and family trusts, as well as increased complexity and uncertainty. The *Hubert* case deals in part with the question of which charges against marital deduction property will cause the marital deduction to be reduced for federal estate tax purposes.

Before the *Hubert* case and the subsequently issued amendments to the marital deduction regulations, if an administration expense was paid out of principal of marital deduction property, this payment would reduce the amount of the marital deduction for federal estate tax purposes. In addition, administration expenses might be charged against the income of a marital trust. Any material limitation upon the spouse's right to income from the marital trust would cause a reduction in the marital deduction. See Treas. Reg. §§ 20.2056(b)-4(a), (b).

In the *Hubert* case, the executors charged $1,500,000 of administration expenses against the income of the residuary estate, which passed approximately one-half to a marital trust and one-half to charities. The expenses were deducted on the estate's income tax return. The IRS argued that the estate tax marital and charitable deductions should be reduced by $1,500,000 (*i.e.*, on a *dollar-for-dollar* basis). The Supreme Court rejected the position of the IRS and found for the executors. Justice O'Connor also invited the IRS to amend the marital deduction regulations to define a "material limitation" on the spouse's right to income from the marital trust.

b. **Proposed and Final Regulations**. In December of 1998, the IRS issued proposed regulations in response to the *Hubert* case. Final regulations were issued in December of 1999. The regulations dispensed with the concept of a material limitation on the spouse's right to income, which was considered too complex and difficult to administer. Treas. Reg. § 20.2056(b)-4(d). The material limitation test was replaced with two categories of expenses:

- Estate transmission expenses; and
- Estate management expenses.

(1) **Estate Management Expenses**. Estate management expenses are defined as expenses incurred in connection with the investment of estate assets and with their preservation and maintenance during a reasonable period of administration – similar to expenses charged to income. The regulations specifically include the following examples: investment advisory fees, custodial fees, stock brokerage commissions, and interest. Treas. Reg. § 20.2056(b)-4(d)(1)(i). The preamble to the final regulations provides that estate management expenses are those expenses that would be incurred with respect to the property even if the decedent had not died.

(2) **Estate Transmission Expenses**. All other estate administration expenses are considered to be estate transmission expenses. Estate transmission expenses are expenses that would not have been incurred except for the decedent's death, and they include expenses incurred in the collection of the decedent's assets, the payment of the decedent's debts and death taxes, and the distribution of the decedent's property – similar to expenses charged to principal. Examples of transmission expenses include executor's commissions and attorneys fees (except to the extent specifically related to investment, preservation and maintenance of the estate assets), probate fees, will construction and contest expenses, and appraisal fees. Treas. Reg. § 20.2056(b)-4(d)(1)(ii).

(3) **Effect on Marital Deduction**. If estate *transmission* expenses are paid from the income or principal of the marital share, the marital deduction is reduced by the amount of the payment (on a *dollar-for-dollar* basis). Treas. Reg. § 20.2056(b)-4(d)(2). If estate *management* expenses are paid from the income or principal of the marital share, the marital deduction is generally not reduced by these payments. Treas. Reg. § 20.2056(b)-4(d)(3).

The final regulations contain two exceptions to the general rule that payment of estate *management* expenses does not reduce the federal estate tax marital deduction.

- The marital deduction is reduced on a dollar-for-dollar basis if estate management fees are paid from the income or principal of the marital share and such fees are deducted on the federal estate tax return (Form 706) under IRC § 2053. Treas. Reg. § 20.2056(b)-4(d)(3); *see* IRC § 2056(b)(9).
- The marital deduction is reduced if estate management fees charged to the marital share are incurred for the non-marital share where the spouse

is not entitled to the income from that non-marital share. Treas. Reg. § 20.2056(b)-4(d)(3).

➔ **Planning Point:** A corporate fiduciary's fee, attorney fees, accounting fees, etc. may be partly an estate management expense and partly an estate transmission expense. In general, record keeping for the various types of administration expenses may be difficult, but it is advisable to distinguish between the services rendered to provide for more flexibility during the administration of the estate.

c. Effect of *Hubert* Regulations on Marital Formula and Trust Funding. When estate *transmission* expenses are paid, each of the marital deduction formulae discussed in this Chapter generally operates the same way as before the issuance of the regulations in response to the *Hubert* case with respect to (i) computation of the amount of the marital deduction for federal estate tax purposes and (ii) funding of the marital and family trusts.

EXAMPLE: A $30,000 estate administration expense is deducted on the estate's income tax return (Form 1041). If the $30,000 is an estate *transmission* expense, for a decedent dying in 2011, the marital deduction funding formula creates a $970,000 family trust, assuming no change in values between date of death (or alternate valuation date) and date of trust funding.

When estate *management* expenses are paid, the formula operates differently than before *Hubert* regarding both the amount of the federal estate tax marital deduction and the funding of the marital and family trusts, depending on whether the management expenses are taken as a deduction on Form 1041 or Form 706.

- Form 1041 income tax deduction. In the above example, assume that the $30,000 is an estate *management* expense. The formula creates a $970,000 family trust, regardless of whether the management expenses are charged to income or principal.
- Form 706 federal estate tax deduction. Assume that the $30,000 estate *management* expense is taken as a federal estate tax deduction on Form 706. Applying the regulations, the marital deduction formula will create a family trust of $1,000,000 and the marital deduction will be reduced by $30,000.

EXAMPLE: Decedent dies in 2011 with a gross estate of $2,500,000, and administration expenses of $30,000. Applying an optimal marital formula, the family trust would be $1,000,000 and the marital deduction would be $1,470,000. The estate would still have a federal estate tax deduction in the amount of $1,500,000 (marital deduction of $1,470,000 plus an administrative expense deduction of $30,000) resulting in a taxable estate of $1,000,000 and an estate tax of zero by applying the applicable exclusion amount.

d. **Drafting under the *Hubert* Regulations**. In drafting wills and revocable trusts to take advantage of the *Hubert* regulations, practitioners should continue to maintain maximum flexibility regarding charging administrative expenses – whether estate transmission expenses or estate management expenses – to either principal or income of the estate or trust. The formula for computing the funding of the marital and family trusts does not need to be revised as a result of the issuance of the final regulations, so long as the formula is self-adjusting and operates to obtain the optimal marital deduction, as do the various funding formulae discussed in this Chapter.

> ➔ **Planning Point:** If the funding formula refers to specific deductions or provisions of the Internal Revenue Code that are to be taken into account in calculating the marital deduction disposition, the governing instrument may need to be revised in light of the *Hubert* regulations.

6. Creating and Funding GST Trusts (The Reverse QTIP Election)

The advantages of lifetime use of the GST exemption or the creation of a generation-skipping trust at death without the use of the so-called reverse QTIP election were discussed above at Section D.5. Lifetime use of the GST exemption without the use of the marital deduction is the most tax efficient method of planning for the GST tax as all future appreciation escapes the estate of the client and the client's spouse. Full use of the GST exemption at the first death for a married client without creating an exempt marital trust for which the reverse QTIP election is made under IRC § 2652(a)(3) is more tax efficient than using the marital deduction to shelter the portion of the GST exemption that exceeds the applicable exclusion amount. The two or three trust approach discussed above at Section D.5. does have the advantage of generally deferring all federal and state estate taxes until the death of the survivor.

In order to properly allocate GST exemption to a trust – regardless of whether it is an exempt marital trust for which a reverse QTIP election is made – and to be sure that trusts are created that have an inclusion ratio of zero or one for GST purposes, it is essential that each trust be treated as a separate trust for Chapter 13 (the GST tax) purposes.

> ➔ **Planning Point:** In drafting and funding trusts at death that will be treated as separate trusts for purposes of Chapter 13, it is necessary to pay close attention to the valuation and division of trust rules contained in the generation-skipping tax regulations. In general, these rules are similar to some of the marital trust funding rules discussed above.

a. **Mandatory Severances**. If a trust created under a will or a revocable trust is divided into two or more trusts pursuant to a *mandatory direction* under the governing instrument, the separate trusts thereby created will be recognized for Chapter 13 purposes without needing to meet the funding and appropriate interest requirements discussed below.

Regulations finalized in 2008 (T.D. 9421, 2008-39 I.R.B. 755) added Treas. Reg. § 26.2654-1(a)(1)(iii), which deals with situations in which the trust instrument requires the division or severance of a single trust into separate trusts or shares upon the future occurrence of a particular event. If such event is not within the discretion of the trustee or any other person and if the trusts or shares resulting from such a division or severance are recognized as separate trusts or shares under applicable state law, then each resulting trust or share is treated as a separate trust for purposes of Chapter 13. Additions to, and distributions from, such trusts are allocated pro rata among the separate trusts, unless the trust instrument expressly provides otherwise. Each separate share and each trust resulting from a mandatory division or severance described in this regulation will have the same inclusion ratio immediately after the severance as that of the original trust immediately before the division or severance. <u>See, e.g.</u>, Treas. Reg. § 26.2654- 1(a)(5), Ex. 8.

b. **<u>Discretionary Severances</u>**. If a trust created under a will or a revocable trust is divided into two or more trusts pursuant to *discretionary authority* granted to the fiduciary, certain additional requirements must be met in order for the trusts thereby created for state law purposes to be recognized for Chapter 13 purposes. Treas. Reg. § 26.2654-1(b)(1)(ii). Among the requirements contained in the regulations are the following:

- The severance must occur prior to the date prescribed for filing the federal estate tax return (including extensions actually granted).

➔ **<u>Planning Point</u>:** Trusts will be treated as meeting this requirement if the federal estate tax return indicates that separate trusts will be created or funded and clearly sets forth the manner in which the trusts are to be divided and funded. Treas. Reg. § 26-2654-1(b)(2).

➔ **<u>Planning Point</u>:** Meeting this disclosure requirement on Form 706 is essential when the trusts will not be funded prior to filing the estate tax return, as is often the case.

- If the new trusts are severed on a fractional basis, the separate trusts need not be funded pro rata based on the assets held in the original trust. The trusts may be funded on a non-pro rata basis provided the funding is based on either: (a) the fair market value of the assets on the date of funding; or (b) in a manner that fairly reflects the net appreciation or depreciation in the value of the assets from the date of death (or alternate valuation date) to the date of funding. <u>See</u> Treas. Reg. § 26.2654-1(b)(4), Ex. 3.
- If the severance is required by the terms of the governing instrument to be made on the basis of a pecuniary amount, the trustee must pay appropriate interest and, if the funding is made in kind, the funding must be based either:

  (a) on the fair market value of the assets on the date of funding; or (b) in a manner that fairly reflects the net appreciation or depreciation in the value of the assets from the date of death (or alternate valuation date) to the date of funding. Treas. Reg. §§ 26.2654-1(b)(1)(ii)(C)(2), (a)(1)(ii).

The appropriate interest requirement may be met in several different ways contained in the regulations.

- Interest must be paid from the date of death until the date of funding at a rate at least equal to the statutory rate of interest applicable to pecuniary bequests under the applicable state law.
- If no statutory rate is provided by state law, interest must be paid at a rate equal to at least 80% of the IRC § 7520 rate in effect at the death of the decedent.
- The appropriate interest requirement is deemed to be met if the funding of the pecuniary trust is irrevocably done within 15 months of the decedent's death.
- The appropriate interest requirement is also deemed to be met if the governing instrument or applicable state law requires the funding of the pecuniary trust to receive a pro rata share of the income earned by the fund from which the payment is being made from the date of death until the date of funding. Treas. Reg. § 26.2642-2(b)(4).

c. **IRC § 2642(a)(3) & Treas. Reg. § 26.2654-1(b)**. IRC § 2642(a)(3) and its corresponding regulations provide for a "qualified severance" of a trust. In this situation, the two resulting trusts will be treated as separate for GST tax purposes. The trusts resulting from a qualified severance (the "resulting trust") may have an inclusion ratio that differs from the inclusion ratio of the original trust. Furthermore, certain actions such as the allocation of GST exemption to one resulting trust, a GST tax election made with respect to one resulting trust or the occurrence of a taxable distribution or termination with regard to a particular resulting trust will not have any GST tax impact on any other trust resulting from that severance. As explained in the Preamble to the final regulations regarding qualified severances issued in 2007 (T.D. 9348, August 2, 2007), the difference between severances under Treas. Reg. § 26.2654-1(b) and under IRC § 2642(a)(3) is that the former applies to severances of testamentary trusts and revocable *inter vivos* trusts included in the transferor's gross estate, and such a severance is effective retroactively to the date of death, while the latter addresses severances that typically would occur after an irrevocable trust (whether *inter vivos* or testamentary) has been in existence for a period of time (regardless of whether the trust assets are includible in the transferor's gross estate) and applies to severances that are effective prospectively from the date of severance.

7. Savings Clauses

a. **In General**. Marital deduction savings clauses have proven useful for expressing the grantor's intent and therefore securing a deduction that otherwise might be lost. An example of a savings clause is as follows:

> I intend that all property passing under this Article qualify for the marital deduction. Accordingly, all powers and discretions conferred on the Trustee by law or other provisions of this instrument shall be exercisable and exercised only in such manner as to give my spouse substantially that degree of beneficial enjoyment of the trust property during my spouse's life that the principles of trust law accord to a person who is unqualifiedly designated as the sole life beneficiary of a trust. All such powers and discretions shall be subject to the imposing of reasonable limits on their exercise by a court. Any power to

retain or invest in assets that consist substantially of unproductive property shall also be subject to the requirement that the Trustee use the degree of judgment and care in the exercise of that power that a prudent person would use as the owner of the trust property. This provision supersedes all other provisions in this instrument to the extent of any inconsistency.

b. __Rulings and Cases__. A number of rulings and cases have approved savings clauses. For example, in *Ellingson v. Comm'r*, 964 F.2d 959 (9th Cir. 1992), a trust instrument provided that all income be distributed to the surviving spouse, but the trustee could accumulate income that was not required for the support of the surviving spouse. The trust instrument also contained a savings clause. The Ninth Circuit allowed the marital deduction, stating that the trust instrument evidenced an intent that the marital bequest qualify for the marital deduction. Thus, the trustee's power to accumulate income, which was inconsistent with an intent to qualify for the marital deduction, could not be given effect. In Rev. Rul. 75-440, 1975-2 C.B. 372, the trust instrument authorized the trustee to invest in life insurance, which is an unproductive asset. The IRS considered the savings clause included in the trust instrument and found that this investment language applied only to the nonmarital trust. In TAM 199932001, a QTIP marital trust's governing instrument with a savings clause and support trust limitations arguably limited another provision requiring income distribution. The IRS construed the support trust limitations to apply only with respect to principal distributions. The IRS found that this language did not restrict the surviving spouse's right to all the trust income because a different interpretation would disqualify the trust for the marital deduction, which would be contrary to the indicated intent. In PLR 200339003, the will contained a provision that expressly authorized the trustee of the marital trust to invest in or retain unproductive properties. However, because the will also contained a savings clause, the trust was not disqualified for marital deduction purposes.

The IRS reached a different conclusion, however, in PLR 8437093, which involved a will that made fractional share marital formula gifts to a marital deduction power of appointment trust. The will also authorized the trustee, both during and after the surviving spouse's life, to make principal distributions to a child and descendants. Distinguishing Rev. Rul. 75-440, and instead relying on Rev. Rul. 65-144, 1965-1 C.B. 442, the IRS found that the savings clause was not merely an aid in interpretation but was an attempt to revoke the power to make principal distributions to a person other than the surviving spouse, which would disqualify the marital deduction. The IRS, therefore, refused to give effect to the savings clause. However, the IRS concluded that another provision authorizing the surviving spouse to make unlimited withdrawals of principal was inconsistent with the provision authorizing principal distributions to a child and descendants during the surviving spouse's life. Because the will expressed an intent to primarily benefit the surviving spouse and qualify for the marital deduction, the IRS concluded that the relevant state court would interpret the will to prevent principal distributions to the child or descendants during the surviving spouse's life. Consequently, the IRS allowed the marital deduction despite the invalidity of the savings clause.

In TAM 9325002, a revocable inter vivos trust instrument granted a power after the grantor's death to either the trustee or any beneficiary to petition a court to amend the trust if the purposes of the trust may be defeated because of a change in circumstances or a change in the law.

Although the grantor clearly expressed an intent that the trust qualify for the marital deduction and that the trustee not exercise any powers contrary to that intent, the IRS held that the power to amend disqualified the trust from receiving a marital deduction. The IRS stated that this provision essentially authorized a court to restrict or even remove the surviving spouse's income interest if the spouse no longer needed that income or could not manage the money or some other change in circumstances occurred.

As the above rulings show, savings clauses should not be relied upon to provide any protection against disqualifying provisions that clearly apply to the gift intended to support the marital deduction. In TAM 200234017, the husband's Will distributed what was referred to as the marital deduction amount to a marital trust and the remainder of the estate to a family trust. The entire income of the marital trust was payable to the surviving spouse at least quarterly. The Trustee had the power to make supplemental distributions of principal from the marital trust as needed to provide the spouse with certain minimum monthly payments as adjusted for inflation. The Trustee also had the power to make supplemental distributions of principal for the spouse's health, maintenance, and support. The spouse had both a lifetime and a testamentary power to appoint the income and principal of the martial trust to or for the benefit of the husband's children or descendants. The Will also stated that it was the husband's desire that the marital trust be eligible for the marital deduction as a QTIP trust under IRC § 2056(b)(7) and that the Trustee was prohibited from operating the trust in any way that would disallow the marital deduction. Because the surviving spouse had the power during her life to appoint property, the IRS ruled that the spouse did not have a qualifying income interest for life. The IRS stated that savings clauses that purport to invalidate any action taken by a Trustee that would disqualify the trust from claiming the marital deduction are not effective for transfer tax purposes. Savings clauses, according to the IRS, may only be used as an aid in interpreting an ambiguous instrument. Furthermore, the savings clause here dealt only with fiduciary powers that would disqualify the trust from claiming the deduction, not spousal powers.

I. Funding Examples

Assume that an estate has a federal estate tax value of $4,500,000, an applicable exclusion amount is $1,000,000 and the optimal marital deduction is $3,500,000.

1. 20% Increase in Value of the Estate Before Funding

Federal Estate Tax Value: $4,500,000
Date of Distribution Value: $5,400,000

	True Pecuniary	Fractional	Reverse Pecuniary
Marital Trust	$3,500,000	.78 x $5,400,000 = $4,212,000	$4,400,000

Family Trust	$1,900,000	.22 x $5,400,000 = $1,188,000	$1,000,000
Capital Gain	$3,500,000 (2,916,000)* $584,000	None	$1,000,000 (833,333)* $166,667
Federal Tax on Capital Gain	$584,000 x 15% $ 87,600	None	$ 166,667 x 15% $25,000.05

*The basis amount is calculated as follows:

For the true pecuniary marital formula, the value of the marital trust divided by the total value of the trust on date of distribution (3,500,000/5,400,000) yields the percent of assets received by the marital trust (64.8%). The percent of assets received is then multiplied by the total basis of the trust which is equivalent to the federal estate tax value (64.8% x 4,500,000). The same method is used with the reverse pecuniary formula, except that the value of the family trust is the numerator of the fraction ((1,000,000/5,400,000) x 4,500,000).

2. 20% Decrease in Value of the Estate Before Funding

Federal Estate Tax Value: $4,500,000
Date of Distribution Value: $3,600,000

	True Pecuniary	Fractional	Reverse Pecuniary
Marital Trust	$3,500,000	.78 x $3,600,000 = $2,808,000	$2,600,000
Family Trust	$100,000	.22 x $3,600,000 = $792,000	$1,000,000
Capital Loss	$3,500,000 ($4,375,000)* ($875,000)	None	$1,000,000 ($1,250,000)* ($500,000)

*The same method of calculating the basis in 1 above was used: (3,500,000/3,600,000) x 4,500,000 for the true pecuniary formula; and (1,000,000/3,600,000) x 4,500,000 for the reverse pecuniary formula.

J. Comparison of Characteristics of Funding Formulae

Characteristic	True Pecuniary	Fractional Share	Reverse Pecuniary	Fairly Representative
Which trust enjoys appreciation or suffers depreciation?	Family Trust (residuary)	Both	Marital Trust (residuary)	Both
Is capital gain recognized on funding?	Yes	No	Yes	No
Do assets have to be revalued on funding?	Yes	No	Yes	Yes
Which trust bears the burden of taxes and expenses?	Family Trust (residuary)	Both	Marital Trust (residuary)	Family Trust (residuary)
Is income in respect of a decedent realized on funding?	Yes	No	Yes	Yes
Is funding formula impartial between Marital and Family Trust beneficiaries?	No	Yes	No	Yes
Can formula produce a larger than desirable Marital Trust?	No	Yes	Yes	Yes
Can formula produce a larger than desirable Family Trust?	Yes	Yes	No	Yes
Is formula time-sensitive (*i.e.* may require early funding)?	Yes	No	Yes	No

K. Post-Mortem Planning

Post-mortem planning provides the practitioner flexibility, and also allows the practitioner the ability to provide some planning for the clients who did not complete their estate plans during their lifetime.

1. Partial QTIP Election

The partial QTIP election, discussed at Section D.5, provides tremendous postmortem flexibility. The executor generally has at least 15 months (nine-month due date for filing the decedent's Form 706 plus an automatic six-month extension) after the death of the first spouse to die to assess the current situation and determine the appropriate QTIP election approach. For example, the executor can determine the optimum amount of the marital deduction for equalization purposes if the surviving spouse dies within 15 months of the decedent. Treas. Reg. § 20.2056(b)-7(b)(4)(i).

If the marital trust is to be severed into elected and non-elected trusts, the severance must be accomplished on a fractional or percentage basis no later than the end of the period of estate administration. Treas. Reg. § 20.2056(b)-7(b)(2)(i). If the trust has not been severed by the time the federal estate tax return is filed, the intent to sever the trust must be signified on the estate tax return.

The decision as to whether a full, partial or no QTIP election is to be made rests with the decedent's executor and, once made, is irrevocable. IRC § 2056(b)(7)(B)(v). The executor may, but need not, be the surviving spouse. Thus, in a situation such as when the decedent's children are not the children of the surviving spouse, an independent executor can make this decision based on an objective analysis of the economic and tax factors relevant at the decedent's death. Even where the surviving spouse is named as the executor, the surviving spouse is choosing between two alternatives, both of which result in the property being distributed to a trust for the sole benefit of the surviving spouse. Thus, any preference on the part of the surviving spouse to have a greater ownership interest in assets or to be the sole beneficiary of a trust to be funded with particular assets is not a factor in determining how much property should pass to a trust protected by the decedent's applicable exclusion amount.

➔ **<u>Planning Point</u>:** If a general power of appointment trust was utilized under IRC § 2056(b)(5), the surviving spouse may make a qualified disclaimer of the general power of appointment. Such a disclaimer will change the GPOA trust into a QTIP trust and a partial QTIP election may be made. Similarly, if a decedent created a trust that does not meet the qualifications for a QTIP trust because the decedent's children also have an interest in the trust, it may be possible for the children to disclaim their interest in order to meet the requirements of a QTIP trust.

The non-elected portion will qualify for the credit for tax on prior transfers (the "TPT credit") under IRC § 2013(a) should the surviving spouse die within 10 years after the death of the deceased spouse. IRC § 2013 grants a credit against a decedent's estate tax for the portion of a previous decedent's estate tax attributable to the actuarially determined value of the income interest in the portion of the trust for which QTIP treatment is not elected (or for any other nonmarital trust) if the decedent has an income interest capable of valuation under IRC § 7520 and Treas. Reg. § 20.7520-3(b)(3), even though none of the trust principal is includable in the decedent's gross estate. Before a credit is allowable, the following conditions must be met: (1) property must have been transferred to the present decedent by the previous decedent (the "transferor"); (2) the transferor must have died within 10 years before or two years after the decedent died (the amount of the allowable credit decreases as the interval between the transferor's death and the decedent's death increases); (3) the transferor's estate must have been subject to a federal estate tax; and (4) the transferred property must have been included as an asset of the transferor's gross estate. The credit is limited to the lesser of the amount of federal estate tax attributable to the transferred property in the transferor's estate and the amount of federal estate tax attributable to the transferred property in the decedent's estate.

If the decedent dies within 15 months of the transferor's death, the executor can maximize the benefit of the TPT credit in the decedent's estate by making a smaller (or no) QTIP election in the transferor's estate.

2. Disclaimer Provisions

Instead of using a formula marital deduction provision, a disclaimer provision may be utilized whereby all of the decedent's property is left to the surviving spouse. The surviving spouse may elect to disclaim all or any portion of the property, and such disclaimed property will pass to a family trust. Typically, the disclaimed amount will be equal to the decedent's remaining applicable exclusion amount. The family trust may provide the surviving spouse with the income for life and discretionary principal to or for the benefit of the surviving spouse and the decedent's descendants.

> **EXAMPLE:** An example of a disclaimer provision is as follows:
>
> "If my spouse survives me, the Residuary Trust shall be distributed to my spouse. Despite the preceding sentence, any property directed in this Paragraph to be distributed to my spouse with respect to which my spouse has made a marital disposition qualified disclaimer shall be administered as provided in the Family Trust."
>
> . . .
>
> "The term "marital disposition qualified disclaimer" means a qualified disclaimer with respect to property passing under Remaining Trust Property Section for which, but for the making of such qualified disclaimer, a marital deduction would be allowed (or, on the making of an election under IRC § 2056(b)(7), would be allowable) in determining the federal estate tax on my estate."

A qualified disclaimer under IRC § 2518 must be made within nine months after the decedent's death, must be in writing, the surviving spouse must not have accepted any benefits from the disclaimed property, and the disclaimed interest must pass without any direction from the surviving spouse.

Including a disclaimer provision is not mandatory, but it provides direction as to the ultimate disposition of the disclaimed property. A disadvantage of using a disclaimer provision is the surviving spouse may decide that he or she wants absolute control of the property and refuse to disclaim any interest in the property. There is a possibility that a surviving spouse may not possess the necessary capacity to exercise a disclaimer at the death of the first spouse.

➔ **Planning Point:** As mentioned above, the surviving spouse cannot receive any benefits from the disclaimed property. Therefore, a disclaimer should be discussed immediately following the death of the decedent to avoid the possibility of the surviving spouse inadvertently accepting any benefits from property that might later be disclaimed.

L. The Gift Tax Marital Deduction

IRC § 2523 provides an unlimited gift tax deduction for property passing to a donee spouse. The purpose of the gift tax marital deduction, like the estate tax marital deduction, was to equalize the treatment in community and non-community states, hence the gift tax marital deduction has very similar rules to the estate tax marital deduction. Such rules will be summarized below and the differences between the gift tax and estate tax marital deductions will be outlined.

One of the main reasons to use a gift tax marital deduction, especially the QTIP trust as discussed below, is to equalize the size of the spouses' estates, and to allow the donee spouse to fully utilize the applicable exclusion amount. See, e.g., PLR 200406004.

EXAMPLE: Donor has an estate of $3,500,000 and Spouse's estate is $500,000. If Spouse dies in 2011 before Donor, Spouse will only utilize one-half of the applicable exclusion amount. If Donor gifts property valued at $500,000 to Spouse and Spouse dies immediately thereafter, Spouse will have enough assets fully to utilize Spouse's applicable exclusion amount, and there will be a potential overall estate tax savings of as much as $785,000 as a result of reducing the size of Donor's taxable estate.

Additionally, all future appreciation from the transferred property escapes taxation in the donor spouse's estate which may save taxes as the property may have been taxed at higher estate tax rates in the donor's estate than in the donee spouse's estate.

1. Requirements

A gift tax deduction is not allowed for a "nondeductible interest." A nondeductible interest is defined as a "terminable interest," or an interest that is not required to be included in a gift tax return for the year of the gift. Treas. Reg. § 25.2523(a)-1(b)(3). A terminable interest is a property interest that will terminate or fail upon the occurrence or non-occurrence of some event or contingency. The marital deduction is not allowed if the donor spouse transfers a terminable interest in property to the donee spouse and (i) the donor spouse retains an interest in the property, (ii) the donor spouse transfers an interest in the property to a person other than the donee spouse, or (iii) the donor retains a power of appointment under IRC § 2523(b)(2). Additionally, if a donor spouse retains a power to appoint an interest in the transferred property, and the donor spouse may exercise such power in a manner that the appointee may possess or enjoy any part of the property after such termination or failure of the interest transferred to the donee spouse, such transfer will be a nondeductible interest.

2. Exceptions to the Terminable Interest Rule

a. <u>Power of Appointment</u>. Under IRC § 2523(e), a marital deduction is allowed for an interest transferred to a donee spouse if it meets the following requirements:

- Donee spouse is entitled to all of the income from the entire interest, or from a specific portion, and such income must be paid at least annually;
- The donee spouse has a general power of appointment over the entire interest, or a specific portion of the interest, and such power is exercisable by the donee spouse alone and in all events; and
- No other person possesses the power to appoint such interest to any person other than the donee spouse.

> **<u>EXAMPLE</u>:** Donor transferred $500,000 to an irrevocable trust. The trust provided that Spouse was to receive all trust income during her lifetime. Spouse also has a testamentary general power of appointment over the entire trust principal. A gift tax marital deduction is allowed for such transfer.

> **<u>EXAMPLE</u>:** The facts are the same as the above example except Spouse's testamentary power of appointment is only over one-half of the trust principal. Even though spouse was entitled to all of the trust income, the gift tax marital deduction is only allowed for one-half of the value of the property transferred to the trust.

b. <u>Qualified Terminable Interest Property</u>. Similar to the estate tax QTIP trust, a donor spouse may transfer an interest to the donee spouse and retain control of the ultimate disposition of the property upon the donee spouse's death with the use of an irrevocable QTIP trust. IRC § 2523(f). The requirements of IRC § 2523(f) are as follows:

- The property is transferred by the donor spouse;
- The donee spouse has a qualifying income interest for life;
- The donor spouse elects to treat such transfer as qualified terminable interest property;
- The donee spouse must have the right to require the trustee to make the trust property productive or convert it within a reasonable time; and
- No person, including the donee spouse, is permitted to possess a power to appoint the property to any person other than the donee spouse during the spouse's lifetime.

The donor spouse may retain a right to receive income from the QTIP trust if the donor survives the donee spouse without such property being included in the donor's gross estate under IRC §§ 2036 or 2038. IRC § 2523(f)(5); Treas. Reg. § 25.2523(d). This allows the donor spouse to continue to receive income from the property if the donor survives the donee spouse. An exception to this rule is where the donee spouse disposes of a qualifying income interest during the donee spouse's life or the property is includible in the donee spouse's gross estate under IRC § 2044. Treas. Reg. § 25.2523(f)-1(d)(2).

EXAMPLE: Decedent transfers a property interest to an irrevocable trust. The income from the trust is payable to Spouse during Spouse's lifetime. Upon Spouse's death, the income is payable to Decedent for life, and upon Decedent's death, the entire trust is to be distributed to Decedent's children. Decedent elects to treat the property as QTIP. Decedent dies survived by Spouse. No part of the trust is included in Decedent's gross estate because Decedent elected QTIP treatment. However, the entire trust will be included in Spouse's gross estate under IRC § 2044.

EXAMPLE: The facts are the same as the above example, except Spouse predeceases Decedent. The entire trust is included in Spouse's gross estate under IRC § 2044, and Spouse is treated as the transferor of such property pursuant to IRC § 2044(c). At Decedent's death, the exception does not apply because the property was included in Spouse's estate under IRC § 2044. However, the property is still not included in Decedent's gross estate as Spouse is treated as the transferor of the property. The property may be included in Decedent's gross estate if Spouse's executor elected to treat the property as QTIP property under IRC § 2056(b)(7).

➔ **Planning Point:** If the donee spouse disposes of any interest in the qualified terminable interest property, whether a subsequent gift or sale of any portion of the interest, careful attention must be given to IRC § 2519 and the gift tax consequences of such a transfer.

c. Joint Interests. IRC § 2523(d) also creates an exception to the terminable interest rules for joint interests that meet the following requirements:

- Donor spouse and donee spouse are the sole joint tenants or tenants by the entirety; and
- Donor's interest in the property exists solely by reason of the possibility of the donor spouse surviving the donee spouse, or a severance of the tenancy may occur.

If the above requirements are satisfied, the donor spouse is not treated as retaining an interest in the transferred property. The transfer is considered a deductible interest for which a marital deduction is allowed for one-half of the value of the transferred property.

3. Non-Citizen Spouse

The gift tax marital deduction is not allowed for a transfer to a donee spouse who is not a U.S. citizen. However, the annual exclusion amount under IRC § 2503(b) is increased to $100,000 for transfers to a non-U.S. citizen spouse, adjusted annually for inflation ($134,000 for 2011). IRC § 2523(i).