Chapter 7

PLANNING FOR COUPLES

Introduction[1]

This Chapter is predominantly about planning for married individuals and it focuses almost exclusively on qualification for and utilization of the marital deduction. But not entirely, because a growing utility is planning for clients who anticipate divorce, as well as planning for couples who are not yet married, including some who cannot or will not ever marry. See page 142. As the discussion of that topic reveals, however, planning for individuals who are not married (be they surviving widows and widowers, same sex couples, or otherwise) pretty much entails the same factors and (lack of) opportunities, but it is not nearly as exciting or helpful as marital deduction planning for married individuals. Our law clearly favors and encourages marriage, at least for estate planning purposes.

This material was prepared after Congress passed legislation that would repeal the estate and generation-skipping transfer tax in 2010 (for just one year) but leave the gift tax alone. It seems likely that any change in this arena will look different from what Congress adopted in 2001, including the possibility that the repeal never will occur (because, for example, Congress will freeze the phase in of reduced rates that makes it happen). The point is that no one knows, which makes planning in this environment uncertain. When will the surviving spouse die becomes a critical inquiry because, until repeal, the unlimited federal estate and gift tax marital deductions (for qualifying dispositions of property to or for the benefit of a taxpayer's spouse) provide the most powerful estate planning tool available for married individuals.

Efficient use of the marital deduction permits effective use of both spouses' unified credits and generation-skipping transfer tax exemptions. Regardless of the size of the estate of the first spouse to die, the marital deduction allows deferral of federal wealth transfer taxes until the surviving spouse dies. Deferral of tax is the best possible plan if the survivor will die after repeal, but other planning may be more appropriate if the survivor dies before repeal (including if repeal never occurs). And the marital deduction becomes irrelevant for other than inter vivos

1. This Chapter is derived in part from Pennell, *Estate Tax Marital Deduction*, 843 (Tax Mgmt. BNA) ESTATES, GIFTS, & TRUSTS PORT. (2005), with the permission of the publisher, Tax Management Inc., a subsidiary of The Bureau of National Affairs Inc., Washington, D.C. All rights reserved.

intraspousal transfers if the decedent will likely die after repeal (although carryover basis has a provision that piggybacks on the qualified terminable interest property marital deduction rules). Notwithstanding all this, some plans will disinherit the surviving spouse in favor of other objects of the decedent's bounty.

With the backdrop of this uncertainty, this Chapter explores the following questions that any estate planner must answer in formulating and funding a marital bequest: How much (if any) marital deduction is appropriate: is deferral of tax until the spouse's death the best result? Which of the many forms of qualifying disposition is preferable? How should a clause be drafted to qualify the preferred disposition for the marital deduction? Which of the eight available alternatives for funding the marital bequest should be used to segregate the marital bequest from the rest of the decedent's property and transfer it to the dispositive vehicle chosen?

Two added questions are only briefly addressed: How should the generation-skipping transfer tax "reverse QTIP election" exemption allocation be factored into effective marital deduction planning? And how must the donor comply with the special requirements for bequests to a spouse who is not a United States citizen? Also addressed in fleeting detail are planning questions aimed at couples facing divorce, those at the more positive end of the spectrum who anticipate marriage, and planning for couples who will not ever marry.

Several topics addressed herein will remain of concern to estate planners even if the federal wealth transfer taxes are repealed. One aspect of this planning relates to the carry over of basis trade for repeal of the wealth transfer tax, which contains an exception of a certain base amount of property transferred to a surviving spouse, either outright or in a qualified terminable interest property (QTIP) format. Of greater concern and uncertainty is the number of state wealth transfer taxes that have been or will be re-enacted to replace revenue previously generated by the federal §2011 state death tax credit that is phased out after 2004. Those state laws might contain concepts similar to the current federal estate tax marital deduction and some may deviate in unexpected ways.

A third aspect of marital planning that likely never will go away, regardless of the tax law treatment of transfers to spouses, is the desire of some decedents to maintain control over their property and to fragment their estates between a surviving spouse and other intended beneficiaries. Most commonly, this involves descendants of a former marriage. This division of wealth, and control from the grave, likely will remain an active ingredient in traditional estate planning for married couples. So will the quintessential tension generated in many jurisdictions by a surviving spouse's statutory forced heir share entitlement and the ability to elect against an unwanted estate plan in favor of that elective share. See page 84.

This Chapter does not provide a detailed study of the federal estate tax marital deduction qualification rules and corresponding elements of its gift tax counterpart. The special technical rules for qualification are addressed in the wealth transfer taxation course and are not hard to meet even with relatively slight detailed knowledge. Planners just need to remember several basic notions (like, don't tinker with a marital form until you've done a good bit more study). The first of three major segments in this Chapter focuses on the planning aspect of the marital deduction that will first confront you: how much marital deduction is appropriate in a given situation? Although the discussion in this segment assumes familiarity with some marital deduction concepts that are covered later in the Chapter, if you are new to this area of the law you will find that these assumptions will not slow you down. This segment is written with current law in mind, on the assumption that repeal either is too far out or is too uncertain to rely upon. Neither may be true.

The second major segment of this Chapter deals more tersely with the technical requirements to qualify for the marital deduction. After determining how much marital deduction is appropriate, the planner must consult with the client to determine which of several common forms of qualifying disposition is preferable and how to draft the preferred disposition to qualify for the marital deduction. In some cases a combination of multiple dispositions will be appropriate, and is permissible. This is not a black and white selection process.

The third major segment of this Chapter deals with the administrative aspect of marital planning known as "funding" the bequest: once the planner has determined how much marital deduction is desired and has specified how it is to be transferred to or for the benefit of the surviving spouse, then the plan must dictate how the bequest is to be segregated from the decedent's property and transferred to the dispositive vehicle chosen. There are eight alternatives available for funding the marital share, each with its own particular advantages and disadvantages, which are explored and compared in the third segment. That discussion is relevant outside a marital deduction arena because essentially it informs planning for any division of any estate among multiple beneficiaries, which often is the case regardless of the decedent's family or other beneficiary cohort.

Importance of the Marital Deduction in Estate Planning

Estate tax §2056 grants an unlimited federal estate tax marital deduction for qualifying dispositions of property to or for the benefit of a decedent's surviving spouse. Correspondingly, §2523 grants an unlimited federal gift tax marital deduction for qualifying lifetime transfers to or for the benefit of a donor's spouse.[2]

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2. Although the gift tax marital deduction is not discussed separately throughout this Chapter, in most respects it is no different from the estate tax marital deduction and should be considered to be consistent with the estate tax marital deduction unless otherwise stated

Collectively these marital deduction provisions constitute the single most important estate planning tool available to married individuals. All federal wealth transfer taxes can be deferred until the death of the surviving spouse through optimum use of the marital deduction, usually regardless of the size of the estate of the first spouse to die. All of the spouses' aggregate assets (undiminished by estate or gift tax) thus can be made available to support the surviving spouse during his or her overlife. And deferral long enough may preclude wealth transfer tax altogether if the estate tax repeal actually occurs.

Be aware, however, that the marital deduction does not necessarily reduce wealth transfer taxes if the surviving spouse dies under the present regime (before repeal of the estate tax or after it is restored). This is because a prerequisite for obtaining the deduction is that assets must be transferred in a manner that requires inclusion in the estate of the surviving spouse. Nevertheless, although an estate tax may be due at the death of the surviving spouse, the burden of the tax, and any liquidity problems that may be encountered in paying the tax, are borne by the next takers (typically, the couple's children) when the surviving spouse dies. In the interim the spouse is protected from tax, and frequently the hope is that the tax itself may go away before the surviving spouse dies.

Throughout this Chapter the first spouse to die is referred to as D and the surviving spouse is referred to as S, without regard to their gender. Unless otherwise stated, 2004 tax rates and credits are used in the tax computations. Section 2010(a) provides a credit against estate tax of the "applicable credit amount," which §2010(c) defines as the amount of the tentative tax that would be imposed if the tentative tax were computed on the "applicable exclusion amount." Most planners continue to refer to the unified credit and to the exemption equivalent or credit shelter amount that may pass free of tax, and that familiar terminology is used here as well. The credit is no longer "unified" (since 2003) because the estate tax applicable exclusion amount is slated to increase while the gift tax exemption amount is frozen at $1.0 million. Compare §§2010(c) and 2501(a)(1). Examples throughout this Chapter use an applicable credit amount of $555,800, an applicable exclusion amount of $1.5 million, and a maximum tax rate of 48%, all because those were the applicable figures in the year (2004) of publication. Those numbers may change but the economics illustrated will not.

(for example, one major difference applies if the spouse is not a U.S. citizen). In addition, §1041 is the income tax equivalent of the wealth transfer tax marital deduction, in the sense that it makes transfers between spouses neutral events for income tax purposes. Spouses do not recognize income and there is no gain or loss realization, on transfers between them. The estate tax repeal slated for year 2010 would not be matched with an income or gift tax change. There is no need for a generation-skipping transfer tax marital deduction because spouses are assigned to the same generation by definition (notwithstanding their ages) and therefore cannot run afoul of the generation-skipping transfer tax rules.

Example 1: D dies in 2004 leaving a $2.0 million estate (net of debts and expenses). If no portion of D's estate qualifies for the marital (or any other) deduction, D's taxable estate of $2.0 million would generate an estate tax of $225,000. If, instead, D leaves the entire $2.0 million to S, the entire estate will qualify for the unlimited marital deduction and no federal estate tax will be incurred at D's death. All federal estate tax will be deferred until S's death. Thus, if S dies several years after D, leaving the $2.0 million estate (net of debts and expenses) to the couple's children, S's taxable estate would generate an estate tax of $225,000 (and potentially less if the applicable exclusion amount ratchets up to an eventual $3.5 million as enacted in 2001, with a phased effective date).[3]

The potential estate tax that may be incurred on S's death may be avoided in Example 1 if D's estate does not "overqualify" for the marital deduction. That is, if D's unified credit were utilized in conjunction with the marital deduction, D's estate would not qualify for more marital deduction than was needed to eliminate taxes in D's estate. The following example illustrates an estate plan that takes advantage of the marital deduction without overqualifying for the deduction. It is said to "shelter" D's unified credit by using the marital deduction only to the extent needed to reduce federal[4] estate taxes to zero (or as close to zero as possible).

Example 2: D died with a $2.0 million estate in 2004 but left only $500,000 to S in a manner that qualified for the marital deduction. D and S will pay no estate tax:

$2,000,000	D's estate (net of debts and expenses)
(500,000)	marital deduction
1,500,000	D's taxable estate
$555,800	tentative estate tax
(555,800)	unified credit
0	D's federal estate tax payable

3. Notice that this example assumed that S had no other wealth. Also note that, for simplicity, unless otherwise stated, all tax computations assume that there are no deductions other than the marital deduction and that there has been no appreciation or depreciation, additions to, deletions from, or consumption of the marital bequest during S's overlife. In addition, no attempt is made to adjust for or anticipate the scheduled increase in the unified credit or reductions in the maximum marginal estate tax rates, nor for notions regarding absolute repeal of the wealth transfer tax. Although these are not necessarily realistic assumptions, they make it easier to illustrate various concepts and make valid comparisons.

4. Note throughout all of this that *state* death tax is *not* considered and might not be minimized by the planning shown. When §2011 was repealed the state law response across the nation was so diverse that it is impossible to consider the state-by-state variations that may affect marital deduction planning. For simplicity this material does not continually refer to the *federal* tax or remind you that state tax may be incurred.

When S later dies:

$500,000	S's estate (net of debts and expenses)
155,800	tentative estate tax
(555,800)	unified credit
0	S's federal estate tax payable

In Example 2, D and S could have owned up to double the applicable exclusion amount without incurring estate tax on either death, if the property was owned in the "proper" manner (half in each estate) or the spouses died in the "right" order and properly used (but did not overuse) the marital deduction (causing the applicable exclusion amount to be taxed in D's estate and leaving only the balance to be taxed in S's estate). In this respect, the marital deduction can be employed to "split" a couple's aggregate estates for transfer tax purposes in a manner that secures the tax-sheltering effect of the unified credits available to both spouses.[5]

> Example 3: Same facts as Example 2 except that D leaves the remaining $1.5 million of D's estate in trust to pay income to S for life, remainder to the couple's descendants. No effort is made to qualify the assets settled in this trust for the marital deduction. The trust corpus is not taxable in S's estate because S was given only a life estate in the trust established by D's will. Only the $500,000 in assets bequeathed to S (and any assets owned by S in S's own right) are includible in S's gross estate. If these assets have not changed appreciably in value since D's death, S's gross estate still will be less than the $1.5 million that can be sheltered by the unified credit available to S's estate. No estate tax will be due from S's estate. Use of this "nonmarital" trust estate plan produces a tax saving of $225,000 compared with Example 1, while the nonmarital trust provides economic benefits to S. Now D and S have the best of both worlds. Enjoyment of the sheltered $1.5 million amount, without paying estate tax in either estate.

In the foregoing examples, it was assumed that D owned assets worth $2.0 million and that S owned no assets. No marital deduction would be available to reduce taxes in D's estate if D survived S and did not remarry. When the property passed to the next generation on D's death, only D's unified credit would be available to reduce taxes; the unified credit available to S's estate would have been wasted. The gift tax marital deduction might be used in such a situation to minimize taxes. D could

5. For larger estates, the marital deduction can be used to allow some property to pass to S but not to fully eliminate taxes, as with an "equalizer" provision that equalizes the estates or the marginal estate tax brackets of both spouses. This will lead to a corresponding reduction of tax at S's death under the progressive estate tax rate structure. See page 23 for a discussion of equalizer provisions.

Basic Marital Deduction Planning

To understand marital deduction planning, it is essential always to be mindful that usually the estate tax marital deduction does not reduce the estate tax on marital assets; it only permits deferral of tax until the death of S. If properly done, it really permits wise use of both spouses' unified credits, making many estates nontaxable because the couple has less than double the applicable exclusion amount. Otherwise, to stay focused on the benefit of the marital deduction, remember that through the estate tax marital deduction, Congress has (in effect) said: "We won't tax your property to the extent you leave it to your spouse in a form that exposes it to taxation in your spouse's estate."

Thus, as a general rule, the primary requisite to qualify for the marital deduction is that the interest passing to S must be in a form that will lead to wealth transfer taxation to S (to the extent of the value of the interest when a taxable transfer by S occurs).[7] Unfortunately, there is no symmetry in the wealth transfer tax system regarding the estate tax marital deduction. The fact that an interest left to S will be includible in S's gross estate at death does not ensure qualification for the estate tax marital deduction. Some includible interests will be nondeductible because they run afoul of the "nondeductible terminable interest" rule.[8] Fortunately, there also is no symmetry in the system in the sense that there will be no payback if S were to die after repeal of the estate tax.

Notwithstanding wealth transfer tax inclusion to S, the unlimited marital deduction allows easier planning for the many marital estates that exceed the amount of property that can be transferred tax free under the shelter of the spouses' available unified credits. That is because the deduction can eliminate the problem of estate tax payment in D's estate, regardless of the size of that estate, regardless of the "mix" of the marital assets (principally community property, principally separate property, or substantial portions of each), and without concern about the liquidity of those assets for tax payment purposes.

It always pays to remember also that hard issues like liquidity problems dodged today usually will present themselves when S dies (often in an even worse form) unless the tax (or the wealth) has disappeared before S dies. So, deferral may provide the opportunity to address these problems, but it also may lull clients into thinking the problem was solved

7. There are exceptions to this general principle. Certain interests can qualify for the estate tax marital deduction even though the interest may terminate and have no value of its own when S dies. Nevertheless, the value represented by the interest may be includible in S's gross estate. For example, annuity payments received by S and not consumed in a manner that has no value when S dies will be includible in S's gross estate (under §2033), although the amount included may bear only a slight resemblance to the marital deduction allowed for the value of the right to receive that annuity on D's death.

8. See page 44. This is well illustrated by the annuity situation: S's net worth will be increased by annuity payments received by S, even if the estate tax marital deduction is not allowed to D's estate, in which the value of the annuity also was includible.

or avoided when in fact it is just silently and relentlessly growing. The secret to marital deduction planning is to know when, and to what extent, to embrace deferral.

Basic Structure of Estate Planning for Spouses

The interrelation of the unified credit and the unlimited marital deduction creates a basic estate planning structure for spouses. In both community and noncommunity property states, the typical (albeit not necessarily the most intuitive) marital and nonmarital dispositions provide for any specific bequests, make an "optimum" marital deduction formula gift to S (or to the trustee of a marital deduction trust), and devise the residuary estate to the trustee of the nonmarital trust.[9]

This nonmarital trust gives S, at most, an income interest for life, a right to receive principal in the trustee's discretion, and perhaps nongeneral powers of appointment exercisable during life, at death, or both, all drafted to avoid wealth transfer tax inclusion in S's estate. Thus, D's estate effectively is "split" for wealth transfer tax purposes. Proper use of both spouses' unified credits through effective marital deduction and nonmarital trust planning permits marital estates of up to double the applicable exclusion amount[10] to pass to the next generation free of wealth transfer taxes.[11]

The key to this planning is to "shelter" (or use) D's unified credit by placing the applicable exclusion amount in the nonmarital trust, using the marital deduction only for the balance of D's otherwise taxable estate. To avoid paying an estate tax in D's estate, however, the amount of the gift to the nonmarital trust cannot exceed the applicable exclusion amount (for example, $1.5 million in 2004). Indeed, because of the concept of

9. Also often referred to as the bypass, family, or credit shelter trust. See Chapter 5. In large estates the marital bequest may be larger than the nonmarital portion of the estate, which leads to problems in making distributions to, and greater administrative inconvenience in funding, the marital deduction bequest. For this reason, in larger estates it may be appropriate to make the formula gift to the trustee of the nonmarital trust, and make the residuary gift in a form qualifying for the marital deduction. This "reverse" or "residuary marital" formula approach is discussed at page 117. Nevertheless, the basic planning discussed here would remain the same.

10. In 2004-2005 that §2010(c) determined amount would be $1.5 million per spouse (slated to increase to $2.0 million per spouse from 2005-2008 and $3.5 million per spouse in 2009, followed by repeal of the tax in year 2010 and resurrection of the entire system in 2011 with an applicable exclusion amount of only $1 million).

11. In considering these general statements, it is assumed for purposes of simplicity that: (1) there is no §2055 charitable deduction that will affect the computations; (2) joint tenancy and other nonprobate property is not so prevalent that it overqualifies the planning discussed; (3) no credits, such as the §2011 state death tax or §2013 previously taxed property credits, are involved; (4) there are no expenses of administration or other deductions; and (5) there is no income accumulation and no appreciation or depreciation in the respective estates between the spouses' deaths and, thus, there is no growth or potential capital gain or loss to consider and no §1014 basis adjustment is relevant. These obviously unrealistic assumptions are embraced here only to simplify the discussion of even the most basic planning approaches.

"nondeductible charges," in most cases the nonmarital trust will be less (perhaps considerably less) than this amount.[12]

Because many factors affect the size of a nonmarital trust, a specific bequest equal to the applicable exclusion amount (for example, $1.5 million in 2004) would virtually always cause taxes to be paid in D's estate. Thus, some other method of creating the proper bequest must be used. The following language is a common *formula* provision that accomplishes this planning:

> **If S survives me, I give to the trustee of the Marital Trust the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death. In determining this pecuniary amount, my personal representative shall consider the credit or the deduction for state death taxes only to the extent those taxes are not thereby incurred or increased, and shall assume that none of the payments and devises under the preceding articles of this will qualify for a federal estate tax deduction.**[13]

Commonly referred to as an "optimum" marital deduction (rather than an "unlimited" or "maximum") bequest, this disposition qualifies for the estate tax marital deduction only the minimum amount needed to generate a nontaxable estate for D. Depending on state law it also may eliminate all state death tax as well.

Note the effect of this plan. No property would pass pursuant to the marital deduction formula if, for example, D's estate was less than the applicable exclusion amount, because no marital deduction would be necessary to reduce taxes to zero. The same result could occur if this provision were used in an estate of up to double the applicable exclusion amount ($3.0 million in 2004) that was all community property: D might bequeath D's entire residuary estate (half of the community property) to

12. Nondeductible charges are items that must be charged against the nonmarital gift because otherwise they would reduce the marital deduction. Nondeductible charges may include such items as: (1) state or federal taxes; (2) bequests (including to S) that do not qualify for the marital or charitable deductions; (3) §642(g) "swing" items (usually administration expenses) for which a deduction is taken against estate income rather than as an estate tax deduction under §2053; (4) adjusted taxable gifts during life that "used up" some of the §2010 unified credit; (5) generation-skipping transfer taxes (such as on a direct skip generated by a child's disclaimer that caused a bequest to pass to a grandchild); and (6) nonprobate property includible in the gross estate that passes to someone other than S or not in a manner that qualifies for the marital deduction. In explaining an "optimum marital" plan to clients, lawyers commonly refer to the "credit shelter" amount that will be available to fund the nonmarital trust. Although this colloquial explanation may ease client understanding, it may lead to subsequent misunderstanding if the trust is funded with substantially less than the illustrated applicable exclusion amount.

13. Many provisions throughout this Chapter are adapted from forms originally copyrighted by The Northern Trust Company, www.northerntrust.com, and are reprinted with permission. Authority is expressly granted to attorneys to use those provisions in the preparation of estate planning documents for clients.

the nonmarital trust and no property would need to qualify for marital deduction purposes. And no bequest would be made to S or the marital trust under this provision if D died after repeal of the estate tax.

It should not be necessary to amend this type of formula marital provision in old or new documents to accommodate gradual increases in the applicable exclusion amount, because the formula itself creates the optimum marital bequest after full usage of the unified credit. Thus, if D's death occurs during 2009, the formula provision would create a nonmarital trust of up to $3.5 million and the couple would be able to pass up to $7.0 million to their intended beneficiaries free of wealth transfer taxes. This formula should work even if Congress further raises, reduces, or freezes the applicable exclusion amount, or phases in the increase to $3.5 million sooner than 2009. Nevertheless, cautious practitioners contact clients with older documents to ascertain that they wish to take advantage of any increases in the unified credit and perhaps amend their documents to make that intent clear. Because the increase effectively disinherits the marital bequest, the plan also might reflect the potential for S to take offense and assert a forced share election.

Tax Sensitive Outright Gifts to S

The optimum marital deduction bequest might be an effective tax plan, but it may generate a smaller marital bequest than D (or S!) wants. Consider, for example, the type of planning that may be desired by clients with "average" size estates who are sensitive to but not driven by tax minimization objectives. To illustrate, assume D's estate is valued at $800,000 and S has little property. For a variety of reasons (such as future contributions to D's qualified pension plan, payments reducing the mortgage balance on the family residence, stock market appreciation, and inflation), D's estate is likely to increase in value over the years, but at an unpredictable rate. There is no way to be sure whether D's estate will exceed the applicable exclusion amount (or whether Congress may reduce that amount before D dies).

In this case there may be no marital deduction drafting or planning concerns because each spouse may prefer to make a simple outright disposition of his or her entire estate to the surviving spouse, notwithstanding any tax consequences. Recall Example 1 at page 5. D and S may have the wisdom to realize that a nonmarital trust does not save taxes in the estate of D; any taxes saved are in S's estate, making the children the real beneficiaries of optimum marital deduction planning that shelters D's unified credit.[14]

14. Thus, although the spouses may have no estate planning concerns, their estate planner ay be quite uncomfortable, recognizing that, after D and S are deceased, their children nquire: "Didn't you tell the folks they could have saved taxes with a bypass trust A cautious planner will explain in writing the tax consequences of a nonmarital plan and confirm (also in writing) their joint desire to forego those savings. In addition, it might be appropriate to draft in contemplation of disclaimer, as discussed at page 16.

It also may not be desirable to allocate the full applicable exclusion amount away from S, especially in a smaller estate in which this could consume a significant portion or all of D's wealth and leave S with little or nothing in a marital bequest. Indeed, depending on the nature of the estate plan, failure to carefully consider the allocation of wealth away from S could result in S's election against D's estate plan and in favor of the statutory elective share.

Thus, despite the size of D's estate, D may eschew a nonmarital trust and leave "all my property to S," giving S the freedom and flexibility of outright ownership. Assuming this is not a subsequent marriage involving children by a former spouse, the marital planning and drafting can be very simple: outright disposition to S under a will or nontestamentary dispositions (such as life insurance or employee benefit plan proceeds paid in a lump sum, or jointly held property with the right of survivorship), all qualifying for the estate tax marital deduction. And potentially all passing tax free when S subsequently dies, because the applicable exclusion amount is adequate or the tax has been repealed.

Unfortunately, the simplicity of this plan is deceptive because it is necessary to consider the contingency of deaths in quick succession. This "all my property" plan should anticipate the not uncommon possibility that S may outlive D by only a short period, in which event there could be substantial taxes in S's estate (recall Example 1, in which $225,000 of estate taxes were unnecessary), even though S died before enjoying the property enough to justify that added tax cost. And don't forget that the wealth may increase to more than the applicable exclusion amount: what if D's death is wrongful and S recovers a tort damage award of several million dollars? Indeed, what if S was so badly injured at the same time that recoveries (or the right to recover) for both D and S are subject to tax when S dies not too long after D? There are several potential solutions to this problem.

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Survivorship Requirements

One approach to S dying before loss of the tax savings is compensated with enjoyment through personal use would be for D to employ a survivorship requirement, such as: "**I leave all my property to S if S survives me by X days.**" Unfortunately, this will not produce the desired result:

> Example: D and S are driving home from a New Year's Eve party when their car is struck head-on by a drunk driver. D dies immediately; S dies two days later.

Nothing passes to S under the marital deduction provision if S does not survive by the requisite period. Let's assume some numbers: D's estate tax computation would show:

$1,600,000	D's gross estate
(0)	marital deduction
1,600,000	D's taxable estate
600,800	tentative estate tax
(555,800)	unified credit
45,000	D's federal estate tax payable†

When S dies in this nearly simultaneous death case, there would be no added taxes (assuming S did not have independent wealth).

Under this same will, if S survived the crash and died slightly more than X days after D, the tax computation in D's estate would be:

$1,600,000	D's gross estate
(1,600,000)	marital deduction
0	D's taxable estate

When S later dies:

$1,600,000	S's taxable estate
600,800	tentative estate tax
(555,800)	unified credit
45,000	S's federal estate tax payable†

Contrary to the expectation that it would reduce taxes, the survivorship requirement had no effect at all: the tax is the same as if S did not live long enough to inherit D's estate. D and S will pay less tax only if a nonmarital plan is employed.[15]

Also failing to produce the right result is a straight presumption of survivorship provision. It will produce the same results as if S survived D by the requisite survivorship period. For example, assume that D's will provided: "**I leave all my property to S if S survives me**" and D and S die before anyone reaches the scene of their car accident (a so-called simultaneous death if the order of their deaths cannot be proven). Under the Uniform Simultaneous Death Act (which is the law virtually everywhere), the property of each of D and S would pass as though each survived the other. Thus, D's property would pass as though S died before D, with the same tax result as in the first computation above: $45,000 of estate tax payable by D's estate.

If, instead, D employed a presumption of survivorship for simultaneous death purposes, the results would match those in the second

† This "universal" footnote will appear in numerous places in this Chapter when reference is made to the payment of taxes, to remind you that this tax payable figure may be subject to other credits, such as the §2013 credit for taxes incurred on prior transfers.

15. Under the same will, if S died years later (and asset values did not change), the tax still would be $45,000 more (assuming the unified credit and tax rates do not change) than if a nonmarital plan had been used, but S will enjoy outright ownership of the assets for S's overlife, which was D's decision. The concern is only with S's death before sufficient enjoyment justifies the $45,000 of "unnecessary" taxes.

computation above: $45,000 of tax on S's death. Thus, D could use a provision that reverses the Uniform Simultaneous Death Act result:[16]

For purposes of this gift S shall be considered to have survived me if S and I die under such circumstances that there is no sufficient evidence to establish the order of our deaths.

In this case, S would be deemed to have survived the car crash that killed both D and S immediately. S would take all of D's property under D's will, generating the marital deduction for D's estate but again not reducing the tax on S's death.

None of these results is very attractive, and they all are attributable to the fact that only one spouse's unified credit is used. Whether D relies on a survivorship requirement, on the Uniform Simultaneous Death Act presumption, or on a "reverse presumption" provision, the tax sheltering effect of the unified credit is lost in either S's estate or D's estate. Thus, an unnecessary tax is incurred on the applicable exclusion amount that could be sheltered by a traditional nonmarital plan. D may be willing to accept this increase in tax if S lives long enough to enjoy outright ownership of all of D's property, but D should be reluctant to incur any tax if S does not survive for a sufficient period to reap significant benefits from this less than tax conscious plan.

Disclaimers

The second primary alternative to this problem is to rely on a disclaimer by S's personal representative if S's death occurs within the §2518 disclaimer period (usually nine months) after D's death. There are problems with disclaimers, the most important being that it must be clear under state law that S's personal representative can disclaim for S (which is not always the case). See the discussion of disclaimer disadvantages at page 18.

The Preferable Approach

Fortunately, there may be a better solution to this survivorship planning problem:

Marital Deduction Gift. If S survives me, I give S the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death. In determining this pecuniary amount, my personal representative shall consider the credit or the deduction for state death taxes only

16. This presumption of survivorship is permitted under Treas. Reg. §20.2056(c)-2(e): "If the order of deaths of the decedent and his spouse cannot be established by proof, a presumption (whether supplied by local law, *the decedent's will*, or otherwise) that the decedent was survived by his spouse will be recognized . . ." (emphasis added).

to the extent those taxes are not thereby incurred or increased, and shall assume that none of the payments and devises under the preceding articles of this will qualify for a federal estate tax deduction.

For purposes of this gift, if S and I die under such circumstances that there is no sufficient evidence to establish the order of our deaths, S shall be considered to have survived me.

Residuary Estate. I give all of the residue of my estate, including any foregoing gift that lapses ("my residuary estate"):

(a) To S if S survives me by X days;

(b) If S does not survive me by X days, per stirpes to my descendants who so survive me; and

(c) If neither my spouse nor any descendant survives me by X days, to my contingent beneficiaries defined [elsewhere in the will].

Under this plan, if D dies followed by S's death within X days, D's estate tax computation would show:

$1,600,000	D's gross estate
(100,000)	marital deduction produced by formula
1,500,000	D's taxable estate
555,800	tentative estate tax
(555,800)	unified credit
0	D's federal estate taxes payable†

When S later dies:

$100,000	S's taxable estate
23,800	tentative estate tax
(555,800)	unified credit
0	S's federal estate taxes payable†

On the postulated facts of D having a $1.6 million estate and S having no independent wealth, the illustrated will provision would save the couple's children $45,000 in taxes if the calamity of deaths in quick succession were to occur. If the deaths do not occur within the specified time, this plan would provide the disposition to S that D wants.

What period should D insert for X? It must be less than six months to come within the "limited survivorship" exception to the nondeductible terminable interest rule of §2056(b)(3), as discussed at page 48. But that rule is of no concern here because the unified credit would shelter this nonmarital amount anyway, making the marital deduction unnecessary. Therefore, the period could be shorter (for example, 30 days, 7 weeks) or longer (for example, a year or more), although a much longer period could create administrative problems because closing the estate might be delayed while waiting for S to survive the contingency period. This contingency is a concern whether S dies 60 minutes or 60 days after D, so D should select a period that is a good compromise between the planning and administration issues involved.

One question that occurs to many observers is whether S will have trouble getting along for the number (X) of days that the residuary gift is contingent. The answer is almost always that the delay aspect of the residuary gift presents no problem: because S will be entitled to a family allowance under state law, and S will enjoy all nonprobate assets that are payable to S or that belong to S (such as life insurance or employee benefit plan proceeds paid in a lump sum, and assets held jointly with the right of survivorship). In addition, S may take something under the marital deduction provision (the only question is how much), which may be partially distributed (in this case any part or all of the $100,000 marital bequest) during the X day period. And S may be D's personal representative with effective control over all of D's probate estate.

A Note About Community Property

In a noncommunity property estate the planning objective is to split the marital property if the spouses die in quick succession. By contrast, in a community property estate the marital property (everything except the respective spouses' separate property) already is split, automatically and evenly by the community property laws. Therefore, the objective is to avoid unsplitting the estate if the spouses die in quick succession.

In a community property estate splitting the wealth does not require a formula marital deduction gift (with a survivorship requirement imposed on S) unless substantial separate property is involved. Instead, the estates will stay split simply by using a survivorship requirement with respect to D's entire community property estate. Thus, the only necessary provision is a residuary gift of D's entire estate "**to S if S survives me by X days.**"

Drafting in Contemplation of Disclaimer

The alternative to an "all outright" plan is an intermediate approach that permits S to take a second look after D dies, to see whether a nonmarital trust is preferable. For example, the estate may have appreciated substantially since the estate plan was written and this increase in value, together with S's age and life expectancy, may make a nonmarital trust appropriate. Indeed, a trust might be a welcome alternative to a guardianship or other fiduciary relation to provide efficient asset management if S no longer is willing or able to manage wealth.

Disclaimer planning anticipates that each spouse will make an unlimited marital deduction bequest to the other, with S disclaiming so much of D's estate as appropriate to cut back to an optimum marital deduction (or other desired amount). The documents effecting this plan would look like the will provisions under "the preferable approach" at page 14, with the addition of the following provision:

> **Family Trust. I give any interest under any preceding provision of this will that S disclaims to the trustee of the Family Trust.**

The Family Trust would contain whatever terms D selects (for example, mandatory income or a discretionary income spray, principal invasion powers in the trustee, powers to appoint in anyone other than S), such that no benefit given to S causes trust corpus to be subject to S's wealth transfer taxation or precludes a qualified disclaimer (which explains why S cannot have a traditional power to appoint).

Note that an undivided portion or a pecuniary amount may be disclaimed. Treas. Reg. §§25.2518-3(b) and 25.2518-3(c). For example, S may make a qualified disclaimer of a fraction of the residuary estate of which the numerator is the amount exceeding the desired marital deduction and the denominator is the value of the residuary estate.

Advantages

Drafting in contemplation of disclaimer alerts the right people to consider this postmortem opportunity. Because the right to disclaim exists under state law, the possibility of a disclaimer need not be mentioned in the estate plan, but a specific provision reminds S to take a second look to decide what is best. A reference to the disclaimer possibility also serves as a red flag, which is useful because a §2518 qualified disclaimer usually must be made within nine months after D's death. Affirmative provisions also may overcome any reluctance that S might feel about making a disclaimer that otherwise might be perceived "as against D's intent."

A second major advantage of drafting in contemplation of disclaimer is that the estate plan can make suitable provision for disposition of the disclaimed interest. In some circumstances it may not be clear what happens to the disclaimed interest otherwise, notwithstanding a statute that attempts to address the problem. For example, Uniform Probate Code §2-801(c) specifies that: "[u]nless the decedent . . . has otherwise provided, the property or interest renounced devolves as though the disclaimant had predeceased the decedent." The 1990 version is virtually the same in UPC §2-801(d)(1).

To illustrate, suppose that S disclaims a portion of an outright bequest under a will that was not drafted in contemplation of disclaimer. The disclaimed interest passes into a residuary trust of which S is a permissible income distributee. Under the statute, is S precluded from receiving income from the disclaimed interest, given that the disclaimed interest is supposed to pass as if the person renouncing had predeceased the decedent? Stated another way, does the statute apply in reading the outright bequest that was disclaimed, does it apply in reading the entire will with respect to the disclaimed interest, or does the trust provision override the statute? A specific designation in the document would solve this problem with a clear statement to the effect that S shall not be disqualified as a beneficiary of the receptacle trust with respect to disclaimed (or any other) property.[17] Federal law permits S to continue to enjoy income from the disclaimed property and S may not disclaim if that enjoyment is not preserved.

Disadvantages

Numerous disadvantages or potential problems attendant to disclaimer planning also deserve attention. One is that S simply may be unwilling to lose control of the property to save taxes for future takers, despite protestations made to the contrary during both spouses' lives. That is, among the world's greatest lies are: (1) "The check is in the mail"; (2) "I'm from the government and I want to help you"; and (3) "Of course I'll disclaim if it will save taxes." Closely related is fear that the property remaining after the disclaimer will not be adequate to support S after incurring some estate tax in D's estate. The disclaimed assets can remain available to S and still be a qualified disclaimer (in the context of a §2518(b)(4)(A) nonmarital trust). So this concern really relates only to prepayment of wealth transfer tax in D's estate due to S's disclaimer, which need not be a factor if all S disclaims is amounts up to the applicable exclusion amount (so no tax payment diminishes the available wealth before S's death).

A second problem with disclaimers is that S may be legally unable to disclaim, or may die before the disclaimer is made.[18] For example, a personal representative cannot disclaim on behalf of a surviving spouse who already is deceased under the original version of UPC §2-801(a). Although the 1990 version of the Uniform Probate Code corrects this problem (allowing the deceased S's personal representative to disclaim), it

17. Although the 1990 version of UPC §2-801(d) addresses this issue by disposing of only the disclaimed interest as if S were deceased, it still does not specify whether S should be regarded as predeceased with respect to income payable by the bypass trust from disclaimed property, and the newer version of the UPC is not the law even in most UPC states, most of which have not yet adopted the 1990 revisions.

18. See 2 Casner & Pennell, Estate Planning §7.1.6.6 (6th ed. 1999), regarding authority of a fiduciary to disclaim on behalf of a beneficiary, such as S. For example, in Estate of Delaune v. United States, 97-1 U.S. Tax Cas. (CCH) ¶60,266 (M.D. La. 1997), rev'd, 143 F.3d 995 (5th Cir. 1998), the trial court originally concluded that purported disclaimers on behalf of a surviving spouse were invalid because they were made too late under state law (because the surviving spouse already had died). The court on appeal, however, held that the disclaimers were valid under Louisiana law, which allows the renunciation of a succession by the heirs of an heir, acting on the heir's behalf. See also Estate of Chamberlain v. Commissioner, 77 T.C.M. (CCH) 2080 (1999) (the decedent allegedly intended to disclaim but failed to sign a writing to that effect before dying, the court rejecting all sorts of extrinsic evidence and ancillary documents—including Forms 706 for both spouses that were consistent with disclaimer—indicative of the intent to disclaim, and also rejected a "close is good enough" argument for substantial compliance with the disclaimer requisites).

has not been widely adopted yet. Moreover, a personal representative who is authorized by local law to disclaim will balk if the disclaimer will affect the ultimate recipients of property from each spouse, unless the personal representative is given clear standards to guide its decision and is indemnified against any liability to disaffected beneficiaries.

Third, a qualified disclaimer under §2518 is impossible if S accepted any benefits from the interest being disclaimed. Thus, D's fiduciary must be astute enough to prevent payment to or acceptance by S of income from the disclaimed property, or use by S of those assets, and sometimes the acceptance of benefits is deemed to occur in unexpected ways. Indeed, at one time the government regarded simply being a joint tenant with a decedent as an acceptance of benefits by surviving joint tenants that might preclude an otherwise qualified disclaimer of joint tenancy property. Although the government since altered its position, the fact that it took years of litigation to resolve the issue is a good reminder that disclaimer planning is fraught with peril and probably nothing to rely upon for affirmative estate planning purposes.

A fourth problem with disclaimers is disposition of the disclaimed interest. Although §2518(b)(4)(A) regards a disclaimer as effective if the interest passes to a nonmarital trust held for the benefit of S, such a disposition might not occur automatically. Thus, the document may need to specify this disposition. For example, in the all outright plan illustrated at page 14 with a survivorship contingency, D's residuary estate passes to descendants if S does not survive by the requisite period. Because S would be treated as predeceased by virtue of a disclaimer, this alternative disposition would apply unless the document specifically provided for a different disposition on disclaimer.

A similar problem is encountered in very large estates that use a residuary marital plan making a formula gift to the nonmarital trust and leaving the residue of the estate to a marital deduction trust. Property disclaimed from the marital deduction residue normally would pass by intestacy, not into the preresiduary nonmarital trust in which D probably would want it to continue to benefit S without estate tax inclusion when S subsequently dies. A special disclaimer pour back into the preresiduary nonmarital trust would be required to accomplish D and S's objectives.

Fifth, to be a qualified disclaimer, S cannot have any power to direct disposition of the disclaimed interest. For example, if S is trustee of the nonmarital trust, the disclaimer will succeed only if the trustee's powers are limited by an ascertainable standard. Moreover, if that trust grants S a power of appointment not limited by an ascertainable standard (for example, an unrestricted nongeneral testamentary power of appointment), S also must disclaim the power.[19] It will be necessary to define that portion

[19]. Note that Treas. Reg. §25.2518-3(a)(1)(iii) permits a power of appointment to be disclaimed while retaining other interests in corpus, but a power of appointment cannot be cut down or otherwise tailored to retain the power while complying with these limitations.

of the nonmarital trust as to which the power is relinquished if S is willing to disclaim the power only to the extent necessary to qualify the disclaimer and not as to all of the nonmarital trust.

Although a fractional approach might be successful, a better approach might be to create a separate trust to which all disclaimed assets will pass by express direction in the marital provision, without affecting the normal nonmarital trust. This trust would give essentially the same benefits as the nonmarital trust (except prohibited powers), and provide for consolidation with, or addition to, the nonmarital trust for ultimate distribution after S's subsequent death. It might even be useful to give S a noncumulative right to withdraw yearly the greater of $5,000 or 5% of the aggregate value of the principal (the disclaimed property) in the nonmarital trust, as permitted under Treas. Reg. §25.2518-2(e)(5) Example 7. This (albeit limited) ability to reach disclaimed corpus might overcome any reticence that S otherwise may feel about disclaiming a portion of the outright gift.

Finally, the disclaimer must properly describe the portion being relinquished out of an unlimited marital bequest. Identifiable, severable assets held in trust may not be disclaimed unless the assets are removed from the trust and pass to other beneficiaries, but a specific dollar or formula amount may be disclaimed from a trust. Treas. Reg. §§25.2518-3(a)(2); 25.2518-3(c). Thus, for example, disclaimer of the income from a specific number of shares of stock or of an identifiable piece of realty would not qualify if the stock or realty continued to be held in trust, but disclaimer of a specific dollar amount or of a fractional or percentile portion of an entire interest is allowable. Depending on the nature of the property likely to be disclaimed, some advance thought must be devoted to the form and drafting of the type of disclaimer that will be required.

Planning and Drafting for Larger Estates

All examples in this segment use an applicable credit amount of $555,800 and an applicable exclusion amount of $1.5 million. The phase-in increase of the applicable exclusion amount will reduce the aggregate dollar savings available but does not alter the principles illustrated. A major change 45/ in focus will be required if we ever get into a flat tax environment, which is slated to occur in 2006 (if Congress does not alter the changes adopted in 2001). The tax does not remain flat, however, after those changes sunset in 2011 (again unless Congress alters the 2001 changes).

The basic truism of marital deduction planning illustrated so far is that giving all of a larger estate to S may "overqualify" the marital deduction:

> Example: D and S have a $2.0 million community property marital estate. D's will bequeaths "all my property" to S.

Because of the unlimited marital deduction there will be no tax in D's estate, but the full $2.0 million is exposed to tax in S's estate, resulting in the following tax computation at S's later death:

$2,000,000	S's taxable estate
780,800.	tentative estate tax
(555,800)	unified credit
225,000	S's federal estate tax payable†

The problem with this dispositive plan is that D's estate did not benefit from the tax sheltering effect of the unified credit. It would have been possible to remove $1.5 million from taxation on S's death through D's gift to a nonmarital trust of all but an optimum marital deduction formula amount, with no increase in tax at D's death and a tax reduction at S's death of $225,000. Sheltering D's unified credit by using only an "optimum" marital bequest is a better approach for tax minimization purposes. However, another planning decision must be made in a larger estate: is it wise to take full advantage of the optimum marital deduction, or would it be better to pay some tax in D's estate to increase the amount that can be sheltered from tax at S's death?

> Example: D and S own $3.5 million of community property. They forego the marital deduction entirely, so that each of their estates will be $1,750,000 at death.

In each estate the tax computations are:

$1,750,000	taxable estate
668,300	tentative estate tax
(555,800)	unified credit
112,500	federal estate tax payable†

Total taxes for both estates would be $225,000. If you run the numbers you will discover that this represents no savings over an optimum marital deduction plan that shelters $1.5 million at D's death and taxes $2.0 million at S's death. Although a savings would be available (with tax payment at D's death) in much larger estates, for most people this isn't a hard decision to make. As a consequence, for our purposes the notion of foregoing the marital deduction has only academic appeal until you represent very large estates. And it disappears once we are in a flat tax environment, so we will not explore it further from a tax savings perspective.

There are, however, a number of noneconomic reasons that favor the payment of some tax at D's death. The most important relates to family planning concerns: the question for most clients is how long their ultimate beneficiaries (typically children) must wait for their inheritance. Most children, for example, are "orphaned" in their 40s or even later, when their surviving parent dies, which may be years or even decades later than the time of their greatest financial needs. This suggests an imbalance that may persuade some clients that deferral should not be based strictly on an economic analysis.

For example, in a $5.0 million estate, the "optimum" plan would involve a nonmarital trust of no more than the applicable exclusion amount. Even if distributed immediately to beneficiaries other than S, it may be that, considering lifestyle and expected health care costs, the marital bequest will allow S to more than "scrape along." Thus, the question for the client to consider is whether to leave less to S, notwithstanding the need to pay some tax at D's death, to provide earlier and greater benefits to the ultimate beneficiaries. This question especially should be considered if S is a subsequent spouse whose death is likely to occur even later in those ultimate beneficiaries' lives.

Indeed, consistent with this notion, some clients may wish to consider a giving program benefiting younger generation beneficiaries while both spouses are living, taking maximum tax minimization advantage of two annual exclusion gifts per donee under §2503, perhaps even exhausting each spouse's unified credit.

As an alternative, if the client's unwavering desire is optimum marital planning or holding property until D dies to generate a new basis by virtue of inclusion in D's gross estate (assuming death occurs before the estate tax is repealed, with a concomitant change from §1014 new-basis-at-death to §1022 carryover basis), it might make sense to include precatory language[20] recommending that S consider making gifts to younger generation beneficiaries after D's death. To make this work most effectively may entail providing at least a portion of the marital bequest in a manner that allows S to make inter vivos gifts.

> Example: S received $1.0 million more property from D than S needs, and is willing to part with that amount in the form of a gift to children and the gift tax thereon. Assuming the worst possible case (that S's marginal gift tax bracket already is 48%). S could give the children $675,676 from the $1.0 million that S does not need; at 48% the tax on this gift would equal the remaining $324,324 that S will pay to the government.[21] This translates into an effective tax rate on the $1.0 million of just 32.43%, which is lower than the lowest marginal rate (45%) that could be imposed on D's estate if a less than optimum marital bequest is utilized. If S is in a gift tax bracket that is lower than the maximum 48%, the differential would be even greater.

To make such planning possible it would be desirable if the trust granted S

20. Perhaps in a letter to S that would minimize any reluctance S might feel to make gifts (even though S has more income than S can or does spend, perhaps because S remembers the Depression).

21. The algebraic formula to make this computation is:

transfer divided by (1 + tax rate) = taxable gift

So, for a 2004 calculation: $1.0 million divided by 1.48 = $675,676. Multiply that by the rate of tax to yield $324,324 of gift tax and the two together total $1 million.

the authority to appoint property (permissible in a §2056(b)(5) trust but not in a QTIP trust, due to the prohibition in §2056(b)(7)(B)(ii)(II) against anyone having a power to appoint QTIP property to anyone other than S) or to withdraw trust principal from either form of marital trust that could be the subject of a gift.

Stop

The Time-Value of Money Rationale for Deferral

Ignore for purposes of this discussion the promised repeal of the estate tax in 2010 (or its reinstatement in 2011): it may never happen, or the spouses both may die before then. More importantly, one purpose of this discussion is to reveal the truth about a pervasive estate planning myth. This very common assumption is relevant in analyzing any marital deduction planning approach that entails payment of estate tax in D's estate. The wrong minded notion is that use of the tax dollars deferred from D's death under an optimum approach will compensate for any difference in tax saved by avoiding estate stacking, which is the term used for adding D's wealth on top of S's estate.

That "time-value-of-money" assumption is false. Two examples will illustrate this, the second assuming time-value as reflected in the aggregate wealth doubling in value during S's overlife. For purposes of this illustration the source of this growth or the amount of time that it takes to occur is irrelevant.[22] What is relevant is that this doubling represents the enjoyment or use of the wealth over S's overlife and therefore illustrates the time-value of the deferred tax payment.

Before embarking on this odyssey of economic comparisons, it bears noting that the choice whether to pay estate tax in D's estate versus in S's estate is all second best planning. As just illustrated, far better planning in an environment with estate and gift taxes intact would be qualification for the marital deduction in D's estate followed by gifts by S. This series of illustrations therefore is more valuable as a means of dispelling the common but wrong minded assumption that the time-value notion makes deferral of tax preferable to either payment of estate tax in D's estate or incurring gift tax before both spouses die. To make an illustration that is meaningful, please excuse the use of very large numbers.

> Baseline Example: First assume that D's estate is $10.0 million, that S has an estate of $1.0 million, and that D dies first, with a marital deduction bequest that equalizes their taxable estates. Compared to an optimum marital deduction approach, the tax computations at the deaths of D followed by S (assuming deaths in 2004, no §2013 previously taxed property credit, and no changes in asset values) would look like:

22. Although there may be income tax differences whether this is due to income accumulation or capital appreciation, that factor is not considered because it is uncertain and therefore impossible to quantify. It also does not change the analysis.

still may make sense to forego an optimum marital bequest in D's estate. Although both estates incur tax in the highest marginal bracket, the average rate of tax is less if they are taxed separately than if one estate is added to the other and the second estate is taxed entirely in the highest marginal bracket. This will remain true until the estate tax loses its progressivity because maximum tax rates have dropped and the applicable exclusion amount has risen to produce a flat tax, as slated to occur after 2005. Thus, it may pay to push a pencil to compare tax saved by equalization (versus simple optimization), to consider whether an equalizer is preferable, and to evaluate the true value of deferring all taxes until the death of S. Indeed, the major point of all these illustrations is to highlight the need to make some calculations rather than making assumptions or, worse, employing the same approach in every situation without careful consideration of each case.

Basis Concerns

One reality is that modest transfer tax savings usually are not enough to encourage most taxpayers to prepay any tax. In addition, these transfer tax savings also must be discounted by any capital gains tax that would be incurred if a sale in the future caused a realization of appreciation that a §1014 basis adjustment would eliminate if that property was includible in S's gross estate (because it qualified for the marital deduction in D's estate). This is quite an imponderable due to guesswork regarding the timing of any potential realization event, the rate of tax that might apply at that time, and the possibility that the spouse will die after repeal of the estate tax and, with it, repeal of the new-basis-at-death rule of §1014 as well.[30] You can see that any discussion about paying tax in D's estate probably is totally academic (meaning a waste of time) in virtually all cases. So the benefit of the foregoing is (1) educational (you know what really is going on) and (2) so you don't make representations that are wrong and get you sued, for doing the right thing perhaps but for wrong reasons that are documented in your letter to D and S, found in their files by their ultimate beneficiaries after both are gone.

Using the Previously Taxed Property Credit

Notwithstanding the last reality, one circumstance that flows from our prior discussion also arises often enough that you need to understand it. Postmortem planning of the size of the marital deduction should consider the effect of a §2013 credit for previously taxed property.[31] To illustrate

30. Carryover of basis in §1022 takes the place of new-basis-at-death in §1014 if the estate tax repeal becomes effective (in 2010). But transfers between spouses (either outright or in a QTIP format) qualify for a $3.0 million increase in basis entitlement (not $3.0 million of property with a basis equal to fair market value but an addition to basis of $3.0 million, allocated as the personal representative chooses among qualifying properties).

31. It is more complex, but in substance §2013 provides that any tax paid by D's estate on property that is includible in S's gross estate within 10 years later becomes a credit against S's estate tax payment.

why, consider the example of Technical Advice Memorandum 8512004, in which D's will bequeathed to S an amount equal to the maximum marital deduction allowable to D's estate, and bequeathed D's residuary estate to a nonmarital trust that gave S an income interest for life. S died three months after D, from causes not foreseeable at D's death. S's personal representative disclaimed the marital deduction bequest and D's entire estate passed under D's residuary clause to the nonmarital trust. Thus, a marital deduction was not available to D's estate. Aggregate estate taxes over both estates were minimized, however, because the estate tax generated in D's estate generated a §2013 credit available in S's estate.

S's income interest in the nonmarital trust was the previously taxed property that qualified for a §2013 credit, notwithstanding that no part of the corpus of that trust was includible in S's gross estate at death.[32] Under the actuarial tables, the value of S's life income interest (and the §2013 credit based thereon) far exceeded the income S actually received during the three months S survived D. Nevertheless, S's estate was able to maximize the credit at a nominal cost because use of the §7520 valuation tables is required unless S's death is clearly imminent due to an incurable physical condition that was known at D's death,[33] *and* S's life expectancy is used rather than S's actual overlife.

> Example: D had an estate of \$3.0 million and S had an estate of \$1.5 million. S died within nine months after D's death (both in 2004) but, because S was not terminally ill when D died, valuation of S's life estate in D's property was based on the actuarial tables, as required by §7520 and Treas. Reg. §20.7520-3(b)(3).

Optimum Marital		§2013 Maximizing Marital
\$3,000,000	D's gross estate	3,000,000
(1,500,000)	marital deduction	(532,268)
1,500,000	D's taxable estate	2,467,732
0	D's federal estate tax	449,511.30
3,000,000	S's taxable estate	2,032,268
705,000	S's tax B4 §2013 credit	240,488.64
(0)	§2013 credit	(240,488.54)
705,000	S's tax after §2013 credit	.10
705,000	tax over both estates	449,511.40

(1.5+1.5)

3
−1.5
1.5 sub to tax

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32. In essence both the income and remainder interests in the trust were taxed in D's estate, and the income interest inflated S's net worth, so it alone is deemed to be includible in S's subsequent estate.

33. See Treas. Reg. §20.7520-3(b)(3), which mandates use of the standard tables unless the individual who is the measuring life is terminally ill (meaning that the individual is known to have an incurable illness or other deteriorating physical condition and there is at least a 50% probability of death within one year).

In this case D and S saved $255,488.60 in tax paid over both estates as compared to an optimum marital result. That is a 36% tax saving, representing almost 5.7% of the aggregate wealth of D and S.

This planning requires some balancing to ensure that S has sufficient assets to generate enough tax to consume the §2013 credit produced from the tax on D's estate, and D's taxable estate is large enough to produce enough tax to generate the necessary credit. Several computations may be needed to strike the proper balance, and more computational complexity will be encountered if a state death tax is involved.[34]

Estate planners face difficult decisions in postmortem planning that incurs an estate tax in the estate of D to produce a §2013 credit in S's estate. That particularly is true today as marital deduction planning is done with one eye on whether S may outlive repeal of the estate tax and the other eye on whether S is likely to die within the §2013 ten year window after D's death. Moreover, drafting bypass trusts requires a decision whether to provide that S will receive all income annually (thereby qualifying for the §2013 credit if death occurs within 10 years after D), or to provide for an income spray to reduce S's income and estate tax liability and to permit other family planning uses of bypass trust income during S's overlife.

With the current compressed income tax rates, the real factor to consider in deciding which approach to follow is the increase in S's gross estate attributable to payment of all income to S annually, which may be an insignificant factor if S is expected to die within the 10 year §2013 period or after the year 2010 promised repeal of the estate tax. In addition, S may be able to make gifts of excess income to prevent bloating S's gross estate, or the trustee may be able to engineer the income yield in the trust with proper investments under the prudent investor rules. Moreover, granting S a five or five withdrawal power in the trust can significantly increase the value of S's interest for §2013 purposes, in some cases by as much as an additional 10%.

A Note About Formula Clauses and Computations

Estate planners have drafted prolix, convoluted formula marital bequests since 1948. In most cases, provisions calling for a bequest of a

34. Assuming S's life estate is worth $1,079,748 (53.5%) in the $2,018,221 nonmarital trust after paying $449,511 in tax. The assumptions underlying this computation will change monthly with the §7520 interest rate and annually with S's age. To make this hypothetical computation the assumptions made were that S is age 77, the §7520 rate is 4.2%, and S is given a five or five power of withdrawal over the nonmarital trust.

Notice that no state death tax, nor the §2011 state death tax credit or §2058 state death tax deduction, is reflected in this calculation, on the theory that — at least under a pickup tax regime — there should be no state death tax if there is no federal estate tax payable after the §2013 credit is applied. That concept is not universally accepted, but was recognized as proper by *In re* Estate of Lacks, 662 N.W.2d 54 (Mi. Ct. App. 2003); Riethmann Trust v. Director of Revenue, 62 S.W.3d 46 (Mo. 2001); Estate of Turner v. Washington State Dep't of Revenue, 724 P.2d 1013 (Washington 1986); and Dickinson v. Maurer, 229 So. 2d 247 (Fla. 1969).

specific dollar amount, specified assets, or a preordained fraction are not sufficiently precise to generate the proper-sized deduction. In some cases, it is advisable to make a few specific bequests to direct distribution of certain assets to particular beneficiaries. Otherwise, the use of a specific provision is too imprecise, given the effect of other qualifying assets, valuation changes, and elections affecting the size of the marital bequest desired, equitable apportionment that may alter the size of the probate estate, and other unpredictables (such as adoption of new tax laws).

Therefore, a formula marital bequest is the appropriate approach in virtually all situations, the real issue being which of several formulas to use. At one time some planners felt comfortable using a "laundry list" approach. They would create a formula itemizing all factors that would affect the ultimate computation of the desired marital deduction. This approach involved substantial complexity, requiring a provision that anticipated at least the following items: (1) the effect and changing valuation of all relevant credits; (2) the effect of all tax elections that may be made; (3) the possibility that S or some other beneficiary may make a qualified disclaimer; (4) the computation of offsets for other qualifying assets passing to S, including some direction as to how the determination is to be made if any part of a nonmarital trust could be elected for QTIP treatment; (5) the effect of §2032(b)(2), which prevents recognition of any changes in asset values prior to satisfaction of the marital bequest that are attributable to the lapse of time or the (non)occurrence of any contingency; (6) the effect of other deductions allowed to the estate (§2053, §2054, §2055, §2057 before its repeal, or §2058 after repeal of the §2011 state death tax credit); and (7) the effect of gifts made during life. In addition, the provision had to specify: (8) which values are to be used for all these computations (those initially reported on the federal estate tax return, those finally accepted for federal estate tax purposes, or some other values); and (9) whether §2032 alternate or §2032A special use valuations are to affect the computation.

The risk of error in creating such a list, and the possibility that changes in the law would require document modification to ensure preservation of the original intent, probably speak against the use of this approach. In the current legislative world, it is difficult to draft a formula provision (marital deduction or otherwise) that effectively anticipates all the factors that should be considered, thus making "laundry list" itemized approaches to drafting a dangerous endeavor.

Some planners are content to use a "maximum marital deduction" provision with a "cut back" clause designed to reduce the marital bequest to the optimum, equalized, or other marital deduction desired amount. This approach may require addition of a provision specifying that available elections in estate administration (for example, alternate valuation, §642(g) income or estate tax deduction, or §2032A special use valuation elections) need not be exercised so as to maximize the estate to "maximize" the marital deduction as well.

It also may be fair to suggest that a cut back provision is harder for a client to understand, even though it is a more complete description of the various steps taken to arrive at the size of the marital bequest. Further, care must be taken in using a cut back clause to state accurately the amount of reduction desired. For example, it is not appropriate to reduce the maximum amount by that amount, if any, that "will reduce taxes paid to zero" because it may not be possible to minimize taxes to that extent.

Many planners therefore use a "fudge" formula that simply describes the desired objective: usually to generate the smallest marital deduction necessary to reduce taxes (federal and sometimes state, although that is very difficult to predict) to the lowest possible amount. This may be the safest approach and it certainly is the easiest to explain to the client, and for the client to understand. It may not, however, be the most palatable psychologically to S, to whom the message is abundantly clear that D "loves you very much, dear, but as my estate plan I leave you the absolute smallest possible amount necessary to generate a tax motivated result." Hopefully, both spouses adequately understand the plan, and the nonmarital trust is sufficiently generous, to avoid any negative impressions this message otherwise might generate.

A fudge formula also assumes that the fiduciary administering the plan will have the acumen to determine the appropriate bequest, considering the myriad factors that can affect the size of the deduction, and that no conflict of interest will interfere with a proper determination of that amount. It seems appropriate to suggest that a fiduciary should not be selected if there is any legitimate doubt about these qualifications, but the reality is that D may have no (or is not willing to consider) other options.

Regardless of the economic arguments that favor payment of some tax in D's estate, most marital deduction bequests are of the optimum deduction variety, sometimes with a six month equalizer, often planned with the possibility of disclaimer or a partial QTIP election for postmortem adjustment. There are, however, at least half a dozen special situations in which the size of the appropriate deduction will be affected by other forms of tax conscious planning. The planner should keep in mind, however, that family planning considerations, rather than taxes, may dictate an entirely different result, notwithstanding the clear tax benefits otherwise available. Most of these other alternatives are way too complex to dig into here, but two deserve some consideration.

Generation-Skipping Transfer Tax Exemption

The §2631 exemption from the generation-skipping transfer tax (GST) available to all transferors is an extremely important entitlement that affects marital deduction planning.

Example: D and S collectively own property of more than $3.0 million in 2004 and wish to create typical optimum marital deduction plans. After S's death the marital trust created by D will pour over into the nonmarital trust, which is a generation-skipping trust for their children and grandchildren. They must decide how to maximize their respective exemptions.

Upon S's death, all the marital trust that is includible in S's gross estate normally is treated as S's property for GST purposes. §2652(a)(1)(A). Thus, with a traditional optimum marital deduction plan, only the property originally placed in the nonmarital trust (usually no more than the applicable exclusion amount) would be treated as D's property for purposes of allocating D's GST exemption. Therefore, any excess of D's exemption would be wasted. The GST exemption and the applicable exclusion amount became the same in 2004, but the nonmarital trust may not fully shelter D's GST exemption because of erosions to the applicable exclusion amount that did not consume any GST exemption, such as inter vivos, testamentary, or nonprobate transfers that do not skip generations, or nondeductible charges in D's estate administration.

One option to avoid wasting any of D's GST exemption is to allocate a larger amount to a nonmarital trust at D's death than just the applicable exclusion amount. The notion is to place an amount in the nonmarital trust that, after incurring federal and state estate taxes on the nonmarital trust amount, would leave a balance that could be sheltered forever (along with any appreciation thereon) by D's full GST exemption.

Congress was aware, however, that the typical client will not opt to prepay any part of the wealth transfer tax in this manner and therefore that most taxpayers will not shelter the full GST exemption in a nonmarital trust if deferral of tax is available through use of the marital deduction. Congress therefore provided an election that allows D to create a QTIP marital deduction trust, allocate any part or all of D's GST exemption to it, and overcome the §2652(a)(1)(A) rule that treats S as the transferor for GST purposes after inclusion of the QTIP trust in S's gross estate. Under §2652(a)(3), D is regarded as the transferor of marital trust property, notwithstanding its subsequent inclusion in S's estate, to the extent a "reverse QTIP" election is made. Thus, if the GST exemption amount and the applicable exclusion amount do not coincide after 2003, reverse QTIP planning is available.

Certain requirements must be met to make this election, the most important being that D must use the §2056(b)(7) QTIP form of marital deduction trust, which may not be the best (or even an acceptable) approach. The point is simply that D must choose among several perhaps unattractive alternatives or lose the benefit of some or all of the GST exemption.

Administration Expenses and the "Swing Item" Election

The other important concept relates to administration expenses that fall under the income tax deduction rules (including end of life health care costs and fees paid to personal representatives, attorneys, appraisers, etc.).[35] These can be taken as deductions against the estate tax under §2053 or against the estate's income tax, but they cannot be used for both purposes (unless they constitute §691(b) deductions in respect of a decedent. §642(g)). The income tax deduction is forfeited to the extent the expenses are allowed for §2053 purposes.

In an "optimum" marital deduction estate plan that is designed to reduce estate taxes to zero, there is a commonly accepted wisdom to use these "swing item" deductions on the estate's income tax return. This is because use as an estate tax deduction does not save estate taxes; the marital deduction eliminates all estate taxes anyway. Thus, the only perceived effect of taking these items as an estate tax deduction under §2053 is to reduce the size of the marital bequest and failure to take the swing items as income tax deductions is seen by some planners as "throwing away a deduction." With this in mind, the decision for these planners is to use the swing items as an income tax deduction, allowing the marital bequest to remain unreduced but reducing income taxes that usually are payable from the nonmarital share of the estate.

This "accepted wisdom" may backfire in many larger estates, however. Imagine a situation in which there is no nonmarital portion of the estate, because the unified credit has been consumed by gifts made during life, by nonprobate property passing to persons other than S at death, or because the nonmarital property was consumed by federal or state death taxes. Because there is no nonmarital property, actual payment of the swing items reduces the *estate* that is available for distribution, which effectively reduces the amount available for the marital deduction.

The marital deduction may equal the fund that actually remains when administration is completed, but only if the swing items are claimed as an estate tax deduction. In that case federal estate taxes will be zero. If, however, these items are claimed as an income tax deduction, the marital deduction needed to eliminate taxes may be larger than the amount of estate property that actually remains available for funding the marital bequest. As a result, the marital deduction allowed will be limited to the amount actually passing as the marital bequest (after payment of the swing items), and estate taxes will be incurred because the marital deduction will not be large enough to reduce the taxable estate to zero.

The election also should be considered carefully in less dramatic situations. Taking the swing items as an income tax deduction will produce an immediate tax benefit, but at a cost of reducing the amount of

35. See §§162, 163, 212, and 213.

nonmarital property and increasing the amount exposed to tax on S's death, as illustrated by a simple example that assumes a 2004 decedent (so the unified credit will shelter $1.5 million of property includible in the estate) with a $1,750,000 gross estate that paid $50,000 of swing item expenses that can be deducted on the estate's estate tax return under §2053 or on the estate's income tax return by making the §642(g) election:

married w/ 1.75?

706 Deduct Under §2053		1041 Deduct Under §642(g)	
$1,750,000	gross estate	$1,750,000	
(50,000)	swing items	0	
(200,000)	marital bequest	(250,000)	
1,500,000	taxable estate	1,500,000	
B Fund 1,500,000	nonmarital property	1,450,000	B Fund

As this illustration shows, the marital bequest needed to produce a taxable estate as to which no estate tax actually will be paid would differ, based on the election made by the personal representative.[36]

In many cases, the assumption is that the benefit of an immediate income tax deduction will outweigh the detriment of a larger amount being exposed to estate tax when S transfers the property, because a deferral element is involved: the estate may invest and enjoy the income tax saved for the entire overlife of S. As already illustrated, that time-value-of-money notion is not correct. Thus, if the marginal income tax rate is lower than the marginal estate tax rate that will apply when S is exposed to tax, reduction of the marital bequest by claiming the swing items for estate tax purposes will produce a larger overall tax saving than taking these items as income tax deductions.[37] The imponderable in all this is whether S will outlive repeal of the estate tax, slated to occur in 2010, or whether restoration of the tax will occur in 2011. There also is an added complexity imposed by a set of regulations that address an important but very involved bit of postmortem administration that need not concern us here but that experienced estate planners consider as part of their marital deduction planning.[38]

ie, another $50 in surviving spouse's estate

At bottom, this segment illustrates the importance of the marital deduction to estate planning, as well as the surprising complexities that

36. This is one of the effects of §642(g) that leads to the do not adjustment provision described in Chapter 11 at page 48. To avoid the need to make any kind of adjustment to compensate for the consequences of the swing item election, the fiduciary should be given authority to elect either approach and probably should be *directed* to make no compensating adjustments. See the provision at page 66 to this effect.

37. Further, it might be wise to claim all the deductions under §2053 if a portion of the deductions will be lost for income tax purposes under §67(e), because the "lost" amount alone cannot be used on the estate tax return. Cf. Rev. Rul. 77-357 (involving lost deductions under the percentage floor provisions of §213).

38. See 3 Casner & Pennell, ESTATE PLANNING §13.3.6 (6th ed. 2001), dealing with Estate of Hubert v. Commissioner, 101 T.C. 314 (1993) (a 14 to 2 reviewed opinion), aff'd, 63 F.3d 1083 (11th Cir. 1995), aff'd, 520 U.S. 93 (1997), and its progeny and attendant fallout in Treas. Reg. §20.2056(b)-4(d)(5).

enter into any determination of the appropriate amount of deduction in various situations. All of the planning noted in this segment requires some ability to model and project taxes over two estates, considering such imponderables as income yield, growth, tax rates, life expectancy, and the wisdom of various postmortem elections.

Even for a math wizard, these comparisons could not be performed economically on a hand-held calculator, which probably explains why many estate planners in the past did not do them at all. Many planners find that they need the help of computer-generated projections to consider properly all the known factors. A number of very good software programs are available to users of relatively inexpensive computer hardware,[39] allowing any computer literate estate planner to insert a limited amount of information, make selected assumptions, and produce illustrations that will permit the client to make judgments based on expectations that the client believes are realistic. The result may be that the client still opts for maximum deferral of tax notwithstanding economies that indicate prepayment would be favorable. But that conclusion ought to be an informed decision made by the client, not a default choice made by the planner without modeling and evaluating the alternatives.

Marital Deduction Qualification

Only four forms of disposition could be employed before 1982 to qualify for the federal estate or gift tax marital deduction:

(1) outright transfers;

(2) §§2056(b)(5) and 2523(e) general power of appointment trusts;

(3) §2056(b)(6) life insurance settlements; and

(4) so-called estate trusts.

All four still qualify for the marital deduction but each grants S unfettered dispositive control over the marital deduction property. This control was considered "acceptable" before 1982 but changed when Congress made it possible for D's entire estate to qualify for the marital deduction. Thus, in 1981 Congress made the tax deferral benefits of the marital deduction available for dispositions in which D does not give dispositive control over marital deduction property to S.

Congress illustrated its concern about S's control over marital deduction property with an example of a decedent with children by a former marriage. H.R. Rep. No. 201, 97th Cong., 1st Sess. 160 (1981). The

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39. See Evans, WILLS, TRUSTS, AND TECHNOLOGY: AN ESTATE LAWYER'S GUIDE TO AUTOMATION, (2d ed. 2004). Often the best sources of information about available software are periodic software reviews that regularly appear in trade journals such as Estate Planning, Probate & Property, Trusts & Estates, CCH Journal of Practical Estate Planning, and internet web sites (which evolve or change over time). See, e.g., evans-legal.com/dan; members.iex.net/~jghodges; lawofficecomputing.com; sohoconsumer.com/legal_sw.htm; abanet.org/rppt/committees/pt/k2/ home.hmt; and sites with links to other sites, such as legaline.com/estate.htm; and taxsites.com/.