The Marital Deduction In Depth:

Formula Provisions (Pecuniary, Fractional, Hybrid); *Hubert's* Impact on Administration Expenses; Impact of Family Business Deduction; Impact of Generation-Skipping Transfer Tax; Funding Problems and Forms

David B. Hirschey
The Northern Trust Company
Chicago, Illinois

Thomas G. Opferman
Sonnenschein Nath & Rosenthal
Chicago, Illinois

I. INTRODUCTION AND OVERVIEW.

A. Scope and Purpose of this Presentation.

A married client can use the federal estate tax marital deduction to defer federal estate taxation until the death of the last to die of the client and his or her spouse. By giving property to a marital trust, a client can obtain the marital deduction and also retain control over the property after the client's demise. The client's estate planning documents can contain a marital deduction formula that gives the marital trust or share the optimal amount of property to defer and minimize federal estate tax. This outline will discuss:

1. Marital deduction trusts, including the post mortem operation and planning opportunities available with them;

2. Marital deduction formulae, including pecuniary, fractional and hybrid provisions;

3. The impact of the U.S. Supreme Court decision in *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997), on marital and credit shelter trust funding and the deduction of administration expenses;

4. The effect of the I.R.C. § 2057 deduction for qualified family-owned business interests on marital and credit shelter trust funding;

5. Drafting and funding inter vivos and testamentary trusts in light of the generation-skipping transfer tax; and

6. Selected funding problems and opportunities, including working with income in respect of a decedent.

B. Definitions.

Set forth below are some of the key definitions used in this article and by estate planners and probate officers in discussing marital trust funding and the use of formula provisions.

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1. *Funding* is the selection of assets, whether cash, property or sales proceeds, to satisfy a gift or bequest under a will or trust.

2. A *formula* gift or bequest is one whose size, composition or value is determined with reference to some external criteria. For example, "I bequeath my son an amount equal to the value of 100 shares of IBM stock" is a formula bequest. Similarly, "I give my son an amount equal to the value of all the gifts I made to my daughter during my lifetime" is a formula gift.

3. A *lead* bequest is a formula bequest that is calculated first, that is, before the residuary bequest.

4. A *residuary* bequest is a disposition of the balance of the assets of the estate after all lead bequests, taxes and expenses have been paid.

5. A *marital deduction formula* is a formula bequest that is determined with reference to the maximum available marital deduction under the Internal Revenue Code, (usually) after taking into account other available estate tax deductions and credits.

6. A *credit shelter formula* is a formula bequest determined with reference to the largest amount that can be transferred free of federal estate tax by reason of the unified credit against estate tax -- now also called the *applicable exclusion amount*. I.R.C. § 2010(c). Unless legislation is enacted that provides otherwise, the credit shelter amount (or applicable exclusion amount) will increase in accordance with the following schedule:

Superceded

Year	Applicable Exclusion Amount	Applicable Credit Amount
1999	$650,000	$211,300
2000	$675,000	$220,550
2001	$675,000	$220,550
2002	$700,000	$229,800
2003	$700,000	$229,800
2004	$850,000	$287,300
2005	$950,000	$326,300
2006	$1,000,000	$345,800

C. Pecuniary, Fractional Share and Hybrid Bequests.

The following is intended to provide an introduction to pecuniary, fractional share and hybrid bequests, examples of language that result in such bequests, and a brief discussion of some of the principal features of each of them.

1. "I give my wife the sum of $100,000." "I give to the Trustees of the Family Trust the sum of $650,000." These are examples of bequests of *pecuniary amounts*. The primary characteristics of a gift or bequest of a pecuniary amount are:

a. All post-death appreciation (and depreciation) in the estate inures to the benefit of the residuary taker.

b. Pecuniary amounts may or may not share in trust accounting income earned during the period of administration. This depends on the specific provisions of (i) state law and (ii) the trust instrument.

c. Capital gains may be incurred if appreciated assets are sold to raise the cash needed to satisfy the bequest. The same result obtains if the bequest is paid by the distribution of specific assets in kind that have appreciated in value between the date of death and the date of funding.

d. The distribution of assets in kind to satisfy a pecuniary bequest would ordinarily require the valuation of the asset at the time of distribution.

e. Any taxes incurred during the "funding" process are generally paid out of the residuary share, along with expenses of administration, taxes, debts and claims.

f. In general, the executor or trustee has broad latitude to select the assets to sell or distribute in order to pay the bequest.

2. "I give my residuary estate in equal shares to the Trustees of Son's Trust and to the Trustees of Daughter's Trust." "I give one-third of my residuary estate to my granddaughter and two-thirds of my residuary estate to my son." "I give my residuary estate in equal shares to my children, A, B & C." Each of these is an example of a *fractional share* bequest.

a. The satisfaction of these fractional share bequests does not give rise to capital gains, unless assets are actually sold. No capital gains are realized if assets are distributed in kind, as long as the assets are divided proportionately.

b. In general, costs, expenses, debts, claims, taxes, appreciation, depreciation, and trust accounting income are shared ratably among fractional shares.

c. Any non-pro rata distribution of available assets must comply with fiduciary standards of impartiality and fair dealing. Unless non-pro rata distributions are authorized either by (i) the governing instrument or (ii) state law, the I.R.S. treats non-pro rata distributions made in satisfaction of a fractional share bequest as a taxable event for income tax purposes.

d. Assets that are divided proportionately and distributed in kind to fund fractional shares do not require revaluation at the time of distribution.

3. *Hybrid* funding formulae are also sometimes used. The following gifts are not really the same, even though they appear to say the same thing.

Example a: "I give my son the sum of $100,00, not to exceed, however, 10% of my estate." The "sum of $100,000" is a pecuniary bequest. The limitation does not change this, although it may change the size of the bequest.

Example b: "I give my son the sum of $100,000; provided, however, that if the value of my estate is less than $1,000,000, I give my son 10% of my estate." The provision that if the estate is less than the stated amount the son will receive

"10% of my estate" changes the bequest from a pecuniary amount to a fractional share if the condition is met.

Example c: "I give my son an amount equal to the lesser of (a) the sum of $100,000 and (b) 10% of the value of my estate." The language "an amount equal to" generally creates a pecuniary bequest, even when the amount is measured with reference to a percentage, because a percentage "of the value of my estate" is still an amount.

Example d: "I give my son 10% of my estate, not to exceed, however, the sum of $100,000." The language "10% of my estate" creates a fractional share of the estate, subject to a limitation.

Example e: "I give my son 10% of my estate; provided, however, that if the value of my estate is more than $1,000,000, I give my son the sum of $100,000." This example illustrates a fractional share that *changes* to a pecuniary bequest if a specified condition is met.

Example f: "I give my son a share of my estate equal to the lesser of (a) 10% of my estate and (b) $100,000." The language "a share of my estate" generally creates a fractional share. In the absence of language denoting an amount, the limitation probably does not change the character of the gift.

g. Although the examples above do not involve marital deduction funding formulae, it is still necessary to determine the nature of the bequest in order to determine whether the bequest (i) shares in income during administration, (ii) can be satisfied in kind without the recognition of capital gain or the revaluation of assets, (iii) will participate in gains and losses during administration, or (iv) will share in the burden of taxes, debts, claims and expenses during administration. The characterization of the bequest is critical to a determination of the nature and extent of the beneficiary's entitlement. Marital deduction formula clauses are no different, although they can be more difficult to analyze, are generally more complex and are invariably more intimidating.

D. <u>Qualifying for the Marital Deduction.</u>

In general, there are six primary ways in which property included in the decedent's gross estate passing to or for the benefit of the decedent's surviving spouse will qualify for the federal estate tax marital deduction under I.R.C. § 2056(a). They are as follows:

1. Outright distributions to surviving spouse of property qualifying for the marital deduction;

2. A marital trust which provides that all of the income of the trust is to be distributed at least annually to the surviving spouse and that the surviving spouse has a general power of appointment (or a legal life estate coupled with a general power of appointment). I.R.C. § 2056 (b)(5);

3. A qualified terminable interest property marital trust which provides that all the income from the trust is payable to the surviving spouse at least annually for life and no person has a power to appoint any of the property to any person other than the surviving spouse during the life of the surviving spouse and for which the decedent's executor

makes an election pursuant to I.R.C. § 2056(b)(7)(B)(v) (or a legal life estate for which such an election is made);

4. A so-called "estate trust" which provides for distribution or accumulation of income or principal to the surviving spouse for life and directs distribution of the principal and accumulated income to the estate of the surviving spouse upon his or her death;

5. Certain life insurance contracts and annuities over which the surviving spouse has a general power of appointment. I.R.C. § 2056(b)(6); and

6. Annuities included in the decedent's gross estate under I.R.C. § 2039 where only the surviving spouse has the right to receive payments during the surviving spouse's lifetime (unless an election is made otherwise). I.R.C. § 2056(b)(7)(c).

A marital trust for the benefit of a spouse who is not a citizen of the United States must also meet the requirements of I.R.C. § 2056A for a qualified domestic trust, which among other things requires that at least one trustee be an individual citizen of the United States or a domestic corporation, that no distribution of principal be made unless such trustee may withhold the additional tax imposed by this Section, and that an irrevocable election be made pursuant to Section 2056A(d). The use of marital trusts and the different types of marital trusts are discussed in greater detail below.

II. MARITAL DEDUCTION TRUSTS.

A. <u>Qualified Terminable Interest Property Trust ("QTIP Trust").</u>

1. Advantages of a QTIP Trust.

The QTIP trust was created by the Economic Recovery Tax Act of 1981. It has become the predominant marital deduction trust. An example of a QTIP marital trust taken with permission from The Northern Trust Company Will & Trust Forms is included as Exhibit A to this outline. The QTIP marital trust has significant advantages over the traditional general power of appointment marital trust.

a. The testator or settlor can determine how much or little control to give the surviving spouse over the QTIP trust. In order to qualify for the gift and estate tax marital deduction, the spouse need be given only an income interest for life. On the other hand, many individuals wish to give the spouse broad control over and benefits from a QTIP trust (*e.g.*, generous principal distribution provisions, "5 or 5" annual withdrawal rights, limited testamentary power of appointment, and spouse as sole trustee or as co-trustee).

b. A QTIP trust can be drafted to preclude a spouse who remarries from appointing the marital trust at death to his or her second spouse or children of the spouse's second marriage.

c. Use of a QTIP trust facilitates post-mortem marital deduction planning, including a partial QTIP election and division of the marital trust into elected and non-elected portions or adding the non-elected portion to the credit shelter trust.

d. A QTIP trust can facilitate planning for minimizing the generation-skipping transfer tax by allowing the testator or settlor to create a marital trust for which the special election is made under I.R.C. § 2652(a)(3).

2. Dispositive Provisions of a QTIP Trust.

a. The spouse must receive all the income from the QTIP trust for his or her lifetime. I.R.C. § 2056(b)(7)(B)(ii)(I).

(i) Some clients may wish the surviving spouse to receive the greater of the income from the QTIP trust or a unitrust amount, defined as a fixed percent of the trust determined annually.

(ii) An example of language to be added to a QTIP marital trust to use the greater of income or a unitrust amount is included as Exhibit B to this outline.

b. Principal may be distributed to the spouse pursuant to an ascertainable standard relating to health, education, support and maintenance or a broad standard, such as best interests.

(i) If a broad principal distribution standard is used and the spouse is sole trustee, the spouse has a general power of appointment over all of the QTIP trust, which will cause inclusion in the gross estate of the spouse under I.R.C. § 2041(a)(2) in addition to I.R.C. § 2044. Such inclusion would prevent a possible partial QTIP election when the marital trust is created.

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

(iii) Principal of a QTIP trust may not be distributed to anyone other than the spouse without disqualifying the trust for the marital deduction. I.R.C. § 2056(b)(7)(B)(ii)(II); Treas. Reg § 20.2056(b)-7(d)(1).

c. A QTIP trust may contain a lifetime withdrawal right by the spouse, which is often limited to "$5,000 or 5%" standard. See I.R.C. §§ 2514(e), 2041(b)(2).

(i) If the spouse is given an unlimited right to withdraw the principal of the QTIP trust, this power converts the trust into a general power of appointment marital trust for purposes of inclusion of the trust in the gross estate of the spouse. An unlimited right of withdrawal given to the spouse also makes the trust ineligible for the special election available to a QTIP trust for purposes of the generation-skipping transfer tax under I.R.C. § 2625(a)(3).

(ii) Annual withdrawal right is limited to "5 or 5" standard to avoid estate tax and gift tax problems for spouse under I.R.C. §§2041(b)(2), 2514(e). An example of a "5 or 5" withdrawal right granted to the surviving spouse over the principal of the marital trust is included as Exhibit C to this outline. If only part of QTIP trust is elected to qualify for the marital deduction, lifetime lapses in excess of the "5 or 5" standard may ruin the post-mortem estate tax planning done at death of settlor or testator. Even if all of a QTIP trust qualifies for the marital deduction, a lifetime lapse that exceeds the 5 or 5 safe harbor may result in the spouse's making a taxable gift of the remainder interest in the excess property.

(iii) There is a potential grantor trust income tax problem under I.R.C. § 678(a)(1) with lapsing rights of withdrawal over a QTIP trust.

d. The QTIP election is made by the executor. See I.R.C. §§ 2056(b)(7)(B)(v) and 2203.

(i) If the decedent has a revocable trust agreement and pour-over will, the QTIP election is made by the legal representative of the estate, or if none, by the trustee of the revocable trust. Treas. Reg. § 20.2056(b)-7(b)(3).

(ii) The governing instrument may direct the fiduciary to elect to qualify all of the QTIP trust for the marital deduction. While such direction limits the flexibility to make a partial QTIP election (discussed below), it may be desirable when the interests of the surviving spouse and the remainder beneficiaries are different (e.g., second spouse and children of first marriage).

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

(i) A limited testamentary power of appointment may be given to the spouse or deleted without jeopardizing the marital deduction.

(ii) No one, including the surviving spouse, can be given a lifetime power of appointment without disqualifying the QTIP trust for the marital deduction. I.R.C. § 2056(b)(7)(B)(ii)(II); Treas. Reg § 20.2056(b)-7(d)(1).

f. Income accrued or undistributed at the death of the surviving spouse can be paid to the spouse's probate estate or can be added to the principal of the QTIP trust or paid to the next income beneficiary of the trust.

(i) Treas. Reg. § 20.2056(b)-7(d)(4) permits such income to be paid to someone other than the spouse or the spouse's estate without jeopardizing the qualification of the QTIP trust for the marital deduction.

(ii) If the accrued or undistributed income is added to the principal of the QTIP trust and not distributed to the estate of the spouse, it nevertheless must be included in the gross estate of the surviving spouse. Treas. Reg. § 20.2044-1(d)(2).

(iii) In *Estate of Rose Howard v. Commissioner*, 91 T.C. 923 (1988), the Tax Court ignored the predecessor proposed regulation and disallowed the marital deduction for a QTIP trust that did not pay the accrued or undistributed income to the spouse's estate or make it subject to a general power of appointment by the spouse. The *Howard* case was reversed on appeal, *Estate of Howard v.Commissioner*, 910 F.2d 633 (9th Cir. 1990), but some estate planners still exercise caution and comply with Tax Court *Howard* decision even though the Treasury Regulations have subsequently been amended to reflect the decision of the Ninth Circuit Court of Appeals.

(iv) In *Estate of Lucille Shelfer*, 103 T.C. 10 (1994), the Tax Court followed its decision in *Howard*. It held that a marital trust that did not pay the accrued and undistributed income to the spouse was not a QTIP trust and thus was not included in the gross estate of the surviving spouse at her death under I.R.C. § 2044, even though a marital deduction had previously been claimed (and allowed) for the trust in her husband's estate. A dissenting opinion noted that the taxpayers had "whipsawed" the IRS. The Court of Appeals for the Eleventh Circuit agreed with the dissent and reversed the Tax Court. *Estate of Lucille Shelfer v. Commissioner*, 96-2 USTC ¶60,238 (11th Cir. 1996).

3. **Partial QTIP Elections.**

a. If a partial QTIP election is made, the QTIP trust may be held as a single fund marital trust. The governing instrument may provide that principal payments to the spouse are charged against the marital deduction portion of the QTIP trust first, thereby reducing the portion that will later be included in the spouse's gross estate for federal estate tax purposes. Treas. Reg. §§ 20.2044-1(d)(3) and (e), example 4.

(i) The current fair market values of the elected share and the non-elected share are calculated immediately prior to the principal distribution. The principal distribution is then made solely from the elected portion of the single fund marital trust. The amount of the principal distribution is then reflected by an adjustment based an current value to both the elected portion and the non-elected portion of the marital trust, thereby reducing the fraction or percentage of the marital trust consisting of property that will be subject to estate tax at the death of the surviving spouse.

(ii) A single fund marital trust with a rolling fraction can present some administrative difficulties and so must be used with care.

(iii) A single fund marital trust for which a partial QTIP election is to be made can also be used in lieu of a marital trust/family trust estate plan without wasting the credit shelter amount of the first to die. An excerpt of a will using a single fund marital trust for which a partial QTIP election would be made to take advantage of the credit shelter amount of the testator is included as Exhibit D.

b. With a partial QTIP election, the governing instrument can provide that the QTIP trust may be severed into two separate trusts, elected and non-elected, that are held under the same dispositive terms and that principal payments shall be made to the spouse from the elected marital trust first. See Treas. Reg. § 20.2056(b)-(7)(b)(2)(ii). This avoids the need to revalue the QTIP trust each time principal is distributed to the spouse and reduces the assets that will be included in the gross estate of the spouse when principal distributions are made from the elected portion.

(i) The non-elected portion clearly will qualify for the credit for tax on prior transfers should the surviving spouse die within 10 years of the deceased spouse whose governing instrument created the QTIP trust for which the partial QTIP election is made. See I.R.C. § 2013(a).

(ii) If the governing instrument is silent on a trustee's right to divide a QTIP trust into two separate trusts, state law may allow the fiduciary to sever the marital trust. For example, Section 4.25 of the Illinois Trusts and Trustees Act allows a trustee to sever a marital trust on a fractional basis into two separate trusts. 760 ILCS 5/4.25.

(iii) The division of a marital trust to reflect a partial QTIP election must be done on a fractional or percentage basis. The funding of the separate trusts that may be created by a partial QTIP election need not be done by transferring a pro rata share of each of the assets in the marital trust prior to division into elected and non-elected shares. Treas. Reg. §§ 20.2056(b)-7(b)(2)(ii)(B), 20.2056(b)-7(h), example 14.

c. Alternatively, the governing instrument can provide that when a partial QTIP election is made by the executor, the non-elected portion of the marital trust is severed from the marital trust and added to the credit shelter disposition. Treas. Reg. § 20.2056(b)-7(d)(3)(i). Where the governing instrument provides for a credit shelter disposition consisting of a family trust in which income or principal can be distributed to the surviving spouse and the descendants of the decedent for their best interests in the discretion of an independent trustee, additional flexibility is gained by using a QTIP trust for which a partial election can be made in appropriate circumstances.

d. Providing for a partial QTIP election in the governing instrument can facilitate post mortem estate tax planning. A partial QTIP election can allow the executor at the first death to try to equalize the taxable estates of the decedent and the surviving spouse or to use the decedent's lower graduated estate tax brackets to achieve a taxable estate of $3,000,000 at the first death.

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

(ii) There is an issue that needs to be addressed in the governing instrument regarding the burden of federal and state estate tax generated by the partial QTIP election.

e. In limited circumstances, the executor may wish to qualify a portion of the credit shelter trust for the marital deduction, including planning for a decedent who did not revise his or her estate planning documents after the Economic Recovery Tax Act of 1981 ("ERTA").

(i) If the decedent dies with a pre-1981 document that uses a "maximum marital deduction" formula, funding of the marital trust may be limited to 50% of the adjusted gross estate under the unlimited marital deduction transitional rule of the ERTA. P.L. 97-34, § 403(a)(1)(A).

(ii) The executor may elect to have part of the credit shelter trust qualify for the marital deduction as qualified terminable interest property. Disclaimer and related post-mortem planning may be necessary to enable the credit shelter trust to meet the requirements of a QTIP trust discussed above.

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

(iv) In the above situation with a pre-1981 document subject to the ERTA transitional rule, the executor might elect to qualify a fractional share of the credit shelter trust for the marital deduction as QTIP, of which (A) the numerator is the smallest marital deduction amount which will result in no federal estate tax payable by reason of testator's death, and (B) the denominator is the federal estate tax value of the assets included in testator's gross estate which became (or the proceeds, investments or reinvestments of which became) a part of the credit shelter trust after payment of all taxes and expenses. In determining the amount of the numerator the credit for state death taxes shall be considered only to the extent those taxes are not thereby incurred or increased. See the formula in III. C. below.

4. **Generation-Skipping Transfer Tax Planning.**

a. A QTIP trust enables some married individuals to use their GST exemption – which currently is $1,010,000 – fully to the extent it is not otherwise used during life or at death See I.R.C. §§ 2631(a), (c).

2009 – 3,500,000

(i) An individual could create a lifetime generation-skipping trust and fully fund it with $1,010,000 of assets, incurring a gift tax of $138,600, assuming no prior lifetime taxable gifts. If his or her spouse consented to split gift treatment, $2,020,000 of assets could be set aside in a generation-skipping trust during life, incurring a gift tax of $277,200.

(ii) Alternatively, the individual could establish a $1,010,000 generation-skipping trust at his or her death. This is good transfer tax planning, but the individual would incur $234,915.25 of estate tax.

(iii) Many married individuals are unwilling to incur gift or estate tax any earlier than absolutely necessary.

b. Accordingly, many married individuals who want to use their full $1,010,000 GST exemption and defer all gift and estate taxes until the death of the surviving spouse will create two or three trusts at the first death:

(i) A $650,000 family trust that uses the applicable exclusion amount (or credit shelter amount for those who prefer the more traditional nomenclature);

(ii) A $360,000 exempt QTIP marital trust, which will be funded with an amount or fraction equal to the difference between the GST exemption ($1,010,000) minus the applicable exclusion amount ($650,000), which equals $ 360,000 for 1999; and

(iii) The balance will pass either outright to the surviving spouse or in a non-exempt marital trust.

(iv) An example of a testamentary three trust generation-skipping estate plan for a married client is contained in Exhibit E to this outline.

c. With respect to the exempt QTIP marital trust, the executor will make a "reverse QTIP election" for generation-skipping transfer tax purposes under I.R.C. § 2652(a)(3) so that the decedent remains the transferor of this trust after the death of the surviving spouse.

d. The residuary marital trust can be either a QTIP trust or a general power of appointment marital trust.

(i) This residuary marital trust often will provide that at the death of the surviving spouse, the federal and state estate tax payable by reason of the inclusion of the exempt QTIP marital trust and the residuary marital trust in the gross estate of the surviving spouse will be paid from the residuary marital trust so that the exempt marital trust will not be reduced by estate taxes.

(ii) The residuary marital trust also can provide for the use of the surviving spouse's GST exemption. To do so, an amount or fraction of the residuary marital trust equal to the unused GST exemption of the surviving spouse would be added to the family trust and the exempt

QTIP marital trust, to pass directly to or in trust ultimately for the benefit of one or more skip persons.

e. If a client's estate plan does not contain distributions to or in trust for skip persons, many attorneys choose not to create a separate $360,000 exempt QTIP trust by a separate formula provision, in part because of the complexity.

(i) In order to provide for an unusual order of deaths or other unplanned distributions to skip persons, the governing instrument can (A) provide for a QTIP trust and (B) give the trustee the power to divide a trust into exempt and non-exempt trusts for generation-skipping tax purposes. An example is contained in Exhibit F.

(ii) The trustee can use this administrative power to divide a QTIP trust into two separate trusts, a $360,000 exempt QTIP trust and a non-exempt QTIP trust. At the death of the surviving spouse, the administrative power could authorize the trustee to (A) pay death taxes solely from the non-exempt QTIP trust and (B) allocate the exempt $360,000 QTIP trust to distributions that are more likely to be to skip persons or generation-skipping trusts.

B. <u>Other Marital Trusts.</u>

1. General Power of Appointment Marital Trusts.

a. Use of general power of appointment marital trusts has declined since ERTA 1981, in part because of the larger degree of control that is afforded through the use of one or more QTIP trusts.

b. In addition, some of the generation-skipping tax planning that is available with the use of one or more QTIP trusts (discussed above) is not possible with a general power of appointment marital trust.

c. The surviving spouse who is a beneficiary of a general power of appointment marital trust can have a number of rights and powers that cannot be used with a QTIP trust or must be used with caution, including:

(i) An unlimited right to withdraw any or all of the principal of the marital trust during the life of the surviving spouse;

(ii) The right to serve as sole trustee or as co-trustee of a marital trust containing broad discretionary principal distribution provisions -- such as best interests -- without adverse estate tax consequences; and

(iii) A lifetime power of appointment exercisable as broadly or narrowly as the deceased spouse wishes to provide in the governing instrument creating the marital trust.

d. An example of a testamentary general power of appointment marital trust is contained in Exhibit G of this outline.

2. Estate Trusts.

a. An estate marital trust allows the trustee broad discretion to distribute any, all or none of the income to the surviving spouse. Undistributed income is added to principal.

b. Principal may be distributed to the surviving spouse pursuant to whatever standard the deceased spouse wishes to provide in the governing instrument.

c. At the death of the surviving spouse, the entire trust, including accumulated income, is distributed to the surviving spouse.

(i) This lack of control over the ultimate disposition of the trust at the death of the surviving spouse is one of the disadvantages of the estate trust to many individuals.

(ii) In addition, the distribution to the surviving spouse's estate creates a probate that might be avoided by use of a QTIP trust or a general power of appointment marital trust.

d. The ability of the trustee to accumulate income of an estate trust during the life of the surviving spouse and the ability to hold unproductive property without the consent of the surviving spouse are among the advantages of an estate trust. See Rev. Rul. 68-554, 1968-2 C.B. 412; PLR 9634020 (May 24, 1996).

e. An example of an estate marital trust is included as Exhibit H to this outline.

3. Qualified Domestic Trusts.

a. If client's spouse is not a citizen of the United States, the only way that the client can obtain the estate tax marital deduction is to have his or her property pass to a qualified domestic trust for the benefit of the surviving spouse. An outright distribution to the spouse will not qualify for the marital deduction. See I.R.C. § 2056(d).

b. A qualified domestic trust ("QDOT") is defined in I.R.C. § 2056A(a) and the Treasury Regulations thereunder. A QDOT is not a separate type of marital deduction trust. Rather, a QDOT is a marital deduction trust which has additional requirements imposed upon it because the spouse is not a U.S. citizen.

(i) At least one trustee of the trust must be an individual citizen of the U.S. or a domestic corporation.

(ii) The U.S. trustee must have the right to withhold estate tax from distributions of trust principal.

(iii) The trust must satisfy requirements detailed in the regulations to ensure the collection of estate tax from the trust, including use of a U.S. bank, bond or letter of credit if the fair market value of the assets passing to the QDOT exceeds $2,000,000 at the decedent's date of death or the alternate valuation date. Treas. Reg. § 20.2056A-2(d)(1)(i)(A),(B), or (C).

(iv) The decedent's executor must irrevocably elect to have I.R.C. § 2056A apply to the trust.

c. If an individual is married to a non-citizen spouse, the marital deduction trusts should be drafted to satisfy the requirements for qualified domestic trusts. This can be done by drafting a standard marital trust and adding to it an additional section that satisfies all of those requirements.

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

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

(ii) Property added to a QDOT by the surviving spouse will qualify for the marital deduction.

e. A QDOT may be created by the decedent or the surviving spouse. Thus, the surviving spouse, as settlor, may establish a qualified domestic trust after the decedent's death. For example, the surviving spouse may establish a trust that (i) contains a general power of appointment marital trust and (ii) satisfies the QDOT requirements.

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

(i) If the beneficiary of the IRA is a QTIP marital trust, the solution is straightforward. The QTIP trust simply is drafted to satisfy the QDOT requirements.

(ii) If the beneficiary of the IRA is the surviving spouse outright, the spouse probably will withdraw the property in the IRA and roll it over to his or her own IRA account, titled in the name of the surviving spouse. The surviving spouse's IRA account has a domestic corporation as trustee, and it satisfies the requirements of a general power of appointment marital trust (I.R.C. § 2056(b)(5)) because the spouse may withdraw any part or all of the income and principal of the IRA trust at anytime. The spouse and the IRA trustee can amend the IRA trust to satisfy all of the QDOT requirements. Thus, the spouse's IRA trust serves as the qualified domestic trust.

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

g. An example of a qualified domestic trust taken with permission from The Northern Trust Company Will & Trust Forms is included as Exhibit I to this outline.

C. **Use of Applicable Exclusion Amount.**

1. Since the advent of the unlimited marital deduction in 1981 and the increase of the applicable exclusion amount to $650,000 for 1999 ($1,000,000 in 2006 pursuant to the Taxpayer Relief Act of 1997 ("TRA '97")), estate planners will often recommend to married clients that they fully utilize both the applicable exclusion amount and marital deduction to eliminate or minimize the federal and state estate taxes at the first death.

2. The formula clauses discussed below in general provide for the marital trust to be funded so that no federal and state estate taxes, or the minimum amount of such taxes, would result.

a. Properly drafted marital deduction and credit shelter formulae will take into account property passing outside the will or trust agreement to the surviving spouse that qualifies for the marital deduction so that the marital trust will not be funded with more assets than needed to minimize or eliminate federal and state estate taxes.

b. The next portion of this outline discusses the uses of marital deduction formulae and funding the marital deduction provisions of the estate plan.

III. COMMON MARITAL DEDUCTION FORMULA PROVISIONS.

A. **Unlimited Marital Deduction Formula Clauses.**

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

2. The most common marital deduction formulae that are discussed in greater detail in this outline are:

a. True pecuniary marital formula;

b. Fractional share marital formula;