c. Rev. Proc. 64-19 marital formula;

d. Credit shelter lead formula; and

e. Minimum worth marital formula.

B. True Pecuniary Marital Formula.

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

2. An example of a true pecuniary marital formula taken from The Northern Trust Will & Trust Forms is as follows:

> All the residue of my estate, wherever situated, including lapsed legacies, but expressly excluding any property over which I may have power of appointment at my death, I give to THE NORTHERN TRUST COMPANY, an Illinois corporation, of Chicago, Illinois, as trustee, upon the trusts hereinafter provided.
>
> If my wife survives me, the trustee as of my death shall set aside out of the trust estate as a separate trust for her benefit (undiminished to the extent possible by any estate or inheritance taxes or other charges) ***the smallest pecuniary amount which, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax payable by reason of my death***. In determining the pecuniary amount the trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased and shall assume that none of the Family Trust hereinafter established qualifies for a federal estate tax deduction. For purposes of this will, my wife shall be deemed to have survived me if the order of our deaths cannot be proved.
>
> ***The trustee shall select and allocate the cash, securities and other property, including real estate and interests therein, which shall constitute the trust, employing for the purpose values current at the time or times of allocation.*** No property shall be selected as to which a marital deduction would not be allowed if it were distributed outright to my wife.
>
> The trust shall be designated the "Marital Trust" and shall be held and disposed of as provided below.
>
> The trustee as of my death shall set aside the balance of the trust estate, or all thereof if my wife does not survive me, as a separate trust. The trust shall be designated the "Family Trust" and shall be held and disposed of as provided below.

3. The advantages of a true pecuniary marital distribution include the following:

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

(i) Assets having the greatest potential for appreciation can be used to fund the credit shelter trust.

(ii) Assets that are expected to appreciate more slowly or decline in value can be used to fund the marital distribution.

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

c. In a rising market, the marital deduction distribution can be funded with less property since date of distribution values are used, which increases the amount of property in the credit shelter trust and decreases the estate tax at the death of the surviving spouse.

d. Commentators suggest that a true pecuniary marital formula should be used if the estate contains real property subject to special use valuation under I.R.C. § 2032A or family-owned business interests subject to the election and deduction provided by I.R.C. § 2057.

4. There are a number of disadvantages of a pecuniary marital deduction provision that may or may not offset its flexibility and simplicity, including the following:

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

(i) The capital gains are realized by the estate or trust that funds the pecuniary marital distribution. See Rev. Rul. 60-87, 1960-1 C.B. 286.

(ii) The tax in effect is borne by the non-pecuniary credit shelter trust since distributions to pay income taxes will reduce the amount of the residue.

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

(i) In general, only $3,000 of capital losses may be taken in any year. I.R.C. § 1211(b).

(ii) Capital losses incurred by a trustee of a revocable trust in funding a marital trust pursuant to a pecuniary formula cannot be recognized. I.R.C. § 267(a)(1),(b)(5). This problem can be avoided by the trustee selling the depreciated assets to recognize the loss before funding and then distributing cash in satisfaction of the distribution to the marital trust.

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

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

c. Another disadvantage of a pecuniary funding formula, whether for the marital or credit shelter trust, is that funding such a distribution with the right to receive income in respect of a decedent is a transfer that accelerates the taxability of the income in respect of a decedent. I.R.C. § 691(a)(2); Treas. Reg. § 1.691(a)-4; Noel v. Commissioner, 50 T.C. 702 (1968).

(i) This can be a significant issue in the case of a decedent whose estate consists mostly of IRD (*e.g.*, individual retirement accounts, a professional entitled to receive substantial contractual death benefits, or a real estate developer with installment sales contracts).

(ii) This problem can be minimized by making the pecuniary trust the smaller of the two trusts.

(iii) This issue can also be minimized by making a specific bequest of the item of income in respect of a decedent either to the residuary trust or to the marital trust (as circumstances require).

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

(i) With interests in real estate, closely held businesses or valuable artwork, this can be a substantial added expense.

(ii) A non-pro rata distribution of a fractional marital funding (discussed below) would also require revaluation.

e. The executor or trustee will be under pressure to fund the pecuniary amount trust early because any decline in the overall value of the assets will reduce the residuary credit shelter trust.

(i) If the marital trust is funded early, the estate loses the advantage of being a separate taxpayer with respect to the assets distributed in satisfaction of the marital gift.

(ii) Early funding may also result in decisions being made before all of the variables, such as the amount of the marital deduction, death taxes and cash requirements, are known.

(iii) **Example:** Estate of $5,000,000 at death; marital trust is to receive $4,350,000 and credit shelter trust is funded with residue ($650,000 based on date of death values). During administration, estate declines 20% in value to $4,000,000. At funding, marital trust receives $4,000,000 and credit shelter trust receives zero. Unhappy beneficiaries of credit shelter trust may sue the fiduciary. To protect itself, the executor or trustee may fund the marital trust shortly after death to ensure the credit shelter trust is not eliminated if the value of the estate declines between the date of death and the date of funding.

f. The holding period for long term capital gains purposes begins on the date of satisfaction of the pecuniary distribution rather than on the earlier date of death.

g. All excess deductions on termination of the estate will be allocated to the residuary credit shelter trust, which may not have sufficient income to utilize the deductions. See I.R.C. § 642(h).

h. In the second marriage situation, where the children of the first marriage are the beneficiaries of the residuary non-marital trust, there may be conflicts of interest if the surviving spouse is the executor with the authority to allocate the most desirable assets to the pecuniary marital distribution.

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

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

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

C. **Fractional Share Marital Formula.**

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

2. If you think back to freshman algebra, you will recall that (x/y) y = x. Therefore, any amount (x) can be converted into a fraction of which the numerator is x (or the amount) and the denominator is the value of the fund against which the fraction is to operate.

3. An example of a fractional share marital formula taken from The Northern Trust Company Will & Trust Forms is as follows:

> All the residue of my estate, wherever situated, including lapsed legacies, but expressly excluding any property over which I may have power of appointment at my death, I give to THE NORTHERN TRUST COMPANY, an Illinois corporation, of Chicago, Illinois, as trustee, upon the trusts hereinafter provided.
>
> If my wife survives me, the trustee as of my death shall set aside out of the trust estate as a separate trust for her benefit (undiminished to the extent possible by any estate or inheritance taxes or other charges) ***a fraction of the trust property of which (i) the numerator is the smallest amount which, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax payable by reason of my death, and (ii) the denominator is the federal estate tax value of the assets included in my gross estate which became (or the proceeds, investments or reinvestments of which became) trust property.*** In determining the amount of the numerator the trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased and shall assume that none of the Family Trust hereinafter established qualifies for a federal estate tax deduction.
>
> For purposes of the preceding paragraph, the trust property is all property in the trust estate which would qualify for the federal estate tax marital deduction if it were distributed outright to my wife. For purposes of this will, my wife shall be deemed to have survived me if the order of our deaths cannot be proved.
>
> The trust shall be designated the "Marital Trust" and shall be held and disposed of as provided below.
>
> The trustee as of my death shall set aside the balance of the trust estate, or all thereof if my wife does not survive me, as a separate trust. The trust shall be designated the "Family Trust" and shall be held and disposed of as provided below.

4. The marital formula set forth above is a *smallest amount* marital distribution. This marital formula gives the marital trust "the smallest amount which...would result in the least possible federal estate tax payable by reason of my death." In most cases, the "least possible federal estate tax" will be zero. This formula is a *reduce estate tax to zero* formula. It gives the marital trust the optimal marital deduction amount allowed by the unlimited marital deduction used in conjunction with the credit shelter amount.

a. The concept is not to fund the marital trust with any more assets than required to reduce the federal estate tax to zero. The *smallest amount* requirement keeps the marital trust as small as possible.

Bad. b. The *smallest amount* formula will automatically adjust the amount of the marital trust to obtain the optimal marital deduction. The formula automatically considers expenses and other legacies which affect the optimal marital amount, so that the governing instrument need not expressly mention those items. The formula also automatically adjusts for yearly increases in the applicable exclusion amount.

c. The *smallest amount* formula is illustrated in the following simplified example. Assume the testator died in 1999 and has a gross estate of $1,000,000.

$1,000,000	Gross estate
(70,000)	Administration expenses deducted on Form1041
(30,000)	Cash legacies to children
$ 900,000	Balance

The marital trust will be funded with $350,000, which is the smallest marital deduction amount that will result in no federal estate tax being payable. The remaining $550,000 is allocated to the credit shelter trust. Note that part of the client's $650,000 applicable exclusion amount is used up by payments and bequests that are not deductible for federal estate tax purposes. If the $70,000 of administration expenses were deducted on the federal estate tax return (Form 706), the marital trust would be funded with only $280,000, because that amount would be the smallest marital deduction that would result in no federal estate tax being payable. The credit shelter trust would be funded with $620,000.

d. The marital formula set forth above provides that the marital distribution is "undiminished to the extent possible by estate and inheritance taxes and other charges." This ensures that the marital deduction distribution is not inadvertently diminished. The will and revocable trust agreement (if any) should also contain coordinated tax and expense clauses that specify which assets or portion of the estate and trust bear the burden of death taxes and expenses.

e. The phrase "if allowed as a federal estate tax marital deduction" is included in the marital formula because this funding provision may be used with a QTIP marital trust.

(i) Not all of the QTIP trust may be qualified for the marital deduction. The executor may make only a partial QTIP election. Regardless of the election actually made, however, the marital trust should be funded with sufficient assets so that if all of the trust did qualify for the marital deduction, the optimal marital deduction would be obtained taking into account the applicable exclusion amount.

(ii) In calculating the distribution to the marital trust, it is assumed that all of the assets passing to the trust will qualify for the marital deduction, regardless of any partial QTIP election or disclaimer.

f. The marital formula set forth above provides: "In determining the amount of the numerator the trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased." This sentence prevents the estate from inadvertently incurring or increasing a state death tax which "picks up" the I.R.C. § 2011 state death tax credit.

(i) In funding the fractional share marital formula quoted above, all the decedent's assets, deductions and certain credits are considered. The *smallest amount* language requires this. The state death tax credit under I.R.C. § 2011, as well as the unified credit under I.R.C. § 2010, can be used to shelter property that is to fund the family trust. The state death tax credit is available, however, only if death tax is paid to the state. This *smallest amount* language avoids the result in which no federal estate tax is payable but a state death tax is payable. In such a case, the state death tax would reduce the distribution to the marital trust. The formula language ensures, however, that the distribution to the marital trust will not be reduced by state death taxes that do not otherwise need to be incurred.

(ii) For example, this sentence limiting consideration of the state death tax credit saves the estate $17,939 of state death tax. Without the sentence, the marital deduction formula creates a taxable estate of $698,385. The applicable credit amount of $211,300 and the state death tax credit of $17,939 result in no federal estate tax being payable. State death tax of $17,939 would be incurred, however. On the other hand, with this sentence in the marital deduction formula, a taxable estate of only $650,000 is created, and no state death tax is incurred.

g. The survivorship sentence provides a presumption that in a simultaneous death situation, the spouse survives the client. The governing instrument would then establish a marital trust for the spouse, and the taxable estates of client and spouse could be equalized by a partial QTIP election in client's estate or by a partial disclaimer by spouse's executor. The couple's estate planning documents should be drafted so that the presumption is that the poorer spouse dies last.

5. The advantages of a fractional share marital funding formula include the following:

a. No capital gain taxes are incurred in funding either the marital or credit shelter trust.

b. Both the marital and non-marital shares bear a proportionate amount of any increase or decrease in value of the estate on an equal basis between date of death and date of funding.

c. There is no acceleration of income in respect of a decedent in funding the marital and non-marital shares, and no need to make a specific gift of items of IRD. See Treas. Reg. § 1.691(a)-4(b).

d. There is no need to revalue the assets on date of distribution unless non-pro rata distributions are made.

e. Excess deductions on termination of an estate are allocated proportionately to the marital and non-marital distributions.

f. There is no pressure to fund early because the date of funding does not alter the share of appreciation or depreciation borne by the marital and non-marital shares. The estate can be used longer as a separate income tax entity.

g. In a second marriage situation or in others where absolute fairness is more important than saving taxes at the death of the surviving spouse, a fractional formula funding is often used to avoid family conflicts and other difficulties.

6. The disadvantages of the fractional marital funding formula include the following:

a. If the assets of the estate or trust increase in value from the date of death to the date of funding, more assets are used to fund the marital share than would be used with a true pecuniary marital formula using date of distribution funding language.

b. A fractional formula is generally considered to be more inflexible and difficult to administer as compared with a true pecuniary marital formula.

c. A fractional formula is generally believed to require the executor or trustee to fractionalize each asset in funding the marital and non-marital shares, except for de minimis amounts.

(i) Fractionalizing some assets (*e.g.*, round lots of listed securities, investment real estate and closely held securities) may reduce the value of the assets, or may simply be impossible.

(ii) If distributions are made between the marital and non-marital shares on a non-pro rata basis and there is no specific authority in the governing instrument for making such distributions, the transaction will be treated as a sale or exchange causing recognition of gain on any appreciation in the assets distributed from the date of death or alternate valuation date until the date of funding. See Rev. Rul. 69-486, 1969-2 C.B. 159; Treas. Reg. §§ 1.661(a)-2(f)(1), 1.1014-4(a)(3).

(iii) If the governing instrument gives the executor or trustee the authority to make non-pro rata distributions so that the executor or trustee can pick and choose the assets in funding the fractional marital formula, many -- probably most -- commentators believe that no capital gain will be recognized on funding in these circumstances. See *In re Fiedler's Estate*, 151 A.2d 201 (N.J. Super. 1959); *Long v. Commissioner*, 35 B.T.A. 95 (1936); Treas. Reg. § 1.661(a)-2(f); Rev. Rul. 69-486, 1969-2 C.B. 159; PLR 8119040 (February 12, 1981); TAM 8145026 (July 31, 1981). However, revaluation of the assets funded on a non-pro rata basis would be required, and issues of fairness and impartiality might arise.

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

7. An excellent practical discussion of how to implement a fractional funding formula can be found in Schindel, Estate Administration and Tax Planning for Survivors, John Wiley & Sons, Inc. (June 1996 Supp.), pages 6-22.12 to 6-26.

D. Rev. Proc. 64-19 Marital Formula.

1. A 64-19 marital formula provides that the amount of the marital distribution is determined as a ***dollar amount*** that is satisfied in cash or in kind, with assets which are distributed in kind ***valued at their federal estate tax values*** (or income tax basis if acquired after death) rather than using date of distribution values in determining the amount of the marital distribution.

   a. This clause is based on the requirements of Rev. Proc. 64-19, 1964-1 C.B. 682.

   b. This is a pecuniary formula that seeks to avoid the capital gain on funding issue that is present with the true pecuniary marital formula using date of distribution values discussed above.

2. An example of a 64-19 marital formula provision is as follows:

Don't use the reduce to Ø language

> If my spouse shall survive me, I bequeath to the Trustee, to be held, managed and distributed as a separate trust (called the "Marital Trust"), ***the smallest portion*** of my residuary estate remaining after carrying out the foregoing provisions that will result in my estate incurring no, or the least possible, federal and state estate taxes, it being my intention to utilize fully the unified credit, any charitable deductions and all other federal estate tax credits (to the extent state estate taxes are not thereby incurred or increased) before utilizing the marital deduction allowable to my estate for federal estate tax purposes. For purposes of this paragraph, all values shall be those finally determined for federal estate tax purposes, except that property purchased after my death shall be valued at its cost. ***The assets, including cash, so distributed (a) shall be fairly representative of the appreciation or depreciation in the value to the date or dates of distribution of all property available for distribution in satisfaction of such bequest*** and (b) shall consist exclusively of assets allowable to my estate as a part of the marital deduction.

3. The primary advantages of a 64-19 marital formula funding provision are as follows:

   a. A 64-19 marital funding formula avoids capital gain on funding of the marital trust by using federal estate tax values (or cost for property purchased after death) in determining the amount distributed to the marital share.

   b. Unlike the fractional formula, the executor or trustee can pick and choose the assets for distribution to the marital trust and need not fractionalize each asset.

      (i) Rev. Proc. 64-19, however, requires that a pecuniary marital trust which is to be funded at federal estate tax values must be funded with assets (including cash) that are fairly representative of the appreciation or depreciation in value of all assets that are available to fund the marital trust.

(ii) Rev. Proc. 64-19 does not prevent the executor or trustee from distributing to the credit shelter trust those assets that such fiduciary believes have the greatest potential for future appreciation and distributing the other assets to the marital trust so long as appreciation or depreciation to the date of distribution is fairly allocated to the marital trust.

c. Both the marital share and the credit shelter trust are treated fairly in that both share in appreciation and depreciation to the date of funding on an equal basis.

d. There is less pressure to fund early as compared with a true pecuniary marital formula, and the estate can be used as a separate income tax entity for a longer period.

4. The primary disadvantages of a 64-19 marital formula include the following:

a. The assets must be revalued at date of distribution in order to demonstrate that the marital share has received a fairly representative amount of appreciation and depreciation during administration of the estate.

b. If the assets of the estate or trust appreciate during the period of administration, the marital share is greater than it would be if a true pecuniary marital provision were used.

* c. A 64-19 marital funding formula probably would be treated as pecuniary formula with respect to both the acceleration of income in respect of a decedent issue and the allocation of excess expenses on termination issues discussed above as disadvantages of true pecuniary formula provisions.

d. Proving that the marital share has received a fairly representative amount of appreciation and depreciation during the administration of the estate is administratively difficult unless either the assets are revalued and careful records are kept on funding or the assets are fractionalized.

E. **Credit Shelter Lead Formula.** Reverse Pecuniary - for large estate

1. When it is clear that the marital distribution will exceed the credit shelter amount, the amount of the credit shelter distribution is sometimes stated as a pecuniary amount using date of distribution values. The marital distribution is the residue of the estate or trust. This type of funding is also sometimes referred to as a "reverse pecuniary formula" and was created in response to the unlimited marital deduction brought about by ERTA 81. See Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions* (U.S. Trust Company, 1997), page 25.

2. An example of a credit shelter lead formula is as follows:

> All the residue of my estate, wherever situated, including lapsed legacies, but expressly excluding any property over which I may have power of appointment at my death, I give to THE NORTHERN TRUST COMPANY, an Illinois corporation, of Chicago, Illinois, as trustee, upon the trusts hereinafter provided.

If my wife survives me, the trustee as of my death shall set aside out of the trust estate as a separate trust, (a) all property in the trust estate as to which a federal estate tax marital deduction would not be allowed if it were distributed outright to my wife, and (b) after giving effect to (a), ***the largest pecuniary amount which will not result in or increase federal estate tax payable by reason of my death.*** In determining the pecuniary amount the trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased, shall assume that none of this trust qualifies for a federal estate tax deduction, and shall assume that all of the Marital Trust hereinafter established (including any part thereof disclaimed by my wife) qualifies for the federal estate tax marital deduction. I recognize that the pecuniary amount may be reduced by certain state death taxes and administration expenses which are not deducted for federal estate tax purposes. For purposes of this will, my wife shall be deemed to have survived me if the order of our deaths cannot be proved.

The trustee shall select and allocate the cash, securities and other property, including real estate and interests therein, which shall constitute the pecuniary amount, employing for the purpose values current at the time or times of allocation.

The trust shall be designated the "Family Trust" and shall be held and disposed of as provided below

The trustee as of my death shall set aside the balance of the trust estate as a separate trust.

(a) If my wife does not survive me, the trust shall be designated the "Family Trust" and shall be held and disposed of as provided below.

(b) If my wife survives me, the trust shall be designated the "Marital Trust."

The Marital Trust shall be held and disposed of as provided below.

3. The advantages of the credit shelter lead formula in general are the simplicity of the administration and ability to pick and choose, as with a true pecuniary marital formula. Since the pecuniary gift to the credit shelter trust is the smaller amount in a larger estate situation, using a credit shelter lead will minimize capital gain or loss on funding as compared with a true pecuniary marital provision. Another advantage is that the applicable exclusion amount will not be reduced by depreciation during the period of administration.

4. The credit shelter lead formula in general has the same disadvantages as the true pecuniary marital provision.

a. Some commentators have expressed concern that a credit shelter lead formula with a residuary marital distribution could result in a disqualification of the marital deduction because the residuary marital distribution bears all risk of depreciation during administration of the estate. See, *e.g.*, Pennell, *Marital*

Deduction Funding After ERTA '81, 7 Notre Dame Estate Planning Institute 288 (1982).

b. The Internal Revenue Service has issued Rev. Rul. 90-3, 1990-1 C.B. 174, which holds that if a pecuniary bequest of the then credit shelter amount of $600,000 is required to be paid with assets valued at the date of distribution, the possibility of post-death fluctuations in the value of the residuary bequest to the surviving spouse does not cause the residuary bequest to be a nondeductible terminable interest for purposes of I.R.C. § 2056(b). The "hybrid" 64-19 and minimum worth formulae should not be used with a credit shelter lead.

c. However, if there is *appreciation* during the administration period, it all accrues to the residuary marital trust, which will have the effect of increasing estate taxes at the surviving spouse's death.

F. <u>Minimum Worth Marital Formula Clauses.</u>

1. Another variation of the pecuniary marital funding language is the minimum worth clause, which directs distribution of the marital portion at the *lower of* federal estate tax values or date of distribution values.

2. There are two variations of the minimum worth formula: the individual asset variation and the aggregate asset variation.

Fund @ Est. tax values but not < Date of Dist.

a. An example of the *aggregate asset variation*, which is specifically mentioned in Rev. Proc. 64-19 as an acceptable form of a marital deduction formula, is as follows:

> If my spouse shall survive me, I bequeath to the Trustee, to be held, managed and distributed as a separate trust (called the "Marital Trust"), ***the smallest portion*** of my residuary estate remaining after carrying out the foregoing provisions that will result in my estate incurring no, or the least possible, federal and state estate taxes, it being my intention to utilize fully the unified credit, any charitable deductions and all other federal estate tax credits (to the extent state estate taxes are not thereby incurred or increased) before utilizing the marital deduction allowable to my estate for federal estate tax purposes. ***For the purposes of this distribution, all values shall be those finally determined for federal estate tax purposes, except that property purchased after my death shall be valued at its cost. The assets, including cash, so distributed (a) shall have an aggregate fair market value on the date or dates of distribution amounting to no less than the amount of this bequest*** and (b) shall consist exclusively of assets allowable to my estate as part of the marital deduction.

b. An example of the *individual asset variation* would be to change the last two sentences of the preceding paragraph as follows:

> ***For the purpose of distribution, the value of each asset shall be the lower of (a) the value finally determined for federal estate tax purposes (or cost, if it was purchased after my death) or (b) the value on the date of distribution.*** The assets, including cash, so distributed

shall consist exclusively of assets allowable to my estate as a part of the marital deduction.

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

4. The primary advantages of the minimum worth formula are as follows:

a. In a rising market, where assets appreciate at different rates, the assets with the greatest appreciation can be placed in the credit shelter trust, and more assets can be placed in the credit shelter trust in these circumstances as compared with a true pecuniary marital provision.

b. The minimum worth clause grants the fiduciary the greatest flexibility in selecting assets for the marital trust.

3. The primary disadvantages of the minimum worth formula are the following:

a. In the case of a decline in values from the date of death or alternate valuation date to the date of funding, the minimum worth formula tends to more adversely reduce the credit shelter trust as compared with the true pecuniary formula.

b. A minimum worth formula is also not appropriate in a second marriage situation or other circumstances where the beneficiaries of marital and non-marital trusts are different.

c. Some commentators have suggested that use of a minimum worth formula is inappropriate where a charitable deduction is being made from the residuary estate on the theory that the charitable deduction may fail because the amount is unascertainable at the date of death or alternate valuation date.

G. **<u>General Guidelines for Selecting a Marital Deduction Formula.</u>**

1. Use a pecuniary amount formula if possible. It allows for selection of assets, is more flexible and understandable, and is easier to administer, than a fractional share formula.

a. If the family trust will be larger than the marital trust, use the true pecuniary marital formula.

b. If the marital trust will be larger than the family trust, use a credit shelter lead formula with a residuary marital trust.

2. The fractional share marital formula is the best single, "all purpose" formula.

a. It works satisfactorily in both small and large estates.

b. The fractional share formula also is the best formula for certain specific situations (*e.g.*, no recognition of IRD or capital gains on funding, treats contentious beneficiaries equitably, avoids need to revalue assets).

3. Using the optimal marital deduction in conjunction with the applicable exclusion amount may not be appropriate for some clients:

a. For example, the client may desire to have his or her children receive a significant amount of property at the client's death. This often is especially important in second marriage situations.

b. It can be advantageous to equalize estates of husband and wife to reduce aggregate estate tax over the two deaths.

c. Tax may intentionally be incurred at the first death when the assets are expected to increase significantly in value during the life of the surviving spouse so that the appreciation is not subject to estate tax at the second death.

Do a reverse Qtip instead of this.

d. The entire GST exemption ($1,010,000 in 1999) may be used to create a generation-skipping trust at the first death, thereby incurring $234,915.25 of estate tax.

4. If an optimal marital deduction is not going to be used, consider the following estate planning techniques:

a. The use of a QTIP marital trust in first marriage situations will facilitate post-mortem tax planning and allow the fiduciary to evaluate all the facts after the death of the testator or settlor.

b. A percentage marital formula provides a marital distribution equal to a percentage of the client's adjusted gross estate. Alternatively, the governing instrument could provide that the marital trust and family trust are to be funded with specified fractions or percentages of the client's net residuary estate.

c. The will or revocable trust can provided fixed pecuniary gifts to children, either outright or in trust (*e.g.*, $300,000 to each child).

d. The client might provide a fixed pecuniary gift to the marital trust and leave the residue of the estate to the family trust (*e.g.*, $500,000 to marital trust; residue to family trust).

e. The governing instrument could contain a specific bequest of assets that are expected to appreciate substantially in value (*e.g.*, closely held stock) to the family trust or a separate QTIP trust for which a partial or no election might be made.

f. Of course, in all of the situations discussed above, it is critical that the governing instrument clearly specify which distributions bear the burden of the estate tax.

IV. SELECTED FUNDING AND DRAFTING PROBLEMS, ISSUES AND SOLUTIONS.

A. Income in Respect of a Decedent.

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

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

a. If an estate satisfies a pecuniary amount legacy with IRD, the transfer will cause immediate realization (and taxation) of the IRD. The legatee is entitled to a pecuniary amount of property, and the estate's transfer of the IRD is treated as a sale. I.R.C. § 691(a)(2); Treas. Reg. § 1.691(a)-4; *Noel v. Commissioner*, 50 T.C. 702 (1968).

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

3. To avoid premature realization of IRD, the client's estate should be planned so that IRD is not used to fund a pecuniary amount legacy, including a pecuniary marital deduction formula or a credit shelter lead formula.

a. For example, if the client has a multi-million dollar estate comprised mainly of IRD, a pecuniary funding formula would not be appropriate. Note that the IRD is realized even if assets distributed in kind to satisfy the pecuniary amount marital are valued at their federal estate tax values.

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

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

d. A specific bequest of IRD will also avoid the problem of accelerating the recognition of the income in funding.

4. To minimize federal estate tax at the death of the client's surviving spouse, many estate planners recommend that IRD be distributed to the spouse or to a marital trust. IRD is a shrinking asset, since the income tax which it generates is paid to the Internal Revenue Service and thus reduces the surviving spouse's gross estate. For purposes of

the marital deduction funding, however, IRD is not discounted because of its built-in income tax liability. See Rev. Rul. 66-348, 1966-2 C.B. 433. If IRD is distributed to the marital share, this enables the fiduciary to allocate to the credit shelter disposition other assets that do not have built in income tax liability.

B. <u>Section 691(c) Deduction.</u>

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

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

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

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

5. If a married client does incur federal estate tax, the fiduciary might allocate IRD away from the marital distribution in order to preserve fully the section 691(c) deduction.

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

b. If the fiduciary relies on *Kincaid*, it can allocate IRD to the marital trust, receive a full section 691(c) deduction, and obtain the estate tax benefit of having the marital trust funded with a shrinking asset due to the built-in income tax liability of the IRD. See also TAM 9219006 (January 31, 1992).

C. <u>Income Earned During Estate Administration.</u>

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

fraction of the accounting income of the estate. This fraction can change during the administration of the estate.

2. Disproportionate partial funding of testamentary trusts can change the fraction of the accounting income of the estate to which each trust is entitled. For example, in a $1,300,000 estate, the executor may fund half of the marital trust, so its interest in the estate is reduced from $650,000 to $325,000:

a. Before partial funding:

Marital Trust	650,000
Family Trust	650,000

b. After partial funding:

Marital Trust	325,000
Family Trust	650,000

c. The Marital Trust is entitled to 1/2 of the income of the estate earned before the partial funding, but it is entitled to only 1/3 of the income of the estate earned after the funding.

3. The fraction of income of the estate to which each trust is entitled can change when taxes or expenses are paid out of the Family Trust. To illustrate, assume that the executor of a $1,300,000 estate elects to qualify none of the true pecuniary QTIP Marital Trust for the marital deduction because the surviving spouse has cancer and may die soon. The will provides that the federal estate tax of $258,500 is paid from the residue of the estate, *i.e.*, the Family Trust.

a. Before payment of estate tax:

Marital Trust	650,000
Family Trust	650,000

b. After payment of estate tax:

Marital Trust	650,000
Family Trust	391,500

c. The Family Trust receives 1/2 of the income of the estate earned before the payment of estate tax, even though it is entitled to only 37.59% (391,500/1,041,500) of the income earned after the tax payment and ultimately receives only 37.59% of the net estate of $1,041,500.

4. The adjustment to the fraction is especially significant when the Marital Trust and Family Trust have different income beneficiaries and the adjustment (or lack thereof) affects a substantial amount of income of the estate.

D. *Estate of Hubert* and Proposed Regulations.

1. Introduction and Summary of Decision.

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

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

c. In the *Hubert* case, the executors charged $1,500,000 of administration expenses against the income of the residuary estate, which passed approximately ½ to a marital trust and ½ to charities. The expenses were deducted on the estate's income tax return. The Internal Revenue Service argued that the estate tax marital and charitable deductions should be reduced by $1,500,000 (*i.e.*, on a *dollar-for-dollar* basis). The Supreme Court rejected the position of the I.R.S. and found for the executors. Justice O'Connor also invited the I.R.S. to amend the marital deduction regulations to define a "material limitation" on the spouse's right to income from the marital trust.

2. Impact of *Hubert* Decision.

a. Before the *Hubert* case, if an administration expense was paid from principal of the estate and deducted on the estate's Form 1041 income tax return, this payment reduced the amount of the credit shelter trust.

> **Example:** $30,000 of administration expenses are paid from principal of the estate and deducted on the estate's Form 1041 income tax return. The amount of the credit shelter trust is $620,000 and not $650,000.

b. After the *Hubert* case, the amount of the credit shelter trust is not reduced by administration expenses that are deducted on Form 1041 if those expenses are (i) paid from the income of the estate or marital trust and (ii) are not a "material limitation" on the surviving spouse's right to income from the marital trust. In the above example, the credit shelter trust would receive a full 650,000 if the expenses were charged to income and not a material limitation.

c. After the *Hubert* decision in 1997, some attorneys revised the administration expense clauses in their wills and trusts. The new clauses give the fiduciary discretion to charge administration expenses against the income or principal of the estate or one or more of the trusts created under the instrument, except to the extent that charging an expense would reduce the marital or charitable deduction otherwise allowable for federal estate tax purposes. The trustee could use this discretion to charge some (or all) of the administration expenses against the income of the marital trust.

3. **Proposed Regulations.**

a. On December 16, 1998, the I.R.S. issued proposed regulations in response to the *Hubert* case. See Proposed Treas. Reg. § 20.2056(b)-4(e). The proposed regulations delete the concept of a material limitation on the spouse's right to income. It is replaced with two categories of administration expenses:

(i) Estate transmission expenses, or

(ii) Estate management expenses.

b. If estate transmission expenses are paid from the income or principal of marital deduction property, the marital deduction is reduced by the amount of the payment (on a *dollar-for-dollar* basis).

c. If estate management expenses are paid from the income or principal of marital deduction property, the marital deduction is ***not*** reduced by these payments.

(i) The proposed regulations contain an exception to the general rule that payment of estate management expenses does not reduce the federal estate tax marital deduction.

(ii) Estate management expenses charged to the marital deduction property if incurred for non-marital deduction property where the spouse is not entitled to the income from that non-marital property will reduce the marital deduction.

d. Estate management expenses are defined as expenses incurred with the investment of estate assets and with their preservation and maintenance during the period of administration.

(i) The proposed regulations specifically cite investment advisory fees, custodial fees, stock brokerage fees, and interest as examples of estate management fees.

(ii) All other estate administration expenses are considered to be estate transmission expenses.

e. Estate transmission expenses according to the preamble to the proposed regulations are expenses that would not have been incurred but for the decedent's death.

(i) Estate transmission expenses include expenses incurred in the collection of the decedent's assets, the payment of the decedent's debts and death taxes, and the distribution of the decedent's property.

(ii) Examples of transmission expenses include executor's commissions and attorneys fees (except to the extent specifically related to investment, preservation and maintenance of estate assets), probate fees, will construction and contest expenses, and appraisal fees.

f. A corporate fiduciary's fee may be partly an estate management expense and partly an estate transmission expense. In general, record keeping for the various types of administration expenses may be difficult. See J. Kasner, "Consider Returning this Gift – IRS's *Hubert* Regs," *Tax Notes* (January 11, 1999, p. 242).

g. The regulations are proposed to be effective for the estates of decedents dying on or after the date final regulations are published in the Federal Register.

4. **Effect of Proposed Regulations on Marital Formula and Trust Funding.**

a. When ***estate transmission expenses*** are paid, each of the marital deduction formulae discussed in this outline generally operates the same way it did before the issuance of the proposed regulations in response to the *Hubert* case with respect to (i) computation of the amount of the marital deduction for federal estate tax purposes and (ii) funding of the marital and credit shelter trusts.

Example: A $30,000 estate administration expense is deducted on the estate's Form 1041 income tax return. If the $30,000 is an estate transmission expense, the marital deduction funding formula creates a $620,000 credit shelter trust, assuming no change in values between date of death (or alternate valuation date) and date of trust funding.

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

(i) *Form 1041 income tax deduction*. In the above example, assume that the $30,000 is an estate management expense. The formula creates a $650,000 credit shelter trust, regardless of whether the management expenses are charged to income or principal.

(ii) *Form 706 estate tax deduction*. Assume that the $30,000 estate management expense is taken as a federal estate tax deduction on Form 706. Applying the proposed regulations, it appears that the marital deduction formula will create a credit shelter trust of $680,000.

(A) **Example**:

Gross estate	$1,000,000
Credit shelter trust	$ 680,000
Marital deduction trust	$ 320,000

(B) The estate has $350,000 of federal estate tax deductions (marital deduction of $320,000 and administration expense deduction of $30,000), resulting in a taxable estate of $650,000 and estate tax of zero.

(iii) This unusual result is generated by a literal application of the rules contained in the proposed regulations. See B. Budin, "IRS Issues Proposed Regulations After *Estate of Hubert*: New Terminology and Maybe New Problems," *Journal of Taxation* (May, 1999, p. 277). Some practitioners, however, refuse to believe that the IRS would really allow a credit shelter trust to be funded with $680,000 when the applicable exclusion amount is only $650,000.

5. **Drafting under the *Hubert* Proposed Regulations.**

a. In drafting wills and revocable trusts to take advantage of the *Hubert* proposed regulations, practitioners should continue to maintain maximum flexibility regarding charging administration expenses – whether estate transmission expenses or estate management expenses as defined in the proposed regulations – to either principal or income of the estate or trust.

b. The formula for computing the funding of the marital and credit shelter trusts does not need to be revised prior to the issuance of the final *Hubert* regulations so long as the formula is self-adjusting and operates to obtain the optimal marital deduction, as do the various funding formulae discussed above in this outline.

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

d. In wills and trusts with pecuniary marital deduction formulae or fractional funding, consider allowing the executor or trustee to charge estate management expenses to the marital disposition to take advantage of the unusual opportunity to increase the amount of the credit shelter disposition by the amount of such expenses that the proposed regulations seems to allow.

E. **<u>Planning for Qualified Family-Owned Business Interests.</u>**

1. **Overview of Election and Deduction under I.R.C. § 2057.**

a. Section 2057 provides an estate tax deduction for the estates of decedents dying after December 31, 1997, consisting in part of qualified family-owned business interests ("QFOBI").

b. The maximum deduction is fixed at $675,000 and is adjusted annually with reference to the applicable exclusion amount. I.R.C. § 2057(a)(2), (3).

(i) The original Section 2033A exclusion was drafted so that the QFOBI and the applicable exclusion amount when added did not exceed $1,300,000.

(ii) For an excellent in depth discussion of the history and details of this provision, see R. Bellatti and S. West, *Estate Planning for Farms and Other Qualified Family-Owned Businesses Under Sections 2032A and 2057* (1999) published by the RIA Group of Warren Gorham & Lamont.

c. In general, this section may apply if the adjusted value of the QFOBI plus certain lifetime gifts exceeds 50% of the adjusted gross estate. I.R.C. § 2057(b)(1)(C).

(i) There is also a material participation requirement similar to the rule under Section 2032A for 5 out of the 8 years preceding the decedent's death. I.R.C. §§ 2057(b)(1)(D), 2033A(b)(1)(C).

(ii) The decedent must be a U.S citizen or resident at the date of death. I.R.C. § 2057(b)(1)(A).

(iii) The executor must make an election under Section 2057, and a recapture agreement must be filed with Form 706 that is signed by each qualified heir and others having an interest in the property. I.R.C. § 2057(b)(1)(B), (h).

2. **Drafting Marital Formula Provisions to Utilize the QFOBI Deduction.**

a. Section 2056(b)(9) provides generally that nothing under Section 2056 or in any other provision of Chapter 11 shall allow any interest in property to be deducted more than once with respect to the same decedent.

(i) This provision was intended to prevent an estate from claiming both a marital deduction and a charitable deduction for the same interest in the same property.

(ii) Section 2056(b)(9) may present a problem if the decedent has QFOBI property that the executor wishes to deduct for both marital deduction and Section 2057 purposes. See *Estate of Reeves v. Commissioner*, 100 T.C. 427 (1993).

b. A true pecuniary marital deduction formula appears to circumvent the problem that Section 2056(b)(9) creates for QFOBI property that passes as part of the marital disposition.

(i) A true pecuniary marital deduction formula is also the one that is best used for married clients who may take advantage of Section 2032A.

(ii) The recognition of capital gain on funding a true pecuniary marital formula with QFOBI property appears to meet the "passing to qualified heir" requirement and to avoid application of Section 2056(b)(9). See I.R.C. §§ 2057 (b)(2)(B), 2032A(e)(9).

F. Creating and Funding Generation-Skipping Trusts.

only adv. is simplicity unless you want to pay tax early

1. The advantages of lifetime use of the GST exemption or the creation of a generation-skipping trust at death without use of the so-called reverse QTIP election were discussed above in II.A.4.

a. Lifetime use of the GST exemption without use of the marital deduction is the most tax efficient method of planning for the generation-skipping transfer tax.

b. Full use of the GST exemption at the first death for a married client without creating an exempt marital trust for which the reverse QTIP election is made under I.R.C. § 2652(a)(3) is more tax efficient than using the marital deduction to shelter the portion of the GST exemption that exceeds the applicable exclusion amount.

c. The two or three trust approach for a married couple discussed above in II.A.4. does have the advantage of generally deferring all federal and state estate taxes until the death of the survivor.

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

a. In drafting and funding trusts at death that will be treated as separate trusts for purposes of Chapter 13, it is necessary to pay close attention to the valuation and division of trust rules contained in the generation-skipping tax regulations.

b. In general, these rules are similar to some of the marital trust funding rules discussed above.

3. If a trust created under a will or a revocable trust is divided into two or more trusts pursuant to a ***mandatory direction*** under the governing instrument, the separate trusts thereby created will be recognized for Chapter 13 purposes without needing to meet the funding and appropriate interest requirement discussed below. Treas. Reg. § 26.2654-1(b)(1)(i).

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

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

(i) Trusts will be treated as meeting this requirement if the federal estate tax return indicates that separate trusts will be created or funded and clearly sets forth the manner in which the trusts are to be divided and funded. Treas. Reg. § 26.2654-1(b)(2).

(ii) Meeting this disclosure requirement on Form 706 is essential when the trusts will not be funded prior to filing the estate tax return, as is often the case.

b. If the new trusts are severed on a ***fractional basis***, the separate trusts need not be funded on a pro rata basis of each of the assets held in the original trust. The trusts may be funded on a non-pro rata basis provided the funding is based on either:

(i) the fair market value of the assets on the date of funding; ***or***

(ii) in a manner that fairly reflects the net appreciation or depreciation in the value of the assets from the date of death (or alternate valuation date) to the date of funding.

c. If the severance is required by the terms of the governing instrument to be made on the basis of a ***pecuniary amount***, the trustee must pay ***appropriate interest*** (defined below) and, if the funding is made in kind, the funding must be based on either:

(i) the fair market value of the assets on the date of funding; ***or***

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

5. The ***appropriate interest*** requirement can be met in several different ways contained in the regulations:

a. Interest must be paid from the date of death until the date of funding at a rate at least equal to the statutory rate of interest applicable to pecuniary bequests under the applicable state law.

b. If no statutory rate is provided by state law, interest must be paid at a rate equal to at least 80 percent of the section 7520 rate in effect at the death of the decedent.

c. The appropriate interest requirement is deemed to be met if the funding of the pecuniary trust is irrevocably done within 15 months of the decedent's death.

d. The appropriate interest requirement is also deemed to be met if the governing instrument or applicable law requires the funding of the pecuniary trust to receive a pro rata share of the income earned by the fund from which the payment is being made from the date of death until the date of funding. Treas. Reg. § 26.2642-2(b)(4).

G. Funding Examples.

Assume that an estate has a federal estate tax value of $3,000,000, the applicable exclusion amount is $1,000,000, and the optimal marital deduction amount is $2,000,000.

1. 20% Increase in Value Before Funding.

	FET VALUE	DATE OF DISTRIBUTION VALUE	TRUE PECUNIARY	FRACTIONAL	CREDIT SHELTER LEAD
Assets	$3,000,000	3,600,000			
Marital Trust			2,000,000	2/3 x 3,600,000 = 2,400,000	2,600,000
Family Trust			1,600,000	1/3 x 3,600,000 = 1,200,000	1,000,000
Capital Gain			2,000,000 (1,666,667) 333,333 x20%	-0-	1,000,000 (833,333) 166,667 x20%
Tax on Capital Gain			66,667	None	33,333

2. 20% Decrease in Value Before Funding.

	FET VALUE	DATE OF DISTRIBUTION VALUE	TRUE PECUNIARY	FRACTIONAL	CREDIT SHELTER LEAD
Assets	$3,000,000	2,400,000			
Marital Trust			2,000,000	2/3 x 2,400,000 = 1,600,000	1,400,000
Family Trust			400,000	1/3 x 2,400,000 = 800,000	1,000,000
Capital Loss			2.000,000 (2,500,000) (500,000)	None	1,000,000 (1,250,000) (250,000)

H. **Comparison of Characteristics of Funding Formulae.**

Characteristic	True Pecuniary Marital Lead	Fractional Share	Credit Shelter Pecuniary Lead	64-19
1. Which trust enjoys appreciation (or suffers depreciation)?	Credit Shelter Trust (residuary)	Both	Marital Trust (residuary)	Both
2. Is capital gain recognized on funding?	Yes	No	Yes	No
3. Do assets have to be revalued on funding?	Yes	No	Yes	Yes
4. Which trust bears the burden of taxes and expenses?	Credit Shelter Trust (residuary)	Both	Marital Trust (residuary)	Credit Shelter Trust (residuary)
5. Is income in respect of a decedent realized on funding?	Yes	No	Yes	Yes
6. Is formula impartial?	No	Yes	No	Yes
7. Can formula produce a larger than desirable Marital Trust?	No	Yes	Yes	Yes
8. Can formula produce a larger Credit Shelter Trust?	Yes	Yes	No	Yes
9. Is formula time sensitive (*i.e.*, require early funding)?	Yes	No	Yes	No

V. EXHIBITS.

A. Qualified Terminable Interest Property Marital Trust.

B. Greater of Income or Unitrust Amount.

C. 5 or 5 Principal Withdrawal Rights for QTIP Marital Trust.

D. Single Fund Marital Trust.

E. Generation-Skipping Trusts for Married Testator.

F. Power to Divide Trusts for GST Purposes.

G. General Power of Appointment Marital Trust.

H. Estate Marital Trust.

I. Qualified Domestic Trust.

The will and trust forms in the following Exhibits and most of the marital deduction funding formulae contained in the text of the above outline are used with the permission of The Northern Trust Company. For further information or to obtain a full set of these forms, including the easy-to-use electronic version, please contact:

Ms. April Cottone
The Northern Trust Company
50 South LaSalle Street
Chicago, Illinois 60675
312-557-3306

A. **<u>Qualified Terminable Interest Property Marital Trust.</u>**

SECTION 1: ***Income.*** Commencing with my death the trustee shall pay the income from the Marital Trust in convenient installments, at least quarterly, to my wife during her lifetime.

Principal Invasion. The trustee may also pay to my wife such sums from principal as the trustee deems necessary or advisable from time to time for her health and maintenance in reasonable comfort, considering her income from all sources known to the trustee.

SECTION 2: ***Election.*** My executor may elect to have a specific portion or all of the Marital Trust, herein referred to as the "marital portion," treated as qualified terminable interest property for federal estate tax purposes. If an election is made as to less than all of the Marital Trust, the specific portion shall be expressed as a fraction or percentage of the Marital Trust and may be defined by means of a formula. I intend that the marital portion shall qualify for the federal estate tax marital deduction in my estate.

If the marital portion is less than all of the Marital Trust, at any time during the lifetime of my wife the trustee in its discretion may divide the Marital Trust into two separate trusts representing the marital and non-marital portions of the Marital Trust. The two separate trusts shall be held and disposed of on the same terms and conditions as the Marital Trust, except that the trustee shall make no invasion of the principal of the non-marital portion trust so long as any readily marketable assets remain in the marital portion trust.

SECTION 3: ***Limited Testamentary Power of Appointment.*** Upon the death of my wife the principal of the Marital Trust shall be held in trust hereunder or distributed to or in trust for such one or more of my descendants and their respective spouses and charitable, scientific or educational purposes, with such powers and in such manner and proportions as my wife may appoint by her will making specific reference to this power of appointment.

Upon the death of my wife any part of the principal of the Marital Trust not effectively appointed shall be added to the Family Trust, and the added property shall be held and disposed of as though the Family Trust were then being created, except that, unless my wife directs otherwise by her will or revocable trust, the trustee shall first pay from the principal of the marital portion, directly or to the legal representative of my wife's estate as the trustee deems advisable, the amount by which the estate and inheritance taxes assessed by reason of the death of my wife shall be increased as a result of the inclusion of the marital portion in her estate for such tax purposes. The trustee's selection of assets to be sold to pay that amount, and the tax effects thereof, shall not be subject to question by any beneficiary.

Notwithstanding any other provision of this will, all income of the Marital Trust accrued or undistributed at the death of my wife shall be paid to her estate.

My wife shall have the right by written notice to require the trustee to convert unproductive property in the trust to productive property within a reasonable time.

B. Greater of Income or Unitrust Amount.

SECTION 1: *QTIP Marital Trust.* Commencing with my death the trustee shall pay to my wife during her lifetime the greater of

(a) the income from the Marital Trust, or
(b) the unitrust amount from the Marital Trust.

Payments shall be made in convenient installments at least quarterly.

SECTION 2: ***Definition of "unitrust amount."*** For purposes of this trust instrument the "unitrust amount" from a trust or share for a calendar year shall be a unitrust amount equal to ~~four percent (4%)~~ of the value of the assets in the trust or share. Assets shall be valued as of the close of the last business day of the preceding calendar year, or in the first year of the trust or share, as of the day on which the trust or share was established. Assets shall be valued at their net fair market value as hereafter provided, with no accrual of interest or other periodic payments, and considering the debts and any accrued estate tax (but not income tax or real estate tax) liability of the trust or share.

The unitrust amount shall be paid first from income, then from capital gains, and then from principal. Any income of the trust in excess of the prescribed unitrust amount shall be added to principal in the calendar year received.

If a trust or share pays a unitrust amount to a beneficiary, the following provisions shall apply to it:

(a) *Valuation of Non-marketable Assets.* In determining the fair market value of a non-marketable asset in a trust or share for a calendar year, the trustee may, but need not, have the non-marketable asset appraised by a valuation professional. The cost of the appraisal shall be paid from the principal of the trust estate. The trustee need not revalue a non-marketable asset each year, but may use the prior year's value if the trustee so chooses; provided, however, that if a non-marketable asset was last valued at more than $100,000, the asset must be revalued within three years. The trustee's assignment of a value to a non-marketable asset, done in good faith, shall be binding on all current and future beneficiaries of the trust or share and shall not be subject to question.

Marketable assets in a trust or share are (i) cash, and moneys held at financial institution, (ii) securities (including mutual fund shares) for which market quotations are readily available, and (iii) interests in common trust funds. "Non-marketable assets" in a trust or share are all assets which are not marketable assets. Examples of non-marketable assets including (but are not limited to) real estate, partnership interests, closely held stock and loans.

The trustee may distribute a non-marketable asset to a beneficiary as part of the beneficiary's unitrust payment, valuing the asset at its fair market value. The trustee may sell a non-marketable asset to a beneficiary, for cash or on credit, at its fair market value.

If the trust or share holds a residence, including a seasonal or vacation home, the trustee in its discretion may allow a beneficiary to occupy the residence. In such case:

(1) The value of the residence shall be excluded in determining the unitrust amount payable to the beneficiary.

(2) The beneficiary shall not pay rent to the trustee.

(3) Neither the expenses of the residence nor the value of its use shall be charged against the unitrust amount payable to the beneficiary. The expenses of the residence (including taxes, assessments, insurance, mortgage payments, repairs and replacements, but not improvements) shall be paid by the trustee, except that the beneficiary shall pay all utilities, ordinary maintenance, painting and decorating and other similar expenses.[1]

(b) *Funding period.* Notwithstanding that the obligation to pay the unitrust amount shall commence with the establishment of the trust or share, payment may be deferred until a reasonable period after the complete funding of the trust. If payment is deferred, the trustee shall pay to the beneficiary (in case of underpayment) or shall recover from the beneficiary (in case of overpayment) an amount equal to the difference between the unitrust amount properly payable and any unitrust amount actually paid, in either case without interest.

(c) *Proration.* In determining the unitrust amount, the trustee shall prorate the same on a daily basis for a short year and for a year in which an estate or interest terminates.

(d) *Incorrect Determination.* If the fair market value of the assets in the trust or share is incorrectly determined for any year, then within a reasonable period after the final determination of the correct value, the trustee shall pay to the beneficiary (in case of undervaluation) or shall recover from the beneficiary (in case of overvaluation) an amount equal to the difference between the unitrust amount properly payable and the unitrust amount actually paid, in each case without interest.

(e) *Additions.* If any property is added to the trust or share after the first day of a calendar year, the unitrust amount for that year shall be increased by ________% of the fair market value of the addition on the day of addition, prorated on a daily basis, including the day of addition, to the end of the year of the addition.

(f) *Prevailing Provisions.* The provisions of this section shall prevail over any other provision in this instrument which are inconsistent herewith.

[1] Any other provision in the trust instrument regarding the residence should be consistent with paragraph (a)(3).

C. <u>5 or 5 Principal Withdrawal Rights for QTIP Marital Trust.</u>

In addition, my wife may withdraw at any time or times from the principal of the Marital Trust not to exceed in the aggregate during any calendar year $5,000 prior to the end of the third full calendar year following my death and thereafter the greater of $5,000 and 5% of the value of the principal of the Marital Trust. If the Marital Trust is divided into marital and non-marital portion trusts, the amount of my wife's withdrawal right under this paragraph shall be determined by aggregating the values of the trusts, but the trustee shall satisfy the withdrawal right first from the principal of the marital portion trust so long as any readily marketable assets remain in that trust. The trustee shall make payment without question upon her written request. The right of withdrawal shall be a privilege which may be exercised only voluntarily and shall not include an involuntary exercise.

NOTE: During the first three years following death, the value of the Marital Trust often is not known. Accordingly, the form limits the withdrawal right to $5,000 during that period of time.

D. **Single Fund Marital Trust.**

All the residue of my estate, wherever situated, including lapsed legacies, but expressly excluding any property over which I may have power of appointment at my death, I give to THE NORTHERN TRUST COMPANY, an Illinois corporation, of Chicago, Illinois, as trustee, to be held and disposed of as follows:

SECTION 1: ***Income.*** If my wife survives me, then commencing with my death the trustee shall pay the income from the trust estate in convenient installments, at least quarterly, to her during her lifetime.

Principal Invasion. The trustee may also pay to my wife such sums from principal as the trustee deems necessary or advisable from time to time for her health and maintenance in reasonable comfort, considering her income from all sources known to the trustee.

SECTION 2: ***Election.*** My executor may elect to have a specific portion or all of the trust estate, herein referred to as the "marital portion," treated as qualified terminable interest property for federal estate tax purposes. If an election is made as to less than all of the trust estate, the specific portion shall be expressed as a fraction or percentage of the trust estate and may be defined by means of a formula. I intend that the marital portion shall qualify for the federal estate tax marital deduction in my estate. For purposes of this will, my wife shall be deemed to have survived me if the order of our deaths cannot be proved. My wife shall have the right by written notice to require the trustee to convert unproductive property in the trust to productive property within a reasonable time.

SECTION 3: ***Limited Testamentary Power of Appointment.*** Upon the death of my wife if she survives me, the principal of the trust estate shall be held in trust hereunder or distributed to or in trust for such one or more of my descendants and their respective spouses and charitable, scientific or educational purposes, with such powers and in such manner and proportions as my wife may appoint by her will making specific reference to this power of appointment. For purposes of this will, the term "spouse" shall include a widow or widower, whether or not remarried.

Default. After the death of my wife any part of the principal of the trust estate not effectively appointed (or after my death if my wife does not survive me, the trust estate) shall be held and disposed of as hereinafter provided, except that upon the death of my wife if she survives me and does not direct otherwise by her will or revocable trust, the trustee shall first pay from the principal of the marital portion, directly or to the legal representative of my wife's estate as the trustee deems advisable, the amount by which the estate and inheritance taxes assessed by reason of the death of my wife shall be increased as a result of the inclusion of the marital portion in her estate for such tax purposes. The trustee's selection of assets to be sold to pay that amount, and the tax effects thereof, shall not be subject to question by any beneficiary.

Notwithstanding any other provision of this will, all income of the trust estate accrued or undistributed at the death of my wife shall be paid to her estate if she survives me.

SECTION 4: ***Distribution.*** Upon the death of my wife, or upon my death if my wife does not survive me, the trustee shall distribute the trust estate in equal shares to such of my children as shall then be living, except that the then living descendants of a deceased child of mine shall take per stirpes the share which the child would have received if living, subject to postponement of possession as provided below.

SECTION 5: ***Postponement of Possession.*** Each share of the trust estate which is distributable to a child of mine who has not reached the age of 30 years or to a more remote descendant who has not reached the age of 21 years shall immediately vest in the child or descendant, but the trustee shall retain possession of the share as a separate trust, paying to or for the benefit of the child or descendant so much or all of the income and principal of the share as the trustee deems necessary or advisable from time to time for his or her health, maintenance in reasonable comfort, education (including postgraduate) and best interests, adding to principal any income not so paid (except that after the child has reached the age of 21 years, the trustee shall pay to him or her all the income from the share in convenient installments, at least quarterly), and distributing 1/2 in value of the principal of the share to the child if he or she has then reached or at such time thereafter as he or she reaches the age of 25 years and the balance to the child when he or she reaches the age of 30 years or distributing the share to the descendant when he or she reaches the age of 21 years, and distributing the share to the estate of the child or descendant if he or she dies before receiving the share in full.

E. **Generation-Skipping Trusts for Married Testator.**

All the residue of my estate, wherever situated, including lapsed legacies, but expressly excluding any property over which I may have power of appointment at my death, I give to THE NORTHERN TRUST COMPANY, an Illinois corporation, of Chicago, Illinois, as trustee, upon the trusts hereinafter provided.

FIFTH: **Family Trust.**

If my wife survives me, the trustee as of my death shall set aside out of the trust estate as a separate trust, (a) all property in the trust estate as to which a federal estate tax marital deduction would not be allowed if it were distributed outright to my wife, and (b) after giving effect to (a), the largest pecuniary amount which will not result in or increase federal estate tax payable by reason of my death. In determining the pecuniary amount the trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased, shall assume that none of this trust qualifies for a federal estate tax deduction, and shall assume that each of the Marital Trusts hereinafter established (including any part thereof disclaimed by my wife) qualifies in full for the federal estate tax marital deduction. I recognize that the pecuniary amount may be reduced by certain state death taxes and administration expenses which are not deducted for federal estate tax purposes. For purposes of this will, my wife shall be deemed to have survived me if the order of our deaths cannot be proved.

The trustee shall select and allocate the cash, securities and other property, including real estate and interests therein, which shall constitute the pecuniary amount, employing for the purpose values current at the time or times of allocation.

The trust shall be designated the "Family Trust" and shall be held and disposed of as follows:

SECTION 1: ***Spray for Spouse and Descendants.*** During the lifetime of my wife the trustee may pay so much or all of the income and principal of the Family Trust to any one or more of my wife and descendants from time to time living, in equal or unequal proportions and at such times as the trustee deems best, considering the needs, other income and means of support, and best interests of my wife and descendants, individually and as a group, and any other circumstances and factors which the trustee deems pertinent, but shall make no invasion of the principal of the Family Trust for my wife so long as any readily marketable assets remain in a Marital Trust. Any income not so paid shall be added to principal. No payment of income or principal to a descendant of mine shall be charged against the share hereinafter provided for the descendant or his or her ancestor or descendants.

Disclaimed Property. A disclaimer by my wife of any part or all of a Marital Trust shall not preclude her from receiving benefits from the disclaimed property in the Family Trust.

SECTION 2: Upon the death of my wife the Family Trust shall be held and disposed of as hereinafter provided.

SIXTH: **Marital Trust #1.**

If my wife survives me, the trustee as of my death shall set aside out of the trust estate as a separate trust for her benefit (undiminished to the extent possible by any estate or inheritance taxes or other charges), a pecuniary amount equal to my federal generation-skipping tax exemption which remained unallocated immediately before my death, less the value for generation-skipping tax purposes of (a) the Family Trust and (b) all direct skips occurring by reason of my death (other than direct skips caused by a disclaimer or from a trust not created or appointed by me).

The trustee shall select and allocate the cash, securities and other property, including real estate and interests therein, which shall constitute the trust, employing for the purpose values current at the time or times of allocation. The trust shall be designated "Marital Trust #1" and shall be held and disposed of as hereinafter provided.

If the trust estate is insufficient to satisfy both the Family Trust and Marital Trust #1 in full, the Family Trust shall be satisfied first.

My wife shall have the right by written notice to require the trustee of Marital Trust #1 and Marital Trust #2 hereinafter established to convert unproductive property in the trust to productive property within a reasonable time. Any part of Marital Trust #1 or Marital Trust #2 disclaimed by my wife shall be added to or used to fund the Family Trust.

SECTION 1: ***Income.*** Commencing with my death the trustee shall pay the income from Marital Trust #1 in convenient installments, at least quarterly, to my wife during her lifetime.

Principal Invasion. The trustee may also pay to my wife such sums from principal as the trustee deems necessary or advisable from time to time for her health and maintenance in reasonable comfort, considering her income from all sources known to the trustee, but shall make no invasion of Marital Trust #1 so long as any readily marketable assets remain in Marital Trust #2.

SECTION 2: ***Election.*** My executor may elect to have a specific portion or all of Marital Trust #1, herein referred to as the "marital portion," treated as qualified terminable interest property for federal estate tax purposes. If an election is made as to less than all of Marital Trust #1, the specific portion shall be expressed as a fraction or percentage of Marital Trust #1 and may be defined by means of a formula. I intend that the marital portion shall qualify for the federal estate tax marital deduction in my estate.

If the marital portion is less than all of Marital Trust #1, at any time during the lifetime of my wife the trustee in its discretion may divide Marital Trust #1 into two separate trusts representing the marital and nonmarital portions of Marital Trust #1. The two separate trusts shall be held and disposed of on the same terms and conditions as Marital Trust #1, except that the trustee shall make no invasion of the principal of the nonmarital portion trust so long as any readily marketable assets remain in the marital portion trust.

SECTION 3: ***Limited Testamentary Power of Appointment.*** Upon the death of my wife the principal of Marital Trust #1 shall be held in trust hereunder or distributed to or in trust for such one or more of my descendants and their respective spouses and charitable, scientific or educational purposes, with such powers and in such manner and proportions as my wife may appoint by her will making specific reference to this power of appointment.

Default. Upon the death of my wife any part of the principal of Marital Trust #1 not effectively appointed shall be added to or used to fund the Family Trust.

Notwithstanding any other provision of this will, all income of Marital Trust #1 accrued or undistributed at the death of my wife shall be paid to her estate.

SEVENTH: **Marital Trust #2 (Residuary).**

If my wife survives me, the trustee as of my death shall set aside the balance of the trust estate as a separate trust. The trust shall be designated "Marital Trust #2" and shall be held and disposed of as follows:

SECTION 1: ***Income.*** Commencing with my death the trustee shall pay the income from Marital Trust #2 in convenient installments, at least quarterly, to my wife during her lifetime.

Principal Invasion. The trustee may also pay to my wife such sums from principal as the trustee deems necessary or advisable from time to time for her health and maintenance in reasonable comfort, considering her income from all sources known to the trustee.

SECTION 2: ***Election.*** My executor may elect to have a specific portion or all of Marital Trust #2, herein referred to as the "marital portion," treated as qualified terminable interest property for federal estate tax purposes. If an election is made as to less than all of Marital Trust #2, the specific portion shall be expressed as a fraction or percentage of Marital Trust #2 and may be defined by means of a formula. I intend that the marital portion shall qualify for the federal estate tax marital deduction in my estate.

If the marital portion is less than all of Marital Trust #2, at any time during the lifetime of my wife the trustee in its discretion may divide Marital Trust #2 into two separate trusts representing the marital and nonmarital portions of Marital Trust #2. The two separate trusts shall be held and disposed of on the same terms and conditions as Marital Trust #2, except that the trustee shall make no invasion of the principal of the nonmarital portion trust so long as any readily marketable assets remain in the marital portion trust.

SECTION 3: ***Limited Testamentary Power of Appointment.*** Upon the death of my wife the principal of Marital Trust #2 shall be held in trust hereunder or distributed to or in trust for such one or more of my descendants and their respective spouses and charitable, scientific or educational purposes, with such powers and in such manner and proportions as my wife may appoint by her will making specific reference to this power of appointment.

Default. Upon the death of my wife any part of the principal of Marital Trust #2 not effectively appointed shall be held and disposed of as hereinafter provided, except that, unless my wife provides for payment by her estate or revocable trust, the trustee shall first pay from the principal of the marital portion of Marital Trust #2 the aggregate amount by which the estate and inheritance taxes assessed by reason of the death of my wife shall be increased as a result of the inclusion of the marital portions of Marital Trusts #1 and #2 in her estate for such tax purposes. The trustee may make payment directly or to the legal representative of my wife's estate, as the trustee deems advisable. The trustee's selection of assets to be sold to pay that amount, and the tax effects thereof, shall not be subject to question by any beneficiary.

Notwithstanding any other provision of this will, all income of Marital Trust #2 accrued or undistributed at the death of my wife shall be paid to her estate.

SECTION 4: ***Spouse's GST Exemption.*** As of the death of my wife, the trustee shall set aside out of Marital Trust #2, as a separate share which will be completely exempt from generation-skipping tax, a fractional share of Marital Trust #2 which has a value for federal generation-skipping tax purposes equal to the amount of my wife's generation-skipping tax exemption, if any, that is allocated to this share of Marital Trust #2. The trustee may rely on the certification of the person allocating my wife's generation-skipping tax exemption as to the amount of the exemption so allocated.

The exempt share of Marital Trust #2, or all of Marital Trust #2 if it is completely exempt from generation-skipping tax, shall be added to or used to fund the Family Trust.

The balance of Marital Trust #2 shall be held and disposed of as hereinafter provided.

EIGHTH: **Spouse Does Not Survive.**

If my wife does not survive me, the trustee as of my death shall hold and dispose of the trust estate as follows:

SECTION 1: ***Family Trust.*** If a child of mine survives me, the trustee shall set aside out of the trust estate, as a separate trust, a pecuniary amount equal to my federal generation-skipping tax exemption which remained unallocated immediately before my death, less the value for generation-skipping tax purposes of all direct skips occurring by reason of my death (other than direct skips caused by a disclaimer or from a trust not created or appointed by me).

The trustee shall select and allocate the cash, securities and other property, including real estate and interests therein, which shall constitute the trust, employing for the purpose values current at the time or times of allocation.

The trust shall be designated the "Family Trust" and shall be held and disposed of as hereinafter provided.

SECTION 2: ***Balance.*** The balance of the trust estate shall be held and disposed of as hereinafter provided.

NINTH: **Division.**

Upon the death of the survivor of my wife and me:

(a) The Family Trust shall be held and disposed of as hereinafter provided; and

(b) The balance of the trust estate shall be divided into equal shares to create one share for each then living child of mine and one share for the then living descendants, collectively, of each deceased child of mine.

Each share created for the descendants of a deceased child shall be distributed per stirpes to those descendants, subject to postponement of possession as provided below. Each share created for a living child shall be held as a separate trust, designated the "Child's Trust," and shall be disposed of as hereinafter provided.

TENTH: **Family Trust.**

Division. Upon the death of the survivor of my wife and me, the trustee shall divide the Family Trust per stirpes among my then living descendants. Each portion set aside for a descendant of mine (herein referred to as a "beneficiary") shall be held as a separate trust and disposed of as follows:

SECTION 1: ***Income.*** The trustee shall pay the income from a beneficiary's trust in convenient installments, at least quarterly, to the beneficiary during his or her lifetime; but if the income so payable to the beneficiary shall at any time or times exceed the amount which the trustee deems to be in his or her best interests (considering his or her other income and means of support known to the trustee, the desirability of augmenting his or her estate, and any other circumstances and factors deemed pertinent), the trustee may pay any part or all of the excess income to any one or more of the beneficiary's descendants from time to time living, in equal or unequal proportions, according to their respective needs and best interests, or accumulate the same and add it to principal as the trustee deems advisable.

Principal Invasion. The trustee may also pay to any one or more of the beneficiary and his or her descendants, in equal or unequal proportions, such sums from the principal of the beneficiary's trust as the trustee deems necessary or advisable from time to time for their health, support in reasonable comfort, and education (including postgraduate), considering the income of each of them from all sources known to the trustee, but shall make no invasion of the trust for the beneficiary so long as any readily marketable assets remain in a Child's Trust for the beneficiary. No payment made for a descendant of the beneficiary shall be charged against the share hereinafter provided for the descendant or his or her ancestor or descendants.

SECTION 2: ***Limited Testamentary Power of Appointment.*** Upon the death of a beneficiary his or her trust shall be held in trust hereunder or distributed to or in trust for such one or more of the beneficiary's surviving spouse, the beneficiary's descendants and their respective spouses, and my descendants (other than the beneficiary) and their respective spouses, with such powers and in such manner and proportions as the beneficiary may appoint by his or her will making specific reference to this power of appointment. For purposes of this will, the term "spouse" shall include a widow or widower, whether or not remarried.

SECTION 3: ***Default.*** Upon the death of a beneficiary any part of his or her trust not effectively appointed shall be divided per stirpes among his or her then living descendants, or if none, then per stirpes among the then living descendants of the nearest ancestor of the beneficiary who is a descendant of mine and who has one or more descendants then living, or if also none, then per stirpes among my then living descendants. Each portion set aside for a descendant of mine for whom a trust is then held under this article shall be added to that trust. Each portion set aside for any other descendant shall be held as a separate trust, with the descendant as the "beneficiary" of the trust, and shall be disposed of as provided in this article.

SECTION 4: ***Termination.*** The trustee shall terminate and distribute any trust under this article which is still held 21 years after the death of the last to die of myself, my wife and my descendants who were living at my death. In addition, a corporate trustee in its discretion may terminate and distribute any trust under this article at any time if the corporate trustee determines that the cost of continuance thereof will substantially impair accomplishment of the purposes of the trust. A trust terminated under this section shall be distributed to the beneficiary of the trust.

ELEVENTH: **Child's Trust.**

A Child's Trust shall be held and disposed of as follows:

SECTION 1: ***Income.*** The income from a Child's Trust shall be paid in convenient installments, at least quarterly, to the child until complete distribution of the trust or his or her prior death.

Principal Invasion. The trustee may also pay to the child such sums from the principal of his or her Child's Trust as the trustee deems necessary or advisable from time to time for the health, maintenance in reasonable comfort, education (including postgraduate) and best interests of the child and his or her descendants, individually and as a group, considering the income of each of them from all sources known to the trustee. The trustee may also pay to an educational organization or medical care provider such sums from principal as the trustee deems necessary or advisable from time to time for the tuition (including postgraduate) and medical care of any descendant of the child. No payment made for a descendant of the child shall be charged against the share hereinafter provided for the descendant or his or her ancestor or descendants.

SECTION 2: ***Right To Withdraw.*** After creation of a Child's Trust and after a child has reached any one or more of the following ages, the child may withdraw from the principal of his or her Child's Trust at any time or times not to exceed in the aggregate:

1/3 in value after 30 years of age;

1/2 in value (after deducting any amount subject to withdrawal but not actually withdrawn) after 35 years of age; and

The balance after 40 years of age.

The value of the Child's Trust shall be its value as of the first exercise of each withdrawal right, plus the value of any subsequent addition as of the date of addition. The trustee shall make payment without question upon the child's written request. The right of withdrawal shall be a privilege which may be exercised only voluntarily and shall not include an involuntary exercise.

SECTION 3: ***Contingent General Testamentary Power of Appointment.*** If a child dies before receiving his or her Child's Trust in full, then upon the death of the child if he or she has one or more descendants then living, the child may appoint the Child's Trust to or in trust for such appointee or appointees (including the estate of the child), with such powers and in such manner and proportions as the child may appoint by his or her will making specific reference to this power of appointment.

SECTION 4: ***Limited Testamentary Power of Appointment.*** If a child dies before receiving his or her Child's Trust in full, then upon the death of the child any part of the Child's Trust not effectively appointed pursuant to the preceding section shall be held in trust hereunder or distributed to or in trust for such appointee or appointees other than the child, his or her estate, his or her creditors and the creditors of his or her estate, with such powers and in such manner and proportions as the child may appoint by his or her will making specific reference to this power of appointment.

SECTION 5: ***Default.*** Upon the death of a child any part of his or her Child's Trust not effectively appointed shall be distributed per stirpes to his or her then living descendants, or if none, then per stirpes to my then living descendants, subject to postponement of possession as provided below, except that each portion otherwise distributable to a child of mine for whom a Child's Trust is then held under this article shall be added to that trust.

TWELFTH: **Postponement of Possession.**

Each share of the trust estate which is distributable to a beneficiary who has not reached the age of 35 years shall immediately vest in the beneficiary, but the trustee shall retain possession of the share as a separate trust, paying to or for the benefit of the beneficiary so much or all of the income and principal of the share as the trustee deems necessary or advisable from time to time for his or her health, maintenance in reasonable comfort, education (including postgraduate) and best interests, adding to principal any income not so paid (except that after the beneficiary has reached the age of 21 years, the trustee shall pay to him or her all the income from the share in convenient installments, at least quarterly), and distributing 1/2 in value of the principal of the share to the beneficiary if he or she has then reached or at such time thereafter as he or she reaches the age of 30 years and the balance to the beneficiary when he or she reaches the age of 35 years or to the estate of the beneficiary if he or she dies before receiving the share in full.

F. **Power to Divide Trusts for GST Purposes.**

SECTION 11: Generation-Skipping Tax. To enable trusts to be either completely exempt or nonexempt from generation-skipping tax, or for any other reason, the trustee may divide a trust into two or more separate trusts and may hold an addition to a trust as a separate trust. The rights of beneficiaries shall be determined as if the trusts were aggregated, but the trustee may pay principal to beneficiaries and taxing authorities disproportionately from the trusts. The trustee shall not be liable for deciding in its discretion to exercise or not exercise these powers.

Upon division or distribution of an exempt trust and a nonexempt trust held hereunder, the trustee in its discretion may allocate property from the exempt trust first to a share from which a generation-skipping transfer is more likely to occur.

If the trustee considers that any distribution from a trust hereunder other than pursuant to a power to withdraw or appoint is a taxable distribution subject to a generation-skipping tax payable by the distributee, the trustee shall augment the distribution by an amount which the trustee estimates to be sufficient to pay the tax and shall charge the same against the trust to which the tax relates.

If the trustee considers that any termination of an interest in trust property hereunder is a taxable termination subject to a generation-skipping tax, the trustee shall pay the tax from the portion of the trust property to which the tax relates, without adjustment of the relative interests of the beneficiaries.

G. <u>General Power of Appointment Marital Trust.</u>

SECTION 1: ***Income.*** Commencing with my death the trustee shall pay the income from the Marital Trust in convenient installments, at least quarterly, to my wife during her lifetime.

Principal Invasion. The trustee may also pay to my wife such sums from principal as the trustee deems necessary or advisable from time to time for her health, maintenance in reasonable comfort, and best interests, considering her income from all sources known to the trustee.

Right To Withdraw. In addition, my wife may withdraw any part or all of the principal at any time or times. The trustee shall make payment without question upon her written request. The right of withdrawal shall be a privilege which may be exercised only voluntarily and shall not include an involuntary exercise.

My wife shall have the right by written notice to require the trustee to convert unproductive property in the trust to productive property within a reasonable time.

SECTION 2: ***General Testamentary Power of Appointment.*** Upon the death of my wife the principal and any accrued and undistributed income of the Marital Trust shall be held in trust hereunder or distributed to or in trust for such appointee or appointees (including the estate of my wife), with such powers and in such manner and proportions as she may appoint by her will making specific reference to this power of appointment. I intend that the Marital Trust shall qualify for the federal estate tax marital deduction in my estate.

SECTION 3: ***Default.*** Upon the death of my wife any part of the principal and accrued and undistributed income of the Marital Trust not effectively appointed shall be added to or used to fund the Family Trust, except that, unless my wife directs otherwise by her will or revocable trust, the trustee shall first pay from the principal of the Marital Trust, directly or to the legal representative of my wife's estate as the trustee deems advisable, the amount by which the estate and inheritance taxes assessed by reason of the death of my wife shall be increased as a result of the inclusion of the Marital Trust in her estate for such tax purposes. The trustee's selection of assets to be sold to pay that amount, and the tax effects thereof, shall not be subject to question by any beneficiary.

H. Estate Marital Trust.

SECTION 1: ***Income and Principal.*** Commencing with my death the trustee may pay to my wife during her lifetime so much or all of the income and principal of the Marital Trust as the trustee deems necessary or advisable from time to time for her health, maintenance in reasonable comfort, and best interests, considering her income from all sources known to the trustee. Any income not so paid shall be added to principal.

SECTION 2: ***Distribution.*** Upon the death of my wife the trustee shall distribute the principal and any accrued and undistributed income of the Marital Trust to the estate of my wife. I intend that the Marital Trust shall qualify for the federal estate tax marital deduction in my estate.

I. **Qualified Domestic Trust.**

SECTION 4: ***Qualified Domestic Trust.*** If my wife is not a citizen of the United States at my death, the provisions of this Section 4 shall apply to the Marital Trust and to this agreement and shall prevail over any other provision in this agreement inconsistent herewith. I intend that the Marital Trust shall be a qualified domestic trust for federal estate tax purposes if so elected.

(a) At least one trustee of the Marital Trust must be an individual citizen of the United States or a domestic corporation.

(b) If the trustee pays or distributes principal of the Marital Trust and federal estate tax under section 2056A is thereby assessed, a trustee who is an individual citizen of the United States or a domestic corporation shall withhold and pay the federal estate tax from the property to be paid or distributed.

So long as my wife is a permissible beneficiary of the principal of the Family Trust and any readily marketable assets remain in that trust, the trustee shall not make discretionary payments of principal of the Marital Trust to my wife which would cause federal estate tax to be assessed under section 2056A.

(c) Upon the death of my wife the trustee shall pay from the principal of the Marital Trust its proportionate share of the federal estate tax assessed under section 2056A by reason of the death of my wife. The trustee's selection of assets to be sold to pay that amount, and the tax effects thereof, shall not be subject to question by any beneficiary.

(d) The trustee of the Marital Trust shall comply with any requirements prescribed by Treasury Regulations issued for qualified domestic trusts. The trustee may amend the terms of this agreement solely for the purpose of enabling the Marital Trust to comply with those requirements and to be a qualified domestic trust.

(e) If my wife becomes a citizen of the United States after my death and the requirements of section 2056(d) (4) or section 2056A(b) (12) have been satisfied, this Section 4 shall cease to apply to the Marital Trust and this agreement.

(f) The section references are to the Internal Revenue Code of 1986, as amended, and shall be deemed to refer to corresponding provisions of subsequent federal tax laws.

principal for S's benefit (pursuant to §[*], permitting discretionary distributions by the trustee or withdrawals by S), as coming from the elected qualified terminable interest portion. The effect is to reduce the amount of property includible under §§2044 and 2519 on termination or disposition of S's income interest.

> Example: The initial fund consisted of $1.25 million and the initial fraction was one-fifth (which produced an optimum marital deduction at the time). A distribution of assets worth $100,000 is made to S when the trust is valued at $1.3 million. The fraction immediately before the distribution, restated to reflect current values, is 260,000/1,300,000 (1/5 of $1.3 million) and, immediately after the distribution, the fraction is 160,000/1,200,000 (2/15). The amount that would be includible in S's estate if S dies when the balance of the trust is valued at $1.8 million would be $240,000 (2/15 of $1.8 million). Had the fraction not been adjusted, the inclusion amount would have been $360,000 (1/5 of $1.8 million). Thus, the effect of the rolling fraction adjustment is to take all of the distribution to S from the marital portion rather than just 20% of it.

The practical problem in the administration of a trust with a rolling fraction is that, before the fraction can be adjusted, it first must be restated to reflect current values. Thus, every asset in the fund must be revalued, which may create a difficult, time-consuming, and potentially expensive administrative chore. Consequently, most planners direct division of the original fund into two separate shares following a partial election, which accomplishes the same result as the rolling fraction, without the need to engage in the administrative chore of adjusting the fraction. Some plans also provide that any nonelected portion of a QTIP trust pours over to the nonmarital trust to make administration easier.

Start

Inter Vivos QTIPs and Joint Settlor Revocable Trusts *

Estate planning for spouses with disparate wealth often leads to the suggestion that the more wealthy spouse make a gift to the less wealthy spouse to cover the contingency of "deaths out of order." Often a planning concern in noncommunity property states, the tax-sheltering benefit of one unified credit or that spouse's GST exemption may be lost if the nonpropertied spouse dies first and no inter vivos intraspousal gifts were made. Until the advent of the inter vivos QTIP trust, the only ways to address this concern were by outright lifetime gift to the less wealthy spouse, by an inter vivos general power of appointment marital deduction trust (which gave the donee spouse unfettered power to dispose of the transferred property), or by a §2513 inter vivos split gift to a third party (which took the property out of the marital coffers entirely).

Since its enactment in 1982, §2523(f) allows the propertied spouse to create an irrevocable inter vivos QTIP trust to pay income to the donee spouse for life with the remainder passing as the donor spouse originally designated in the trust (or as the donee may appoint pursuant to a nongeneral testamentary power of appointment, if granted by the trust). See §§2523(f)(3) and 2056(b)(7)(B)(ii) (flush language). The donor spouse may make an inter vivos QTIP election under §2523(f)(4), making the initial transfer gift-tax free and, on the donee spouse's death, corpus will be includible in the donee spouse's gross estate, thus sheltering that spouse's unified credit and taking advantage of the donee spouse's GST exemption. All without giving the donee spouse more control over the trust property than the donor chooses.

If control is not a concern and if bifurcation of the wealth between the two spouses to create a chunk for each is not viable or desirable, a different but equally effective alternative may be available in the joint settlor trust approach. This plan provides very desirable marital deduction results as illustrated by Private Letter Ruling 200101021, in which spouses created a joint settlor trust, funded with tenancy by the entirety or joint tenancy property. While both spouses were alive either could revoke the trust unilaterally, in which case the property would be partitioned and delivered to them in equal shares. D was given a general testamentary power to appoint all of the trust property and, in default of exercise, the property was allocated first to a credit shelter trust and any excess to S outright.

The government's conclusions regarding the tax consequences are entirely favorable to taxpayers. When D died all the trust property was includible in D's estate, half under §2038 due to the transfer with retained power of revocation and half under §2041 due to the general testamentary power of appointment. The property deemed gifted by S to D was regarded as qualified for the gift tax marital deduction as if it was a death bed inter vivos gift just before D died. This view of S making a completed gift to D immediately before D's death is as if D and S had figured out who would die first and placed title to their joint property entirely in D's name. Because there is no gift tax on creation of the trust and no estate tax to be paid because any property includible in D's estate is matched by a §2056 marital deduction or sheltered by the unified credit, this planning is desirable because there is no need to guess which spouse will die first. Their collective property can be placed in the trust to take advantage of D's unified credit or GST exemption, effectively accomplishing what inter vivos transfers to equalize estates would do.

The most desirable aspect of this planning relates to whether S may enjoy a life estate in all of the trust property after D's death. In such a plan, the question is whether that secondary life estate in a nonmarital trust will cause §2036(a)(1) (transfer with retained enjoyment) to apply when S subsequently dies. The government's private letter ruling position is that trust property includible in D's gross estate under §2041 is regarded as if D were the transferor and any secondary life estate in S is deemed created by D, rather than having been retained by S. Under this vision, §2036(a)(1) would not apply at S's subsequent death.

According to a variety of Private Letter Rulings, inclusion in S's gross estate is avoided, like the position taken in Treas. Reg. §25.2523(f)-1(f) Example 11 regarding the effect of §2044 inclusion of an inter vivos QTIP trust in D's estate, followed by a secondary life estate in S. That treatment avoids §2036(a)(1) inclusion when S dies because estate tax inclusion in D's estate "cleanses" S's involvement with the trust, and makes this planning effective and harmless. There are a variety of refinements to this planning (often meant to minimize the control granted to D to exercise the general power of appointment) and you would not engage in this plan if D and S do not trust each other. But the overall result is very desirable in any client situation in which spouses have more than the applicable exclusion amount but not enough to split it and shelter either unified credit regardless of the order of their deaths.

Estate and Gift Tax Attributable to QTIP Trusts

Absent a contrary provision in S's will, §2207A provides that any tax attributable to inclusion of QTIP trust corpus in S's gross estate under §2044 (and any interest and penalties attributable thereto) is recoverable from the corpus of the QTIP trust. See the discussion regarding tax payment in general in Chapter 11. The amount of tax attributable to the QTIP trust, computed under §2207A(a)(1), is the difference between the amount of the actual estate tax in S's estate and the amount of estate tax that would be due if the corpus of the QTIP trust was not includible. Thus, §2207A allows a recovery of the amount by which S's estate tax is increased by inclusion of the QTIP, sometimes referred to as the "incremental" tax attributable to the QTIP. However, no recovery is granted for any amount of S's unified credit exhausted by the inclusion (because §2207A is for tax paid, not for tax payable), nor for any state estate or inheritance taxes attributable to the QTIP trust. Treas. Reg. §§20.2207A-1(a)(1) (last two sentences) and 20.2207A-1(b).

As discussed in Chapter 11 at page 18, an unexpected inequity can result under §2207A because the QTIP property is taxed at the highest estate tax rate applicable to S's estate. In addition, failure of S's estate to exercise the right to recover the tax under §2207A is a taxable gift "from the persons who would benefit from the recovery" (usually S's residuary beneficiaries) "to the persons from whom the recovery could have been obtained" (the QTIP remainder beneficiaries). Treas. Reg. §20.2207A-1(a)(2). This gift may be negated to the extent S's beneficiaries cannot compel recovery because S waived the right or, presumably, because the QTIP remainder beneficiaries are judgment proof. Treas. Reg. §20.2207A-1(a)(3). So waiver might avoid nasty gift tax problems, but it also may be inappropriate if S's estate otherwise is unable to pay its estate taxes or does not wish to alter the relative equities of these rules.

A surviving spouse who assigns all or any part of a QTIP income interest triggers a gift of the full value of the remainder interest in the QTIP trust under §2519, in addition to a §2511 gift of the value of the assigned income interest. S is liable for the gift tax on both transfers, but is entitled under §2207A to recover only the gift tax attributable to the gift of the remainder interest from "the person receiving the property," which is the trustee if the property continues to be held in trust. Treas. Reg. §25.2207A-1(e). As illustrated only obliquely by Treas. Reg. §25.2207A-1(f), the §2207A right of reimbursement for gift taxes does not extend to any tax imposed under §2511 on the gift of the income interest.

Failure of S to exercise the §2207A right of recovery on an inter vivos assignment also may result in a taxable gift, again to the persons who are benefited thereby. The gift under §2519 is the value of the corpus less the amount of any §2207A reimbursement to which S was entitled, and S makes an *added* gift of the amount of any reimbursement not collected. See Treas. Reg. §§25.2207A-1(b), 25.2519-1(c). Some drafters preclude assignment simply to avoid the potential for all these unexpected additional gifts. That can reduce flexibility for planning by S, but caution always is in order.

Annuities, Employee Benefit Payments, and Individual Retirement Accounts

An annuity generally will qualify for the marital deduction if there is no refund or survivor benefit payable (other than to S's estate) that would cause the annuity to be a nondeductible terminable interest. If the annuity is a terminable interest because there is an interest in a beneficiary other than S, automatic QTIP qualification will salvage the marital deduction if the annuity was includible in D's gross estate under §2039 and S is the sole beneficiary during S's overlife. See §2056(b)(7)(C), applicable unless D's personal representative affirmatively elects out of this automatic QTIP qualification. A corresponding automatic gift tax marital deduction is provided by §2523(f)(6) if joint annuity payments begin during a participant's life.

The regulations are silent on qualification of a joint and survivor annuity as commonly found in employee benefit plans that meet the §401(a)(11) spousal annuity rules. Treas. Reg. §20.2056(b)-7(h) Example 10 deems the annuity payable from an individual retirement account directly to S to qualify for the marital deduction under §2056(b)(7)(B)(ii), leaving as a major unresolved issue only individual retirement accounts in which a QTIP trust (rather than S directly) is the sole designated beneficiary during S's overlife but a remainder benefit is payable to a third party after S's death. Rev. Rul. 2000-2 establishes the requirements to qualify such an IRA for marital deduction QTIP election purposes.

The marital deduction qualification issue is easy if S possesses a lifetime power to accelerate payments by making a complete withdrawal from the IRA, because that power satisfies the all-income-annually requisite of either a (b)(5) or a QTIP trust and constitutes a general power of appointment for §2056(b)(5) purposes as well. Treas. Reg. §§20.2056(b)-5(f)(6); 20.2056(b)-7(d)(2). Qualification also is easy if whatever remains in the IRA passes to S's estate at death because the estate trust qualification for marital deduction treatment would apply and nondeductible terminable interest problems would not exist. So the discussion here is about IRA designations of a QTIP trust as beneficiary in which the power of complete withdrawal is not available.

For most purposes the real significance of Rev. Rul. 2000-2 therefore, and the reason for its issuance, is §2056(b)(7) QTIP qualification, which turns on the all-income-annually requirement. Like any typical QTIP trust, S was entitled to all income of the QTIP trust that was the designated beneficiary of the IRA in that Ruling. More critical then was that S was given a power by the QTIP trust to compel the QTIP trustee to withdraw from the IRA annually an amount equal to all the income earned by the IRA assets during that year and distribute that same amount to S as income beneficiary of the QTIP trust. The QTIP trustee would receive the annual minimum distribution amount from the IRA if S did not exercise that withdrawal right. If S *did* exercise the right, however, the Ruling states that the QTIP trust would receive the minimum distribution amount *or* the amount of the IRA income for the year, whichever is greater.

In that context, and put another way, the only issue is income earned in the IRA in excess of the minimum distribution amount: the minimum distribution amount will come out of the IRA in all events. A glance at the mortality tables reveals that the likelihood of the IRA having income in excess of the minimum distribution amount declines as the designated beneficiary (S in this case) ages. By way of example, if S is a 60-year-old surviving spouse, the minimum distribution amount is about 4.1% of the value of the IRA; if S is age 65 that percentage rises to 5%. Either way, many fiduciaries report that they do not earn that much income annually, meaning that the minimum distribution amount will exceed the income amount and all the issues here addressed disappear.

Assuming, however, that there is an excess income issue, the question is whether the IRA qualifies as QTIP elected marital deduction property. Rev. Rul. 2000-2 concluded that S was entitled to all income annually from the IRA as well as from the trust by virtue of S's power to compel the QTIP trustee to make withdrawals from the IRA of the excess income. The Ruling also states that both the IRA and the QTIP trust were subject to §§2519 and 2044; indeed, "[b]ecause the trust is a conduit for payments equal to income from the IRA to [S, the] executor needs to make the QTIP election . . . for both the IRA and the testamentary trust." In effect, this double election mandate makes it clear that the government views *the IRA* *itself* as qualified terminable interest property, as opposed to thinking of the IRA as just a proper asset of or payable to a QTIP trust. That is an important vision because most observers think of the IRA as merely an asset; the government instead elevates the IRA to the same status as the QTIP trust and, most importantly, requires a separate QTIP election with respect to both the trust and the IRA.

Instead of a power granted to S to demand that the QTIP trustee make withdrawals from the IRA, dicta in Rev. Rul. 2000-2 states that the same marital deduction qualification result would apply if the trust simply required the trustee to withdraw from the IRA annually an amount equal to the excess income earned by the IRA assets and distribute that amount to S.

The hard question for planners is which approach to follow, given the reality that a power in S to compel the QTIP trustee to make a withdrawal from the IRA could lapse and with that lapse may flow all sorts of issues.[63] So perhaps the better approach, all around, is to forego any perceived income tax benefits of leaving the excess income in the IRA and just ensure that the QTIP trustee is obliged to obtain from the IRA any excess income amount. Another alternative not noted by the Ruling is for the QTIP trust simply to require the trustee to distribute (or allow S to withdraw) QTIP trust corpus equal to any difference between the minimum distribution and the IRA income amount. That also will qualify under the all-income-annually requirement.

For marital deduction purposes alone, knowing that the government requires the double QTIP election (trust and IRA both) makes compliance easy and predictable. How to make qualified plan benefits satisfy the marital deduction QTIP requirements entails more difficult questions regarding how much income is earned annually by an IRA or a qualified plan held for a participant's account and payable to S. As explained in Chapter 10, the best course is simply to name S individually as beneficiary, if D is willing to give S control over the distribution amounts.

Qualified Plan Spousal Annuity Issues

Different questions surround qualified employee benefit plans, which are required by §401(a)(11) to create spousal annuities for the benefit of surviving spouses of plan participants. These annuities may be waived under §417(a) if the participant's spouse consents to a different beneficiary designation, but Congress failed to consider the tax consequences of the consent. For example, §2523(f)(6) provides that (1) any gift caused by a

63. For example, does S become a transferor to the QTIP trust, or to the IRA itself? There would be completed gift and annual exclusion issues, §2702 valuation possibilities, estate tax inclusion concerns (if the inclusion provision is §2036(a)(1), for example, instead of §2044, which could inform different estate tax right of reimbursement entitlements), and potential GST transferor issues if S is a transferor to the trust. There are a host of income tax qualification and ownership questions in addition to all those wealth transfer tax problems if lapse of S's power to compel withdrawal is regarded a contribution to the IRA itself.

participant's retirement, which locks in a spousal joint and survivor annuity, automatically qualifies for the marital deduction as QTIP property unless the participant affirmatively elects out of this treatment, and (2) §2044 will not apply to include the annuity in the nonparticipant spouse's gross estate if the nonparticipant spouse predeceases the participant. Similar automatic QTIP treatment is provided by §2056(b)(7)(C) if the participant dies and a qualified preretirement annuity locks in for the benefit of S.

Unresolved are the tax consequences (1) if the nonparticipant spouse dies before the participant retires, or (2) when the participant retires and the annuity locks in for the benefit of the participant for life. Does the nonparticipant spouse have any kind of property interest in the plan by virtue of the spousal annuity rule? Is there a wealth transfer from or to either spouse in either of these events? If so, does that transfer qualify for the gift or estate tax marital deduction? These unanswered questions may be exacerbated in community property jurisdictions because it seems even more likely that each spouse owns a portion of the participant's employee benefit.[64]

Technical Advice Memorandum 8943006 considered the estate tax consequences of a nonparticipant spouse's community property interest in a qualified employee benefit plan (S was the plan participant). A portion of the value of the plan was includible in D's gross estate under §2039 by virtue of D's community property interest in the plan and D's will gave all D's community property to D's children. Nevertheless, the government concluded that, under state law, no part of the qualified plan would pass to anyone other than S, who was the participant, a result confirmed by Boggs v. Boggs, 520 U.S. 833 (1997). Thus, D's interest in the plan was held to qualify for the estate tax marital deduction. The Technical Advice Memorandum noted that §2056(b)(7)(C) normally would qualify S's interest in the plan for the marital deduction if D had been the plan participant. Essentially this is the same treatment, granted in the reverse situation presented, as §2056(b)(7)(C) with respect to any portion of a plan that is includible in a nonparticipant's gross estate under §2033.

Although it is not yet clear whether a nonparticipant spouse in a *non*community property state *has* a property interest in such a plan that is includible under either §2033 or §2039, Technical Advice Memorandum 8943006 should clarify that any amount that *is* includible will qualify for the marital deduction. Unfortunately, however, neither §2056(b)(7)(C) (which applies only to §2039 interests includible in a participant's gross estate or to the community property interest of a nonparticipant that is includible under §2033) nor the final QTIP regulations specifically address these questions.

64. §2056(b)(7)(C) recognizes the nonparticipant spouse's interest. It provides that the nonparticipant spouse's interest in an annuity arising under state community property laws qualifies as QTIP property if it is included in the nonparticipant spouse's gross estate under §2033 and passes to the surviving participant spouse.

See Treas. Reg. §20.2056(b)-7(f). It also is unclear whether a nonparticipant spouse makes a gift to a participant spouse when the participant spouse retires and, if so, whether that gift qualifies for the gift tax marital deduction. Consistent results dictate that the answer to the second question should be yes to the full extent of any gift the nonparticipant spouse is deemed to make, but these gift tax issues also were reserved under Treas. Reg. §25.2523(f)-1(c)(4). Presumably the appropriate result is that the nonparticipant spouse in a noncommunity property jurisdiction has no property interest whatsoever for tax purposes.[65]

QTIP and Charitable Remainder Trusts

Although adopted along with §§2056(b)(7) and 2523(f) and regarded by many planners as QTIP substitutes, §§2056(b)(8) and 2523(g) are truly independent and not governed by or even surrogates for those QTIP rules. Instead, these provisions are additional distinct exceptions to the nondeductible terminable interest rule and apply if a donee or surviving spouse:

(1) is given a unitrust or annuity trust interest for life pursuant to the charitable remainder trust split interest rules of §664; and

(2) is the only beneficiary who is not a charitable beneficiary (other than the donor, if a lifetime transfer is involved).

If D creates a qualifying charitable remainder annuity trust or unitrust, S's lead interest will qualify for the marital deduction under §2056(b)(8) and the charitable remainder will qualify for the charitable deduction under §2055. Similar rules apply for inter vivos transfers. D or D's estate will incur no tax on the total value of the trust and, because no QTIP election is involved, there will be no §2044 inclusion in S's gross estate at death or §2519 exposure inter vivos. Indeed, there will be no estate tax inclusion of the trust corpus under any Code section at S's death if properly structured, and the trust property will pass unreduced by wealth transfer tax to the charitable remainder beneficiary.

Although a number of substantive differences apply, an alternative approach exists through conventional QTIP planning. As explained in the legislative history to §2056(b)(8), a charitable remainder deduction can be obtained through a normal QTIP trust:

65. Were this not true: (1) a participant's getting married and thereby creating potential rights in a new spouse could be regarded as a gift, which is silly, even if it were to qualify for the marital deduction; (2) the participant's receipt of benefits under the plan would constitute a gift by the nonparticipant to the participant that would need to go through the marital deduction qualification routine, which also would be silly; and (3) the fact that §2503(f) applies to a nonparticipant's waiver during the participant's life but not otherwise essentially would force spouses to waive spousal annuity entitlements during participants' lives, to avoid these consequences, which would be the wrong policy result. Forcing a nonparticipant spouse to waive the annuity to be better off is exactly the opposite of what Congress was attempting to accomplish by creating the §401(a)(11) entitlements.

> The general rules applicable to qualifying income interests may provide similar treatment where a decedent provides an income interest in the spouse for her [sic] life and a remainder interest to charity. If the life estate is a qualifying [§2056(b)(7)(B)(ii)] income interest, the entire property will . . . be considered as passing to the spouse. Therefore, the entire value of the property will be eligible for the marital deduction and no transfer tax will be imposed. Upon the spouse's death, the property will be included in the spouse's estate [under §2044] but, because the spouse's life estate terminates at death, any property passing outright to charity may qualify for a charitable deduction.[66]

Thus, for example, a trust might provide that "the trustee shall pay the trust income to S at least quarterly for life. On S's death the trustee shall distribute the trust principal to [qualified charitable organization]." Being a QTIP trust interest, the §2056(b)(7)(B)(v) QTIP election automatically would apply to the extent D's estate reports the value of the trust principal on Schedule M of its estate tax return, Form 706. The entire trust corpus would qualify for a marital deduction in D's estate, it would cause §2044 inclusion in S's gross estate, and it would qualify for a §2055 charitable deduction in computing S's taxable estate. By virtue of §2044(c), the remainder in a QTIP trust qualifies for a charitable deduction in S's estate because the interest is deemed to pass to the charity from S, in whose estate it is includible. Again, there would be no tax in either estate.

An advantage of the QTIP alternative over the §2056(b)(8) qualified charitable remainder trust approach is that it is not necessary to draft within the complicated confines of the §664 charitable remainder trust rules, and corpus distributions may be made to S from the QTIP trust. Alternatively, the §2056(b)(8) split interest trust approach provides a number of advantages over the QTIP alternative.

For example, if created inter vivos, the §2523(g) inter vivos version of the §2056(b)(8) trust generates a §170 income tax deduction for D that the QTIP alternative would not generate. In addition, the tax character of the trust precludes ordinary income, capital gains, and income in respect of the decedent from being subject to income tax to the extent not carried out to S as beneficiary of the annual payment. Nor must the trust distribute all its income annually to S or worry about satisfying the qualified income interest rules.[67] Indeed, under the authority of §664(f), the trust may be drafted to distribute to the qualified charitable remainder beneficiary prior to S's death, either because S's interest is limited to a term of years or because it is made terminable on a contingency (such as remarriage).[68]

66. H.R. Rep. No. 201, 97th Cong., 1st Sess. 162 n.4 (1981).

67. Because §2056(b)(8) provides that the nondeductible terminable interest rule of §2056(b)(1) does not apply at all, this trust is not an exception to that rule and need not meet the income payment requirements common to §§2056(b)(5) and 2056(b)(7) trusts.

68. Although §664(f)(2) precludes the contingent acceleration of the charitable remainder