MARITAL DEDUCTION PROVISIONS IN WILLS AND TRUSTS
(LAW, PLANNING & DRAFTING)

Richard M. Baskett, J.D., C.P.A.
BASKETT LAW OFFICES
Lambros Center
1001 South Higgins Avenue
Missoula, Montana 59801
Phone (406) 549-1110

TABLE OF CONTENTS

---

[1] First, These Few Words

For simplicity of discussion, this outline has been prepared referring to the decedent's will as the testamentary instrument. The principles apply to trusts as well.

Although the topic of this outline is the marital deduction, planning for the marital deduction is inextricably intertwined with planning for effective use of the credit shelter. That has been "assumed into" this outline, with little explicit discussion of credit shelter planning.

Citations in this outline are to the Internal Revenue Code of 1986, unless otherwise noted (e.g., a citation to §2056 is to §2056 of the Internal Revenue Code of 1986). Citations that begin with "Reg." are to Treasury regulations promulgated under the Internal Revenue Code of 1986. Citations to the "M.C.A." are to the Montana Code Annotated.

Finally, this outline is attempts to cover in brief form a complicated subject. For more detailed information, a bibliography is provided at the end of this outline.

[2] History of the Marital Deduction

2.01 1916

(a) The estate tax was instituted in 1916, three years after the income tax.

(b) No provision was made for a marital deduction. As a result, residents of community property states enjoyed an advantage over residents of common law states: their marital estates were split in half which usually results in the lowest overall tax burden.

2.02 1942

(a) Congress was sensitive to the advantage enjoyed by residents of community property states .... so it took the advantage away.

(b) The 1942 amendments required all community property to be included in the decedent's estate, except to the extent it could be shown the property was attributable to the services or property of surviving spouse.

2.03 1948

(a) In 1948, the marital deduction made its appearance for the first time in the estate tax code.

(b) The deduction was limited to 50% of the adjusted gross estate exclusive of community property.

2.04 1976

(a) A minimum marital deduction was introduced in 1976.

(b) The 50% deduction still applied to estates in excess of $250,000, but beginning in 1976 there was a 100% deduction for the first $250,000 of property passing to the surviving spouse.

2.05 1981

(a) The unlimited marital deduction arrived in 1981; there is no longer any limit on the amount of property that can qualify for the marital deduction.

(b) The unlimited marital deduction, together with the increases in the unified credit authorized in 1981, fundamentally changed standard estate planning. There is no longer any need to incur estate tax on the estate of the first spouse to die.

(c) A transitional rule applies to pre-1982 formula bequests.

(1) The unlimited marital deduction, in general, does not apply to property passing under an instrument executed prior to 9/13/81 which provides that the surviving spouse is to receive the maximum amount of property qualifying for the marital deduction. Pre-1982 law applies to such formula bequests.

(2) The unlimited marital deduction *does* apply to pre-9/13/81 instruments if (1) the formula is amended after 9/12/81 to refer to the unlimited marital deduction, or (2) the state enacts a statute that construes such a formula as referring to the unlimited marital deduction allowed by federal law.

2.06 A Caution

(a) Although the last significant statutory change to the marital deduction was 16 years ago, many clients have wills older than that.

(b) Any client who is a candidate for credit shelter planning and the marital deduction and who has a will pre-dating 1981 should be counseled of the changes.

[3] Requirements for the Estate Tax Marital Deduction [§2056]

3.01 Amount of the Estate Tax Marital Deduction

(a) The value of the taxable estate is determined by deducting the value of any interest in property which passes to the surviving spouse. [§2056(a)]

(1) There is no limit on the amount of the marital deduction that may be allowed, as long as the requirements of §2056 are met.

(2) For tax planning purposes, however, it is not always advisable to take the maximum allowable marital deduction.

(b) The deduction applies to any interest in property which passes "or has passed" from the deceased spouse to the surviving spouse.

(c) The marital deduction is only for the net value of interests in property passing to the surviving spouse.

(1) Consequently, any estate or inheritance taxes will reduce the marital deduction to the extent they affect the net value of the interests passing to the surviving spouse, [§2056(b)(4)(A)]; and

(2) Encumbrances against the property will reduce the amount of the marital deduction to the extent they affect the net value of the interests passing to the surviving spouse. [§2056(b)(4)(B)]

(i) If the Personal Representative is required, either by the decedent's will or under local law, to discharge, out of other assets of the decedent's estate, a mortgage or other encumbrance on property passing from the decedent to the surviving spouse, or is required to reimburse the surviving spouse for the amount of the mortgage or other encumbrance, the payment or reimbursement constitutes an additional interest passing to the surviving spouse. [Reg. § 20.2056(b)-4(b)]

(ii) If estate or inheritance taxes or administration expenses are allocable to the marital property, the marital deduction will be reduced accordingly. Consequently, the will should include a provision that clearly specifies the marital amount is not to be subject to any death taxes or administration expenses.

3.02 Conditions to Obtain the Estate Tax Marital Deduction

(a) **Property Included in Estate:** The interest in property passing to the surviving spouse must be included in determining the value of the decedent's gross estate. [§2056(a)]

(b) **Passing Requirement:** The interest must pass *from* the deceased spouse *to* the surviving spouse. [§2056(a)] See 3.03.

(c) **Surviving Spouse:** The property must pass to the decedent's "spouse."

(1) Status as a "spouse" is determined under state law. [Rev. Rul. 67-442, 1967-2 C.B. 65].

(i) A legal separation will not affect marital status; only divorce or annulment will terminate the status as a spouse. [Rev. Rul. 57-368, 1957-2 C.B. 896; 72-2-812(a) M.C.A.]

(ii) But even an invalid divorce or annulment decree will terminate one's status as a spouse in Montana, as long as it was obtained or consented to by the surviving "spouse." [72-2-812(2) M.C.A.]

(2) The spouse must "survive."

(i) In Montana, an individual who fails to survive the decedent by 120 hours is considered to have predeceased the decedent. Survivorship for the required period must be established by clear and convincing evidence. [72-2-114 M.C.A.]

(ii) The regulations, however, will respect a presumption that the spouse survived, whether supplied by local law or by the governing instrument. [Reg. § 20.2056(c)(2)(e)]

(iii) If it is important to make use of the marital deduction, the will should contain a provision providing which spouse will be deemed to have died first.

(A) The spouse who is more wealthy should be presumed to have died first. That spouse's will should contain a provision something similar to the effect of this: "If my spouse and I die under circumstances where it is not readily apparent which of us died first, my spouse shall be presumed to have survived me."

(B) The other spouse's will need not contain any provision regarding survivorship, since state law could be relied upon, but it could add certainty to have a provision something to the effect of this: "If any person and I die under circumstances where it is not readily apparent which of us died first, that person shall be presumed to have predeceased me." If there is a testamentary trust, a more broadly-worded provision might be used, such as "If it is not readily apparent whether a person who would be entitled to receive property under any provision of this Will failed to survive the event which would so entitle that person, that person shall be presumed to have failed to survive such event."

(3) The surviving spouse must be a U.S. citizen, unless a QDOT is used.

(d) **No Double Deduction.** The interest must be not be deductible either under §2053 (i.e., for funeral expenses, administration expenses, claims against the estate, and indebtedness in respect of property included in the value of the gross estate) or §2054 (i.e., for losses during administration). Such an interest is deductible under those code sections, not under §2056.

(e) **Not a Nondeductible Terminable Interest.** In general, if the interest is "terminable," a deduction will not be allowed. A "qualified" terminable interest *is* deductible though, and so are certain other forms of terminable interests. *See* 3.04.

3.03 Passing Requirement

(a) **§2056(c):** The Code [§2056(c)] specifies seven means by which an interest in property will be treated as passing from the deceased spouse to the surviving spouse:

(1) by Will (i.e., bequest or bequest);

(2) by intestacy;

(3) by dower or curtesy interest (or statutory interest in lieu thereof) of such person as surviving spouse of the decedent;

(4) by transfer to the spouse by the decedent at any time;

(5) by survivorship (i.e., the property interest was, at the time of the decedent's death, held by the spouse and the decedent (or by them and any other person) in joint ownership with right of survivorship);

(6) by power of appointment (i.e., the decedent had a power, either alone or in conjunction with any person, to appoint such interest and if he appoints or has appointed such interest to the surviving spouse, or if the surviving spouse takes such interest in default on the release or non-exercise of such power; or

(7) by insurance contract (i.e., the property interest consists of proceeds of insurance on the life of the decedent receivable by the surviving spouse).

(b) **Ascertainable.** If at the time of the decedent's death it is not possible to ascertain the particular person or persons to whom an interest in property may pass from the decedent, such interest shall be considered as passing from the decedent to a person other than the surviving spouse. [§2056(c)].

(1) Exception #1: This rule does not apply to a life estate with power of appointment in the surviving spouse.

(2) Exception #2: This rule does not apply to life insurance or annuity payments with power of appointment in the surviving spouse.

3.04 Terminable Interests

(a) §2056(b) provides that no marital deduction is allowed with respect to certain property interests, referred to generally as "terminable interests," passing from a deceased spouse to the surviving spouse. [Reg. §20.2056(b)-1(b)].

(b) A "terminable interest" in property is an interest which will terminate or fail on the lapse of time or on the occurrence or the failure to occur of some contingency.

(1) Life estates, terms for years, annuities, patents, and copyrights are therefore terminable interests. [Reg. §20.2056(b)-1(b)].

(2) However, a bond, note, or similar contractual obligation, the discharge of which would not have the effect of an annuity or a term for years, is not a terminable interest. [Reg. §20.2056(b)-1(b)].

(c) Nondeductible Terminable Interests.

(1) A terminable interest is nondeductible if –

(i) Another interest in the same property passed from the decedent to some other person for less than an adequate and full consideration in money or money's worth, and

(ii) By reason of its passing, the other person or his heirs or assigns may possess or enjoy any part of the property after the termination or failure of the spouse's interest.

(2) Even though a property interest which constitutes a terminable interest is not nondeductible by reason of these rules, such an interest is nondeductible if–

(i) The decedent has directed his executor or a trustee to acquire such an interest for the decedent's surviving spouse, or

(ii) Such an interest passing to the decedent's surviving spouse may be satisfied out of a group of assets which includes a nondeductible interest. In this case, however, full non-deductibility may not result.

(d) Deductible Terminable Interests. A property interest passing to a decedent's surviving spouse is deductible [Reg. §20.2056(b)(-1(d)] even though it is a terminable interest, and even though an interest therein passed from the decedent to another person, if it is a terminable interest only because–

(1) It is conditioned on the spouse's surviving for a limited period, in the manner described in Reg. §20.2056(b)-3 (i.e., the spouse is required to survive for no more than 6 months and does in fact survive the required period);

(2) It is a right to income for life with a general power of appointment, meeting the requirements set forth in Reg. §20.2056(b)-5 (*See* 4.03);

(3) It consists of life insurance or annuity payments held by the insurer with a general power of appointment in the spouse, meeting the requirements set forth in Reg. §20.2056(b)-6 (*See* 4.04);

(4) It is qualified terminable interest property, meeting the requirements set forth in Reg. §20.2056(b)-7 (*See* 4.05); or

(5) It is an interest in a qualified charitable remainder trust in which the spouse is the only non-charitable beneficiary, meeting the requirements set forth in Reg. §20.2056(b)-8 (*See* 4.06).

[4] Types of Marital Bequests

4.01 Outright Bequest

(a) An outright bequest to the surviving spouse will qualify for the marital deduction–as long as it is not subject to a nondeductible form of terminable interest–but places the property outside the control of the decedent. The surviving spouse is not obligated to dispose of the property in any particular fashion.

(b) An outright bequest to the surviving spouse is simple, but may also have disadvantages. Consider these examples:

(1) **Surviving Spouse lacks financial acumen.** If the surviving spouse has never handled money, a bequest in trust may be preferable.

(2) **Second Marriage.** If the decedent spouse has children by a prior marriage, there may be concern that the surviving spouse might not leave the property to the children.

(3) **Third Spouse.** The surviving spouse may remarry. Even if the surviving spouse has a will leaving everything to the children of the decedent, the newly-acquired spouse will have a right to elect against the will. Property held in trust for the surviving spouse would not be subject to election.

4.02 Estate Trust

(a) With this form of trust, income is payable to the surviving spouse for a term of years, or for life, or is to be accumulated, with all of the undistributed trust property passing to the surviving spouse's executor or administrator at her death. [Rev. Rul. 68-554, 1968-2 C.B. 412] This is the only form of trust qualifying for the estate tax marital deduction that does not require annual payment of all trust income to the surviving spouse for life.

(b) The basic terminable interest rule denies a deduction for an interest passing to a surviving spouse only if an interest in the same property also passed "from the decedent to any person other than such surviving spouse (or the estate of such spouse)." §2056(b)(1). Estate trusts are allowed because of the parenthetical language.

(c) This form of trust allows the Trustee to be given discretionary power to accumulate the income of the trust and to retain unproductive assets.

(1) The Trustee may retain stock in a closely held corporation, without jeopardizing the allowance of the marital deduction. Another way around this problem, however, is to provide that the trustee is directed to retain unproductive property, unless the surviving spouse compels the trustee to make the property productive or to convert it to productive property within a reasonable time. Reg. §20.2056(b)-5(f)(4) and (5).

(2) The Trustee is permitted to accumulate income, which may be useful if the surviving spouse does not need all the income from the trust. But with compressed income tax brackets for trust, this is not the advantage it once was.

(3) <u>Disadvantages</u>: The property will be subject to

(i) claims of creditors against the estate of the surviving spouse;

(ii) claims of a subsequent spouse to an elective share;

(iii) family awards; and

(iv) increased costs of estate settlement.

4.03 Life Interest-General Power of Appointment Trust (§2056(b)(5))

(a) A general power of appointment trust qualifies for the marital deduction.

(b) 5 requirements under Reg. §20.2056(b)-5(a):

(1) The surviving spouse is entitled for life to <u>all of the income</u> from the entire interest, or a specific portion of the entire interest, or to a specific portion of all the income from the entire interest;

(2) The income is payable to the surviving spouse <u>annually</u> or at more frequent intervals;

(3) The surviving spouse is given the <u>power to appoint</u> the entire interest or the specific portion to himself or herself or to his or her estate;

(4) The power is <u>exercisable by the surviving spouse alone</u> and (whether exercisable by will or during life) must be exercisable in all events; and

(5) The entire interest or the specific portion is <u>not subject to a power in any other person to appoint</u> any part to any person other than the surviving spouse.

(c) Income Payments [Reg. §20.2056(b)-5(f)(8)]

(1) Income need not be paid annually if the surviving spouse has the right, exercisable not less frequently than annually, to require distribution of the trust income to himself or herself, with the trust income otherwise to be accumulated and added to corpus.

(2) Similarly, as respects the income for the period between the last distribution date and the date of the spouse's death, it is sufficient if that income is subject to the spouse's power to appoint. Thus, if the trust instrument provides that income accrued or undistributed on the date of the spouse's death is to be disposed of as if it had been received after her death, and if the spouse has a power of appointment over the trust corpus, the power necessarily extends to the undistributed income.

(d) <u>Legal Life Estate with General Power of Appointment</u>

(1) There is no requirement that the interest be in trust, but as a practical matter, it will be.

(2) To obtain the marital deduction would require appending a general power of appointment to a legal life estate ... an uncommon practice.

(e) <u>Example</u>: A clause establishing a marital deduction power of appointment trust might read as follows:

I give to my Trustee, IN TRUST, [language setting forth the bequest]. My Trustee shall pay the net income from the trust to my spouse in convenient installments, but no less frequently than annually, for life. Upon the death of my spouse, the Trustee shall distribute the trust estate, including any accrued but undistributed income, to such persons, including the estate of my spouse, as my spouse may appoint by will, making specific reference to this power of appointment. If and to the extent this power of appointment is not effectively exercised, on the death of my spouse, the Trustee shall distribute the balance of the trust estate per stirpes to my then-living descendants.

(1) The trustee could also be given discretion to invade principal for the benefit of the surviving spouse.

(2) But if distributions could be made to anyone other than the surviving spouse, the marital deduction would not be allowable.

(f) Note that with this form of trust, no election is required in order to obtain the marital deduction.

(1) A QTIP trust requires an election, and so is distinct from a general power of appointment trust in this regard. [§2056(b)(7)]

(2) Partial elections are not available. Consequently, there is a loss of flexibility, since the entire amount of the trust will be deductible from the deceased spouse's estate and includible in the surviving spouse's estate. This may be significant in the case where the surviving spouse dies before the estate tax return for the deceased spouse is filed. In that situation, with a general power of appointment trust, there is no opportunity to equalize the two estates (which equalization generally results in the lowest overall tax burden).

(g) General Power of Appointment

(1) Distinguish this general power of appointment from other forms.

(i) §2041 requires to be included in a decedent's estate any property with respect to which the decedent had a general power of appointment.[1] For that purpose, a general power of appointment is defined as one "exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate."

(ii) For purposes of §2056(b)(5), a general power of appointment is one "exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either."

(2) The power of the surviving spouse must be a power to appoint the entire interest or a specific portion of it as unqualified owner or as part of her estate. [Reg. §20.2056(b)-5(g)(2)]

(i) Note, this can be limited to a specific portion of the interest.

(ii) An unlimited power to invade will qualify. [Reg. §20.2056(b)-5(g)(1)(i)]

(iii) A combination of powers will qualify. For example, the surviving spouse could have the power to appoint to herself until she attains age 50, and thereafter have a power to appoint to her estate, but in all events the property interest or a specific portion of it must at the time of the surviving spouse's death be subject to one power or the other. [Reg. §20.2056(b)-5(g)(1)(iii)]

(h) Income: The surviving spouse must be entitled to all trust income annually if the trust is to qualify for the marital deduction under §2056(b)(5). Any qualification on this requirement would forfeit the marital deduction.

(1) Example: If the income interest terminates on remarriage, the trust will not be deductible. [Brown v. U.S., 72-2 U.S.T.C. ¶12,887 (N.D. Ala. 1972)]

(2) Example: If the income interest is for a term of years, the trust will not be deductible, even if the surviving spouse's life expectancy is shorter than the term of years. [Reg. §20.2056(b)-7(d)(3)]

(i) Productive Assets: The regulations require that the trust may not invest in unproductive assets unless the surviving spouse can require the trustee to invest in productive assets. [Reg. §20.2056(b)-5(f)(5)]

4.04 Life Insurance or Annuity Payments with Power of Appointment in Surviving

---

[1]The statute differs in its treatment of powers created on or before October 21, 1942 and powers created after that date.

Spouse [§2056(b)(6)]

(1) Life insurance proceeds or the proceeds of an endowment or annuity contract will qualify for the marital deduction if similar requirements as under §2056(b)(5) are met that —

(i) the surviving spouse will have the exclusive lifetime benefit of the interest in the property; and

(ii) the surviving spouse will have a general power of appointment over the property interest.

(2) The lifetime payment requirements do differ from §2056(b)(5). The insurance company might pay the surviving spouse a lump sum, but otherwise three options are available:

(i) Interest. The proceeds may be left with the insurance company, which is obligated to pay a guaranteed rate of interest to the surviving spouse.

(ii) Amortized Installments. The insurance company is obligated to pay regular installments of principal and interest according to a predetermined schedule until principal is paid off.

(iii) Annuity. The insurance company is obligated to pay a life income for the surviving spouse with or without refund, or it may provide a joint and survivor annuity.

(3) Any periodic payments must commence not later than 13 months after the decedent's death. [Reg. §20.2056(b)-6(a)(2)]

4.05 Qualified Terminable Interest Property (QTIP) [§2056(b)(7)]

(a) Since its introduction in 1981, the Qualified Terminable Interest Property (QTIP) trust has been a popular form of marital trust.

(b) With a QTIP trust, the surviving spouse is entitled to income for life–as with the general power of appointment trust–except the spouse need not be given any control over the ultimate disposition of the property. The decedent spouse controls ultimate disposition of the property.

(c) Another important feature of the QTIP trust is that it is elective. The Personal representative can claim this election with respect to part or all of the property.

(d) QTIP property is included in spouse's taxable estate to the extent an election was made to deduct it from the deceased spouse's estate.

(e) Some power to invade principal may be given to the surviving spouse.

(1) 5+5 power ok

(2) Ascertainable standard ok

(3) But unlimited power of withdrawal or other general power of appointment would include all trust property in spouse's taxable estate under §2041. Takes away PR's flexibility in making election for less than all of the property.

(f) Requirements: §2056(b)(7) imposes four basic requirements:

(1) the property must "pass" from the deceased spouse to the surviving spouse;

(2) the surviving spouse must have a qualifying income interest for life;

(3) no other beneficiary may have any rights in the trust during the lifetime of the surviving spouse; and

(4) an irrevocable QTIP election must be made.

(g) Qualifying Income Interest

(1) The surviving spouse must be entitled for life to all of the income from the entire interest, or a specific portion of the entire interest. [Reg. §20.2056(b)-7(d)(2)]

(i) The principles of Reg. §20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

(ii) As a result, income need not be paid annually if the surviving spouse has the right, exercisable not less frequently than annually, to require distribution of the trust income to himself or herself, with the trust income otherwise to be accumulated and added to corpus. *See* [4]4.03(c).

(2) The trustee may be given a power to distribute principal to or for the benefit of the surviving spouse without causing the income interest in the trust to fail to qualify for deduction. [Reg. §20.2056(b)-7(d)(6)]

(3) Though very similar to the income requirements under a general power of appointment trust, the requirements for a QTIP trust differ in one important respect. For a general power of appointment trust, the surviving spouse must be given a general power of appointment over "stub" income, that is, income earned but not distributed prior to the death of the surviving spouse. For a QTIP trust, the regulations provide that stub income need not be subject to a general power of appointment nor must it be paid to the estate of the surviving spouse at death. [Reg. §20.2056(b)-7(d)(4)]

(4) The stub income would still be includible in the estate of the surviving spouse under §2044.

(h) Election

(1) The statute requires that an election be made on the estate tax return in order to qualify for the marital deduction. Once made, the election is irrevocable. [§2056(b)(7)(B)(v)]

(2) The QTIP election is deemed to be made unless the donor or the Personal Representative elects out.

(3) If a Personal Representative has been appointed, he is responsible for the election, even as to non-probate property. If no Personal Representative has been appointed, the person in possession of the property is responsible for the election. For example, in the absence of an appointed Personal Representative, the trustee of an inter vivos trust that is included in the gross estate of the decedent can make the election. [Reg. §20.2056(b)-7(b)(3)]

(4) The election is made on the estate tax return, which is defined to mean the last estate tax return filed by the Personal Representative on or before the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the Personal Representative after the due date. [Reg. §20.2056(b)-7(b)(4)]

(5) The Personal Representative can make a protective election to treat property as QTIP. [Reg. §20.2056(b)-7(c)(1)]

(i) This protective election is available only if at the time the estate tax return is filed, the Personal Representative must reasonably believe that there is a bona fide issue that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive.

(ii) The protective election must identify either the specific asset, group of assets, or trust to which the protective election applies and the specific basis for the protective election.

(6) Drafting Considerations

(i) Some drafters prefer to place a specific requirement in the will that the Personal Representative shall elect QTIP treatment for the marital trust. This presumably has the advantage of making the Personal Representative aware that an election is required.

(ii) Other drafters prefer either to omit any direction to the Personal Representative or to include only precatory language, the purpose being to maintain maximum flexibility as to whether and to what extent to elect QTIP treatment.

(i) Legal Life Estates

(1) There is no requirement that the disposition be in trust in order to qualify for the QTIP marital deduction.

(2) As a practical matter, however, legal life estates with QTIP-qualifying provisions must be rarely used — at least this author is not aware of any such dispositions.

4.06 Current Interest in Charitable Remainder Trust [§2056(b)(8)]

(a) If the surviving spouse of the decedent is the only noncharitable beneficiary of a qualified charitable remainder trust, any interest in such trust which passes or has passed from the decedent to such surviving spouse will not be non-deductible terminable interest.

(b) The term "qualified charitable remainder trust" means a charitable remainder annuity trust or charitable remainder unitrust described in §664.

4.07 Qualified Domestic Trust (QDOT) [§§2056(d), 2056A]

(a) No deduction is allowed for any property interest passing to a spouse who is not a U.S. citizen. Congress wants to assure that the property is eventually subject to estate tax.

(b) There are two exceptions to this rule:

(1) The deduction is allowable if the surviving spouse becomes a U.S. citizen before the day on which the decedent's estate tax return is due and the surviving spouse was a U.S. resident at all

times between the date of the deceased spouse's death and the date the surviving spouse becomes a citizen. [§2056(d)(4)]

(2) The deduction is allowable for property transferred to a Qualified Domestic Trust (QDOT) if an election is made on the decedent's federal estate tax return. [§§2056(d)(2)(A), 2056A]

(c) A QDOT is a trust that requires that–

(1) At least one trustee must be an individual citizen of the United States or a domestic corporation; and

(2) No distribution (other than a distribution of income) may be made from the trust unless a trustee who is an individual citizen of the United States or a domestic corporation has the right to withhold from such distribution the tax imposed by this section on such distribution. [§2056A(a)]

(d) Any distribution before the date of the death of the surviving spouse from a qualified domestic trust and the value of the property remaining in a qualified domestic trust on the date of the death of the surviving spouse is subject to estate tax. [§2056A(b)] In general, the tax is at the marginal rate applicable to the estate of the deceased spouse. [§2056A(b)(2)]

[5] Amount of the Marital Bequest

5.01 General Concepts

(a) In general, the marital bequest should be no larger than is necessary to eliminate estate tax on the estate of the deceased spouse.

(b) In some situations, it may be advisable to incur some estate tax on the first death so that the estates of both spouses are equalized.

(1) An equalization clause might be desirable for purposes of obtaining the lowest overall estate tax. *See* 5.04.

(2) If generation skipping transfers are contemplated, and the couple wishes to make maximum use of their $1,000,000 GST exemptions, estate tax would be due on the first death, unless a reverse QTIP trust were employed.

(c) A formula is often used to compute the amount of the marital bequest, but a formula is not always necessary.

(1) If the size of the combined estate is less than the unified credit equivalent, and is anticipated to remain below that amount, there are no tax savings and consequently no need for use of a formula clause.

(2) The use of a formula clause is not necessary if the client chooses to rely on a disclaimer by the surviving spouse. *See* 5.02.

(3) The use of a formula clause is not necessary if the deceased spouse's estate passes entirely, or

almost entirely, to a QTIP trust, for which the Personal Representative may elect to exclude the credit shelter amount — but this depends on a Personal Representative who knows about the election and how much to allocate.

5.02 Disclaimer

(a) The decedent might leave the residuary estate outright to the surviving spouse, subject to disclaimer by the surviving spouse.

(1) The will need not mention the right of disclaimer; that exists by operation of law.

(2) It is prudent, however, to provide an alternate disposition of property that is disclaimed. In fact, the will may be drafted specifically contemplating that the surviving spouse *will* disclaim part or all of the bequest.

(i) A disclaimer may be of the entire property interest, or a specific portion thereof.

(ii) The surviving spouse enjoys a status not available to others: the surviving spouse may disclaim property which will then devolve in such a manner that the surviving spouse will still receive a benefit from the property. For example, it is permissible for the surviving spouse to disclaim a portion of the deceased spouse's estate, even though the deceased spouse's will provides that such disclaimed property will then be distributed to the credit shelter trust, of which the surviving spouse is a beneficiary. If any person other than a surviving spouse made such a disclaimer, it would not be recognized as a qualified disclaimer for federal estate tax purposes, and the distribution would be taxed as if no disclaimer had been filed.

(b) Disclaimers can be used to carefully craft the amount that ought to go into a credit shelter trust, but their use depends on a certain degree of sophistication.

(1) <u>Time Limits</u>: In general, a disclaimer is effective only if it is executed and filed with the court and delivered to the Personal Representative within 9 months of the decedent's death. [72-2-811(2) M.C.A.]

(2) <u>Control</u>: A disclaimer is effective only if the surviving spouse has not exercised control or dominion over the disclaimed property. [§2518]

(3) <u>Amount</u>: If more than the credit shelter equivalent is disclaimed, there will be immediate estate tax.

(4) <u>Incapacitated Spouse</u>: If the surviving spouse dies before a disclaimer can be executed, or if the surviving spouse is mentally incompetent at the death of the deceased spouse, the opportunity to use the disclaimer may be lost. Under Montana law [72-2-814, M.C.A.], a Personal Representative would be allowed to disclaim on behalf of the surviving spouse (whom we are assuming is now deceased), but depending on how the disclaimer would affect the beneficiaries of the surviving spouse's estate, the Personal Representative may not wish to exercise the disclaimer, and if the clients no longer live in Montana at the time of the deceased spouse's death, the Personal Representative of the surviving spouse may not have this power.

5.03 Formula clauses

(a) Formula clauses are used to specify how much of the decedent's estate will pass to the surviving spouse in a manner qualifying for the marital deduction. In general, the formula will specify either an optimum marital deduction or an equalization formula.

(1) An optimum marital deduction formula provides just enough of a marital deduction to eliminate estate taxes on the death of the first spouse. Any estate tax is deferred until the death of the surviving spouse.

(2) An equalization formula may trigger estate taxes in the first estate, but reduce to total tax burden on a married couple's two estates.

(b) The marital bequest may be made out of the residuary or as a pecuniary bequest. The formula will take one of three forms:

(1) Credit shelter pecuniary with a marital residuary. *See* 5.06.

(2) Marital pecuniary with a credit shelter residuary. *See* 5.07.

(3) Fractional share of the residuary divided into marital and credit shelter shares. *See* 5.08.

5.04 Equalization Clauses

(1) Because of the graduation in the estate tax brackets from 37% for estates in excess of $600,000 to 55% for estates in excess of $3,000,000, there is an overall tax savings from shifting assets from the estate taxed at a higher rate to the estate taxed at the lower rate.

(2) An equalization clause might be incorporated into the will so that the estate of the surviving spouse is not taxed at a higher rate than the estate of the deceased spouse. This is accomplished by making a non-marital bequest from the deceased spouse that is approximately equal to the expected size of the estate of the surviving spouse.

(3) Of course, if there is a significant difference in the age or health of the spouses, so that one would be expected to die much sooner than the other, the time value of money should be factored into the decision.

(4) The IRS attacked equalization clauses as terminable interests, but has now acquiesced. [Rev. Rul. 82-23, 1982-1 C.B. 139]

(5) The following equalization clause was upheld in Estate of Charles W. Smith, 66 T.C. 415, *nonacq.*, 1978-1 C.B. 3, *withdrawn and acq. substituted*, 1982-2 C.B. 1, *aff'd*, 565 F.2d 455 (1977):

> *(a) There shall first be allocated to the Residual Portion any asset or the proceeds of any asset (or interest therein) with respect to which the marital deduction would not be allowed if allocated to the Marital Portion.*
>
> *(b) There shall then be allocated to the Marital Portion that percentage interest in the balance of the assets constituting the trust estate which shall when taken together with all other interests and property that qualify for the marital deduction and that pass or shall have passed to Settlor's said wife under other provisions of this trust or otherwise, obtain for Settlor's estate a marital deduction which would result in the lowest Federal estate taxes in Settlor's estate and Settlor's wife's estate, on the assumption Settlor's wife died after him, but on the date of his death and that her estate were valued as of the date on*

(and in the manner in) which Settlor's estate is valued for Federal estate tax purposes; Settlor's purpose is to equalize, insofar as possible, his estate and her estate for Federal estate tax purposes, based upon said assumptions.

5.05 Funding Pecuniary Bequests

(a) Factors to Consider

(1) Gain is recognized on the transfer of appreciated property in satisfaction of a pecuniary bequest. Gain is not recognized upon the satisfaction of the residuary bequest, regardless of change in value of the assets used to fund the residuary bequest. In order to minimize the amount of gain on funding, the pecuniary bequest, if used, should be to the portion anticipated to be smaller, whether marital or nonmarital.

(2) What remains of the marital bequest will be included in the estate of the surviving spouse, as long as it qualified for the marital deduction at the death of the deceased spouse. Consequently, where both a marital trust and a credit shelter trust are used, prudent tax planning often suggests shifting as much appreciation as possible to the credit shelter trust and away from the marital trust. In order to minimize the size of the surviving spouse's estate, the Personal Representative will want to fund the marital with assets least likely to appreciate–but the IRS has restricted the Personal Representative's freedom to pick and choose assets that carry out this purpose. *See* [5]5.05(b).

(b) Restrictions on Funding a Pecuniary Bequest: Rev. Proc. 64-19

(1) Rev. Proc. 64-19, 1964-1 C.B. 682, addresses the amount of the marital deduction allowed for a pecuniary bequest in a will or for a transfer in trust of a pecuniary amount where the governing instrument not only provides that the executor or trustee may, or is required to, select assets in kind to satisfy the bequest or transfer, but also provides that any assets distributed in kind shall be valued at their values as finally determined for Federal estate tax purposes.

(2) The IRS concluded in Rev. Proc. 64-19 that a marital deduction would be allowed, but only on the conditions that (1) the fiduciary must distribute assets having an aggregate fair market value at the date of distribution amounting to no less than the amount of the pecuniary bequest or transfer, as finally determined for Federal estate tax purposes, or (2) the fiduciary must distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property available for distribution in satisfaction of such pecuniary bequest or transfer.

(3) By its terms, Rev. Proc. 64-19 does not apply to specified other dispositions, namely:

(i) In a bequest or transfer in trust of a fractional share of the estate, under which each beneficiary shares proportionately in the appreciation or depreciation in the value of assets to the date, or dates, of distribution.

(ii) In a bequest or transfer in trust of specific assets.

(iii) In a pecuniary bequest or transfer in trust, whether in a stated amount or an amount computed by the use of a formula, if:

(A) The fiduciary must satisfy the pecuniary bequest or transfer in trust solely in cash, or

(B) The fiduciary has no discretion in the selection of the assets to be distributed in kind, or

(C) Assets selected by the fiduciary to be distributed in kind in satisfaction of the bequest or transfer in trust are required to be valued at their respective values on the date, or dates, of their distribution. This would be a "true worth" distribution. *See* [5]5.05(d).

(4) A pecuniary formula may be used for either a marital or non-marital bequest.

(i) Rev. Rul. 90-3, 1990-1 C.B. 176 permits a marital deduction based upon estate tax values where a pecuniary non-residuary bequest was satisfied according to date of death values.

(ii) Prior to Rev. Rul. 90-3, there was some uncertainty whether the IRS would allow a marital deduction when the non-marital bequest was a pecuniary amount that could be funded according to date of distribution values. Because the pecuniary non-marital amount was fixed, the amount actually distributed for the marital bequest would rise or fall depending on appreciation or depreciation of assets subsequent to the death of the deceased spouse.

(5) Based on Rev. Proc. 64-19, as further explained in Rev. Ru. 90-3, there are at least three means of funding a pecuniary bequest, if discretion is to be given to the Personal Representative as to the assets used to fund the bequest:

(i) A "fairly representative" bequest, which requires that the Personal Representative distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property available for distribution in satisfaction of such pecuniary bequest or transfer (*See* [5]5.05(c)); and

(ii) A "true worth" bequest, which requires that the Personal Representative distribute assets valued at their respective values on the date, or dates, of their distribution (*See* [5]5.05(d));

(iii) A "minimum worth" bequest, which requires that the Personal Representative distribute assets having an aggregate fair market value at the date of distribution amounting to no less than the amount of the pecuniary bequest, as finally determined for Federal estate tax purposes. (*See* [5]5.05(e)).

(c) Fairly Representative Funding

(1) Rev. Proc. 64-19 authorizes a pecuniary bequest which requires that the Personal Representative distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property available for distribution in satisfaction of such pecuniary bequest or transfer.

(2) An example of a "fairly representative" clause might be as follows:

My Personal Representative shall distribute in satisfaction of this bequest assets included in my gross estate (or the proceeds of their disposition), including cash, which have an aggregate fair market value as of the date or dates of distribution fairly representative of the appreciation or depreciation in value to the date or dates of distribution, of all property then available for distribution.

(3) A fairly representative clause will allocate a portion of post-death appreciation to the marital bequest, which may be contrary to the desired result. *See* [5]5.05(a)(2). On the other hand, if the surviving spouse is not a beneficiary of the non-marital bequest, sharing in the appreciation

may be desirable.

(4) Use of a fractional share bequest would accomplish the same end with less uncertainty as to what was "fairly representative."

(d) True Worth Funding

(1) A "true worth" funding clause will require the pecuniary bequest be satisfied with assets valued on the date of distribution. Such a clause might read as follows:

> *My Personal Representative shall select and distribute to the Trustee the assets which will constitute the pecuniary amount, using for this purpose asset values at the date or dates of distribution.*

(2) The effect of such a clause is to preclude the pecuniary bequest from sharing in any appreciation or depreciation of assets subsequent to the estate valuation date. If the surviving spouse is also a beneficiary of the credit shelter trust, this provides an attractive means of shifting appreciation away from the marital trust and into the credit shelter trust.

(3) The estate, however, will recognize gain if and to the extent the value at the date of distribution in the assets used to fund the pecuniary bequest exceeds their income tax basis. [Rev. Rul. 56-270, 1956-1 C.B. 325; Rev. Rul 60-87, 1960-1 C.B. 286; Reg. §1.1014-4(a)(3)]

(4) §267 restricts loss recognition between related parties. §267 applies to transactions between the fiduciary of a trust and a beneficiary of the trust, but does not apply to transactions between an estate and a beneficiary of the estate.

(5) A chief advantage of the true worth bequest is its simplicity.

(e) Minimum Worth Funding

(1) With a minimum worth pecuniary bequest, assets distributed in kind must have an aggregate fair market value on the date or dates of distribution of no less than the amount of the pecuniary bequest. In other words, the assets distributed typically are valued at the *lower* of basis or value (determined as of date of distribution).

(2) The Personal Representative is allowed to choose assets to fund the bequest, and consequently this form of pecuniary bequest has the advantage of flexibility. The Personal Representative would be able to direct assets with potential for appreciation to the credit shelter trust and those with lower appreciation potential to the marital trust. It is a more difficult provision to administer, however, than the true worth pecuniary bequest.

(3) The Personal Representative may be directed to use a value for each asset equal to the lower of the asset's value as finally determined for federal estate tax purposes, or at the date of distribution. With this form of clause, no asset distributed should have a value in excess of basis, and consequently, no gain is realized when assets are distributed in kind to fund a minimum worth bequest. An example of such a minimum worth marital clause might read as follows:[2]

---

[2] *See* Segal, *Drafting and Funding Marital Deduction Trusts for Estate Tax Purposes*, 44TH ANNUAL N.Y.U. INSTITUTE, §56.15.

My Personal Representative shall satisfy this gift by valuing any distribution in kind at the lower of (i) the value of such item as is finally determined for federal estate tax purposes or, if such item is an investment or reinvestment of property included in my gross estate for federal estate tax purposes or the proceeds of any sale or other disposition of property so included or any such investment or reinvestment, at the federal income tax basis of such item at the actual date of distribution, or (ii) the fair market value of such asset at the actual date of distribution.

(4) The preceding form of minimum worth clause restricts the discretion of the Personal Representative, but it need not be so restricted. Another form of minimum worth marital clause might read as follows:[3]

My Personal Representative shall satisfy this bequest by valuing any distribution in kind at its date of distribution value; provided that my Personal Representative in his sole discretion may value each asset distributed in kind with a date of distribution value that exceeds its federal income tax basis at any value not less than such basis nor more than its date of distribution value.

(5) To the extent the pecuniary bequest was satisfied with appreciated assets, gain would be recognized. There is some question whether loss would be recognized, but the simple solution to this problem is for the Personal Representative to sell the asset and distribute cash.

(6) A minimum worth distribution clause places a floor under the pecuniary bequest, but no ceiling over it. For example, using the preceding clause, the Personal Representative would have a choice of distributing assets valued at their basis, or at their current value, or anywhere in between. Whether the Personal Representative chose to value the assets for distribution purposes at their basis, at their current value, or at some intermediate value, the "value" of the assets would have to be no less than the pecuniary amount of the bequest.

(7) If a minimum worth funding clause were used for a pecuniary non-marital bequest, it could substantially reduce or eliminate the marital bequest, since there is no ceiling on the amount of appreciation that can be allocated to the pecuniary bequest under this form of funding clause. Consequently, a minimum worth funding clause should be used for a pecuniary nonmarital bequest only if leaving nothing to the marital bequest is an acceptable risk. That may be the case where the surviving spouse is also the primary beneficiary of the non-marital bequest.

5.06 Credit Shelter Pecuniary Bequests

(a) A credit shelter pecuniary clause makes a pecuniary bequest of the credit shelter equivalent. It would be followed by a clause disposing of the residuary, presumably to the spouse in the context of our discussion. This is a form of optimum marital deduction clause because it results in a marital bequest that is only enough to eliminate estate tax on the deceased spouse's estate.

(b) With this formula, the pecuniary amount will be equal to the credit shelter equivalent. That amount can then either be left outright to beneficiaries or, as is often the case, to the Trustees of the credit shelter trust.

(c) Although the concept is straightforward, the language tends to get convoluted. An example of a

---

[3] *See* Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions*, (United States Trust Company of New York, 1984), p. 97.

credit shelter pecuniary formula provision, employing a true worth funding clause, might be as follows:[4]

> *If my spouse survives me, I devise to my Trustees, IN TRUST, (i) all property in my estate as to which a federal estate tax marital deduction would not be allowed if it were given outright to my spouse, and (ii) after giving effect to (i) the largest pecuniary amount which will not result in or increase federal estate tax payable as a result of my death. In determining the pecuniary amount my Personal Representative shall consider the credit for state death taxes (provided use of this credit does not require an increase in state death taxes paid) and shall assume that all of the marital trust established below (including any part thereof disclaimed by my spouse) qualifies for the federal estate tax marital deduction. I recognize that certain taxes and expenses will reduce the pecuniary amount. My Personal Representative shall select and distribute to the Trustee the assets which shall constitute the pecuniary amount, employing for this purpose asset values at the date or dates of distribution.*

5.07 Marital Pecuniary Bequests

(a) A marital pecuniary formula leaves the marital bequest to the surviving spouse as a pecuniary amount and the residuary to the credit shelter bequest. Note, in this formula, the residuary is equal to the credit shelter equivalent. This also is a form of optimum marital deduction clause because it results in a marital bequest that is only enough to eliminated estate tax on the deceased spouse's estate.

(b) An example of a marital pecuniary formula clause with true worth funding is as follows:

> *If my spouse shall survive me, I give, devise and bequeath to my spouse property passing under this Will having a value equal to the maximum marital deduction as finally determined for federal estate tax purposes, less the aggregate amount of marital deductions, if any, allowed for such tax purposes by reason of property or interests in property passing or which have passed to my said spouse otherwise than pursuant to the provisions of this Article; provided, however, the amount of this bequest shall be reduced by the amount, if any, needed to increase my taxable estate (for federal estate tax purposes) to the largest amount that, after allowing for the unified credit against the federal estate tax, and the state death tax credit against such tax (but only to the extent that the use of such state death tax credit does not increase the death tax payable to any state), will result in the smallest (if any) federal estate tax being imposed on my estate. My Personal Representative shall not be required as a result of this provision, but rather shall retain the discretion, to exercise any election respecting the deduction of estate administration expenses, the determination of the estate tax valuation date, or any other tax election which may be available under any tax laws, only in such manner as will result in a larger allowable estate tax marital deduction than if the contrary election had been made. My Personal Representative shall have the sole discretion to select the assets which shall constitute this bequest. In no event, however, shall there be included in this bequest any asset or the proceeds of any asset which will not qualify for the federal estate tax marital deduction, and this bequest shall be reduced to the extent that it cannot be created with such qualifying assets. My Personal Representative shall value each and every asset selected by my Personal Representative for distribution in kind as a part of this bequest at the value of such asset at the date of distribution of such asset.*[5]

---

[4] *See* Segal, *Drafting and Funding Marital Deduction Trusts for Estate Tax Purposes*, 44TH ANNUAL N.Y.U. INSTITUTE, §56.11.

[5] This last sentence is what makes this a true worth clause.

5.08 Fractional Share Bequests

(a) With a fractional marital provision, the marital bequest is a fraction of the residue.

(b) A sample of a fractional marital provision is as follows:

> *If my spouse shall survive me, my Personal Representative shall divide my residuary estate into two (2) separate shares, hereinafter designated as the QTIP Trust and the Family Trust.*
>
> *The QTIP Trust shall be composed of that fraction of my residuary estate determined as follows: the numerator of the fraction shall be the maximum marital deduction as finally determined in my federal estate tax proceedings, less the aggregate amount of marital deductions, if any, allowed for such tax purposes by reason of property or interest in property passing or which have passed to my spouse otherwise than pursuant to the provisions of this Article; provided, however, the numerator of the QTIP Trust shall be reduced by the amount, if any, needed to increase my taxable estate (for federal estate tax purposes) to the largest amount that, after allowing for the unified credit against the federal estate tax, and the state death tax credit against such tax (but only to the extent that the use of such state death tax credit does not increase the death tax payable to any state), will result in the smallest (if any) federal estate tax being imposed on my estate. The denominator of the fraction shall be the value of my residuary estate as finally determined in my estate tax proceedings. My Personal Representative shall not be required as a result of this provision, but rather shall retain the discretion, to exercise any election respecting the deduction of estate administration expenses, the determination of the estate tax valuation date, or any other tax election which may be available under any tax laws, only in such manner as will result in a larger allowable estate tax marital deduction than if the contrary election had been made. In no event, however, shall there be included in the marital fraction any asset or the proceeds of any asset which will not qualify for the federal estate tax marital deduction and the marital fraction shall be reduced to the extent that it cannot be created with such qualifying assets. Such nonqualifying asset shall be allocated to the Family Trust and the marital fraction shall be created from my residuary estate less the nonqualifying asset. The QTIP Trust and the Family Trust shall be held and administered as hereafter provided.*

(c) Because it is not a pecuniary amount, no gain or loss recognition occurs upon funding a fractional marital bequest.

(d) Administration of such a bequest can be complicated, however, because it requires the Personal Representative to distribute a fraction of each asset to the marital bequest and a fraction to the credit shelter bequest. This may not be a difficulty, however, if the surviving spouse is the sole lifetime beneficiary of both the marital and the credit shelter trust.

5.09 Choosing Between a Formula Pecuniary Bequest and a Formula Fractional Share Bequest

(a) Fractional share formula

(1) This is perhaps the most fair formula, but it is also complicated

(i) This formula requires distribution of a fractional share in <u>each</u> asset.

(ii) The fraction must be recalculated at each non-pro rata partial distribution.

(2) Gain Recognition

(i) Satisfaction of debt with appreciated property triggers gain. Thus, gain in value of assets during probate will be recognized when used to satisfy pecuniary bequest.

(ii) But no gain is triggered on distribution of fractional bequest.

(3) Asset Selection: The Personal Representative does not have as broad power with a fractional share bequest to select and allocate assets to the marital share as with a pecuniary bequest.

(b) Credit Shelter Pecuniary Amount

(1) If the credit shelter amount will be small, an outright disposition may be preferable to a disposition in trust.

(2) If the estate is small enough that the credit shelter disposition may use up the entire estate, a credit shelter pecuniary amount disposition should not be used. That may result in an unnecessary capital gain upon distribution of appreciated property. Use of a marital deduction pecuniary amount formula or fractional share formula would be preferable.

(c) Marital Deduction Pecuniary Amount

(1) This formula allocates appreciation to the credit shelter disposition. But it also allocates all depreciation to the credit shelter disposition.

(2) If the marital portion is substantially larger than the credit shelter portion, use of a marital pecuniary disposition is not advisable. Reason: A decrease in value of the estate assets during probate could result in the credit shelter disposition being eliminated. (Remember: with pecuniary dispositions, all gain or loss is allocated to the residuary.) Use fractional share or credit shelter pecuniary amount instead.

(d) Pecuniary Dispositions in General

(1) If the estimated value of the residuary disposition is less than roughly one-fourth of the aggregate value of this disposition and the pecuniary bequest, consider reversing the dispositions or using a fractional share. Reason: The use of a pecuniary amount disposition that constitutes a large part of the disposable estate creates a large fixed dollar charge that puts the Personal Representative under pressure to fund the disposition promptly to be sure the assets are sufficient to satisfy it.

(2) Time of Funding: The Personal Representative may be unwilling to delay funding for more than a few months, because of possibility of loss in value of estate assets.

(3) Income in Respect of a Decedent

(i) Distribution of IRD to satisfy pecuniary amount would trigger income.

(ii) No triggering of income if specific bequest.

(4) Closely-held stock

(i) Pecuniary amount disposition will require second valuation of stock on date of distribution if used to satisfy this disposition. Gain may be recognized.

(ii) Section 303 redemptions do not escape dividend treatment if they are for the payment of income taxes, as opposed to death taxes and funeral and administration expenses.

[6] The Gift Tax Marital Deduction

6.01 Requirements

(1) The marital deduction is available for lifetime as well as testamentary gifts to a spouse. [§2523]

(2) As with the estate tax marital deduction, no gift tax marital deduction is available for gifts of terminable interests. [§2523(b)]

(3) Gifts in QTIP are available for the gift tax marital deduction. [§2523(f)]

6.02 Gifts to Use Unified Credit

(a) If the assets of one spouse are substantially under the unified credit equivalent, part of that spouse's unified credit will be wasted if that spouse dies first.

(b) Example: Assume S1 has assets worth $900,000 and S2 has assets worth $100,000. If S1 dies first, a credit shelter trust can be fully funded, and the balance of $300,000 could pass outright to S2 and, assuming no change in the value of S2's assets, S2 would not have a taxable estate. The entire $1,000,000 would pass on to the children free of estate tax. If S2 were to die first, however, only $100,000 would be available for the credit shelter trust, leaving S1 with a taxable estate.

(c) Lifetime gifts from one spouse to the other could eliminate the risk of the wrong spouse dying first.

(d) Example: Using the facts above, if S1 were to give $300,000 or more to S2, it would reduce S1's estate sufficiently that there would be no estate tax on S1's estate, even if S2 died first.

6.03 Equalizing Estates by Lifetime Gifts

(a) Because of the graduation in estate tax rates, there will be more overall tax if one estate is taxed in a higher bracket than the other.

(b) An equalization clause may be used, as discussed above. *See* 5.04. But if the poorer spouse dies first, the opportunity to equalize estates will be lost. Lifetime gifts may be used to equalize the estates of the two spouses without incurring gift tax.

6.04 Getting Stepped-Up Basis with Lifetime Gifts

(a) If one spouse is likely to die before the other, there may be tax advantage to making lifetime gifts to that spouse of appreciated assets to get stepped-up basis under §1014.

(b) If the transfer is made during the 1-year period ending on the date of the decedent's death, and the surviving spouse gets the property upon the death of the deceased spouse, there will be no step-up in basis of the property. [§1014(e)].

Bibliography

Covey, *Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions*, United States Trust Company of New York (1984)

Pennell, 843 T.M., *Estate Tax Marital Deduction*

Price, *Price on Contemporary Estate Planning*, Little Brown & Co. (1992)

Segal, *Drafting and Funding Marital Deduction Trusts for Estate Tax Purposes*, 44TH ANNUAL N.Y.U. INSTITUTE, Ch. 56.

Wilkins, *Drafting Wills and Trust Agreements*, Shepard's - McGraw Hill