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PROBLEMS IN MARITAL DEDUCTION PLANNING

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I. **Introduction**:

a. The unlimited marital deduction contained in Internal Revenue Code Sections 2056 and 2523 has been an element of federal tax law since 1982, and thus has been part of the legal landscape for the entire working career of a majority of actively practicing attorneys. Arguably, familiarity breeds complacency, and sometimes attorneys employ a "standard" approach to marital deduction planning – the same strategies and formulas they've used for years - without fully recognizing the nuances and complexities involved in this area of the law. Moreover, the fact that the unlimited marital deduction has been a fundamental part of the gift and estate tax laws for four decades may lead practitioners to overlook the somewhat radical changes that have been made in recent years – most importantly, the addition of "portability" of exemptions – and continue to use the same planning approaches without applying new thinking based on new concepts.

b. The purpose of this manuscript is not to provide a highly technical analysis of applicable law – there are plenty of sources for that, including the excellent paper penned by Mickey Davis and Melissa Willms in 2020, entitled *Estate Planning for Married Couples in a World with Portability and the Marital Deduction* (and most of the examples contained in this manuscript are drawn from that paper). Rather, the intent here is to focus on how estate planning attorneys should think about the marital deduction in the context of differing client needs, situations, and plans, taking into account the changes to this area of the law that have occurred during the past 10-15 years. That is, this paper is more of a practical guide than a deep technical analysis.

c. Accordingly, this paper will cover the following:

i. First, there will be a brief primer on the basic tax principles that impact marital deduction planning.

ii. Second, the paper will discuss the concept of portability of exemptions afforded by the concept of Deceased Spousal Unused Exclusion (DSUE).

iii. Third, the paper will consider the factors that determine whether a planner should rely on portability of exemption or apply the first decedent spouse's exemption to a so-called "bypass trust".

iv. Fourth, there will be a discussion of alternative ways to define the marital share and the non-marital share of the decedent's estate, if the plan is to utilize the exemption of the first decedent spouse, rather than rely on portability.

v. Fifth, the paper will examine options for how to pass the marital bequest to the surviving spouse.

vi. Finally, the paper will examine in detail the various "optimal" marital deduction formulas that could be employed, if the planner determines such a mandatory formula is appropriate, and will discuss the pros and cons of various alternative formulas.

II. **Summary of Basic Tax Principles**: The basics of the federal estate tax that impact marital deduction planning are relatively straight-forward:

a. Unlimited Marital Deduction:
    i. There is an unlimited marital deduction for assets passing to a surviving spouse or to certain types of marital trusts. Code Section 2056. Thus, no matter how large the decedent's estate, if it passes to a spouse or a qualifying trust (discussed below), there will be no estate tax owed. Of course, this may be a deferral of tax, not an avoidance of tax, as estate tax may be imposed at the surviving spouse's subsequent death, depending on the size of his or her taxable estate and the amount of the estate tax exemption available at that time.
    ii. The unlimited marital deduction has an important exception – it is not available to surviving spouses who are not U.S. citizens (unless the surviving spouse becomes a U.S. citizen before the date on which the decedent spouse's estate tax return is filed). Code Section 2056(d)(4). For such spouses, the marital deduction can be claimed only with the use of a Qualified Domestic Trust (QDOT), which is discussed below. Code Section 2056(d)(2).

b. Estate Tax Exemption:
    i. The law provides that U.S. decedents may leave a certain amount of assets to non-spousal/non-charitable beneficiaries without the imposition of estate tax. This estate tax exemption (technically known as the applicable exclusion amount) is comprised of two elements: the basic exclusion amount, plus the Deceased Spousal Unused Exclusion (DSUE) amount, if any.
    ii. Basic Exclusion Amount:
        1. Prior to 2018, the basic exclusion amount was $5,000,000 indexed for inflation from 2012.
        2. The 2017 Tax Act increased that number, effective starting in 2018, to $10,000,000 indexed for inflation. That number in 2023 is $12,920,000.
            a. At almost $13 million, the augmented estate tax exemption has effectively repealed the estate tax for most Americans. For example, the Population Division of the Bureau of the Census estimated that only 0.15% of decedents dying in 2019 filed estate tax returns, and only about 0.07% of those decedent's estates will pay any estate tax.
        3. Current law provides for a "sunset" of the augmented exemption amount at the end of 2025. Accordingly, on January 1, 2026 (barring any contrary action by Congress), the basic exclusion amount will return to $5,000,000 indexed for inflation.
    iii. Deceased Spousal Unused Exclusion (DSUE) Amount:
        1. As discussed in greater detail below, a decedent who doesn't fully utilize his or her applicable exclusion amount may pass the unused exemption (DSUE) to a surviving spouse. Code Section 2019(c).
        2. DSUE is available only if a federal estate tax return is filed to document the amount of the DSUE.
        3. DSUE is not indexed for inflation – that is, the total amount of DSUE available to a surviving spouse does not change over the survivor's remaining lifetime (except that it may be reduced by taxable gifts made during lifetime).

c. Tax Rates:
    i. Once the net taxable estate exceeds the applicable exclusion amount, the federal estate tax is imposed at a flat rate of 40%. Code Section 2001(c).
    ii. Twelve states and the District of Columbia impose a separate estate or inheritance tax, and in some cases the exemption amount for a state is different

than the federal exemption. For example, Maryland's exemption is $5 million and its top rate is 16%. North Carolina repealed its estate tax effective January 1, 1999.

III. Portability of Exemption and Deceased Spousal Unused Exclusion (DSUE) Amount

a. Introduction: For the first half of the author's career, the estate tax exemption was a "use it or lose it" proposition – if a decedent's estate passed entirely to a surviving spouse, and therefore qualified for the marital deduction, the decedent's estate tax exemption was effectively eliminated. Coupled with an exemption that was only $600,000 for most of the 1980s and 1990s, this non-portability led to the wide use of "optimal" marital deduction formulas, with credit shelter trusts employed at the first death, to preserve the first decedent's exemption, even for couples with relatively modest estates. In the Tax Relief Act of 2010, Congress recognized this situation was creating undue complexity for middle class Americans, and introduced portability of exemptions. Portability was made a "permanent" part of the estate tax system by the American Taxpayer Relief Act of 2012.

b. DSUE Defined: This change led to a new category of estate tax exemption – Deceased Spousal Unused Exclusion, or "DSUE." DSUE is simply the amount of a deceased spouse's exclusion that passes to a surviving spouse when a valid portability election is made. Code Section 2010(c)(4).

   i. *Example*:

      1. W dies in 2023 with an estate of $15 million, leaving everything outright to H.
      2. W's executor timely files a 706 and claims portability.
      3. H has a DSUE of $12.92 million (plus his own exemption of $12.92 million).
      4. If H then dies with a taxable estate of $25.84 million or less, no estate tax will be due.

c. Limitations on DSUE amount: The introduction of DSUE has led most married couples to think of their available estate tax exemption as a unitary amount, comprised of both parties' basic exclusion amounts. However, there are two primary limitations on the amount and availability of DSUE, which potentially limit or undermine its utility, as follows:

   i. Impact of Inflation: The DSUE amount is not indexed for inflation; rather, it remains, in the surviving spouse's hands, the same amount it was at the time of the first decedent's death (although the surviving spouse's basic exclusion amount continues to adjust upwards for inflation).

      1. This lack of inflationary adjustment in DSUE could be a significant problem for a younger couple – if husband dies in 2023 when husband and wife are both age 50, the likelihood is that wife will live another 30 or 40 years. If one assumes that inflation will, on average, run at 2.5% annually, then the current real dollar value of a $12.92 million DSUE in 2053 (when wife will be 80) is only $6,159,515. In contrast, if assets equal to the husband's exemption had been placed in a credit shelter trust and grew at an annual rate of 4%, net of inflation (i.e., a total return of 6.5% annually), then the effective real dollar value of husband's estate tax exemption in 2053 is $41,904,696. At a 40% tax rate, the effective estate tax impact on the difference between those two sums is over $14 million.

   ii. "Last" deceased spouse: Subsequent marriages can reduce or eliminate the DSUE that a surviving spouse otherwise would have, because you can only claim

DSUE from your "last" deceased spouse – that is, the most recently deceased person to whom the surviving spouse was married. Reg. Section 2010-1(e)(5). If a surviving spouse remarries and his or her new spouse then dies without leaving them any DSUE, then that surviving spouse will have no DSUE, even if he or she previously received DSUE from their first spouse. (Yet another concern for children when a parent remarries!) However, a subsequent marriage does not impact the DSUE received from the first spouse if the second marriage ends in divorce prior to the new spouse's death.

1. *Example*: W1 dies in 2011 survived by H. W1's estate passes outright to H, and the executor of W1's estate makes a valid portability election. As a result, H receives W1's DSUE amount of $5 million. H then marries W2. H's applicable exclusion amount continues to be his basic exclusion amount plus the $5 million DSUE amount he received from W1. Later, H divorces W2, who then dies. Since W2's death occurred when she was not married to H, her death does not cause a loss of the DSUE amount H received from W1.
2. *Planning tip*: This result suggests that tax benefits might be preserved for married persons with a DSUE amount received from a predeceased spouse (W1), by obtaining a divorce from a terminally ill second spouse (W2), if the DSUE amount available from W2 is less than the DSUE previously received from W1. Alternatively, as discussed below, H could consider a lifetime gift, utilizing the DSUE from W1, before W2's death.

d. <u>How to Claim "Portability"</u>:

i. Introduction: There are essentially three requirements to establish DSUE under Code Section 2010(c)(5)(a), which we will review in turn below:
   1. Form 706 – The decedent's executor must timely file a federal estate tax return.
   2. Valuation/computation – the estate assets must be valued and the DSUE amount computed on the return.
   3. Election – a portability election must be made on the Form 706.

ii. The Form 706 filed by the decedent spouse's executor must be a "complete and properly-prepared return". As a result, the decedent's estate must file a full estate tax return, and value every asset, even if no estate tax return otherwise would be required (i.e., because the decedent's estate is under the filing threshold) and even if no estate tax will be owed under any circumstance because of the unlimited marital deduction.
   1. Note: if executor intends to make a QTIP election, that election must be made on the 706.
   2. The added cost and complexity of creating and filing a Form 706 will lead to a fundamental cost/benefit analysis, based on the surviving spouse's likely need to rely on the DSUE at the subsequent death, based on assumptions about the probable size of his or her estate and the then-applicable estate tax laws. The uncertainty of those laws (underscored by the "sunset" of the augmented exemption amount at the end of 2025) suggests erring on the side of caution and filing in almost every case.

iii. Often the biggest hurdle to the completion of a Form 706 is the valuation of assets where the estate includes hard-to-value assets such as real estate and closely-held business interests. Fortunately, Rev. Proc. 2017-34 provides some relief here:

1. Estimates of value are allowed for assets qualifying for the marital or charitable deduction; and
2. The estate is allowed to round up to nearest $250,000 for any asset.

iv. The DSUE election must be made on a "timely filed" 706:
   1. The general rule is that an estate tax return is due 9 months from date of death, with the possibility of a 6-month extension.
   2. However, the Service adopted a simplified procedure for a lengthened extension where the Form 706 would not be required but for the need to claim DSUE. In that case, Rev. Proc. 2017-34 provided the due date for the return is automatically extended for two years after date of death; subsequently, in Rev. Proc. 2022-32, this extension period was extended to five years.
      a. Note – if the estate is relying on this special extension, the estate should cite the Revenue Procedure at the top of the Form 706.

v. The fact that DSUE may be claimed only if a Form 706 is filed, and the fact that filing a 706 can result in significant expense to the decedent's estate, may create conflict where the surviving spouse is not the primary beneficiary of the estate – for example, in a second marriage situation where the decedent (who perhaps has modest assets) is leaving his assets to children from a first marriage. In that case, the children may argue that the executor's fiduciary duty to them, as the beneficiaries of the estate, prohibits the executor from incurring an expense that provides no benefit to the children. Accordingly, the question arises of whether the surviving spouse may compel the filing of an estate tax return?
   1. Naturally, this issue should be considered and addressed in the estate planning process, and the Will should contain specific language regarding portability.
      a. *Example*: "My Executor may make the election described in Section 2010(c)(5) of the Code to compute my unused exclusions amount and thereby permit my spouse to take that amount into account. My Executor may incur and pay reasonable expenses to prepare and file any estate tax return or other documentation necessary to make such election, and to defend against any audit thereof."
   2. In addition, this issue should be addressed in a premarital agreement. One possibility is for the premarital agreement to require each spouse to include in their Will a direction to the executor to file a 706 and claim portability.
   3. In the absence of such express language, does the filing of an estate tax return constitute the "unjust enrichment" of surviving spouse? Or, is the surviving spouse a "beneficiary" of the estate by reason of DSUE, and therefore the executor owes him or her a fiduciary duty to file the 706 to allow the spouse to claim the DSUE?
      a. There is little case law on this point, but an interesting decision is *Estate of Vose v. Lee* (Okla. 2017), where the court held:
         i. The executor had a fiduciary duty to all persons interested in the estate;
         ii. Because the surviving spouse could benefit from a portability election, he was an interested person; and
         iii. Therefore, the executor was compelled to file a 706 and claim portability.

b. The *Vose* decision was cited with approval by a Maryland Circuit Court in a procedural ruling, where the court ruled that a surviving husband "had an obvious interest in the portability of his wife's DSUE," and therefore sufficiently stated a claim of action against an accounting firm that failed to advise the husband on the filing of an estate tax return to claim DSUE. *Martin v. Gelman, Rosenberg & Freeman*, 2021 MDBT 1, 2021 Md. Cir. Ct. LEXIS 1.

e. Impact of DSUE on Lifetime Gifts by Surviving Spouse:
   i. DSUE may be used by the surviving spouse for lifetime gifts; in fact, a favorable ordering rule requires that such lifetime gifts utilize DSUE first, before reducing the donor's basic exclusion amount. Treas. Reg. Section 25.2505-2(b).
      1. The surviving spouse may make use of DSUE at any time after the decedent spouse's death, so long as a portability election is ultimately properly made. So, the surviving spouse could make a gift using DSUE on the day immediately following the decedent spouse's death, if the decedent's executor later files a timely 706 and makes the portability election.
   ii. This ordering rule provides a planning opportunity. As noted above, DSUE can be received only from the "last deceased spouse." However, in the case of a lifetime gift by the surviving spouse, the identity of the "last surviving spouse" is determined at the time of the gift, meaning that a donor may lock in DSUE from a first deceased spouse without risk of loss of that DSUE due to a subsequent marriage.
      1. *Example*: W1 dies in January 2022, leaving her entire estate to H. H marries W2 in February. In March, H makes a taxable gift of $20 million. W2 dies in June. If a portability election is ultimately made with regard to W1's estate on a timely filed estate tax return, H may apply his basic exclusion amount plus an DSUE amount received from W1 in order to shelter the gift from tax, since W1 was H's "last deceased spouse" at the time that the gift was made. If no portability election is made for W1's estate (or if an election to opt out of portability is made), then H may use only his basic exclusion amount to offset the gift from tax.
      2. In effect, the DSUE at the time of the surviving spouse's death is the sum of (i) DSUE from the last deceased spouse, plus (ii) the DSUE received from all other prior deceased spouses to the extent it was applied to lifetime gifts. The fact that strategic lifetime gifting may allow someone to claim DSUE from multiple deceased spouses is sometimes referred to as the "Black Widow" rule.
         a. *Example*: H1 dies in 2021 with $5 million of unused exclusion and H1's executor makes a valid portability election. In 2023, after H1's death, W makes a gift of $ 17.92 million, all covered by her gift tax applicable exclusion amount (which includes her basic exclusion amount plus the DSUE amount from H1). W then marries H2 (who is poor and in poor health) who also predeceases W. The executor of H2's estate makes a portability election, providing W with a DSUE amount of $5 million. Can W make another $5 million gift without paying gift tax? Because of the regulations, yes! If W makes another $5 million gift, this second gift is entirely sheltered by W's applicable exclusion,

since her remaining basic exclusion amount ($0), plus the DSUE amount received from H2 ($5 million) is $5 million.

f. Statute of Limitations on DSUE Computation:
   i. The IRS may challenge the computation of DSUE at any time prior to the expiration of the limitations period on the surviving spouse's 706. This makes sense, because the impact of DSUE is to reduce tax in the surviving spouse's estate, not the estate of the first decedent spouse. Therefore, where the first decedent's estate contained hard-to-value assets, there is some risk that the surviving spouse will not have an accurate DSUE number to apply to lifetime gifts. Even if the surviving spouse files a gift tax return, Form 709, and the applicable statute of limitations runs on that return, the surviving spouse is not assured of the availability or amount of the DSUE being claimed.
   ii. *Example*: An estate tax return is timely filed for H's estate reflecting an estate of $4.9 million, all of which passes to a trust for W for which a QTIP election is made. The return is filed on March 1, 2014 making the portability election. W dies in 2022 with a taxable estate, and her estate tax return reflects the DSUE amount shown on H's estate tax return. In the course of examining W's estate tax return, the IRS determines that (i) the value of H's estate was actually $6.5 million; and (ii) the trust for W was ineligible for the QTIP election. Although the statute of limitations for H's estate tax return precludes the IRS from collecting any estate tax as a result of H's death, the IRS may nevertheless eliminate the DSUE amount claimed to be available by W's executor.

g. DSUE and Non-Citizen Spouses: The marital deduction, of course, is generally available only for assets passing to a surviving spouse who is a U.S. citizen – with the important exception of assets passing to a Qualified Domestic Trust, or "QDOT." So, how is portability of exemptions affected when a non-U.S. citizen is one of the spouses? Let's consider two situations:
   i. Citizen (or Resident) Decedent Spouse and Non-Citizen Surviving Spouse
      1. If the decedent creates a QDOT for the surviving spouse, then DSUE is available for the QDOT. Principal distributions from a QDOT to the surviving non-citizen spouse are generally subject to estate tax, but DSUE may be applied to eliminate tax on such principal distributions up to the amount of the DSUE.
         a. However, the non-citizen spouse may not utilize DSUE of the citizen decedent prior to death or the earlier termination of the QDOT.
         b. This point is likely merely an academic one - If the decedent spouse has available exemption, it will be more effective to have the decedent's exemption amount pass into a bypass trust, of which the surviving spouse could be the beneficiary. Such a trust may be administered with greater flexibility and less tax complexity than a QDOT with DSUE.
      2. Generally speaking, no DSUE is available for outright distributions to the surviving non-citizen/non-resident spouse. There is an important exception, however – DSUE can be claimed by the surviving spouse if he or she subsequently becomes a resident or citizen (and will therefore be subject to the US estate tax laws at his or her death). Therefore, the conservative course of action is to file a 706 to claim portability even if survivor is a non-resident/non-citizen at the time of the decedent spouse's death, because that status may change in the future.

ii. *Non-Citizen/Non-Resident Decedent Spouse and Citizen Surviving Spouse*
    1. If the decedent is a non-citizen/non-resident of the U.S., then no DSUE is provided at his or her death, and portability is not applicable.

IV. Portability Versus Bypass Trust – Factors to Consider

a. Introduction: Prior to the introduction of portability of exemptions, a decedent's exemption could be preserved only by utilizing it at the first death. Where the intent was to provide the surviving spouse with access to all of the estate assets, claiming the decedent's exemption meant utilizing a separate trust share for the benefit of the surviving spouse – sometimes referred to as a "credit shelter trust" or a "bypass trust." Today, given the ease and relative simplicity of relying on DSUE, planners have to consider whether the added complexity of building bypass trust provisions into the estate plan is advisable.

b. Factors Favoring Use of Portability: There are several reasons planners might opt to rely on portability/DSUE, including -
    i. *Simplicity* – The couple's Wills or Revocable Trusts will be less complex and easier for them to understand if all of the first decedent's assets pass to the surviving spouse outright or in a single, simple marital trust.
    ii. *Unlimited marital deduction* – The marital deduction ensures that no tax need be paid until the second death. Accordingly, the estate tax is not a tax the married couple will pay – it simply might reduce the amount of their children's inheritance. Where an estate is unlikely to be subject to tax, a couple might be willing to run the risk that some tax will be paid at the second death, in order to achieve simplicity.
    iii. *Control* – Relying on DSUE means the surviving spouse may receive all of the decedent's assets outright, giving him or her complete control over, and unlimited access to, those assets. Although a surviving spouse could be the primary beneficiary and the trustee of a bypass trust, their control over and access to the trust assets are subject to certain limitations, including required standards for distributions (e.g., health, education, maintenance and support) and fiduciary duties to preserve assets for remaindermen.
    iv. *Additional step-up in basis at second death* – The adjustment of an asset's tax basis to fair market value at the time of the owner's death (so-called "stepped up basis") is an important and powerful tax benefit. Taking into account federal and state capital gains taxes and the Net Investment Income Tax (NIIT), stepped-up basis likely saves an amount equal to about 30% of unrealized appreciation at the time of death. At the second death, this basis adjustment applies to assets held in the second spouse's individual name or in a qualified marital trust, but it does not apply to assets held in a bypass trust, because that trust is not part of the second spouse's taxable estate. If the DSUE amount plus the surviving spouse's own basic exclusion amount would eliminate any potential estate tax liability at the second death, then the loss of stepped up basis for assets in a bypass trust could have a significant negative tax impact for the family.
        1. For example, assume that H dies in 2012 with an exclusion amount of $5 million, which is directed into a bypass trust. Assume further that W, the surviving spouse dies in 2023 with a taxable estate of $6 million, and the bypass trust at that time has a value of $8 million. Also assume that the sole asset in the bypass trust is stock in ABC Corporation, which has risen in value from $5 million to $8 million. Under this scenario, all of the assets pass to the descendants of H and W free of estate tax – W's assets are covered by her exemption, and H's assets (in the bypass trust)

are protected by the application of his exemption to the bypass trust. However, the descendants have an unrealized capital gain on the ABC stock of $3 million, which translates into a roughly $900,000 tax liability at the time of sale. If instead H had simply left his assets to W, then at W's death her taxable estate of $14 million would be covered by her applicable exclusion amount of $17,920,000 – W's basic exclusion amount of $12,920,000 plus DSUE of $5 million. That exemption would have eliminated all estate tax and the descendants would have received a stepped-up basis on all the assets, thereby eliminating the potential capital gain tax liability of $900,000.

v. *Possible higher marginal income tax rates for a trust* – While income tax rates are the same for individuals and trusts, a trust reaches the top 37% bracket on ordinary income much more quickly (for 2023, at only $14,451 of income). If the bypass trust accumulates income (for example, to maximize growth in the trust and therefore enhance the impact of the first spouse's exemption), that income might be taxed at a higher marginal rate than if the assets producing that income were simply owned outright by the surviving spouse.

c. Factors Favoring Use of Bypass Trust: On the other hand, there are several factors that would lead a planner to utilize a bypass trust rather than simply rely on DSUE, including -

i. *Possible loss of portability* – The ability to utilize DSUE could be lost between the two deaths, for several reasons:
   1. Legislative changes to the estate tax law that eliminates or limits portability;
   2. An intervening marriage and death that changes the identity of the "last deceased spouse" to someone who has little or no unused exemption to pass to the surviving spouse; or
   3. The failure or refusal of first spouse's estate to file a Form 706, which is required to claim DSUE.

ii. *Loss of the first decedent's GST exemption* - While the estate tax exemption is portable, the GST exemption is not; but a bypass trust could be designed as a generation-skipping trust and utilize both the estate tax exemption and GST exemption of the first decedent spouse.

iii. *Risk of disinheritance of first spouse's children by surviving spouse* – If all assets are left outright to the surviving spouse, there is a risk the surviving spouse might dispose of those assets at the second death in a manner contrary to the first spouse's intent. This risk is especially high where the first spouse's children are from a prior marriage. Using a bypass trust locks in the first spouse's dispositive intent.

iv. *Post-mortem appreciation in assets funding the credit shelter bequest* – As indicated earlier in this paper, there is no inflation adjustment for the DSUE amount. If the surviving spouse lives for many years beyond the first death, the erosion in the real dollar value of the DSUE could be significant. In contrast, the assets in a bypass trust will grow in value outside of the second spouse's taxable estate, shielding all of that growth from estate tax.

v. *Ability to sprinkle assets to children/descendants with bypass trust* – If all assets pass outright to a surviving spouse, any subsequent use of those assets for the benefit of children or grandchildren may have gift tax consequences. If those assets pass to a Marital Trust, no distributions are permitted to anyone other than the surviving spouse, so it cannot be a source of funds for children or grandchildren. In contrast, the first decedent's descendants may be named as

permissible beneficiaries of a bypass trust, and distributions to them from the trust have no gift tax implications (although such distributions may carry out taxable income – DNI – to the beneficiaries).

vi. *Creditor protection* –

1. Assets passing outright to the surviving spouse may be exposed to third-party claims, such as those arising from lawsuits or bankruptcy. In contrast, a bypass trust likely qualifies as a spendthrift trust, such that its assets are shielded from claims against the trust beneficiary. (Of course, you could achieve the same asset protection result while relying on DSUE if the assets pass into a Marital Trust, rather than outright to the surviving spouse.)
2. Generally speaking, assets received by inheritance are considered "separate property", not subject to division upon divorce. However, in some states, under certain circumstances such assets may be added to marital property by the court, and in any event it is frequently the case that the spouse's actions may effectively convert separate property to marital property (for example, by commingling assets).

d. Use of a Disclaimer Trust Plan: Given the uncertainty of which approach will be most favorable, one approach is for planners to include in the Will or Revocable Trust a so-called "disclaimer trust plan" (discussed below), which allows the surviving spouse to make a choice, at the time of the first death, as to whether to receive assets outright or have them pass into a bypass trust. Such a plan pushes any decision into the future, when more will be known about the couple's assets and the direction of the estate tax laws. Alternatively, use of a *Clayton* formula approach (also discussed below) would achieve similar flexibility.

V. Defining the Marital Share

a. Introduction: If a decision is made not to rely on DSUE, but rather to utilize the first decedent's estate tax exemption at the time of the first death, then the issue is how to define the two shares of the estate – the "credit shelter bequest", being the portion covered by the decedent's exemption; and the "marital bequest", being the remainder of the estate which is protected from tax by the marital deduction. Essentially, the planner has four options: (i) an "optimal" marital deduction formula; (ii) a "one lung" Qualified Terminable Interest Property (QTIP) trust; (iii) a "disclaimer trust" plan; or (iv) a "*Clayton* formula" plan. These options will be discussed in order, below.

b. Optimal Marital Deduction Formula:

i. This formula either defines the credit shelter bequest, with the residuary passing as the marital bequest; or it defines the marital bequest, with the residuary passing to the bypass trust. The alternative versions of such a formula, and the alternative ways in which the marital bequest may be passed, are explored in later sections of this paper.

ii. The application of this formula at the time of the first death is mandatory – the executor/trustee has no discretion as to whether to make the formulaic division of the estate. This inflexibility suggests that an optimal marital deduction formula is appropriate only in larger estates, where it is a virtual certainty that (i) the first decedent's estate will have sufficient assets to utilize the exemption, and (ii) utilization of the exemption at the first death almost certainly will decrease overall estate taxes at the second death. In such an estate, generation-skipping planning is typically warranted, providing further justification for a mandatory formula that can also affirmatively allocate the first decedent's GST exemption.

c. One Lung QTIP Trust:

i. Only certain types of trusts qualify for the estate tax marital deduction. One of the most widely-used is a QTIP Trust, which is described in further detail later in the paper.

ii. When a decedent spouse's Will or Trust utilizes a QTIP Trust for the surviving spouse, the executor must elect to qualify the Trust as a QTIP Trust by listing the Trust on Schedule M of the Form 706. However, this election is not an all-or-nothing proposition – the executor may make a partial QTIP election, with the result that a portion of the Trust will qualify for the marital deduction, and the remainder of the Trust will utilize the decedent's estate tax exemption. After the election, the QTIP portion and the non-QTIP portion would be segregated into separate trust shares, with the non-QTIP trust essentially functioning as a bypass trust.

    1. An optimal marital deduction plan can be thought of as a "two lung" plan, with the marital trust and the bypass trust being the two "lungs" of a diagram of the decedent's estate plan. In contrast, if only a QTIP marital trust is used, only a single "lung" is shown on the diagram – hence, the "one lung" nomenclature.

iii. In many ways, this approach is similar to a disclaimer trust plan (discussed below), in that the married couple can take a "wait and see" attitude as to whether it will be best to apply the exemption at the first death or rely on DSUE. However, there are some important differences:

    1. Because the marital trust must be able to qualify as a QTIP trust, the spouse will have a mandatory income interest, meaning the trust cannot accumulate income and therefore its growth, outside of the surviving spouse's taxable estate, will be limited to some degree, arguably lessening the impact of the first decedent's exemption. However, this "one lung" approach is typically used in more modest estates, where it is unclear whether a bypass trust is needed, and in such cases the surviving spouse is likely to need all of the trust income for living expenses. Moreover, the amount of trust accounting income that must be distributed could be minimized through an investment strategy that emphasizes equity appreciation rather than dividends and interest.
    2. The ability of the trust to qualify for QTIP treatment also means that the only permissible beneficiary during the spouse's lifetime is the spouse. Accordingly, no trust distributions may be made to children or other descendants. This limitation on a marital trust's beneficial interests may be a meaningful disadvantage vis-à-vis a bypass trust, because the first spouse's death means the surviving spouse has only one annual exclusion amount to use for gifts to descendants, which may create tax consequences if the spouse wants to make larger gifts – for example, to enable a child to buy a house or start a business. As discussed above, the first decedent's DSUE is available for application to lifetime gifts, but if that first decedent's exemption has been exhausted by application to the non-QTIP trust share, there will be no DSUE available for lifetime gifts to augment the survivor's annual exclusion gifts. However, as mentioned above, this one lung approach is typically used with more modest estates where the surviving spouse will need access to the full range of assets for his or her support; in which case large gifts to children or grandchildren are probably out of the question anyway.
    3. A significant advantage to a one-lung QTIP over a disclaimer trust plan is that with a QTIP trust, the surviving spouse may be given a broad

testamentary power of appointment. In contrast, for a disclaimer into a bypass trust to be a qualified disclaimer for tax purposes, the spouse cannot retain any power of direction over the disclaimed property – and therefore, no power of appointment is permitted. Given potential changes in tax and trust laws and alterations in family circumstances, the ability to modify the trust's dispositive provisions at the second spouse's death may be highly desirable.

d. Disclaimer Trust Plan:
    i. Any beneficiary, including a surviving spouse, may disclaim an asset or an interest in an estate and trust, in which case the disclaimed assets will pass as if the beneficiary had predeceased the decedent/grantor. *See, e.g.,* Chapter 31B of the North Carolina General Statutes.
    ii. Such a disclaimer potentially has gift tax consequences, as the disclaimant may be deemed to have made a taxable gift by virtue of refusing the property. However, a disclaimer is a "qualified disclaimer", and therefore has no gift tax consequences, if it meets certain criteria (*see* Treas. Reg. Section 2518-2):
        1. The disclaimer must be irrevocable and unqualified.
        2. The disclaimer must be in writing.
        3. The disclaimer must be made and delivered within 9 months of the date on which the transfer creating the interest in the disclaimant is made (e.g., the decedent's death).
        4. The disclaimant must not have accepted the benefits of the property being disclaimed.
        5. As a result of the disclaimer, the disclaimed interest must pass to either the surviving spouse or someone other than the disclaimant without any direction on the part of the disclaimant.
    iii. As indicated above, as a general rule the disclaimant may not receive an interest in the disclaimed property. However, there is an important exception to this rule for a surviving spouse. As a result, a disclaimer by a spouse that has the effect of shifting the disclaimed assets into a trust for the benefit of the surviving spouse may be a qualified disclaimer for gift tax purposes. Consequently, one option for defining the marital bequest and the credit shelter bequest is to use a disclaimer trust plan, whereby the surviving spouse effectively decides how much to pass into the bypass trust through a post-mortem disclaimer. The decedent's Will or Revocable Trust would provide that all assets pass to the surviving spouse (or to a Marital Trust for the spouse), but would specify that if the surviving spouse disclaims, the disclaimed portion of the decedent's estate would pass into a bypass trust.
    iv. There are several advantages to a disclaimer trust plan:
        1. This approach is highly flexible, as it allows the surviving spouse to take a "wait and see" approach – making the decision as to whether to fund a bypass trust (and in what amount) at the time of the first death, when the spouse will have more information about the size of the estate and the status and direction of the estate tax laws.
        2. A disclaimer plan is simple and easy for clients to understand during the estate planning process.
        3. A disclaimer may be effectuated with precision, as the disclaimer may be stated in terms of an amount, as a percentage/fraction of the estate, or by reference to specific assets.
        4. A bypass trust funded through a post-mortem disclaimer may have additional beneficiaries, other than the surviving spouse (typically,

children and other descendants). This provides the surviving spouse with a source from which funds may be provided to children and grandchildren without gift tax consequences – which may be important given that the first spouse's death eliminated one annual exclusion amount that the couple previously had to cover gifts to family members. In contrast, a non-exempt marital trust created under a "one lung" plan may have only one beneficiary – the surviving spouse.

v. A disclaimer plan has some limitations and disadvantages as well:
    1. While the surviving spouse may have more information at the time of the decedent's death than he or she has today, the spouse's information will still be imperfect. What he or she really wants to know is what the estate tax laws will say and what the size of the estate will be at the time of the second death, which of course will still be unknowable at the first death.
    2. The surviving spouse's post-mortem actions may unwittingly foreclose the ability to disclaim assets. As indicated above, a qualified disclaimer is not possible with respect to any asset of which the disclaimant has accepted the benefits. The days and weeks following a spouse's death are often a confusing and chaotic time, and a surviving spouse may take financial actions (e.g., pulling funds from a bank account or an investment account to cover living expenses) without the benefit of counsel, thereby unintentionally eliminating the possibility of funding a disclaimer trust with those specific assets.
    3. A disclaimer must be made relatively soon after the first death – no later than nine months; but often the effective due date for the disclaimer is earlier because of the prohibition on the acceptance of the disclaimed assets. If the surviving spouse needs access to the decedent's financial assets for living expenses, he or she may need to disclaim relatively soon after the decedent's death.
    4. A disclaimer plan assumes the surviving spouse will, in fact, be able to make a logical decision about whether to disclaim assets. It is not uncommon for the spouse to be emotionally distraught to the point that he or she is unable to deal with what may appear to be a cold, calculating decision about money and assets.
    5. The disclaimant spouse cannot retain any power to direct the ultimate passage of the disclaimed assets. Accordingly, he or she may not hold a power of appointment over the disclaimer trust, which limits the spouse's flexibility in formulating his or her own estate plan to take into account changing circumstances after the first decedent's death.

e. *Clayton* Formula:
    i. Introduction:
        1. A *Clayton* formula (named for the formula considered in *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992)) combines the flexibility of a disclaimer trust plan with many of the benefits of an optimal marital deduction formula plan. The funding formula contained in the decedent's Will or Trust would provide essentially as follows:
            a. If a QTIP election is made by the decedent's executor as to an asset or portion of the estate, then those assets will pass into a QTIP Marital Trust; but
            b. If a QTIP election is not made as to a portion of the estate, then those assets pass into a bypass trust.

2. The IRS litigated for many years over the efficacy of a *Clayton* formula approach, but finally conceded with Treas. Reg. 20.2056(b)-7 after losing in several Federal Circuits.
3. Note that the election must be made by an independent executor, so the spouse is relying on a third-party to determine the funding of the estate shares.

ii. The advantages of a *Clayton* formula are many:
1. Like a disclaimer plan, it provides flexibility by allowing the surviving spouse to take a "wait and see" approach regarding the utilization of the first spouse's exemption.
2. Moreover, it eliminates the risk that an "acceptance of benefits" would foreclose the use of a disclaimer to fund a bypass trust.
3. The fact that an independent executor would make the QTIP election means the funding of the bypass trust is not dependent on the decision of the surviving spouse, who may be emotionally unable to make the call.
4. Because the decision on funding the bypass trust is made through an estate tax election, the *Clayton* formula effectively gives the estate 15 months to make a decision (versus a maximum of 9 months with a disclaimer). While the election must be made on a timely-filed Form 706, the estate may easily obtain a six-month extension beyond the original nine-month due date.
5. Because the bypass trust is not funded with a disclaimer, the surviving spouse may be given a testamentary power of appointment, providing further flexibility in designing the family's estate distribution at the second death.
6. Unlike the non-QTIP trust share under a one lung QTIP plan, the bypass trust under a *Clayton* approach may have descendants as permissible beneficiaries.

iii. However, a *Clayton* formula approach has some drawbacks:
1. Because the formula depends on a tax election, the estate will have to file a Form 706 even if no filing was otherwise required, increasing the expense of the estate administration.
2. A *Clayton* formula is conceptually complex and therefore more difficult for clients to understand, which may impact the estate planning process.
3. To avoid gift tax implications for the surviving spouse, the QTIP election must be made by an independent trustee. This requirement may add complexity to the plan, as the family may prefer for the spouse or a child to serve as the executor. It may also be difficult to identify an independent executor who is willing to assume responsibility (and possibly liability) for making this election, knowing that his or her decision will alter the beneficial interests in the estate. Such an independent executor may also require releases and indemnities from the family, further complicating the estate administration. In this regard, a *Clayton* formula has some similarity to the concept of appointing a Trust Protector under an irrevocable trust – in theory, the added flexibility sounds attractive, but the reality of the execution of the concept may be more difficult than imagined.

f. Recommendations: There is, of course, no perfect approach to the selection of a methodology for defining the marital share and the credit shelter share. The best course of action depends, naturally, on the particular facts and circumstances of the married couple and their family, and it relies on certain assumptions or guesses as to the future

status of the estate tax laws and the clients' assets. However, some general guidelines can be provided, as follows:

i. For very large estates, where it is a virtual certainty there will be an estate tax at the second death, use an optimal marital deduction formula plan to ensure the utility of the first decedent's estate tax and GST exemptions and to remove from the transfer tax all appreciation in value of the credit shelter bequest between the first and second deaths.

ii. Where it seems likely, but not certain, that the surviving spouse's exemption (including any DSUE) will cover all or most of his or her taxable estate at the second death, use either a one lung QTIP Trust plan or a disclaimer trust plan. Or, use both – the first decedent's Will or Trust could direct the residuary estate into a QTIP Marital Trust, as to which a partial QTIP election could be made; while also specifying that if the surviving spouse disclaims any assets that otherwise would pass into the Marital Trust, those disclaimed assets would instead pass into a bypass trust.

iii. On the other hand, where the couple's assets are likely, but not certain, to exceed the total exemption available at the second death (including DSUE), and therefore it is probable that the first decedent's exemption should be utilized at the first death to maximize estate tax savings, consider using a *Clayton* formula, which in many ways combines the benefits of both a marital deduction formula and a disclaimer approach.

VI. How to Pass the Martial Bequest

a. Outright vs. Marital Trust: Once the planner has identified how to define the marital bequest, there is the further issue of whether to pass the marital bequest to the surviving spouse outright or use some version of a marital trust. The factors influencing this decision are as follows:

i. *Simplicity* - An outright distribution is, of course, simple to apply and creates less administrative complexity down the road. It may also be more consistent with the way in which the married couple conducted their financial affairs while both were alive. In contrast, with a marital trust, there will be separate accounts to be maintained, an additional income tax return to be filed, etc.

ii. *Control and Access* – With an outright distribution, the surviving spouse has complete control over and access to the assets passing under the marital bequest. In contrast, if a marital trust is utilized and there is a third-party trustee, the surviving spouse's control and access will be far more limited. Moreover, even if the surviving spouse is the trustee of the marital trust, and therefore has managerial control over the trust, there will be some limits on the spouse's ability to tap into the trust principal, as such distributions must fall within the ascertainable standard of health, education, maintenance, and support (which is broad, but not unlimited).

iii. *Creditor Protection* – If the surviving spouse receives assets outright, those assets will be exposed to any third-party claims against the spouse – for example, resulting from a lawsuit or a bankruptcy. Moreover, while inherited assets should be considered "separate property" for purposes of an equitable distribution in the event of a divorce, if the surviving spouse remarries he or she might unwittingly change the character of assets for this purpose by commingling them with assets of the new spouse, thereby exposing the assets to claims in a family law setting. In contrast, assets held in a marital trust should be protected from any third-party claims against the surviving spouse – even if the spouse is a trustee.

iv. *Estate Planning* – If the spouse receives the marital bequest outright, he or she may utilize those assets in proactive estate planning to minimize estate tax at the second death. In contrast, a marital trust may limit the ability to engage in aggressive estate planning because the only permissible trust beneficiary is the spouse. Moreover, if distributions to the spouse are limited to an ascertainable standard (which must be the case if the spouse is the trustee), the trustee may not have the ability to make significant principal distributions to enable such planning, as it is possible that gifting is not included in "maintenance" or "support." Of course, this issue can be addressed by naming (or enabling the appointment of) a special trustee who can make unlimited principal distributions for any purpose, including gifting.

b. Type of Marital Trust: If the decision is made to use a marital trust, the next issue is the type of marital trust to use.
    i. *QTIP* – the most commonly used marital trust is a Qualified Terminable Interest Property, or QTIP, Trust.
        1. The requirements for a QTIP Trust are simple:
            a. The trust must distribute all trust accounting net income to the spouse, at least annually.
            b. The spouse must have the right to require the trustee to convert unproductive property into income-producing assets (and, the trustee will have a fiduciary duty to produce a reasonable amount of income).
            c. The executor must make a QTIP election on a timely-filed estate tax return.
                i. The QTIP election is an "opt-out" election – that is, if a QTIP marital trust is listed on Schedule M of the Form 706, a QTIP election will be deemed made unless the executor affirmatively opts out of that election.
                ii. Note that some of the states with a state estate tax may have a separate QTIP election requirement
            d. The trustee may, but need not, be given the discretion to make principal distributions to the spouse.
        2. The planner has essentially two options in defining the income interest that must be distributed to the spouse:
            a. First, the trust could define the income interest in a traditional manner, as trust accounting net income (essentially, ordinary income items such as dividends, interest, and rent, less expenses). Defining the income interest in this manner creates certain challenges, however:
                i. The spouse may have little predictability as to the amount and timing of the income distribution.
                ii. It also creates administrative challenges for the trustee, because if the trustee wants to make income distributions throughout the year, the trustee must estimate the likely amount of income and deductions for the year and then "true-up" the TANI amount after year-end (when the actual amounts are known).
                iii. The trustee is required to produce a reasonable amount of income, and therefore may feel it necessary to allocate a significant portion of trust assets to income-producing assets (e.g., bonds). This may negatively impact the

overall investment results of the trust (as, historically, over long periods of time stocks have outperformed bonds), and it may create tensions between the competing interests of the surviving spouse (who may want more income) and the remainder beneficiaries (who want more growth).

iv. These challenges may be abated, to some degree, if the trustee has the authority, either under the trust instrument's terms or pursuant to applicable state law, to reclassify principal gains as trust income. Most states now grant such authority to a trustee, but the best practice is to include express (and broad) authority to reclassify receipts within the trust document itself.

b. Alternatively, if permitted under state law, the trust could define the income interest as a unitrust amount – that is, a dollar amount determined by reference to a percentage of the value of the trust at the beginning of each year. Typically, the permissible percentage (which is defined by state law) is between 3% and 5%.

i. For example, if a Marital Trust using a unitrust income definition of 4% had assets, as of January 1, equal to $10 million in value, the income distribution for that year would be fixed at $400,000, regardless of the amount of actual income.

ii. Using a unitrust approach provides greater predictability, for both the beneficiary and the trustee, as to the amount and timing of income distributions, thus simplifying the trust administration process and lessening the likelihood of confusion or disagreement over such distributions.

iii. It also allows the trustee to invest for the best overall investment returns, regardless of whether those returns take the form of equity appreciation or income yields.

iv. A unitrust approach also lessens the potential for disputes between the spouse and the remainder beneficiaries, as the trust instrument itself defines their respective interests and defines those interests in a compatible manner – growth in the value of the trust benefits both sets of beneficiaries, because it increases the unitrust amount paid to the spouse and enhances the value of the principal that ultimately passes to the remaindermen.

3. Any planner utilizing a QTIP Trust should be cognizant of Rev. Proc. 2016-49. Generally, a QTIP election is void if not necessary to reduce the estate tax to zero. In other words, if the decedent spouse's taxable estate were less than his or her applicable exclusion amount, it would appear a QTIP election could not be made. However, Rev. Proc. 2016-49 effectively resolves this problem by providing that a QTIP election is not void if the executor makes a portability election.
4. In addition, planners should be aware of the so-called "QTIP Tax Apportionment Trap."

a. At the second death, the value of the QTIP Trust is, of course, included in the second spouse's taxable estate, and therefore may create or augment an estate tax liability for that estate. The general rule is that the marginal estate tax caused by the inclusion of the QTIP assets must be paid by the QTIP marital trust. However, this may cause inequities where the remainder beneficiaries of the surviving spouse's estate are different than the beneficiaries of the marital trust.

b. *Example:* H and W each have a $25 million estate. H dies with a Will leaving all to a QTIP trust for W, with the remainder interest in the trust passing upon W's death to H's children from a prior relationship. H's executor files an estate tax return making both the QTIP and portability elections. W immediately thereafter, knowing she can live from the QTIP trust income, makes a gift of her entire $25 million estate to her children. No gift tax is due since W can apply her applicable exclusion amount to eliminate the tax (i.e., her basic exclusion amount of $12.92 million plus H's DSUE amount of $12.92 million). Upon W's later death, the remaining QTIP trust assets are subject to estate tax under Section 2044 of the Code. Since W used nearly all of her applicable exclusion amount to shelter her gift to her children, none of her exclusion (or a nominal amount because of the inflation adjustment of her basic exclusion amount) is available to shelter estate tax, and the entire $26 million (assuming no changes in value) is taxed. All of this tax is attributable to the QTIP trust assets, so unless W's Will expressly provides otherwise, the estate tax liability of roughly $10 million is charged to the trust (and therefore, in effect, to H's children). As a result, H's children are left with $15 million from the remainder of the QTIP assets, while W's children receive $25 million tax-free. Note that this same result occurs if W makes no gift! Her applicable exclusion amount (including H's DSUE amount) would shelter her assets from estate tax, with the QTIP paying all of the marginal tax caused by the inclusion of its assets in W's estate.

c. *Possible solutions*:

i. As part of the estate planning process, the couple could enter into a post-nuptial agreement requiring the surviving spouse to sign a Will equitably apportioning any estate tax due. Of course, this complicates the planning, as each spouse will need separate counsel.

ii. Alternatively, the executor of the first decedent spouse could condition the QTIP/portability election on surviving spouse's waiver of estate tax recovery. However, this approach could expose the executor to competing claims of breach of fiduciary duty.

ii. *LEPA Trust* – an alternative type of marital trust is one sometimes referred to as a Life Estate Power of Appointment Trust ("LEPA Trust")

1. Under Code Section 2065(b)(5), the marital deduction is permitted for a trust where:

a. Spouse receives all income, and

b. Spouse has a power of appointment which may be exercised, *inter alia,* in favor of the spouse or the estate of the spouse.

2. This power of appointment ensures the inclusion of the trust assets in the surviving spouse's estate, which also results in a second set-up in basis.
3. The power of appointment also provides the surviving spouse with the flexibility to modify the estate plan at the second death.
4. Because the LEPA Trust is not dependent on a tax election, there is no need to file an estate tax return to make a QTIP election.
5. There are, however, some potential drawbacks to a LEPA Trust:
    a. No reverse QTIP election is available, so the first spouse's available GST exemption, which is not portable, may go unused.
    b. In addition, if the second spouse actually exercises the power of appointment, such exercise may defeat the first decedent's estate plan by directing the trust assets to beneficiaries other than those designated by the first spouse.
    c. In some states, the mere existence of an exercisable general power of appointment may make the trust subject to claims of creditors of the spouse/beneficiary.

iii. *QDOT Trust* – Finally, the planner must consider the use of a Qualified Domestic Trust (QDOT) where one member of the married couple is a non-US citizen.

1. Generally speaking, the marital deduction is not available for assets passing to a foreign spouse. The policy reason for this rule is clear – the United States is concerned the spouse will return to his or her native country with the assets, thereby depriving the government of potential estate tax revenue at the second death.
2. However, the marital deduction is available if the assets pass into a QDOT trust for the foreign spouse.
3. The requirements for such a trust are as follows:
    a. All net income must be distributed to the spouse (just as with other types of marital trusts)
    b. While the QDOT may allow principal distributions to the spouse, such distributions will result in an estate tax, computed as if the assets were passing to the foreign spouse from the decedent's estate.
    c. At least one trustee must be a U.S. citizen; and, as a general rule, a U.S. bank or trust company must serve as a trustee if the QDOT has assets exceeding $2 million.

c. <u>Recommendations</u>:

i. Use a marital trust for creditor protection. If the couple wants the surviving spouse to have control over and access to the assets, that can effectively be achieved with a trust by naming the spouse as the sole trustee, giving the trustee broad authority (within the HEMS standard) to make principal distributions, and specifying that the trustee may favor the spouse's current and future interests over those of the remainder beneficiaries.

1. The spouse or another party could also have the power to name an independent trustee, who would have the power to make distributions beyond those covered by "health, education, maintenance, and support". This flexibility could be particularly important if the spouse wishes to use marital trust assets to make gifts to family members, as distributions for gifting purposes may not fall within the HEMS standard.

ii. If all the children are from the same marriage, and if generation-skipping planning is unimportant (because the children are unlikely to have taxable estates), consider using a LEPA Trust – especially if the estate is unlikely to exceed the filing threshold for an estate tax return.
iii. However, if generation-skipping planning is important, and the utility of the decedent spouse's GST exemption should be preserved, a QTIP trust is preferable.
iv. If the two spouses have different children, use a QTIP Trust but designate an independent trustee (or, name an independent party as a special trustee for purposes of making any principal distributions). In addition, be certain to address the tax apportionment trap in some manner.

VII. Issues with Optimal Marital Deduction Formulas

a. Introduction: If the decision is made to utilize an optimal marital deduction formula to define the marital bequest and the credit shelter bequest, the planner has to elect between a number of possible formulas, each of which provide advantages and disadvantages. This portion of the manuscript explores the factors that govern the planner's decision on this point.
b. Overview of Marital Deduction Formulas: A marital deduction formula is governed by three factors: (i) whether it is a "pecuniary" or a "percentage" (or "fractional") formula; (ii) whether it is a front-end marital or a reverse marital formula; and (iii) whether, in funding the bequest, assets are valued at their value as determined for estate tax purposes (referred to below as "estate tax value") or at their value on the date or dates of distribution (referred to below as "distribution value").
c. Pecuniary v. Percentage Formulas: The most basic decision in devising a marital deduction formula is choosing between a pecuniary and a percentage (or fractional) formula. Some of the general characteristics of pecuniary and percentage formulas are described below:
    i. *Pecuniary Formula:* A pecuniary formula provides "a sum equal to ... " or "an amount equal to ... "
        1. The portion of the estate being defined by the pecuniary formula will be an exact dollar amount determined under the formula based on the federal estate tax return figures. This type of formula has the same effect as a specific bequest of a sum of money. Accordingly, a pecuniary formula generally "freezes" the bequest defined by the formula, so that any post-mortem appreciation or depreciation affects only the residuary bequest.
        2. In the absence of authority to distribute assets in kind, a pecuniary bequest must be satisfied in cash. Most practitioners specifically authorize the personal representative to satisfy a pecuniary bequest in cash or in kind.
            a. If distribution in kind is authorized, and absent direction in the governing instrument to the contrary, assets so distributed must be valued at their distribution values for purposes of satisfying the pecuniary bequest.
            b. The satisfaction of a pecuniary bequest in kind with assets having a value different from their basis will require the estate to recognize a gain or loss equal to the difference. This is similar to an individual who satisfies a legal obligation to pay a fixed dollar amount by delivering appreciated assets. Note

that this gain or loss will be long-term gain or loss, regardless of the date of distribution.

c. The recipient of the pecuniary bequest takes the assets distributed in kind at a basis equal to the assets' distribution values. This makes sense, because the estate will have recognized capital gain in the distribution.

3. If a right to receive income in respect of a decedent (IRD) is distributed in satisfaction of a pecuniary bequest, that distribution causes an acceleration of the income represented by the IRD item into the estate's tax year of distribution, resulting in a bunching of income and potentially higher income taxes as a result. IRD refers to those amounts to which a decedent was entitled as gross income, but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. Regs. § l.691(a)-1(b). Examples of IRD items include accrued income for a decedent who reports income on a cash receipts basis, employee benefit plans, Series E or EE U.S. Savings Bonds, and installment sale contracts.

a. **Example:** *D's entire net worth was comprised of undeveloped real property for which his basis was $1,000,000. Immediately prior to his unexpected death, D sells the land to a developer in return for a $20,000,000 installment promissory note. Assume that D was entitled to report his gain on the installment basis. D receives no payments before his death. D's Will contains a pecuniary marital formula, which defines the credit shelter bequest as a pecuniary amount. When that pecuniary credit shelter bequest is funded with a $12,920,000 interest in his promissory note, all of the gain on that $12,920,000 interest will be accelerated, resulting in a capital gain of $12,274,000 ($12,920,000 less a pro rata basis of $646,000).*

4. In order to minimize the recognition of capital gain or loss and the risk of significant appreciation or depreciation of estate assets, a pecuniary bequest generally should be funded as soon as possible during the estate administration.

5. Because of the simplicity and ease of application of a pecuniary formula, it probably is the most commonly used formula. As discussed below, however, the author believes it should not be blindly adopted and it should <u>never</u> be used in estates holding significant amounts of installment sales contracts or other IRD items, or closely-held businesses or other difficult-to-value assets.

ii. Percentage Formula: A percentage formula sets aside "that percentage of my residuary estate ... " The same result can be achieved with a fractional formula or a numerator/denominator formula. The fractional formula would set aside "that fraction of my residuary estate ... " The numerator/denominator formula is identical, and would define a fraction whereby the denominator is the residuary estate and the numerator is the portion to be funded (the marital bequest or the credit shelter bequest, as the case may be). For purposes of this manuscript, a reference to a percentage formula includes fractional and numerator/denominator formulas.

1. A percentage formula does not entitle the recipient to a fixed dollar amount, but rather a pro rata portion of the residuary estate.

2. There is no requirement that a percentage bequest be satisfied in cash.

a. In the absence of a contrary provision in the governing instrument, assets delivered in kind in satisfaction of a percentage formula are to be valued at their estate tax values.

b. Distributions in kind will not cause a recognition of gain or loss where a percentage formula is used. Accordingly, the recipient of the marital bequest or the credit shelter bequest, as the case may be, takes the assets distributed in kind at a basis equal to the basis in the hands of the personal representative (generally, the value as finally determined for federal estate tax purposes).

3. A percentage formula is generally more difficult to administer because it always requires revaluation of all assets at the time of distribution, but it avoids problems with installment sales contracts and other IRD items, and closely-held businesses and other difficult-to-value assets. Therefore, the author considers it the most conservative choice.

d. Front-End Marital v. Reverse Marital Formula: Marital deduction formulas are also distinguished by whether they define the marital bequest (a "front- end marital" formula) or whether they define the credit shelter bequest (a "reverse marital" formula). The author usually refers to this type of formula as a "front-end credit shelter" formula, but has used the "reverse marital" nomenclature throughout this manuscript since it appears to be used by most commentators.

i. *Front-End Marital Formula:* This type of formula defines the marital bequest (i.e., that portion of the estate qualifying for the marital deduction), with the credit shelter bequest (i.e., that portion of the estate not qualifying for the marital deduction) constituting the residuary of the estate. A front-end marital formula has been the standard for many years and is still preferred by most draftsmen.

1. With a pecuniary formula, a front-end marital bequest has the effect of "freezing" the marital bequest, with any post-mortem appreciation accruing to the benefit of the credit shelter bequest (subject to the requirements of Rev. Proc. 64-19, discussed below). In some estates, this may provide favorable estate tax planning opportunities.

ii. *Reverse Marital:* This formula carves out the credit shelter bequest, with the marital bequest constituting the residuary of the estate. It is most commonly employed in connection with the use of a pecuniary formula in a very large estate. In such a case, since the credit shelter bequest will be a relatively small portion of the estate, the gain/loss issues and other problems associated with a pecuniary bequest are minimized. The author's rule-of-thumb is to use a pecuniary reverse marital formula only if the credit shelter bequest is likely to be no more than 10% of the total estate.

1. With a pecuniary formula, a reverse marital bequest has the effect of "freezing" the credit shelter bequest, with any post- mortem appreciation accruing to the benefit of the marital bequest (subject to the requirements of Rev. Proc. 64-19, discussed below). Since this result generally is not desirable, a pecuniary reverse marital formula typically should be funded as soon as possible in the

estate administration to ensure that a pro rata part of all future appreciation accrues to the credit shelter portion of the estate.

e. Estate Tax Values v. Distribution Values: The third variable in devising a marital deduction formula is whether, for purposes of satisfying the marital bequest or credit shelter bequest, as the case may be, assets distributed in kind are to be valued at their estate tax values or at their distribution values.
    i. *Effect of Governing Instrument:* The governing instrument (the Will or the Trust Agreement, as the case may be) may specify whether assets are to be valued at their estate tax values or their distribution values.
        1. If a pecuniary formula is used, unless the governing instrument provides to the contrary, assets will be valued at their distribution values for purposes of satisfying the pecuniary bequest.
        2. In the absence of a contrary provision, if a percentage formula is used, assets will be valued at their estate tax values for purposes of satisfying the percentage bequest.
    ii. *Effect of Revenue Procedure 64-19:* In selecting a pecuniary or percentage formula and in determining whether to value assets at their estate tax values or their distribution values, the draftsman must consider the effect of Revenue Procedure 64-19, 1964-1 C.B. 682. Rev. Proc. 64-19 will apply whenever the marital deduction formula gives the personal representative the authority to select assets for distribution in kind at their estate tax values. The purpose of 64-19 is to prevent the personal representative from distributing in satisfaction of the marital bequest only those assets which have depreciated in value and distributing to the credit shelter bequest those assets which have appreciated in value (a sort of post-mortem "estate freeze").
        1. In those situations, Rev. Proc. 64-19 states, as a requirement for the qualification of the marital deduction, that the personal representative must be required by the governing instrument or by local law to do one of two things:
            a. To distribute assets having a fair market value on the date of distribution at least as great as the dollar amount determined on the death tax return to be the marital deduction; or
            b. To distribute assets in satisfaction of the marital bequest which are "fairly representative" of the appreciation or depreciation of all assets in the residuary estate and available for distribution. While this requirement might not force the personal representative to distribute a pro rata share of each asset held in the residuary estate to both the marital bequest and the credit shelter bequest, that is the only absolutely safe course of action.
        2. N.C. Gen. Stat. § 28A-22-5 incorporates the "fairly representative" requirement into State law. N.C. Gen. Stat. § 28A-22-6 authorizes the personal representative to enter into agreements with the IRS to provide for the satisfaction of this "fairly representative" requirement.
        3. If the document lists specific properties to be used in satisfaction of the marital bequest or credit shelter bequest, as the case may be, Rev. Proc. 64-19 is inapplicable since the personal representative no

longer has the authority to pick and choose those assets which have depreciated in value.

f. Comparison of Different Marital Deduction Formulas: Different combinations of the three factors described above result in six different possible marital deduction formulas. These alternatives, and the relative advantages and disadvantages of each, are summarized below:

i. Pecuniary Front-End Marital Formula, Using Estate Tax Values:

1. Description: This formula defines the marital bequest as a pecuniary amount (with the credit shelter bequest constituting the residuary), but specifies that assets distributed in kind must be distributed at their estate tax values. This specific direction overrides the general requirement of a pecuniary formula that assets be distributed at their distribution values. This type of formula is sometimes referred to as a "fairly representative pecuniary" formula.
2. Sample Language: "The 'Marital Bequest' shall be a sum which, together with the total of any other amounts included in my gross estate and passing to my spouse, either under the provisions of this Will or in any other manner as to qualify for the marital deduction, shall equal the maximum allowable marital deduction; provided that this sum shall be reduced by an amount, if any, needed to increase my taxable estate to the largest amount which, after allowing for the unified credit against the federal estate tax and any other allowable credits or exclusions (but only to the extent that the use of the credit for state death taxes does not increase the death tax payable to any state), will result in no federal estate tax being imposed on my estate ... Notwithstanding any provision herein to the contrary, I specifically grant to my Executor the power to make distributions (including the satisfaction of any pecuniary bequests) in cash or in specific property, real or personal, or an undivided interest therein, or partly in cash and partly in such property, and in installments or all at one time. Assets distributed in kind shall be valued at their values as finally determined for federal estate tax purposes; provided that the assets distributed shall be selected in such a manner that they have an aggregate fair market value fairly representative of the appreciation or depreciation in the value to the date or dates of distribution of all assets then available for distribution."
3. Allocation of Appreciation/Depreciation: Because of the applicability of Rev. Proc. 64-19, both the marital bequest and the credit shelter bequest will share ratably in post-mortem appreciation and depreciation. Functionally, this formula may operate similarly to a percentage formula.
    a. **Example:** *D has an estate valued at $25,840,000 at date of death. This estate is comprised one-half of stock in corporation A and one- half of stock in corporation B. By the date of distribution, stock A has increased in value to $15,920,000, and stock B has fallen in value to $9,920,000. Because of Rev. Proc. 64-19, the marital bequest and the credit shelter bequest will each receive one-half of stock A and one-half of stock B, so that each bequest will be funded at a value of $12,920,000.*

4. Recognition of Gain or Loss: No gain or loss is recognized on the distribution of assets in kind, since assets are being distributed at a value equal to their basis.
5. Revenue Procedure 64-19: Rev. Proc. 64-19 applies to this formula, with all of the consequences discussed above.
6. Revaluation of Assets: If the marital bequest and the credit shelter bequest are funded with a pro rata share of each and every asset in the estate, no revaluation of assets is required. Otherwise, in order to ensure compliance with Rev. Proc. 64-19, all assets must be revalued at the time of funding of the marital share.
7. Acceleration of IRD: The distribution of an IRD item in satisfaction of a pecuniary marital bequest will cause the acceleration of the income represented by that IRD item (without generating any cash for the payment of the income tax). Furthermore, payment of the income tax by the estate will have the effect of reducing the credit shelter bequest. If the IRD item is allocated to the surviving spouse or to a marital deduction trust by specific bequest, however, no acceleration of income will occur, and the income tax paid by the surviving spouse surviving will have the effect of reducing the surviving spouse's subsequent taxable estate.

ii. Pecuniary Front-End Marital Formula, Using Distribution Values:

1. Description: This formula defines the marital bequest as a pecuniary amount (with the credit shelter bequest being the residuary), and is either silent as to the valuation of assets distributed in kind or specifies that they are to be valued at their distribution values (which is the default requirement with a pecuniary bequest). This type of formula is sometimes referred to as a "true worth pecuniary" formula.
2. Sample Language: "The 'Marital Bequest' shall be a sum which, together with the total of any other amounts included in my gross estate and passing to my spouse, either under the provisions of this Will or in any other manner as to qualify for the marital deduction, shall equal the maximum allowable marital deduction; provided that this sum shall be reduced by an amount, if any, needed to increase my taxable estate to the largest amount which, after allowing for the unified credit against the federal estate tax and any other allowable credits or exclusions (but only to the extent that the use of the credit for state death taxes does not increase the death tax payable to any state), will result in no federal estate tax being imposed on my estate ... Notwithstanding any provision herein to the contrary, I specifically grant to my Executor the power to make distributions (including the satisfaction of any pecuniary bequests) in cash or in specific property, real or personal, or an undivided interest therein, or partly in cash and partly in such property, and in installments or all at one time. Assets distributed in kind shall be valued at their date or dates of distribution values."
3. Allocation of Appreciation/Depreciation: This formula "freezes" the marital bequest at date of death values, so that any post-mortem appreciation or depreciation affects only the credit shelter bequest. In an appreciating estate, this fact may have positive tax implications because it "overfunds" the credit shelter bequest; in a depreciating

estate, however, it may cause underfunding of the credit shelter bequest. This latter risk is particularly relevant where an estate is largely comprised of a closely-held business.

a. **Example 1:** *D's estate consists of $25,840,000, all of which is stock in D's closely-held corporation. As of the date of funding, the stock has risen in value to $30,840,000. Under this formula, the marital bequest would receive $12,920,000, and the credit shelter bequest would receive $17,920,000.*

b. **Example 2:** *Same facts as Example 1 above, except that between date of death and date of distribution, the stock falls in value by 50% to $12,920,000. Under this formula, the marital bequest would receive $12,920,000 and the credit shelter bequest would receive nothing.*

4. Recognition of Gain or Loss: The distribution of assets in kind under this formula will cause a recognition of capital gain or loss if those assets have a distribution value different from their basis.
5. Revenue Procedure 64-19: Rev. Proc. 64-19 has no application to this formula, since the personal representative does not have the discretion to distribute assets at their estate tax values.
6. Revaluation of Assets: Those assets being distributed in kind to satisfy the marital bequest will need to be revalued as of date of distribution.
7. Acceleration of IRD: The distribution of an IRD item in satisfaction of a pecuniary marital bequest will cause the acceleration of the income represented by that IRD item (without generating any cash for the payment of the income tax). Furthermore, payment of the income tax by the estate will have the effect of reducing the credit shelter bequest. If the IRD item is allocated to the surviving spouse or to a marital deduction trust by specific bequest, however, no acceleration of income will occur, and the income tax paid by the surviving spouse surviving will have the effect of reducing the surviving spouse's subsequent taxable estate.

iii. Pecuniary Reverse Marital Formula, Using Estate Tax Values:

1. Description: This type of formula defines the credit shelter bequest as a pecuniary amount, but specifies that assets distributed in kind must be distributed at their estate tax values. This specific direction overrides the general requirement of a pecuniary fo1mula that assets be distributed at distribution values. This type of formula is sometimes referred to as a "fairly representative reverse pecuniary" formula.
2. Sample Language: "The 'Credit Shelter Bequest' shall be a sum equal to the largest amount, if any, that can pass free of federal estate tax under this Article by reason of the unified credit against the federal estate tax, the state death tax credit, and any other allowable credits or exclusions (but only to the extent that the use of the credit for state death taxes does not increase the death tax payable to any state) ... Notwithstanding any provision herein to the contrary, I specifically grant to my Executor the power to make distributions (including the satisfaction of any pecuniary bequests) in cash or in specific property, real or personal, or an undivided interest therein, or partly in cash and partly in such property, and in installments or all at

one time. Assets distributed in kind shall be valued at their values as finally determined for federal estate tax purposes; provided that the assets distributed shall be selected in such a manner that they have an aggregate fair market value fairly representative of the appreciation or depreciation in the value to the date or dates of distribution of all assets then available for distribution."

3. Allocation of Appreciation/Depreciation: Because of the applicability of Rev. Proc. 64-19, both the marital bequest and the credit shelter bequest will share ratably in post-mortem appreciation and depreciation. Functionally, this formula may operate similarly to a percentage formula. *See* Example in Section VII.f.i.3.a above.
4. Recognition of Gain or Loss: No gain or loss is recognized on the distribution of assets in kind, since assets are being distributed at a value equal to their basis.
5. Revenue Procedure 64-19: Rev. Proc. 64-19 applies to this formula with all of the consequences discussed above.
6. Revaluation of Assets: If the marital bequest and the credit shelter bequest are funded with a pro rata share of each and every asset in the estate, no revaluation of assets is required. Otherwise, in order to ensure compliance with Rev. Proc. 64-19, all assets must be revalued at the time of funding of the credit shelter share.
7. Acceleration of IRD: The distribution of an IRD item in satisfaction of a pecuniary credit shelter bequest will cause the acceleration of the income represented by that IRD item (without generating any cash for the payment of the income tax). One potentially beneficial aspect of this income tax liability is that payment of the tax by the estate will have the effect of reducing the marital bequest, thereby reducing the surviving spouse's taxable estate.

iv. Pecuniary Reverse Marital Formula, Using Distribution Values:

1. Description: This formula defines the credit shelter bequest as a pecuniary amount (with the marital bequest being the residuary), and is either silent as to the valuation of assets distributed in kind or specifies that they are to be valued at their distribution values (which is the default requirement with a pecuniary bequest). This type of formula is sometimes referred to as a "true worth reverse pecuniary" formula.
2. Sample Language: "The 'Credit Shelter Bequest' shall be a sum equal to the largest amount, if any, that can pass free of federal estate tax under this Article by reason of the unified credit against the federal estate tax, the state death tax credit and any other allowable credits or exclusions (but only to the extent that the use of the credit for state death taxes does not increase the death tax payable to any state) ... Notwithstanding any provision herein to the contrary, I specifically grant to my Executor the power to make distributions (including the satisfaction of any pecuniary bequests) in cash or in specific property, real or personal, or an undivided interest therein, or partly in cash and partly in such property, and in installments or all at one time. Assets distributed in kind shall be valued at their date or dates of distribution values."
3. Allocation of Appreciation/Depreciation: This formula "freezes" the credit shelter bequest at date of death values, so that any post- mortem

appreciation or depreciation affects only the marital bequest. In an appreciating estate, this fact may have negative tax implications because it "overfunds" the marital bequest; in a depreciating estate, however, it may have positive tax consequences because it will cause underfunding of the marital bequest.

a. **Example 1:** *D's estate consists of $25,840,000, all of which is stock in D's closely-held corporation. As of the date of funding, the stock has risen in value to $30,840,000. Under this formula, the credit shelter bequest would receive $12,920,000, and the marital bequest would receive $17,920,000.*

b. **Example 2:** *Same facts as Example I above, except that between date of death and date of distribution, the stock falls in value by 50% to $12,920,000. Under this formula, the credit shelter bequest would receive $12,920,000 and the marital bequest would receive nothing.*

4. Recognition of Gain or Loss: The satisfaction of the pecuniary bequest with assets having a value different from their basis will require the estate to recognize a gain or loss.
5. Revenue Procedure 64-19: Notwithstanding the fact that in a depreciating estate the marital bequest could be less than the amount taken as a deduction on the estate tax return, Rev. Proc. 64-19 has no application to this formula. *See* Rev. Rul. 90-3, 1990-1 C.B. 174.
6. Revaluation of Assets: Revaluation of assets will be required, but only those assets being distributed in satisfaction of the pecuniary bequest need to be revalued.
7. Acceleration of IRD: The distribution of an IRD item in satisfaction of a pecuniary credit shelter bequest will cause the acceleration of the income represented by that IRD item (without generating any cash for the payment of the income tax). One potentially beneficial aspect of this income tax liability is that payment of the tax by the estate will have the effect of reducing the marital bequest, thereby reducing the surviving spouse's taxable estate.

v. Percentage Front-End Marital Formula, Using Estate Tax Values:

1. Description: This formula defines the marital bequest as a percentage of the residuary (with the credit shelter bequest constituting the remainder of the residuary), and it is either silent as to the valuation of assets distributed in kind or it specifies that assets be valued at their estate tax values (which is the default requirement for a percentage formula). It is identical in effect to a percentage reverse marital formula.
2. Sample Language: "The 'Marital Bequest' shall be that percentage of my residuary estate which together with the total of any other amounts allowed as a marital deduction in the federal estate tax proceeding relating to my estate shall equal the maximum allowable marital deduction as finally determined in such proceeding; provided that the maximum allowable marital deduction shall be reduced by an amount, if any, needed to increase my taxable estate to the largest amount which, after allowing for the unified credit against the federal estate tax and any other allowable credits or exclusions (but only to

the extent that the use of the credit for state death taxes does not increase the death tax payable to any state), will result in no federal estate tax being imposed on my estate ... Notwithstanding any provision herein to the contrary, I specifically grant to my Executor the power to make distributions (including the satisfaction of any pecuniary bequests) in cash or in specific property, real or personal, or an undivided interest therein, or partly in cash and partly in such property, and in installments or all at one time. Assets distributed in kind shall be valued at their values as finally determined for federal estate tax purposes; provided that the assets distributed shall be selected in such a manner that they have an aggregate fair market value fairly representative of the appreciation or depreciation in the value to the date or dates of distribution of all assets then available for distribution."

3. Allocation of Appreciation/Depreciation: Because of the applicability of Rev. Proc. 64-19, both the marital bequest and the credit shelter bequest will share ratably in post-mortem appreciation and depreciation.
    a. **Example 1:** *D's estate consists of $25,840,000, all of which is stock in D's closely-held corporation. As of the date of funding, the stock has risen in value to $30,840,000. Under this formula, the marital bequest would receive $15,420,000, and the credit shelter bequest would receive $15,420,000.*
    b. **Example 2**: *Same facts as Example I above, except that between date of death and date of distribution, the stock falls in value by 50% to $12,920,000. Under this formula, the marital bequest would receive $6,460,000 and the credit shelter bequest would receive $6,460,000.*
4. Recognition of Gain or Loss: No gain or loss will be recognized by the estate in the event of distributions in kind.
5. Revenue Procedure 64-19: Rev. Proc. 64-19 applies to this formula, with all the consequences discussed above.
6. Revaluation of Assets: If the marital bequest and the credit shelter bequest are funded with a pro rata share of each and every asset in the estate, no revaluation of assets is required. Otherwise, in order to ensure compliance with Rev. Proc. 64-19, all assets must be revalued at the time of funding of the marital bequest and the credit shelter bequest.
7. Acceleration of IRD: There is no acceleration of gain on IRD items.

vi. Percentage Front-End Marital Formula, Using Distribution Values:

1. Description: This formula defines the marital bequest as a percentage of the residuary (with the credit shelter bequest constituting the remainder of the residuary), and it specifies that assets distributed in kind are to be valued at their distribution values, thereby overriding the usual requirement that a percentage formula use estate tax values. This type of formula is sometimes referred to as a "pick-and-choose fractional share" formula.
2. Sample Language: "The 'Marital Bequest' shall be that percentage of my residuary estate which together with the total of any other amounts allowed as a marital deduction in the federal estate tax proceeding relating to my estate shall equal the maximum allowable

marital deduction as finally determined in such proceeding; provided that the maximum allowable marital deduction shall be reduced by an amount, if any, needed to increase my taxable estate to the largest amount which, after allowing for the unified credit against the federal estate tax and any other allowable credits or exclusions (but only to the extent that the use of the credit for state death taxes does not increase the death tax payable to any state), will result in no federal estate tax being imposed on my estate ...Notwithstanding any provision herein to the contrary, I specifically grant to my Executor the power to make distributions (including the satisfaction of any pecuniary bequests) in cash or in specific property, real or personal, or an undivided interest therein, or partly in cash and partly in such property, and in installments or all at one time. Assets distributed in kind shall be valued at their date or dates of distribution values."

3. Allocation of Appreciation/Depreciation: Both the marital bequest and the credit shelter bequest will share ratably in post-mortem appreciation and depreciation.
4. Recognition of Gain or Loss: No gain or loss is recognized in the event of distributions in kind.
5. Revenue Procedure 64-19: This formula avoids the application of Rev. Proc. 64-19, since the personal representative does not have the discretion to distribute assets at their estate tax values.
6. Revaluation of Assets: Revaluation at the time of distribution is required for all assets in order to reapply the percentage as of the date of distribution.
7. Acceleration of IRD: Gain on IRD items is not accelerated.

vii. Possible Use of Post-Mortem Power to Select Marital Deduction Formula:

1. In PLR 9143008, the IRS approved a marital deduction formula which allowed the personal representative to choose among: (i) a pecuniary front- end marital formula, using distribution values; (ii) a pecuniary reverse marital formula, using distribution values; and (iii) a percentage front-end marital formula. The marital deduction formula required the personal representative to make the election before the due date for filing the estate tax return. The IRS concluded that this formula does not give the fiduciary the power to control the amount passing under the marital bequest, nor did it affect the "indefeasible character" of the marital bequest.
2. The IRS apparently failed to consider that the selection of a percentage or a pecuniary bequest will alter the allocation between the marital bequest and the credit shelter bequest of any appreciation or depreciation generated during the course of administration. Although this choice would not affect the amount of the marital bequest reported on the estate tax return, it would affect the funds actually allocated to the marital bequest, because a pecuniary front-end marital formula using distribution values would preclude the marital bequest from sharing in any appreciation or depreciation.
3. The IRS's approval of this marital deduction formula presents a possible solution to the fact that the draftsman never knows with certainty what the client's assets will be at the time of death. However, given that a private letter ruling lacks precedential

value, it would appear somewhat risky to adopt this strategy without further support in the form of judicial rulings or IRS regulations approving this method. Furthermore, such a formula adds to the complexity of estate administration and is likely to result in significant tax savings only in large estates.

g. Conclusions and Recommendations:

i. It appears that most practitioners today use a pecuniary marital formula, primarily to avoid the need for a revaluation of assets each time a distribution is made. In particular, many such practitioners object to the fact that a percentage formula requires a revaluation each time income is distributed if it is being distributed pro rata to different beneficiaries. This objection is a valid one if there are likely to be frequent distributions of income and if more than one beneficiary is to receive income during the course of the estate administration. However, it should be noted that many draftsmen provide that all income in the estate, not just a pro rata share, is to be paid to the spouse, thereby effectively removing the basis for this particular objection.

ii. Despite the fact that it requires the revaluation of assets, a percentage formula minimizes the risk of an unanticipated skewing of the estate shares dues to significant post-mortem appreciation or depreciation in the estate assets, and also minimizes the risk of adverse income tax consequences, such as the recognition of gain or loss or the acceleration of IRD items. This fact also makes a percentage formula the "fairest" formula, an important consideration where the marital bequest and the credit shelter bequest will pass to different parties (e.g., in a second marriage situation, where the spouse gets the marital bequest and the children from the first marriage get the credit shelter bequest). Moreover, since it is difficult to know exactly what the client's situation will be at the time of death, a percentage formula is the safest and most conservative choice. Furthermore, a percentage formula using distribution values avoids the complications of Rev. Proc. 64-19. Accordingly, a percentage front-end marital formula, using distribution values, is the author's choice except in unusual circumstances.

iii. A pecuniary front-end marital bequest, using distribution values, presents an opportunity to shift post-mortem appreciation into the credit shelter bequest. However, because of the risks involved with a pecuniary formula, it should be used only where the draftsman is likely to maintain close contact with the client, so the draftsman will become aware of any asset holdings (such as large amounts of IRD items) that might make the use of such a formula inadvisable.

iv. In an estate of more than $129,200,000, a pecuniary reverse marital formula may be used effectively. Such a formula is easy to apply, and in a larger estate the adverse income tax consequences sometimes associated with a pecuniary formula will be minimized (or avoided altogether) when only the credit shelter bequest (10% or less of the residuary estate) will be funded as a pecuniary bequest.