Estates and Trusts Committee - Marital Deduction Planning in Times of Uncertainty

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Marital Deduction Planning Outline

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Planning In the Wake of Death Tax Reform

With newfound "certainty" in 2013 we appear to be firmly settled in the same flat rate estate and generation-skipping transfer tax environment that we entered in January 2006 when the applicable exclusion amount became \$2.0 million. When that occurred several hoary old estate planning notions became bankrupt. For example, as shown in note 9 at page 20, estate freezing became yesterday's game, although several closely related planning opportunities remain (such as payment of tax early with dollars that are fixed in value, to shelter the growth in dollars that are not frozen in value, as illustrated in the half hot example at page 16).

Today the gift tax basic exclusion amount is \$5.25 million (\$5 million indexed after 2011 for inflation), portability is a permanent reality, the §2011 state death tax credit is gone and the §2058 deduction for state death tax enacted in its place needs to be addressed in formula marital deduction provisions. With luck the §2057 Qualified Family Owned Business Interest deduction also is gone forever. I still fear that a grand bargain may repeal the wealth transfer taxes so that carryover of basis will become a reality, but the good news is that §1040 would limit pecuniary funding gain realization to postmortem appreciation, and debt in excess of basis is disregarded, so marital deduction funding need not adapt even if that worst fear did materialize.

After 2012 the biggest or most difficult marital deduction planning issue may be the balkanization in state death tax law, which may be a critical issue for some clients. Indeed, the patchwork aspect of planning for this imponderable makes it nearly impossible to plan for, other than by being flexible — to adapt to whatever the state death tax environment is when the first spouse dies. As we will see, portability may be the salvation for this issue.

Planning in the political theatre over the last several years was difficult and may now be easier, but some of the following items may still be worth considering in marital deduction planning and drafting today:

1. Formula marital bequests send an unpredictable amount to a nonmarital trust. Even if the client used the applicable exclusion amount in 2012, the nonmarital trust will grow by the amount of the inflation index increase every year after execution of the plan.

- Notwithstanding the relative predictability of the applicable exclusion amount (since 2012), personally I don't think that wealth transfer tax reform is over – at least I'm not confident about stability – but I also think that there are better ways to address uncertainty than to reconsider your marital vs. nonmarital bequest division. I also do not favor that the nonmarital be limited in size by some form of cap.
- I suspect that plans leaving all to the surviving spouse (S) and depending on disclaimer of an appropriate and acceptable amount will invite failure — there are just too many ways for disclaimers to go wrong. See, e.g., Estate of Engleman v. Commissioner, 121 T.C. 54 (2003) (S's exercise of power to appoint marital trust during two month overlife precluded otherwise qualified disclaimer by S's personal representative intended to fund nonmarital trust). And PLR 200442027 "cascading disclaimer" planning impresses me as too complex and too unreliable, also.
- Plans that rely on partial QTIP and portability elections to engineer the tax results may put the personal representative at risk (and some observers worry that S may make a gift if, acting as executor, making a partial QTIP election causes nonelected property to flip into a nonmarital trust as to which S's enjoyment is different). Nevertheless, on balance I sense that partial QTIP planning is a more reliable avenue than disclaimer planning.

2. If the family is not friendly, and if there is a desire to shelter as much wealth as possible in a nonmarital trust that favors a broader class of nonspouse beneficiaries, then plans that leave less to S in noncommunity property jurisdictions will invite more elective share claims

by surviving spouses. Estate planners in these situations ought to consider how to protect the plan against defeat by the forced share election. In that regard, consult Pennell, Cline, & Turnipseed, *Spouse's Elective Share*, 841 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2012), and Pennell, *Minimizing the Surviving Spouse's Elective Share*, 32 U. MIAMI INST. EST. PLAN. ¶900 (1998). There is plenty that can be done to effectively disfranchise a surviving spouse's elective share. In summary form here is a list of options to consider (and, in the process, beware of conflicts of interest by purporting to represent both spouses):

- Execute a postnuptial agreement — work it out now
- Make completed inter vivos gifts — and outlive any pull back rule
- Change domicile — to a more hospitable jurisdiction (e.g., AZ, GA, NM, NV, or TX)
- Invest in Treasury obligations — to rely on Free v. Bland
- Take advantage of state law that inadequately augments the probate estate
- Create a trust that does not retain too much enjoyment or control under state law
- Satisfy the elective share with assets the client doesn't want to preserve for others
- Embrace the UPC — if the marriage is short term
- Embrace the UPC— if S is incompetent

3. In most cases my strongest recommendation is to employ traditional marital planning (with your state specific variations) and minimize the consequences of shifting a larger amount (or, after 2012 year end gifting, potentially a much smaller amount) to the nonmarital trust by making the marital and nonmarital trusts as nearly identical as possible. That is, my *default* recommendation (all other things being equal) is (to the extent the client is willing and S is able) to begin with a template or recommended plan that would provide:

- a delayed power of withdrawal in the QTIP trust and a nongeneral inter vivos power to appoint the nonmarital trust,
- S as trustee of each trust,
- mandate annual distribution to S of all income from both trusts, and
- provide for no other beneficiaries of either trust during S's overlife.

The rationale for various of these recommendations will become more clear throughout this material. For example:

- The withdrawal right in the QTIP trust permits S to incur the lowest taxes possible by making inter vivos gifts.
- Each alternative serves to make S less likely to reject the plan in favor of an elective share in noncommunity property states. I would want to minimize the potential for conflict, avoid the use of disclaimers as an affirmative planning device, and similarly avoid the potential for partial QTIP elections to generate gift tax issues.
- Mandatory income and no other beneficiaries serves a §2013 credit planning objective, which also makes adding a five or five withdrawal power for S in the nonmarital trust wise planning.
- It also may avoid the need to comply with the separate share regulations, discussed at page 30.
- It also ought to permit a state-level QTIP partial election on the nonmarital trust if avoiding all state death tax until S's death is desirable, the state has decoupled from the federal regime, and the state exclusion amount will not allow a credit shelter of the same amount as the federal. In such a case two options exist – either qualify more for the federal marital deduction and elect portability for D's unused federal exclusion amount,

or pay state death tax and shelter the full federal exclusion amount. Many clients will prefer to pay no tax and rely on portability of the unused federal exclusion.

- If the income generated by such a plan runs the risk of overinflating S's gross estate at death it may be possible to configure the investment portfolio in the nonmarital trust to favor growth over income and eschew principal and income act adjustments that favor the income beneficiary.

4. Deferral of all tax using the marital deduction probably is wise if S is likely to die when the estate tax is in effect. If S is likely to die within the §2013 previously taxed property credit window, however, then that opportunity should be factored into the marital plan, which requires payment of some tax in the estate of the first to die (D), as discussed at page 16. To be so nimble probably requires a plan that permits partial QTIP elections, including if S dies shortly after D. The only likely change dictated in many estate plans now outstanding is mandatory income and exclusive benefit to S in a nonmarital trust. This is what many clients want anyway, and it will reduce conflict in all events. If the nonmarital and marital trusts can be made more uniform in their terms it won't matter where the wealth settles — marital or nonmarital – and the assumption is that S will not care.

5. The need for reverse QTIPs continues, especially because the applicable exclusion amount may have been used on inter vivos gifts in 2012 that did not consume GST exemption. Which increases the possibility that more of the inflation-indexed GST exemption will be available at death than the amount sheltered in a nonmarital trust. Add the notion of nonprobate property not passing to S or not qualifying for the marital deduction, and nondeductible charges that reduce the typical nonmarital share, and the continued need for reverse QTIP elections seems pretty realistic.

6. Gifts to a dying spouse are not needed to "fill up" that spouse's estate *if* portability (which now is a permanent feature of the federal law) is an acceptable option. If not, however, or if you encourage your clients *not* to rely on portability, then planning to shelter both spouses' applicable exclusion amounts may be important, potentially requiring equalization inter vivos. The same planning may be viable for both purposes, using an inter vivos QTIP that denies S control or, if that is not an issue, using planning similar to a joint settlor revocable trust. See page 26. Not many clients will actually embrace that planning, however. In addition, many of the reasons expressed just after portability was enacted, for not relying on portability, simply are not realistic, as expressed below. Portability therefore is the only viable way that D's unused exclusion amount will be salvaged, in most cases. Thus, what follows is a discussion of portability – first a list of pros and cons as articulated during the early days of portability, and then a discussion of the proposed and temporary portability regulations.

Portability

When first enacted the prevailing wisdom among estate planners – particularly those who represented the high and ultra high net worth clients – was that portability was not a useful concept. Many planners for the middle rich have reached a different conclusion. Among the pros and cons to consider are the following observations:

1. The DSUE amount is not indexed for inflation, whereas amounts left in a nonmarital trust can grow during S's overlife and the full appreciated amount will avoid estate tax when S dies. Thus, with a 100% marital deduction and portability the appreciation will be subject to estate tax when S dies, whereas it could avoid tax if it was sheltered from inclusion in S's gross estate because it was in a nonmarital trust.

Counterbalancing this factor is the prospect for depreciation in value. Both appreciation and depreciation as a factor are illustrated beginning at page 13. In addition, inclusion in S's gross estate will yield a new basis at S's death, which eliminates any appreciation for capital gain income tax purposes. That would generate a tax saving (albeit likely at a lower rate than the estate tax rate, and only if or when that appreciation was recognized for income tax purposes). It also may be avoidable if D successfully engages in planning that causes inclusion of nonmarital trust appreciated assets in S's estate at death (to the extent doing so will not incur estate tax because S's estate is below S's applicable exclusion amount). Drafting to accomplish that objective is not easy, however, especially if denying control to S is critical to D.

2. The GST exemption is not transportable to S. Thus, in any generation-skipping situation the choice is to allocate D's GST exemption to a nonmarital trust, or to make a reverse-QTIP election. The latter may not be as efficient because income must be distributed currently in the QTIP marital deduction trust, which means that the GST exemption cannot be leveraged with income earned and accumulated in a nonmarital trust during S's overlife. D also may not favor a QTIP marital deduction trust, or that trust may be too small to fully absorb all of D's GST exemption. But GST exemption allocation, income accumulation, and dynasty trust planning may be of slight concern in smaller situations in which portability is most desirable.

3. Portability of the DSUE amount is a federal tax concept that may not be matched with a similar concept for state wealth transfer tax purposes. This means that any state level benefits of credit shelter planning could be lost. Portability is not an all-or-nothing option, however, so sheltering only the state tax exclusion amount and electing portability for the rest of D's estate may be appealing to clients who wish to defer all state death tax until S's death. It also is easier than the approach illustrated in PLR 201131011, in which the taxpayer relied on Rev. Proc. 2001-38 to "undo" a federal QTIP election that was not needed for federal estate tax purposes but that was required because the state death tax exclusion amount was less than the federal exclusion (and, apparently, state law did not allow a different federal and state QTIP election). So the estate was forced to make a federal QTIP election over the nonmarital trust. The PLR allowed the executor to subsequently "retract" the federal election, presumably at some time after the state death tax marital deduction had been allowed and the state statute of limitation had run.

4. D may wish to make the nonmarital trust available to beneficiaries other than S during S's overlife. This sharing cannot be assured if D elects portability and qualifies property for the marital deduction in reliance on S making that wealth available to those beneficiaries. On the other hand, to the extent S *does* make that wealth available, the annual and ed/med exclusions make lifetime transfers by S more efficient. These notions are discussed beginning at page 18.

5. Election of portability requires the filing of an estate tax return for D's estate, whereas a smaller than $5,250,000 estate would not need to file a federal return at all otherwise (unless that smaller estate must prepare and file a Form 706 because of state death tax requirements and a lower exclusion amount). Moreover, that return remains open to audit until after S's death (but only for purposes of challenging the DSUE amount available to S). This might mean that valuation or other sensitive issues in D's estate remain subject to government scrutiny for potentially much longer. Quaere whether it will be more expensive to file a Form 706 for D's estate, or to maintain a nonmarital trust for the duration of S's overlife. To minimize the expense of filing a Form 706 in an otherwise nontaxable estate, Temp. Treas. Reg. §20.2010-2T(a)(7)(ii)(A) establishes a good faith and due diligence standard by which the estate may estimate the value of property as falling within a specified range (options that

are provided on the draft Form 706 for 2012 decedents). See the discussion of this portability regulation flexibility, beginning at page 6.

6. Portability requires an election by D's executor that could affect the beneficial interests of various beneficiaries under D's overall plan (depending on how formula provisions are structured and the terms of various trusts that would hold property that is subject to the election). Indeed, some planners worry that it might generate gift tax concerns if S is the executor who alters S's entitlement. Any displacement of benefits could subject the executor to liability to disaffected beneficiaries, unless the document indemnifies the personal representative from liability.

7. The portability election could impact D's estate differently, based on the nature of D's includible assets. For example, if a large portion of the estate is retirement benefits, the beneficiary designation and the flexibility in naming beneficiaries could play a role in deciding whether to shelter the benefits in a nonmarital trust or to name S as beneficiary directly, rely on portability, and a rollover election by S to minimize income taxation.

8. Portability planning may affect whether either D or S's estate will meet percentage ownership and other requirements under provisions such as §§303, 2032, 2032A, and 6166.

9. Portability is a §2010 unified credit concept that applies only if D and S are subject to estate tax under §2001. Thus, portability is a nonstarter if either D or S is a nonresident noncitizen of the United States and their estate is taxable under §2101 instead of §2001, because §2102(b)(1) was not amended to provide a DSUE amount.

10. Portability may be "lost" if S remarries after D's death and survives that new spouse, because portability applies only for the unused exclusion amount of a decedent's last post-2010 predeceased spouse. It is not very likely that either D or S will remarry a new spouse who also will die first and use all of their unified credit, so that portability from that subsequent spouse will be frustrated. This is because the vast majority of widows do not remarry, and widowers who remarry usually select a younger, less wealthy wife. This will necessarily require individuated and somewhat subjective evaluation, however. In addition, the portability regulations make several concessions that make remarriage much less worrisome, as noted beginning at page 8.

Treasury issued proposed and temporary regulations (meaning that they currently apply, with a June 15, 2015 expiration date) that clarify the concept of the §2010(c)(2)(B) and 2010(c)(4) deceased spousal unused exclusion (DSUE) amount and the §2010(c)(5)(A) portability election. Released on June 15, 2012, which was the last possible day for them to be applied retroactively, many positions taken are taxpayer-favorable, making retroactivity a good deed. Generous in unexpected ways, these regulations address the following important concepts (among many others):

1. Because nontaxable estates are not otherwise required to file an estate tax return, Temp. Treas. Reg. §20.2010-2T(a)(2) continues the position previously stated in Notice 2011-82, 2011-1 C.B. 516, that merely filing an estate tax Form 706 for a nontaxable estate constitutes the requisite §2010(c)(5)(A) portability election. And, because nontaxable estates are not otherwise required to file a return, Temp. Treas. Reg. §20.2010-2T(a)(1) declares that the return filing due date (including extensions) for taxable estates applies for these purposes. Finally, Temp. Treas. Reg. §20.2010-2T(a)(4) makes the election by an appointed executor revocable until the return filing due date passes. Thus, the normal 15 month (nine months plus an automatic six month extension, if sought) filing deadline applies, during which an executor can have a change of mind about whether to make the election. The last timely filed return is the one that counts.

2. Notwithstanding that an election normally is not irrevocable until after the filing deadline, Temp. Treas. Reg. §§20.2010-3T(c)(1) and 25.2505-2T(d)(1) provide that the election relates back to the date of the decedent's death. This means that the surviving spouse can use that DSUE amount before the decedent's return is filed, and before the DSUE amount is known with any certainty. Indeed, the amount is subject to audit at any time until the statute of limitation runs out on the surviving spouse's own estate tax return. If transfers of the surviving spouse's wealth will be taxable in any event, then not knowing the ultimate amount of the DSUE should not dissuade transfers that otherwise make sense, and the relation back nature of the election allows the surviving spouse to make use of the portable exclusion long before any administrative or judicial wrangling is completed.

3. A curious question – unanswered by these regulations – is whether the spouses may establish a presumption of survivorship as between themselves that, if honored for state law purposes, would allow the deemed survivor to use the DSUE amount of the spouse who is deemed to die first. This might be attractive planning to permit a wealthy spouse to use a portable exclusion amount from a less wealthy spouse, in a simultaneous death context. The alternative is for the wealthy spouse to presume the less wealthy spouse to survive for marital deduction purposes, make a transfer to that spouse (for example, using a QTIP trust) that ultimately will benefit the same objects of the wealthy spouse's bounty. Either approach could be followed to effectively shelter the less wealthy spouse's unused exclusion amount, and either spouse ought to be able to presume the other to be the survivor for purposes of either the marital deduction or to make a portability election. Arguably the "relation back" regulation accomplishes that objective, but a statement to that effect would be a nice addition when the regulations become final.

4. An election is made by filing a "complete and properly-prepared" Form 706 estate tax return. There is no Form 706EZ – and statements from Treasury officials strongly suggest that there is not likely to be one – notwithstanding passionate calls for simplicity in making the portability election for nontaxable estates. This likely emanates from the fact that §2010(c)(5)(A) requires the filing of an estate tax return, and the government needs certain information to confirm that the marital deduction is properly allowed for property passing to the surviving spouse, and that there is adequate information to compute the DSUE amount.

Nevertheless, these regulations establish a special valuation rule for some property that will qualify for the marital or charitable deduction. Applicable only if no return otherwise is required, and if four stated disqualifications are avoided, then this deductible property need not be formally appraised. Instead, Temp. Treas. Reg. §20.2010-2T(a)(7)(ii)(A) establishes a good faith and due diligence standard by which the estate may estimate the value of property as falling within a specified range (options that are provided on the draft Form 706 for 2012 decedents). The preamble to these regulations noted that the same standard is applied to determine whether an estate exceeds the filing threshold itself, so the application is new but the concept is not.This relief from normal valuation procedures is unavailable if any of the following four disqualifications apply:

(a) If the value of the property involved "relates to, affects, or is needed to determine the value passing from the decedent to another recipient." This means that the amount of the marital and charitable bequests cannot be determined by a formula that divides the estate, such as between marital and nonmarital trusts.

(b) If "[l]ess than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property." This means that an intestate estate cannot qualify unless the surviving spouse and charity receive 100% of the decedent's probate estate – which can occur, for example, in states (such as UPC jurisdictions) in which a spousal support allowance comes off the top of an intestate estate and may consume the entire estate. Note, however, that Temp. Treas. Reg. §20.2010-2T(a)(7)(ii)(C) *Example 2* illustrates a probate estate that qualifies for the appraisal exception, notwithstanding life insurance that passes to children outside of probate. In the example the insurance does not escape normal rules to establish its value, but the probate estate does.

(c) If only a partial QTIP election is made, or there is a partial disclaimer, resulting in less than 100% of the entitlement qualifying for the marital or charitable deductions.

(d) If values are needed to determine the estate's qualification for relief under §§2032 (alternate valuation), 2032A (special use valuation), 6166 (deferred payment of estate tax), "or other provision of the Code."

As a practical matter, the non-appraisal regime is likely to be less valuable to estates than it is symbolic that Treasury, acting subject to the §2010(c)(5)(A) mandate that a return must be filed, is seeking to be sensitive to the cost and inconvenience involved in making the portability election. But it does make it possible to leave an "I love you" will that gives everything to the surviving spouse and thus simplify the administrative return filing burden.

5. An impasse may arise if a surviving spouse wants the decedent's estate to make the portability election but the executor is not the spouse and chooses not to do so. This tension is not relieved, because any "appointed" executor's decision governs. But Temp. Treas. Reg. §20.2010-2T(a)(6)(ii) does specify that, if there is no §2203 appointed executor acting, then any person in possession of estate property ("a non-appointed executor") may file a return and make an election, with the first to file having supremacy. Only appointment of a §2203 executor that then timely files a Form 706 can subsequently overcome or reverse this filing. This puts a premium on any race to file and it gives a surviving spouse who is in possession of estate assets one avenue to accomplish postmortem portability planning. Particularly because anyone else possessing estate property has no incentive to file a return to preclude a portability election.

6. The preamble to these regulations specifies that, under Temp. Treas. Reg. §20.2010-2T(c)(1), the DSUE amount determined for the year of the decedent's death is controlling – meaning that there is no DSUE amount "recapture" or "clawback" if the exclusion amount subsequently declines, prior to the surviving spouse's death. That is the correct rule, because a decedent otherwise could have used a nonmarital trust to take advantage of the full exclusion amount in the year of the decedent's death, and avoided inclusion in the surviving spouse's estate. A change in the exclusion amount after such an election is made should not undo the planning option that was selected on the basis of the law that was in effect in the year of the decedent's death.

7. The preamble also stated that §2010(c)(4)(B)(i) contained a mistake, because it referenced the decedent's "basic exclusion amount" instead of the "applicable exclusion amount." This error was noted by the General Explanation to the 2010 legislation (the Bluebook), with a notation that a technical amendment might be needed to repair the statute. ATRA 2012 §101(c)(2) made that technical correction but, even before Congress acted, Temp. Treas. Reg. §§20.2010-1T(d)(4) and 20.2010-2T(c)(1)(ii)(A) conformed to what the preamble said is the only rule that makes sense. The net result is an "ordering" rule in Temp. Treas. Reg. §25.2505-2T(b) that provides that a surviving spouse uses any portable DSUE amount before using the spouse's own basic exclusion amount. This is particularly significant for inter vivos transfers made by the spouse after remarrying but before that new spouse dies. It means that the surviving spouse can preserve and use a prior deceased spouse's DSUE amount without risk of losing it if the new spouse also predeceases the

surviving spouse (which would cause the new spouse to become the last deceased spouse of the surviving spouse). See Temp. Treas. Reg. §25.2505-2T(a)(3) for confirmation that use after remarrying but before the new spouse's death is copacetic.

8. In a related vein, Temp. Treas. Reg. §20.2010-3T(a)(3) also specifies that divorcing a new spouse before that new spouse dies will preserve the surviving spouse's ability to use the DSUE amount from the last prior deceased spouse. Either way, these rules mean that a surviving spouse who did remarry and is likely to survive that new spouse can avoid loss of a portable DSUE amount by acting before the new spouse dies, either via divorce or by making a gift that consumes the portable DSUE amount.

9. Temp. Treas. Reg. §20.2010-3T(b)(1) also confirms that a surviving spouse can make use of multiple DSUE amounts by surviving a series of spouses whose estates all make the portability election, *if* that surviving spouse is willing and able to make gifts of the portable exclusion amount of the last deceased spouse before the next (current) spouse dies. This portends serial "skid-row" monogamy for wealthy individuals who are willing to make inter vivos gifts while their new, penniless spouses are on death's door.

10. Temp. Treas. Reg. §20.2010-2T(c)(2) states a sensible rule that is not likely to apply often, dealing with calculation of the DSUE amount. The §2010(c)(4)(B) calculation subtracts "the amount with respect to which the tentative tax is determined under section 2001(b)(1)" from the decedent's applicable exclusion amount. This means that the DSUE amount is that portion of a decedent's applicable exclusion amount that was not consumed by inter vivos taxable gifts, or by the decedent's taxable estate at death. The regulation fixes a glitch that relates to inter vivos taxable gifts that exceeded the exclusion amount that existed in the year of the gift, as to which the decedent paid gift tax. The regulation provides that, because those taxable gifts did not use the exclusion amount during life, they do not reduce the amount that can be transported at death. This is *only* relevant if (a) the exclusion amount increases subsequent to the year of those gifts, and therefore was not totally consumed by the inter vivos gifts, and (b) the estate at death also does not fully consume this increased exclusion amount (meaning that it remains unused). In such a case the calculation of the DSUE amount that can be transported to the surviving spouse calls for a reduction by only the amount of the exclusion actually used to reduce gift tax inter vivos and estate tax at death. This is a proper adjustment in calculating the exclusion amount, but it won't often apply – because few taxpayers make inter vivos gifts that exceed the exclusion amount at the time of the gift. And it relies on the exclusion amount increasing in the future.

11. Note that this last item applies in precisely the same situation in which a taxpayer can lose credit for gift tax paid inter vivos, by virtue of the calculation of estate tax in §2001(b)(2). Temp. Treas. Reg. §25.2501-1T(b) makes more clear an aspect of the estate tax calculation that results in a "reverse clawback" phenomenon that also can apply only if a taxpayer paid gift tax inter vivos on gifts that at the time exceeded the exclusion amount but, because the exclusion amount increases prior to death, would not have been taxable had the taxpayer waited until death to make those transfers.

These new regulations are the first ever guidance dealing with the unified credit (which has been in the law since 1976) and, even with the added explanation, the regime under the Code is difficult to decipher. The gist of the rule involved is that a taxpayer at death is deemed to have paid gift tax inter vivos based on the unified credit calculated *as if* the law in effect at death had applied in the year of the gift. This requires use of the rates that apply for the year of death as well as the applicable exclusion amount for the year of death, because the unified credit is a function of both of those elements – the applicable exclusion amount and the rate schedule in §2001(c). The estate tax calculation – which reflects gift tax incurred inter vivos – relies on both of these factors, in each case applied using the law in effect in the year of death, *not* those that actually applied when the gifts were made.

So, for example, a gift in 2012 of $5.12 million did not result in payment of gift tax (if none of the unified credit previously was used), but that does not mean that the credit for gift tax payable will be zero in that taxpayer's estate tax calculation. Instead, if the decedent dies in a year when the exclusion amount is less (not as serious a concern today as it was in 2012), the clawback concern expressed by many was that reduction of the exclusion would retroactively result in a deferred tax liability, payable at death, on any differential in the amount in the year of the gift and the lower amount in the year of death. The reason why this does not present a problem is because the amount of gift tax applied as a credit at death is based on the tax that *would have been* paid inter vivos, based on the credit and rates that apply at death. Meaning that the taxpayer would have made a taxable transfer and would have paid gift tax on that amount, which becomes a credit against estate tax at death. Even though no such tax actually was paid. This explains why clawback is a nonstarter (although some still believe that clarification of the law is needed to guarantee that this is the correct result).

The flip side of this entails a gift tax that actually was paid inter vivos on gifted property that would have been sheltered by a larger exclusion amount available in the year of death. That gift tax paid is "wiped out" as a credit in the calculation at death. The new regulations provide that this gift tax paid does not mess up portability of the larger exclusion, which was not actually used, but the net effect is still negative for any donor who made large lifetime gifts that required payment of gift tax that is lost as a credit at death. To avoid that result is as simple as the taxpayer making added lifetime gifts of the amount of any increase in the exclusion amount. Which is to say, such a donor must always consume the larger unified credit that is made available by increases in the exclusion amount. And remember that this is a seldom-encountered problem, limited to taxpayers who made huge lifetime gifts *and* actually *paid gift tax*, followed by the exclusion amount being larger at death (which *will* occur if the exclusion amount has indexed to a higher number when the taxpayer dies). None of that is particularly likely for the vast majority of clients.

12. The portability election is more complex if a decedent employs a qualified domestic trust (QDOT) for marital deduction purposes because the surviving spouse is not a United States citizen. This is because §2056A(b) taxes a QDOT as if it was still the decedent-settlor's property. It is fundamentally unlike a normal marital deduction trust that incurs tax payable by the surviving spouse's estate when the spouse dies. The surviving spouse *also* may incur tax on a QDOT but that does not eliminate the tax imposed on the donor's estate. It simply gives the spouse a nonlapsing credit similar to that in §2013 for tax paid by the deceased settlor. The end result is that a QDOT incurs tax in the settlor's estate, with the calculation deferred in most cases until the surviving spouse dies. And that tax ultimately will consume what otherwise might appear to be a DSUE amount. Which is to say that the DSUE amount cannot be known until the QDOT has terminated and all tax attributable to that trust and imposed on the settlor has been calculated. As a result, Temp. Treas. Reg. §§20.2010-2T(c)(4), 20.2010-2T(c)(5) *Example 2*, 20.2010-3T(c)(2), and 25.2505-2T(d)(2)(ii) *Example* all address the QDOT situation. In the final analysis these provisions confirm that a QDOT is merely a means by which the decedent's estate tax is deferred, rather than being shifted to the surviving spouse. This may be preferable, however, because the deceased spouse may have a larger exclusion amount than the survivor (who may not be a resident or a citizen at death, and thus whose tax liability may be imposed under §2101, with the much smaller §2102 credit amount).

Note also that Temp. Treas. Reg. §§20.2010-2T(a)(5) and 20.2010-3T(e) confirm that a noncitizen nonresident decedent's estate could not make a portability election in the first instance, even though it could use the §2056A QDOT. So care is required to distinguish between noncitizens and nonresidents and to carefully consider whether estate tax will be imposed under §2001 in either spouse's estate.

13. The Technical Directive that promulgated these regulations invites comment on the guidance given, and on one piece of guidance that was withheld. That one is the proper priority of the credits in §§2010, 2013, 2014, and 2015 in calculating the DSUE amount. Specifically, should any credits reduce the estate tax liability before the unified credit, meaning the DSUE amount would be greater, or is the unified credit in §2010 used first and those other credits are applied in some other sequence? Both §§2013 and 2014 reflect the tax policy that it is improper to subject the same property to two different taxes in certain circumstances – under §2013 if two taxpayers incurred estate tax on the same property and died within 12 years of each other [psst: 12 is not a typo – read the provision again to see why], and under §2014 if one taxpayer owns property that is subject to tax both in the United States and abroad. Each credit relieves the burden of double taxation, which means that they ought to be applied before the §2010 unified credit. Were the sequence otherwise the §2010 unified credit would be used to offset a tax that the tax policy concludes should not be imposed at all. Thus, application of §2010 first would defeat the underlying objective that there should be no double taxation. The DSUE amount ought to be calculated *after* application of those credits, meaning that there will be more exclusion amount available to the surviving spouse. Because §2015 is tied to the credit under §2014, the sensible result is for the same sequencing rule to apply. And note that, if a taxpayer eschews portability, a larger nonmarital trust would result under current law if any of these credits is available. Portability should not alter that application of these rules. Indeed, it raises suspicions about why Treasury thought the question needed added thought – because this result is obvious.

A second question, not raised by the Technical Directive, may be too obvious or easy for consideration. It is whether a taxpayer may engineer the marital deduction and portability to intentionally incur and pay a small amount of estate tax in the decedent's estate, and a smaller amount if the §2032 alternate valuation election is made. To satisfy the §2032(c)(2) requirement that the aggregate of estate and generation-skipping transfer tax incurred in a decedent's estate must be reduced by making the alternate valuation election. The policy question is whether a taxpayer may pay tax and bank the exclusion amount for portability to the surviving spouse? For gift tax purposes the government's position in Rev. Rul. 79-398, 1979-2 C.B. 338, is that a taxpayer may not bank the unified credit by paying gift tax that the credit otherwise would offset. The primary reason for that rule is to prevent taxpayers from intentionally reducing their gross estates at death by payment of gift tax during life – this rule precludes taking maximum advantage of the tax exclusive calculation of the gift tax by intentional payment of gift tax (itself not a taxable transfer) on transfers that otherwise would be sheltered by the unified credit. If the estate would be taxable at death, the benefit is payment of a gift tax that would be a credit against the estate tax at death – essentially a prepayment – with a corresponding reduction of the gross estate at death. The advantage in the §2032 alternate valuation context from intentional payment of a smidgeon of estate tax is different, but the government may still deem that manipulation to be improper. Treasury may not wish to speak to this issue – the planning involved is not new – and taxpayers may not want to force the government to announce a position. On the other hand, it would be nice to know whether this postmortem planning is (not) viable.

Considering all of these factors, the traditional marital and nonmarital trust plan may be difficult to embrace if S's estate is not likely to exceed double the basic exclusion amount (and therefore likely will not be subject to tax when S dies), particularly if D and S trust each other (or they do not have different objects of their bounty). It seems predictable that reasons offered by planners to discourage portability and instead hew to the tried-and-true nonmarital trust approach will fall on deaf ears of many married couple clients.

The net effect of these factors seems to be the desirability of postmortem planning that allows engineering of the marital deduction and nonmarital bequests, GST exemption allocation, state death tax minimization, and income minimization through effective use of document provisions that empower and indemnify fiduciaries, and that permit easy qualification for the marital deduction at both the state and federal levels.

Size of the Marital Bequest

First, a disclaimer: even with the unprecedented flurry of taxable gifts made in 2012, most clients will not pay wealth transfer tax sooner than absolutely necessary and, in many cases, this reluctance makes good sense. Many clients are scared about exhausting their wealth (particularly on health care costs) before S dies. In other cases there are liquidity problems that the client would prefer to defer — a difficult notion to address objectively because the client may be in a better position to find liquidity during life than relying on successors to find it after S dies. It also encourages married clients to favor survivor life insurance coverage when many couples (particularly baby boomer or younger generations) need first to die insurance instead — because neither spouse alone could support the family's life style on one income, after the death (or, worse, disability) of one of the spouses.

Some clients also justify deferral by the time-value of money notion, which wise planners know to be false. More than any other learning that will come from this segment, the one reality illustrated here is that, economically, in a flat tax system such as now exists, it does not matter when a client pays wealth transfer tax. If appreciation is expected the portability election can be disadvantageous and using the unified credit early is wise. Conversely, if depreciation is expected (and in some cases it *is* predictable – for example if the estate holds a large amount of IRD that will incur income tax postmortem), then portability is the best choice. As illustrated by the calculations beginning at page 13.

A final aspect is crystal ball gazing: Will an estate tax be due when S dies? Optimum use of the marital deduction after sheltering D's unified credit causes some "estate stacking" in S's estate. D's marital bequest is taxed "on top" of any assets S already owns, which may result in a higher marginal rate of tax being imposed on D's bequest (if state or federal law provides for progressive rates) and, therefore, more tax over both estates than if no marital deduction had been taken. This factor is exaggerated to the extent D's property appreciates during S's overlife, although the benefit of generating a new basis at S's death under §1014 minimizes this cost (attributable to inclusion of D's property in S's gross estate because it qualified for the marital deduction in D's estate).

A second factor that may minimize the tax bite at S's later death is tax free dissipation of the wealth, either through consumption that does not leave value in S's estate for wealth transfer tax purposes, or gifts that exploit certain benefits such as the tax exclusive computation of gift tax on gifts that avoid the gross up rule of §2035(b), use of a deceased spouse's DSUE amount inter vivos and the potential acquisition of another spouse's DSUE amount following remarriage, or the gift tax annual and ed/med exclusions. Each exclusion affords an opportunity to reduce the amount subject to tax in S's estate even if S is unwilling to make large enough gifts to incur gift tax during life.

The Time-Value of Money Notion is Bizarre: This segment of these materials illustrates that the time-value of money concept — which encourages taxpayers to defer paying a tax liability and use the money they otherwise would have paid to the government to invest and make added money – does not work for wealth transfer tax purposes. This segment employs an example in which D's gross estate is $20 million and S's gross estate is $1 million. These are big numbers that may exceed the average planner's typical client net worth, but they illustrate several important factors. The truths shown here do not change in smaller estates. In all of these illustrations assume that D and S both die when the basic exclusion amount is $5,250,000, sheltered by the unified credit. Because we don't yet know the inflation adjusted exclusion amount in 2013 this is just a conservative guess (and, to avoid confusion in these examples, no §2013 credit is illustrated until much later). The tax computations at the deaths of D followed by S (also assuming no changes in asset values) look like:

Portability	Optimum Marital	Equalizer Marital	
$20,000,000	$20,000,000	$20,000,000	D's gross estate
(20,000,000)	(14,750,000)	(9,500,000)	marital deduction
0	5,250,000	10,500,000	D's taxable estate
0	2,045,800	4,145,800	tentative estate tax
(2,045,800)	(2,045,800)	(2,045,800)	unified credit
0	0	2,100,000	D's FET payable
0	5,250,000	8,400,000	nonmarital trust after D's taxes
When S later dies:			
$21,000,000	$15,750,000	10,500,000	S's taxable estate
8,345,800	6,245,800	4,145,800	tentative estate tax
(4,145,800)	(2,045,800)	(2,045,800)	unified credit[1]
4,200,000	4,200,000	2,100,000	S's FET payable
4,200,000	4,200,000	4,200,000	total tax over both estates
16,800,000	16,800,000	16,800,000	assets remaining

As illustrated, in a flat tax world all three approaches generate no tax difference over both estates. And the portability illustration, in which D qualifies D's entire estate for the marital deduction and D's estate makes the §2010(c)(5)(A) election, saves no tax in D's estate relative to the optimum marital. But what about deferral so the estate can make money on the $2,100,000 otherwise payable at D's death in the equalizer example?

Time-Value Example: Will income earned in the portability or optimum examples on the estate tax that would be paid in D's estate in the equalizer example constitute an advantage for the portability or optimum alternatives?

1. The credit in the portability column is the aggregate of S's own $2,045,800, which is the tax on $5,250,000, and the unified credit of $2,100,000, attributable to D's portable exclusion amount of $5,250,000, which is taxed at a 40% stacked on top of S's $5,250,000. Contrary to early pronouncements regarding portability, taxing D's estate on top of S's estate will *not* cause a loss equal to the tax saved by a "bracket run" on the first $500,000 that would be includible in D's estate. Instead, D's wealth taxed in S's estate (at a maximum 40%) may generate an added credit for S of as much as $200,000 of tax, which differs from saying that S is entitled to D's unused unified credit, which would be the tax on that first $500,000 in D's estate (which at rates less than 40% would have been only $155,800). This differential is eliminated because S's unified credit amount attributable to portability is calculated at S's marginal brackets after stacking D's unused exclusion amount on top of S's exclusion amount — rather than just transporting D's unused unified credit. The government confused those very similar concepts in its initial Form 706 construction, but it now has corrected that error.

Many people assume that the deferred tax plans are preferable if S outlives D by a sufficient period of time. A number of factors are relevant for illustration purposes, including S's health and overlife expectancy, the likely after tax return on the deferred taxes (which in turn depends on general rates of return and S's income tax bracket), the effect of inflation, appreciation, and income accumulations that will increase (and invasions or depreciation that will dissipate) S's estate, and the effect of other credits that may apply in one estate or the other. To minimize the effect of guesswork, the following illustration eases the analysis by assuming that all the variables come together during S's overlife so that between the deaths of D and S all property values double, which reflects the use of the money during S's overlife. The same computations when S later dies now reveal:

Portability	Optimum Marital	Equalizer Marital	
\$21,000,000	\$15,750,000	\$10,500,000	S's gross estate
×2	×2	×2	
\$42,000,000	\$31,500,000	21,000,000	S's taxable estate
16,745,800	12,545,800	8,345,800	tentative estate tax
(4,145,800)	(2,045,800)	(2,045,800)	unified credit[2]
12,600,000	10,500,000	6,300,000	S's FET payable
29,400,000	21,000,000	14,700,000	amount of S's taxable estate remaining after S's taxes
0	10,500,000	16,800,000	double the amount of nonmarital trust remaining after D's taxes
29,400,000	31,500,000	31,500,000	assets remaining

The portability result is attributable to \$2,100,000 of tax on \$5,250,000 of appreciation that could have been avoided if D had utilized a nonmarital trust to shelter that appreciation from inclusion in S's gross estate.

As between the other two options, the time-value assumption is that the optimum marital approach would be more beneficial because S can invest and reinvest the \$2,100,000 of tax dollars not otherwise paid during S's overlife. This example illustrates that the time-value bromide regarding these alternatives is wrong. Indeed, in a progressive tax rate world the equalizer actually produces *better* results.

Note the assumption that income earned is the same as gain generated in measuring the time-value of the deferred taxes under the optimum marital approach. This equation is contrary to many planners' expectation, probably because of historical notions regarding fiduciary accounting and investment standards that treat growth in the form of appreciation as different from growth in the form of income generated. As illustrated by the Uniform Prudent Investor Act and various state fiduciary laws that embrace the portfolio theory of investment prudence, however, planners should not think of income and growth as different items for time-value analysis. They are merely two different ways to earn money with the assets that are available, both appropriate under a total portfolio performance standard. Moreover, unless S expends greater income in ways that generate no net worth increase at S's death, the fact that income would be paid to S while gain would increase the trust corpus also does not alter the equation.

2. Again assuming deaths in 2013, now in S's estate. This would produce a §2013 previously taxed property credit that, if illustrated, would preclude an apples to apples comparison. So it is ignored. But that added factor will further support the absolute advantage of being in the equalizer column instead of using either the optimum or the portability approach.

Under this analysis, the combination of income and growth — total portfolio performance — is considered as one element. Properly considered, here it illustrates that traditional notions about the time-value of taxes deferred from the death of D to the death of S and about an optimum approach being more economical is a fallacy. There may be other legitimate reasons for deferring the payment of estate tax in the combined estates of D and S, such as lack of liquidity or fear about too little wealth remaining for S to live on, but a decision to defer taxes through use of portability or an optimum marital bequest cannot be supported by the time-value notion.

As illustrated, portability suffers if appreciation is expected. The converse is true if depreciation is expected and cannot be avoided (for example, because the investment portfolio is not liquid, the entire economy tanks and there is no place to hide, the wealth consists largely of IRD with a built-in income tax liability, or the decline is attributable to tax-free dissipation or consumption during S's overlife). In this example assume that values decline 50% during S's overlife.

Portability	Optimum Marital	Equalizer Marital	
$20,000,000	$20,000,000	$20,000,000	D's gross estate
(20,000,000)	(14,750,000)	(9,500,000)	marital deduction
0	5,250,000	10,500,000	D's taxable estate
0	2,045,800	4,145,800	tentative estate tax
(2,045,800)	(2,045,800)	(2,045,800)	unified credit
0	0	2,100,000	D's FET payable
0	5,250,000	8,400,000	amount of nonmarital trust remaining after D's taxes
When S later dies:			
$10,500,000	$7,875,000	5,250,000	S's taxable estate
4,145,800	3,095,800	2,045,800	tentative estate tax
(4,145,800)	(2,045,800)	(2,045,800)	unified credit
0	1,050,000	0	S's FET payable
0	2,625,000	4,200,000	50% of nonmarital trust
10,500,000	9,450,000	9,450,000	assets remaining

The differential in the portability column is $1,050,000 less tax because $5,250,000 of nonmarital wealth was taxed in the other two examples but only $2,625,000 was taxed in the portability example, due to the loss of 50% of the value during S's overlife. The tax at 40% on $2,625,000 is $1,050,000.

There is a cost of losing the §1014 basis adjustment on more property at S's death if the nonmarital trust was $5,250,000 and doubles in value. So an estate with great appreciation potential raises planning considerations that require an analysis of D's portfolio and whether there are sufficient nonappreciating assets to pay the tax incurred at D's death in a less than optimum bequest situation. This next illustration shows that the use of "hot" assets to pay the tax in D's estate reduces the resulting saving.

Under selective facts a more compelling case for either prepayment or deferral may arise. For example, an estate with great but only select income generation or appreciation potential raises new considerations that require an analysis of D's portfolio and whether there are sufficient nonappreciating assets to pay the tax incurred at D's death in a less than optimum bequest situation. This is because use of "hot" (highly appreciating) assets to pay the tax in D's estate reduces the resulting saving, as illustrated again by two examples. Both illustrations assume that

D will bequeath to S an amount that, along with S's $1 million, will total $5,250,000 at S's death and thereby take advantage of S's unified credit on the second death:

All Hot Example: D's estate of $20 million consists entirely of highly appreciating assets. Although it is unrealistic, assume for calculation purposes that it is possible to predict with precision that every dollar will double during S's overlife. So D's estate qualifies $2,125,000 for the marital deduction and pays $5,050,000 of tax on the remaining $17,875,000 that will pass to a nonmarital trust. The $2,125,000 marital doubles in value and, combined with S's own $1 million, is entirely sheltered from tax when S dies. The $12,825,000 remaining in the nonmarital trust also doubles in value to $25,650,000 during S's overlife. An aggregate of $30,900,000 would remain at S's death, with no more wealth transfer tax to be paid.[3]

If, instead, D's estate paid no tax at D's death because it utilized traditional optimum marital deduction planning, the marital deduction would be $14,750,000, the nonmarital would be $5,250,000, and again the entire $20 million doubled in value during S's overlife, a tax of $10,100,000 would be incurred on the $30,500,000 includible in S's estate at death (assuming a traditional nonmarital plan sheltered $5,250,000 at D's death that doubled in value to $10,500,000) leaving the same $30,900,000 after S's death.

Prepay All Tax		**All Hot Example**	Defer All Tax	
Marital	Nonmarital		Marital	Nonmarital
$2,125,000	$17,875,000	D's estate	$14,750,000	$5,250,000
0	(5,050,000)	D's FET payable	0	0
2,125,000	12,825,000	D's post tax wealth	14,750,000	5,250,000
2,125,000	12,825,000	×2 appreciation	14,750,000	5,250,000
4,250,000	25,650,000	D's wealth when S dies	29,500,000	10,500,000
1,000,000	0	S's other wealth	1,000,000	0
5,250,000	0	S's taxable estate	30,500,000	0
0	0	S's FET payable	(10,100,000)	0
5,250,000	25,650,000	assets remaining	20,400,000	10,500,000
30,900,000		aggregate wealth	30,900,000	

Half Hot Example: Consider what happens instead if D's estate paid tax with assets that would not grow in value, to protect appreciating assets from later tax. To wit, assume D's $20 million estate consists of equal parts of highly appreciating and nonappreciating assets. D's estate qualifies $4,250,000 of the nonappreciating assets for the marital deduction and pays $4,200,000 of tax on the remaining $15,750,000 of nonmarital wealth. The estate pays this tax out of the remaining $5,750,000 of nonappreciating assets, to shelter all the growth on the $10 million of appreciating assets. When S dies the $4,250,000 marital trust has not changed in value and S pays no tax on that plus S's $1 million (instead, it simply absorbs S's unified credit) and the nonmarital trust is worth $21,550,000 ($10 million of the original value doubled, plus the

3. Remember, however, that a capital gains tax may be incurred on a subsequent realization event because, as nonmarital property that is not includible in S's gross estate at death, this property will not receive a new basis to eliminate that appreciation for future income tax purposes. The significance of this factor is uncertain because S's beneficiaries may never sell the asset, may do so when there are losses to offset against the gain, and Congress may bow to pressure from tax policy theorists and repeal §1014 before S dies, thereby denying the basis adjustment even in the optimum marital situation.

$1,550,000 of nonappreciating property remaining after paying the tax in D's estate). This full amount also passes tax free at S's death, for a total of $26,800,000 after all tax is paid.

If D's estate had paid no tax at D's death, $5,250,000 of appreciating assets would have been sheltered in the nonmarital trust and would have grown to $10,500,000 tax free at S's death. The remaining $4,750,000 million of appreciating assets would qualify for the marital deduction and be worth $9,500,000 at S's death, includible in S's gross estate, along with S's $1 million and the remaining $10 million of D's estate that consisted of nonappreciating assets. Now only $24,900,000 would remain after incurring $6,100,000 of tax at S's death.

Prepay All Tax		**Half Hot Example**	Defer All Tax	
Marital	Nonmarital		Marital	Nonmarital
0	$10,000,000	D's hot assets	4,750,000	$5,250,000
$4,250,000	5,750,000	D's not hot assets	10,000,000	
0	(4,200,000)	D's FET payable	0	0
4,250,000	11,550,000	D's post tax wealth	14,750,000	5,250,000
	10,000,000	×2 appreciation	4,750,000	5,250,000
4,250,000	21,550,000	D's wealth when S dies	19,500,000	10,500,000
1,000,000		S's other wealth	1,000,000	
5,250,000		S's taxable estate	20,500,000	
0	0	S's FET payable	(6,100,000)	
5,250,000	21,550,000	assets remaining	14,400,000	10,500,000
26,800,000		aggregate wealth	24,900,000	

The saving attributable to prepayment is $1,900,000 over the optimum marital that defers all taxes. It represents avoidance of a 40% tax on $4,750,000 of growth that was includible in S's taxable estate in the defer tax alternative. This saving is attractive enough to D in terms of prepaying $4,200,000 in tax at D's death rather than at S's death, especially because the assets used to pay that tax would not appreciate during S's overlife. And the example illustrates an unexpected reality that reveals factors that must be considered. If D's estate has a ready source of funds, such as an insurance trust that will collect the proceeds of insurance on D's life or other nonappreciating liquid assets, the situation may be ripe for the payment of some tax at D's death to shelter appreciating assets during S's overlife.

§2013 Credit Maximizing Example: Postmortem planning of the size of the marital deduction also should consider the effect of a §2013 credit for previously taxed property, if S is expected to die within 10 years after D's death (and especially in the unfortunate case in which S already has died before the marital deduction has been claimed on D's Form 706).

For example, in TAM 8512004, D left a will that bequeathed to S an amount equal to the maximum marital deduction allowable to D's estate, and bequeathed D's residuary estate to a nonmarital trust that gave S an income interest for life. S died three months after D, from causes not foreseeable at D's death. S's personal representative disclaimed the marital deduction bequest, with the result that D's entire estate passed under the residuary clause to the nonmarital trust. This meant that no marital deduction was available to D's estate.

Aggregate estate taxes over both estates were minimized, however, because the estate tax generated in D's estate increased the amount of the §2013 credit available in S's estate. This was because S's income interest in the nonmarital trust was sufficient to qualify for a §2013 credit notwithstanding that no part of that trust was includible in S's estate at death (and notwithstanding the nondeductible terminable interest rule for marital deduction purposes).[4]

Under the actuarial tables, the value of S's life income interest (and the §2013 credit based thereon), was far in excess of the income actually received by S during the three months that S survived D. Nevertheless, because Rev. Rul. 80-80, 1980-1 C.B. 194, required use of the actuarial tables (because S's death was not clearly imminent due to an incurable physical condition that was known at D's death), S's estate was able to maximize the credit at a nominal cost. The same result would be reached today under the §7520 regulations. In a less well planned manner, essentially this is what generated a sizeable savings in Estate of Howard v. Commissioner, 91 T.C. 329 (1988), and was the opportunity at stake in the simultaneous death cases of Estate of Carter v. United States, 90-1 U.S. Tax Cas. (CCH) ¶60,003 (E.D. La. 1989), rev'd, 921 F.2d 63 (5th Cir. 1991), and Estate of Marks v. Commissioner, 94 T.C. 720 (1990), these three cases involving tax savings of approximately $600,000, $300,000 and $200,000, respectively.

This being the case, some planning choices need to be made inter vivos, such as whether the death of both spouses within 10 years of each other is sufficiently likely that planning the nonmarital trust to maximize the value of S's income interest is better than use of an accumulation or spray trust. Addition of a five or five withdrawal power will further maximize the value of S's nonmarital trust interest for §2013 planning. See, e.g., Estate of Shapiro v. Commissioner, 66 T.C.M. (CCH) 1067 (1993) (91 year old S died within five months of D; five or five power added 13.5% to value of lifetime annuity). In a recent calculation with a 77 year old S the five or five power added over 22% in value to the life estate calculation.

Example: D has an estate of $20 million and S has an estate of $1 million. S dies within nine months after D's death but, because S was not terminally ill when D died, valuation of S's life estate in D's property is based on the actuarial tables, as required by §7520 and Treas. Reg. §20.7520-3(b)(3). Using 2013 rates and credits:

Optimum Marital		§2013 Maximizing Marital
$20,000,000	D's gross estate	$20,000,000
(14,750,000)	marital deduction	(7,773,255)
5,250,000	D's taxable estate	12,226,745
0	D's federal estate tax	2,790,698
15,750,000	S's taxable estate	8,773,255
4,200,000	S's tax before §2013 credit	1,409,302
0	§2013 credit	(1,409,302)
4,200,000	S's tax after §2013 credit	0
4,200,000	tax over both estates	2,790,698

The §2013 credit was computed based on S's life estate being worth 50.5% ($4,765,204) of the $9,436,047 nonmarital trust after paying $2,790,698 in tax. The assumptions underlying this computation will change monthly with the §7520 interest rate and annually with S's age. To

4. Estate of Weinstein v. United States, 820 F.2d 201 (6th Cir. 1987), and TAM 8608002 illustrate that this technique may succeed even if income is payable only in the trustee's discretion rather than as an absolute entitlement of the surviving spouse. However, Technical Advice Memoranda 8717006 and 8944005 denied the credit for discretionary income interests, so the better approach is to guarantee income to the survivor.

make this hypothetical computation the assumptions made were that S is age 80, the §7520 rate is 3.0%,[5] and S is given a five or five power of withdrawal over the nonmarital trust.

Notice that no state death tax, nor the §2058 state death tax deduction, is reflected in this calculation, on the theory that there would be no state death tax if there is no federal estate tax payable after the §2013 credit is applied. That concept is not universally accepted, but was recognized as proper in a §2011 pick-up tax environment by Comptroller v. Phillips, 865 A.2d 590 (Md. 2005), In re Estate of Lacks, 662 N.W.2d 54 (Mich. App. 2003), Riethmann Trust v. Director of Revenue, 62 S.W.3d 46 (Mo. 2001); In re Estate of Eberbach, 512 N.E.2d 902 (Ind. Tax Ct. 1987); Estate of Turner v. Washington State Dep't of Revenue, 724 P.2d 1013 (Wash. 1986), and Estate of Hemphill v. Washington State Dep't of Revenue, 105 P.2d 391 (Wash. 2005) (when the federal §2011 credit went to zero the state death tax did too); and Dickinson v. Maurer, 229 So. 2d 247 (Fla. 1969). With state tax variations in the wake of repeal of §2011 after 2004 it is impossible to generalize about how state death tax might be affected by such planning.

In this case D and S saved $1,409,302 in tax paid over both estates, representing a 33.56% tax saving (in this case, 6.7% of the aggregate wealth of D and S). This planning requires some balancing to ensure that S has sufficient assets to generate enough tax to consume the §2013 credit produced from the tax on D's estate, and D's estate is large enough to produce enough tax to generate the necessary credit. Several computations may be needed to strike the proper balance, and more computational complexity will be encountered if a state death tax is involved. Software *is* available to do the calculation.

<u>Your Client Trusts the Surviving Spouse to Make Gifts</u>

Everything seen so far illustrates the *second* best manner to move wealth. At this point it does not seem likely that the basics of wealth transfer taxation will change (Congress could repeal the estate tax but preserve the gift tax, but that doesn't seek likely). Unless that occurred, the better mechanism for moving property to the next generation at the lowest aggregate tax cost to spouses is to give S the full optimum marital deduction amount needed to avoid tax in D's estate, and then have S immediately make gifts to the same beneficiaries who would benefit from a larger nonmarital trust. Similarly, having S make a *non*qualified disclaimer from D's estate would produce the same preferable results. This is true because, even if S is in the highest marginal bracket for gift tax purposes, the effect of the tax exclusive calculation of the gift tax means that the effective tax rate on gifts made by S is less than the lowest rate that could be incurred on the same property in D's estate. And if S does this right after D dies, new basis for D's assets means that capital gain in the gifted assets need not infect the analysis.

To illustrate, assume S receives $1 million more property from D than S needs, and that S is willing to part with that amount in the form of a gift to children and the gift tax thereon. If S's marginal gift tax bracket is 40%, S could transfer $714,286 from the $1 million that S does not need; at 40% the tax on this gift would equal the remaining $285,714 that S will pay to the government (assuming no unified credit is available because, in this case, S already has made sufficient gifts to run through the brackets and in the process used the full credit).[6] This 28.57%

5. Note that, at the time this is written, the §7520 rate was at an historic low of 1.0%, so this illustration assumes that D dies when that rate is more "normal." Note also that D's death is when we compute the value of S's life estate, based on life expectancy, rather than computing it at S's death when we know how long S actually survived. That is crazy but it is the way this operates, and it is why the gambit involving the §2013 credit is effective – it is based on the disconnect between the calculation and reality.

6. The algebraic formula to make this computation is:

	transfer	÷	1 + tax rate	= taxable gift
So:	$1 million	÷	1.4	= $714,286

tax rate on the $1 million that S was willing to part with is less than the 40% flat tax that could have been incurred in D's estate if a less than optimum marital bequest is utilized.

The risk to consider is that S will not live three years after making the gift and the gross up rule of §2035(b) will apply. Like other aspects of postmortem planning to minimize the aggregate tax burden imposed on spouses, this concept also requires a little crystal ball gazing. If living three years appears to be a bad gamble, however, the alternative that should be considered seriously is §2013 planning.

To confront all these risks and opportunities, perhaps the plan that makes sense for family and tax planning purposes is to create a QTIPable trust that pays all income to S so that, if a postmortem partial QTIP election is made to incur some tax in D's estate, a full §2013 credit will be available based on the income interest granted to S. And to permit gifting, grant S a power to withdraw from the QTIP marital beginning after some delay — making this a QTIP trust and not a §2056(b)(5) trust (which would not affect the marital deduction but it might deny the partial QTIP election ability if the power were available earlier — because the (b)(5) marital is automatic).

The withdrawal power grants the ability to make the inter vivos gifts, which is the second aspect of the plan that makes sense. Notice, however, that the withdrawal power raises the unanswerable issue whether inclusion when S dies will be under §2041 or §2044, which is relevant only in terms of the different §§2207 and 2207A rights of reimbursement — and this may not be relevant if S's tax payment provision is drafted properly.[7]

There is a capital gain issue involved if S makes gifts of appreciating property rather than holding them until S dies to permit a §1014 basis adjustment at S's later death, but pushing the pencil will show that the new basis at S's death (avoiding a typical, potential *worst case* 20% capital gain tax) may not make up for the tax saving attributable to making the gift. The differential in tax will be a minimum 11.43% — between a 40% estate tax and a 28.57% maximum effective gift tax.

The gift may fall behind holding property until S dies if S dies within three years after making the gift, §2035(b) therefore applies, and low basis assets must be sold to generate liquidity to pay the estate tax generated by that event. Usually the assets used by S's estate to pay the tax attributable to that event receive a basis adjustment at S's death, so this would be relevant only if transferee liability is imposed on S's donees who hold low basis property — not a very likely scenario. Otherwise, holding high basis property until death to garner the new basis under §1014 may be a fool's errand — it may not compensate for the gift tax saving otherwise available.

Given these advantages of lifetime giving by S, an appropriate question is why more plans do not grant S the power to make gifts. Indeed, quaere whether most estate planners even ask their married clients whether they trust giving the survivor of them the power to make gifts. One frequently heard response is that one spouse fears that the other spouse will remarry and disinherit their children in favor of their new spouse. As confirmed by statistics (and probably also undeniable in practice experience), the likelihood of a surviving widower remarrying after the death of his wife is 2.5 times greater than the likelihood of a surviving widow remarrying.[8]

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7. See Pennell, *Transfer Tax Payment and Apportionment*, 834 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2011).

8. A 1989 study cited by Waggoner, *Marital Property Rights in Transition,* 59 MO. L. REV. 21 at 49 n.71 (1994), reveals that only 8% of all surviving widows remarry and that they wait an average of 8 years before doing so, whereas over 20% of all widowers remarry and in less than 4 years on average. In the time since that study do you think these numbers have gotten more or less dramatic?

Although these statistics do not show how often remarried spouses disinherit their children by former marriages in favor of new spouses, most estate planners of any experience will confirm that surviving remarried widows seldom engage in this planning, whereas surviving remarried widowers do so with much greater frequency. So, if control over D's wealth is a problem, it ought to be the wife who articulates the concern, and then only if the husband is likely to be the survivor and has the smaller estate (meaning there is sense in a marital deduction bequest), which isn't yet the normal paradigm for planning purposes. Instead, in the more common but opposite situation, the statement of fear about remarriage probably is a manifestation of what the husband would do if he survived rather than a legitimate fear of what the wife is likely to do if she survives and has the power to withdraw corpus to make gifts.

The bottom line is that, with the advantages to be gleaned from inter vivos giving by S, the estate planner owes it to the couple to at least explore the notion of giving S the discretion to make gifts. Unfortunately, due to the prohibition in §2056(b)(7)(B)(ii)(II) against anyone, including S, having an inter vivos power to appoint QTIP property, this form of planning cannot be accomplished with an inter vivos nongeneral power of appointment and instead requires either that the trustee make distributions to S (without condition on how S may use that wealth) or that S be given the authority to withdraw corpus from the trust and, in either case, independently make a gift to anyone S chooses.

The previous discussion illustrated just one of several advantages traditionally associated with inter vivos giving: the tax exclusive computation of the gift tax. Other advantages routinely noted for inter vivos transfers are the gift tax annual and ed/med exclusions, using a portable DSUE amount if S *does* remarry, and shifting future income. So long as the tax remains a flat rate proposition, shifting appreciation does not make sense,[9] but these other opportunities remain — none are offset by the improper time-value of money notion. Moreover, there is another advantage to inter vivos transfer of wealth, being valuation differences between the estate and gift taxes. Those differences inform the next topic of concern among married clients.

Nonqualified Disclaimers from QTIP Trusts

Speaking of QTIPs, and before digging into the specific discount planning opportunities presented in a marital planning context, the planning accomplished and the result reached in PLR 199926019 was relatively unbelievable, in that it blessed a taxpayer technique to minimize §2519 exposure on termination of S's interest in a portion of a QTIP trust. S, as beneficiary of that QTIP trust, accomplished a severance into two portions and then made a nonqualified disclaimer of one of the two portions. That action constituted a taxable gift of 100% of the value of that portion, as to which S retained no enjoyment. That gift was taxable under §§2511 and 2519 in an amount equal to the full value of the trust corpus, and net gift treatment was allowed to the extent S imposed the gift tax liability on the donees — a result that reduces the aggregate gift tax value and therefore the gift tax cost of the transfer and that mimics the net gift treatment under §2207A.[10]

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9. For example, if S's wealth totals \$2x and the flat tax rate was 40%, a tax of \$0.8x could be paid presently, leaving \$1.2x. If the \$2x were to triple in value before tax is incurred, \$6x would incur \$2.4 of tax, leaving \$3.6x after S's death. Had the tax been paid earlier (that is, if an estate freeze had been performed), the remaining \$1.2x would have tripled to the same \$3.6x, making the freeze a zero sum game in terms of shifting appreciation.

10. The same §§2511 and 2519 result with net gift treatment was generated in PLRs 200717016, 200628007, 200604006, 200530014, 200324023, 200224016, 200223047, 200137022, 200122036, 200116006, 200044034, and 200022031, which also involved nonqualified disclaimers of QTIP interests as to which the taxpayers conditioned their disclaimers on donee payment of the gift tax, and PLR 200250033 (which did not mention the net gift aspect of an

PLR 200122025 added a different wrinkle to a similar severance, in that case involving an assignment of income by S to a charitable remainder beneficiary. The government concluded that §§2511 and 2519 both applied with respect to the severed portion as to which the income was assigned and a §2522 charitable deduction was allowed for the full value of the gift, along with a §170 income tax deduction (with no split interest impediment under §170(f)(3) because the exception in §170(f)(3)(B)(ii) for a contribution of the taxpayer's entire interest was applicable).

PLR 200230017 added yet another iteration by S selling the income interest from one portion of the severed QTIP, again with §2519 limited to that one portion, again with net gift calculation, and avoiding §2702. Similarly, PLR 201024008 involved S, a QTIP trust beneficiary who obtained a court order authorizing severance of the trust into two portions. One was the discounted present value of S's income interest, and the other the balance of the trust. Both trusts would terminate and be distributed to the remainder beneficiaries, but S would receive cash and a note from the trust that represented the value of the life estate income interest. Essentially S would sell the income interest trust for full and adequate consideration. The PLR held that S would make a gift of the full value of both trusts, less the value of the note and cash paid from the life estate trust. The gifts would be subject to the distributees' agreement to pay any gift tax generated (a net gift), and no part of the original trust would be subject to §2044 inclusion when S died. The net gift conclusion is consistent with §2207A and the §2044 conclusion is consistent with the standard rule that application of §2519 preempts §2044 inclusion at S's death. The intriguing question is whether §2036(a)(1) is avoided when S dies, based on the exception to §2036 for transfers made for full and adequate consideration. If that was the case, then S could continue to receive payments on the note (rather than a fluctuating income entitlement that would increase or decline with changes in investment returns), without estate tax inclusion of the date of death fair market value of the trust. That result might be desirable if accelerating taxation of the QTIP trust freezes the value of the trust assets, taxing them during S's life rather than at death (at a higher value or in a higher tax bracket), but it is not worth doing in a flat tax enrivornment in which estate freezing no longer is beneficial. See note 9. That §2036 issue was not addressed but it should be no different than any sale to a trust for an installment note.

Most important about these PLRs, by virtue of the severance, is that S was deemed not to have made a transfer that triggered §2519 with respect to the other portion of the QTIP trust, thereby avoiding added gift tax on the transfer and also avoiding further taxation with respect to that portion because, as to it, S did not retain any enjoyment.

In PLR 200801009 the wrinkle was that the QTIP trust was not severed — S made a nonqualified disclaimer with respect to the whole trust — and obtained a ruling that the disclaimed trust would roll into a credit shelter trust. S was not a beneficiary of that trust so the gift made by the nonqualified disclaimer was complete and there was no lingering estate tax exposure to S who made the disclaimer. Unusual was the fact that the marital trust was a residuary entitlement, meaning that the disclaimed property should not have flowed into the credit shelter trust. That required a state court order, determining that the property would pass as if originally part of the credit shelter trust.

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otherwise similar situation), and PLRs 200723014 and 200328015 (which involved severances under state court order, the earlier involving a gift after removal of a spendthrift restriction and the later a commutation and termination). PLR 201243004 also involved court ordered severance, assignment of the QTIP income interest, but waiver of the §2207A gift tax right of reimbursement. PLR 200602031 added a wrinkle in that the severance and disclaimer accelerated a charitable remainder, the taxpayer was a trustee of the charitable remainder trust into which the property fell, and the deemed gifts triggered under §§2511 and 2519 therefore were regarded as incomplete, meaning that §2036(a)(2) would apply at death, at which time a charitable deduction also would be available. With respect to the net gift result in the inter vivos QTIP context see Treas. §§25.2207A-1(b) and 25.2519-1(c).

Notwithstanding the endeavor in these situations to reduce the gift tax cost of S's action, in some cases it may be wise to take advantage of the opportunity to make gifts that use S's applicable exclusion amount (if, for example, S has remarried and will lose a DSUE amount acquired from predeceased D if S also survives that new spouse). The beauty of the gift tax incurred in the cases noted here is that it does not require S to relinquish any of S's own property to make a gift — not even the dollars used to pay the gift tax itself. Instead, S can trigger application of §2519 by a nonqualified disclaimer (or, if there is no spendthrift provision in the QTIP trust, by an assignment) of the tiniest portion of S's income interest in the trust and rely on §2207A to apportion the tax itself to the QTIP trust. Even if §2036 inclusion is not avoided at death, the gift achieves the goal of excluding the gift tax dollars from S's gross estate if S survives the transfer by three years (to avoid §2035(b) gross up) and takes advantage of other advantages of inter vivos gifting.

One added value of incurring gift tax would be available *if* §2036 estate tax inclusion can be avoided and there is no state *gift* tax (but there is a state estate tax) – because state wealth transfer taxation could be avoided. The §2036 aspect takes us into an area (such as use of a domestic asset protection trust and application of Rev. Rul. 2004-64) that is beyond the intended reach of these marital deduction materials.

Valuation Differences Between Gifted Property and Property Held at Death

TAM 9403005 involved a control block of corporate stock included in the estate of D. Because the ultimate destination of the stock was irrelevant for inclusion valuation purposes, the government properly held that the stock was subject to valuation under §2031 as a single block for estate tax inclusion purposes, notwithstanding that D's estate plan divided it between a marital and a nonmarital trust. But the government then held that the marital deduction available for the value of the portion of the stock transferred to the marital deduction trust was limited to the discounted value of that minority interest, citing Ahmanson Foundation v. United States, 764 F.2d 761 (9th Cir. 1981), and Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987).

Division of the stock after D's death subjected the estate to wealth transfer tax at a higher value than if the stock had been divided inter vivos, and caused inclusion at a higher value than that used to compute the marital deduction attributable to the stock. If corporate control does not change during the overlife of S and the stock is held until S dies, the amount taxable in S's estate will reflect the discount attributable to the minority block of stock at the time of funding, so the cure is to avoid the valuation disparity in D's estate and at the same time create a minority discount that will be available in S's estate.

To illustrate, assume that D owns 75% of Family Corporation stock and makes an inter vivos gift of just over one-third of that interest to S. See, e.g., Estate of Frank v. Commissioner, 69 T.C.M. (CCH) 2255 (1995). Both the gift tax value and the gift tax marital deduction generated by the gift of that minority interest would be the same, reflecting a minority interest discount. When the slightly less than 50% interest remaining in D's hands is subject to tax (either at death or on a subsequent gift), it too would be valued at a discount to reflect its lack of control in the corporation.[11] See, e.g., TAM 9432001, discussed at page 24, in which the decedent died owning 48% of the stock of a family corporation; the decedent's legatee was the 52% shareholder and the government held that the stock should be valued without reference to the number of legatees or the stock they already held. Assuming that D is not reluctant to part with absolute control over a portion of the stock during life, this division would ensure that no greater value would be

11. An issue might arise if that remaining block were given to S, although traditional valuation principles appear to hold that destination of the stock is not relevant for this valuation purpose.

subject to gift or estate tax in D's hands than would qualify for the marital deduction. A similar plan would entail a 100% owner giving 49% to S, giving a child 2%, and holding the remaining 49% to be taxed at death, all with appropriate minority discounts.

Assume, however, that D is unwilling to part with any of the stock during life. A second alternative that guarantees a marital deduction in the same amount as the value subjected to tax is for D to bequeath a control block of the stock to S (or a marital deduction trust), followed by S making an inter vivos gift of a minority interest that will leave a minority interest to be included in S's estate, both valued at a discount.

This postmortem division of a control block of stock requires, however, that S be given some control over the ultimate destination of the stock. For example, in a QTIP marital deduction trust, S would need an inter vivos power to withdraw the stock to make a gift thereof, because §2056(b)(7)(B)(ii)(II) precludes anyone, including S, from possessing a power to appoint assets from a QTIP trust to a third party during S's overlife. Alternatively, D could create a §2056(b)(5) marital deduction trust that permits S an inter vivos nongeneral power of appointment to make the same division of the stock (and a testamentary general power of appointment to qualify for the marital deduction). If either alternative is acceptable to D, then the value subject to gift tax would be discounted to reflect its minority status, and the remaining minority interest includible at S's death similarly would be discounted, meaning that D's controlling interest would be subjected to wealth transfer tax at a net minority discount.

TAM 9403005 involved a slightly more difficult application of this planning because D owned both common and preferred stock, making the application of §2701 a potential hazard during S's overlife. Assuming the values permit, an easy way to avoid §2701 problems is to allocate all the preferred stock to one of the two trusts created by D and all the common stock to the other and to avoid application of the attribution rules by excluding S as a beneficiary of the nonmarital trust. If the conclusion reached in Treas. Reg. §25.2702-2(d) *Example* 3 is predictive of the government's position under §2701, this division of the common and preferred stock in funding D's marital and nonmarital trusts would not trigger the special valuation rules of §2701 and subsequent gifts of the marital trust's stock by S should not trigger application of that provision either.

A fair amount of recent valuation controversy has involved efforts such as these to split property in search of minority discounts. TAM 8907002 held that a gift of a small sliver of stock that caused the donor to lose control should be taxed at the full value of the transferred property standing alone, *plus* the full control premium that was relinquished. More recently, however, Rev. Rul. 93-12, 1993-1 C.B. 202, and Technical Advice Memoranda 9449001 and 9436005 held that the family attribution rule previously applied by the government to deny minority discounts for intrafamily gifts of stock that destroy control in the donor no longer would be advocated.[12] Effective fractional or minority interest planning is accomplished if a marital deduction is generated prior to division of property but subsequent wealth transfer tax inclusion is delayed until after division of property, assuming the loss of control that is represented by a division occurs without incurring a tax on the lost value.

Traditional analysis of inter vivos gifting notes the advantage of the tax exclusive computation and shifting future income, measured against the improper consideration of shifting

12. Both Mooneyham v. Commissioner, 61 T.C.M. (CCH) 2445 (1991), and Estate of Pillsbury v. Commissioner, 64 T.C.M. (CCH) 284 (1992), held that fractional interests in real estate generate 15% valuation discounts; in *Pillsbury* this result obtained notwithstanding that the portion includible in the decedent's gross estate passed to a trust that owned the other portion of the property, meaning that there never would be a sale of just the includible fractional interest.

future growth, the time-value of money, and the legitimate concern over loss of new basis at death. A far more significant and fundamental reason for prepaying wealth transfer tax in the form of inter vivos gifts that really has not been written about or focused upon by planners is illustrated by several government pronouncements. Think again about TAM 9432001, which reached a result that is correct for estate tax purposes and that was favorable to the taxpayer involved, but in a fact situation that is opposite the norm. That decedent owned 48% of the stock of a family corporation; the decedent's legatee was the 52% shareholder and the question was whether the decedent's stock was entitled to a minority discount for estate tax purposes.

In that respect the same issue would have existed if the legatee had owned anything more than 2% of the stock and, indeed, the issue might have been more significant if it was the decedent's transfer that gave the legatee control that the legatee did not enjoy previously. Notwithstanding that the legatee would hold the 48% interest as part of a control block, the government held that the decedent's stock should be valued without reference to the number of legatees or the stock they already held, citing Estate of Lee v. Commissioner, 69 T.C. 860 (1978), nonacq., 1980-2 C.B. 2, withdrawn and acq., Rev. Rul. 93-12, 1993-1 C.B. 202, and Estate of Zaiger v. Commissioner, 64 T.C. 927 (1975), acq., 1976-1 C.B. 1. Thus, the legatee's post-gift control of the business was irrelevant. Alternatively, however, had the situation been more normal, by which a decedent who controls an entity divides that ownership among a group of legatees, no one of whom receiving a controlling interest, the amount includible for estate tax purposes would reflect the decedent's controlling interest and not the minority interests received by each legatee.

Curiously, the result may differ for gift tax purposes, notwithstanding Treas. Reg. §25.2511-2(a):

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer . . . . On the contrary, the tax . . . is an excise upon [the] act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

This regulation is at least facially consistent with the estate tax valuation regime, under which it does not matter how property is distributed from a decedent's estate. Particularly notable about the government's statement in TAM 9432001 that the number of donees is irrelevant for estate tax purposes is that this issue was not addressed for gift tax purposes in Rev. Rul. 93-12, 1993-1 C.B. 202, which involved a donor who transferred 100% of the stock in a corporation in five equal inter vivos gifts during one year. Without even raising the issue of consistency with the estate tax, the Ruling stated that a minority discount would not be denied to any of those gifts on account of the donees being related family members.

In the context of marital deduction planning, this reveals that the truly effective mechanism to generate minority interest discounts is to bifurcate property between husband and wife by making inter vivos transfers, with the gift tax valuation and the gift tax marital deduction coinciding to produce no gift tax — as compared to waiting until the death of D and making the division at that time, with the phantom value result produced in a case like TAM 9403005.

Fractional Interest Discounts for QTIP Property

This fractional interest creation during the life of both clients is underscored by five valuation decisions involving married individuals who employed a qualified terminable interest property trust, and confirm the ability to substantially reduce the value of certain assets with effective premortem planning. Estate of Mellinger v. Commissioner, 112 T.C. 26 (1999), acq. AOD 1999-

006,[13] Estate of Bailey v. Commissioner, 83 T.C.M. (CCH) 1862 (2002); Estate of Lopes v. Commissioner, 78 T.C.M. (CCH) 46 (1999), and Estate of Nowell v. Commissioner, 77 T.C.M. (CCH) 1239 (1999), all presented the same question originally addressed in the taxpayer's favor in Estate of Bonner v. United States, 84 F.3d 196 (5th Cir. 1996): QTIP aggregation for §2031 inclusion purposes. The government's simple argument is that aggregation should apply with respect to multiple portions of an asset that are includible in S's gross estate, part under §2044 as QTIP trust property and part as S's own property, either under §2033 because it was owned outright, or under §§2036 or 2038 because S transferred it into a revocable inter vivos trust. *Bonner* directly rejected that argument, and now has been affirmed in each of these three cases. Different about the facts in *Nowell* was that S had a nongeneral testamentary power to appoint the QTIP property, giving S control and the ability to combine portions owned by S and by the QTIP trust in a way that might cause a court to decide the valuation discount for a fractional interest differently. As it turned out, notwithstanding that it had been revealed in the briefs, the Tax Court did not even mention this fact, indicating that it was of no moment.

Otherwise, *Bonner* and all of its progeny are essentially the same and in each the court correctly rejected aggregation, essentially on the grounds that QTIP inclusion under §2044 is different than inclusion of property owned by the decedent and includible under any other provision. As stated by the court in *Mellinger*, "QTIP property does not actually pass to or from the surviving spouse" and there is "no indication that section 2044 mandated identical tax consequences as an outright transfer to the surviving spouse." Curiously enough PLR 9848011 mirrored that conclusion in the context of §2042 inclusion of life insurance on the life of the decedent but owned by a corporation that, if controlled by the decedent, might cause incidents of ownership to be deemed owned by the decedent. According to the government in that PLR, "under [Treas. Reg.] §20.2042-1(c)(6), the surviving spouse will not be considered the owner of the stock held in the QTIP" trust.

In Estate of Fontana v. Commissioner, 118 T.C. 318 (2002), the Tax Court concluded that stock held by S outright and stock held in the general power of appointment marital deduction trust properly should be aggregated, distinguishing *Bonner* and its progeny and never mentioning the reality that the *Nowell* taxpayer had control through the testamentary nongeneral power. The rationale for this treatment was the Tax Court's recognition that for tax purposes it is a *general* power that is equated with outright ownership, because the powerholder can appoint the subject property to the taxpayer's own estate. The fact that the decedent surviving spouse in *Fontana* could exercise the general power at the moment of death, described by the court as "the critical moment for estate tax valuation purposes," meant that aggregation was a physical possibility that ought to be reflected for valuation purposes.

Although it would seem that this ought to raise the same aggregation possibility in a case like *Nowell*, in which S also had control — albeit in the context of a nongeneral power — the *Fontana* court made it clear that §2041 treats only the general power of appointment as the

13. Stating that:

> closely-held stock held in a QTIP trust should not be aggregated, for valuation purposes, with stock in the same corporation held in a revocable trust and includible in the decedent's gross estate. The Tax Court's decision in this case is consistent with the Service's position regarding the valuation of minority interests passing to QTIP trusts. The proper funding of the QTIP trust should reflect, for example, the value of minority interests in closely-held entities or fractional interests in real estate that are used in satisfying the marital bequest. Cf. Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987); see also Rev. Rul. 84-105, 1984-2 C.B. 197.

Original publication with a footnote that the acquiescence was in result only was an error that was corrected in a subsequent republication of the acquiescence.

functional equivalent of ownership for tax purposes. The power in *Nowell* was nongeneral and therefore irrelevant, and §2044 is fundamentally different for valuation aggregation purposes.

By the way, the solution in a case like *Fontana* is not for S to relinquish the general power of appointment, because the second sentence of §2041(a)(2) will continue to apply at S's death. Instead, S should gift the half that is under S's control as an owned asset. Furthermore, this discussion reveals that two separate QTIP trusts may be needed if such a fractional interest discount potential asset exists in D's estate. One QTIP would not grant a power of withdrawal and this particular asset would be placed in it, to avoid the §2041 issue.

The net result is that marital funding and the movement or division of property between spouses while both still are alive has been made extremely important by these decisions if the asset involved is such that fractional ownership will produce a valuation discount. In such a case, splitting the asset between the estates of the two spouses, or avoiding imputed ownership between S's estate and a QTIP trust that is taxable in S's estate, will generate discounts for valuation purposes or otherwise avoid unfavorable consequences.

Again, however, caution is in order, because division of an asset at the death of an owner, sending a portion to a nonmarital trust and a portion to the marital deduction QTIP trust, will not pay a dividend, because the discount is not available for inclusion but it will apply for funding purposes as well as subsequent inclusion in S's estate. So the key is to fragment the asset before either spouse dies and then keep it divided until after the survivor's death.

The net result may be an increase in the tension posed by dead hand control in the form of a QTIP trust and the desire of many surviving spouses to obtain a share of the marital wealth outright. It seems that hand-in-glove with an increase in the use of QTIP trusts will come at least the potential for an explosion in the number of surviving spouses who will exercise their rights under state law (in all of the noncommunity property jurisdictions other than Georgia) to take a statutory forced share of the decedent's wealth outright. That possibility can be minimized by building flexibility into QTIP trusts, and the disruption caused by an election can be minimized with effective forethought. But with that planning comes added tension for conflict of interest purposes, all as discussed in Pennell, *Minimizing the Surviving Spouse's Elective Share,* 32 U. MIAMI INST. EST. PLAN. 9-1 to 9-53 (1998). At the very least, use of a QTIP marital deduction trust is not a "no brainer," even as all these results make it appear to be the vehicle of choice.

Inter Vivos Credit Shelter Planning

The planning that underlies the discussion in this section arose before adoption of §2010(c)(2)(B) portability of a deceased spouse's unused exclusion amount in 2010. That rule, now a permanent addition to the Code, provides an easier alternative to the planning presented by this discussion, but some planners eschew portability, in which case this segment may remain viable for its original purpose. But there is a larger issue involved, which will be viable as long as §1014 new-basis-at-death remains in the law.

To appreciate the situation requires a diversion into §1014(e). The §1014 basis adjustment at death has produced some aggressive planning by which some married couples have attempted to generate a new basis at the death of D for *all* property owned by *both* spouses, without incurring an estate tax cost, by making use of the marital deduction. This is permitted by §1014(b)(6) with respect to community property, as to which both halves receive a new basis at the death of D. An effort to mimic that result explains the planning in TAM 9308002. The spouses involved created a revocable inter vivos trust in a noncommunity property state. Most of the property they transferred to the trust was qualified joint tenancy property, and the trust was fully revocable without the consent of the other with respect to the property each contributed. Thus, neither spouse made a completed taxable gift on creation of the trust. Most importantly, each was granted a §2041 inclusion-generating general power of appointment in the form of a right to direct payment of his or her debts and taxes at death from *any* property in the trust — not just from the property that he or she contributed.

Assuming that all the trust property qualified for the marital deduction in the estate of D, this inclusion did not create an estate tax and the government predictably rejected the taxpayer's conclusion that a new basis was generated in the entire trust. S retained "dominion and control" over the property that he or she contributed to the trust. As a result the government concluded that "[S's] property was not acquired [by S] from the decedent under §1014(a) and §1014(e), notwithstanding that it is includible in the decedent's gross estate." Therefore, it held that no new basis was available.

More to the point for this discussion, the TAM discussed the anti-abuse rule found in §1014(e),[14] which precludes a taxpayer from giving property to an individual who is about to die and receiving the same property back from that decedent's estate with a new basis generated by its inclusion in the decedent's estate. The TAM noted the government's guiding principle that the "Taxpayer's position in this case would produce the 'unintended and inappropriate' tax benefit Congress expressly eliminated in enacting §1014(e)."[15]

This led to a second (and more refined) PLR that addressed a very similar plan, with very desirable marital deduction planning results (albeit with the same denial of double new basis opportunities). In PLR 200101021 the spouses created a joint settlor trust, funded with tenancy by the entirety or joint tenancy property. While both spouses were alive either could revoke the trust unilaterally, in which case the property would be partitioned and delivered to them in equal shares. D was given a general testamentary power to appoint all of the trust property and, in default of exercise, the property was allocated first to a credit shelter trust and any excess to S outright.

The government's conclusions regarding the tax consequences are favorable to taxpayers in all respects except the one most critical to their fundamental objective in these plans, which was new basis on both spouses' property when the first of them died. Forget about that, and focus on the rest.

According to the PLR,[16] when D died all the trust property was includible in D's estate, half under §2038 due to the transfer with retained power of revocation and half under §2041 due to

14. According to the legislative history, H. Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981), §1014(e) applies if the property passes directly or indirectly back to the donor or the donor's spouse. Thus, if the property increases D's gross estate and thus increases the amount of D's formula marital deduction bequest back to the donor, the legislative history suggests that §1014(e) will deny a new basis even if the property is not used to satisfy that marital bequest. Even a specific bequest of the actual property received away from the marital bequest should not avoid §1014(e) if the formula bequest is increased by virtue of inclusion.

On the other hand, if there is no marital deduction in D's estate, then presumably §1014(e) is not applicable at all. Adding further confusion is PLR 9321050, suggesting that if all the donor enjoys after the first decedent's death is a life income interest, then perhaps any potential §1014(e) application is limited to the income interest only and it does not apply as to the basis in the remainder. The PLR declined to opine on that speculation.

15. The same result would have been reached, perhaps more easily, by ruling that S reacquired his or her own property, which was transferred to D within one year of D's death. Indeed, it was "acquired" for tax purposes by D at the moment of death, in the form of the general power of appointment that lapsed at that moment. Viewed in this way, that property would be subject to the §1014(e) one-year rule.

16. See also the following PLRs, all involving inter vivos QTIP trusts with a life estate in the surviving spouse. PLRs 200406004, 9109029 (the donee spouse was granted a general testamentary power of appointment exercisable only with the consent of a nonadverse party, which did not qualify as a §2056(b)(5) marital deduction trust because the power was not exercisable alone), 9026036 (the donee spouse also was given a nongeneral testamentary power of

the general testamentary power of appointment. The trust property treated as a gift from S to D was regarded as being returned to S. That triggered application of §1014(e) — denying a basis increase on S's half of the trust corpus. In essence, the government simply viewed S as making a completed gift to D immediately before D's death, as if D and S had figured out who would die first and placed title to their joint property entirely in D's name.[17]

The most important conclusion was similar to the position in Treas. Reg. §25.2523(f)-1(f) Example 11 regarding the effect of §2044 inclusion of an inter vivos QTIP trust in the estate of the donee spouse, followed by a secondary life estate in the surviving donor. That is, inclusion in D's estate precludes §2036(a)(1) inclusion when the donor spouse dies second, notwithstanding the retained secondary life estate. The regulation regards estate tax inclusion in D's estate as "cleansing" or erasing S's involvement in creating the trust.

This planning is desirable if there is no gift tax on creation of the trust and no estate tax to be paid because any property includible in D's estate is matched by a §2056 marital deduction or is sheltered by D's unified credit. More importantly, there is no need to guess which spouse will die first. Their collective property can be placed in the trust to take advantage of the unified credit or GST exemption of whoever dies first, effectively accomplishing what inter vivos transfers to equalize estates would do. And the result is use of D's unified credit without reliance on §2010(c)(2)(B) portability of D's unused exclusion amount, which is second best planning.

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appointment, limited to a specified class of permissible appointees, which added a degree of flexibility, for example to divest the donor, if necessary, to avoid what might have been adverse tax consequences), and 8944009 (the inter vivos QTIP trust granted a general testamentary power of appointment to the donee, exercisable in favor of creditors of the donee's estate (which did not qualify as a §2056(b)(5) marital deduction trust because the requisite general power must be exercisable in favor of S or S's estate); the government also ruled that the donee would be treated as the transferor of the trust property for GST tax purposes).

According to the attorney who secured the 1989 PLR (but not explained in the PLR), the general power of appointment was given the effect stated because, under state law, it precluded the donor's creditors from treating the trust property as available to satisfy their claims against the donor. Lacking this power of appointment, the creditors could have reached the donor's retained secondary income interest (even if it was only a discretionary income interest) and, therefore, §2036(a)(1) would have applied at the donor's death. See Dodge, Redoing the Estate and Gift Taxes Along Easy-to-Value Lines, 43 Tax'n L. Rev. 241 (1988) at nn.124-126 and accompanying text. The PLR did not indicate whether a power of appointment exercisable in favor of creditors of the donee's estate but only with the consent of a nonadverse party (such as the trustee) still would produce the stated results. Such a power of appointment would cause §2041 inclusion in the donee's estate, but presumably state law would determine whether such a restricted power of appointment still would preclude the donor's creditors from reaching the trust. If it would, then the donor effectively could handcuff the donee's exercise of the general power of appointment while still accomplishing the desired objective of sheltering the donee's unified credit or GST exemption, all without losing enjoyment of the transferred property if the donee died first. It may not be wise to make the donor the trustee of such a trust, however, although arguably even that degree of control would not be problematical if it was circumscribed properly to avoid inclusion under §§2036(a)(2) and §2038(a)(1) and if state law still kept the donor's creditors at bay.

17. If they could do this more than one year before D's death the new basis at death rule would be allowed to operate. Instead, because they are deemed to accomplish their planning immediately before D died, §1014(e) properly applies to preclude their attempt to adjust the basis in S's half.

Assume that the spouses created the trust more than one year before either died and made the transfer into trust irrevocable, with each preventing a taxable gift by retaining a nongeneral testamentary power to appoint the property he or she contributed. If each spouse gave the other a general inter vivos power to appoint the property he or she contributed, this might cause the intended inclusion D's estate but might avoid §1014(e) because the creation and transfers occurred more than one year before either spouse died. Inclusion of each spouse's own property in his or her own estate presumably could be guaranteed under §2036(a)(1) by retention of a right to receive income from the transferred property, and inclusion of S's property in D's estate would be generated by the general power of appointment granted by S to D.

Additional PLRs are nearly identical to PLR 200101021. For example, PLR 200210051 (which is not as carefully or fully documented or articulated) involved just one minor difference in that not all the property funding the trust was the spouses' joint tenancy or tenancy by the entireties. In addition, the general power of appointment available to D was exercisable inter vivos, not testamentary, in that each spouse had a unilateral right to revoke, to withdraw, or to convey trust property while they both were alive.[18] PLRs 200604028, 200413011, and 200403094 also blessed variations on the marital deduction planning designed to shelter both spouses' unified credits with their respective properties, no matter which spouse died first.[19]

In the aftermath of these PLRs some observers recommend that one spouse with most of the wealth create such a trust, giving the less wealthy spouse a general power of appointment that will absorb the unified credit and GST exemption of whomever dies first. That ought to be as effective as a joint settlor trust, although the power would need to be contingent on the less wealthy spouse dying first, so that its lapse — if that spouse survived — did not attract estate or gift tax.

Some planners encourage granting an inter vivos power instead of a testamentary power, to avoid uncertainty about the marital deduction consequence of the joint settlor plan. That is, some observers question the suggestion that S makes a gift to D in the form of the general *testamentary* power of appointment, and that this gift qualifies for the gift tax marital deduction. This may avoid the question of how a living spouse makes a gift to a deceased spouse, and how it can qualify for the marital deduction if the deemed recipient already is deceased. Marital deduction qualification is easier to embrace if the power is inter vivos rather than testamentary. The PLRs don't seem to be fazed in either case, however.

Some planners also favor a power to appoint only a formula amount that absorbs just any unused portion of D's unified credit or GST exemption, thus minimizing any potential risks of this plan, if the PLRs are wrong on one or more counts.[20] Others recommend that the powerholder immediately release the inter vivos general power, thereby assuring the donor spouse that no control actually will be exercised that might be contrary to the donor's intent.[21]

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18. This did not produce a different result for §1014(e) (or any other purpose), the PLR making a broad unsupported statement that §1014(e):

> will apply to any Trust property includible in the deceased Donor's gross estate that is attributable to the surviving Donor's contribution to Trust and that is acquired by the surviving Donor, either directly or indirectly, pursuant to the deceased Donor's exercise, or failure to exercise, the general power of appointment over the Trust property.

19. Although none spoke to the issue of new basis being generated for property contributed by S. Given that the number one priority of the government in evaluating this planning is to deny new basis on both spouses' property at D's death, the conclusion that the nature of the general power does not alter the result is not surprising. It is possible that the latest PLRs involved taxpayers who were not interested in the basis aspects of this planning or who withdrew requests on the basis issue rather than receive a negative result.

20. Other planners go as far as to suggest that the nonmarital trust grant S a formula general power of appointment of the smallest amount needed to fully utilize S's unified credit with low basis assets, to garner a basis step up on S's death, with no added estate tax liability (to the extent S's credit is not fully utilized).

The objective of producing a new basis in both spouses' property at D's death can be accomplished without all the trouble involved in these situations, only if the spouses are able to guess which of them will die first and the expected survivor transfers all of his or her property to that spouse more than one year before that expected death. It also would be available under the Alaska voluntary community property approach, if that tax-motivated planning is respected. The government views the taxpayers' plans as violating the spirit of §1014(e), and planners should expect to be challenged by the government in this arena.

21. Note that the powerholder's ongoing income interest in the trust will guarantee inclusion at the powerholder's death, notwithstanding this release. See the second clause of §2041(a)(2), which provides that inclusion occurs at death

Finally, note that §2010(c)(2)(B) portability of the donee spouse's unused exclusion amount minimizes the need for all of this planning if that spouse dies first, but it does not preserve that spouse's unused GST exemption.

Income Tax Separate Share Rule

This next bit of lint in your ear is relevant to marital deduction planning only because so much of the marital funding decision process involves income tax consequences. The separate share rule regulations added another flavor to that mix. Applicable to decedents who died after 1999, Treas. Reg. §1.663(c) establishes the parameters of §663(c) separate share treatment in estates and revocable inter vivos trusts that qualify to make the §645 election to be treated as part of an estate for income tax purposes. Applicable *only* to determine distributable net income and the extent of any §§661 and 662 distributions deduction and income carry out inclusion to beneficiaries, the regulation recognizes that an estate or qualifying trust may consist of multiple separate entitlements. For marital deduction funding purposes they make nearly every marital bequest the functional equivalent of fractional maritals for administration and income tax purposes.

A separate share exists if beneficiaries (or a class of beneficiaries) have identifiable economic interests that — under a standard adopted by final Treas. Reg. §1.663(c)-4(a) — "neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries." As illustrations, Treas. Reg. §1.663-4 lists a surviving spouse's elective share and any §645 qualifying trust — the preamble to the final regulations says even if no election is made (and the regulation adds that the trust could have separate shares within it as well, which will be separate from the estate proper in all events). In addition, a specific bequest that fails to qualify for the §663(a)(1) exclusion from the distributable net income carryout rules (because it is payable in more than three installments, or in our case because the determination of the amount of the bequest is not fixed at the moment of death — because it is a formula marital bequest) is a separate share (although the final regulation takes pains to note that §663(a)(1) qualifying bequests are *not* separate shares, because they are not part of the §§661 and 662 income carryout scheme). No mention is made of a surviving spouse's community property share titled in the decedent's name and therefore subject to estate administration. Presumably S's portion of any community property is the quintessential separate share, entitled to its own income but no other DNI carryout.

Because the regulation recognizes that a separate share may have multiple beneficiaries whose respective entitlements within that share may not be separate, the regulation does not eliminate entirely the potential for inequitable distribution of an estate's income tax burden, but situations that do not involve subclasses (for example, the typical marital deduction bequest) will benefit from the separate share rule to the extent it precludes much of the potential to impose a disproportionate share of distributable net income on one beneficiary. In the process, however, postmortem planning also wanes to the extent it engineers distributions that direct income to some beneficiaries who are better able to absorb it in any given year. Fortunately (at least for the fiduciary in most cases), the need to make compensatory adjustments in the wake of this form of engineered (or, in some cases, inept) inequity also has waned. Unfortunately, however, Treas. Reg. §1.663(c)-5 *Examples 6 and 9*, discussed below, open new avenues for postmortem engineering with income in respect of a decedent and highlight the potential need for a not yet adjudicated equitable adjustment.

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if, following a release, the powerholder continues to have any interest or power that would trigger inclusion under §§2036-2038 if the trust property was the powerholder's own contribution to the trust.

In place of the administrative difficulties implicit in making some prior compensatory adjustments comes a much more invidious administrative burden — one that presumably cannot be waived by a provision in a will (as could the need to make compensatory adjustments) — and estate administration now has the look and feel of a fractional marital deduction bequest. Illustrated overtly in Treas. Reg. §1.663(c)-5 *Example 3* and obliquely in *Examples 6* and *10* is the notion that separate but undivided shares require accounting that allocates income and deductions, and reflects non pro rata distributions, with a "rolling fraction" that changes with every administrative act that alters the respective entitlements of the various separate beneficiaries.

Thus, for example, if S is entitled to 62% of an estate (after debts, expenses, and taxes) as a marital deduction bequest or an elective share and two children split the other 38%, income and deductions would be prorated between them 62%, 19%, and 19% initially, and when a non-lock-step distribution is made to any of the three the relative proportions will be readjusted. For example, if S received a distribution that reduces the remaining entitlement to 60% of the residue and increases the children's respective shares to 20% each, the fraction must be adjusted accordingly.

To illustrate, assume the trust was $13.2 million originally, and that S was entitled to 62.1212% of it ($8,200,000). That trust grows to $13,300,000, at which time S's 62% is worth $8,262,120. A distribution to S of $50,000 is made, and the fraction must be adjusted to reduce both the numerator and the denominator of that fraction by the $50,000. So $8,262,120/13,300,000 becomes $8,212,120/13,250,000 and S's new share is 61.9783%. The children's shares correspondingly increase.

To make this calculation first required that the entire estate be revalued to determine the absolute dollar value of each respective share, followed by subtraction of the distribution to reduce the future proportionate distribution entitlement of the particular recipient and increase the proportionate share of all the other beneficiaries. The net result is calculation of new relative percentages of the balance of the estate for future allocation of income and deductions. Required was a determination of (1) when the income of the entity was earned, (2) when any capital gain was incurred, (3) when distribution occurs relative to both the income and capital gain generation, and (4) the extent of any valuation changes. This last matter is highlighted by the preamble to the final regulation, which makes clear that the government intentionally did not provide relief from adjustment, even if the government successfully challenges valuations on audit of an estate tax return.

The only possible relief provided by the regulation is in the form of a loose "reasonable and equitable" allocation, valuation, and calculation standard articulated in Treas. Reg. §1.663(c)-4(c), which ostensibly provides some flexibility to fiduciaries in making the requisite computations. It may be that changes in the relative size of various shares of an estate or qualifying trust will occur after filing a Form 1041, reflecting valuation changes or the imposition of transfer taxes and other obligations payable from one share only, and perhaps amendment of such a return will not be required. But the math will not often be easy with respect to changes that occur before the end of a tax year, and valuation problems may pose significant administrative costs; each of which may compel lock step distributions or loans in lieu of interim partial distributions.

One potential consequence of these regulations is that pecuniary formula marital bequests — which Treas. Reg. §1.663(a)-1(b) specifies as failing to satisfy as §663(a)(1) specific bequests because the amount typically is not determinable as of the moment of the decedent's death – are become as administratively cumbersome as fractional marital bequests were in the past (unless pains are taken to avoid any form of interim partial distribution or valuation changes). See generally Cantrell, *Separate Share Regulations Propose Surprising Changes*, 138 TRUSTS & ESTATES 56 (March 1999). As some commentators have correctly noted, these complexities were standard operating procedure in revocable inter vivos trusts used as will substitutes, after the settlor's death but before full severance and distribution of marital and nonmarital portions. Thus, the expansion of traditional accounting requirements to estates and qualifying §645 trusts is nothing new — except to the vast majority of income tax professionals who never complied with the adjustment requirements previously. Oddly enough, the silver lining in this may be that more planners should embrace the pick-and-choose fractional marital approach, given that in many respects it is a more favorable funding mechanism that was shunned in the past because of a perception that it posed greater administrative complexity. That differential disappeared when these regulations became final.

A good bit of the devil in the final regulation is revealed in examples that were newly added to final Treas. Reg. §1.663(c)-5. A number of them are worthy of elaboration here because of gnarly questions they raise but do not answer. To illustrate, *Example 3* involves a formula marital bequest and partial non pro rata distribution of some but not all shares under the estate, expressly requiring adjustment of the fraction used in the future to allocate income and deductions to the respective shares. The example contains a statement, however, that "depending on when the distribution is made," it may not be necessary to adjust the fraction for the year of distribution, without giving any detail regarding the intended meaning of that caveat.

Presumably an interim disproportionate distribution made several days before the end of the estate's tax year would not require readjustment of the fraction for the few remaining days of that year, and this might be a useful administrative simplification if the estate terminates during that same year. But surely the fraction must be amended if administration continues into a new year.

Perhaps the caveat also suggests that non lock step distributions made at different times over a short span and that collectively maintain the proportions of estate shares will not require adjustment of the fraction at all. The caveat does not appear to offer a special dispensation if a deviation from proportionate lock step distributions involves a de minimis dollar amount (such as $1,000 too much to one share or the other) rather than a modest timing disparity, although it is possible (perhaps even probable) that the "reasonable and equitable" standard in Treas. Reg. §1.663(c)-2(c) would apply even in that case.

Example 4 posits a formula credit shelter pecuniary bequest that is distributable in no more than three installments, making it appear that it is leading to the §663(a)(1) specific bequest exception. However, a formula bequest that cannot be determined in amount as of the moment of death cannot qualify under §663(a)(1). Thus, really involved in *Example 4* is the added stated fact that the formula bequest "is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets" — which reads back into Treas. Reg. §1.663(c)-4(b), providing separate share treatment if these double requirements relating to income and valuation fluctuations are met. The example concludes that "[b]ecause, under the terms of the will, no estate income is allocated to the bequest . . . the distributable net income for that . . . share is zero."

Not clear is whether the two requisites for the caveat to apply must be *expressed* by the document: no income and no fluctuation in value. It ought to be applicable if the nature of the bequest (for example, a true worth pecuniary marital or nonmarital bequest) freezes the value of the entitlement and state law or the document provides that no income or interest is payable. Thus, if under state law a marital or nonmarital bequest is frozen in value — it neither shares in appreciation nor depreciation — *and* it is not entitled to income under the document or state law, that portion of the estate is immune to DNI carryout. Without proper drafting in advance this probably only describes a true worth pecuniary not in trust, as to which neither income nor changes in value are attributed to the pecuniary entitlement. Pecuniary bequests in trust often carry income when distribution is made, which would preclude this treatment as above and beyond the separate share DNI carryout rules.

It also is curious that the Example posits no distributable net income carryout consequence because no income is allocable to the bequest. The caveat requires both elements to be present — neither an income entitlement nor a valuation fluctuation. Presumably this means that a fractional division of shares that pro rates appreciation or depreciation would be subject to income carryout under these regulations even if state law or the governing document provided that the particular share does not benefit from income earned during administration.

A final fact illustrated in the Example is capital gain realized on an in-kind distribution of appreciated property in satisfaction of the bequest. The regulation states that no distributable net income would carry out with the distribution, without making special mention of the issue whether capital gain might be includible in distributable net income in such a case. This is consistent with the traditional §643(a)(3) notion that capital gain incurred on funding is not properly includible in distributable net income and, although that aspect is not specifically noted, that result should not change even if the bequest carried out income.

Examples 6, 9, and *10* all involve income in respect of a decedent (IRD) and a special rule added in final Treas. Reg. §1.663(c)-2(b)(3) that IRD is allocable only among those separate shares "that could potentially be funded with these amounts . . . [with the allocation] based on the relative value of each share that could potentially be funded with such amounts." Thus, a document will be respected that apportions IRD among various beneficiaries for income tax purposes, which has been common in pecuniary marital deduction funding provisions that prohibit the use of the right to receive IRD to prevent §691(a)(2) acceleration of the IRD. *Example 9* illustrates that the personal representative controls the tax consequence of the IRD by timing distributions — in that case positing that the IRD is received by the estate prior to funding a separate share to which the IRD is allocable. Stated by the Example is that any distributions made *to either share* during that year will cause allocation of the IRD to the separate share to which it is payable under the document.

What seems odd is that distribution to some other share would cause taxation of the IRD to the share to which it *is* allocable. Indeed, it doesn't seem possible that this rule could cause taxation of the IRD to the share to which it ultimately is payable, if no distributions are made during that year to the IRD recipient share, because there would be no §§661 and 662 income carry out to that share for that year at all. Thus, reference in the example to "distributions . . . to either" beneficiary seems to be in error. In addition, however, if the personal representative makes certain that *no* distributions are made during the year the IRD is received, then the income tax liability flowing from that income — and presumably any §691(c) deduction attributable to it as well — will be borne or enjoyed by *both* shares proportionately, because the estate as a whole would be the proper taxpayer with respect to that IRD.

Finally, *Example 10* reveals that the pro ration of IRD can be altered by valuation fluctuations, presumably meaning that the personal representative also can engineer the allocation of IRD tax consequences by timing distributions in concert with valuation changes. All of this may require the personal representative to make an equitable or compensatory adjustment of the same variety as a *Warms* adjustment in the context of the familiar §642(g) "swing item" election. There is no known case calling for such an adjustment, although the equities for one are compelling.

Example 7 illustrates S's elective share entitlement of an estate, which is treated as a separate share under Treas. Reg. §1.663(c)-4(a) if S is entitled to *both* income and appreciation/depreciation during estate administration. Curious is that Treas. Reg. §1.663(c)-4(b) states that an elective share is a separate share if state law provides that S is entitled to *neither* income nor appreciation/depreciation during estate administration. It is not clear why the rule is not that an elective share entitlement is a separate share in all events. Nor does the rule state what happens if the share is entitled under state law to *either* income or appreciation/depreciation, but not both. Presumably elective shares are separate shares in all cases.

The Example is even more troublesome because it posits an elective share that is not entitled to estate income; rather, it is entitled to statutory interest on delayed payment.[22] In that case there is no §661 and 662 income tax consequence. Instead, the interest is taxable to S as §61 income earned, and the estate is denied an interest expense deduction because it's payment is personal interest that is nondeductible under §163(h). That is a truly lousy result, and it is not clear whether a document could alter this result by dictating that income be paid in lieu of statutory interest (assuming that state law would so permit), and cause the elective share to be regarded as a separate share with §661 and 662 treatment. And again, would it be necessary that this income entitlement be coupled with a sharing of appreciation/depreciation or would the income right alone suffice? The preamble discusses elective shares in some length but does not illuminate any of these questions.

Example 8 illustrates a bequest that qualifies as a §663(a)(1) bequest of specific property, which Treas. Reg. §1.663(c)-4(a) provides is not a separate share — indeed, it is outside the §§661 and 662 income carryout scheme entirely. The Example says: "The will . . . directs the executor to distribute *the* X stock and all dividends therefrom to Child A and the residue of the estate to child B." The emphasis is because "the" X stock is not identified and appears to have no antecedent in the regulations, but presumably means *any* X stock in the estate. Notice that a bequest of *any* X stock found in an estate at death — rather than specified shares of X stock — probably is a general bequest under state law, not a specific bequest.

Under §663(a)(1) that fine, technical distinction under wills law appears to be irrelevant with respect to the X stock itself, but this Example shows that it can be important with respect to an entitlement under state law to income earned postmortem on the X stock. In most jurisdictions the earnings postmortem from a specific bequest belong to the recipient of that specific bequest, even if the document is silent. A different rule typically applies to a general bequest, such as a pecuniary marital or nonmarital amount (which earns interest on a delayed distribution, but is *not* entitled to postmortem earnings on the particular property distributed in satisfaction of the general bequest). This distinction helps to explain why the wills law classification of the bequest can be important, and it also might mean that in most cases of a specific bequest this Example will be applicable, even in the absence of a specific document provision directing the income from the specific bequest, such as posited in the Example.

Note that none of this matters if both trusts require mandatory distribution of income to S. Which adds to the reasons for the template recommended at page 2.

22. Cf. In re Estate of Beren, *** P.3d *** [2012 WL 5871034] (Colo. Ct. App. 2012), involving delayed satisfaction of a surviving spouse's elective share. UPC §2-202(a) regards the share of a surviving spouse as "an amount" determined by a formula and §2-209(e) (by virtue of a cross reference to §3-904) regards that as a general pecuniary amount that is entitled to interest for any delay in distribution, beginning one year after the date of death. Colorado had not adopted the 2008 amendment to the UPC that entitles a spouse to interest on a delayed distribution – nor was the elective share regarded as a fraction of the estate that would participate in either appreciation or depreciation during estate administration. As a result, the spouse was denied any portion of a very significant appreciation in value. The result in most other states would differ.

Funding Marital Deduction Transfers

Two items of interest to estate planners are relevant regarding the actual satisfaction of marital deduction bequests. The first involves an argument made by the government in several family limited partnership or limited liability company valuation cases and is illustrated by Estate of Turner v. Commissioner, 102 T.C.M. (CCH) 214 (2011), in which assets transferred to an FLP were includible in the taxpayer's gross estate under §2036 without considering discounts attributable to the FLP. To illustrate the various issues, assume a lifetime transfer of $10x of value to an FLP, in exchange for $6x of FLP interests (reflecting a 40% valuation discount attributable to the terms and restrictions in the FLP agreement). Immediately after creation of the FLP the taxpayer transfers $1x of those FLP interests by gift, retaining $5x. After which all the assets in the FLP double in value, as do the FLP interests.

Proper Analysis		IRS/Court Approach
10x	§2033 inclusion	0
20x	§2036 inclusion	20x
(6x)	§2043 offset	0
1x	Adjusted taxable gifts	0
25x	Net amount taxable	20x

Because the taxpayer actually owns the FLP interests at death, §2033 should include the full value of the interests that the taxpayer received and did not previously give away, which in the left column represents $6x received, reduced by the gift of $1x, and then a doubling in value to $10x by death. By virtue of §2036, *also* includible is the estate tax value of the assets transferred to the FLP, and then the Code ameliorates the double taxation issue correctly perceived by the court through the §2043(a) offset. The government's approach in the right column, embraced by the court without mention of §2043, simply ignores all aspects of the original contribution to the FLP, the gift, and the FLP interests held at death, as if the taxpayer had done nothing during life.

A subsequent decision by the same judge in *Turner* was promulgated seven months after the original, this time as a regularly reported decision, adding one more issue to complicate the FLP analysis. Estate of Turner v. Commissioner, 138 T.C. 306 (2012), reflects a concern that has arisen in several FLP cases that also involved the estate tax marital deduction.

The marital deduction issue comes in two pieces, and *Turner* sidestepped the one that has caused taxpayers the most heartburn. That issue entails a "whipsaw" argument by the government that (1) the value includible in the gross estate under §2036(a) is the date of death value of the assets transferred into the FLP, with no valuation discounts, but (2) the value for marital deduction purposes is the discounted value of the FLP interests owned by the decedent at death and that are allocated to the surviving spouse in actual satisfaction of the marital bequest. Denying a valuation discount for inclusion but respecting it for marital deduction funding causes the estate to have phantom value that results in tax liability, notwithstanding an optimum formula marital bequest that is designed to reduce estate tax to zero. The government did *not* assert that issue, so the court was able to sidestep it here.

The other issue, that the court correctly decided in favor of the government, is so clear that the estate's approach is a mystery. The simple fact in *Turner* is that the taxpayer received FLP interests and then made gifts of some of them. That explains why the calculation above shows the $1x gift of FLP interests, which the court purged from the estate tax calculation when §2036 inclusion of the underlying FLP assets was applied with no discounts. But when estate distribution is called for neither the underlying assets within the FLP nor those gifted FLP interests were actually owned by the estate, and neither was available for satisfaction of the marital bequest.

The amount of marital deduction needed to zero-out the estate tax liability is inflated by inclusion of the FLP assets without discount valuation, but the full amount of that increased marital bequest cannot be satisfied with assets that actually are owned by the decedent at death, that can meet the "passing" test, and that will be includible in the estate of the surviving spouse at the second death. So this second opinion correctly limited the marital deduction to the value of estate assets that actually could be transferred in satisfaction of the marital bequest. Which meant that the estate had phantom value on which it owed estate tax.

Not discussed in the opinion is the fact that the estate presumably must invade the marital bequest to finance the tax generated on the phantom value, which probably will reduce the marital bequest and thus the deduction even further, generating more tax yet again, that also needs to be paid, causing a further invasion of the marital bequest, ad nauseum. Those facts are not given in the opinion but that issue likely is the lurking consequence of the court's resolution of this issue. And it might arise in many other FLP discount cases involving a marital deduction bequest to a surviving spouse.

Here is an illustration of how this resolves, based on the first calculation above:

Proper Analysis		IRS/Court Approach
10x	§2033 inclusion	0
20x	§2036 inclusion	20x
(6x)	§2043 offset	0
1x	Adjusted taxable gifts	0
25x	Net amount taxable	20x
(1.5x)	AEA (death in 2004)	(1.5x)
23.5x	Formula marital needed	18.5x
18x	Estate assets available	18x
5.5x	Phantom amount taxable	0.5x

This calculation assumes the whipsaw argument is *not* applied – so the assets deemed to be available to satisfy the marital bequest are not limited to those actually owned (FLP interests worth $10x) but instead are those deemed to be included under §2036 ($20x), less the value that was transferred inter vivos ($1x at the time, which doubled in value under the facts assumed). Given that the court did not resolve the whipsaw issue in the government's favor, presumably we must assume that estate assets available to satisfy the marital bequest are the $20x included under §2036, reduced by those given away during life. In which case, in each column there will be phantom value if the gift is respected. In truth, because the estate actually owns only $10x at the time of funding the marital bequest, the whipsaw argument would yield phantom value of $13.5x in the left column and $8.5x in the right hand column. Neither result is very palatable. And notice how the §2036(a) result is dramatically worse than the other alternatives noted when these marital deduction issues are factored into the equation.

The second marital funding item of interest relates to the following hugely abbreviated discussion, which provides a basis for quick comparison of the various factors recommending marital funding alternatives. Although reference may be made to this material during the session, full marital deduction funding analysis is simply too time consuming to fit within the time allocation for this topic. For an up to date exegesis of marital funding consult Pennell, *Estate Tax Marital Deduction*, 843 Tax Estates, Gifts, and Trusts Portfolio Part VIII (Tax Mgmt. 2012), Pennell, *Funding Marital Deduction (and other) Bequests*, 35 U. Miami Est. Plan. Inst. Chapter 15 (2001), or 2 Casner & Pennell, ESTATE PLANNING §13.7 (8th ed. 2012).

The most significant consequences of each funding approach that might be considered in weighing their various advantages and disadvantages are summarized below. In thinking about gain or loss consequences, the most notable aspect of the 2001 Act was the amendment to §1040 that will prevent any carryover regime from altering the results under current law. So no new thinking is required with respect to this aspect of marital deduction planning.

- The *true worth pecuniary* allows full pick-and-choose flexibility, without risk of overfunding and potentially without regard to the separate share rule, but at a cost of capital gain in funding, the need to do some revaluations in the funding process, and protection of the marital bequest from abatement in a declining market.
- The *fairly representative pecuniary* avoids gain or loss in the current new basis at death environment, at the risk of over- or underfunding the marital, with a reduction in flexibility and the need to revalue all assets to comply with Rev. Proc. 64-19 and the separate share rule.
- The *minimum worth pecuniary* avoids gain (but not loss) at the risk of overfunding the marital (unless the New York style collective asset modification is made), with a minimum of revaluation required, but with a higher degree of sophistication required, a need to comply with the separate share rule, and a greater risk of challenge by disaffected beneficiaries.
- The *true worth reverse pecuniary* allows full pick-and-choose flexibility and minimizes some administrative problems and gain or loss on funding, but allocates all appreciation and depreciation during administration to the marital residue and the marital share constitutes a separate share for income tax purposes. It removes the need to rely on §2032 alternate valuation in a declining market because all depreciation is suffered by the marital bequest (essentially mirroring the effect of alternate valuation).
- The *fairly representative reverse pecuniary* offers all the advantages of the true worth reverse pecuniary and it avoids capital gain or loss on funding in the current new basis at death environment. It requires compliance with the separate share rule, along with Rev. Proc. 64-19 (but this latter requirement allows pro rata sharing of appreciation or depreciation between the marital and nonmarital portions).
- The *pro rata fractional* avoids gain or loss and might avoid revaluations, at a cost of lost flexibility, administrative and separate share rule problems, and a marital share that is not frozen in value.
- The *pick-and-choose fractional* allows full flexibility without gain or loss on funding, but requires revaluation of all assets. It produces a marital share that is subject to the same administrative complexities as a pro rata fractional and that also is not frozen in value.
- The *single fund* marital essentially avoids most funding issues altogether but requires revaluation at periodic intervals if the rolling fraction is used. It also offers no flexibility in funding, cannot shelter appreciating assets, and cannot be used to segregate a fund for GST exemption allocation.

No single approach is appropriate in all situations, given all asset mixes and different family situations. Most sophisticated estate planners find that they narrow their selection to several comfortable alternatives and choose among them as the circumstances dictate. The following chart provides a quick comparison of the various factors recommending the marital funding alternatives considered briefly here:

	Traditional Up Front Pecuniary			***Credit Shelter Pecuniary***		***Fractional***		
	True Worth	**Fairly Rep**	**Minimum Worth**	**True Worth**	**Fairly Rep**	**Pro Rata**	**Pick & Choose**	**Single Fund**
Is marital frozen?	Yes	No	NO	***NO!***	No	No	No	No
Funding incurs gain or loss	Yes	Gain=0	Gain=0. Loss may be §267	Yes	Gain=0	No	No	No
Accelerates IRD?	Yes	Yes	Yes	Yes	Yes	No	No	No
Income tax separate share?	Yes, but DNI is 0	Yes	Yes	Yes	Yes	Yes	Yes	Yes
How much DNI is carried out?	FMV	Lesser of FMV/AB	Lesser of FMV/AB	FMV	Lesser of FMV/AB	Lesser of FMV/AB	Lesser of FMV/AB	None
Revaluation	All assets distributed	All assets	Loss assets distributed	Only assets distributed	All assets	All assets, often?	All assets, often	Rolling fraction
Administrative problems?	Only §663	§663 plus?	Only §663	Only §663	§663 plus?	Same as §663?	Same as §663?	Rolling fraction
Flexible?	Yes	Doubtful	Yes	Yes	Doubtful	None	Yes	None

Food for Thought: Funding With Split Interests

There should be no doubt about the sanctity of the marital deduction if, sometime (long) after funding, the marital trust sells a remainder interest in trust assets following a life estate measured by the life of S.[23] The advantage of such a sale exists in beating the §7520 valuation tables for valuation of life estates, terms, and remainders. Likely purchasers of a remainder interest might be a generation-skipping trust, to leverage the generation-skipping transfer tax exemption, or any other nonmarital trust, to leverage the unified credit.[24] Similarly, the marital and nonmarital or generation-skipping trusts could purchase split interests in assets, with the marital trust purchasing a life estate in property at the same time the nonmarital or generation-skipping trust buys a remainder therein.[25]

If these transactions are permissible, then quaere whether it would be permissible to fund the marital and nonmarital bequests initially with temporal interests. There should be no question about the validity of funding a marital deduction trust with a note (including a self-canceling installment note tied to S's life expectancy), preferred stock, or with a naked life estate, provided

23. A sale of a remainder interest long after funding would not create a nondeductible terminable interest. It might raise §2702 concerns — if the remainder beneficiary transfers the remainder in exchange for cash and an interest in the trust is retained by S (an applicable family member if S is an ancestor of the remainder beneficiary) — but those are of no concern here. See 1 Casner & Pennell, Estate Planning §7.2.2 (7th ed.).

24. For the sale of a remainder interest to be a permissible transaction (assuming §2702 does not prevent the underlying objective), however, the two trusts probably must grant specific authority to sell or invest in split or future interests and in unproductive property. Under such authority, the marital trust would own a wasting asset (because the life estate will expire at the surviving spouse's death) while the generation-skipping or nonmarital trust would own only a future interest with no present income entitlement. Even if the underlying property is a proper investment, each interest is an otherwise improper investment for trust law purposes because temporal interests have been divided between the two trusts.

25. In this case, §2702 probably does not even arguably apply, meaning that it may be possible to engage in split interest estate freezing during the overlife of the surviving spouse in a manner that could not be accomplished during the life of the decedent.

that S's beneficial interest in the marital trust is not a nondeductible terminable interest for purposes of §2056(b). As an investment, these interests are like any other asset that might be owned by a marital deduction trust. If the document authorizes the trustee to invest in wasting assets for the marital trust (the life estate) and in non-income-producing assets for the nonmarital trust (the remainder interest), then this form of investment should not be problematical for marital deduction purposes. And if S is likely to die sooner than the government's valuation tables predict, all of this planning translates into a permissible form of estate freezing for S's overlife (valuable if estate freezing seems to make sense).[26]

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26. See 1 Casner & Pennell, Estate Planning §7.2.2.5 (8th ed. 2012) with respect to the §2702 aspects of all of this. A similar form of postmortem freeze might entail recapitalization of a corporation and allocation of preferred stock to a marital trust and common stock to a nonmarital trust. See id. §7.2.3.1 note 156 and accompanying text.

Example 3 of Treas. Reg. §25.2702-2(d)(1) provides that the creation of a trust for the benefit of a spouse for life, remainder to a child, in which the settlor retains no interest, is not subject to §2702 (notwithstanding that S is an applicable family member), because S did not hold an interest in the trust both before and after its creation. The intriguing issue that this raises is whether split interest funding of marital and nonmarital trusts is permissible without triggering §2702 because there is no transfer or retention by S that meets the requisites for application of that section. There is no direct answer to this question in either the Code or regulations, but the following analysis may be helpful.

A "joint purchase" rule found in §2702(c)(2) appears to be the only relevant provision. It applies if more than one family member acquires property in split interest format (for example, life estate and remainder interest). It is notable that, although the title of this provision uses the word "purchases," the body of the provision uses the word "acquires." Although it does not appear to have been Congress' intent, this difference in language might be interpreted to allow §2702 to reach acquisitions by purchase or any other method. This probably is the weakest link in this analysis, however, because it seems clear that §2702(c)(2) was not meant to apply if, for example, two family members receive property in the form of a life estate and remainder from a third party by gift or devise. The situation involved here — funding marital and nonmarital trusts after an individual's death — seems to be analogous even if the decision to fund using temporal interests is made by the decedent's personal representative rather than by the decedent in the form of a specific devise.

If "acquires" can encompass the form of acquisition involved in a split interest funding, the issue then arises whether family members are involved if it is marital and nonmarital trusts that actually acquire title to property. In this respect, §2702(e) is relevant, it incorporating by reference §2704(c)(2) for the definition of "member of the family." Under that provision a trust is not a family member, but §2704(c)(3) contains an attribution rule that — although not expressly stated — appears to apply for purposes of all of §2704(c). That attribution rule is an incorporation by reference of the entity attribution rule in §2701(e)(3), and that rule appears to apply with respect to a marital deduction trust of any variety authorized under §2056. So it seems fair to assume that split interest funding involving trusts could be regarded as split interest ownership by the trust beneficiaries, rather than by the trusts or their trustees, for purposes of §2702.

Now the question returns to the relevance of Treas. Reg. §25.2702-2(d)(1) Example 3, which prompted this digression. Can it be that D's transfer of property to an irrevocable marital deduction trust for S's benefit is not subject to §2702 but that a personal representative's split interest funding of such a trust is? The regulation states that S did not hold an interest in the property both before and after the transfer into trust and, therefore, that §2702 cannot apply. The crux is that Treas. Reg. §25.2702-2(a)(3) defines the "retained" requirement for purposes of §2702(a)(1) to mean that an interest was held by the same individual both before and after the subject transfer. In this case, the result of §2702(c)(4) joint purchase treatment, if applicable, is that S (by attribution through the marital deduction trust) is treated as having acquired the entire property and then made a transfer of the remainder interest to the nonmarital trust. This analysis is possible, however, only if split interest funding is regarded as an "acquisition" for §2702(c)(4) purposes.

A final question seems appropriate: If §§2701 and 2702 are in pari materia, in the sense that each is designed to preclude valuation abuses through freezing transactions that bifurcate ownership interests, would it be proper to apply §2702 in a situation in which §2701 does not apply? In this respect, §2701(a)(1) is relevant, it speaking of a

An overriding policy-oriented question is whether there is any reason to suggest that any provision of the Code was meant to apply to bifurcated asset ownership in the form of a marital and nonmarital trust. No indication appears in the direct provisions of the Code or the regulations under Chapter 14,[27] although the ability to engage in these transactions would represent an opportunity to engage in estate freezing during S's overlife, which may encourage the government and ultimately the courts to conclude that these sections are applicable. And yet the limited existing authority seems to indicate that the converse is true.

There is one source of potential concern, however, and it is difficult to evaluate because it has been around since the original marital deduction regulations were promulgated and never has been applied in any precedent. Indeed, a computer assisted search reveals that it appears never to have been cited by court or government alike.[28] Nevertheless, Treas. Reg. §20.2056(b)-1(g) Example (5) purports to take a position that might be regarded as relevant — positing a decedent who transferred property for less than full and adequate consideration during life, reserving a term of years, which the decedent's will distributed to a trust that otherwise qualified for the

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transfer of an interest to a member of a decedent's family with an applicable retained interest held by the transferor or an applicable family member. If entity attribution applies here to treat the beneficiaries of marital and nonmarital trusts as holding the interests transferred to those trusts, it may be possible for the government to argue that §2701 applies to freeze-funding of marital and nonmarital trusts. And because S could be defined as both a family member (as beneficiary of the nonmarital trust) and an applicable family member (as beneficiary of the marital deduction trust), it seems possible that §2701 could apply to freeze-funding as well. Perhaps the most difficult aspect of this analysis is figuring out who has made a gift to whom, if S is a (perhaps the only) beneficiary of both trusts.

At this point, then, the positions stated in PLR 9321046 become relevant and, if they are correct, they may shed additional light on this issue. They certainly reveal a trap under §2701 about which many tax advisors are unaware. Involved was the multiple attribution rules in Treas. Reg. §25.2701-6(a)(5), applicable to stock held in a nonmarital trust created by the taxpayer's predeceased spouse. Without specifying what the next step might be, the PLR addressed only the consequences if the corporation was recapitalized so that its existing common stock was replaced with both common and preferred stock. Under Treas. Reg. §25.2701-1(b)(3)(i) a recapitalization is not a transfer for §2701 purposes if all stockholders in the transferor's family hold substantially the same interest after the transaction as before, and in this case each stockholder would end up with the same percentages of both common and preferred stock as they previously held of common stock alone. As a result, at first blush it appeared that the recapitalization alone would not trigger §2701.

Then the question arose about how to regard the stock held in the trust, which the attribution rules require to be treated as held by the beneficiaries thereof. That alone would not be a problem because the relative interests of the beneficiaries would not change in the trust. Upon closer inspection, however, the PLR stated that different attribution occurs with respect to preferred stock (an applicable retained interest) than with respect to common stock (a subordinate equity interest) under the disparate rules of Treas. Reg. §25.2701-6(a)(5)(i) and (ii). Because of this disparity, the PLR concluded that the parties would not be deemed to hold substantially the same interests before and after the recapitalization, which meant that the recapitalization alone would trigger §2701 even though nothing occurred other than issuance of new stock certificates to represent the same percentage ownership of the corporation.

Because of the deemed transfer involved, the §2701 valuation rules would be employed to determine the value of what the parties are deemed to own before and after the recapitalization, all reflecting deemed ownership under the attribution rules. The consequence could be a substantial gift tax liability notwithstanding that no transfers of any kind actually occur. If PLR 9321046 is correct, it also could mean that a postmortem recapitalization by an estate in anticipation of using preferred and common stock to fund, respectively, a marital and a nonmarital trust, would result in gift tax liability even before an allocation is made and even though that liability would not apply if the estate made the same allocations of preferred and common stock that was held by the decedent at death.

27. Treas. Reg. §25.2702-2(d)(1) Example 3.

28. TAM 7835002 did refer to this particular example but it involved a decedent who created a life income interest with a remainder to charity and therefore is distinguishable from the situation here, because the decedent does not have anything to do with creation of the temporal interests in the situation under consideration.

§2056(b)(5) exception to the nondeductible terminable interest rules. The regulation concludes that the bequest does not qualify for the marital deduction, as if the term interest had been transferred to S directly.

Two responses are appropriate to the suggestion that the example indicates that the marital deduction should not be available in such a situation. One is that the regulation improperly conflates the trust and S's beneficial interest in the trust, with the trust corpus that funds the trust. S's interest in the trust is what the decedent transfers to S and it alone must meet the exception to the nondeductible terminable interest rule. If this was not true a trust never could qualify for an exception to the nondeductible terminable interest rule in §2056(b) unless the trust prohibited the trustee from owning as a trust asset any interest that could not pass to S outright — which is not a requirement imposed for trust qualification purposes.

The other response is that the case posited by the example is not germane at all, because the personal representative who funds a marital deduction bequest in trust with temporal interests created postmortem cannot trigger the nondeductible terminable interest rule. That rule requires a transfer by the decedent inter vivos, for less than full and adequate consideration, and so on. Because this is not a §2056(b)(1)(C) case in which the personal representative is directed by the decedent to acquire a terminable interest for S, no rule even purports to reach such a situation. Nor is there any abuse involved — much less any more opportunity to minimize transfer taxes than if the marital and nonmarital trusts were funded with cash and at some time in the future jointly acquired property to be held by them in trust in temporal versus fractional interests.

SLATs

Some taxpayers in 2012 who sought to use the then $5.12 million exclusion amount worried about running out of wealth before they die. So a technique that intrigued many was the so-called Spousal Lifetime Access Trust (SLAT or SPLAT, depending on whose lexicon you use). The initial trust was essentially the same as any credit shelter trust in a marital deduction context. The only difference was that the trust was created inter vivos, for the primary benefit of the donor's spouse. It also could benefit children or other beneficiaries but, to simplify matters, assume that the spouse was the only current beneficiary.

The vision was that the donor's spouse would receive income and principal in the trustee's discretion, that any income would go into a bank account that was jointly held with the donor, and that income also would flow onto their joint income tax return. As such, the couple would never really miss owning the $5.12 million that was transferred – unless the donee spouse died first.

In that case the donor may want to enjoy benefits in the trust for the donor's overlife. So the notion was that, if the donee spouse dies first, the donee would exercise a nongeneral power of appointment, to create a life estate in the donor for the balance of the donor's overlife.

To appreciate why this will not work, it is necessary to recall the common law treatment of a nongeneral power of appointment, by which the powerholder is treated as the donor's agent, essentially amending the trust on the donor's behalf. Any change in the trust terms effected by that exercise is said to be effective from inception of the trust, under the relation-back doctrine. As such, when the power is exercised to create a secondary life estate in the donor, it is as if the donor had retained that life estate interest from inception of the trust. And if the donor had actually retained a life estate, then §2036(a)(1) would apply when the donor dies.

There should be no concern in these cases if the power never is exercised. It also would be no concern if the trust was includible in the spouse's gross estate – which is said to "cleanse" the wealth and make the spouse the effective settlor of the trust. But that inclusion would destroy the intended use of the donor's basic exclusion amount in the 2012 year end planning that informed the transfers we were talking about. So, with no inclusion to the powerholding spouse, the relation-back principle discussed here would be relevant. If the retained life estate would avoid §2036 under Rev. Rul. 2004-64, because asset protection trust legislation is applicable, then again it would not pose a problem. Otherwise, this strategy will not succeed.

Reciprosity

A different issue exists if spouses create trusts – SLATs or any others – for each other for life. To avoid the notion that creation of a trust with retained enjoyment would trigger §2036(a)(1) inclusion to the settlor at death, some advisors recommend crossing the trusts so that one spouse creates a trust for the other, and vice-versa. The danger here is application of the reciprocal trust doctrine.

Identification of the proper transferor to a trust may be confused by intentional efforts, such as through the use of reciprocal trusts, to obfuscate the proper tax treatment of the trust. The classic illustration is spouses who each create mirror image trusts in which the other settlor is granted interests or powers that would cause inclusion under §2036 or §2038 if the beneficiary or powerholder had been the settlor. In these cases the reciprocal trust doctrine uncrosses the trusts at the settlor level, treating the beneficiary or powerholder as the settlor of the trust in which their interests or powers are granted.

According to the doctrine as established in Estate of Grace v. United States, 395 U.S. 316 (1969), asking whether the decedent established the trust as consideration for the trust of which the decedent was beneficiary places "too much emphasis on the subjective intent of the parties in creating the trusts and for that reason hinders proper application of the federal estate tax laws. Instead, the reciprocal trust doctrine does not depend on finding a quid pro quo. It also is not necessary to prove the existence of any tax avoidance motive. "Rather . . . application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries."

Mutuality of value is illustrated by Rev. Rul. 74-533, 1974-2 C.B. 293, and Rev. Rul. 57-422, 1957-2 C.B. 617. Assume that reciprocal trusts are created, one of $400,000 and the other of $300,000; all the FMV of the smaller trust and 75% of the value of the larger would be subject to uncrossing, regardless of their relative sizes when the taxable event ultimately occurs that causes the reciprocal trust doctrine to be relevant. And, contrary to some suggestions for avoiding the reciprocal trust doctrine, creating trusts in different amounts will not succeed. They will still be uncrossed "to the extent of mutual value."

The issue under *Grace* is how to avoid the trusts from being regarded as "interrelated" – which requires that they not be created at substantially the same time or that they do not have substantially the same economic effect to the settlors. Unless the clients have enough time and are patient to effect their plan, the challenge is to create trust terms that do not provide substantially the same economic enjoyment to the settlors. Thus, for example, the advice of some commentators that the trusts have different trustees will not preclude application of the reciprocal trust doctrine, nor will differences in the terms that apply to interests of beneficiaries *other than* the settlors.

To avoid a determination that trusts are interrelated, many advisors rely on Estate of Levy v. Commissioner, 46 T.C.M (CCH) 910 (1983), in which the two trusts were identical except one granted a nongeneral power of appointment to the settlor's spouse and the other did not. PLR 200426008 accepted *Levy* for the proposition that it would avoid reciprocity. Although we know that PLRs are not citable or reliable precedent, many people don't know that *Levy* is not reliable either. Not because it is a Tax Court Memorandum opinion – these opinions are not precedential either – but because the reciprocal trust element in *Levy* was *stipulated*. Thus, the court did not need to rule on the result reached, that the power of appointment would keep the trusts from being reciprocal.

Instead, according to the opinion, the government "agrees that, if valid, the special power of appointment [in one trust only] prevents the two trusts from being interrelated." The government argued simply – and without success – that "the provision creating the special power of appointment is invalid under New Jersey law. In the alternative, respondent contends that the provision is subjectively and objectively worthless." The court rejected both of those arguments, without reaching the merits whether the power alone was a sufficient difference to preclude application of the reciprocal trust doctrine. So more difference may be needed to preclude application of the reciprocal trust doctrine and no one really knows how much difference will suffice. Meaning that crossing trusts likely is not a wise plan.

More recently, Estate of Green v. United States, 68 F.3d 151 (6th Cir. 1995), rejected application of the reciprocal trust doctrine in a case involving grandparents who created separate identical trusts, one for each of their two grandchildren, his with her as trustee for the benefit of one grandchild and hers with him as trustee for the benefit of the other grandchild. Because neither settlor could benefit personally, the court rejected application of the doctrine to uncross the trusts and cause him to be regarded as trustee of the trust he created and her as trustee of the trust she created, followed by application of §§2036(a)(2) and 2038(a)(1) by virtue of their respective retained powers over beneficial enjoyment of trust benefits by the respective grandchildren.

According to the court, the reciprocal trust doctrine requires that the settlor be in "the same economic position" as if no crossing occurred on creation of the trusts and that, if there is *no* economic enjoyment of trust benefits by the settlors, there can be no economic position upon which the doctrine can apply. The *Green* majority opinion specifically cited Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977) (essentially the same facts), which held otherwise, and stated that it is the sole opinion in the government's favor and that it has been rejected by every circuit that had considered application of the doctrine as it might apply to powers instead of interests. That claim is regarded as "curious" by Marty-Nelson, Taxing Reciprocal Trusts: Charting a Doctrine's Fall from Grace, 75 N.C. L. Rev. 1781, 1798 (1997), which opines that no circuit court has explicitly rejected *Bischoff*.

The *Green* majority also concluded that the government cannot apply the reciprocal trust doctrine with respect to retained *powers* because the "core mandate" of *Grace* is retained *economic* benefit. The dissent in *Green* argued that the settlors did maintain "the same economic position" as if the trusts had not been crossed, because their powers constituted as much of an economic benefit as would retained personal enjoyment. It also maintained that the retained economic enjoyment that the majority regarded as the "core mandate" of *Grace* was merely the operative fact of that case and not an immutable requirement for application of the doctrine. The majority retorted with an ad hominem attack that the dissent "totally misconstrues and reflects a misunderstanding of the concept and elements of the reciprocal trust doctrine generally and its limited application as dictated by the Supreme Court in *Grace*" and then distinguished every retained power case as *also* involving retained enjoyment.

In each respect the dissent made good points, especially that it makes little sense to regard the reciprocal trust doctrine as applicable for purposes of §2036(a)(1), which deals with retained enjoyment, and not for purposes of its counterpart §2036(a)(2), which deals with retained control over another beneficiary's enjoyment. The reality is that the Code addresses each as two peas from the same pod. The dissent also is compelling in the sense that, once personal needs are satisfied, the next most important benefit of wealth is the control it gives over others and the personal enjoyment that flows from that power. Distinguishing consumptive enjoyment from control seems difficult to justify, particularly because Congress chooses to predicate inclusion under §2036 on the retention of either.

As a result, for estate planning purposes *Levy* and *Green* only appear to make it possible to dodge application of the reciprocal trust doctrine with easy drafting that includes (or perhaps just alters the permissible appointees of) a nongeneral power of appointment in one of two related trusts, or that does not retain personal enjoyment at all. On close inspection, both alternatives may prove to be a chimera.

An alternative to avoid reciprocity may be merely altering sufficiently when the trusts are created so that they are not created at "approximately" the same time, which was another ill defined aspect of the *Grace* determination of what constitutes interrelated trusts. In *Grace* they were created 15 days apart. There is no reliable indication of what timing differential would suffice. Surely fifteen months should suffice, and 15 days would not, but would 15 weeks?

While talking about inter vivos credit shelter trusts, providing for the donor's spouse for life and then potentially providing for the donor for the donor's overlife, consider one other iteration on this theme. Assume that a wealthy spouse creates an inter vivos QTIP trust for a donee spouse, to absorb or shelter that donee spouse's exclusion amount. And then, following inclusion in the donee-spouse's gross estate under §2044, that trust continues for the overlife of the original donor spouse. In this case the government concedes that inclusion in the donee spouse's gross estate under §2044 cleanses the trust and the secondary life estate in the original donor will not cause §2036(a)(1) inclusion at the donor's subsequent death. See Treas. Reg. §25.2523(f)-1(f) *Example 11*. That inclusion defeats the intent of most reciprocal trusts, however, and is not likely the salvation sought.

<u>Supercharged Credit Shelter Trusts</u>

An opportunity touted by Gans, Blattmachr, & Zeydel in Probate and Property (July/August 2007) dangles the possibility of "supercharging" an inter vivos QTIP trust during the donor spouse's overlife. In their view the trust income could be taxed to the donor (not to the trust, or to other trust beneficiaries), even if that income is not distributed to the donor. In effect, the donor can pay income tax on trust income – thereby increasing the value of the trust – without incurring gift tax on that added benefit. Here is what the authors posit:

> . . . for income tax purposes, the trust can continue to be treated as [the donor spouse's] grantor trust after the [donee spouse's] death, provided the trustee has discretion to make distributions of income and principal to the [donor spouse]. Regardless of the way in which the trustee in fact exercises this discretion, the trust's taxable income will continue to be attributed to the [donor spouse] under the grantor trust rules by reason of the [donor spouse's] discretionary interest in trust income and principal. See Code §§676, 677. Most critically, the [donor spouse] is viewed as remaining the grantor of the trust for income tax purposes – thus triggering Code §676 and/or Code §677 – even though, at [the donee-spouse's] death, it was included in [the donee spouse's] gross estate under Code §2044. See Treas. Reg. § 1.671-2(e)(5) (no change in identity of the grantor unless someone exercises a general power of appointment over the trust).

The proposition is that inclusion in the donee-spouse's gross estate under §2044 does not alter the identity of the grantor for ongoing income tax purposes. In this respect, the cited regulation says:

> (5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in

> favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferee trust is treated as the owner of the transferor trust under [the grantor trust rules].

The intent of this regulation is that a conveyance of trust property to another trust won't alter the grantor trust identity of the original trust corpus. Meaning that a grantor cannot dance away from grantor trust treatment by a mere trustee-to-trustee transfer.

Written at a time when grantor trust treatment was a bad thing, the idea was that it should not be possible to avoid grantor trust treatment by having the original trust make a distribution to a trust created by someone else. An exception applies if the trust is estate tax includible to a new taxpayer – in this case by virtue of a different person holding a general (taxable) power of appointment. The idea is the same as noted above in the context of avoiding §2036(a)(1) inclusion to the original donor spouse following inclusion of a QTIP trust in the estate of the donee spouse. Inclusion to the donee cleanses the wealth – in this case (like that) by changing the identity of the grantor. Essentially, trust property is deemed to be that of the last taxpayer in whose estate it was included for wealth transfer tax purposes.

Notice, however, that the exception only mentions inclusion by virtue of a general power of appointment (which would be under §2041). Why does it not also mention inclusion under §2044 by virtue of it being a QTIP trust, the donee spouse beneficiary of which having died (or under §2519 if the donee spouse accelerated that tax liability by an inter vivos transfer)? The authors assert that their "supercharged credit shelter trust" idea works because this regulation does not mention QTIP inclusion. Is it because QTIP trusts somehow are different? Or because §2044(c) (which dictates that §2044 inclusion causes the donee spouse to be treated as the transferor for wealth transfer tax purposes) does not mention the income tax?

The answer lies in the portion of most laws and regulations that many students don't read – the effective dates. This regulation was written in 1958, and has not been amended to reflect adoption of QTIPs in 1981. So, you judge whether the proposition of on-going grantor trust treatment to the donor spouse is viable following inclusion to the donee spouse.

Remainder Purchase Marital (RPM) Trusts

David Handler of Chicago, architect of the RPM Trust, states that "an RPM Trust is designed to qualify the spouse's interest for the gift tax marital deduction without subjecting the property of the RPM Trust to estate tax at the spouses' death." He means that the trust corpus would escape inclusion to either the donor (D) or the donee spouse (S).

At first blush this would make you consider whether the technique should work, given the fundamental "bargain" represented by the marital deduction that D will avoid estate or gift tax, but there will be payback inclusion to S.

As explained below, even if it works (there is no authority yet saying whether this gambit does work), the RPM is not an abuse, which should make you to wonder why it would be favorable to D. So here is an evaluation of its fundamental elements:

1. D must do two things "simultaneously" (for reasons explained below) – (a) D must create a trust for S that will pay an income or annuity interest to S for life or for a term of years, and (b) D must sell a remainder interest in that trust to objects of D's bounty (assume that this is D's children or a trust for their benefit).

2. S's lead interest qualifies for the gift tax marital deduction because it is not a nondeductible terminable interest. This is because the remainder interest passes to the children for adequate and full consideration. Thus, only the value of the lead interest will be subject to

estate or gift tax inclusion to S (to the extent the value of that interest inflates S's net worth and is not consumed in ways that have no value when S dies). Put another way, the lead interest does not escape tax – any payback inclusion is merely deferred (to no later than when S dies).

3. The consideration received by D will be includible in D's gross estate at death. So the only advantage gained is an exchange of one property for another – the hope being that the property funding the RPM Trust will appreciate more rapidly than the consideration received for its purchase. That gambit requires no special planning – any donor could swap properties with intended beneficiaries in hopes of putting more appreciation into the hands of the beneficiaries and holding less value (the replacement property) at death.

To make the transaction work there are at least four pressure points:

a. The children must have clean consideration to purchase the remainder interest. This transaction would not work if D gave the children the consideration that they then used to purchase the remainder. That would be no different than if D gave them the remainder directly, which would trigger application of §2702.

b. The consideration paid must be full and adequate to avoid the nondeductible terminable interest rule. This raises issues under *Gradow* (to the extent courts get confused about transfers of less than a fee simple interest in property) and may entail difficult valuation considerations.

c. The transfer to the trust and the sale to the children must occur simultaneously. Otherwise §2702 will apply if the sale occurs while D still owns the property, or the marital deduction will not be allowable if the sale occurs after a transfer to the trust. Either way, missing the promised simultaneous transfer will entail gift tax to D.

d. Sale of the remainder must avoid income tax gain or loss realization to D.

Given the potential gift and income tax exposure, and the fact that nothing ultimately escapes wealth transfer taxation, why engage in this transaction?

<u>Odd QTIP Decision Favors Taxpayer</u>

In Estate of Kite v. Commissioner, T.C. Memo 2013-43, the surviving spouse (S) was more wealthy than her predeceased husband (D). Very shortly before D died S created an inter vivos QTIP marital trust for D's benefit. D apparently had more wealth than his exclusion amount, so it does not appear that this was meant to shelter D's unused exclusion amount (D died in 1995, long before portability was enacted). Instead, S may have engaged in this planning to generate a new basis under §1014 for very low basis stock that S transferred into the QTIP trust. This inter vivos QTIP trust reserved a secondary life estate for S, and inclusion in D's estate was offset with a QTIP election made by D's estate, which qualified the trust for the marital deduction in D's estate. As a result, S's stock passed into this trust and then was held for S's benefit, all tax free due to the two marital deductions.

D died one week after this QTIP trust was created, meaning that §1014(e) should have denied any basis increase for the appreciated stock that S transferred into the trust that was §2044 includible in D's gross estate. Nevertheless, the court's footnote 9 reveals that new basis was generated, despite Congress' intent to preclude such end-of-life planning. See H. Rep. No. 201, 97th Cong., 1st Sess. 188-189 (1981), providing that property passing to D within one year of D's death will not receive a new basis if inclusion increases D's gross estate, which correspondingly increases the amount of D's formula marital deduction bequest back to S. So, new basis on this highly appreciated stock was the first taxpayer victory in *Kite*. (Note, however, that this may have been a hollow victory in *Kite*, given the subsequent events described below, because the end owner of this property was the decedent's children and they bought it for a deferred annuity on which they made no payments, which meant that their basis would be zero from the purchase.)

D's estate created two more marital trusts for the benefit of S. One was a reverse-QTIP trust that sheltered D's GST exemption. The other was a §2056(b)(5) general-power-of-appointment marital deduction trust. These three trusts participated in the transactions that were central to the case. Which (vastly simplified for these purposes) entailed termination of all three marital trusts, distribution of their assets to S, who placed them into S's revocable inter vivos trust, which then sold them to S's children, in exchange for a ten-year deferred annuity payable to S, who died before the deferral period ended. Thus, no payments were ever made in exchange for this wealth, meaning that the private deferred annuity arrangement significantly reduced S's gross estate. The government sought to preclude this reduction in two different ways.

First, the government asserted that the annuity transaction was a taxable gift by S, based on several alternative arguments that the annuities were not full and adequate consideration for the transfers made to the children. Those annuities were structured using the §7520 tables, which applied because the estate established (via a physician's statement that the government did not challenge) that S was not terminally ill at the time of the annuity transaction. Although the annuities proved to benefit the children, the court rejected the government's suggestion that they were not full and adequate consideration for the asset transfers. The court also "disagree[d] with [the government's] position that the annuity transaction lacked economic substance." And it rejected the government's suggestion that the annuity transaction was "illusory," saying that the annuity agreements were enforceable and that the parties intended to comply with their terms. The court even suggested that S intended to profit from the transaction (which seems unlikely). The result was that the transaction did not constitute a taxable gift because "the annuity transaction was a bona fide sale for adequate and full consideration." This was a second, significant taxpayer victory in *Kite*.

The government also asserted that the annuity transaction triggered gift tax under §2519 because it involved a disposition of S's income interest in the two QTIP trusts. Recall that §2056(b)(7) allows the estate tax marital deduction for a trust that grants S only a life estate. In return, §2519 gift tax or §2044 estate tax inclusion occurs when any part of the income interest is assigned or terminates. The court understood, however, that a mere "conversion of QTIP into other property in which the surviving spouse has a qualifying income interest for life" is not subject to §2519, citing Treas. Reg. §25.2519-1(f). Furthermore, reinvestments, as a substitution of property of equal value for QTIP trust assets, also do not trigger §2519, because there is no diminution in the amount that will be includible in S's gross estate at death. Having found that the annuities were adequate and full consideration for the assets that S transferred to the children, the government's second theory also should have failed.

Instead, the court held that "liquidation of the QTIP trusts and subsequent sale of [S's] interests . . . disregarded the QTIP rules. . . . [T]he termination of the QTIP trusts was part of a prearranged and simultaneous transfer of the QTIP trust assets [and] would circumvent the QTIP regime and avoid any transfer tax imposed by section 2519." Further, the court also turned logic on its head by stating that, because S received adequate and full consideration for S's QTIP trust interests, S therefore "made a disposition of her qualifying income interest" and triggered application of §2519 gift taxation. This would appear to be a significant taxpayer defeat in *Kite*, but it is not, and it is wrong.

The court's §2519 conclusion is baffling, because the government similarly argued that the annuity transaction effectively constituted a §2514 taxable release of S's general power to appoint the §2056(b)(5) marital trust. The court rejected *that* argument because that trust's assets went into S's revocable inter vivos trust and thus did not constitute a transfer to another person. So, termination of S's interest in the QTIP trusts triggered §2519, but termination of S's interest in the general power trust did not trigger §2514. Because §§2514 and 2519 are the corresponding provisions that tax inter vivos termination of general power and QTIP marital deduction trusts, this inconsistency is inexplicable.

The end result was the court holding that "the portions of the annuity value originally traceable to the ownership interest of [the two QTIP trusts] . . . less the value of [S's] qualifying income interest [in those two trusts] . . . are subject to Federal gift tax" under §2519. That statement *also* is inverted, because §2519 taxes the full value of a QTIP trust, less the value of the income interest in that trust. The court's statement therefore confused the annuity amount with the value of the QTIP trust itself. That may make sense, because the estate's attorneys confirm that the annuity amount was equal to the full value of the trusts, and not just the value of S's income interests in them. And that is a critical fact.

The net result in *Kite* should be no §2519 taxation at all, because §2519 only taxes the excess *uncompensated* value of the QTIPs over the value of S's income interest. Oddly, the court never determined the values that will apply, which means that this element remains for a Rule 155 determination. Because the private deferred annuities were equal to the full value of the QTIP trust assets, what appears to be a taxpayer defeat likely will result in the estate owing no gift tax. (Note, however, that this aspect of the QTIP holding – found in the last two paragraphs of the court's opinion – is a muddle; it simply is not clear what the opinion was saying.) By all accounts, therefore, the §2519 result is the third significant taxpayer victory in *Kite*.

Attorney Larry Katzenstein, author of the Tiger Tables valuation software, confirms that calculation of the deferred annuity did equal the full fair market value of the trust assets sold. But he also stresses that the *Kite* annuity transaction may cause capital gain to be realized in the transferred assets, which would not be deferred under current law. In *Kite* the new basis resulting from the initial transfer of appreciated stock into the inter vivos QTIP, and the different law applicable at that time, may have been critical components for the taxpayer's success. And failure to litigate the §1014(e) issue may be the government's most significant error.

One final matter deserves mention. The children were made trustee of the marital trusts immediately before their termination. They also were the remainder beneficiaries. Termination of these trusts and distribution of the assets to S meant that their remainders were destroyed (and, presumably, the GST exemption allocated to the reverse-QTIP also was lost). Yet the court's footnote 37 states that the government "does not raise the issue of whether the . . . children's termination of the QTIP trusts, and the subsequent liquidation of QTIP trust assets, was a gift from the remainder beneficiaries . . . to the lifetime income beneficiary." This actually makes sense, because the marital deduction and the payback inclusion of the full value of the marital trusts in S's gross estate at death means that S is deemed to already own the full fee simple value of these trusts for tax purposes. This should mean that the children could make no gifts to S because, for tax purposes, S already owned the entire value of the marital deduction trusts.

It is true, however, that there was no assurance that the children would receive any value from S, and the annuity transaction posed the possibility that S might live longer than the mortality tables predict. In that case the children could have been significantly disadvantaged by this transaction. Whether those facts suggest that the children made a gift apparently did not warrant government attention, and the court similarly dismissed it. And that result is a fourth taxpayer victory in *Kite*.

Finally, it may be difficult in other cases to terminate a trust, as was done in *Kite*, due to the nearly universal existence of spendthrift trust provisions. And favorable but (according to the court) unique facts also may prevent replication of *Kite* in another circumstance. Advisors who are intrigued by *Kite* will want to study the decision and analyze the various steps involved (most of which are summarized without elaboration here), before seeking to mimic the planning involved.