Using and Misusing the Marital Deduction

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Table of Contents

13 Marital Deduction Planning 1
§13.0 INTRODUCTION 1
§13.0.1 Importance of the Marital Deduction in Estate Planning 2
§13.1 BASIC MARITAL DEDUCTION PLANNING 5
§13.1.1 Basic Structure of Estate Planning for Spouses 8
§13.1.2 Tax Sensitive Outright Dispositions to S 13
§13.1.2.1 Survivorship Requirements 15
§13.1.2.2 The Preferable Approach 15
§13.1.3 A Note About Community Property 17
§13.1.4 Drafting in Contemplation of Disclaimer 17
§13.1.4.1 Advantages 18
§13.1.4.2 Disadvantages 19
§13.2 PLANNING AND DRAFTING FOR LARGER ESTATES 21
§13.2.1 Advantages of Deferral 23
§13.2.2 Disadvantages of Deferral 24
§13.2.3 The Time-Value of Money Rationale for Deferral 26
§13.2.4 Sheltering D's Unified Credit 31
§13.2.5 Using the Previously Taxed Property Credit 35
§13.2.6 A Note About Formula Clauses and Computations 41
§13.4 QUALIFICATION REQUIREMENTS 43
§13.4.1 In General 43
§13.4.2 The Easy Qualification Requirements 44
§13.4.2.1 D Need Not Be a United States Citizen or Resident 44
§13.4.2.2 S Must Survive 45
§13.4.2.2.1 Survivorship 45
§13.4.2.2.2 Marital Status 46
§13.4.2.3 Interest Must Be Includible in D's Gross Estate and Pass to S 49
§13.4.2.3.1 Disclaimers 50
§13.4.2.3.2 Controversy Involving D's Estate Plan 51
§13.4.2.3.3 The Net Value Rule 55
§13.4.3 The Nettlesome Qualification Requirement: The Interest Must Be Deductible 60
§13.4.3.1 Inclusion in D's Gross Estate 60

§13.4.3.2 Double Deductions Prohibited 61
§13.4.3.3 The Nondeductible Terminable Interest Rule 62
§13.4.3.3.1 Terminable Interest Defined 63
§13.4.3.3.2 Nondeductible Terminable Interests 64
§13.4.3.4 The Unidentified Asset Rule 70
§13.4.4 Exceptions to the Nondeductible Terminable Interest Rule 71
§13.4.4.1 In General 71
§13.4.4.2 Limited Survivorship Exception 72
§13.5 FORMS OF DISPOSITIONS 76
§13.5.1 Special Dispositions that Qualify 76
§13.5.2 Marital Deduction Power of Appointment Trust 77
§13.5.2.1 General Power of Appointment 79
§13.5.2.2 All Income Annually 81
§13.5.2.2.1 Administrative Provisions 83
§13.5.2.2.2 Unproductive Property 85
§13.5.2.2.3 Timing of Payments 89
§13.5.2.3 Specific Portion Requirement 90
§13.5.3 Legal Life Estate with General Power of Appointment 92
§13.5.4 Life Insurance or Annuity Payments with General Power of Appointment 94
§13.5.5 Estate Trusts 95
***§13.5.6* QTIP** 96
§13.5.6.1 Requirements 99
§13.5.6.1.1 Passing 99
§13.5.6.1.2 Qualifying Income Interest for Life 99
§13.5.6.1.3 No General Power of Appointment Is Required 101
§13.5.6.1.4 No Other Beneficiaries During S's Overlife 102
§13.5.6.1.5 The QTIP Election 106
§13.5.6.2 Legal Life Estates Can Qualify for QTIP Treatment 107
§13.5.6.3 The QTIP Election 109
§13.5.6.3.1 Remedying Defective Elections 113
§13.5.6.3.2 Protective QTIP Elections 117
§13.5.6.3.3 Authorizing the Election 118
§13.5.6.4 Partial QTIP Elections 120
§13.5.6.4.1 Separate Shares Permitted 123

§13.5.6.4.2 Paying Taxes from Nonelected Portion 125
§13.5.6.4.3 Contingent Income 127
§13.5.6.5 Inter Vivos QTIPs 129
§13.5.6.6 Estate and Gift Tax Attributable to QTIP Trust 134
§13.5.6.7 Annuities, Retirement Benefit Payments, and IRAs 136
§13.5.6.8 Qualified Plan Spousal Annuity Issues 144
§13.5.6.9 QTIP and CRTs 146
§13.5.7 QDOTs 149
§13.5.7.1 Citizenship Requirement 150
§13.5.7.2 Exceptions 153
§13.5.7.3 QDOT Qualification Requirements 157
§13.5.7.4 Taxation of QDOTs 161
§13.7 FUNDING MARITAL DEDUCTION TRANSFERS 165
§13.7.1 Types of Marital Deduction Formula Clauses 165
§13.7.1.1 Available Funding Mechanisms 166
§13.7.12 Conclusions Regarding Marital Deduction Funding 167
§13.9 PLANNING IN CONTEMPLATION OF MARRIAGE 169

13 Marital Deduction Planning

§13.0 INTRODUCTION

This chapter is predominantly about planning for married individuals and it focuses almost exclusively on qualification for and utilization of the marital deduction. But not entirely, because a growing utility is planning for clients who anticipate divorce, as well as planning for couples who are not yet married, including some who cannot or choose not to marry. The discussion of that topic reveals, however, that planning for individuals who are not married pretty much entails the same factors and (lack of) opportunities – nothing nearly as exciting or useful as marital deduction planning is available for unmarried individuals.[1]

Change is the only constant in this arena, which Congress revealed by legislation in 2001 that repealed the estate and GST tax in 2010 – for just one year – and again by a last-minute compromise in 2010 giving a two-year extension of both estate and GST tax with a $5 million exclusion or exemption amount, and then legislation in 2017 that doubled both the exclusion and exemption amounts for years 2018 through 2025. Because Congress has not reduced the exclusion or exemption amounts since the depths of the Great Depression, all examples in this chapter are based on the $10 million level (as dictated by §2010(c)(3)(A) as amended in 2017), without reflecting the inflation adjustment.[T] Readers should run illustrations based on the prospects as they appear at any given time, and remember that the $10 million exclusion is scheduled to snap back to $5 million (plus another inflation adjustment, reflecting changes since 2010) in 2026. Also reflected in examples in this chapter is the 40% rate that was adopted in 2013, but that factor also could change with future legislation and political compromises.[T] The point is that no one can possibly know what the planning environment will be when either spouse dies – especially when the surviving spouse (S) dies, which is the most important factor in marital deduction planning. That uncertainty makes flexibility the most powerful estate planning tool in qualifying dispositions to or for the benefit of a taxpayer's spouse for the deduction.

Efficient use by the donor or deceased spouse (D) of the marital deduction permits effective use of both spouses' unified credits and GST exemptions and, regardless of the size of D's estate, allows deferral of federal wealth transfer taxes until S dies. Congress also adopted in 2010 the concept of "portability" that allows D's unused exclusion amount to be used by S – but there is no portability of D's GST exemption. Thus, planning for effective use of both entitlements also becomes critically important and, because of the dissonance, it also is more difficult.

This chapter explores questions that any estate planner must answer in formulating and funding a marital bequest. How much (if any) marital deduction is appropriate – is deferral of tax until S's death the best result? Which form of qualifying disposition is preferable? How must a clause be drafted to qualify the preferred disposition for the marital deduction? Which alternative for funding the marital bequest should be used to segregate the marital bequest from the rest of D's property? How should the GST reverse QTIP election exemption allocation be factored into effective marital

[1] **§13.0** This chapter is derived in part from the author's Estates, Gifts, & Trusts Portfolio, 843-2d Estate Tax Marital Deduction, with the permission of the publisher, Tax Management Inc., a subsidiary of The Bureau of National Affairs Inc., Washington, D.C. All rights reserved.

deduction planning? And how must D comply with special requirements if S is not a United States citizen? Also addressed are planning questions aimed at couples facing divorce, those at the more positive end of the spectrum who anticipate marriage, and planning for couples who will never marry.

Also of great concern and uncertainty is the extent to which state wealth transfer taxes will be re-enacted to replace revenue previously generated by the federal §2011 state death tax credit (which was fully eliminated after 2004). Some state laws contain concepts similar to the current FET marital deduction, but some deviate in unexpected ways.

An important aspect of marital planning is the desire of some individuals to maintain control over their property and to fragment their estates between S and other intended beneficiaries. The most common occurrence of this involves family members who are the product of blended families, such as descendants by a former relationship. This division of wealth, and control from the grave, is an active ingredient in traditional estate planning for married couples. As is the tension generated in jurisdictions in which S may elect a statutory forced heir share entitlement in lieu of a less desirable estate plan.[2]

This chapter contains a detailed study of the FET marital deduction and corresponding elements of its gift tax counterpart. The first of three major segments focuses on how much marital deduction is appropriate in a given situation. Although the discussion in this segment assumes familiarity with some marital deduction concepts that are covered in more detail later in the chapter, readers who are new to this area of the law will find that these assumptions will not slow them down. Nevertheless, uninitiated readers may want to refer to other portions of the chapter as they proceed, particularly the discussion of the QTIP form of marital deduction disposition.

The second major segment of this chapter deals with the technical requirements to qualify for the marital deduction. After determining how much marital deduction is appropriate, the planner must consult with the client to determine which form of qualifying disposition is preferable, and how to draft the preferred disposition to qualify for the marital deduction. A combination of multiple dispositions may be appropriate, and is permissible.

The third major segment of this chapter deals with the administrative aspect of marital planning known as "funding" the bequest. Once the planner has determined how much marital deduction is desired and how it is to be transferred to or for S's benefit, then the plan must dictate how the bequest is to be segregated from D's property and transferred to the dispositive vehicle chosen. Alternatives for funding the marital share each present particular advantages and disadvantages, which are explored and compared in the third segment. That discussion is relevant outside a marital deduction arena because it informs planning for any division of any estate among multiple beneficiaries.

§13.0.1 Importance of the Marital Deduction in Estate Planning

Gift tax §2523[3] and estate tax §2056 grant unlimited federal gift and estate tax marital deductions for qualifying dispositions of property to or for the benefit of a donor's spouse or a

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[2] See §3.4.

[3] Although the gift tax marital deduction is not discussed separately throughout this chapter, in most respects it is no different from the estate tax marital deduction and should be considered to be consistent with the estate tax marital deduction unless otherwise stated. In addition, §1041 is the income tax equivalent of the wealth transfer

decedent's surviving spouse. Collectively these marital deduction provisions constitute the single most important estate planning tool available to married individuals. All federal wealth transfer taxes can be deferred until S's death through optimum use of the marital deduction, usually regardless of the size of D's estate. All of both spouses' aggregate assets, undiminished by estate or gift tax, thus can be made available to support S during his or her overlife.

However, the marital deduction does not necessarily reduce wealth transfer taxes, because a prerequisite for obtaining the deduction is that assets must be transferred in a manner that requires inclusion in S's estate. Nevertheless, if an estate tax is due at S's death, the burden of the tax, and any liquidity problems that may be encountered in paying the tax, are borne by the next takers on S's death (typically, the couple's children), as illustrated in the following examples.[4] And in the interim S is protected from tax.

> *Example 1:* D dies in 2022 leaving a $25 million estate (net of debts and expenses). If no portion of D's estate qualifies for the marital (or any other) deduction, D's taxable estate of $25 million would generate an estate tax of $6,000,000 after reflecting the $10 million exclusion amount. If, instead, D leaves the entire $25 million to S and D's executor elects portability of D's unused exclusion amount (making it available to S) the entire estate will qualify for the unlimited marital deduction and no FET will be incurred at D's death. All FET will be deferred until S's death. Thus, if S dies several years after D, leaving the $25 million estate (net of debts and expenses) to the couple's children, S's taxable estate would generate an estate tax of $2,000,000,[5] which reflects the use of both unified credits of D and S.

A second form of planning to minimize the potential estate tax that may be incurred on S's death is to use D's unified credit in D's estate, rather than preserving it by portability for use at S's death. D's estate would not qualify for more marital deduction than needed to eliminate taxes in D's

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tax marital deduction, in the sense that it makes transfers between spouses neutral events for income tax purposes – no one recognizes income and there is no gain or loss realization on transfers between spouses.

[4] Throughout this chapter the first spouse to die is referred to as D and the surviving spouse is referred to as S, without regard to their gender. Unless otherwise stated, 2022 tax rates are used in the tax computations. §2010(a) provides a credit against estate tax of the "applicable credit amount," which §2010(c) defines as consisting of two components. One is the basic exclusion amount, which is $10 million (indexed for inflation after 2010). The second component is the amount of exclusion that D's last predeceased spouse did not use, which could be as little as $5 million (it is the unused basic exclusion amount of D's last post-2010 predeceased spouse, *not further* indexed for inflation). Most planners refer to the unified credit and the exemption equivalent or credit shelter amount that may pass free of tax, and that familiar terminology is used here as well. The credit was not "unified" between 2004 and 2010 because the gift tax exclusion was frozen at $1 million, but reunification occurred in 2011 and now the gift tax exclusion also is $10 million (also indexed for inflation). Examples throughout this chapter use an applicable credit amount of $3,945,800, a basic exclusion amount of $10 million (without reflecting an inflation adjustment), and a maximum rate of 40%. Those numbers may change but the economics illustrated will not.

[5] For simplicity, unless otherwise stated, all tax computations assume that there are no deductions other than the marital deduction and that there has been no appreciation or depreciation, additions to, deletions from, or consumption of the marital bequest during S's overlife. In addition, no attempt is made to anticipate Congressional changes in the unified credit or in the maximum marginal estate tax rates. Although these are not necessarily realistic assumptions, they make it easier to illustrate various concepts and make valid comparisons. Note that at S's death the exclusion amount is $20 million but the unified credit available is $3,945,800 for S, and $4,000,000 for D's unused exclusion amount, as explained in §13.2 n.2.

estate, making use of D's own credit. The following example illustrates an estate plan that takes advantage of less marital deduction, which is said to "shelter" D's unified credit.

Example 2: D died with a $25 million estate in 2022 but left only $15,000,000 to S in a manner that qualified for the marital deduction. D and S will pay the same estate tax:

$25,000,000	D's estate (net of debts and expenses)
(15,00,000)	marital deduction
10,000,000	D's taxable estate
3,945,800	tentative estate tax
(3,945,800)	unified credit
0	D's FET payable†

When S later dies:

15,000,000	S's estate (net of debts and expenses)
5,945,800	tentative estate tax
(3,945,800)	unified credit
2,000,000	S's FET payable†

> †This "universal" footnote symbol appears in numerous illustrations in this chapter when reference is made to the payment of taxes, to remind the reader that this tax payable figure may be subject to other credits, such as the §2013 credit for taxes incurred on prior transfers. See, e.g., TAM 8714001 for the proposition that calculation of the formula marital deduction automatically should reflect the §2013 credit if D survived a prior decedent and was entitled to that credit for taxes incurred in the prior decedent's estate.

In Example 2, D and S also could avoid estate tax on double the basic exclusion amount if D shelters that amount from tax when S subsequently dies. D would employ a nonmarital trust (also known as a bypass, credit shelter, or family trust – all those terms being synonyms for the same approach) for which no effort is made to qualify the trust corpus for the marital deduction. Typically S is given only a life estate in the trust and the trust corpus is not includible in S's estate. Unlike the situation prior to Congress adopting portability, it is not necessary for the property to be owned in the "proper" manner (at least $10,000,000 in each estate) or that the spouses die in the "right" order and properly use (but not overuse) the marital deduction. The basic exclusion amount may be taxed in D's estate and sheltered from tax at S's death, with only the balance qualifying for the marital deduction, to be taxed in S's estate. Or portability can be used to permit marital deduction qualification of D's entire estate and both credits can be used when S dies. Unless additional factors are introduced, either approach (or a combination of portions of each)[6] will produce the same taxes.

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[6] This is not an either/or planning choice. D can shelter some wealth but not the full $10,000,000 and any unused credit can be carried over to S. Or D could shelter more than $10,000,000 and pay some tax in the first estate to reduce the amount subject to tax when S subsequently dies (as with a provision that equalizes the estates, the marginal estate tax brackets, or the tax liability of both spouses). This can lead to a corresponding reduction of tax at S's death under certain circumstances. See §13.2.3 for a discussion of equalizer provisions.

§13.1 BASIC MARITAL DEDUCTION PLANNING

To understand marital deduction planning, it is essential to remember that usually the estate tax marital deduction does not reduce the estate tax on marital assets. Instead, it only permits deferral of tax until S's death. Through the estate tax marital deduction, Congress has, in effect, said: "We won't tax these assets in your estate, provided that you leave them in a form that causes their inclusion in your spouse's estate." Thus, as a general rule, the primary requisite to qualification for the marital deduction is that the interest passing to S must be in a form that will lead to wealth transfer taxation to S (to the extent of the value of the interest when a taxable transfer by S occurs).[1]

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1 **§13.1** The fundamental equity of this "payback" inclusion is illustrated by a state death tax case, In re Estate of Bracken, 290 P.3d 99 (Wash. 2012), in which the court denied the Washington State Department of Revenue's effort to require inclusion of QTIP trusts in the estates of surviving spouse decedents, because there was no QTIP marital deduction allowed (because there was no state death tax) in the estates of the trust settlors. These trusts did qualify as marital deduction QTIP trusts in D's estate for FET purposes and the state death tax was a piggyback on the federal inclusion. But, having garnered no state death tax benefit in D's estate, the court correctly held that it was not appropriate for the Department to seek payback inclusion when S died.

In response to *Bracken*, the Washington legislature amended its Estate and Transfer Tax Act to specifically allow the Washington Department of Revenue to tax QTIP trusts, regardless of when created or whether the state had granted a marital deduction in the estate of the settlor spouse. *See* Wash. Rev. Code § 83.100.048. This amendment was upheld as constitutional in Estate of Hambleton v. Dep't of Revenue, 335 P.3d 398 (Wash. 2014).

Consistent with the Washington legislation, Estate of Ackerley v. Dep't of Revenue, 389 P.3d 583 (Wash. 2017), subsequently held that federal gift tax included in a decedent's federal gross estate under §2035(b) (the so-called "gross up" rule) also is subject to state estate tax, because the state tax piggybacks on the federal taxable estate. These developments reveal an effort to tie state estate tax to the federal estate tax return, making whatever is includible for federal purposes also includible for state estate tax purposes.

In this context, consider Estate of Brooks v. Comm'r of Rev. Servs, 159 A.3d 1149 (Conn. 2017), in which the settlor of two QTIP trusts died in Florida, which has no state estate tax. These trusts qualified for the federal estate tax marital deduction but served no estate death tax deferral function because there was no state death tax to be deferred. The surviving spouse relocated to and subsequently died in Connecticut, which does have an estate tax. Although these QTIP trusts didn't garner a deferral of Connecticut estate tax, Connecticut successfully imposed its estate tax on these QTIP trusts when the surviving spouse died, based on the logic in both *Bracken* and *Ackerley*, that the state estate tax piggybacks on the federal gross estate and QTIP trusts are includible in the federal gross estate of a surviving spouse. The lack of deferral and notions of payback notwithstanding, the court also stated that termination of the surviving spouse's life estate is a "sufficient 'shifting at death of particular incidents of property' to properly impose an excise tax" on the transfer of wealth.

Shaffer v. Comm'r of Rev., 148 N.E.3d 1197 (Mass. 2020), relied on *Brooks* to uphold state taxation of a QTIP trust created by a New York decedent but held by the surviving spouse who was subject to Massachusetts estate tax at death. Dangerous about both cases is the notion expressed in *Shaffer* that the remainder beneficiaries "received a present interest in the QTIP assets . . . upon the death of the decedent that constitutes a transfer for estate tax purposes and brings the QTIP assets within the Massachusetts taxable estate." This concept could justify estate tax inclusion in the estate of a life income beneficiary when the following remainder interest becomes possessory, with or without the added fact of a prior QTIP election. That would be a major break with federal law and prior precedent. The key to these decisions should be state death tax inclusion that piggybacks on the federal inclusion, and not some notion that termination of a life estate is an adequate transfer to cause inclusion of the underlying income-producing assets. That unwarranted extrapolation beyond the federal estate tax treatment of the expiration of a life estate would not justify inclusion for state death tax purposes at the death of a life tenant.

As decided below, Comptroller of the Treasury v. Taylor, 213 A.3d 629 (Md. 2019), rev'g 189 A.3d 799 (Md. Ct. Special App. 2018), was contrary to *Brooks* (although never citing it). The settlor died in Michigan, created a QTIP trust, and a QTIP election was made for both state and federal tax purposes. The surviving spouse died in Maryland, which has an estate tax. Nevertheless, the lower court held that the QTIP trust was *not*

Unfortunately, there is no symmetry in the wealth transfer tax system regarding the estate tax includible in the survivor's estate for Maryland estate tax purposes, notwithstanding that it was includible for federal purposes. That decision subsequently was reversed by Maryland's high court. Of interest in the opinion is Maryland Tax – General Code §7-309(b)(6)(i):

> For purposes of calculating Maryland estate tax, a decedent shall be deemed to have had a qualifying income interest for life under §2044(a) of the Internal Revenue Code with regard to any property for which a marital deduction qualified terminable interest property election was made for the decedent's predeceased spouse on a timely filed Maryland estate tax return . . . .

This provision reflects Maryland Statute §7-309(b)(5)(ii), which allows a Maryland QTIP election, separate from that made for federal purposes, causing Maryland estate tax inclusion of a trust that was not subject to §2044 inclusion for federal purposes. The state argued "that Maryland could tax the assets of a QTIP for which no Maryland election was made," which the lower court rejected as "not plainly within the statute's language" and that "[t]he fiction created by the QTIP election, which includes the trust in the estate of the surviving spouse, is explicitly limited to those instances where an election has been made to create it" for state estate tax purposes. There having been no Maryland marital deduction and no Maryland QTIP election in *Taylor* meant that there could be no payback inclusion in the survivor's Maryland estate. The high court rejected this conclusion in reversing and holding that federal inclusion of the QTIP under §2044 was definitive for state death tax inclusion.

A dissenting opinion in *Taylor* stated the obvious case: because no marital deduction was granted by Maryland in the estate of the decedent's predeceased spouse, there was no "quid pro quo" to justify taxation in the estate of the surviving spouse. "The QTIP deduction is premised on an exchange of benefits between the surviving spouse and the government granting a tax deferral. . . . [The surviving spouse] received no benefit from the State of Maryland that could justify subjecting the QTIP assets to the Maryland estate tax." And then, based on a constitutional nexus argument, the dissent also concluded that "[a]ssessment of a Maryland estate tax on a trust that is not located in Maryland and has not been afforded the protection of Maryland law contravenes the Fourteenth Amendment."

Perhaps this Constitutional argument in *Taylor* was the impetus for the taxpayer's argument in Estate of Evans v. Dep't of Revenue, 2020 WL 2764495 (Ore. Tax Ct.), aff'd, 492 P.3d 47 (Or. 2021), which involved the same issue of piggyback inclusion of a QTIP trust in the Oregon estate of a deceased surviving spouse. The conclusion was the same, but the court's analysis was addressed entirely to the taxpayer's assertion that Oregon taxation of the QTIP trust violated the Due Process Clause of the United States Constitution.

The United States Supreme Court undertook the nexus question for purposes of state *income* taxation of trusts in North Carolina Department of Revenue v. Kaestner 1992 Family Trust, 139 S. Ct. 2213 (2019). *Evans* confronted the nexus question for state *wealth transfer* tax purposes. Only the surviving spouse had a connection to Oregon and her only interest in the QTIP trust was the right to receive income, annually. Neither the settlor, the trustee, the remainder beneficiaries, nor the trust itself had any connection to Oregon, yet the Oregon court concluded that there were sufficient minimum contacts and rational relation between the trust and the State for tax purposes. In the process it distinguished *Kaestner*, saying that insufficient contacts existed in *Kaestner* because the beneficiary "had no present right" to trust benefits "because her ability to enjoy either income or corpus of the trust was at the complete discretion of a trustee who had never distributed to her any amounts from the trust." In contrast, in *Evans*, the spouse "had an exclusive lifetime interest in the trust . . . and received substantial payments from the trust." The final conclusion in *Evans* was that "inclusion of the trust property in [the surviving spouse's] estate does not violate the federal Due Process Clause because [the surviving spouse] had an exclusive lifetime interest in the trust property and was an Oregon domiciliary at the time of her death."

Quaere whether Michigan (the state in which the *Taylor* QTIP marital deduction was granted) could impose its estate tax as payback for granting a marital deduction in the estate of the trust's settlor. If the answer is no (because the surviving spouse was not a resident of Michigan at death and therefore the Michigan estate tax could not apply), then the flip side of this controversy becomes apparent: the estates of this couple would have deferred and then avoided any state tax on the QTIP trust assets if the surviving spouse had died domiciled in a state with no estate tax. The dissent also raised the possibility that an estate could make a federal QTIP election but forgo the deduction for state death tax purposes, opting instead to incur state death tax in the estate of the first spouse to die. When the surviving spouse subsequently dies, §2044 inclusion at the federal level would also yield inclusion for state death tax purposes, constituting double tax on the same property. Each of these results should be seen as inconsistent with the fundamental notion of the marital deduction.

The "piggyback" concept applied in *Ackerley* and *Brooks* works to a state's disadvantage if there is no estate tax when either the decedent or the surviving spouse dies. For example, In re Estate of Seiden, NYLJ 10/12/18 p. 23, col. 5 (N.Y. County Surr. Ct.), involved a settlor of a QTIP trust who died in 2010, when the

marital deduction. The fact that an interest left to S will be includible in S's gross estate at death does not ensure qualification for the estate tax marital deduction. Some includible interests will be nondeductible because they run afoul of the "nondeductible terminable interest" rule.[2] Fortunately, there also is no symmetry in the system, in the sense that there may be no payback if S were to die after a significant reduction of the estate tax.

Notwithstanding this wealth transfer tax inclusion to S, many marital estates that exceed the amount of property that can be transferred tax free under the shelter of the spouses' available unified credits are made easier to plan because of the unlimited marital deduction. Because the deduction

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federal estate tax was in hiatus, and the estate therefore did not need to make a QTIP election to qualify for the federal estate tax marital deduction. As a result, §2044 did not require inclusion of the QTIP trust in the survivor's gross estate when the surviving spouse subsequently died. At the time, New York Tax Law §954(a) expressly provided that the New York gross estate of a deceased resident "means his or her federal gross estate" – a classic piggyback form of state estate tax. So, because the QTIP trust was not includible in the survivor's federal gross estate, the estate did not include it in the survivor's New York gross estate either, which the court held was correct. The opinion does not indicate what the New York estate taxation of the settlor's estate entailed, nor whether a state QTIP election was made that, by all rights, should mean that payback inclusion in the estate of the survivor would be appropriate. The court simply dismissed the state's argument for New York estate tax inclusion because of the very clear piggyback nature of the New York statute.

The *Taylor* dissent was right to question the proper result if the facts are reversed, and the surviving spouse qualified for the estate tax marital deduction in the estate of the first spouse to die but then moved to and died in a no-tax state such as Florida. The *Seiden* opinion essentially invited the New York legislature to amend its statute, saying "the legislature could still amend the Tax Law to apply to future estates." It did so in 2019. Also, quaere the result in *Brooks* if the facts had been reversed, and the surviving spouse had qualified for the estate tax marital deduction in Connecticut but then moved to and died in Florida. The *Seiden* opinion noted this anti-payback result, saying that "it is not guaranteed that all or even part of any QTIP trust would be subject to New York estate tax at the death of the surviving spouse under present law. The trust property might decrease in value; it might be distributed and spent down; or the surviving spouse might change domicile to another state."

The fundamental notion articulated in *Brooks, Shaffer,* and *Taylor* is that the law of the surviving spouse's domicile at death is the applicable law for purposes of the state death tax imposed, again regardless of the federal payback concept. That notion merits consideration when planning the estate of a surviving spouse, which (as between the two spouses) is the estate in which tax liability is more likely to be incurred. Planners are accustomed to thinking about planning a client's domicile to minimize state income taxation. These decisions confirm that planners also can consider state domicile for wealth transfer tax minimization purposes, in these cases even after the death of the first spouse to die. Indeed, changing a surviving spouse's domicile might be easier than would be a change of domicile for the married couple while both spouses are alive.

There are other exceptions to the general principle of payback inclusion. Certain interests can qualify for the estate tax marital deduction even though the interest may terminate and have no value of its own when S dies. Nevertheless, the value represented by the interest may be includible in S's gross estate. For example, annuity payments received by S and not consumed in a manner that has no value when S dies will be includible in S's gross estate (under §2033), although the amount included may bear only a slight resemblance to the marital deduction allowed for the value of the right to receive that annuity on D's death.

Perhaps because of this discordance, the Treasury Department has reserved judgment on whether annuities qualify for the estate tax marital deduction as QTIP property. See the last sentence of §2056(b)(7)(B)(ii) ("[t]o the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified)"), §2056(b)(7)(C), and the slew of Treasury regulations cited in §13.5.6.7 n.254, all permitting annuities to generate an estate tax marital deduction for the amount of corpus needed to produce the annuity, but only if the transfer creating the annuity predated the October 25, 1992, enactment date of §2056(b)(10). The final regulations otherwise are silent on qualification for transfers after that transition date.

[2] See §13.4.3. This is well illustrated by the annuity situation. S's net worth will be increased by annuity payments received by S, even if the estate tax marital deduction is not allowed to D's estate, in whose estate the value of the annuity also was includible.

can eliminate the problem of estate tax payment in D's estate, regardless of the size of that estate, regardless of the "mix" of the marital assets (principally community property, principally separate property, or substantial portions of each), and without concern about the liquidity of those assets for tax payment purposes.

It always pays to remember that hard issues like liquidity problems dodged today usually will present themselves when S dies – often in an even worse form – unless the tax (or the wealth) has disappeared before S dies. So, deferral may provide the opportunity to address these problems, but it also may lull clients into thinking the problem was solved or avoided when in fact it is just silently and relentlessly growing. The secret to marital deduction planning is to know when – and to what extent – to embrace deferral.

§13.1.1 Basic Structure of Estate Planning for Spouses

The discussion in this section represents an alternative to §2010(c) portability of D's unused exclusion amount (DSUE amount) by which a 100% marital deduction would accompany an election to allocate the DSUE amount to S. Portability would avoid the complexity of the following traditional approach but it would not be the choice of all clients in taxable situations, for several reasons:

(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 are two considerations. One is the fact that consumption or a decline in asset values favors portability, because a smaller amount will be taxable when S ultimately dies. The other is that 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, but likely at a lower rate (capital gain tax rates being lower than estate tax rates) 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) Contrary to earlier pronouncements, 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 $1,000,000 that would be includible in D's estate. Instead, D's wealth taxed in S's estate (at a maximum 40%) may generate a credit for S of as much as $400,000 of tax, which differs from saying that S is entitled to D's unused unified credit, which would be the tax on that first $1,000,000 in D's estate (which, at rates less than 40%, would have been only $345,800). As explained in §13.2 n.2, 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 corrected its earlier confusion of those very similar concepts.

(3) It may be wise in any generation-skipping situation to allocate D's GST exemption to a nonmarital trust, because the GST exemption is not transportable to S. Otherwise a reverse-QTIP election must be made to avoid loss of D's GST exemption. And use on a QTIP trust may not be as

efficient as allocation to a nonmarital trust, because income must be distributed currently in the QTIP marital deduction trust. This means that the GST exemption cannot be leveraged with income earned and accumulated in a nonmarital trust during S's overlife. Also of concern is that D may not favor a QTIP marital deduction trust as to which a reverse QTIP election could be made, or that trust may be too small to fully absorb all of D's GST exemption.

(4) 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 would be lost. On the other hand, 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.

(5) 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 gift tax annual and ed/med exclusions make lifetime transfers by S more efficient.

(6) Election of portability requires the filing of an estate tax return for D's estate,[2.1] whereas a smaller than $10,000,000 estate would not need to file at all otherwise. In some cases the decedent's

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2.1. Because nontaxable estates are not otherwise required to file an estate tax return, Treas. Reg. §§20.2010-2(a)(2) and -2(b) provide that merely filing an estate tax Form 706 for a nontaxable estate constitutes the requisite §2010(c)(5)(A) portability election. Because nontaxable estates are not otherwise required to file a return, Treas. Reg. §20.2010-2(a)(1) declares that the same return filing due date (including extensions) for *taxable* estates will apply for these purposes. This is important because no extension of the time to file a late portability electing return can be granted under Treas. Reg. §301.9100-3 if the estate is larger than the decedent's basic exclusion amount, because the time when those estates must file is established by statute. But discretion to grant relief for tardy filing is available for smaller estates because the deadline for them to file is established by these regulations.

Prior to June of 2017 hundreds of private letter rulings granted requests for extensions of the time to file a "complete and properly prepared" Form 706 estate tax return for a decedent whose estate and lifetime taxable gifts did not exceed the basic exclusion amount. These extensions were sought because the estate wished to make a portability election to preserve the decedent's unused exclusion amount for a surviving spouse, but had missed the timely return filing deadline. Prior to issuance of Rev. Proc. 2017-34, 2017-26 I.R.B. 1282, relief required payment of a user fee, because it required a PLR that would grant the request for an extension of the filing deadline. The 2017 Rev. Proc. established a "simplified method for certain taxpayers to obtain an extension of time" to file the Form 706 and elect portability – without paying a user fee or following the PLR process. It created a permanent window of time within which relief may be had, if six requirements are met: (1) the decedent was a citizen or resident, (2) who died after 2010, (3) with a surviving spouse; (4) the decedent's estate was not required to, (5) and did not, file a Form 706 (because the estate – added to all taxable lifetime gifts – was below the exclusion amount), and (6) a complete and properly prepared Form 706 is filed in accordance with Treas. Reg. §20.2010-2(a)(7). If done before an extended deadline, the portability election is allowed by filing the return and *not* electing out of portability (the protocol in Treas. Reg. §20.2010-2(a)(2) being that filing a return that otherwise is not required is deemed to be a portability election unless the return elects out of portability). The deadline for the 2017 procedure was two years after the decedent's death, which was basically just a nine month extension of when an estate tax return otherwise is required (nine months under §6075, plus an automatic six-month extension under §6081 if requested). If the two-year deadline was missed, however, the decedent's personal representative had to request a PLR to grant an extension, and pay the fee. In 2021 there were at least 25 virtually identical PLRs of this nature, and there were another 30 in the first *quarter* of 2022, suggesting that these nontaxable estates needed a ruling because the relief granted by the 2017 Rev. Proc. did not apply. As a consequence, the government released Rev. Proc. 2022-32, 2022-30 I.R.B. 101, that expanded the

personal representative wishes to minimize the costs of estate administration, particularly if portability only benefits the surviving spouse and other individuals (such as step-children) are the primary objects of the decedent's estate plan.[2.2] Moreover, that return remains open to audit until after S's death for purposes of challenging the DSUE amount available to S.[2.3] This *might* mean that valuation or other sensitive issues in D's estate remain subject to government scrutiny for potentially much longer. Fortunately, Treas. Reg. §20.2010-2(a)(2) and the Form 706 for decedents dying after 2010 provide that merely filing the return is adequate to constitute the portability election for any unused exclusion amount (affirmatively opting out is required to prevent that result). And 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.

(7) 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). That displacement of benefits could subject the executor to liability to disaffected beneficiaries. Indeed, some planners worry that it might generate gift tax concerns if S is the executor who affected S's entitlement.

(8) 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 major role in whether to shelter the benefits in a credit shelter trust or to name S as beneficiary directly and rely on portability and a rollover election by S to minimize income taxation.

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

(10) Portability is a §2010 unified credit concept that applies only if D and S are subject to estate tax under §2001. 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

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relief from two years to five years after the decedent's death, stating that "the considerable number of ruling requests for an extension of time to elect portability received since the publication of Rev. Proc. 2017-34 indicates the need for continuing relief" and that "[t]he IRS has observed that a significant percentage of these ruling requests have been from estates of decedents who died within five years preceding the date of the request." The requirements for obtaining relief otherwise were unchanged.

2.2 In re Estate of Vose, 390 P.3d 238 (Okla. 2017), ordered the decedent's personal representative (a child by a prior marriage) to make the portability election to preserve the decedent's unused exclusion amount for the decedent's surviving spouse, who agreed to pay all costs associated with filing the return to make the election. The court regarded the DSUE amount as a valuable estate asset that the personal representative had a fiduciary duty to preserve.

2.3 Estate of Sower v. Commissioner, 149 T.C. 279 (2017), affirms the government's §2056(c)(5)(B) authority to audit D's estate tax return to determine the proper DSUE amount available to S, even after expiration of the statute of limitation to assess added tax in D's estate. Inspection of D's return (as previously accepted by the government) revealed taxable gifts that D made but did not report (and that S split for gift tax purposes) and that consumed nearly $1 million of D's exclusion amount, which correspondingly reduced the amount that was available to S (whose estate also did not report those gifts). No deficiency was asserted against D's estate but S's estate was increased by the amount of S's half of those unreported gifts and S's applicable exclusion amount also was correspondingly reduced, both of which appropriately increased the estate tax liability in S's estate.

amended to provide a DSUE amount. Treas. Reg. §20.2010-3(e) clarifies that this might be altered by an applicable treaty.

(11) 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. The planning issue is whether it is likely that either spouse as a survivor will remarry a new spouse who also will die first *and* use all of their unified credit, so that portability from D will be lost and portability from that subsequent spouse will be frustrated? The vast majority of widows do not remarry, and widowers who remarry usually select a younger, less wealthy wife. Note, also, that Treas. Reg. §§20.2010-3(b)(1) and 25.2505-2(a)(3) confirm that S may use D's carryover exclusion amount inter vivos (either before or after remarriage) before S's new spouse dies, and not suffer any form of "recapture" if the new spouse ultimately predeceases S. Similarly, Treas. Reg. §§20.2010-1(c)(1)(ii)(A) (explicitly), 20.2010-2(c)(1)(ii)(A) (implicitly), and 25.2505-2(b) (explicitly) establish the same "ordering" rule at S's death before S's new spouse. Each rule effectively means that S uses any portable exclusion amount that S received from D before S uses any of S's own basic exclusion amount. Thus, if S dies before the new spouse and has a smaller estate than the applicable exclusion amount of S's own and D's portable exclusion amount, D's DSUE amount is not lost or wasted by virtue of S's remarriage.

Considering all of these reasons, 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 hew to the tried-and-true approach will fall on deaf ears of many married couple clients.

The traditional two-trust tax-conscious plan integrates a deceased spouse's unified credit and the unlimited marital deduction. In both community and noncommunity property states, the traditional approach is not the most simple, intuitive, or economical to administer, because it provides for any specific bequests, makes an "optimum" marital deduction formula gift to S (or to the trustee of a marital deduction trust), and devises the residuary estate to the trustee of a nonmarital trust.[3] A marital and a nonmarital trust likely generate more administrative expense and it may be less attractive, particularly to S, or to a marital deduction trust, than would be a bequest of all D's estate outright to S or to a marital deduction trust, coupled with portability.

The traditional nonmarital trust gives S, at most, an income interest for life, a right to receive principal in the trustee's discretion, and perhaps nongeneral powers of appointment exercisable during life, at death, or both – all drafted to avoid wealth transfer tax inclusion in S's estate. Thus, D's estate effectively is "split" for wealth transfer tax purposes. Proper use of both spouses' unified credits through effective marital deduction and nonmarital trust planning in D's estate permits marital

[3] In large estates the marital bequest may be larger than the nonmarital portion of the estate, which leads to problems in making distributions to, and greater administrative inconvenience in funding, the marital deduction bequest. For this reason, in larger estates it may be appropriate to make the formula gift to the trustee of the nonmarital trust, and make the residuary gift in a form qualifying for the marital deduction. This "reverse" or "residuary marital" formula approach is discussed in §13.7.6. Nevertheless, the basic planning discussed here would remain the same.

estates of up to double the basic exclusion amount[4] to pass to the next generation free of wealth transfer taxes, without the concerns noted above with respect to portability.[5]

In lieu of portability, traditional planning shelters (or uses) D's unified credit by placing the basic exclusion amount[6] in the nonmarital trust. Then D uses the marital deduction only with respect to the balance of the otherwise taxable estate. To avoid paying an estate tax in D's estate, however, the amount of the gift to the nonmarital trust cannot exceed the basic exclusion amount. Indeed, because of the concept of "nondeductible charges," in most cases the nonmarital trust will be less – perhaps considerably less – than this amount.[7]

Because of the many factors that can affect the size of the nonmarital trust, a simple bequest of the basic exclusion amount[8] would virtually always cause taxes to be paid in D's estate. Thus, some other method of creating the proper bequest must be used. The language below is a common *formula* provision that accomplishes this planning:

> If S survives me, I give to the trustee of the Marital Trust the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death. In determining this pecuniary amount, my personal representative shall consider the credit or the deduction for state death taxes only to

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4 The §2010(c) basic exclusion amount is $10,000,000 per spouse (increased by an inflation adjustment).

5 In considering these general statements, it is assumed for purposes of simplicity that: (1) there is no §2055 charitable deduction that will affect the computations; (2) joint tenancy and other nonprobate property is not so prevalent that it overqualifies the planning discussed; (3) no credits, such as the §2013 previously taxed property credit, are involved; (4) there are no expenses of administration or other deductions; and (5) there is no income accumulation and no appreciation or depreciation in the respective estates between the spouses' deaths and, thus, there is no growth or potential capital gain or loss to consider and no §1014 basis adjustment is relevant. These obviously unrealistic assumptions are embraced here only to simplify the discussion of even the most basic planning approaches.

6 This ignores the §2058 state death tax deduction, which might increase the nonmarital trust amount to a maximum that exceeds the basic exclusion amount of the unified credit. For ease of discussion only the §2010 unified credit shelter amount is reflected in this discussion.

7 Nondeductible charges are discussed in §13.3.4 and include items that must be charged against the nonmarital gift because otherwise they would reduce the marital deduction. Nondeductible charges include such items as: (1) state death taxes; (2) bequests that do not qualify for a marital, charitable, or other deduction; (3) §642(g) "swing" items (usually administration expenses) for which a deduction is taken against estate income rather than as an estate tax deduction under §2053; (4) adjusted taxable gifts during life that "used up" some of the §2010 unified credit; (5) GST taxes (such as on a direct skip generated by a child's disclaimer that caused a bequest to pass to a grandchild); and (6) nonprobate property includible in the gross estate that passes to someone other than S or not in a manner that qualifies for the marital deduction.

In explaining an "optimum marital" plan to clients, advisors commonly refer to the "credit shelter" amount that will be available to fund the nonmarital trust. Although this colloquial explanation may ease client understanding, it may lead to subsequent misunderstanding if the trust is funded with substantially less than the illustrated exclusion amount. Accordingly, it may be advisable to explain the impact of nondeductible charges when explaining the estate plan. See, e.g., Estate of Haskell v. Commissioner, 58 T.C. 197 (1972) (a formula marital bequest self-adjusted to account for state death tax on the marital bequest); In re Estate of Weissman, 755 N.Y.S.2d 562 (Surr. Ct. 2003) (a nonmarital trust for children by a former marriage was wiped out because a life estate to S in a personal residence did not qualify for the marital deduction because of a termination on remarriage condition; there is a perversion in a result of less to S generating less to D's other intended beneficiaries too).

8 Making such a bequest would be a challenge simply because Congress has shown a proclivity to change the unified credit, often with phase-in provisions as it did in 2001.

> the extent those taxes are not thereby incurred or increased,[9] and shall assume that none of the payments and devises under the preceding articles of this will qualify for a federal estate tax deduction.[10]

Commonly referred to as an "optimum" marital deduction (rather than an "unlimited" or "maximum") bequest, this disposition only qualifies for the estate tax marital deduction the minimum amount needed to generate a nontaxable estate for D.

Note the effect of this plan. No property would pass pursuant to the marital deduction formula if, for example, D's estate was less than the basic exclusion amount, because no marital deduction would be necessary to reduce taxes to zero. The same result could occur if this provision was used in an estate of up to double the basic exclusion amount ($20,000,000, plus inflation adjustments) that was all community property. D might bequeath D's entire residuary estate (half of the community property) to the nonmarital trust and no property would need to qualify for marital deduction purposes.

It should not be necessary to amend this type of formula marital provision in old or new documents to accommodate gradual increases in the basic exclusion amount, because the formula itself creates the optimum marital bequest after full usage of the credit. This formula should work even if Congress further raises the basic exclusion amount, all at once or phases in any increase. Nevertheless, the cautious practitioner may wish to contact clients with older documents to ensure that they wish to take advantage of any increases in the unified credit and perhaps amend their documents to make that intent clear, to avoid issues similar to those raised under the 1981 transition rules.[11] Because the increase effectively disinherits the marital bequest, the plan also might reflect the potential for S to take offense and assert a forced share election.

§13.1.2 Tax Sensitive Outright Dispositions to S

The optimum marital deduction bequest might be an effective tax plan, but it may generate a smaller marital bequest than the client (or the spouse) wants. Consider, for example, the type of planning that may be desired by clients with "average" size estates who are sensitive to (but not driven by) tax minimization objectives. To illustrate, assume D's estate is valued at $2,000,000 and S has little property.[12] For a variety of reasons (such as future contributions to D's qualified pension plan, payments reducing the mortgage balance on the family residence, stock market appreciation, and inflation), D's estate is likely to increase in value over the years, but at an unpredictable rate.

In this case there may be no marital deduction drafting or planning concerns[13] because each spouse may prefer a simple outright disposition of D's entire estate to S, notwithstanding the tax

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[9] See §13.3.4 for an explanation of this clause.

[10] Many provisions throughout this chapter are adapted from (but are not identical to) forms originally copyrighted by The Northern Trust Company, Chicago (Personal Financial Planning Division), and are reprinted with permission. Authority is expressly granted to attorneys to use those provisions, with the appropriate cautions, in the preparation of estate planning documents for clients.

[11] ERTA §403(e)(3). See §13.0.3.

[12] The plans outlined below would be the same even if the marital asset mix was different. For example, only a bit of fine tuning of the plans outlined would be required if S had the more substantial estate. Also, the same basic principles apply to community property estates.

[13] Although the spouses may have no estate planning concerns, their estate planner may be quite uncomfortable, recognizing that, after D and S are deceased, their children may inquire: "Didn't you tell the folks they could

consequences. Recall Example 1 in §13.0.1. D and S may have the wisdom to realize that a nonmarital estate plan does not save taxes in D's estate. Any taxes saved are in S's estate, making the children the real beneficiaries of optimum marital deduction planning that shelters D's unified credit.

It also may not be desirable to allocate the full basic exclusion amount away from S, especially in a smaller estate in which this could consume a significant portion or all of D's wealth and leave S with little or nothing in a marital bequest. Indeed, depending on the nature of the estate plan, failure to carefully consider the allocation of wealth away from S could result in an election against D's estate plan in favor of the statutory elective share.[14]

There also may be a question regarding the proper interpretation of a document that uses a formula provision making reference to the maximum amount of property that can pass from a decedent outside a marital deduction bequest without incurring FET. This concern arises if it was executed prior to changes in the law that permit D to bypass S with a much larger amount of property than would have been the case at the time of execution.[15] The issue under state law might be litigated whether D would have wanted the estate division anticipated at the time of execution or that allowed under the law as it exists at D's later death. In a tax sensitive situation the latter result would be preferable, but only if S's estate is likely to be taxable. The tax sensitive result also may cause an allocation of assets that arguably is contrary to D's intent, again with the potential to drive S to make a statutory election against the estate plan.

Thus, despite the size of D's estate, D may eschew a nonmarital trust and leave "all my property to S," giving S the portable DSUE amount and the freedom and flexibility of outright ownership. Assuming this is not a subsequent marriage involving children by a former spouse, the marital planning and drafting can be very simple. It would entail an outright disposition to S under a will or nontestamentary dispositions (such as life insurance or retirement benefit plan proceeds paid in a lump sum, or jointly held property with the right of survivorship), all qualifying for the estate tax marital deduction. And potentially all passing tax free when S subsequently dies, because with portability of D's DSUE amount the applicable exclusion amount (S's basic exclusion and the DSUE amount) is adequate, or the ultimate beneficiary is charity.

Unfortunately, the simplicity of this plan is deceptive because it is necessary to consider the potential that the wealth may increase more than the applicable exclusion amount. For example, if D's death is wrongful and S recovers a tort damage award of several million dollars. Indeed, S might

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have saved taxes with a nonmarital plan?" See, e.g., MacLeish v. Boardman & Clark LLP, 2018 WL 1358445 (Wis. Ct. App.), in which the children sued (unsuccessfully) the attorney, for over $250,000 of unnecessary estate tax in S's estate, essentially due to the attorney's failure to shelter the decedent's (pre-portability) exclusion amount. A cautious planner will explain in writing the tax consequences of a nonmarital plan and confirm (also in writing) their joint desire to forsake that saving. In addition, it might be appropriate to draft in contemplation of disclaimer, as discussed in §13.1.4.

14 With respect to planning in light of this possibility, see §3.4, Cline, Pennell, & 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).

15 For example, consider enactment in 1997 (and amendment in 1998) of legislation that increased the unified credit and added the §2057 QFOBI deduction, and then legislation in 2001 and again in 2010 that substantially increased the basic (née applicable) exclusion amount.

be so badly injured at the same time that recoveries (or the right to recover) for both D and S are subject to tax when S dies not too long after D. There are several potential solutions to this problem.

§13.1.2.1 Survivorship Requirements

The order of D and S dying does not matter if portability is appropriate and available. A 100% marital deduction and the election to transfer D's unused exclusion amount to S works fine, regardless of the order in which spouses die. But, portability may not be appropriate in some cases. Thus, it is important to consider survivorship if D and S die under circumstances such that proof of the order of their deaths is impossible (often referred to as "simultaneous" death, even though seldom do individuals literally die at the same instant).

> *Example:* D and S are driving home from a New Year's Eve party when their car is struck head-on by a drunk driver. When the emergency responders arrive D and S both are dead. Onlookers vary in their reports about whether either actually survived the original impact.

This is a so-called "simultaneous" death because the order of D and S's deaths cannot be proven. Under the USDA (which is the law everywhere),[16] the property of each of D and S would pass as though each was the survivor. To illustrate the consequence of this assume that D's estate is $23 million and S's estate is $2 million. The tax calculations would reflect that D's property would pass as though S died before D.

$23,000,000	D's gross estate
(0)	marital deduction
23,000,000	D's taxable estate
9,145,800	tentative estate tax
(3,945,800)	unified credit
5,200,000	D's FET payable†

S's estate would incur no tax in this situation because S's estate is below the basic exclusion amount. Indeed, a portion of S's unified credit would be wasted and the portability election also is not available for allocation to D because S is deemed to be the survivor with respect to S's estate. The solution is for D to employ an optimum marital formula gift that shelters D's unified credit, along with a presumption of survivorship for simultaneous death purposes that reverses the USDA result.[17] In this example, if D sheltered D's unified credit and qualified the balance of D's estate for the marital deduction, that excess would take advantage of S's unused unified credit, allowing D and S to match the results of portability regardless of the order of their deaths (and, by using a marital trust, D determines the destination of D's property without giving S control or subjecting it to S's creditors).

§13.1.2.2 The Preferable Approach

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16 See §3.2.5.4 n.83 and accompanying text.

17 See §13.4.2.2.1 for sample language. A presumption of survivorship is permitted under Treas. Reg. §20.2056(c)-2(e): "If the order of deaths of the decedent and his spouse cannot be established by proof, a presumption (whether supplied by local law, *the decedent's will*, or otherwise) that the decedent was survived by his spouse will be recognized . . ." (emphasis added).

If D does not want a nonmarital trust and S does survive, then the final step in this planning is for D to give S control over the nonmarital portion of D's estate, at an appropriate time.

> Marital Deduction Gift. If S survives me, I give S the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death. In determining this pecuniary amount, my personal representative shall consider the credit or the deduction for state death taxes only to the extent those taxes are not thereby incurred or increased, and shall assume that none of the payments and devises under the preceding articles of this will qualify for a federal estate tax deduction.
>
> For purposes of this gift, S shall be deemed to have survived me if the order of our deaths cannot be proved.
>
> Residuary Estate. I give all of the residue of my estate, including any foregoing gift that lapses ("my residuary estate"):
>
> (a) To S if S survives me by X days;[18]
>
> (b) If S does not survive me by X days, per stirpes to my descendants who so survive me; and
>
> (c) If neither my spouse nor any descendant survives me by X days, to my contingent beneficiaries defined [elsewhere in the will].

On the postulated facts of D having a $23 million estate and S having $2 million, if D dies followed by S's death within X days, D's estate tax computation under this plan would show:

$23,000,000	D's gross estate
(13,000,000)	marital deduction produced by formula
10,000,000	D's taxable estate
3,945,800	tentative estate tax
(3,945,800)	unified credit
0	D's FET payable[†]

When S later dies:

[18] What period should D insert for X? It must be less than six months to come within the "limited survivorship" exception to the nondeductible terminable interest rule of §2056(b)(3), as discussed at §13.4.4.2 n.119 and accompanying text. But that rule is of no concern here because the unified credit would shelter this nonmarital amount anyway, making the marital deduction unnecessary. On the other hand, if the nonmarital amount passes to S and will be taxable when S subsequently dies, it would be preferable for the marital deduction to apply in D's estate and to elect portability. Therefore, the period could be shorter (for example, 30 days, 7 weeks) but it should not be longer than the six months §2056(b)(3) period. A wise drafter would specify some number of days (e.g. 180) that cannot exceed any six calendar month period. This also would be shorter than the portable election period (which is the same as the Form 706 return filing deadline, including extensions. See Treas. Reg. §20.2010-2(a)(1)). It also should not create administrative problems because closing the estate might be delayed while waiting for S to survive the contingency period. This contingency is a concern whether S dies 60 minutes or 60 days after D, so D should select a period that is a good compromise between the planning and administration issues involved.

15,000,000	S's taxable estate
5,945,800	tentative estate tax
(3,945,800)	unified credit
2,000,000	S's FET payable†

The illustrated will provision would save the couple's children $3,200,000 in taxes if the calamity of deaths in quick succession were to occur (by moving $8 million to S to soak up S's unused credit). Alternatively, this plan provides the outright disposition to S that D wants if the deaths do not occur within the specified time. In that case D's estate would preserve D's unused exclusion amount by making the §2010(c)(5)(A) portability election.

S should have no trouble getting along for the number (X) of days that the residuary gift is contingent. S will be entitled to a family allowance under state law, and will enjoy all nonprobate assets that are payable to S or that belong to S (such as life insurance or retirement benefit plan proceeds paid in a lump sum, and assets held jointly with the right of survivorship). In addition, S may take something under the marital deduction provision (in this case any part or all of the $2 million marital bequest), which may be partially distributed during the X day period. S also may be D's personal representative with effective control over all of D's probate estate.

Why do it in two bites? Because portability may not be available, S may have unexpected creditors (for example, S may have caused that accident), and reliance on disclaimer is risky.[19]

§13.1.3 A Note About Community Property

In a noncommunity property estate the planning objective is to split the marital property if the spouses die in quick succession. By contrast, in a community property estate the marital property (everything except the respective spouses' separate property) already is split, automatically and evenly by the community property laws. Therefore, the objective is to avoid unsplitting the estate if the spouses die in quick succession.

In a community property estate it is not necessary to employ a formula marital deduction gift with a survivorship requirement imposed on S unless substantial separate property is involved. Instead, the estates will stay split simply by using a survivorship requirement with respect to D's entire community property estate. Thus, if an outright gift to S is desired the only necessary provision is a residuary gift of D's entire estate "to S if S survives me by X days."

§13.1.4 Drafting in Contemplation of Disclaimer

Another alternative to an "all outright" plan is an intermediate approach that permits S to take a second look after D dies, to see whether a nonmarital trust is preferable. For example, the estate may have appreciated substantially since the estate plan was written. Given S's age and life expectancy, this increase in value may make a nonmarital trust appropriate. Indeed, a trust might be a welcome alternative to a guardianship or other fiduciary relation to provide efficient asset management if S has become advanced in age or otherwise no longer is willing or able to manage D's wealth.

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19 See §7.1.6.6 and the discussion of disclaimer disadvantages at §13.1.4.2.

Disclaimer planning anticipates D making an unlimited marital deduction bequest to S, in anticipation of S disclaiming so much of D's estate as appropriate to cut back to an optimum marital deduction (or other desired amount). Indeed, each spouse might employ the same pattern. The documents effecting this plan would look like the will provisions in §13.1.2.2, with the addition of the following provision:

> Family Trust. I give any interest under any preceding provision of this will that S disclaims to the trustee of the Family Trust.

The Family Trust would contain whatever terms D selects (for example, mandatory income or a discretionary income spray, principal invasion powers in the trustee, powers to appoint in anyone other than S), provided that no benefit given to S causes trust corpus to be subject to S's wealth transfer taxation or precludes a qualified disclaimer.[20]

Note that an undivided portion or a pecuniary amount may be disclaimed.[21] For example, a disclaimer by S of a fraction of the residuary estate of which the numerator is the amount exceeding the desired marital deduction and the denominator is the value of the residuary estate would be a qualified disclaimer, as would be a disclaimer of the converse amount by beneficiaries other than S, looking to increase the amount of the marital deduction.[22]

§13.1.4.1 Advantages

Drafting in contemplation of disclaimer alerts the right people to consider this postmortem opportunity. The right to disclaim exists under state law, and the possibility of a disclaimer need not be mentioned in the estate plan. Nevertheless, a specific provision reminds S to take a second look to decide what is best. A reference to the disclaimer possibility serves as a red flag, which is useful because a §2518 qualified disclaimer usually must be made within nine months after D's death. Affirmative provisions also tend to overcome the reluctance that S might feel about making a disclaimer that otherwise might be perceived "as against D's intent."

A second major advantage of drafting in contemplation of disclaimer is that the estate plan can make a suitable provision for disposition of the disclaimed interest. Otherwise, at least in some circumstances, it may not be clear what happens to the disclaimed interest, notwithstanding a statute that attempts to address the problem. For example, UPC §2-1106(b)(3)(A) specifies that: "the disclaimed interest passes as if the disclaimant had died immediately before the time of distribution."[23]

To illustrate the problem with such a straightforward statute, suppose that S disclaims a portion of an outright bequest under a will not drafted in contemplation of disclaimer. The disclaimed interest

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20 See §7.1.6.

21 Treas. Reg. §§25.2518-3(b) and 25.2518-3(c).

22 See PLR 9733006 (children of a decedent were permitted to disclaim that formula amount of the estate that would generate only $X of tax in D's estate, followed by their disclaimer of all intestate entitlement in that amount, causing it to pass to S and in that manner qualify for the estate tax marital deduction); PLRs 9338010, 8702023, and 7913119 (S permitted to disclaim intestate property or stock bequeathed outright to S by a formula geared to the amount that exceeded the marital deduction desired). For a detailed discussion of disclaimers, see §7.1.6 and Cline, Disclaimers, 848-2d Tax Mgmt. (BNA) Estates, Gifts, and Trusts Port. (2010).

23 8 Pt. 1 U.L.A. 192 (Supp. 2010).

passes into a residuary trust of which S is a permissible income distributee. Under the statute, is S entitled to income from the disclaimed interest, given that the disclaimed interest is supposed to pass as if the person renouncing had predeceased D? Stated another way, does the statute apply only in reading the outright bequest that was disclaimed, or does it apply in reading the entire will with respect to the disclaimed interest? A specific designation in the document would solve this problem with a clear statement to the effect that S shall not be disqualified as a beneficiary of the receptacle trust with respect to disclaimed property.[24]

§13.1.4.2 Disadvantages

Numerous disadvantages or potential problems attend to disclaimer planning. One is that S simply may be unwilling to lose control of the property to save taxes for future takers, despite protestations made to the contrary during both spouses' lives.[25] Closely related is fear that the property remaining after the disclaimer will not be adequate to support S after incurring some estate tax in D's estate. As discussed below, the disclaimed assets can remain available in the context of a §2518(b)(4)(A) nonmarital trust, so this concern really only relates to prepayment of wealth transfer tax in D's estate due to S's disclaimer and need not be a factor at all if S disclaims no more than the basic exclusion amount.

A second problem with disclaimers is that S may be legally unable to disclaim, or may die before the disclaimer is made.[26] For example, a personal representative cannot disclaim on behalf of a surviving spouse who already is deceased under the original version of UPC §2-801(a).[27] Although this was corrected in the 1990 version of the UPC[28] (allowing S's personal representative to disclaim), the more recent versions have not been widely adopted. Moreover, a personal representative who is authorized by local law to disclaim will balk if the disclaimer will affect the ultimate recipients of property from each spouse, unless the personal representative is given clear standards to guide its decision and is indemnified against or exonerated for any liability to disaffected beneficiaries.[29]

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24 Although UPC §2-1106(b)(3)(A), 8 Pt. 1 U.L.A. 192 (Supp. 2010), addresses this issue by disposing of only the disclaimed interest as if S was deceased, it still does not specify whether S should be regarded as predeceased with respect to income payable from the nonmarital trust from disclaimed property.

25 That is, among the world's greatest lies are: (1) "The check is in the mail"; (2) "I'm from the government and I want to help you"; and (3) "Of course I'll disclaim if it will save taxes."

26 See §7.1.6.6 regarding authority of a fiduciary to disclaim on behalf of a beneficiary, such as S. For example, in Estate of Delaune v. United States, 97-1 U.S. Tax Cas. (CCH) ¶60,266 (M.D. La. 1997), rev'd, 143 F.3d 995 (5th Cir. 1998), the trial court originally concluded that purported disclaimers on behalf of S were invalid because they were made too late under state law (because S already had died). The court on appeal, however, held that the disclaimers were valid under Louisiana law, which allows the renunciation of a succession by the heirs of an heir on the heir's behalf. See also Estate of Chamberlain v. Commissioner, 77 T.C.M. (CCH) 2080 (1999) (decedent allegedly intended to disclaim but failed to sign a writing to that effect before dying, the court rejecting all sorts of extrinsic evidence and ancillary documents – including Forms 706 for both spouses consistent with disclaimer – indicative of the intent to disclaim, and also rejected a "close is good enough" argument for substantial compliance with the disclaimer requisites).

27 8 Pt. 1 U.L.A. 449 (1998).

28 8 Pt. 1 U.L.A. 206 (1998).

29 Related to the question of postmortem disclaimers is the issue whether a statutory forced heir election can be made on behalf of a disabled surviving spouse. In Williams v. Skeen, 401 S.E.2d 442 (W. Va. 1990), S's personal representative disclaimed the interest left to S under D's will and elected the statutory share instead. The court held that judicial approval for the disclaimer was required. Under UPC §2-212, 8 Pt. 1 U.L.A. 126

Third, a qualified disclaimer under §2518 is impossible if S accepted any benefits from the interest being disclaimed.[30] Thus, D's fiduciary must be astute enough to prevent payment to or acceptance by S of income from the disclaimed property, or use by S of those assets. Sometimes the acceptance of benefits is deemed to occur in unexpected ways.[31] Indeed, at one time the government regarded simply being a joint tenant with a decedent as an acceptance of benefits by surviving joint tenants that might preclude an otherwise qualified disclaimer of joint tenancy property. Although it since altered its position, the fact that it took years of litigation to resolve the issue is a good reminder that disclaimer planning is fraught with peril and probably nothing to rely upon for affirmative estate planning purposes.[32]

A fourth problem with disclaimers is disposition of the disclaimed interest. Although §2518(b)(4)(A) regards a disclaimer as effective if the interest passes to a nonmarital trust held for the benefit of S, such a disposition might not occur automatically. Thus, the document may need to specify this disposition.[33]

(1998), the right of election may be exercised on behalf of S by a personal representative, but only if S is alive at the time of the election.

30 See generally §7.1.6.3. PLR 200442027 blessed a form of planning that in effect partially circumvents this restriction. Involved was S, whose disclaimer from Trust 1 would cause the disclaimed property to drop into Trust 2, and disclaimer by S from Trust 2 would cause that disclaimed property to pass into Trust 3, and disclaimer from Trust 3 would cause a cascade down into Trust 4, and from it into Trust 5. Each trust was progressively different. For example, the initial trust would terminate after the nine month disclaimer period and distribute outright to S, the second and third trusts appeared to be QTIPable and (speculating now, because the Ruling is not explicit) perhaps differed only in that one was designed for reverse QTIP election treatment and the other was a vanilla QTIP. The last two trusts appeared to be nonmarital trusts, the differences again not being explicitly described but, again, possibly GST exemption allocation planning explained the strategy. By a series of disclaimers S could engineer through postmortem planning the amount to be held in each trust and, conceivably, there could have been added pools in the cascading waterfall of assets that provided for different beneficiaries entirely, granting S what amounts to inter vivos exercise of a nongeneral power to appoint even potentially QTIP property.

31 For example, PLR 200832018 concluded that authorizing reinvestment of a joint brokerage account disqualified a disclaimer by the surviving co-owner, TAM 8405003 opined that the interest-free use of estate funds prevented an otherwise qualified disclaimer, Estate of Engelman v. Commissioner, 121 T.C. 54 (2003), involved exercise of a power of appointment by S during a short 10 week overlife, and Estate of Delaune v. United States, 97-1 U.S. Tax Cas. (CCH) ¶60,266 (M.D. La. 1997), rev'd, 143 F.3d 995 (5th Cir. 1998), originally concluded that the payment of certain of S's expenses from the disclaimed property constituted an impermissible §2518(b)(3) acceptance of benefits that would disqualify an otherwise qualified disclaimer. That determination ultimately was reversed on appeal, based on the court's historical interpretation of the Louisiana Civil Code of 1870 dating back to the French Code Napoleon of 1804 and a determination that the acceptance of benefits was not authorized by the survivor's representative.

32 See §10.5.3 regarding these issues and the litigation trail.

33 For example, in the all outright plan illustrated in §13.1.2.2 with a survivorship contingency, D's residuary estate passes to descendants if S does not survive by the requisite period. Because S would be treated as predeceased by virtue of a disclaimer, this alternative disposition would apply unless the document specifically provided for a different disposition on disclaimer. A similar problem is encountered in very large estates that use the residuary marital plan described in §13.7.6, making a formula gift to the nonmarital trust and leaving the residue of D's estate to a marital deduction trust. Property disclaimed from the marital deduction residue normally would pass by intestacy, not into the preresiduary nonmarital trust in which D probably would want it to continue to benefit S without estate tax inclusion when S subsequently dies. That may explain why S and all descendants (acting through guardians and under court orders) all made disclaimers in PLR 200303020 of all but the exclusion amount.

Fifth, to be a qualified disclaimer, S cannot have any power to direct disposition of the disclaimed interest. For example, if S is trustee of the nonmarital trust, the disclaimer will succeed only if the trustee's powers are limited by an ascertainable standard.[34] Moreover, S also must disclaim any power of appointment not limited by an ascertainable standard (for example, a general testamentary power of appointment).[35] It is necessary to define that portion of the nonmarital trust as to which the power is relinquished, if S is willing to disclaim only that portion of the power necessary to qualify the disclaimer and not disclaim the power as to all of the nonmarital trust.

Although a fractional disclaimer approach might be successful, a better alternative is to create a separate trust to which all disclaimed assets will pass by express direction in the marital provision, without affecting the normal nonmarital trust. This trust would give essentially the same benefits as the nonmarital trust (except prohibited powers), and provide for consolidation with, or addition to, the nonmarital trust for ultimate distribution after S's subsequent death (because the cost of maintaining separate trusts is not justified by any income tax advantages of maintaining separate tax paying entities). It might even be useful to give S a noncumulative right to withdraw yearly the greater of $5,000 or 5% of the aggregate value of the principal over the disclaimed property in the nonmarital trust, as permitted under §2518.[36] This (albeit limited) ability to reach disclaimed corpus might overcome any reticence that S otherwise may feel about disclaiming a portion of the outright gift into the trust.

Finally, the disclaimer must properly describe the portion being relinquished (if only a portion of an unlimited marital bequest is likely to be disclaimed). Identifiable, severable assets held in trust may not be disclaimed unless the assets are removed from the trust and pass to other beneficiaries,[37] but a specific dollar or formula amount may be disclaimed from a trust.[38] Thus, for example, disclaimer of the income from a specific number of shares of stock or of an identifiable piece of realty would not qualify if the stock or realty continued to be held in trust, but disclaimer of a specific dollar amount or of a fractional or percentile portion of an entire interest is allowable. Depending on the nature of the property likely to be disclaimed, some advance consideration must be devoted to the form and drafting of the type of disclaimer that will be required.

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[34] See §7.1.6.3 n.269 and accompanying text.

[35] Note that Treas. Reg. §25.2518-3(a)(1)(iii) permits a power of appointment to be disclaimed while retaining other interests in corpus, but a power of appointment cannot be cut down or otherwise tailored to retain the power while complying with these limitations. See §7.1.6.4 n.288 and accompanying text.

[36] See Treas. Reg. §25.2518-2(e)(5) Example 7.

[37] Treas. Reg. §25.2518-3(a)(2).

[38] Treas. Reg. §25.2518-3(c). See §7.1.6.4 n.300 et seq. and accompanying text.

§13.2 PLANNING AND DRAFTING FOR LARGER ESTATES

All examples in this section use an applicable credit amount of $3,945,800 and a basic exclusion amount of $10,000,000, without the inflation adjustment. Remember that the exclusion amount snaps back to $5 million (again with an inflation adjustment) if Congress does not act before 2026 to make the current amount permanent.[T] Any future change in the basic exclusion amount may alter the aggregate dollar saving available but will not alter the principles illustrated. Any future change that restores a progressive rate for calculating the tax would alter the results shown, and probably in a manner that would surprise some observers – because it would favor early payment rather than deferral of the tax.

The basic truism of marital deduction planning illustrated in §13.0.1 is that giving all of a larger estate to S may "overqualify" the marital deduction:

> *Example:* D and S have a $25 million community property marital estate. D's will bequeaths "all my property" to S.

Because of the unlimited marital deduction there will be no tax in D's estate, but the full $25 million is exposed to tax in S's estate. If D's estate elected §2010(c)(2)(B) portability of D's unused exclusion amount the tax computation at S's later death would be:

$25,000,000	S's taxable estate
9,945,800	tentative estate tax
(7,945,800)	unified credit
2,000,000	S's FET payable[†]

Prior to 2011 the problem with this dispositive plan was that D's estate did not benefit from the full tax sheltering effect of the unified credit. D could remove up to $10,000,000[1] from taxation on S's death by giving that amount to a nonmarital trust, with no increase in tax at D's death. With portability the tax is the same as a traditional credit shelter plan, as next illustrated:[2]

$15,000,000	S's taxable estate
5,945,800	tentative estate tax
(3,945,800)	unified credit
2,000,000	S's FET payable[†]

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1 **§13.2** "Up to" $10,000,000 reflects the possibility that a portion of D's unified credit may have been exhausted on inter vivos taxable transfers or on nonprobate transfers that do not qualify for a deduction at D's death.

2 The government's first draft of the post-2010 Form 706 suggested that there would be a difference in the tax on D's $12.5 million half of their community property computed in D's estate – $4,945,800 – compared to the tax on that property in S's estate – $5,000,000. The difference would be $54,200 because D's first $1,000,000 would be taxed at less than 40%, whereas the full $12.5 million is taxed in S's estate in the 40% bracket if added to the $12.5 million half of their community property already owned by S. That difference reflects the increase in tax at the marginal rate that is incurred if S's estate is $12.5 million larger. The government then concluded that the statute does not give S the unused unified credit from D's estate ($3,945,800). Instead, S is entitled to D's unused exclusion amount, which is $10,000,000 and translates into the tax on that $10,000,000, which in S's estate is $4,000,000. So S's applicable exclusion amount of $20,000,000 produces unified credit in S's estate of S's own $3,945,800 plus D's $4,000,000.

Sheltering D's unified credit by using only an "optimum" marital bequest might be a better approach for tax minimization purpose if appreciation is expected, because the growth would avoid tax in S's estate. Which forecasts another planning decision that must be made in a larger estate. Is it wise to take full advantage of the optimum marital deduction, or would it be better to pay some tax in D's estate to increase the amount that can be sheltered from tax at S's death?

> *Example:* D and S own $25 million of community property. They forsake the marital deduction entirely, so that each of their estates will be $12.5 million at death.

In each estate the tax computations are:

$12,500,000	taxable estate
4,945,800	tentative estate tax
(3,945,800)	unified credit
1,000,000	FET payable†

Total taxes for both estates would be $2,000,000. An optimum marital deduction plan would shelter $10,000,000 in D's estate, qualify $2,500,000 for the marital deduction, tax $15,000,000 in S's estate, and incur the same $2,000,000 in tax after using S's unified credit. No saving is available (even with larger payments at D's death) in the flat tax environment that now exists.

§13.2.1 Advantages of Deferral

When the estate tax is progressive an economic analysis reveals that combined taxes over both spouses' estates are lower if some estate tax is paid in each estate. That often proved to have only theoretical interest, because most married clients who learn that estate taxes can be deferred until the death of S usually are not interested in economic arguments about the possible advantage of paying some tax prematurely. Put another way, taxpayers are like Congress. Seldom is it necessary to cajole them to postpone paying liabilities. Moreover, in a flat tax environment such as under current law there is no saving to garner.

Several objective reasons support the preference to put off until later what could be paid today. The most important reason not to pay tax earlier than necessary is the enjoyment value of money. S will have the use of the tax dollars that otherwise would be paid on D's death. Thus, deferral is advantageous from S's perspective, particularly if S fears that the wealth is not adequate to support S until death. There also are undeniable psychological factors. S simply may be happier if there is no estate tax to pay when D dies. Deferral also delays any liquidity problems until S dies, which can be particularly useful if business, farm or ranch property, or other illiquid assets are involved. In addition, the optimum marital plan allows a choice when D dies of either going with the original plan for maximum deferral or achieving lower taxes through postmortem planning, such as using disclaimers or partial QTIP elections and portability of D's unused exclusion amount.

An additional 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 the gift tax annual exclusion, the gift tax ed/med exclusion, or the benefit of the tax exclusive computation of gift tax on gifts that avoid the gross up rule of §2035(b).[3]

> *Example:* S has three married children and five grandchildren. S can make $16,000 annual exclusion gifts in 2022 to each of the children and grandchildren, $128,000 total per year, without the need to even file a gift tax return, or $176,000 per year if each child's spouse is included in the giving program. If removed from the 40% estate tax, gifts of $128,000 in one year would achieve a projected estate tax saving of $51,200. Gifts of $176,000 would save $70,400.

Moreover, the $16,000 per donee annual exclusion under §2503(b) is in addition to the §2503(e) ed/med exclusion for tuition and medical expenses paid directly to a provider of educational or medical services. The unfortunate limitation on this advantage of estate tax deferral is the fear of many surviving spouses that they may be left destitute. They simply refuse to engage in a gifting program, or they wait until it is too late to work a significant saving.

§13.2.2 Disadvantages of Deferral

Optimum use of the marital deduction (after sheltering D's unified credit) causes some "estate stacking" in S's estate. That is, D's marital bequest is taxed "on top" of any assets S already owns. In a progressive tax rate system this may result in a higher marginal rate of tax being imposed on D's bequest in S's estate than the rate that would have applied in D's estate. As the two examples in §13.2 reveal, this is not an issue in a flat tax context. Therefore, no additional tax will be incurred over both estates than if no marital deduction had been taken, unless D's property appreciates during S's overlife.[4] Before investigating these economic factors, a number of noneconomic reasons that favor the payment of some tax at D's death also should be noted.

The most important relates to family planning concerns. The question for some clients is how long their ultimate beneficiaries (typically children) must wait for their inheritance. Most children, for example, are "orphaned" in their 50s or later, when their surviving parent dies, which may be years or even decades later than the time of their greatest financial needs. This suggests to some clients that deferral should not be based strictly on an economic analysis.

For example, in a large estate, the "optimum" plan would involve a nonmarital trust of no more than the basic exclusion amount. Even if distributed immediately to beneficiaries other than S, it may be that, considering lifestyle and expected health care costs, the marital bequest will allow S to more than "scrape along." Thus, the question for the client to consider is whether to leave less to S, notwithstanding the need to pay some tax at the client's death, to provide earlier and greater benefits to the ultimate beneficiaries. This question especially should be considered if S is not those

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3 See §7.1.1.1 regarding the annual exclusion, §7.1.1.11 regarding the ed/med exclusion, and §6.2.1 regarding the tax exclusive gift tax calculation.

4 The benefit of generating a new basis at S's death under §1014 (attributable to inclusion of D's property in S's gross estate because it qualified for the marital deduction in D's estate) also favors deferral, if the property appreciates in value during S's overlife. Note, however, that (contrary to the common assumption) the economic return on the tax dollars deferred – the time-value of money – does not justify deferral. As illustrated in §13.2.3, this never was correct.

beneficiaries' other parent and S's death is likely to occur even later in those ultimate beneficiaries' lives.

Indeed, consistent with this notion, some clients may wish to consider a giving program benefiting younger generation beneficiaries while both spouses are living, taking maximum tax minimization advantage of two annual exclusion gifts per donee under §2503, perhaps exhausting each spouse's unified credit, and (if estate tax ultimately is expected when D and S die) potentially paying some gift tax to take maximum advantage of the tax exclusive computation of the gift tax (the DuPont effect) that the §2035(b) gross up rule precludes only for gifts made within three years of death (all with the added dividend of deriving satisfaction from seeing the benefits of those gifts while D and S still are alive).

As an alternative, if D's unwavering desire is optimum marital planning or holding property until D dies to generate a new basis by virtue of inclusion in D's gross estate, it might make sense to include precatory language[5] recommending that S consider making gifts to younger generation beneficiaries after D's death. To make this work most effectively may entail providing at least a portion of the marital bequest in a manner that allows S to make inter vivos gifts.

> *Example:* S received $1 million more property from D than S needs, and is willing to part with that amount in the form of a gift to children and the gift tax thereon. Assuming the worst possible case – that S's marginal gift tax bracket already is 40% – S could give the children $714,286 from the $1.0 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.[6] This translates into an effective tax rate on the $1 million of just 28.57%, which is lower than the lowest marginal rate (40%) that could be imposed on D's estate if a less than optimum marital bequest is utilized.

To make such planning possible it would be desirable if the trust granted S the authority to appoint property (permissible in a §2056(b)(5) trust but not in a QTIP trust, due to the prohibition in §2056(b)(7)(B)(ii)(II) against anyone having a power to appoint QTIP property to anyone other than S)[7] or to withdraw trust principal that could be the subject of a gift.

It may be possible to accomplish this planning even without specific authority. For example, S could make a nonqualified disclaimer and incur gift tax (provided that the beneficiaries S wishes to favor are the takers in the event of a disclaimer). In addition, Estate of Hartzell v. Commissioner[8] involved document authority to distribute principal from the marital deduction trust to S for "comfort, maintenance, support and general well being," which was deemed sufficient to permit distributions to S to finance a continuing gifting program that began when both spouses were alive. The risk to consider under this analysis is that S will not live three years after making the gift and the §2035(b)

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5 Perhaps in a letter to S that would minimize any reluctance S might feel to make gifts (perhaps because S remembers the Depression), even though S has more income than S can (or does) spend.

6 The algebraic formula to make this computation is:
transfer divided by (1 + tax rate) = taxable gift
So, for a 2022 calculation: $1 million divided by 1.40 = $714,286.

7 See §13.5.6.1.4.

8 68 T.C.M. (CCH) 1243 (1994).

gross up rule will apply, which would eliminate the saving in this case because it is attributable to the tax exclusive computation of gift tax.

A second factor that may speak in favor of paying some wealth transfer tax prior to when S dies is that an optimum marital bequest may give S more income than D wants S to receive. Unless an estate trust format[9] is used, S must be entitled to all income from the marital property for life. Consider a client with a $25 million estate who is in a subsequent marriage in which each spouse has children by former marriages. Based on the assume exclusion amount of $10,000,000, an optimum marital bequest would give at least $15,000,000 to S or to a trust for S's benefit and leave no more than $10,000,000 to a nonmarital trust. If this gift passing to S provides more income than S needs, excess marital trust income would be available for S to give to the children by S's former marriage, which may be contrary to D's desires. Although the estate trust format would avoid this income flow problem, it also may be undesirable to D because it results in S having testamentary control over the entire trust corpus, including all accrued but undistributed income. A viable alternative today may be a lower income investment program, authorized under modern portfolio investment rules (although concerns over the marital deduction all-income-annually requirement might preclude severe engineering of this factor).

A smaller marital bequest is a more direct and effective solution to this sort of problem. And, because estate planning involves more than saving taxes, securing the client's family planning goals always should be a principal objective. If reducing taxes is only corollary to D's family planning goals, it might be appropriate to increase the amount of the nonmarital trust over the amount that can be sheltered by D's unified credit, paying estate tax in D's estate to provide D's descendants with more assets and income flow during S's overlife. This especially would be true if the nonmarital trust would not be as large as the basic exclusion amount due to inter vivos or nonprobate transfers at death that directed some of that amount in other directions.

§13.2.3 The Time-Value of Money Rationale for Deferral

One purpose of the following discussion is to reveal the truth about a common estate planning myth. A very common assumption in analyzing any marital deduction planning approach that entails payment of estate tax in D's estate is that use of the tax dollars deferred from D's death under an optimum approach will compensate for the difference in tax saved by avoiding estate stacking.

That assumption is false. Two examples illustrate this, the second assuming time-value is reflected in the aggregate wealth doubling in value during S's overlife. For purposes of this illustration the source of this growth or the amount of time that it takes to occur is irrelevant.[10] What is relevant is that this doubling represents the enjoyment or use of the wealth during S's overlife and therefore illustrates the time-value of the deferred tax payment.

Before embarking on this odyssey of economic comparisons, it bears noting that the choice whether to pay estate tax in D's estate versus in S's estate is all second best planning. As illustrated in §6.2.2, far better planning would be to incur gift tax during D's life, or qualification for the marital

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[9] See §13.5.5.

[10] There may be income tax differences whether this is due to income accumulation or capital appreciation. That factor is not considered because it is uncertain and therefore impossible to quantify. It also does not change the analysis.

deduction in D's estate followed by gifts by S (either directly or through nonqualified disclaimers by S after D's death). This series of illustrations therefore is more valuable as a means of dispelling the common but wrong-minded assumption that the time-value notion makes deferral of tax preferable to either payment of estate tax in D's estate or incurring gift tax before both spouses die.

Baseline Example: First assume that D's estate is $20 million, that S has an estate of $5 million, and that D dies first. D has two alternatives that are compared to an optimum marital deduction approach. One is to qualify D's entire estate for the marital deduction and for D's estate to make the §2010(c)(5)(A) portability election to transfer D's unused exclusion amount to S. The second is to qualify that portion of D's estate for the marital deduction that will equalize the size of D and S's estates. Illustrated are the tax computations at the deaths of D followed by S (assuming an exclusion amount of $10 million, no §2013 previously taxed property credit, and no changes in asset values):

Portability	Optimum Marital	Equalizer Marital	
$20,000,000	$20,000,000	$20,000,000	D's gross estate
(20,000,000)	(10,000,000)	(7,500,000)	marital deduction
0	10,000,000	12,500,000	D's taxable estate
0	3,945,800	4,945,800	tentative estate tax
(3,945,800)	(3,945,800)	(3,945,800)	unified credit
0	0	1,000,000	D's FET payable†
0	10,000,000	11,500,000	amount of nonmarital trust remaining after D's taxes
When S later dies:			
$25,000,000	$15,000,000	12,500,000	S's taxable estate
9,945,800	5,945,800	4,945,800	tentative estate tax
(7,945,800)	(3,945,800)	(3,945,800)	unified credit
2,000,000	2,000,000	1,000,000	S's FET payable†
2,000,000	2,000,000	2,000,000	total tax over both estates
23,000,000	23,000,000	23,000,000	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 leaves D's entire estate to S and D's estate makes the §2010(c)(5)(A) election, saves no tax in D's estate relative to the optimum marital.[11]

But what about deferral so the estate can make money on the $1,000,000 otherwise payable at D's death in the equalizer example?

Time-Value Example: Will the 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?

[11] The credit in the portability column is the aggregate of S's own $3,945,800, which is the tax on $10,000,000, and D's portable exclusion of $4,000,000, which is the 40% tax on D's $10,000,000 stacked on top of S's $10,000,000, which is the point discussed in note 2.

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**	
$25,000,000	$15,000,000	$12,500,000	S's gross estate
×2	×2	×2	
$50,000,000	$30,000,000	25,000,000	S's taxable estate
19,945,800	11,945,800	9,945,800	tentative estate tax
(7,945,800)	(3,945,800)	(3,945,800)	unified credit[12]
12,000,000	8,000,000	6,000,000	S's FET payable†
38,000,000	22,000,000	19,000,000	amount of marital trust remaining after S's taxes
0	20,000,000	23,000,000	double the amount of nonmarital trust remaining after D's taxes
38,000,000	42,000,000	42,000,000	assets remaining

[12]Again assuming deaths in 2022, 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 as illustrated in §13.2.6, 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.

The portability result is attributable to $4,000,000 of tax on $10,000,000 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 $1,000,000 of tax dollars not otherwise paid during S's overlife. This example illustrates that the time-value bromide regarding these alternatives is, simply stated, just wrong. Indeed, in a progressive tax world the equalizer actually produces *better* results.

This is so critical – and so contrary to many advisors' understanding – that a reader who does not believe it should stop now and run the numbers personally, to be persuaded that time-value notions regarding deferred payment of taxes may be a viable notion for income tax purposes but they are exactly wrong for wealth transfer tax purposes.[12]

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[12] See §6.2.2 and Pennell & Williamson, The Economics of Prepaying Wealth Transfer Tax, 136 Trusts & Estates 49 – 60 (June 1997), 40 – 51 (July 1997), and 52 – 56 (August 1997), abridged and reprinted in 52 J. Fin. Serv. Profs. 62 (Nov. 1998) and 53 J. Fin. Serv. Profs. 42 (Jan. 1999).

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 also 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.

Under this analysis, the combination of income and growth – total portfolio performance – is considered as one element and, 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 are a fallacy. There are numerous legitimate reasons to defer the payment of estate tax in the combined estates of D and S, such as lack of liquidity, fear about too little wealth remaining for S to live on, or the notion that having the money during the overlife of S provides many more opportunities than if the tax already was paid.[13] But a decision to defer taxes through use of portability or an optimum marital bequest cannot be supported economically by the time-value notion. That is the *only* point being made here.

Well, except to also illustrate that portability suffers if appreciation is expected. The converse would be true if depreciation is expected and cannot be avoided (for example, the investment portfolio is not liquid or the decline is attributable to tax-free dissipation or consumption during S's overlife). An example showing the effect of depreciation in value must use numbers that involve payment of tax at S's death (for example, an apples-to-apples comparison is flawed if S's credit exceeds S's tax liability at death, so some is wasted). So, again assume that D has $20 million and S has $5 million, but that values *decline* 20% 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)	(10,000,000)	(7,500,000)	marital deduction
0	10,000,000	12,500,000	D's taxable estate
0	3,945,800	4,945,800	tentative estate tax
(3,945,800)	(3,945,800)	(3,945,800)	unified credit
0	0	1,000,000	D's FET payable†
0	10,000,000	11,500,000	amount of nonmarital trust remaining after D's taxes
When S later dies:			
$20,000,000	$12,000,000	10,000,000	S's taxable estate
7,945,800	4,745,800	3,945,800	tentative estate tax
(7,945,800)	(3,945,800)	(3,945,800)	unified credit
0	800,000	0	S's FET payable†
0	8,000,000	9,200,000	80% of nonmarital trust
20,000,000	19,200,000	19,200,000	Assets remaining

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[13] See §13.2.1.

The differential in the portability column is $800,000 less tax because $10,000,000 of nonmarital wealth was taxed in the other two examples but only $8,000,000 was taxed in the portability example, due to the loss of 20% of the value during S's overlife. The tax at 40% on the lost value of $2,000,000 is $800,000.

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 $5 million, will total $10,000,000 at S's death and thereby take advantage of S's unified credit on the second death:

> *All Hot Example*: D's estate of $30 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 $2,500,000 for the marital deduction and pays $7,000,000 of tax on the remaining $27,500,000 that will pass to a nonmarital trust for S. The $2,500,000 marital doubles in value and, combined with S's own $5 million, is entirely sheltered from tax when S dies, and the $20,500,000 remaining in the nonmarital trust also doubles in value to $41,000,000 during S's overlife. An aggregate of $51,000,000 would remain at S's death, with no more wealth transfer tax to be paid.[14] 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 $20,000,000, the nonmarital would be $10,000,000, and again the entire $30 million doubled in value during S's overlife, a tax of $14,0000,000 would be incurred on the $45,000,000 includible in S's estate at death (assuming a traditional bypass plan sheltered $10,000,000 at D's death that doubled in value to $20,000,000) leaving the same $51,000,000 after S's death.

Prepay All Tax		*All Hot Example*	Defer All Tax	
Marital	**Nonmarital**		**Marital**	**Nonmarital**
$2,500,000	$27,500,000	D's estate	$20,000,000	$10,000,000
0	(7,000,000)	D's FET payable†	0	0
2,500,000	20,500,000	D's post tax wealth	20,000,000	10,000,000
2,500,000	20,500,000	×2 appreciation	20,000,000	10,000,000
5,000,000	41,000,000	D's wealth when S dies	40,000,000	20,000,000
5,000,000	0	S's other wealth	5,000,000	0

[14] 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, denying the basis adjustment even in the optimum marital situation. See §13.2.5 for an analysis. And see MacLeish v. Boardman & Clark LLP, 862 N.W.2d 654 (Wis. Ct. App. 2015), in which the court rejected the attorney's defense in a suit for malpractice involving marital deduction planning that the damages were too speculative because of the offsetting new basis and reduced capital gain attributable to inclusion of more property in S's gross estate than otherwise would be necessary. The court considered the capital gain evidence as relevant to the calculation of damages but not so speculative as to justify dismissal of the malpractice action.

10,000,000	0	S's taxable estate	45,000,000	0
0	0	S's FET payable†	(14,000,000)	0
10,000,000	41,000,000	assets remaining	31,000,000	20,000,000
51,000,000		**aggregate wealth**	**51,000,000**	

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 $30 million estate consists of equal parts of highly appreciating and nonappreciating assets. D's estate qualifies $5,000,000 of the nonappreciating assets for the marital deduction and pays $6,000,000 of tax on the remaining $25,000,000 of nonmarital wealth. The estate pays this tax using the remaining $10,000,000 of nonappreciating assets, to shelter all the growth on the $10 million of appreciating assets. When S dies the $5,000,000 marital trust has not changed in value and S pays no tax on that plus S's $5 million (instead, it simply absorbs S's unified credit) and the nonmarital trust is worth $34,000,000 ($15 million of the original value doubled, plus the $4,000,000 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 $44,000,000 after all tax is paid. If D's estate had paid no tax at D's death, $10,000,000 of appreciating assets would have been sheltered in the nonmarital trust and would have grown to $20,000,000 tax free at S's death. The remaining $5,000,000 of appreciating assets would qualify for the marital deduction and be worth $10,000,000 at S's death, includible in S's gross estate, along with the remaining $15 million of D's estate that consisted of nonappreciating assets. Now only $25,320,000 would remain after incurring $8,000,000 of tax at S's death. The saving attributable to prepayment is $2,000,000 over this optimum marital result, which represents avoidance of a 40% tax on $5,000,000 of growth that was includible in S's taxable estate in the optimum marital alternative. This saving is attractive enough to D in terms of prepaying $6,000,000 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. But the example illustrates an unexpected reality that reveals factors that must be considered.[15]

Prepay All Tax		*Half Hot Example*	Defer All Tax	
Marital	**Nonmarital**		**Marital**	**Nonmarital**
0	$15,000,000	D's hot assets	5,000,000	$10,000,000
$5,000,000	10,000,000	D's not hot assets	15,000,000	0
0	(6,000,000)	D's FET payable†	0	0
5,000,000	19,000,000	D's post tax wealth	20,000,000	10,000,000
0	15,000,000	×2 appreciation	5,000,000	10,000,000
5,000,000	34,000,000	D's wealth when S dies	25,000,000	20,000,000
5,000,000	0	S's other wealth	5,000,000	0
10,000,000	0	S's taxable estate	30,000,000	0
0	0	S's FET payable†	(8,000,000)	0
10,000,000	34,000,000	assets remaining	22,000,000	20,000,000

15 In addition to the reality that a modest transfer tax saving usually is not sufficient to encourage most taxpayers to prepay tax, any transfer tax saving also must be discounted by the capital gains tax that would be incurred if a sale in the future caused a realization of growth that a §1014 basis adjustment would eliminate if that property was includible in S's gross estate (because it qualified for the marital deduction in the estate of D). This again is quite an imponderable due to guesswork regarding the timing of any potential realization event and the rate of tax that might apply at that time.

44,000,000	**aggregate wealth**	**42,000,000**

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.

§13.2.4 Sheltering D's Unified Credit

The planning that underlies the discussion in this section arose before adoption of portability of a deceased spouse's unused exclusion amount (the §2010(c)(2)(B) DSUE amount, enacted in 2010 for a two year period but subsequently made permanent). But a larger issue involved with portability really entails the §1014 new-basis-at-death rule.

To appreciate the situation requires a diversion into §1014(e) first. 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 "the [surviving spouse's] property was not acquired [by the surviving spouse] from the decedent under §1014(a) and §1014(e), notwithstanding that it is includible in the decedent's gross estate." Therefore, the TAM 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),[16] which precludes a taxpayer from giving property to an individual who is about to die and receiving the same property back from the decedent's estate with a new basis generated by its

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[16] 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. See §10.4. 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 the suggestion in PLR 9321050 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 Ruling declined to opine on that speculation.

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)."[17]

This led to a second (and more refined) ruling 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,[18] when D died all the trust property was includible in D's estate, half under §2038 due to the transfer with retained power of revocation and half under §2041 due to the

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17 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.

18 See also the following rulings, 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 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 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, e.g., §7.3.4.2 n.137 et seq. and accompanying text, and 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 ruling 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. See §7.3.3 nn.55 – 59 and accompanying text for a discussion of how to draft a trust with the donor as trustee and still avoid §§2036 and 2038 exposure by using ascertainable standards to limit the trustee's discretion.

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.[19]

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.[20] 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.[21]

Additional rulings 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.[22] PLRs 200604028, 200413011, and 200403094 also blessed

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19 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 in 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.

20 See §13.5.6.5.

21 See §13.1.1.

22 This did not produce a different result for §1014(e) (or any other purpose), the Ruling 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.

variations on the marital deduction planning designed to shelter both spouses' unified credits with their respective properties, no matter which spouse died first.[23]

In the aftermath of these Rulings 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 Rulings 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 Rulings are wrong on one or more counts.[24] 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.[25] 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.

§13.2.5 Using the Previously Taxed Property Credit

Postmortem planning of the size of the marital deduction also should consider the effect of a §2013 credit for previously taxed property. To illustrate why, consider the example of TAM 8512004,

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23 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 Rulings 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.

24 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 voluntary community property approaches in Alaska, South Dakota, and Tennessee, if that tax-motivated planning is respected. See §10.7.2 n.33. 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.

25 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 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 which D's will 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 and D's entire estate passed under D's residuary clause to the nonmarital trust. Although a marital deduction was not available to D's estate, aggregate estate taxes over both estates were minimized because the estate tax generated in D's estate increased the §2013 credit available in S's estate.

The key to this result is that S's income interest in the nonmarital trust qualifies for the §2013 credit, notwithstanding that no part of that trust was includible in S's estate at death.[26] Under the actuarial tables, the value of S's life income interest (and the §2013 credit based thereon) far exceeded the income S actually received during the three months S survived D. Nevertheless, because Rev. Rul. 80-80[27] 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.[28]

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26 And notwithstanding the life estate being a nondeductible terminable interest for marital deduction purposes. See §13.4.3.3.

27 1980-1 C.B. 194, obsoleted by Rev. Rul. 96-3, 1996-1 C.B. 348, which was superseded by Treas. Reg. §20.7520-3(b)(3), which precludes use of the standard tables if the individual who is the measuring life is terminally ill (meaning that the individual is known to have an incurable illness or other deteriorating physical condition and there is at least a 50% probability of death within one year).

28 In a less well planned manner, essentially the §2013 credit generated a sizable saving in Estate of Howard v. Commissioner, 91 T.C. 329 (1988), rev'd, 910 F.2d 633 (9th Cir. 1990), dealing with the "stub income" issue in a QTIP trust, as discussed in §13.5.6 nn.90 – 97 and accompanying text. The saving generated by the §2013 credit for a naked life estate in a nonmarital trust in *Howard* was almost $675,000.

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), involved the proper value of S's life estate (a usufruct) in D's estate. Both spouses died simultaneously. The lower court determined the value of S's life estate based on (1) a state law presumption that the younger spouse was the survivor when they died under circumstances making proof of the order of their deaths impossible and (2) §2013(d), which determines the value of S's life estate as of D's death, at which moment S was deemed to be alive and well, notwithstanding that S died immediately after D. In Estate of Harrison v. Commissioner, 115 T.C. 161 (2000) (deemed simultaneous deaths of spouses whose private aircraft never reached its destination and was presumed crashed with no survivors), and in Estate of Marks v. Commissioner, 94 T.C. 720 (1990) (a reviewed opinion involving facts virtually identical to *Carter*), the Tax Court held that the value of S's life estate must reflect the simultaneous death. The Court of Appeals for the Fifth Circuit agreed in reversing *Carter*. According to that opinion, simultaneous death rendered S's life estate "worthless" for §2013 purposes because

> the use of [the actuarial valuation] tables is subject to the underlying premise that what is sought to be achieved is value "as of the date of [D's] death on the basis of recognized valuation principles" [and] "recognized valuation principles" includes examination of facts known about [S] at the time of [D's] death. [W]e opt . . . to apply the maxim that certainty should be deemed a "recognized valuation principle." Just as it would be foolish to "predict" yesterday's weather, there is no reason to use uncertain valuation principles – regardless of how sophisticated – to "value" something for which a value in fact has already been indelibly fixed by the course of events.

921 F.2d at 67 – 68. The *Carter* opinion on appeal specifically stated that it was limited to "situations in which the transferee and transferor of an indeterminate interest such as a [life estate] die in a common disaster, because in this situation it is known with certainty that the transferee will die . . . ." 921 F.2d at 68. This statement is disturbing for two reasons. First, it does not indicate what "common disaster" means, or whether it may differ from the situation presented in which the deaths occurred under such circumstances that the order of death could not be established by proof. Some common disaster deaths will not be such that the order of death is unproveable – such as if two individuals die as a result of injuries suffered in an automobile accident, with one lingering

Example: D has an estate of $30.0 million and S has an estate of $5 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 a 40% rate and $10 million basic exclusion amount:

Optimum Marital		§2013 Maximizing Marital
$30,000,000	D's gross estate	$30,000,000
(20,000,000)	marital deduction	(10,033,225)
10,000,000	D's taxable estate	19,966,775
0	D's FET payable†	3,986,710
25,000,000	S's taxable estate	15,033,225
6,000,000	S's tax before §2013 credit	2,013,290
0	§2013 credit[30]	(2,013,289)
6,000,000	S's FET payable†	1
6,000,000	Tax over both estates	3,986,709

[30]The §2013 credit was computed based on S's life estate being worth 50.5% ($10,083,221) of the $19,966,775 nonmarital trust after paying $3,986,710 in tax. The assumptions underlying this computation will change monthly with the §7520 interest rate and annually with S's age. To make this hypothetical computation the calculation also assumed that S was 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 FET 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 the related but not same case of 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.

longer than the other. In such a case perhaps actual facts and the survivor's short life expectancy will be considered because death is imminent and the tables will not apply.

Second, when computing any §2013 credit for the value of a life estate, the length of S's overlife always is known when the credit is being claimed in S's estate, meaning that actual life always could be used if that was Congress' intent. The fact that §2013(d) instead requires valuation as of D's death is a clear indication that valuation hindsight is not appropriate, under a simultaneous death or any other situation. See Lee, The Common Disaster: The Fifth Circuit's Error in Estate of Carter v. United States and the Glitch in the "Tax on Prior Transfer" Credit in Valuing Life Estates Created in a Common Disaster, 40 Emory L.J. 1269 (1991). As a clear confirmation of that see TAM 199917066, in which the first decedent died before the §7520 tables were promulgated but the survivor died thereafter and the issue was whether computation of the §2013 credit should reflect the prior Rev. Rul. 80-80 rule regarding deviation with respect to life expectancy or the newer rule in Treas. Reg. §20.7520-3(b). The government properly held that the rule in effect when the first decedent died is the applicable standard, which is consistent with the rule in Treas. Reg. §20.2013-4(a) that the credit is computed using the predictions that apply at the first decedent's death and not the realities as known when the survivor dies. On the substantive issue itself, see Treas. Reg. §§20.7520-3(b)(3)(iii), 20.7520-3(b)(4) Example 2.

In this case D and S saved $2,013,289 in tax paid over both estates as compared to an optimum marital result (in this case, just 5.75% of the aggregate wealth of D and S). In a smaller situation the saving would be more impressive, but 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 an alternate valuation election[29] or a state death tax is involved. Software *is* available to do the calculation.

Similar results to this example are available if S is not terminally ill,[30] whether the marital bequest is outright or in trust, and whether the marital deduction is fine tuned by formula, disclaimer of a portion of a marital bequest, or a partial QTIP election under §2056(b)(7)(B)(v).[31] Somewhat surprisingly, TAM 8608002 held that an income interest granted to S may qualify for the §2013 previously taxed property credit notwithstanding that D created a family trust for the benefit of S, for a child, and for grandchildren, authorizing the trustee to distribute income to any of these beneficiaries "as the Trustee in its absolute and sole discretion shall determine." Moreover, the Trustee could distribute principal to any of these beneficiaries "as it may deem necessary" to "generously support and maintain" S "and suitably to provide for" the child and grandchildren.

Treas. Reg. §20.7520-3(b)(2)(ii)(B) provides that the standard §7520 valuation of an income interest may not be used if the trust permits the beneficiary's income to be withheld, diverted, or accumulated for another person's benefit without the beneficiary's consent. Or if the trust permits distributions of principal to another person without the beneficiary's consent and without making some adjustment that would account for that distribution to otherwise preserve the value of the beneficiary's income interest. Nevertheless, focusing on a specific provision stating D's intent "that the income from the Family Trust shall be expended primarily for the benefit of [S] unless in the sole judgment and opinion of the Trustee, [child] . . . or Settlor's grandchildren have real need for any portion of said income," the government determined that the fact that the income interest could be diminished by distributions to others did not preclude the credit.

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29 Rev. Rul. 81-118, 1981-1 C.B. 453, held that the value of a life estate created in a transferor's estate that elected to use the alternate valuation date should reflect the actuarial life estate factor for the life tenant's age at D's death, not at the alternate valuation date, but applied it against the FMV of the estate on the alternate valuation date.

30 As defined in Treas. Reg. §20.7520-3(b)(3)(i). See, e.g., Boryan v. United States, 690 F. Supp. 459 (E.D. Va. 1988) (decedent's predeceased husband gave her a life estate in a trust susceptible of valuation in accordance with recognized valuation principles and therefore generated a §2013 credit).

31 For example, although TAM 9145004 denied a §2013 credit for S's income interest in a discretionary income nonmarital trust, citing Rev. Rul. 67-53, 1967-1 C.B. 265, the government allowed the previously taxed property credit with respect to S's mandatory income entitlement in QTIPable property as to which no QTIP election was made. Because that property was held separate from the nonmarital portion of D's estate, the government allowed a credit for the "taxes attributable to the marital deduction trust," but it did not explain the proper computation of the amount of the credit. For example, if the nonmarital trust was $1 million in value and the partial QTIP election left another $250,000 taxable in D's estate, would the tax attributable to that QTIP trust be the full increment in tax caused by the partial QTIP election or just 20% of the total tax paid by the estate? This issue is relevant because only the tax attributable to the partial QTIP elected trust, and no tax generated by the nonmarital trust, would be available for §2013 purposes at the death of S. A fair reading of §2013(b) indicates that the credit should be a proportionate share of the total tax paid by D's estate, regardless of the fact that all of the tax paid is attributable to the partial QTIP election.

This was because (1) "the dispositive provisions of the trust instrument clearly evidence an intention on the part of [D] to favor [S] over [the child] and grandchildren with respect to the payment of trust income," (2) "the trustee here has only a limited power to invade trust principal for others," and (3) that limited power "constitutes an ascertainable standard which renders [S's] life interest susceptible of valuation." No indication was given as to how that income interest was to be valued, nor does it seem clear from the facts that an ascertainable standard was used.[32] Nevertheless, the TAM underscores the flexibility of §2013 and the fact that the credit is available in S's estate notwithstanding (1) termination of the life interest at S's death and (2) the amount of income actually paid during S's life and includible under §2033 may be less than estimated at the time of D's death or estimated under whatever valuation approach the government adopts.

Although a life estate that terminates on remarriage is a nondeductible terminable interest for purposes of §2056,[33] nevertheless it is capable of valuation and qualifies for the §2013 credit for tax on prior transfers.[34] Thus, in Rev. Rul. 85-111,[35] D's estate created such a terminable interest in S, failing to qualify for the marital deduction in D's estate but generating a §2013 credit in S's estate several years later.[36] That the value of the property producing the life estate was not includible in S's

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[32] The TAM referred to Rev. Rul. 67-53, as well as Rev. Rul. 70-292, 1970-1 C.B. 187, Rev. Rul. 75-550, 1975-1 C.B. 357, and Estate of Pollock v. Commissioner, 77 T.C. 1296 (1981), in discussing when a life interest is susceptible of valuation for purposes of §2013. See also Estate of Weinstein v. United States, 820 F.2d 201 (6th Cir. 1987) (§2013 credit allowed for S's discretionary nonmarital trust income interest "to continue to maintain [S] ... in the manner to which ... [D and S were] accustomed throughout their married life," considering S's other income but not other property available to S, notwithstanding that the nonmarital trust also contained a standard provision directing exhaustion of the corpus of a marital deduction trust created for S before invading corpus of the nonmarital trust for S), citing Treas. Reg. §20.2013-4(a) and Estate of Lloyd v. United States, 650 F.2d 1196 (Ct. Cl. 1981); TAM 200218003 (asserting that trustee power to invade corpus pursuant to an ascertainable standard would increase the value of S's life estate). In sharp contrast to *Weinstein* see TAM 8717006 (the §2013 previously taxed property credit was not allowed for the income interest in a nonmarital trust because S's estate refused to provide information regarding S's other income and assets, which were relevant in evaluating the standard used in the trust); TAM 8944005 (a totally discretionary income interest did not qualify for the §2013 credit because it was not susceptible to generally recognized valuation principles; the government distinguished *Lloyd* because the beneficiary was the sole income beneficiary of that trust and distinguished *Weinstein* because S was deemed to be the primary beneficiary and all other permissible recipients of income were meant to be secondary beneficiaries only, and concluded that, unlike *Weinstein*, S was not meant to be the primary beneficiary and nothing in the document indicated otherwise). See §5.2.2 n.22.

[33] See §13.4.3.3 n.83 and accompanying text.

[34] The government's recognition that the terminable interest can be valued notwithstanding the contingency of termination on remarriage merely underscores how illogical the nondeductible terminable interest rule is for purposes of §2056.

[35] 1985-2 C.B. 196.

[36] Rev. Rul. 85-111, 1985-2 C.B. 196, involved a decedent who received an income interest under a trust created by a prior decedent that was to last until D's death or remarriage. The issue was whether a credit under §2013 was available in D's estate when D died four years after the prior decedent. The Ruling referred to Rev. Rul. 67-53, 1967-1 C.B. 265, and Estate of Wraith v. United States, 575 F.2d 1288 (9th Cir. 1978), which held that the interest is not capable of valuation as of the date of the transferor's death if the life income beneficiary's interest is subject to discretion in the trustee as to what the beneficiary is to receive; thus, no credit was available under §2013. But Rev. Rul. 74-557, 1974-2 C.B. 301, held that the possibility of termination of a survivor's annuity upon remarriage of the annuity beneficiary is taken into account as a valuation factor in determining the value of the annuity includible in a decedent's gross estate under §2039. "Thus, a remarriage contingency in these circumstances does not render a lifetime interest incapable of valuation for purposes of sections 2039 or 2013 of the Code." 1985-2 C.B. at 197.

estate was irrelevant, because the income generated by the life estate increased S's net worth, which *was* includible (to the extent not consumed in ways that have no value when S dies).

Postmortem planning that incurs an estate tax in the estate of D to produce a §2013 credit in S's estate is particularly difficult if it is not clear whether S will die within the §2013 ten year window. Moreover, drafting nonmarital trusts requires a decision whether to provide that S will receive all income annually, thereby maximizing the §2013 credit if death occurs within 10 years after D, or to provide for an income spray to reduce S's income and estate tax liability and to permit other family planning uses of nonmarital trust income.

In this last regard it is not a solution to direct that all income be paid to S for a given period and permit a spray of income thereafter, because that subsequent shift in beneficial enjoyment would be reflected in valuing S's nonmarital trust entitlement. With the current compressed income tax rates, the real factor to consider in deciding which approach to follow is the increase in S's gross estate attributable to payment of all income to S annually, which may be an insignificant factor if S is expected to die within the 10 year §2013 period. It also can be adjusted by making a prudent investment in growth versus income-generating assets.

Thus, it may be best to draft mandatory income payments to S, if death is likely to fall within the §2013 period. In addition, S may be able to make gifts of excess income to prevent bloating S's gross estate, to the extent that remains a concern. Finally, granting S a five-or-five withdrawal power in the trust can significantly increase the value of S's interest for §2013 purposes, in some cases by as much as an additional 20% or more.[37]

In terms of the actual calculation of the §2013 credit, two limitations restrict the §2013 credit itself. The first, under §2013(b), limits the credit to the amount of tax incurred in D's estate attributable to the previously taxed property. Implicit in this limitation is that there must be some tax incurred in D's estate to generate the credit in S's estate. And the credit cannot exceed the tax incurred on the property in D's estate if the estate tax rate was lower than the rate imposed in S's estate. Thus, the tax computed at S's higher rate is imposed, the lower credit is applied, and the difference in tax between the two estates is collected at S's death.

The second limitation, under §2013(c)(1), prevents the credit from exceeding the tax attributable to the previously taxed property in S's estate.[38] Thus, the credit cannot exceed the tax

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[37] For an illustration, see Estate of Shapiro v. Commissioner, 66 T.C.M. (CCH) 1067, 1070 n.3 (1993) (a 91 year old surviving spouse died within five months but a five-or-five withdrawal right increased the value of a trust interest qualifying for the §2013 credit by 13.5%).

[38] Any marital deduction allowed to S's estate must be considered in computing the second limitation (taxes in S's estate). Rev. Rul. 90-2, 1990-1 C.B. 169, specifies how the post-1981 unlimited marital deduction is to be reflected in this computation. To illustrate, assume S's gross estate was worth $17,750,000, S remarried after D died and S's marital deduction was $1 million, and the previously taxed property in S's estate was worth $500,000. The second limitation would be the difference in tax between the estate tax computed with and without inclusion of the $500,000 of previously taxed property. With a gross estate of $17,750,000 and a marital deduction of $1 million, assume S's estate tax after the unified credit would be $3,100,000. With a gross estate of only $17,250,000 and a marital deduction of $1 million, assume S's estate tax after the unified credit would be $2,900,000. Thus, the second limitation on the §2013 credit in S's estate would be $200,000. If, however, S utilized a post-1981 formula marital deduction of the smallest amount needed to reduce taxes to zero, the second limitation will produce a §2013 credit of zero because there would be no tax after utilizing the unified credit in S's estate, either with or without inclusion of the previously taxed property.

incurred on the property in S's estate if the property was taxed in D's estate at an average rate higher than the rate imposed in S's estate. In effect, the credit from D's estate cannot be used to eliminate the tax on the property in S's estate and then reduce the tax on other assets in S's estate as well. Taken together, these two limitations ensure that property includible in two different estates will be taxed at the higher rate as between the two estates but will not be taxed more than once if death occurs within the §2013 period.[39]

§13.2.6 A Note About Formula Clauses and Computations

Estate planners draft formula marital bequests because bequests of a specific dollar amount, specified assets, or a preordained fraction are not sufficiently precise to generate the proper-sized deduction.[40] Occasionally it is advisable to make specific bequests to direct distribution of certain assets to particular beneficiaries.[41] Otherwise, specific provisions are too imprecise, given the effect of other qualifying assets, valuation changes affecting the estate, elections affecting the size of the desired marital bequest, equitable apportionment that may alter the size of the probate estate, and other unpredictables (especially including adoption of new tax laws).

Thus, the issue is which formula to use. At one time some planners felt comfortable using a "laundry list" approach to create a formula itemizing all factors that would affect the ultimate computation of the desired marital deduction. This approach involves substantial complexity, requiring a provision that anticipates at least the following items: (1) the effect and changing valuation of all relevant credits; (2) the effect of all elections that may be made; (3) the possibility that S or some other beneficiary may make a qualified disclaimer; (4) the computation of offsets for other qualifying assets passing to S,[42] including some direction as to how the determination is to be made if any part of a nonmarital trust could be elected for QTIP treatment; (5) the effect of §2032(b)(2), which prevents recognition of any changes in asset values prior to satisfaction of the marital bequest that is attributable to the lapse of time or the (non)occurrence of any contingency; (6) the effect of other deductions allowed to the estate; (7) the effect of gifts made during life; and (8) the impact of any applicable state death tax. In addition, the provision must specify which values are to be used for all these computations (typically those finally accepted for FET purposes, including §2032 alternate or §2032A special use valuations).

The Revenue Ruling effectively treats previously taxed property as being allocated to nonmarital deduction bequests under S's will, because its absence from the gross estate in computing the second limitation does not reduce the marital deduction. Thus, the estate tax computed without the previously taxed property is less – by an amount equal to the incremental tax on the value of the previously taxed property – which is taxpayer favorable.

39 For a detailed discussion of the previously taxed property credit, see Peebles, Estate Tax Credits and Computations, 844-3d Tax Mgmt. (BNA) Estates, Gifts, and Trusts Port. (2009).

40 Even if they were, planning involving such factors as the §2013 credit would require postmortem tinkering. See §13.2.6.

41 E.g., to avoid accelerating any §691 IRD included among the general assets of the estate at the time the estate is distributed in satisfaction of a pecuniary bequest, as discussed in §13.7.3.2.4.

42 PLR 9724016 demonstrates the value of using a formula marital bequest that reflects other qualifying dispositions. In that case nonprobate property passing to S caused the formula-determined marital bequest amount to reduce to zero. Notwithstanding a QTIP election with respect to the trust, the amount of marital trust assets required to fully qualify for the marital deduction was deemed to be zero and the QTIP election with respect to the trust therefore was regarded as an election of zero, which avoided wealth transfer tax in each spouse's estate.

The risk of error in creating such a list, and the possibility that changes in the law would require document modification to ensure preservation of the original intent, usually discourage this approach. A useful illustration of this is TAM 8722010, which used formula language that itemized various factors to be considered in determining the amount needed to eliminate taxes in D's estate, limiting those factors to: (1) other items passing to S that qualified for the marital deduction; (2) the state death tax credit; and (3) the unified credit. On audit of the estate tax return the government increased the size of the estate for tax computation purposes by adding a prior adjusted taxable gift. The taxpayer asserted that the marital deduction formula would adjust automatically to increase the marital bequest and continue to produce a sufficient deduction to eliminate taxes.[43] The government concluded that prior gifts was not an itemized factor and the marital bequest was not increased by this audit consequence, thereby causing the estate to incur some estate tax.[44]

More significant in the current legislative environment is drafting formula provisions that effectively anticipate every factor that should be considered, which makes laundry list drafting dangerous.[45] Imagine, for example, the effect on a prior document of Congress' adoption of the §2057 QFOBI deduction and its predecessor (the §2033A exclusion), for which there was no precedent and about which (an exclusion) probably no formula provision properly was adapted. Imagine also repeal of the §2011 credit and replacement with the §2058 deduction.

Some planners are content to use a "maximum marital deduction" provision with a "cut back" clause designed to reduce the marital bequest to the optimum, equalized, or other desired amount. This approach may require the addition of a provision specifying that elections made in estate administration (for example, alternate valuation, §642(g) income or estate tax deduction, or special use valuation) need not "maximize" the estate or the marital deduction.[46]

A cut back provision may be harder for a client to understand, even though it is a more complete description of the various steps taken to arrive at the size of the marital bequest. Further, care is

43 For example, for a $10.1 million estate, the necessary optimum marital bequest would be $100,000 (employing normal assumptions for a decedent dying in 2022). If D made a $300,000 adjusted prior gift, the optimum marital bequest would increase to $400,000 because the tentative tax base would increase to $10.4 million. If, on audit, the government asserted that this prior gift was really worth $350,000, then the $10,450,000 tentative tax base would require an $450,000 marital bequest to eliminate all tax.

44 The TAM may be wrong just on the facts. If any unified credit was available to offset gift taxes incurred on that adjusted prior gift, the audit change would have reduced the available unified credit, which is a factor that could be considered in determining the size of the marital bequest. If this assumption is not correct, the question should have been moot, because no increase in the marital deduction at death would eliminate the taxes otherwise caused by addition of that prior adjusted taxable gift. For example, if adjusted prior gifts were more than $10,000,000 and increased on audit, the optimum marital bequest in 2022 would be the entire available estate and would be unaffected by the audit change. Indeed, the marital bequest would be insufficient to eliminate all tax in the estate in either case.

45 See TAM 8519001 for a similar case in which the government reached the result intended by the taxpayer. A formula marital bequest of the amount "that can pass free of federal estate tax under this will by reason of the unified credit" was deemed to self-adjust for inter vivos gifts that used a portion of the unified credit.

46 Absent such a provision S might argue that higher valuation should be favored by the personal representative because it results in a higher basis under §1014(b)(9) and it increases the size of a formula marital bequest to S with a corresponding tax cost only to whomever pays the estate tax when S dies. See, e.g., Smail v. Smail, 617 S.W.2d 889 (Tenn. 1981), in which the parties were arguing over the value of stock includible in the gross estate. If the same higher value was used to determine the allocation of that stock in satisfaction of the inflated formula marital gift S would receive property with a higher FMV, and a larger relative percentage of the gross estate, but not necessarily more shares of the stock.

required to accurately state the desired reduction. For example, it is not appropriate to reduce the maximum amount by any amount that will reduce taxes paid to zero, because it may not be possible to minimize taxes to that extent.[47]

Most planners use a "fudge" formula that simply describes the desired objective. Usually it is to generate the smallest marital deduction necessary to reduce taxes to the lowest possible amount. This may be the safest approach and it certainly is the easiest to explain to a client, and for the client to understand. It may not, however, be the most palatable psychologically to S, to whom the message is abundantly clear that D "loved you but left the absolute smallest possible amount necessary to generate a tax motivated result." Hopefully, both spouses adequately understand the plan, and that the nonmarital trust is sufficiently generous to avoid any negative impressions this message otherwise might generate.

A fudge formula also assumes that the fiduciary administering the plan has the acumen to determine the appropriate deduction, considering the myriad factors that can affect the size of the deduction, and that no conflict of interest will interfere with that determination. Although a fiduciary probably should not be selected if there is any legitimate doubt about these qualifications, the reality is that a client may have few viable options.

[47] Recall §4980A, which imposed an excise tax on excess retirement plan accumulations and made a reduction of the FET to zero impossible in some estates. State death tax also may be unavoidable. The §4980A excess accumulations tax was repealed for estates of decedents dying after 1996 but the notion remains that, under unanticipated changes in state or federal law, a zero tax formula provision simply may fail for impossibility.

§13.4 QUALIFICATION REQUIREMENTS

§13.4.1 In General

Before 1982 only four forms of disposition could be employed to qualify for the federal estate or gift tax marital deduction:

- outright transfers
- §§2056(b)(5) and 2523(e) general power of appointment trusts
- §2056(b)(6) life insurance settlements
- so-called estate trusts.

All four still qualify for the marital deduction but each grants S unfettered dispositive control over the marital deduction property. This control was considered an acceptable price to pay for the tax deferral benefits of the marital deduction when the maximum entitlement was half D's adjusted gross estate,[1] but earlier notions about acceptable levels of control also changed when Congress enacted the unlimited marital deduction.[2] Thus, for the first time in 1981 Congress made the tax deferral benefits of the marital deduction available for dispositions in which D does not give dispositive control over marital deduction property to S.

Congress illustrated its concern about a spouse's control over marital deduction property with an example of a decedent with children by a former marriage.[3] Congress recognized that the spouse could divert the property and disinherit D's children if S had unfettered power to dispose of the marital bequest (which Congress envisioned could be the grantor's entire estate). Congress adopted §2056(b)(7) and the QTIP form of marital transfer to avoid this potential problem.[4] The marital deduction now is available for a trust or legal life estate that gives S an income interest for life, with the remainder passing on S's death to beneficiaries D selected, free from any control by S. In essence, this was the same form of trust that §2056(b)(5) already authorized but without the requisite general power of appointment.

Absent §2056(b)(7), the QTIP form of disposition would not qualify for the marital deduction. It would violate the nondeductible terminable interest rules of §2056(b) because S's interest terminates at death. By virtue of §2056(b)(7) and a number of unique planning options available *only* to QTIP trusts (the partial QTIP election and the reverse QTIP election), QTIP trusts have become the preferred form of disposition if a trust is desired, although there are situations in which other forms of qualifying marital transfer may be desirable. Consequently, the advantages and disadvantages of each qualifying form of transfer must be evaluated. First, however, is a summary of other basic requirements to qualify for the marital deduction.

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1 **§13.4** Or $250,000 if greater, for a short period before the 1981 changes.
2 P.L. 97-34, §403, 97th Cong., 2d Sess. (1981).
3 H.R. Rep. No. 201, 97th Cong., 1st Sess. 160 (1981).
4 ERTA §403(d)(1).

This discussion is estate tax oriented because the vast majority of the law relating to qualification requirements arises under §2056 for estate tax purposes. Virtually all is reflected in the §2523 gift tax rules, which are not addressed independently but should not be overlooked for inter vivos planning.

§13.4.2 The Easy Qualification Requirements

There are three essential requirements to qualify an interest for the §2056 estate tax marital deduction:

- D must be survived by a United States citizen spouse
- The interest must be includible in D's United States gross estate and pass to S
- the interest must not be a nondeductible terminable interest.

The first two of these requirements are relatively simple, although some complications exist. The nondeductible terminable interest rule, however, commands a significant degree of attention.

§13.4.2.1 D Need Not Be a United States Citizen or Resident

Before 1988 no marital deduction was available unless D was a citizen or resident of the United States at the time of death.[5] Surprisingly, before 1988 S was not required to be either a citizen or a resident of the United States.[6] Adoption of §§2056(d), 2106(a)(3), and 2523(i) in 1988[7] changed both rules. Now a marital deduction is allowable for property situated in the United States that is owned by a nonresident who is not a United States citizen but that is included in that decedent's United States gross estate, provided the other §2056 requirements to qualify for the marital deduction are met.[8] But no marital deduction is allowable if S is not a United States citizen *unless* the §2056A QDOT exception to §2056(d) applies.[9]

§13.4.2.2 S Must Survive

To qualify for the marital deduction there must be a surviving spouse. The burden of proving both survivorship and the requisite marital status is on D's personal representative.[10]

§13.4.2.2.1 Survivorship

Actual survival for however short a period will suffice if it can be proven. A presumption that the spouse survived, whether supplied by local law or by the governing instrument, will be respected if the order of the spouses' deaths cannot be established by proof.[11] This deemed survivorship result

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5 Treas. Reg. §20.2056(a)-1(a), subsequently amended. See PLR 9021037 (pending citizenship application filed during D's life would not satisfy the citizenship requirement).

6 Treas. Reg. §20.2056(a)-1(a).

7 §5033 of the Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, 100th Cong., 2d Sess. (1988).

8 §2106(a)(3).

9 See §13.5.7 for a discussion of the QDOT.

10 Treas. Reg. §20.2056(a)-1(b)(1). See also Treas. Reg. §20.2056(c)-2(e).

11 Referred to by many people as "simultaneous death," even though the deaths may occur over some time but still under circumstances that preclude proof of the order of death.

applies, however, only to the extent the deductible property will be includible in the deemed survivor's gross estate.[12]

Under most states' version of the USDA, if two persons die under circumstances such that the order of their deaths cannot be established by proof, each decedent's property is distributed as though that person was the survivor.[13] Thus, neither spouse's property would pass to the other.[14] The USDA thus creates the wrong result if it is important to secure the marital deduction in the estate of one of the spouses (usually the "propertied" spouse).[15] A provision that reverses the Act[16] should be used in that spouse's estate plan, reading something like:

> For purposes of [this will] [the marital deduction gift made in Article *], S shall be deemed to have survived me if the order of our deaths cannot be proved.

Some drafters, probably informed by §2056(b)(3)(A), refer to deaths "as a result of a common disaster resulting in the death" of both spouses. A presumption of survivorship in this situation may not be respected. To illustrate, assume that both D and S were injured in the same automobile accident, with D dying immediately and S lingering before dying. Here the "common disaster" provision might be met[17] but a presumption that D survived would be ineffective for FET purposes because the actual order of their deaths could be proved.[18] The document for S might leave property to D, but no marital deduction would be allowed.

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12 Treas. Reg. §20.2056(c)-2(e). See, e.g., Estate of Gordon v. Commissioner, 70 T.C. 404 (1978), acq. 1979-2 C.B. 1 (involving a murder-suicide pact in which a presumption was respected because it was doubtful which spouse died first); Estate of Lion v. Commissioner, 52 T.C. 601 (1969) (presumption respected in the case of deaths caused in an airplane crash).

13 See §3.2.5.4 n.83 and accompanying text.

14 The object of the USDA is to avoid subjecting either spouse's property to administration or taxation in more than one estate. Thus, jointly owned property is deemed to be held by the spouses in equal shares as tenants in common, with each spouse's share passing as if the other spouse was the first to die, and life insurance proceeds are paid as if the beneficiary predeceased the insured.

The USDA has been supplanted by a "120-hour" rule in some states that have enacted the UPC. This newer rule requires an heir or beneficiary to survive the decedent by 120 hours, absent a will provision requiring the beneficiary to survive the testator by some other period. UPC §§2-104(a)(1) and 2-702, 8 Pt. 1 U.L.A. 43 (Supp. 2010) and 8 Pt. 1 U.L.A. 182 (1998).

15 Further, portability of that decedent's unused exclusion amount would not apply because the USDA presumes that decedent to be the survivor, not the deceased spouse.

16 Both the USDA and the UPC allow the maker of a will, living trust, or other dispositive document to create a different presumption as to the order of the deaths of the transferor and the beneficiaries and thereby generate the marital deduction by preserving transfers between spouses. No authority addresses whether a presumption of survivorship will permit a §2010(c)(5)(A) election to allocate a DSUE amount to a presumed surviving spouse, although Treas. Reg. §20.2010-3(c)(1) treats the portability election to have been made at the date of D’s death, which may play back into a ruling that S is entitled to the portable exclusion amount if state law regards S as the survivor of the two.

17 See, e.g., Silver v. Schroeder, 474 So. 2d 857 (Fla. Dist. Ct. App. 1985), for a comprehensive discussion of the meaning of a "common disaster" provision (not in the context of marital deduction planning or qualification), and Stephens v. Beard, 485 S.W.3d 914 (Tex. 2016), also discussing the meaning of “common disaster” and a poorly drafted condition limiting an alternative devise (which failed) following the murder/suicide of spouses whose deaths occurred 116 minutes apart.

18 See Treas. Reg. §20.2056(c)-2(e) (first sentence), Estate of Gordon v. Commissioner, 70 T.C. 404 (1978) (allowing the deduction but analyzing the issue fully), and Estate of Lee v. Commissioner, 94 T.C.M. (CCH)

In addition, care must be exercised to ensure that both spouses use consistent presumptions. Both should not presume the other to have survived except in unusual cases or unless each employs an equalizer provision. In addition, the presumptions must be in the proper documents. For example, a will provision probably would not govern a dispositive direction in an inter vivos trust, and vice versa. Further, a common disaster provision may raise problems of construction as to whether the deaths were the result of a common disaster or, instead, were from independent causes.[19] Finally, difficulties may be encountered if one party dies instantly but the other, although seriously injured in the common accident, survives for an extended period. The deduction will be disallowed if the marital bequest is conditioned on the spouse not dying as a result of injuries suffered in a common disaster and, upon final audit of the estate tax return, it still is not certain whether the spouse ultimately will die as a result of those injuries.[20]

§13.4.2.2.2 Marital Status

Implicit in the surviving spouse requirement is that the survivor be D's "spouse" as determined under state law at D's death.[21] The issue of federal recognition of state law marriage of same-sex couples and the constitutionality of federal laws disregarding those state sanctioned relations reached the marital deduction in *Windsor v. United States*,[22] which declared the Federal Defense of Marriage Act (DOMA) discrimination against same sex marriage to be unconstitutional. Two years later, *Obergefell v. Hodges*[22.1] extended the same analysis to invalidate all state-level bans on same-sex marriage as well. As a result, marriages of same-sex couples now are recognized for marital deduction purposes (and all other federal and state tax entitlements and responsibilities),[23] the same as for any other spouses whose marriages are respected under state law.

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604 (2007) (in which D's spouse died 46 days before D and a presumption of survivorship was rejected because the order of death was not uncertain).

[19] See, e.g., In re Estate of Davis, 61 N.Y.S.2d 427 (Surr. Ct. 1946), aff'd, 69 N.Y.S.2d 327 (1947).

[20] Treas. Reg. §20.2056(b)-3(c).

[21] S. Rep. No. 1013, 80th Cong., 2d Sess. (1948), 1948-1 C.B. 335.

[22] 133 S. Ct. 2675 (2013), aff'g, 699 F.3d 169 (2d Cir. 2012), aff'g 833 F. Supp. 2d 394 (S.D. N.Y. 2012) (marital deduction allowed because D's Canadian same-sex marriage was recognized as valid by New York law).

[22.1] 576 U.S. 644 (2015) rev'g sub nom. 772 F.3d 388 (6th Cir. 2014), which rev'd 962 F. Supp. 2d 968 (S.D. Oh. 2013) (consolidating several cases raising various state law issues, none involving the marital deduction).

[23] Rev. Rul. 2013-17, 2013-38 I.R.B. 11, announced the federal tax consequences of *Windsor* for same-sex married couples. And Notice 2017-15, 2017-6 I.R.B 783, announced procedures to recalculate a taxpayer's §§2010(c), 2505, and 2631 exclusion and exemption amounts for transfers prior to *Windsor* that should have reflected the taxpayer's marital status. For example, generation assignment for GST purposes may differ for descendants of a spouse than for descendants of a same-sex partner to whom the taxpayer is not legally married. Treas. Reg. §301.7701-18 now defines "spouse, husband, and wife" to include any individual whose "marriage would be recognized by any state, possession, or territory of the United States." The preamble to that regulation when it was proposed in 2015 stated that a marriage conducted in a foreign jurisdiction will be recognized if it would be recognized in at least one state, possession, or territory, which may be a veiled reference to the notion that polygamy is recognized in some foreign countries but not by any U.S. jurisdiction. No further explanation is given of the breadth of this rule. On the same date as the Revenue Ruling (August 29, 2013) the government also released two lists of frequently asked questions dealing with same-sex couples, one addressing couples who lawfully marry, and the other for couples (same-sex or otherwise) who choose to be registered domestic partners or participate in a civil union that is not the equivalent of a legal marriage under state law. (There appears to be no official designation or number by which to locate these FAQ documents but they are available on Tax Notes Today as 2013 TNT 169-17 and 169-18.)

D's marital status for §2056(a) purposes is not affected by a legal separation or other judicial action that falls short of a final divorce decree terminating the marriage prior to D's death.[23] In addition, because the determination is made at D's death, a transfer by D during life to a donee to whom D was not married at the time will qualify for the estate tax marital deduction if the transfer is includible in D's gross estate at death and D was married to the donee at death.[24] Conversely, estate

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The Revenue Ruling, the regulation, and the Q+A all state that the federal government will follow a "state of celebration" rule – meaning that a marriage valid in the state in which it was performed will be regarded as valid for all federal tax purposes, no matter where the couple may live. Thus, marriage for convenience or marriage followed by a change of domicile will not alter the married-for-tax-purposes treatment of that couple. However, they expressly provide that "the term 'marriage' does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a marriage under that state's law. Regardless of whether individuals who have entered into such relationships are of the opposite sex or the same sex." So, if a taxpayer wants "married" treatment, the taxpayer must in fact become married. Because, today, there is no legal impediment to doing so. Accord, Jiwungkul v. Director, Div. of Tax'n, 161 A.3d 767 (N.J. Super. Ct. 2017) (denying state estate tax benefits to a couple that opted against civil union (which would have been respected) and whose marriage date was set for six days after one of them unexpectedly died).

This does not necessarily negate the relevance for other purposes of registering as domestic partners, but it does call into question the on-going application of authorities such as PLR 201021048, which established that each "registered domestic partner" who is treated as entitled to "full community property treatment" under California law (1) must report half the combined earned income of both partners, (2) is entitled to half of the credits for income tax withholding at the source of both, and (3) makes no transfer subject to gift tax by virtue of being a registered domestic partner. Chief Counsel Advisory 201021050 similarly provided that California registered domestic partners should be treated the same as any other community property owners. And Chief Counsel Advisory 201021049 correspondingly provided that the government may consider the assets of each registered domestic partner when determining the reasonable collection potential of either taxpayer's offer in compromise. Earlier, CCA 200608038 stated that a state civil union or registered domestic partner law will not be respected for income tax purposes, which may be a function of whether state law grants these individuals the same rights as the California statute giving full community property treatment to registered domestic partners who are not legally married. Released in September of 2011, Publication 555 contains added guidance regarding the community property treatment of registered domestic partners, including guidance relating to their children and various deductions. Because Rev. Rul. 2013-17 and the proposed regulation do not apply to these registered domestic partners, these pronouncements may continue to be relevant, as some same-sex partners will choose not to become married under state law.

Rev. Rul. 2013-17 applied "prospectively as of September 16, 2013" and the regulation became effective upon publication as final on September 2, 2016. The Revenue Ruling states that married couples who previously filed as not married taxpayers could, but were not required to, amend prior returns. Meaning that the treatment announced may be applied retroactively if the couple was married prior to *Windsor* announced that DOMA §3 was unconstitutional and the couple wished to apply that married taxpayer treatment. But the couple need not change its prior reporting position and the time for any amendment may run out. The couple is, however, obliged to honor the marriage for future tax purposes, beginning with returns filed after September 15, 2013. And the FAQ made it clear that employers were obliged to update their systems after that date for things like withholding, social security or Medicare taxes, and retirement and health care plans.

Notice 2014-19, 2014-17 I.R.B. 979, specified that qualified plans must recognize same-sex marriages back to June 26, 2013 when *Windsor* was decided and may, but need not, recognize them even before then. Plans that do not in any way identify which marriages are respected (but, instead, merely refer to "spouses" or similar generic terms) need not be amended but must be administered in a manner that does not distinguish between same-sex and other marriages. Plans terms that are inconsistent with *Windsor,* Rev. Rul. 2013-17, or the regulation must, however, be amended. Most likely to be impacted by this guidance are the qualified spousal (preretirement or survivor) annuity requirements, the required minimum distribution rules, and rollover alternatives that are available to spouses but not to other beneficiaries.

23 See Rev. Rul. 57-368, 1957-2 C.B. 896; Eccles v. Commissioner, 19 T.C. 1049 (1953), acq., 1957-2 C.B. 4.

24 S. Rep. No. 1013, 1948-1 C.B. at 335; Rev. Rul. 79-354, 1979-2 C.B. 334.

tax inclusion of the transferred property in the donor's gross estate will not suffice to permit an estate tax marital deduction if the donee was D's spouse at the time of the inter vivos transfer but not at D's death (which could occur because the marriage ended *either* by divorce or because the donee spouse predeceased the donor spouse after the gift).[25]

A transfer to a donee spouse might be includible in the donee spouse's gross estate prior to the donor's death, in which case subsequent inclusion in the donor's gross estate under any of the §§2035 – 2038 string provisions will subject the property to inclusion in both estates. The §2013 previously taxed property credit might be available in that case if the donor spouse died no more than two years after the donee spouse,[26] but otherwise there is no amelioration of that double taxation result. As a consequence, inter vivos transfers to a nonpropertied spouse who may die first (which may be desirable planning to shelter the donee spouse's unified credit and GST exemption) are better accomplished using an inter vivos QTIP trust that can provide enjoyment for the donor spouse as the surviving spouse but prevent estate tax inclusion when the donor spouse subsequently dies.[27]

Recognition of common law marriages (and the validity of divorce decrees) normally turns on state law,[28] assuming D's estate can prove that the requisites for a valid marriage existed.[29] Although

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25 Rev. Rul. 79-354, 1979-2 C.B. 334.

26 See §2.0 n.3.

27 See §13.5.6.5.

28 Rev. Rul. 58-66, 1958-1 C.B. 60 (an income tax ruling). See ncsl.org/research/human-services/common-law-marriage.aspx (last visited 24 January 2021) for a list of common law marriage states.

29 Rev. Rul. 76-155, 1976-1 C.B. 286 (an alleged common law marriage had not been established, so no marital deduction was available). TAM 201734007 (the appropriate state agency concluded that a common law marriage existed, which was good enough for federal tax purposes). TAM 200132004 contains a fine discussion of common law marriage; it rejected the marital deduction because the law of D's domicile did not recognize that form of union. The decedent in Cohen v. Shushan, 212 So. 3d 1113 (Fla. Dist. Ct. App. 2017), was an Israeli who established the "functional equivalent" of an American common law marriage (roughly translated from Hebrew as "Known in Public"). Florida law does not permit common law marriage but it respects common law marriages from jurisdictions where that form of marriage is valid. Over a vigorous dissent, the court held that the only "marriage" that counts in Israel is a religious marriage, which the decedent and his reputed spouse lacked. Even though they were together for over 20 years, had four children together, held themselves out as husband and wife, and to all the world "would have seemed a married couple," their Known in Public relation was not a religious marriage, so they were not married under Israeli law, which meant that they were not married for purposes of Florida law. The converse situation to *Cohen* existed in Estate of Grossman v. Commissioner, 121 T.C.M. (CCH) 1492 (2021), in which D's prior Mexican divorce was not effective under New York law, but it was honored by an Israeli religious court, which therefore allowed and respected D's subsequent religious marriage in Israel, which therefore satisfied the "state-of-celebration" rule for determination of the validity of D's marriage to S, albeit D died as a New York domiciliary. Notable is the court's holding that validity of D's prior divorce is not the proper question; rather, the issue is solely whether validity of the subsequent marriage is recognized in the state in which D's estate is administered, and that law respected the marriage, because it was valid in the state in which it was performed.

The validity of a decedent's marriage usually turns on state law, which typically reflects the "state of celebration" rule that a marriage valid under the law of the state where performed is respected as valid in every state. This raises challenging notions with respect to same sex partners who never actually were married but who held themselves out as married in a state that honors common law marriage. Their status as married should apply in other jurisdictions. See In re Estate of Carter, 159 A.3d 970 (Pa. Super. Ct. 2017) (same-sex common law marriage deemed to exist before state law eliminated that status and even though state law also precluded same-sex marriage at that time). Cf. In re Estate of Peacock, 788 S.E.2d 191 (N.C. Ct. App. 2016), which respected the parties' marriage notwithstanding that it was done without a license, because applicable state law did not invalidate a marriage performed without a license (instead, it punished the functionary who performed that marriage).

the government will not challenge the validity of a marriage on its own motion,[30] it will rely on a state court decree invalidating D's marriage or any prior divorce (which may make D's "marriage" to the surviving "spouse" illegal) if either result will disqualify the marital deduction.[31]

§13.4.2.3 Interest Must Be Includible in D's Gross Estate and Pass to S

To qualify for the estate tax marital deduction, the value of the interest must be includible in D's gross estate[32] and must pass from D to or for the benefit[33] of S.[34] This passing requirement is broadly defined in §2056(c) to include interests acquired by S by will, intestate succession, dower or elective share,[35] right of survivorship, the exercise or in default of exercise of a taxable power of appointment, or pursuant to a life insurance beneficiary designation. Although not expressly mentioned in the statute, the passing requirement also can be satisfied by designating S as beneficiary of retirement death benefits or any other deferred compensation or annuity includible in D's gross estate under §2039,[36] or (unlikely though this may be) as the remainder beneficiary of a QTIP trust includible in D's gross estate under §2044.[37] For example, a surviving spouse who is the beneficiary of a QTIP trust that grants a sufficiently broad nongeneral power of appointment may appoint in favor of a new spouse and the interest passing to the new spouse will qualify for a marital deduction in S's estate to the extent the value of the trust corpus is includible in S's gross estate under §2044.

The statutory passing requirement ignores property law niceties whether an interest actually passed from D, and the regulations establish practical rules to determine whether an interest meets the passing requirement.[38] Thus, for example, interests passing by right of survivorship qualify for

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30 Rev. Rul. 67-442, 1967-2 C.B. 65.

31 See, e.g., Estate of Goldwater v. Commissioner, 539 F.2d 878 (2d Cir. 1976); Estate of Steffke v. Commissioner, 538 F.2d 730 (7th Cir. 1976); but see Estate of Spalding v. Commissioner, 537 F.2d 666 (2d Cir. 1976) (reversing the Tax Court's denial of the marital deduction because the estate was administered in a state other than the one that decreed the divorce to be invalid, and because S, not D, was the party to the former marriage and the invalid divorce decree purporting to terminate it).

32 See the last clause of §2056(a), limiting the marital deduction "to the extent that [an interest in property passing to S] is included in determining the value of the gross estate." Thus, for example, only the 50% of a §2040(b) qualified joint interest that is includible in D's gross estate will qualify for the marital deduction, notwithstanding that S is the owner of 100% of that property after D's death.

33 Compare Rev. Rul. 79-383, 1979-2 C.B. 337 (payment by D to a creditor of S in discharge of S's debt was sufficient to satisfy the passing requirement), with Treas. Reg. §20.2056(c)-2(a) (flush language) (requiring that S receive the beneficial interest; ownership as fiduciary or otherwise with an obligation to convey the property to a third party is not adequate).

34 §2056(a). See Citizens & Southern Nat'l Bank v. United States, 451 F.2d 221 (5th Cir. 1971).

35 Treas. Reg. §20.2056(c)-2(c); Estate of Harper v. Commissioner, 93 T.C. 368 (1989); Estate of Evers v. Commissioner, 57 T.C.M. (CCH) 718 (1989). See also Rev. Rul. 90-45, 1990-1 C.B. 175, and PLR 8817061 (S elected against D's will in favor of a statutory share of the estate and then effectively disclaimed that portion of the share in excess of a specified dollar amount that was the desired marital deduction sought); Harter v. Commissioner, 39 T.C. 511 (1962), acq., 1963-2 C.B. 3 (disinherited S elected a statutory share and then made gifts to descendants who otherwise took under the will, effecting a better tax result than D's intended plan, with which S obviously agreed; the court rejected the government's objection that the election and gift effected no real change in D's plan and therefore should not be respected).

36 Treas. Reg. §20.2056(c)-1(a)(6). See also TAM 9008003 (death benefits from qualified profit sharing, money purchase, and Keogh plans that were paid to S because the beneficiary designations did not comply with the §401(a)(11) spousal annuity rules qualified for the marital deduction because they were includible under §2039 and were paid to S, notwithstanding D's wishes).

37 See Treas. Reg. §20.2044-1(b).

38 Treas. Reg. §20.2056(c)-1.

the marital deduction to the extent includible in D's gross estate, even though property law treats S as entitled to the interest by operation of law without any passing of title at D's death. The marital deduction for a qualified joint interest is limited to half the value of the property because that is the amount includible in D's gross estate under §2040(b).

Similarly, to the extent the property is includible in D's gross estate under §2041, property passing to S by D's exercise of a general power of appointment, or in default of exercise, is deemed to pass from D for marital deduction purposes, even though property law regards it as passing directly from the donor of the power. Further, life insurance proceeds or retirement benefits payable directly to S from the insurer or plan administrator qualify as passing from D to the extent includible in D's gross estate under §2042(2) or §2039(a), respectively. This also would be true whether D selected that beneficiary designation or it occurred by operation of law or as a default rule under the contract or plan.

On the other hand, an interest given by D to S, who must forfeit it under a local law slayer statute will not qualify for the marital deduction.[39]

An interest is deemed to have passed from D to S if "such interest has been transferred to such person by D at any time."[40] Thus, lifetime transfers includible in D's gross estate under §§2035 through 2038 can qualify for the estate tax marital deduction if D and the donee were married at D's death. This might be common with a GRAT or QPRT that D did not outlive. It also is common and useful because a routine method of securing the estate tax marital deduction is by way of a revocable inter vivos trust to which D's estate pours over. This property qualifies for the estate tax marital deduction to the extent the trust is includible in D's gross estate under §2036 or §2038 and meets the other marital deduction requirements.[41]

§13.4.2.3.1 Disclaimers

Property subject to a valid disclaimer is deemed to pass directly from D to the person who takes as a result of the disclaimer (the disclaimant usually being regarded as having predeceased D for state property law purposes).[42] Thus, no marital deduction is available if S is the disclaimant, because no interest is deemed to pass to S. However, the passing requirement is met if property passes to S as a result of a third party's §2518 qualified disclaimer.[43] These rules make it possible to engage in

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[39] Estate of Cloud v. United States, 89-1 U.S. Tax Cas. (CCH) ¶13,798 (S.D. W. Va. 1988); TAMs 9530003 and 8026021.

[40] §2056(c)(4).

[41] See Treas. Reg. §§20.2056(c)-1 and 20.2056(c)-2 for additional examples of interests deemed to meet the passing requirement.

[42] Treas. Reg. §20.2056(c)-2(a)(4).

[43] Treas. Reg. §20.2056(d)-2(b). See, e.g., TAM 9228004 (property passing to S under intestacy as a result of children's disclaimers qualified for the marital deduction), and PLR 200604003 (illustrating how difficult this planning can be, in this case requiring disclaimers by four children, five grandchildren (acting through a court appointed fiduciary), two siblings, two nieces, and their minor children (also acting through a court appointed fiduciary)). But see TAM 8804004 (S agreed with other beneficiaries of a trust that trust property should pass to S by intestacy, but this disclaimer was made more than nine months after D's death and therefore did not qualify under §2518 because it was not timely; as a result, the property did not pass from D and no marital deduction was generated). Note that this discussion is too simplistic, in the sense that disclaimers by S *and* all other beneficiaries may be required to qualify a trust for the marital deduction, with S's disclaimer removing interests or powers that preclude marital deduction qualification. See, e.g., Estate of Lassiter v. Commissioner, 80 T.C.M.

postmortem planning to engineer marital deduction results. Great care is required, however, to be certain that the effect of a disclaimer is to cause S to acquire an interest in the property that will qualify for the marital deduction. In some cases the effect is quite different and the disclaimant loses the property without generating a corresponding marital deduction.

§13.4.2.3.2 Controversy Involving D's Estate Plan

Property passing to S in settlement of a will contest or similar litigation also will qualify for the marital deduction, but only to the extent the settlement is regarded as "a bona fide recognition of S's enforceable rights in D's estate."[44] For example, TAM 9610004 involved a surviving spouse and children of D who successfully petitioned the local probate court for permission not to probate D's will, which had the effect of causing D's estate to pass by intestacy. In this case that meant that S was entitled to D's entire probate estate. The government ruled that this action was neither a qualified disclaimer by the children nor a bona fide settlement of a controversy that reflected the relative rights

(CCH) 541 (2000), in which disclaimers elevated the entitlement of S and removed the entitlement of other beneficiaries, thereby generating an otherwise unallowable deduction. Notable about *Lassiter* was the conclusion that S could retain a power to appoint the disclaimed trust property because, by virtue of marital deduction qualification, that property would be includible in S's gross estate at death and denial of continued control over disclaimed property under §2518(b)(4) and Treas. Reg. §25.2518-2(e)(2) is not applicable with respect to property that will be subject to wealth transfer taxation to S. See also §§7.1.6.6 (regarding disclaimers by fiduciaries in general as being ineffective), 13.0.3 of the sixth edition (disclaimers for transitional date purposes), 13.5.2 n.8 (relating to §2056(b)(5) power of appointment trusts), 13.5.2.2 n.31 (relating to §2056(b)(7) trusts that may distribute income to third parties), and 13.5.6.1.4 n.118 (relating to §2056(b)(7) trusts that may distribute corpus to third parties), and accompanying text in each case.

44 Treas. Reg. §20.2056(c)-2(d)(2); Peirce v. United States, 80-1 U.S. Tax Cas. (CCH) ¶13,338 (W.D. Pa. 1980) (the settlement was a bona fide reflection of enforceable rights turning on the possible invalidity of a prenuptial agreement); PLRs 201046004 (court approved settlement of controversy between spouse and child by decedent's former marriage, each of whom was separately represented, involving a trust with ambiguous terms that were inconsistent with a marital property agreement and uncertain IRA beneficiary designation, tax apportionment, and expense allocation provisions); 200417030 (involving a settlement agreement between S and a charity to resolve a dispute over S's waiver of rights under pre- and then postnuptial agreements with D), 9610018 (an agreement resolving a former spouse's claim to enforce a property settlement was a negotiated good faith recognition of enforceable rights, effective to determine property passing to S for marital deduction purposes); 9546004 (an agreement creating a QTIP trust was a bona fide recognition of S's enforceable rights; the marital deduction was allowed for the FMV of trust property at D's death); 9040032 (property passing to S under an agreement settling a claim against D's estate for failure to fulfill a prenuptial agreement qualified for the marital deduction as a bona fide compromise in settlement of enforceable rights); and TAM 7840008 (the settlement was a bona fide reflection of S's rights, which depended on whether the statute of limitation against S's state law action was tolled by an estoppel caused by the defendants' inducements). Compare Estate of Sikler v. Commissioner, 42 T.C.M. (CCH) 1389 (1981), which limited the marital deduction to the amount S received under a compromise agreement relating to S's guilty plea of voluntary manslaughter of D, with TAM 9530003, in which S was convicted of murdering D and by state law was not entitled to inherit property from D. Nevertheless, S and D's children reached a settlement that directed property to S. The government ruled that this property could not qualify for marital deduction purposes and must be deemed to have passed to S from the children and not from D because the settlement could not possibly constitute a bona fide reflection of enforceable rights, which in this case would be zero. According to the government, there might be some uncertainty under state law regarding rights to nonprobate property, of which there was some in this case, but a settlement reflecting that issue certainly would have been much smaller than what S received. Thus, the government concluded that the settlement must have been a "hedge" against the all-or-nothing consequences of a criminal prosecution and the risks of litigation in the estate settlement, and not a bona fide reflection of the merits of S's claim, if any, to nonprobate property proper.

of the parties. As a result, the government advised that the marital deduction was not available because the property passing to S did not pass from D.[45]

In ILM 201416007 D created an inter vivos trust in a foreign country, funded it with shares of several foreign corporations, and named D and one child as the only beneficiaries. The value of the trust corpus was includible in D's gross estate for federal estate tax purposes, and D's surviving spouse elected against D's estate to take a forced heir entitlement provided by the state law of D's domicile. Under that law the trust value was counted in calculating S's entitlement. In addition, the state law order of abatement to satisfy the elective share calculated a portion of the trust assets as subject to distribution to S. D's estate tax return reported the full elective share as passing to S and qualifying for the marital deduction, which the government rejected because the foreign jurisdiction law governing the trust would not respect the state law forced heirship, nor was the elective share entitlement under state law enforceable against the trust under the law of that foreign jurisdiction. Thus, the child was regarded as the beneficial owner of the trust assets following D's death and satisfaction of the elective share with trust assets only could occur if the child did not assert the foreign jurisdiction asset protection trust law. Meaning that, for marital deduction purposes, any amount passing to S from the trust was deemed to pass from the child, not from D, and therefore failed the passing requirement for marital deduction purposes.

In addition, the property passing must meet the other marital deduction requirements.[46] For example, in Rev. Rul. 66-139[47] S renounced a terminable interest under D's will and claimed an

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[45] If, however, state law did not require the beneficiaries of a will to petition to admit a will to probate, then it could have been the case that the children never owned and never were entitled to any property from D's estate, and S could have been regarded as entitled to it, permitting the marital deduction. At the very least, the marital deduction should have been allowed for that portion of the probate estate that S would have received under the will (which, in this case, was everything in the probate estate except a nonmarital bequest of the largest amount that could pass tax free by virtue of D's unified credit).The TAM did not address whether the children made a gift to S by allowing the estate to pass by intestacy. Arguably, the proper answer should mirror the result in Rev. Rul. 74-492, 1974-2 C.B. 299, which held that S's decision not to elect a statutory share of D's estate is not a taxable gift even if that share would be larger than what S received otherwise.

[46] Waldrup v. United States, 499 F. Supp. 820 (N.D. Miss. 1980) (the settlement qualified; in the process the court determined that it was unnecessary to determine whether the interests S would have received absent the litigation and its settlement would have been deductible).

[47] 1966-1 C.B. 225, 226; cited in TAM 8236004 (because an interest in trust would not have qualified for the deduction, settlement of litigation involving that interest also would not qualify, even though S received a fee simple interest; the effect was to treat the settlement as an invalid postmortem conversion of the nondeductible interest into a fee simple); criticized by Ahmanson Foundation v. United States, 674 F.2d 761, 774 (9th Cir. 1981), which stated that:

> We cannot square Revenue Ruling 66-139 with [*Commissioner v. Estate of*] *Bosch. Bosch* would require that the interest be enforceable; the revenue ruling appears only to require that the state law claim be sufficiently plausible to support a good-faith arm's-length settlement. For this reason, the revenue ruling, which predates *Bosch*, is of no effect.

Clarified in Rev. Rul. 83-107, 1983-2 C.B. 159, 161 (the commuted value of S's dower interest was deductible as a bona fide settlement of litigation with respect thereto; "only good faith negotiated settlements based on a surviving spouse's enforceable rights to a deductible interest, under properly interpreted state law, will be recognized" for marital deduction purposes); accord, Estate of Carpenter v. Commissioner, 67 T.C.M. (CCH) 2400 (1994), aff'd, 53 F.3d 1266 (4th Cir. 1995) (the probate court terminated a nonqualifying trust upon petition of S and D's child by a former marriage, with distribution to S of fee simple interests worth less than the actuarial value of the life estate in trust; no marital deduction was allowed); followed in Davies v. United States, 124 F. Supp. 2d 717 (D. Me. 2000) (settlement of a forced share controversy that required S to relinquish a

elective share, which the estate denied on the basis of a prenuptial agreement, which S argued was invalid. A compromise allowed the marital deduction, but only "to the extent that the interest which would have passed to [S] as a result of the completed exercise of such rights would have been a deductible interest."

Similarly, in TAM 9246002 S received cash from D's estate, equal to the commuted value of S's statutory forced heir share that entitled S to a life estate in one-third of D's realty.[48] Stating that local law granted the right to partition the property, force a sale of it, and receive an amount from the proceeds equal to the commuted value, the government advised that a settlement with the estate that produced a distribution of the same amount was effective for marital deduction purposes. An alternative would have been to make a QTIP election for the property producing the life estate, if a larger deduction (and a larger amount ultimately taxable to S) would be acceptable.[49]

Spurious suits designed for settlement to direct property to S are not effective for marital deduction purposes, and the government scrutinizes settlements and court decrees to determine whether the litigation was bona fide.[50] Moreover, the marital deduction will be reduced to the extent

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nondeductible annuity in exchange for an otherwise deductible payment did not qualify because it constituted an improper postmortem commutation or substitution for a nondeductible interest).

48 Citing Rev. Rul. 83-107, 1983-2 C.B. 159.

49 Compare PLR 9101025 (the passing requirement was not met with respect to corpus of a trust as to which a QTIP election was made; S elected a statutory forced heir share but settled with the heirs for a life estate in trust; the agreement was not a bona fide reflection of S's rights because, "for purposes of determining the allowable marital deduction ... the interest passing from the [D] to [S] is an outright interest in one-third of the net estate," not a trust interest that has an actuarially determined value equal to that statutory entitlement; the deduction was reduced to the one-third statutory share amount). The distinction is that, in the PLR, S was not entitled to a life estate in trust and in the TAM that life estate was S's entitlement and it was QTIPable. See also TAM 9251002 (S's claim to a statutory forced heir share of D's estate was settled by a compromise agreement between S and the remainder beneficiaries, requiring property to be placed in trust for S's overlife; for marital deduction purposes the deduction was allowed as if S had received the discounted present value of S's income interest in the trust outright, which was less than the value of the statutory share and less than the value of the entire trust); PLR 9253006, which allowed a marital deduction for the full value of property that D promised S in a prenuptial agreement but devised to a charity; the charity and S agreed that the property would be held in a QTIP marital trust for S's life, with only the remainder passing to charity. The government reasoned that S had enforceable rights to the property under the prenuptial agreement, that those rights would have qualified for the marital deduction, and that the agreement with the charity was a bona fide compromise of those enforceable rights that satisfied the passing requirement.

50 See Estate of Brandon v. Commissioner, 86 T.C. 327 (1986), rev'd on other grounds, 828 F.2d 493 (8th Cir. 1987), on remand, 91 T.C. 829 (1988) (originally a bona fide settlement was deemed to qualify for the marital deduction even though the law in effect as S's basis for the claim subsequently was invalidated; reversed because the Tax Court failed to determine independently whether the state supreme court would have found the claim enforceable at the time the settlement was reached and, on remand, the Tax Court found the state statute was gender biased and therefore unconstitutional, meaning that S's only enforceable right was to a small bequest under D's will, and limited the deduction attributable to the settlement agreement to that small sum); Estate of Aronson v. Commissioner, 85 T.C.M. (CCH) 1561 (2003) (disregarding a lower state court action and rejecting the desired marital deduction because reformation of that defective discretionary income trust for S and a grandchild into a mandatory income QTIPable trust for S alone was inconsistent with D's clear intent, which was to preserve D's control over the property at all costs, even over any desire to qualify for tax benefits; granted by the state court with no hearing, no testimony, no affidavits, nor any other evidence regarding D's intent, the Tax Court found that the decree did not "merely clarify" the will and was not a bona fide evaluation or genuine and active contest settled such that S received a reasonable facsimile of rights otherwise provided and, although the court acknowledged that some state court actions may be respected and might garner otherwise elusive tax benefits, it determined that this endeavor was improper); Estate of Simpson v. Commissioner, 67 T.C.M. (CCH)

S relinquishes property that otherwise would qualify for the marital deduction in settlement of a contest brought by a third party – it being the net amount passing to S that is allowable as a marital deduction.[51]

DePaoli v. Commissioner[52] demonstrates the significant costs of failing to properly accomplish the desired postmortem reallocation of D's property in search of a marital deduction. Involved was a purported will contest settlement that directed property to S but failed to generate a marital deduction because it was not a bona fide reflection of S's rights under state law. The estate's fallback allegation was that this rearrangement of D's property constituted a qualified disclaimer, which the court also rejected because, among other defects, the property did not pass to those individuals (nonmarital children of the disclaimant, who were entitled to take under state law because the disclaimant was deemed to have acknowledged them by claiming them as dependents for federal income tax purposes) to whom it would have passed if the disclaimant had predeceased D. The marital deduction was denied, and the alleged disclaimant also incurred both a gift tax on the value of the property distributed to S and a penalty for failing to file a gift tax return.[53]

3062 (1994) (the marital deduction was disallowed for an amount transferred to S pursuant to the settlement of a nonadversarial state court proceeding because the evidence presented was insufficient to evaluate S's enforceable rights under local law); TAM 7839134 (the settlement of a statutory election did not qualify for the marital deduction because S had no enforceable rights under state law). Consider In re Substitute Indenture of Trust, 789 N.E.2d 1051 (Mass. 2003) (this taxpayer action converted a nonqualifying trust paying a $25,000 annual annuity to S into a trust that would pay that amount *or* all the trust income annually, whichever was larger, which would qualify as a QTIP marital deduction trust), which did not determine the FET qualification of the marital trust but which was done "right" under state law that was designed (by giving direct access to the state's highest court) to permit federal tax qualification.

Similarly, the government announced in Rev. Rul. 89-31, 1989-1 C.B. 277, that it will scrutinize will contest settlements involving charitable split interests to ensure that the settlements are not attempts to circumvent the statute by instituting collusive contests.

51 Treas. Reg. §20.2056(c)-2(d)(1), reflected in Schroeder v. United States, 924 F.2d 1547 (10th Cir. 1991) (S relinquished survivorship property to avoid litigation with D's children from a prior marriage), and Estate of Ransburg v. United States, 800 F. Supp. 716 (S.D. Ind. 1991) (involving a settlement agreement relating to S's share), even though a will contest was not involved, based on the determination that the regulation reflected a policy that should be applied in all litigation relating to estate settlement. On similar facts with similar results, see Citizens & Southern Nat'l Bank v. United States, 451 F.2d 221 (5th Cir. 1971) (involving a settlement of intestacy rights rather than a will contest); United States Trust Co. v. Commissioner, 321 F.2d 908 (2d Cir. 1963) (involving settlement with respect to rights in French property of the United States decedent); Pastor v. United States, 386 F. Supp. 106 (E.D. N.Y. 1974) (the settlement involved intestate property, not a will contest; the marital deduction was denied for property S relinquished); Estate of Frost v. Commissioner, 65 T.C.M. (CCH) 2101 (1993) (the marital deduction was denied for property S transferred to D's children by a former marriage pursuant to a settlement agreement to avoid controversy that followed S's election against D's estate plan, the court rejecting the argument that, because there was no actual will contest, Treas. Reg. §20.2056(c)-2(d) was not applicable, and concluding that "controversy" as used in the regulation should be given a broad interpretation); Estate of Suzuki v. Commissioner, 62 T.C.M. (CCH) 1550 (1991) (denying marital deduction for property passing pursuant to settlement between S and a child of D that did not involve property included in D's estate); Estate of Tebb v. Commissioner, 27 T.C. 671 (1957), acq., 1957-1 C.B. 5 (the interest S relinquished in settlement of a contest does not qualify because it does not pass to S); and TAM 9005003.

52 66 T.C.M. (CCH) 1493 (1993).

53 The taxpayer ultimately prevailed on appeal in DePaoli v. Commissioner, 95-2 U.S. Tax Cas. (CCH) ¶60,205 (10th Cir. 1995), but not without overcoming significant odds, the court holding that the Tax Court erred on the state law issue whether the disclaimed property would pass to S by operation of law. To find that, the court accepted the taxpayer's argument that the disclaimant had no descendants for state law purposes, notwithstanding the two nonmarital sons he claimed as dependents for income tax purposes. To filiate a

§13.4.2.3.3 The Net Value Rule

Implicit in the passing requirement is a limitation of the deduction to the net value passing to S, as determined under §2056(b)(4). In this respect the most commonly encountered question concerns the treatment of property passing to S that is encumbered by a mortgage or other debt.

> If a property interest passed from the decedent to his surviving spouse subject to a mortgage or other encumbrance, ... [for marital deduction purposes] the value of the property interest is to be reduced by the amount of the ... encumbrance.... However, if under the terms of the decedent's will or under local law the executor is required to discharge, out of other assets of the decedent's estate, a mortgage or other encumbrance on property passing from the decedent to his surviving spouse, or is required to reimburse the surviving spouse for the amount of the mortgage or other encumbrance, the payment or reimbursement constitutes an additional interest passing to the surviving spouse.[54]

This question often arises in connection with the marital home.

> *Example:* D devised a residence worth $200,000 to S, subject to a $40,000 mortgage lien securing a note on which D personally was liable. The residence is included in D's gross estate under §2033 at a value of $200,000. The $40,000 indebtedness is taken as a deduction under §2053. The interest passing to S is valued for marital deduction purposes under §2056(b)(4)(B), which establishes that only the net value of the interest passing to S ($160,000) qualifies for the marital deduction. Thus, D's estate will deduct $200,000 in two pieces: $160,000 under §2056 and $40,000 under §2053.[55]

A second, and unfortunately somewhat common, situation arises under §2056(b)(4) if the interest passing to S must bear a portion of the FET or state death tax imposed on the decedent's estate, or must bear expenses of administration. Under §2056(b)(4)(A), only the net value of the interest qualifies for the deduction.

> *Example:* D created a marital trust for S of "50% of my adjusted gross estate" and stated a general intent that the trust qualify for the estate tax marital deduction, but made no provision dealing with a state inheritance tax liability.

This type of provision is subject to differing interpretations. For example, Estate of Bauknecht v. Kellogg-Citizens Nat'l Bank[56] held that state law required taxes on the marital trust to be chargeable to the marital trust absent an express intent clearly stated in D's will to shift the tax burden, which

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nonmarital child state law required a written instrument that had the intent to recognize the child "as an heir." The court held that listing the nonmarital children as sons on the disclaimant's tax returns did not necessarily recognize them as heirs. Consequently, the court held that the disclaimer was effective under state law to pass the property to S and that the settlement agreement therefore did reflect the bona fide rights of S and supported the marital deduction based thereon.

54 Treas. Reg. §20.2056(b)-4(b).

55 TAM 200140008 illustrates that if the property is §2040(b) tenancy by the entirety or joint tenancy, and the debt is joint and survivor liability, inclusion is limited to 50%, the note is 50% deductible under Treas. Reg. §20.2053-7, and the marital deduction is the net value of the half that is includible reduced by the half that is deductible.

56 182 N.W.2d 238 (Wis. 1971).

reduced the marital trust by the amount of the state inheritance taxes. The court noted that D's will referred only to FET and did not contemplate state inheritance tax.[57]

In contrast, it has been held that charging the state inheritance tax to the marital trust is incompatible with a decedent's intent to obtain the maximum marital deduction allowable. The court in Putnam v. Putnam[58] reasoned that, to allow the trust to be funded with an amount necessary to obtain the maximum marital deduction and then require state inheritance taxes to be paid from the trust effectively destroys the maximum marital deduction, stating:

> *Example:* It would be a rare case in which a conflict of terms or an ambiguity in a will should be resolved by attributing to the testator an intention which as a practical matter is likely to benefit the taxing authorities and no one else.... A testator who wishes to make a gift to his state and country can do so directly, and he should not be presumed to have intended such a gift by indirect means.

In Estate of Fine v. Commissioner[59] language in D's will leaving half of D's residuary estate to S provided that all debts, expenses, and taxes should be paid out of the residue "without apportionment." Most states embrace the concept of equitable apportionment, providing that dispositions that generate the tax should pay the tax and those that are deductible and therefore do not produce tax should bear no portion of the tax.[60] Notwithstanding that state law embraced the concept of equitable apportionment, the court held that the marital bequest payable from the residuary

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[57] See also Brown v. United States, 329 F.3d 664 (9th Cir. 2003), aff'g 2001-2 U.S. Tax Cas. ¶60,424 (C.D. Cal. 2001) (D died within three years of incurring a gift tax liability, triggering application of the §2035(b) gross-up rule, generating estate tax in D's estate attributable to the gift tax; the court required a dollar for dollar reduction of the marital deduction to the extent corpus of D's estate was cannibalized to pay the estate tax attributable to that gift tax), also discussed in §§7.2.5 n.353 and 7.3.6 n.232; TAM 8922001(the tax clause in D's estate plan apportioned estate and inheritance taxes attributable to any portion of the gross estate as to which a QTIP election was not made, directing that those taxes be paid from the nonelected portion, but no provision addressed the apportionment of any taxes attributable to the portion of the estate as to which a QTIP election was made, and state inheritance tax attributable to a QTIP elected trust was incurred that state law provided was a charge proportionately against the property that produced the tax, which caused a reduction of the estate tax marital deduction, which generated a FET that also was deemed payable from the QTIP trust, which also reduced the deduction and further increased the tax burden, and so on). Accord, Estate of Murphy v. United States, 524 F. Supp. 862 (W.D. Wis. 1981) (state inheritance tax was payable by the marital deduction bequest because D did not expressly provide otherwise); Estate of Ferrara v. United States, 94-2 U.S. Tax Cas. (CCH) ¶60,181 (N.D. Ohio 1994) (state estate tax was apportioned against the marital share under a state apportionment statute because the will had no tax apportionment provision).

[58] 316 N.E.2d 729, 735 (Mass. 1974).

[59] 90 T.C. 1068 (1988) (applying Virginia law). Accord, Ballantine v. Tomlinson, 293 F.2d 311 (5th Cir. 1961) (administration expenses that could be paid from it reduced the marital bequest for deduction purposes, even though none actually was paid from the marital bequest because estate income was used instead); Estate of Reid v. Commissioner, 90 T.C. 304 (1988) (applying Illinois law to a revocable trust worded similarly to that in *Estate of Fine*; on the issue whether income taxes payable by D on trust income was a liability that affected the allowable marital deduction, the court held that the marital property was unencumbered by federal tax liens and rejected the government's assertion that S was obligated for D's income taxes by virtue of filing joint income tax returns); Estate of Wheeler v. Commissioner, 26 T.C. 466 (1956) (the marital deduction for a gift of the residuary estate was reduced to zero by administration expenses, debts, and taxes).

[60] See §3.3.3.3. Compare Rev. Rul. 81-165, 1981-1 C.B. 472 (new Virginia law), with Rev. Rul. 77-313, 1977-2 C.B. 335 (prior Virginia law that did not protect a marital bequest from payment of inheritance tax).

estate would be reduced by those obligations because the quoted provision effectively waived this important benefit.[61]

Similarly, the tax payment provision in TAM 9434004 was a classic burden on the residue directive that waived all rights of reimbursement and was deemed to override state apportionment rules that would have pro rated the tax liability against includible nonprobate properties. After making several preresiduary bequests, the will divided what it referred to as the residue between a formula bequest that it described as "the exemption equivalent of the maximum unified credit allowable in determining the FET on my gross estate" and the residue of the residue, which was left to a marital deduction trust.

The formula bequest made reference to the preresiduary bequests passing under the will that did not qualify for the marital deduction. But it did not indicate that it also should be reduced by the includible nonprobate assets or inter vivos gifts that consumed a portion of D's basic exclusion amount because they too did not qualify for the marital deduction. As a result, the formula bequest called for an amount that was larger than the amount that could be sheltered from tax payment by what remained of D's unified credit, and taxes were incurred that were payable from the marital deduction residue. This reduced the estate's marital deduction, which increased the tax liability,

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[61] See also §3.3.4 n.51, and Estate of Swallen v. Commissioner, 65 T.C.M. (CCH) 2332 (1993), rev'd, 98 F.3d 919 (6th Cir. 1996) (D's will overcame statutory equitable apportionment and caused all of D's estate tax to be charged to the residue of D's estate that was meant to qualify for the estate tax marital deduction); Estate of Reno v. Commissioner, 916 F.2d 955 (4th Cir. 1990), rev'd en banc, 945 F.2d 733 (4th Cir. 1991) (tenancy by entireties property was originally required to bear a portion of the estate tax because the will directed that other specified realty not bear any tax and there was insufficient probate property; the court reasoned that federal law "is simply more encompassing than any [state] common law property principle that would exclude tenancy by the entireties property as a collection source for the tax"); Martin v. United States, 923 F.2d 504 (7th Cir. 1991) (estate tax generated by pre-1981 transfers was brought back into the estate under §§2035 and 2036(a)(1) and exceeded the residuary estate so assets otherwise passing to S were required to bear the tax; the marital deduction fell short of the amount D intended because state law did not require nonprobate property to pay its share of the tax and because the estate lacked sufficient funds to provide for the tax liability); Chiles v. United States, 843 F.2d 367 (9th Cir. 1988) (FET incurred on dollars used to pay state death taxes had to be paid from the marital bequest, with consequent reduction of the marital deduction); First Nat'l Bank v. United States, 634 F.2d 212 (5th Cir. 1981) (tax payment from the residue before division into marital and nonmarital shares resulted in less wealth available for S and a smaller marital deduction); Estate of Ransburg v. United States, 765 F. Supp. 1388 (S.D. Ind. 1990), aff'd and clarified, 800 F. Supp. 716 (S.D. Ind. 1991) (the tax clause in a will did not indicate the source of tax payment but that clause was placed before the residuary distribution provision and was held to negate the state equitable apportionment regime, which resulted in a reduction of amounts qualifying for the marital and charitable deductions because it appeared that taxes were to be paid from the residue first); Estate of Sawyer v. Commissioner, 55 T.C.M. (CCH) 492 (1988) (D's will imposed all death costs on the residuary estate, which included a farm that D provided to be held in a nonmarital trust for eventual distribution to a remainder beneficiary, which left insufficient assets to fully fund the marital trust; the personal representative transferred a note from the nonmarital trust to the marital trust, which the court regarded as improper, causing a reduction in the marital deduction); TAMs 199915001 and 9313002 (both involving reduction of the marital deduction for a residuary bequest charged with payment of taxes); TAM 8714010 (intestate property received by S, which was liable for administration expenses, must be reduced in value for marital deduction purposes by the maximum estimated amount of interest payable on taxes deferred under §6166 even though the estate could not deduct that interest in any amount under §2053(a)(2) until it was paid, and only in the amount of the interest actually paid); TAM 8701004 (same result regarding §6166 interest on deferred taxes).

which also was payable from the marital bequest, resulting in a circular whirlpool computation of D's estate tax liability.[62]

One way to effectively avoid reduction in the marital deduction attributable to a tax payment provision might be for those beneficiaries who would benefit from waiver of equitable apportionment to disclaim the benefit attributable to that provision. This should work if the effect under state law and the balance of the document would be to restore application of traditional principles that would direct the tax liability to the nonmarital portions of the estate.[63]

A similar reduction may occur due to drafting intended to add flexibility to the document.

> *Example:* D's will made a "maximum allowable" marital deduction formula gift of $400,000 to the trustee of a marital deduction trust and devised the residue of D's estate to the trustee of a nonmarital family trust. The will provided: "I further direct that all inheritance, estate, and transfer taxes due by reason of my death shall be paid out of that portion of my estate that is not included in the Marital Trust to be administered by my trustee unless, in the best business judgment and sole discretion of my executor, such taxes could be more prudently paid from any assets in my estate without respect to what is or is not included in the Marital Trust created by my Will." The executor in fact paid all $120,000 of death taxes out of the residuary estate.

In Estate of Wycoff v. Commissioner[64] the government correctly reduced the marital deduction on these facts by the $120,000 of death taxes that the executor could have paid out of the marital trust

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62 In addition, because the inter vivos transfers, the nonprobate includible assets, and the improperly described formula bequest totaled more than $600,000, and because the marital deduction did not eliminate taxes in this estate, the marginal estate tax bracket in which the estate was taxable was higher than the 37% marginal rate that normally applied in computing the "exemption equivalent" of the then applicable $192,800 unified credit. This created its own circular computation because, at a higher marginal rate, less than $600,000 of total taxable property would generate the same $192,800 of tax liability ("exemption equivalent of the unified credit") applicable in this estate, which caused the formula bequest to be smaller, resulting in a greater residue of the residue qualifying for the marital deduction. This produced slightly less tax and therefore a slightly larger marital deduction as a result of its own secondary circular computation, and that again affected the exemption equivalent computation, setting off another round of interrelated computations.

63 Cf. Estate of Boyd v. Commissioner, 819 F.2d 170 (7th Cir. 1987) (the recipient of life insurance effectively disclaimed D's waiver of the §2206 right of reimbursement, causing the insurance to bear its proportionate share of the tax liability and correspondingly increasing the marital deduction for that portion of the estate that otherwise would have paid those taxes had the waiver been effective); PLR 200127007 (permitting taxpayers to disclaim the benefit of the waiver of the §2207A right of reimbursement to increase a charitable deduction; a QTIP trust passed to various beneficiaries, and S's residuary estate passed to a Foundation, S's will waived that right of reimbursement, causing the QTIP trust to pass free of tax and correspondingly causing the residue of S's estate to be reduced by those same taxes, which reduced the charitable deduction, so the beneficiaries of the marital deduction trust caused the charitable deduction to be increased by disclaiming D's waiver of the §2207A reimbursement right).

64 506 F.2d 1144 (10th Cir. 1974) (applying Utah law); accord, Jeschke v. United States, 814 F.2d 568 (10th Cir. 1987); Adee Trust No. 1 v. United States, 83-2 U.S. Tax Cas. (CCH) ¶13,534 (D. Kan. 1983); Estate of Reno v. Commissioner, 916 F.2d 955 (4th Cir. 1990), rev'd (en banc) on other grounds, 945 F.2d 733 (4th Cir. 1991); Estate of Rice v. Commissioner, 41 T.C. 344 (1963), aff'd sub nom., Boston Safe Deposit and Trust Co. v. Commissioner, 345 F.2d 625 (1st Cir. 1965) (reduction of the marital deduction by the full amount of state and federal taxes that could have been paid from the marital share); Estate of Lewis v. Commissioner, 69 T.C.M. (CCH) 2396 (1995) (the tax burden was imposed on the residuary estate, which would qualify for the marital deduction, coupled with waiver of apportionment and reimbursement rights, and caused a loss of the deduction because the tax on preresiduary bequests unexpectedly exceeded the unified credit); Rev. Rul. 79-14, 1979-1

assets. PLR 9113009 applied similar principles to reduce the marital deduction because an estate trust and a QTIP trust were potentially liable for D's loan guarantees. The government ruled that, to the extent that estate assets were insufficient to satisfy the face amount of the guarantees, the excess amount of the guarantees potentially payable by the marital trusts would reduce the amount of the marital deduction.

That ruling was controversial and wrong and was retracted and revised in PLR 9409018, which held that the marital deduction will be reduced under similar facts only to the extent guaranteed loans are outstanding, default is likely, and the estate's subrogation rights appear to be worthless. As shown in PLR 9409018, the proper result in PLR 9113009 is that the value of the encumbrance represented by the guarantees should reduce the marital deduction allowable with respect to the property pledged as collateral under those guarantees. Because that same reduction in value should be reflected for §2031 valuation purposes as well, the result should be that the pledged assets passing to a surviving spouse or marital deduction trust will produce no tax in the guarantor's estate.

On a different theory, the government unsuccessfully attempted in Estate of Friedberg v. Commissioner[65] to reduce the marital deduction by arguing that a present interest valuation should be used that reflected the fact that distribution of the marital bequest might be delayed by up to five years. The court rejected the government's argument because that bequest would carry interest determined under state law at least equal to a pro rata share of the estate's income earned during the delay period.[66]

Arguably Treas. Reg. §20.2056(b)-5(f)(9) and its reference to Treas. Reg. §20.2056(b)-4 reflect a policy that delayed distribution of a marital bequest, without interest for the period of the delay, might require a discounting of the marital deduction, but various authorities reject the notion that delay requires such a diminution,[67] and administrative realities make it virtually impossible to know

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C.B. 309; TAM 8247001 (by all appearances involving the *Adee* situation); PLRs 8622022, 8517036, 8508022, and 8450018. See also Estate of Landers v. Commissioner, 38 T.C. 828 (1962) (an intestate entitlement was reduced by FET); but see Pyne v. United States, 638 F. Supp. 946 (D. Me. 1986) (state inheritance tax attributable to S's share of the estate did not reduce that share because D indicated an intent to qualify for the "maximum marital deduction allowable"); and cf. Patterson v. United States, 181 F.3d 927 (8th Cir. 1999) (the court reflected on the fact that no taxes were paid from the marital portion, and suggested in dicta that discretion to pay taxes from the marital portion would reduce the deduction only to the extent it was exercised; that extrapolation from the opinion would be a dangerous proposition on which to rely).

[65] 63 T.C.M. (CCH) 3080 (1992).

[66] See also Commissioner v. Estate of Hubert, 520 U.S. 93 (1997), discussed in extensive detail in §13.3.6; cf. TAM 9235003 (rejecting the taxpayer's attempt to discount flower bonds because of the delay in their use to pay estate tax, the government supporting its conclusion by stating that the marital deduction is not discounted to reflect delays in satisfaction). The flip side of this issue is to whom income earned on estate assets ultimately consumed by payment of taxes and other expenses should be distributed, and whether it might increase the marital deduction. Buchanan v. United States, 377 F. Supp. 1011 (W.D. Pa. 1974), held that it would not increase a charitable deduction, basically because computations are made as of the date of death and postmortem facts such as this should not increase the deduction. See §3.3.7.4 regarding the opposite issue of the proper apportionment of interest incurred on a delayed payment of estate tax. Estate of Miller v. Commissioner, 58 T.C. 699 (1972), rejected the notion that it could be used to pay various expenses and taxes and thereby insulate the marital bequest from reduction by those obligations; cf. Rev. Rul. 73-98, 1973-1 C.B. 407 (to the same effect, involving the charitable deduction).

[67] See, e.g., PLR 9125016 (D's estate consisted primarily of improved commercial real estate that produced little income and, due to depreciation reserves that would be a proper charge to income under state law, likely would have little or no distributable income during administration of the estate; a marital deduction trust prohibited

by the time a closing letter must issue how long such a delay might last and therefore how large the reduction might be. Indeed, the regulation provides that a marital bequest will not fail to qualify "merely because the spouse is not *entitled* to the income from estate assets for the period before distribution of those assets" unless distribution is delayed by express authority or direction.[68] State law may dictate that the particular variety of disposition carries interest or income earned after D's death,[69] and many well drafted documents avoid the potential for conflict with the government and S alike by providing that income need not be paid during the period prior to distribution but that it will accrue and S will be entitled to receive it once distribution occurs.

§13.4.3 The Nettlesome Qualification Requirement: The Interest Must Be Deductible

The final requirement to qualify for the marital deduction is that the interest passing to S must be "deductible." Any interest is deductible unless it falls into one of three categories of nondeductible interests.[70] The first two categories are straightforward.

§13.4.3.1 Inclusion in D's Gross Estate

An interest is nondeductible to the extent that it is not includible in D's gross estate.[71] This test is a counterpart of the passing requirement under §2056(c) that the interest must be includible in D's gross estate. An interesting way to consider the nature of this rule is illustrated by Lake Shore Nat'l Bank v. Coyle,[72] in which an outright bequest of a specified sum was "to be paid ... out of the income of my estate" and the marital deduction was disallowed, on the ground that estate income is not includible in D's gross estate.

On one level that's a silly statement, because inclusion of the corpus of any asset necessarily embraces – indeed the value of any asset anticipates – the right to receive income from that asset in the future. And the bequest – the value of the income earned and paid to S – will be includible in S's estate at death because it increases S's net worth. So there is no reason to fear that a marital deduction granted to D's estate will not be matched with payback liability in the survivor's estate. In addition, a

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retention of unproductive property for more than a reasonable time without the consent of S, the personal representative – although recognizing that a lengthy administration would be required due to the illiquid nature of the property – represented that the property would be retained only so long as reasonably necessary to dispose of the property in an orderly manner, and the government held that the marital deduction all-income requirement would not be violated and that no reduction in the value of the property passing to the marital trust would be necessitated to reflect any delay in administration); TAM 9235003 (which stated in passing on another issue that "bequests to a . . . surviving spouse, which under state statutes may bear no interest for delay in payment . . . after the decedent's death . . . are not discounted to reflect the deductible value of the bequest . . ."). Cf. Weld v. United States, 94-1 U.S. Tax Cas. (CCH) ¶60,164 (Ct. Fed. Cl. 1994), aff'd, 55 F.3d 623 (Fed. Cir. 1995) (rejecting a discount for includible Treasury bonds redeemable at par plus accrued interest in payment of FET to reflect a delay of nine months before the redemption would occur).

68 Treas. Reg. §20.2056(b)-5(f)(9) (emphasis added). See Rev. Rul. 77-346, 1977-2 C.B. 340 (the marital deduction was allowed even though income payments did not relate back and carry income from the date of death). Although the Regulation is drafted with reference to probate administration by a personal representative, the Ruling regards it as equally applicable to postmortem distributions from a funded inter vivos trust.

69 See §3.2.5.3 (accessions).

70 Treas. Reg. §20.2056(a)-2(b).

71 Treas. Reg. §20.2056(a)-2(b)(1), relied on by Estate of Turner v. Commissioner, 151 T.C. 160 (2018) (disallowing an increase in the marital deduction for income generated postmortem).

72 296 F. Supp. 412 (N.D. Ill. 1968), rev'd on other grounds, 419 F.2d 958 (7th Cir. 1969).

gift of an annuity interest or a note payable over time would qualify for the marital deduction, which is difficult to distinguish from a guaranteed entitlement to a specified dollar bequest that just happens to be payable as income is received.

On the other hand, if the gift of this bequest payable from income qualified for the marital deduction, then presumably a temporal interest in the corpus of other estate property also ought to qualify, and the nondeductible terminable interest rule would make little sense if temporal interests like this qualified for the marital deduction. As will become clear, the nondeductible terminable interest rule makes *no* sense,[73] but it wouldn't be likely for a court to ignore the nondeductible terminable interest rule in a case like *Coyle*. Which makes the result stated predictable and consistent with other requirements that will be explored in more detail. It also forewarns students of this topic that there is a good bit of nonsense in these requirements.

§13.4.3.2 Double Deductions Prohibited

An interest cannot qualify for the marital deduction if it otherwise is deducted under either §2053 or §2054. For example, a claim against the estate, such as repayment of a bona fide debt owed by D to S, which is deducted under §2053 does not also qualify for the marital deduction.[74] And a casualty loss sustained during estate administration with respect to property bequeathed to S will preclude a marital deduction to the extent the personal representative properly deducted the loss under §2054.[75]

The marital deduction is precluded only to the extent an item actually is allowed as a deduction under another provision of the estate tax. Any failure to claim or to be entitled to a deduction elsewhere will preserve the entitlement to a marital deduction. For planning purposes, however, usually it is wiser to claim a §2053 or §2054 deduction, if possible, because D's estate will enjoy the same reduction in value for estate tax purposes without increasing S's estate for subsequent estate or gift taxation.

The §2056(b)(9) prohibition on double deductions was meant to preclude a §2055 charitable and a §2056(b)(8) marital deduction for the same property.[76] Nevertheless, it is not limited by its terms just to circumstances in which a charitable deduction was allowed, as illustrated by the government's reliance on it in the *Hubert* regulations[77] and in Estate of Reeves v. Commissioner,[78] in which stock distributed to a marital deduction trust was sold to an ESOP and generated a §2057 deduction (prior to its repeal). In that case of first impression the court held that §2056(b)(9) precluded a marital deduction to the extent of the §2057 deduction. The same likely will be true regarding the §2058 state death tax deduction, if it should become relevant in some manner.

Reeves made it clear that the §2056(b)(9) issue can be finessed in drafting by reliance on a prohibition in the document against satisfaction of a marital bequest with any asset as to which the

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73 The nondeductible terminable interest rule is addressed in §13.4.3.3.
74 Treas. Reg. §20.2056(a)-2(b)(2).
75 Treas. Reg. §20.2056(a)-2(b)(3).
76 See Staff of Joint Comm. on Tax'n, General Explanation of H.R. 6056, Technical Corrections Act of 1982 at 12 (1982), and Treas. Reg. §20.2056(b)-9.
77 See §13.3.6.
78 100 T.C. 427 (1993).

marital deduction would not be allowed. That type of prohibition is standard marital deduction boilerplate to avoid the unidentified asset rule in §2056(b)(2),[79] and its existence in a document for the one purpose ought to serve to protect the marital deduction for both purposes.

§13.4.3.3 The Nondeductible Terminable Interest Rule

The third category is the most significant – and the most troublesome. To qualify for the marital deduction the interest passing to S must not be a "nondeductible terminable interest."[80] As a general principle, an interest passing to S must be subject to inclusion in S's gross estate to the extent it is not consumed or disposed of during S's overlife. This reflects the fact that, in its basic operation, the marital deduction only permits deferral of the estate tax. In effect, Congress has said, "We won't tax your property to the extent you leave it to S in a manner that exposes it to taxation in S's estate."

The clearest example of an interest that qualifies for the deduction is an outright, fee simple gift of property to S. But care is required, because it does not necessarily follow that an interest that will be includible in S's gross estate will qualify for the marital deduction. The §2056(b)(1) issue is whether the interest is a nondeductible terminable interest. Meaning that it will terminate or fail on the lapse of time or the (non)occurrence of an event or contingency. If so, then the marital deduction is disallowed if, after the termination, the interest passes to a third party.

The fact or likelihood that the interest will be subject to inclusion in S's gross estate is not sufficient to qualify for the deduction.

Example: D left an interest in trust for S until S's death or remarriage, remainder to D's children.

This is a nondeductible terminable interest because, on the occurrence of an event (S's remarriage or death) the interest passing to S will terminate and an interest in the property (the remainder interest) will pass from D to someone other than S (the children as remainder beneficiaries).[81] The fact that income paid to S prior to that termination will be includible in S's gross estate does not rectify this result, And to complicate matters, not all terminable interests are nondeductible.[82] Thus, the key to analysis is first to determine whether an interest is terminable and then to ascertain whether it is nondeductible.

§13.4.3.3.1 Terminable Interest Defined

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79 See §13.4.3.4.

80 §2056(b)(1).

81 See Treas. Reg. §§20.2056(b)-1(g) Example (1); 20.2056(b)-7(d)(3). Compare Brown v. United States 72-2 U.S. Tax Cas. (CCH) ¶12,887 (N.D. Ala. 1972) (outright disposition to S was subject to the proviso that all D's property would descend to D's heirs at law if S remarried), and PLR 200006052 (outright gift to S under a joint and mutual will was terminable in part in the event of remarriage; qualification was generated, however, by effective disclaimer by all beneficiaries in the event of remarriage, and by S, thus causing an intestacy that S took free of restriction), with Estate of McCune v. Commissioner, 48 T.C.M. (CCH) 1510 (1984) (reference in an otherwise qualifying outright disposition to "an understanding" that the property should go to their descendants if S remarried was regarded as precatory and not sufficient to create a terminable interest) and TAM 8915004 (similar: expression of a "desire" that S convey the property to their children following remarriage also was regarded as only precatory). See §13.5.2.2 n.28 and accompanying text regarding the most common application of this, in the context of a trust income interest that terminates on remarriage.

82 Treas. Reg. §20.2056(b)-1(d).

A terminable interest is any interest in property that will terminate or fail either on the mere lapse of time (for example, a term of years, a patent, copyright, or royalty interest), or on the occurrence or nonoccurrence of some event or contingency (such as S's death or remarriage, death or survivorship of a third party, or failure to perform certain acts). The determination whether an interest is terminable is made as of D's death, even if §2032 alternate valuation is selected and even though subsequent facts reveal that the interest will not in fact terminate.[83]

> *Example:* D, who was survived by S and a 17-year-old child, left an annuity interest to S, providing for payments to S for life. Under the annuity contract, survivorship payments would be made to the child after S's death if S died before the child reached age 18. Otherwise the annuity would just terminate when S died. D's executor elected alternate valuation under §2032 and the child reached age 18 before the alternate valuation date (six months after D's death). As a result, when D's estate tax return was filed it was clear that the provision for the child had lapsed and no annuity payment ever would be made to anyone other than S. Nevertheless, the annuity is a terminable interest because, viewing events as of D's death, payments could be made to a third person (the child) upon termination of S's interest.[84]

Similarly, postmortem conversions or elections of any kind by S cannot alter the terminable interest character of an interest. Thus, if D bequeathed property to S for life with remainder to D's children, the interest passing to S is a terminable interest even if S and the children agree to a fractional division of the estate in fee in lieu of the temporal interests, or if S sold the life estate for cash, or acquired the remainder interest from the children by purchase or gift.[85]

Conversely, postmortem actions will not convert a deductible interest into a nondeductible terminable interest. For example, selection by S of an insurance policy settlement option that involves a terminable interest is not nondeductible if a lump-sum payment option could have been selected. Nor will an interest be rendered nondeductible merely because S must make a purely procedural or ministerial election as a prerequisite to receiving it.[86]

§13.4.3.3.2 Nondeductible Terminable Interests

Not all terminable interests are not deductible. Indeed, terminable interests are deductible unless: (1) the interest was acquired by D's personal representative at D's direction;[87] or (2) upon termination of S's interest (a) another interest in the same property will pass (b) for less than full and adequate consideration (c) from D (d) to a third person whose enjoyment or possession commences upon termination of S's interest.[88] It does not matter if the interest passing to the third person was created and conveyed by the same instrument that gave S an interest (for example, a remainder

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[83] Treas. Reg. §20.2056(b)-1(e)(3).

[84] Rev. Rul. 85-100, 1985-2 C.B. 200. As explored in more detail in §§13.4.3.3.2 nn.94 – 95 and accompanying text, and 13.5.6.7, not all life annuities fail to qualify for the marital deduction, because they may qualify for the QTIP exception in §2056(b)(7), including the automatic §2056(b)(7)(C) exception for certain annuities.

[85] Treas. Reg. §20.2056(b)-1(e)(3); S. Rep. No. 1013, 80th Cong., 2d Sess. (1948), 1948-1 C.B. 338. See §13.4.2.3.2 n.49.

[86] See Rev. Rul. 82-184, 1982-2 C.B. 215. See also PLR 9229034 (annuities were not nondeductible terminable interests because S was entitled to elect how to receive the proceeds of those annuity contracts and one option was a lump sum payment).

[87] §2056(b)(1)(C).

[88] §§2056(b)(1)(A) and 2056(b)(1)(B).

following S's life estate) or by a separate instrument (for example, a reversion retained by D and subsequently given to a third party).[89]

Further, to determine whether an interest in the same property passed from D both to S and to some other person, a distinction must be made between property and an interest in property.[90] The term "property" is used in a comprehensive manner and includes all objects or rights that are susceptible of ownership. The term "interest" refers to the quantum or quality of ownership of property. Thus, for example, if D devises to S an estate for life in FarmAcre, the interest passing to S is the life estate and the property in which that interest exists is FarmAcre. If, however, all D owns is a term of years that survives D's death and that D gives to S, the property for estate tax inclusion and marital deduction qualification is what D owns – the term interest – and, as illustrated below, this bequest would qualify for the marital deduction. That distinction may seem goofy, because it is. As shown below, these rules are senseless.

The following 11 examples illustrate the operation of the rules governing nondeductible terminable interests.

Example 1: D bequeaths to S an installment note that is payable over six years.

The note is a terminable interest because it will be extinguished upon the obligor's final payment in six years. It is not a nondeductible terminable interest, however, and thus it qualifies for the marital deduction, because no interest in the property will pass to any person other than S on termination. For the same reason, a patent, copyright, or royalty (which have no interest that survives termination of the underlying property interest that can pass to a third party) and a life estate with remainder to S's estate[91] all are terminable interests that are deductible, because no interest passes from D to a third person for enjoyment or possession after S's enjoyment terminates.

> *Example 2:* D purchased a joint and survivor annuity contract providing for payments to D and S and then to the survivor of them. On the death of the survivor of D and S all payments will cease. D dies and the present value of the remaining annuity payments to which S is entitled is included in D's gross estate under §2039.

Notwithstanding that it is a terminable interest, the value of the annuity qualifies for the marital deduction because it was includible in D's gross estate and no interest owned by D in the annuity (the property) survives S and passes to a third party.[92]

> *Example 3:* D's will directed D's personal representative to use estate funds to purchase a single life, no refund annuity for S.

D's estate is not entitled to a marital deduction under §§2056(b)(1)(C) and 2056(b)(7)(C). This result is illogical. S's annuity is no different from that in Example 2, except for the manner in which it was acquired. Indeed, D's estate would be entitled to a marital deduction if D's will bequeathed cash to S,

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89 Treas. Reg. §20.2056(b)-1(e)(1).

90 Treas. Reg. §20.2056(b)-1(e)(2).

91 Treas. Reg. §20.2056(b)-1(g) Example (6).

92 §2056(b)(7)(C) and Treas. Reg. §20.2056(b)-1(g) Example (3). See also the authorities cited in §13.5.6.7 n.249 and accompanying text.

who used the money to purchase an identical single life annuity for S. Illustrated here is the first form of nondeductible terminable interest. Fortunately for most purposes this senseless application functionally is irrelevant because estate plans seldom if ever direct a personal representative to purchase terminable interests.

> *Example 4:* D purchased an annuity providing for payments to D for life and then to S for life if S survives D. Unlike the annuity described in Example 2, however, this annuity has a "20 years certain" refund feature. If D and S both die during a 20-year period, additional payments will be made to their child for the remaining portion of the 20 years. D dies before year 20 and the value of the annuity is included in D's gross estate under §2039. At the time of D's death, S's life expectancy is longer than the balance of the 20-year term certain.

Without more, no part of the value of this annuity interest passing to S qualifies for the marital deduction.[93] If D had died after expiration of the 20-year term certain the marital deduction would have been allowable for the amount includible in D's estate under §2039 because there would be no interest that could pass to a third party after S's subsequent death. Similarly, the marital deduction would be allowable if the balance of the term annuity was payable to S's estate rather than to a third party.

Here it is not clear to the government how to regard the value of this annuity in D's estate. Indeed, the government simply is conflicted or confused about application of the nondeductible terminable interest rule to annuities.[94] It is the government's belief that the adoption of §2056(b)(10) may affect the qualification of annuities in the form of a specified dollar amount payable annually or an annuity or unitrust interest like that found in a §664 qualified CRT. Reflecting the last sentence of §2056(b)(7)(B)(ii) ("[t]o the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified)") and applying the authority of §2056(b)(10), regulations issued in 1994 reserve judgment regarding the ability even to make a QTIP election in cases in which an annuity rather than a straight income interest is payable to S.[95]

> *Example 5:* D's will bequeathed Blackacre "to my sibling Terry for life, and on Terry's death the remainder shall pass to S." Blackacre is worth $200,000 at D's death.

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93 Treas. Reg. §20.2056(b)-1(g) Example (3). See, e.g., Estate of Baker v. Commissioner, 56 T.C.M. (CCH) 417 (1988) (insurance renewal commissions payable for 30 years, to S and after S's death to D's children; no QTIP election was made, so §2056(b)(7) was not implicated); Rev. Rul. 85-100, 1985-2 C.B. 200 (a survivor annuity with a refund feature if S died while the children were minors, which occurred, and as to which §2056(b)(7) QTIP treatment was not involved; although the minor children reached the age of majority before the alternate valuation date and the alternate valuation election was made, marital deduction qualification is determined at the date of death and at that time the contingent refund feature disqualified the deduction); PLR 9016084 (insurance renewal commissions payable to S for life, then to children were deemed to qualify automatically under §2056(b)(7)(C) but only for the value of S's annuity and not for the full value of the contract, showing that without the special treatment afforded by §2056(b)(7)(C) the nondeductible terminable interest rules were operable).

94 As illustrated by Treas. Reg. §20.2056(b)-7(e) (during S's overlife S's lifetime annuity in a trust created by D qualifies for the marital deduction if no person other than S may receive any distribution of the property, or its income, out of which the annuity is payable), applicable only with respect to decedents dying before the effective date of §2056(b)(10).

95 See §13.5.6.7 n.254.

Becoming more common is the "sandwich" generation of clients who are supporting children and parents at the same time, and the life estate illustrated may provide for the client's dependent parents for the balance of their lives. In either case, the remainder interest passing to S qualifies for the marital deduction in D's estate because it is not a terminable interest. Here only the life estate is terminable.

TAM 9604003 is instructive with respect to Example 5, it having declared that the marital deduction was not available because unproductive property was involved and S had no ability to make it productive. The facts were a bit unusual, involving a vested remainder that D owned, subject to a life estate in D's mother. Although the TAM described the interest as "contingent on surviving the decedent's mother," because it did not commence in possession or enjoyment until then, characterization of it as contingent was incorrect. The remainder was vested, with possession and enjoyment subject only to expiration of the preceding term interest. Had D left the remainder interest to S outright there would have been no question of its qualification for the marital deduction because, as a remainder interest, it was not a terminable interest.

Moreover, because the remainder was created by D's father – who created the life estate and gave the remainder to D – it would not be nondeductible even if it somehow was a terminable interest. All this made the government quite wrong in stating that S's interest in the remainder "cannot be characterized as a right to receive all the income from the property for the spouse's entire life." S was entitled to all the income from the property, which was the remainder that D owned and that was includible in D's gross estate. S was entitled to receive all the income that was generated by that interest – the remainder that S owned. The income simply would not commence until the interest itself became a present interest in S – when the preceding life estate terminated.

There was, however, another problem, because D's estate plan converted the remainder into a nondeductible terminable interest by giving S only the "life use and possession" of the remainder interest. That is what made S's portion of that future interest terminable.[96] It also is important to note that a statement in the TAM that "[p]rior to the receipt by the spouse of her life estate, another person is entitled to the use and enjoyment of the property" was reminiscent of a similarly wrong statement that

> to constitute a qualifying income interest for life, the donee spouse must be granted the immediate right to receive the income from the property. Thus, an income interest does not constitute a qualifying income interest for life if the donee spouse receives the right to trust income commencing at some time in the future, e.g., on the termination of a preceding life income interest ....[97]

That statement was irrelevant to the case. The lack of current income would be true of any remainder interest, and a remainder interest is not a nondeductible terminable interest. There would have been no need to get involved in exceptions to the nondeductible terminable interest rule if D had given S

[96] D's estate made a QTIP election with respect to the remainder, which created an all-income-annually requirement, relevant with respect to any QTIP. Although it is only speculation (because the TAM did not discuss this issue), it seems reasonable to assume that S as the owner of only an income interest in the remainder had no authority under state law to convert anything to make the remainder productive of a reasonable amount of income. That defect properly would disqualify S's terminable interest in the remainder for the deduction. See §13.5.2.2.2.

[97] Treas. Reg. §25.2523(f)-1(c)(2). See §13.5.6.5 n.232 and accompanying text.

the entire remainder interest rather than just the lifetime enjoyment of it. In that case no problem would arise attributable to the non-income-producing nature of the remainder interest.

Example 6: D's will created a trust in which S is granted a power to withdraw the greater of 5% of the value of the trust or $5,000 from corpus annually.

Because S must be alive to exercise the annual withdrawal power, only the value of the power that is exercisable in the year of D's death is allowable as a marital deduction. The value of the powers available for the balance of S's life, even if discounted to present value, is a nondeductible terminable interest.[98]

Example 7: A statutory family allowance is payable to D's surviving spouse until the first to occur of S's death or remarriage, or termination of administration of D's estate.

This is a nondeductible terminable interest to the extent the estate assets from which the allowance is paid ultimately pass to a third person.[99] The Supreme Court addressed the family allowance issue

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[98] Estate of Hollingshead v. Commissioner, 70 T.C. 578 (1978); Estate of Cummings v. Commissioner, 31 T.C. 986 (1959); Guiney v. United States, 295 F. Supp. 789 (D. Md. 1969), rev'd on other grounds, 425 F.2d 145 (4th Cir. 1970); Allen v. United States, 250 F. Supp. 155 (E.D. Mo. 1965); TAM 8202023. Compare Rev. Rul. 66-38, 1966-1 C.B. 212, in which S's unlimited power to withdraw the entire trust existed only during the first year after D's death; the government disallowed the marital deduction as a §2056(b)(5) all income, general power of appointment marital trust because the power was not exercisable by S in all events (a wrong minded result because expiration of the power to withdraw after the first year would trigger §2514 under the gift tax, meaning there was no abuse; the difference in the example is that annual lapse of the five-or-five power will be gift tax free under §2514(e) but not estate tax free under §2041(a)(2) if the power did not lapse prior to death in the year of death), and Estate of Edmonds v. Commissioner, 72 T.C. 970 (1979) (S could reside in D's home for life and could notify the fiduciary of a desire to purchase a different home, in which case the fiduciary was directed to pay up to $100,000 to effect that purchase, which S exercised and the fiduciary distributed; the marital deduction was denied for the added amount because the court regarded the right as subject to substantial conditions that made it less than an absolute entitlement as of the date of D's death), with Estate of Neugass v. Commissioner, 555 F.2d 322 (2d Cir. 1977), rev'g 65 T.C. 188 (1975) (an all-income-annually trust with the right to withdraw the full corpus anytime within six months after D's death qualified for the marital deduction simply because there was no abuse of the government's interest); the document was construed as effectively giving S the right to choose whether to receive a life estate or a fee simple interest, much the same as the right to choose whether to exercise a statutory elective share, which also qualifies for the marital deduction, as discussed in §13.6.1.2.1 n.12 and accompanying text, Ritter v. United States, 297 F. Supp. 1259 (S.D. W. Va. 1968) (the marital deduction was allowed for an amount paid by the personal representative at S's request under a provision giving the fiduciary discretion to purchase a residence for S, holding that S had an unqualified right to the amount needed to purchase the residence), Estate of Tompkins v. Commissioner, 68 T.C. 912 (1977), acq., 1982-1 C.B. 1 (a marital deduction was allowed to the extent S exercised a right to receive a specific bequest payable outright in lieu of an interest in trust that did not qualify for the marital deduction), and Estate of Trunk v. Commissioner, 37 T.C.M. (CCH) 497 (1978) (a marital deduction was allowed to the extent S exercised an unconditional right to request up to $200,000 from D's estate).

[99] Treas. Reg. §20.2056(b)-1(g) Example (8); Rev. Rul. 56-26, 1956-1 C.B. 447. But see Estate of Radel v. Commissioner, 88 T.C. 1143 (1987), acq., 1987-2 C.B. 1 (same facts as the last sentence in Treas. Reg. §20.2056(b)-1(g) Example (8), with the government attempting to disallow the marital deduction for two-thirds of the allowance because, under Minnesota law, S received only one-third of the estate; the court permitted the deduction for the entire allowance, essentially as if it was an annuity payable in a fixed number of installments, with no condition subsequent that would cut it short), following Estate of Green v. United States, 441 F.2d 303 (6th Cir. 1971) (involving Michigan law). Also citing the taxpayer's victory in *Green*, Estate of Watson v. Commissioner, 94 T.C. 262 (1990), held that the Mississippi widow's allowance of an amount sufficient to provide one year's support, with no reduction or termination if S dies or remarries, is not a nondeductible

in Jackson v. United States,[100] holding that the character of a survivor's allowance must be judged as of the date of D's death and the interest is nondeductible if the interest is not vested until a later date.[101]

Example 8: D devised Blackacre to S and a child as joint tenants with right of survivorship.

Both S and the child own terminable interests in Blackacre because one will enjoy the entirety of the property after the death of the other. Although a trust would make better sense in many cases, D may prefer the joint tenancy for convenience and the marital deduction is allowable for a portion of the devise equal to what S would receive on a division if S has a power under state law to sever the tenancy without the child's consent.[102]

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terminable interest. The requirement that a Chancellor must determine the award amount was not a condition or contingency that made the award a terminable interest. See also Molner v. United States, 175 F. Supp. 271 (N.D. Ill. 1959) (allowing the marital deduction under Illinois law because the widow's allowance was not terminable); Miller v. United States, 74-2 U.S. Tax Cas. (CCH) ¶13,039 (N.D. Ohio 1974) (year's allowance under Ohio law was a vested entitlement at D's death and therefore was deductible).

Citing *Radel*, TAM 9219001 similarly allowed a marital deduction for a maintenance award payable to S under Minnesota law of "up to $500 per month for a period of 18 months." Cf. Estate of Kyle v. Commissioner, 94 T.C. 829 (1990) (Texas homestead rights are nondeductible terminable interests not eligible for QTIP treatment because they are subject to termination in case of abandonment).

100 376 U.S. 503 (1964). See also Iowa-Des Moines Nat'l Bank v. United States, 306 F. Supp. 320 (S.D. Iowa 1969) (the Iowa widow's allowance did not qualify because an application for the award is necessary and a judicial determination relative thereto must be made before the grant of any allowance; only a contingent interest was created even though the statute had been revised for the express purpose of qualifying for the marital deduction); Connecticut Nat'l Bank v. United States, 76-1 U.S. Tax Cas. (CCH) ¶13,132 (D. Conn. 1976) (the Connecticut widow's allowance does not qualify because the grant and amount involved are subject to the discretion of the probate court). Accord, Estate of Rubinow v. Commissioner, 75 T.C. 486(1980) (involving Connecticut law). And see United States v. Edmonson, 331 F.2d 676 (5th Cir. 1964) (involving Georgia law); Hamilton Nat'l Bank v. United States, 353 F.2d 930 (6th Cir. 1965) (involving Tennessee law); Estate of Snider v. Commissioner, 84 T.C. 75 (1985) (the deduction was disallowed because, under Texas law, the allowance was deemed to be contingent rather than a vested, unconditional entitlement); Estate of Abely v. Commissioner, 60 T.C. 120 (1973), aff'd, 489 F.2d 1327 (1st Cir. 1974) (involving Massachusetts law).

101 The Court found support for its conclusion in the failure of the Senate to approve House-passed amendments that would have made the terminable interest rule inapplicable to all survivors' allowances actually paid within a specified period. As passed by the House of Representatives, the bill that ultimately was enacted as the Internal Revenue Code of 1954 contained a provision that provided in substance that a survivor's allowance paid within one year of D's death would qualify for the marital deduction. H.R. 8300, 83d Cong., 2d Sess., §2056(b)(7) (1954). The Senate deleted this provision, stating its belief that complications of the provision were unnecessary because many survivors' allowances would qualify for the marital deduction under existing law without regard to the time of payment. H.R. Rep. No. 2543, 83d Cong., 2d Sess. 75 (1954).

102 Treas. Reg. §20.2056(b)-5(g)(2) effectively recognizes the §2056(b)(5) life estate with general power of appointment exception to the nondeductible terminable interest rule in this case by likening the power to sever to a power to appoint to S personally. Thus, the marital deduction is allowable for any portion that S would receive outright on termination of the tenancy without a consent that would constitute an impermissible restriction on that power of appointment. Compare Eubanks v. Commissioner, 26 T.C.M. (CCH) 936 (1967) (marital deduction permitted for the half interest S would take), and PLR 9224010 (the marital deduction was allowed for the one-third interest of an account held with two children), with Jeschke v. United States, 814 F.2d 568 (10th Cir. 1987) (no marital deduction was allowed because the other joint tenant had a unilateral power to terminate S's interest in the tenancy).

Example 9: Under state law a surviving spouse may take the cash value of any right to dower or curtesy.

If absolute, the right to dower or curtesy is deductible notwithstanding that it is a commutation of an otherwise nondeductible terminable interest.[103] Similarly, an award in lieu of homestead as provided by the applicable state law may qualify for the marital deduction.[104]

Example 10: D and S executed a joint and mutual will that gave D's property to S and, upon S's death, left their combined assets to their children.

No marital deduction is allowable for D's estate if, under state law, the will is a binding contract that prohibits S from disposing of D's assets other than pursuant to the will.[105] (Quaere why that binding obligation does not just reduce the value of the property received by S, allowing a marital deduction to the extent the property received by S exceeds in value the obligation imposed on S by D's contractual will.)

Example 11: D's father created a 50-year term in Blackacre, giving it to D outright. When D died the term had a number of years to run, which D gave to S.

This is a deductible, albeit terminable, interest because D did not convey the remainder to a third party. The interest left to S would be a nondeductible terminable interest if D had created the 50-year term by bequeathing the remainder thereafter to C. The terminable interest passing to S also would qualify for the marital deduction under §2056(b)(1)(A) if D had sold that remainder interest to C for its full FMV at the time of the sale. There is no logical foundation to support the statute's disparate treatment of these identical interests passing to S.[106]

The equalizer form of bequest noted in §13.2 creates a deductible interest, notwithstanding the government's objection. In the late 1970s the government challenged this form of planning under the nondeductible terminable interest rule on the ground that events after D's death (for example, valuation of the estates of D and S) could cause the bequest to fail. The government lost its challenge and finally acquiesced.[107]

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103 First Nat'l Exchange Bank v. United States, 335 F.2d 91 (4th Cir. 1964); Rev. Rul. 83-107, 1983-2 C.B. 159; Rev. Rul. 72-8, 1972-1 C.B. 309; Rev. Rul. 72-7, 1972-1 C.B. 308.

104 Rev. Rul. 76-166, 1976-1 C.B. 287; Rev. Rul.72-153,1972-1 C.B. 309.

105 Estate of Grimes v. Commissioner, 851 F.2d 1005 (7th Cir. 1988); Batterton v. United States, 406 F.2d 247 (5th Cir. 1968); Estate of Grimes v. Commissioner, 56 T.C.M. (CCH) 890 (1988) (involving the child of D in the earlier *Grimes* case, whose attorney also botched the marital deduction in the child's case); Estate of Goldstein v. United States, 72-1 U.S. Tax Cas. (CCH) ¶12,819 (D. Minn. 1971); Estate of Siegel v. Commissioner, 67 T.C. 662 (1977); Estate of Abruzzino v. Commissioner, 61 T.C. 306 (1973); Estate of Krampf v. Commissioner, 56 T.C. 293 (1971); Estate of Opal v. Commissioner, 54 T.C. 154 (1970); TAM 8347002.

106 The policy rationale underlying the nondeductible terminable interest rule is discussed and criticized in Abrams, A Reevaluation of the Terminable Interest Rule, 39 Tax L. Rev. 1 (1983).

107 Estate of Laurin v. Commissioner, and Estate of Meeske v. Commissioner, 645 F.2d 8 (6th Cir. 1981) (consolidated cases); Estate of Smith v. Commissioner, 565 F.2d 455 (7th Cir. 1977), acq., Rev. Rul. 82-23, 1982-1 C.B.139.

Rev. Rul. 70-527, 1970-2 C.B. 193, addressed a formula determined charitable deduction that would change if the personal representative made a §2032 alternate valuation election and the effect on the charitable

§13.4.3.4 The Unidentified Asset Rule

The pool of assets (or proceeds of assets) available to satisfy a marital deduction gift may include particular assets that do not qualify for the marital deduction (nondeductible terminable interests or interests that are not includible in D's gross estate). In computing the allowable marital deduction, §2056(b)(2) states that "the value of [any] interest passing to [the surviving] spouse shall . . . be reduced by the aggregate value of such particular assets." Captioned "Interest in Unidentified Assets" for reasons that are not entirely clear, the consequences of triggering §2056(b)(2) are graphic. The marital deduction is reduced if a particular asset *could* be used to satisfy the marital bequest, without regard to whether the asset actually is so distributed.

> *Example:* D's will bequeaths half of D's residuary estate to S. The residuary estate includes the right to the rentals of an office building under a 20-year lease that D reserved under a deed of the building by way of a gift to a child several years before D's death.

The rental right is a nondeductible terminable interest. The interest will terminate on the happening of an event (cessation of the rental payments upon expiration of the lease) and an interest in the property (the reversion) will pass to the child.[108] Thus, if the right to the rentals is included in D's gross estate (say, at a value of $60,000) and if D's personal representative has the authority to distribute the entire rental right in partial satisfaction of the bequest to S, under the unidentified asset rule the bequest is a nondeductible interest and will reduce the allowable marital deduction by $60,000. The marital deduction would be reduced by only $30,000 if D's personal representative could only distribute a half interest in the rental right as part of the fractional residuary bequest to S.[109]

This is the only example in the regulations to illustrate the unidentified asset rule. As suggested by the labored facts of the example, unidentified assets rarely are encountered. Fortunately, the cited regulation suggests an easy way to eliminate any concern about operation of the rule: "If the

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formula bequest did not disqualify the charitable deduction. The same should apply for marital deduction purposes as well.

Rev. Rul. 55-643, 1955-2 C.B. 386, recognized that a personal representative may make the §642(g) election and alter the size of a formula marital bequest with no reduction or risk of disqualification to the marital deduction by virtue of that power alone. Cf. §5.8.4 (addressing equitable adjustments that reflect the fact that the election can alter the beneficiaries' entitlements).

Distinguishing *Smith*, TAM 9010001 disallowed a marital deduction for a bequest of "an amount equal to what my personal representative at the time of my death determines in his sole discretion will increase the total estate of my said husband to what my personal representative deems most desirable for reducing the total federal estate tax liability of our respective estates." Unlike equalizer cases like *Smith*, *Meeske*, and *Laurin*, in which a formula provision establishes the intent of D regarding the size of the marital deduction without specifying the amount of the actual bequest, this provision provided no mechanism to determine at D's death what was meant to pass to S. Thus, it was deemed to fail the §2056(c) passing requirement. The result reached is proper and does not implicate traditional equalizer marital planning. See Casey v. United States, 64-1 U.S. Tax Cas. (CCH) ¶12,215 (S.D. Ill. 1964) (an increase in the bequest from $100,000 to $200,000 as the executor deemed appropriate could not qualify).

[108] It does not matter that the interest passing to a third person is not pursuant to the same instrument that gave S an interest. Treas. Reg. §20.2056(b)-1(e)(1).

[109] Treas. Reg. §20.2056(b)-2(d). Cf. Estate of Reeves v. Commissioner, 100 T.C. 427 (1993) (apparently the only case ever to apply §2056(b)(2) – even in an ancillary manner – in *Reeves* as just one factor in the context of disallowing a portion of the marital deduction under the double deduction prohibition of §2056(b)(9), discussed in §13.4.3.2 at text accompanying n.80).

decedent's will provided that [S's] bequest could not be satisfied with a nondeductible interest, the entire bequest is a deductible interest." Accordingly, a boilerplate provision such as the following should be employed in any will or trust in which the marital deduction is involved:

> No asset (or the proceeds of any asset) shall be distributed in satisfaction of the marital deduction bequest as to which the marital deduction would not be allowed if it were distributed outright to my spouse.

In a similar manner, an estate plan that employs a reverse pecuniary or residuary marital gift (under which the residuary estate is intended to qualify for the marital deduction)[110] should shunt away from the marital bequest any unidentified assets that possibly may be included in the estate, as follows:

> In funding the bequest to the nonmarital trust, my executor shall first distribute assets (or the proceeds of assets) as to which the marital deduction would not be allowed if distributed to my spouse.

A fractional marital approach also will "purge the pot" of any nonqualifying assets for the same reason.[111]

§13.4.4 Exceptions to the Nondeductible Terminable Interest Rule

§13.4.4.1 In General

When the marital deduction was introduced by the Revenue Act of 1948, Congress established the §2056(b)(1) nondeductible terminable interest rule as the primary test for determining whether an interest passing to S qualifies for the deduction. The 1948 Act carved out several important exceptions to the rule, however, which permit certain trust settlements to qualify for the marital deduction notwithstanding that S is given only a terminable interest. In addition, Congress provided for a "limited survivorship" exception to the nondeductible terminable interest rule, which applies to outright gifts as well as to trust dispositions.

> The major rationale underlying the exceptions to the nondeductible terminable interest rule permitting certain trust settlements is to prevent the marital deduction from creating incentives to make imprudent disposition of an estate solely to obtain the deduction.
>
> Standing alone, the nondeductible terminable interest rule creates considerable pressure to give property outright to a surviving spouse in order to take advantage of the marital deduction, although wisdom might dictate a more conservative disposition. The exceptions to the terminable interest rule seek to ease this pressure by providing that certain restrictions upon the interest passing to a surviving spouse will not disqualify the interest given ... for the marital deduction.[112]

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110 See §13.7.6.
111 See §13.7.8.2.2.
112 Lowndes, Kramer, & McCord, Federal Estate and Gift Taxes 465 (3d ed. 1974).

These trust distribution exceptions are so important that they form the focus of the entire next section of this chapter.

§13.4.4.2 Limited Survivorship Exception

It is a common practice to draft wills that include a clause requiring a legatee to survive the testator by a stated period (for example, 120 hours, 30 days, 6 months) to take under the will. A survivorship clause tends to ensure that the property will pass to alternate beneficiaries the testator designated in the will, rather than to the heirs or devisees of a legatee who did not live long enough to enjoy the property. An additional purpose of a survivorship condition is to avoid double administration and, for tax sensitive planning, to prevent estate stacking or double taxation (subject to the previously taxed property credit of §2013) of the same property in two estates if the testator and the legatee die in quick succession.

By way of example, In Estate of Acord v. Commissioner[113] D's will specified that S would not receive D's estate if S "dies before I do, at the same time that I do, or under such circumstances as to make it doubtful who died first." The apparent intent in this community property estate was to preclude estate stacking if the spouses died in a common disaster. As it turned out, D and S died within 38 hours of each other. Showing how the planning in such a case can be counterintuitive, the government argued successfully that S was entitled to take under the specific terms of D's survivorship provision. Indeed, the will overcame a state law 120 hour survival rule by virtue of that provision,[114] because the will specifically addressed simultaneous deaths. As a result, D's estate passed to S.

Because this transfer qualified for the estate tax marital deduction and D's estate therefore incurred no tax, it produced no §2013 credit in S's estate. The effect was that D's share of their community property was stacked on top of S's own property, all to be taxed in S's estate, causing more tax to be incurred under the progressive tax tables than if the state law 120 hour survivorship rule had applied. This result was particularly egregious because, in any community property estate, the planning goal should be to avoid "unsplitting" the estates of spouses who die in rapid succession.

One way to mitigate the effect of such a result would be to make the §2010(c)(5)(A) election to allocate D's unused exclusion amount to S. But doing so would not eliminate the estate stacking detriments involved. Otherwise, if faced with such a situation, it also might be possible for the devisee to disclaim D's property.[115] In states in which postmortem disclaimers are possible, the best planning

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[113] 93 T.C. 1 (1989), aff'd, 946 F.2d 1473 (9th Cir. 1991).

[114] The 1990 version of UPC §2-702 specifies that a beneficiary under a decedent's will must survive the decedent by 120 hours to avoid being treated as predeceased. This rule does not apply, however, if the decedent's will "contains language dealing explicitly with simultaneous deaths or deaths in a common disaster" or "expressly indicates that an individual is not required to survive an event, including the death of another individual, by any specified period or expressly requires the individual to survive the event by a specified period."

[115] That possibility was foreclosed under the earliest version of UPC §2-801(a) once the devisee died, but the 1990 version of UPC §2-801(a) specifically granted the power to disclaim to the devisee's personal representative. The current version of §2-1105(b), in conjunction with §2-1102(4), is not as explicit but intends the same result. In some states it may require litigation to establish the right. See, e.g., Estate of Rolin v. Commissioner, 588 F.2d 368 (2d Cir. 1978) (spouses died within four months of each other; executors of the deceased surviving spouse's estate were permitted to disclaim a general power of appointment granted by an inter vivos trust created by the predeceased spouse); Estate of Lamson v. Estate of Lamson, 662 A.2d 287 (N.H. 1995) (spouses died

opportunity in a case of this type would be to balance the estates of D and S in such a manner that some estate tax is incurred in D's estate, which will produce a sufficient §2013 credit in S's estate to offset estate tax incurred on S's estate (including any property received from D).[116]

Absent a special exception, a survivorship condition attached to an interest bequeathed to a surviving spouse would trigger the nondeductible terminable interest rule. The bequest would fail and an interest in the property would pass from D to some person other than S upon the happening of an event or contingency (S's death within the contingency period). Fortunately, §2056(b)(3) provides that a bequest subject to a survivorship condition is not a nondeductible terminable interest if the condition of survival is for a period not exceeding six months[117] and the contingency of S dying within that period does not occur.

Thus, a survival requirement for up to six months can be attached to an interest passing to a surviving spouse without necessarily disqualifying it for the marital deduction. No marital deduction will be available if S does not survive for the stated period because no interest will actually pass from D to S. But if the spouse survives for the requisite period the interest passes and the condition is ignored for marital deduction qualification purposes.

The deduction will be disallowed, however, if survival is keyed to a period that could exceed six months, even if the period does not in fact exceed six months and S actually takes the property.

> *Example:* D's will devised D's residuary estate to S "absolutely and in fee simple; provided, however, in the event S should die before my will is probated, I then devise the said property to my children in equal shares." D's will was probated four weeks after D's death and, in due course, the residuary estate was distributed to S.

The interest passing to S does not qualify for the marital deduction because D's will could have been probated within or outside the six month period.[118]

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within three months of each other; the government refused to accept a disclaimer made by the personal representative on behalf of the survivor's estate until the authority to do so was established by the highest court of the state).

116 See the illustration of §2013 postmortem planning in §13.2.6.

117 The six month survivorship period expires on the day of the sixth calendar month after the decedent's death that numerically corresponds to the day of the calendar month on which death occurred. Rev. Rul. 70-400, 1970-2 C.B. 196. To avoid any questions if the sixth calendar month does not have a date that numerically corresponds to the date of the decedent's death (for example, if the date of death is March 31, August 29 – 31, October 31, or December 31), many drafters require survival by 180 days, which is never longer than any six calendar month period.

118 Treas. Reg. §20.2056(b)-3(d) Example 4. Similar conditions or events that could exceed six months would be completion of probate administration, distribution of an estate, funding of a trust, or will or trust provisions becoming operative. All similarly will result in denial of the marital deduction. See, e.g., Estate of Robertson v. United States, 903 F.2d 1034 (5th Cir. 1990); Estate of Fried v. Commissioner, 445 F.2d 979 (2d Cir. 1971); Bookwalter v. Lamar, 323 F.2d 664 (8th Cir. 1963); Sowder v. United States, 407 F. Supp. 2d 1230 (E.D. Wash. 2005), aff'd, 2007-2 U.S. Tax Cas. (CCH) ¶60,550 (9th Cir. 2007) (marital deduction was salvaged, however, by a very broad state statute effectively construing a document to comply with the marital deduction provisions if it is determined that D intended to qualify for the marital deduction); Estate of Harmon v. Commissioner, 84 T.C. 329 (1985); Estate of Shepherd v. Commissioner, 58 T.C.M. (CCH) 671 (1989); Rev. Rul. 88-90, 1988-2 C.B. 335; TAM 8747003.

In TAMs 8834002 and 8816001 the surviving spouses were required to be alive when the decedents' estates were distributed, which could occur after the permissible six month survivorship period. The government disallowed the marital deduction, notwithstanding state statutes providing that a survivorship condition in excess of six months would be cut back to just six months if the marital deduction was involved.[119] According to the government, those statutes did not apply because they require that a definite survival period in excess of six months be specified and the conditions imposed by these decedents (a) might not exceed six months and (b) were not specific periods.

Although these results seem unnecessarily harsh, they were mirrored in Estate of Heim v. Commissioner,[120] in which S was similarly required to survive distribution of the estate to be entitled to take. The applicable state statute was deemed inadequate to save the bequest because it was deemed to apply only to "marital deduction gifts" involving a "survivorship requirement ... in excess of six months" and the subject provision made no reference to the marital deduction and did not specify a definite period of survivorship that was in excess of six months.[121]

To the same effect was Estate of Bond v. Commissioner,[122] in which S was required to survive "distribution" to be entitled to receive the residue of D's estate. Citing *Heim*, a state law saving provision again was deemed inapplicable because it too required a "marital deduction gift" and

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119 For an illustration of the operation of such a statute see TAM 8810002, in which the will conditioned bequests to S on surviving D for one year, which S did. A state statute provided that, if a will contains a marital deduction gift, any survivorship requirement expressed in the will in excess of six months shall be limited to a six month period beginning with the testator's death. This cut-down provision was deemed to apply because the government concluded "that the one year survival period was stated for administrative convenience rather than as a substantive condition to the absolute vesting of the interests." Consequently, §2056(b)(3) also was deemed to apply and the marital deduction was allowed. In a slightly different manner the marital deduction similarly was salvaged by a state statute and state court action, based on a finding that D clearly intended to qualify for the marital deduction. The fact that D intentionally altered a 60 day survivorship requirement to 365 days by interlineation at the time of execution did not prevent the court from finding that a statutory construction rule to comply with the marital deduction requirements was operative to reduce the survivorship requirement to the original 60 days. In re Estate of Keller, 46 P.3d 1135 (Kan. 2002), was binding on the federal government because the Kansas Supreme Court acted on its own motion to take jurisdiction over the case and affirm the lower court's construction.

120 914 F.2d 1322 (9th Cir. 1990).

121 See also Estate of Dunn v. United States, 80-1 U.S. Tax Cas. (CCH) ¶13,347 (M.D. Fla. 1980); Rev. Rul. 54-121, 1954-1 C.B. 196. Compare Estate of Doughty v. United States, 70-1 U.S. Tax Cas. (CCH) ¶12,651 (C.D. Cal. 1969) (a bequest that was contingent on S not failing to survive distribution of D's estate qualified for the marital deduction because the court interpreted the condition to mean if S shall "fail to survive my death"). And in TAM 9020003 D's will bequeathed residential property to S on the condition that the remainder interest in the property would be distributed to their respective children if S died within five years after D. S's estate would receive the remainder in that property if S lived for more than five years. The estate secured a ruling from a local court that the contingent distribution provision was unclear and therefore void because this survivorship provision exceeded the permissible six month survivorship contingency under §2056(b)(3). The government ruled that the contingency created an impermissible terminable interest and that the state court order was not binding on the government, which was not a party to the local court determination. The TAM also ruled that a state statute that would reduce time contingencies to six months if necessary to qualify a bequest for the marital deduction was inapplicable because the bequest made no reference to the marital deduction as required by the statute, citing *Heim* and noting that the local court did not rely on the state statute in its attempt to salvage the marital deduction. Note that no mention was made about a QTIP election being available for this bequest; presumably it would have qualified for the marital deduction if an election had been made because S was entitled to a life estate in all events.

122 104 T.C. 652 (1995).

nothing in D's will mentioned the martial deduction. The marital deduction was allowed nevertheless, for approximately 90% of the residue that consisted of real estate that passed to S, because state law provided that title to realty vested at D's death and because "distribution" in the document was deemed to refer to when actual distribution was deemed to occur rather than when any order approving distribution was entered in the probate process. Because actual distribution was deemed to occur at D's death,[123] and because marital deduction qualification is determined by rights determined as of D's death, the court held that S's right to the real estate was not a nondeductible terminable interest.

With respect to personalty includible in the residuary estate that in fact passed to S, however, the marital deduction was denied, notwithstanding that it too would be includible in S's gross estate at death (meaning that the government would not lose revenue if the marital deduction was allowed) and notwithstanding that S was personal representative of the estate and, in that capacity, controlled when S would receive the property (an issue that apparently never was raised by the taxpayer).

In contradistinction, in TAM 8809003 S was required to "survive ... for a sufficient length of time to receive [distribution of the marital] bequest." The government permitted the deduction because S was named as independent personal representative and local law permitted administration and distribution without court intervention, entirely in the personal representative's discretion.[124]

Section 2056(b)(3)(A) also allows a marital deduction for a bequest subject to a survivorship condition that provides that S not die "as a result of a common disaster resulting in the death of the decedent and the surviving spouse," unless death actually occurs. Nevertheless, knowledgeable drafters do not use common disaster provisions because the regulation[125] disallows the marital deduction if, at final audit of D's return, it is not certain that S will not die as a result of injuries suffered in such a disaster. Virtually all deaths suffered by spouses in close proximity will occur within 180 days of each other, making a 180-day survivorship provision easier and safer to use.[126]

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123 Subject only to recall to pay debts, family allowances, and administration costs, which is true of any property includible in a decedent's probate estate and distributed prior to closing of the estate.

124 To the contrary is TAM 8516011, in which S was required to be alive when the will was admitted to probate and S was the personal representative; S died before the will was admitted to probate, the marital gift was defeated, and no deduction was allowed, notwithstanding the estate's argument that S had what amounted to a general power of appointment through the ability to probate the will before dying.

125 Treas. Reg. §20.2056(b)-3(c).

126 The wisdom of using a survivorship provision of some sort is discussed in §13.2.4.

§13.5 FORMS OF DISPOSITIONS

§13.5.1 Special Dispositions that Qualify

Before investigating the complex rules that relate to sophisticated forms of disposition meeting the nondeductible terminable interest rule under the special exceptions of §§2056(b)(5) through 2056(b)(8), it is worth stating the obvious. Under §2056(c), outright dispositions to S of nonterminable assets qualify for the marital deduction whether passing by will, intestate succession, dower or curtesy (or statutory substitute therefor), right of survivorship, the exercise or nonexercise of a general power of appointment, as life insurance, or a retirement benefit paid in a lump sum. Moreover, outright transfers have the advantage of simplicity. Generally they are easy to draft[1] and easy for the client to understand.

Notwithstanding unsubstantiated claims sometimes made to the contrary, the most important factor to consider is that empirical research confirms that clients prefer outright dispositions.[2] The consistency of response is dramatic, when asked which form of disposition clients most frequently choose (outright bequest or a transfer in one of the three most common types of trust that qualify for the marital deduction). Over two-thirds of all respondents select the outright bequest as the first choice for a husband's plan and three-fourths make the same response when drafting the wife's,[3] in each case assuming neither spouse has children by a former marriage. These percentages drop as the size of the estate grows and with older clients, although almost 40% still opted for the outright bequest

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1 **§13.5** One item of potential complexity relates to the state law right to receive income on a marital bequest not in trust for the period of probate administration. Under Uniform Principal and Income Act §201(3) (1997), 7A U.L.A. 471 (2006) and §5(b)(2) before it (1962), 7A U.L.A. 570 (2006), the payment of *income* on a bequest *not in trust* is not addressed by the Act, which instead defers to the state law that applies to estates. Unless state law or the document provides for the payment of *interest* instead of income, it is conceivable that the government would insist on a reduction in the value of that bequest for marital deduction purposes, under Treas. Reg. §20.2056(b)-4(a). See §§13.4.2.3.3 nn.67 – 71 and §13.5.2.2.3 n.53 and accompanying text in each case. Some state statutes that address these issues with respect to estate distributions will not apply if the outright marital bequest is from a funded inter vivos revocable trust that was used to avoid probate.

Also consider whether state law abatement rules would protect the marital bequest if assets of the estate are inadequate to satisfy all estate obligations. It may be wise to specify that a formula pecuniary bequest should take abatement priority over other nondeductible bequests if protection of the marital deduction is paramount.

2 See Quilliam, How Leading Texas Probate Lawyers Are Handling Marital Deduction Problems (An Empirical Study), Advanced Estate Planning & Probate Course (State Bar of Texas) 1987 (survey of Texas estate planners with strong Texas and "national" reputations on their marital deduction planning practices); cf. Moore & Pennell, Practicing What We Preach: Esoteric or Essential?, 27 U. Miami Inst. Est. Plan. ¶1217 (1993) (survey of University of Miami Estate Planning Institute registrants revealing that, on a frequency of "sometimes" or more often, 60% of the respondents' clients give their surviving spouse inter vivos control over marital deduction assets, although this control may not be in the form of an outright bequest).

3 It is not likely that this sex based disparity can be explained by asset ownership patterns, because the survey was among community property lawyers whose married clients owned predominantly community property. The most likely single explanation is that all the survey respondents were males, raising the question of the respondents' proper role in determining "client preferences." Quilliam noted that, although the rating criteria called for an indication of the client's preference, "one can hardly doubt that 'attorney preference' plays a major role in the decisions made by the client." Quilliam, however, does not criticize this attorney influence, recognizing that attorneys can apply their experience in "guiding the client ... to an intelligent choice." It is possible that these disparities are less pronounced today, because demographics in the legal profession in general, among estate planners in particular, and among the client base all have evolved.

when the facts assumed the wife is over age 60 when the husband's will is drafted. More than half still selected the outright bequest when the husband is over age 60.

In addition to planned estates, in which outright dispositions are the most popular form of marital transfer, it also is important to note that estate planning "by default" also "favors" outright transfers. For example, the intestate share of a spouse who survives a decedent who dies without a valid will qualifies for the marital deduction, as does the statutory forced heir share of a surviving spouse who elects against D's estate plan.[4]

An outright marital of D's entire estate likely is the preference of many clients, coupled with a §2010(c)(5)(A) election to allocate the DSUE amount to S. Arguments about the advantages of a credit shelter plan notwithstanding,[5] portability is a difficult alternative to reject in favor of a more complex plan.

§13.5.2 Marital Deduction Power of Appointment Trust

The principal original exception to the nondeductible terminable interest rule adopted in 1948 is §2056(b)(5). It permits the use of a trust that gives S a life income interest, provided that S also is granted a distinctive form of general power of appointment.

Some clients prefer not to leave property outright to their surviving spouse out of a concern for a spouse's ability to manage assets, or for S's age and possible subsequent incapacity, or to resist predators such as greedy children, persistent charities, creditors, or hopeful suitors (the often-feared "gigolo" or "gold-digger" factor). Before the §2056(b)(7) QTIP trust was introduced in 1981, power of appointment trusts (sometimes referred to as §2056(b)(5) trusts or, more simply, as (b)(5) trusts) were the most widely used means of securing the marital deduction by way of a trust disposition.[6]

To qualify for the marital deduction under §2056(b)(5), a trust must provide that:

(1) All trust income must be payable to S at least annually for life.

(2) The trust must grant S an all-events general power of appointment by which S can appoint trust property to S or to his or her estate.

(3) No other person can be a beneficiary of the trust during S's overlife.[7]

A power in the trustee to distribute property to anyone other than S (for example, descendants, in case of need) would disqualify the trust,[8] although the trustee can be given a discretionary power to

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4 Treas. Reg. §20.2056(c)-2(c).

5 See §13.1.1.

6 A similar but seldom used form of disposition involving insurance proceeds held in a trust – like settlement is authorized under §2056(b)(6). See §13.5.4 for a discussion of its requirements, which are similar to the §2056(b)(5) requisites.

7 See §13.5.6.1.4.

8 See Estate of Weisberger v. Commissioner, 29 T.C. 217 (1957) (a trust was disqualified even though the likelihood of distributions to children based on need was remote). Cf. §2056(b)(7) authorities that predict the same result under §2056(b)(5): Treas. Reg. §20.2056(b)-7(h) Example 4 (a trust was disqualified because the trustee could distribute up to $5,000 annually for the support of D's daughter); TAM 8508002 (a trust that provided for payment of income to S for life, payment of an annuity to D's sister if the sister was widowed, and

distribute trust property to S that S might thereafter transfer to third parties, and S can be given an inter vivos power to appoint the trust property to third parties.[9]

> *Example:* The trustee of a §2056(b)(5) trust is directed to distribute trust corpus to D's children as S directs from time to time.

This provision is permissible in a §2056(b)(5) trust because distributions directed by S are treated as distributed to S first, followed by a gift by S to the children.[10]

State law governing administration of the trust is controlling in determining whether these requirements are met.[11] For example, silence as to the frequency of income payment will not prevent qualification unless applicable local law permits payment to be made less frequently than annually. Thus, a qualifying §2056(b)(5) trust could be drafted as simply as:

> The trustee shall pay the trust income to S in convenient installments at least annually, for life. On the death of S the trustee shall distribute the trust estate, including any accrued but undistributed income, to such persons, including S's estate, as S may appoint by will. To the extent this power is not effectively exercised, on the death of S the trustee shall distribute the balance of the trust estate per stirpes to my then living descendants.

Unlike the §2056(b)(7) trust, which requires an election by D's personal representative to qualify for the marital deduction,[12] a §2056(b)(5) trust with the proper provisions automatically qualifies for the deduction. This is not necessarily a good thing, because the QTIP allows for postmortem planning that reduces the amount includible in S's gross estate. The automatic qualification of a §2056(b)(5) trust does not permit such postmortem engineering (short of a disclaimer by S).

The rationale behind the three essential §2056(b)(5) qualification requirements (the right to receive all trust income at least annually, general power of appointment, and restriction on the trustee's power to distribute corpus to other persons) can be explained in terms of their tax results. Except for capital gains (and rare forms of other income that is allocable to corpus for fiduciary accounting purposes), which may not be taxable currently to S, the income tax and estate tax consequences of a §2056(b)(5) trust are the same as if the marital deduction amount had been bequeathed outright to S. All of the trust's fiduciary accounting income will be taxed to S currently

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gave the trustee discretion to pay taxes and administration expenses out of corpus did not qualify for the marital deduction); TAMs 9147065 and 9139001 (a "sweetheart" price to purchase closely held stock and a requirement that a child must consent to any sale violated the sole benefit requirement); Estate of Rinaldi v. United States, 97-2 U.S. Tax Cas. (CCH) ¶60,281 (Ct. Fed. Cl. 1997), aff'd, 98-2 U.S. Tax Cas. (CCH) ¶60,322 (Fed. Cir. 1998) (most likely the case involved in TAM 9139001). See §§7.1.6.6 (regarding disclaimers by fiduciaries in general as being ineffective), 13.5.2.2 n.32 (relating to §2056(b)(7) trusts that may distribute income to third parties), and 13.5.6.1.4 n.118 (relating to §2056(b)(7) trusts that may distribute corpus to third parties), and accompanying text in each case.

9 See Rev. Rul. 72-154, 1972-1 C.B. 310. This is an important advantage of a (b)(5) trust over a QTIP. See §13.5.6.1.4.

10 This logic ought to permit the same treatment in a QTIP but, as noted in §13.5.6.1.4, this effectively amounts to a nongeneral inter vivos power of appointment and would disqualify a §2056(b)(7) QTIP trust.

11 Treas. Reg. §20.2056(b)-5(e). The determination of applicable local law is governed by principles established in Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). See Verbit, State Court Decisions in Federal Transfer Tax Litigation: Bosch Revisited, 23 Real Prop., Prob. & Trust J. 407 (1988).

12 §2056(b)(7)(B)(i)(III) and (b)(7)(B)(v)]. See §13.5.6.3.

and, because of the general power of appointment, the trust corpus will be includible in S's gross estate at death (or subjected to §2514 gift tax to the extent S exercises or releases the power during life).

In addition, taxation of all the trust corpus to S is guaranteed by precluding distributions to third parties. The sole benefit requirement also may be understood as an adjunct to the requirement that S be entitled to all trust income for life, because corpus distributions to third parties diminish trust corpus that generates S's income entitlement. Thus, it may be correct to consider the sole benefit requirement as founded in a concern that trust corpus not avoid wealth transfer tax in S's hands, which Congress may have thought possible if trust distributions were made by the trustee directly to third parties.[13]

§13.5.2.1 General Power of Appointment

Not just any general power of appointment will suffice for §2056(b)(5) trust qualification purposes. A "general power" for §2041 purposes could be one that is exercisable in favor of S, his or her estate, or creditors of either.[14] However, the power required for §2056(b)(5) trust qualification must be exercisable in favor of either S or his or her estate. The creditor-type power alone would cause §2041 estate tax inclusion but would not qualify for the deduction under §2056(b)(5). Thus, although any other permissible appointees are allowable, exercise in favor of S or his or her estate must be authorized by the power. And care is required to avoid the likely disaster of causing inclusion to S without qualifying for a marital deduction in D's estate.

The §2056(b)(5) requirement that the general power of appointment be exercisable by S "alone and in all events" means that there can be no substantive restrictions on the grant of the power or conditions on the power's exercise. An inter vivos general power exercisable only after (or until) a certain date,[15] or only if a certain contingency does (or does not) occur, will not qualify. Nor will one that requires another party's consent to exercise.[16] Probably the most common form of disqualifying

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13 But see TAM 8943005 (notwithstanding the same prohibition in §2056(b)(7)(B)(ii)(II), the marital deduction was allowed despite S's inter vivos general power to appoint $5,000 or 5% of trust corpus annually; the government's rationale was that exercise of this general power would generate gift tax to S and guarantee wealth transfer taxation of distributed property to S).

14 See §12.1 at text accompanying n.1.

15 Rev. Rul. 76-446, 1976-2 C.B. 295, involved an unusual application of this rule, because any exercise of the power would not be reflected until two years after S's death, during which time income would be accumulated; that delay was not authorized by Treas. Reg. §20.2056(b)-5(g)(4) and it disqualified the trust.

16 Treas. Reg. §§20.2056(b)-5(g)(3) and 20.2056(b)-5(g)(4); Estate of Draper v. Commissioner, 55 T.C.M. (CCH) 797 (1988) (inter vivos power to distribute principal for various needs was not exercisable alone and in all events because S held it as a cotrustee; the standard used also might have been regarded as ascertainable ("comfort and enjoyment" being the questionable terms), which would have made the power nongeneral); Rev. Rul. 82-156, 1982-2 C.B. 216, and PLR 9047051 (S's powers were not exercisable alone and in all events because in each case the consent of remainder beneficiaries or the trustee was required; if the trustee was not an adverse party the power that failed for marital deduction purposes nevertheless would be a §2041 general power of appointment, meaning that S would have inclusion at death with no marital deduction in D's estate, and only any available §2013 credit to ameliorate the double tax consequence of that worst-case scenario); TAM 8924003 (S's power was exercisable only if D's executor did not make the QTIP election); TAM 8952002 and Estate of Adams v. Commissioner, 60 T.C.M. (CCH) 1324 (1990) (S's power was deemed not exercisable alone and in all events because children had a right to purchase the contents of a family home at a reasonable price if S ever disposed of them; thus, S's power of sale was deemed subject to partial control by any child); Winkle v. United States, 381 F. Supp. 536 (S.D. Ohio 1974) (a bequest to S, conditioned on disposition to D's grandchildren, was deemed to

limitation on a general power of appointment terminates the power (or S's entire trust interest) if S remarries.[17] A related disqualification would occur if any one or any thing other than S could divest S's power, such as in the event of incompetence.[18]

The regulations do permit conditions on the form of instrument that may be used to exercise the power. Thus, for example, a qualifying trust may specify that an inter vivos power must be exercised by a written instrument delivered to the trustee during S's life, or that a testamentary power may be exercised only by specific reference to it in S's will.[19]

Although general *testamentary* powers were more common in the past, inter vivos general powers in the form of *withdrawal* rights are more common among those choosing the §2056(b)(5) trust approach today, particularly as a permissible method to permit S to make inter vivos transfers.[20] As a drafting matter, it is less dangerous to also give S a general testamentary power of appointment that is expressly exercisable in favor of "such persons, including S's estate,[21] as S appoints by will," because reliance on an inter vivos general power alone to satisfy the all-events requirement is risky if it may be determined that the power's exercise is subject to restrictions.

For example, in Estate of Foster v. Commissioner[22] D's will provided a legal life estate to S, "with the right to use so much of the principal thereof for her needs and the needs of my children as she in her sole discretion may deem necessary." Notwithstanding the broad discretion given to S, the court disallowed the marital deduction, holding that this was not an all-events general power because, under controlling local law, exercise of the power in satisfaction of S's needs was subject to a good

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entail a power of disposition that was not exercisable in all events and the bequest failed to qualify for the marital deduction).

The all-events test was satisfied in TAM 9030001 (S could revoke or amend the trust and require distribution of trust income and principal to S during S's life), and in Estate of Davis v. Commissioner, 86 T.C. 1156 (1986) (any inequitable exercise of the general power of appointment among D's children would be balanced by compensating distributions from a nonmarital trust, which did not restrict S's power or negate marital deduction qualification).

17 For an odd application of this see Estate of Johnson v. Commissioner, 36 T.C.M. (CCH) 539 (1977) (an otherwise qualified general power was deemed to fail because it precluded exercise in favor of any surviving spouse of S, which was construed to preclude exercise to S's estate and therefore fell short as a §2056(b)(5) general power).

18 See Estate of Tingley v. Commissioner, 22 T.C. 402 (1954). And see §13.5.2.1 nn.25 – 26 and accompanying text.

19 Treas. Reg. §20.2056(b)-5(g)(4). This is a wise requirement to avoid inadvertent exercise, as discussed in §12.4.4.

20 An inter vivos power may alter certain elements of the trust, notably §678 pseudo grantor trust income tax exposure on capital gains allocable to corpus (see §5.11.7 n.154 and accompanying text) and exposure to creditor claims (see §12.4.3.2 n.26 and accompanying text). Perpetuities differences also might be relevant (see §11.2 nn.20 – 22 and accompanying text), although it is unlikely that perpetuities concerns are at the forefront of such a planning decision. See Chapter 6 regarding the advantages of making inter vivos transfers in general, and §13.2.2 regarding the benefits in marital planning in particular.

21 Adding the specificity of "including S's estate" is wise because there is case law that would regard "such person or persons" as being restricted and nongeneral. See, e.g., Estate of Allen v. Commissioner, 29 T.C. 465 (1957); Rev. Rul. 76-502, 1976-2 C.B. 273. Cf. Bryan v. United States, 406 A.2d 423 (Md. Ct. App. 1979) ("pursuant to a general power of testamentary disposition" was deemed *not* adequate to permit appointment to the powerholder personally or to the powerholder's estate). Contra, Rev. Rul. 74-120, 1974-1 C.B. 282 (applying New York statutory law, a power to appoint to "the person or persons" S designated was a general power of appointment for §2056 purposes). See also §12.1 n.5 and accompanying text.

22 725 F.2d 201 (2d Cir. 1984).

faith standard.[23] The marital deduction would have been allowed if, in addition to the inter vivos power, the will had granted S a general testamentary power.

If D had died after 1981, the marital deduction in *Foster* also could have been salvaged notwithstanding the defective power of appointment – because the disposition provided for the payment of all income annually to S for life, meaning that a §2056(b)(7) QTIP election would have been available (although notice that, had the power permitted distribution to the children directly, this test would have failed on all accounts).[24]

In TAMs 9514002 and 9511002 each trustee only had the power to distribute income and principal if S was incapacitated but S had the power, exercisable alone and in all events, to withdraw either income or principal, which power did not lapse upon incapacity. Citing Rev. Rul. 75-350,[25] the government held that this power of withdrawal was adequate to meet the all-income-annually requirement. It also confirmed that the requisite general power of appointment in a §2056(b)(5) marital deduction trust can be granted in the form of a power to withdraw or revoke the trust. Further, the potential for incapacity will not preclude marital deduction qualification if the document itself does not impose a limitation on exercise.[26]

§13.5.2.2 All Income Annually

S must be entitled to distribution or a right to withdraw all trust income annually for the trust to qualify as a §2056(b)(5) trust. Because the same requirement is applicable to QTIP trusts as well,[27] this requirement is the single most significant aspect of marital deduction qualification for estate plans that do not pass the marital deduction bequest outright to S.

As with the general power of appointment requirement, qualification for this exception to the nondeductible terminable interest rule can be thwarted by unauthorized conditions or restrictions on the income interest. The most common is an income interest that terminates on remarriage.[28] Also

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[23] See also Estate of Raisler v. Commissioner, 54 T.C.M. (CCH) 1390 (1987) (a trust provision requiring the trustee to distribute to S such corpus as S may require "for living purposes," with S to "be the sole judge as to whatever additional sums" were appropriate, was not a general power of appointment under state law). But see Estate of Smith v. Commissioner, 79 T.C. 974, 976 (1982) (qualification because the trust provided that S was to "have the entire principal ... available to him without limitations of any kind," which the court construed to constitute the requisite general power of appointment because S could compel distributions under state law); TAM 8840001.

[24] See §§13.5.6.1.3 and 13.5.6.1.4.

[25] 1975-2 C.B. 367.

[26] See Rev. Rul. 55-518, 1955-2 C.B. 384; TAM 8141005; PLR 6603179620A; and see §12.3 n.7 and accompanying text.

[27] Treas. Reg. §20.2056(b)-7(d)(2) provides that the "principles of §20.2056(b)-5(f), relating to whether S is entitled for life to all of the income from the entire interest, apply ..." to the income requirements for QTIP trusts. See, e.g., TAM 9040001 (holding that S's right to occupy a residence for life, coupled with the right to receive 50% of any sale proceeds, is a right to the lifetime enjoyment of 50% of the property interest represented by the residence and, thus, is a qualifying income interest with respect to 50% of the residence's value).

[28] See, e.g., Estate of Urge v. Commissioner, 31 T.C.M. (CCH) 275 (1972) (involving a life estate in realty, not in trust, that would terminate on remarriage; the marital deduction was disallowed).
This quintessential nondeductible terminable interest problem may exist without the taxpayer even knowing it. For example, under the law of Tennessee, an inter vivos transfer in trust for the benefit of a spouse is revoked if the donor and the spouse later terminate their marriage. Thus, an inter vivos trust that otherwise could qualify for the marital deduction was denied the deduction in TAM 9127005, the government advising that no reformation

encountered are improper interests for a term of years (even if S's life expectancy is shorter than the specified term)[29] and provisions in favor of third parties that might apply during S's overlife (for example, distribution of a percentage of the trust corpus when a child reaches a specified age).[30]

Qualified §2518 disclaimers executed by all income beneficiaries other than S (including unascertained and unborn beneficiaries) might cure some defects, enabling the trust to qualify. For example, in TAM 9003007 D's will created a trust to pay income to S in the trustees' discretion "as they, in their discretion, deem appropriate," with the balance of the income to be distributed to descendants per stirpes. Because these nonspouse beneficiaries' entitlements would preclude a marital deduction for the trust, D's adult children disclaimed their income entitlement under §2518 and a guardian ad litem made the same disclaimer for minors and unborn or unascertainable

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of the trust was available to salvage the deduction. Although the statute did not apply if the trust specified otherwise, the TAM stated that a general intent to qualify for the marital deduction was not adequate to specify otherwise and overcome this result. But see Nye v. Robertson, 859 N.E.2d 772 (Ind. App. Ct. 2007), and Estate of Guidotti, 109 Cal. Rptr. 2d 674 (Cal. Ct. App. 2001), which purported to invalidate remarriage contingencies on the ground that they violated public policy as an illegal restraint on marriage. *Nye* was a legitimate dispute between S and a child by a former marriage but *Guidotti* was a clear attempt to qualify for the marital deduction. The state court order may not be correct for state law purposes, and it may not be effective for FET purposes either (but that was not resolved).

Also consider the limited reformation authority cited in §13.5.6.4.3 n.218. See also TAM 9140004 (a devise of a residence to S for as long as S lives there and does not remarry is not a qualifying income interest for life); PLR 9340018 (the marital interest terminated on remarriage). Cf. Eckel v. United States, 259 F. Supp. 184 (S.D. N.Y. 1966) (termination of an income interest in trust upon marriage resulted in distribution of half the corpus to S and the other half elsewhere; the marital deduction was denied in its entirety because the power to remarry was deemed not the equivalent of a general power of appointment; presumably the income interest in the half that passed to S was a nondeductible terminable interest because of the income requirement and not because of a power or appointment issue, because no one other than S would receive the corpus in that half following termination); had these interests been terminable only on S's death they would have been eligible for the marital deduction if D's personal representative elected to qualify them as §2056(b)(7) QTIP dispositions.

29 See Treas. Reg. §20.2056(b)-7(d)(3).

30 See, e.g., Davis v. Commissioner, 394 F.3d 1294 (9th Cir. 2005) (the flaw was making income discretionary only, "for the health, education, or support, maintenance, comfort and welfare of [S] in accordance with [S's] accustomed manner of living," which is not the degree of unfettered entitlement required); TAMs 200505022 (giving S a power to withdraw income "in such amounts and at such times as [S], in her sole discretion but in consultation with the Trustee, shall desire for her maintenance, education, health or support commensurate with her station in life," which was deemed to be an impermissible limitation on S's ability to access the income; the withdrawal right would have been sufficient had it not been limited by the standard involved and was exercisable by S alone and in all events; the "consultation" provision was questionable, the government saying any income was subject to the trustee's approval, which is not so clear), 8913003 (involving a QTIP trust), and 8740003 (trustee discretion to accumulate income); Estate of Doherty v. Commissioner, 95 T.C. 446 (1990) (the trustee could accumulate income and the court rejected the argument that, because S was the trustee, S would pay all the trust income to S, because the possibility that a successor trustee might dispose of the income differently precluded a qualifying income interest).

But see Estate of Ellingson v. Commissioner, 964 F.2d 959 (9th Cir. 1992), rev'g 96 T.C. 760 (1991) (income payable to S from a QTIP trust was subject to accumulation to the extent it exceeded the amount the trustee deemed necessary for S's "needs, best interests and welfare"; although S was a cotrustee, control in that capacity over trust income was terminable with S's incapacity or resignation), in which the court allowed the marital deduction because "[t]he Commissioner's reading of the Trust Agreement causes the agreement to self-destruct in defiance of the settlor's obvious intent." Loss of the marital deduction would have generated taxes that would have necessitated liquidation of the principal trust asset (a family farm), which would not have been in the "best interests" of S as that standard was used in the accumulation provision itself. Thus, the accumulation provision was deemed not applicable in a manner that would disqualify the trust for marital deduction purposes.

beneficiaries. Although the trust still did not expressly require the distribution of all income to S annually, the government nevertheless allowed the marital deduction because, without descendants entitled to income, it was assumed that income had to be paid to S because the trust did not anticipate accumulations.[31]

That result was a generous, nonliteral interpretation of the will and the disclaimers and reveals that, in the marital deduction arena, the government generally is generous in its interpretation of documents. The government is not always as generous, however, in allowing disclaimers.[32]

§13.5.2.2.1 Administrative Provisions

Caution must be exercised to ensure that the trust's administrative provisions do not give the trustee any power that unduly restricts S's right to income. Treasury Regulation §20.2056(b)-5(f)(1) provides:

> [S] is "entitled for life to all of the income" ... if the effect of the trust is to give [S] substantially that degree of beneficial enjoyment of the trust property ... which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Such

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31 Accord, Estate of Lassiter v. Commissioner, 80 T.C.M. (CCH) 541 (2000) (apparently the same case as TAM 9818005, in which disclaimers did not convert S's discretionary income interest into a mandatory income entitlement, but it was not clear whether the trust anticipated that income in excess of S's needs could be accumulated and a state law enacted to qualify defective trusts for the marital deduction was deemed to require payment of all income to S; the court also found that income had to be distributed to S by default – literally because there were no other beneficiaries to whom income *could* be distributed during S's overlife). Cf. PLR 200222024, in which the *Lassiter* approach was successful with respect to one trust but not another, the nonqualifying situation involving a court order and beneficiary action that the government rejected because S was not an income beneficiary of any degree, so there was no way to upgrade a discretionary entitlement to a guarantee of all income annually by dropping other beneficiaries out; there was no legitimate way to add S as a beneficiary of the second trust.

32 Compare Cleaveland v. United States, 88-1 U.S. Tax Cas. (CCH) ¶13,766 (C.D. Ill. 1988) (marital deduction allowed after the trustee disclaimed its power to utilize the income and principal of the trust for children's education; copies of that disclaimer were served upon the children, whose failure to object estopped them from claiming an interest in the trust), PLRs 8815038 (the marital deduction was allowed after beneficiaries other than S disclaimed disqualifying trustee authority to distribute income and principal) and 8810080 (the trustees had the power to determine income in their sole and absolute discretion, which they renounced with the advice and consent of the trust beneficiaries, all as represented to be permitted under state law; the government held that this gave S an income interest that qualified for the QTIP marital deduction), and TAM 9003007 and PLRs 9119047, 9010068, and 8906036 (descendants were permitted to disclaim prohibited income interests to permit a QTIP marital deduction), with Estate of Bennett v. Commissioner, 100 T.C. 42 (1993) (rejecting the trustees' efforts to renounce powers to make distributions of income and principal to beneficiaries other than S, and deeming ineffective disclaimers by those beneficiaries of their rights to receive distributions because they were not timely under state law; no argument was made that the beneficiaries' attempted disclaimers constituted their ratification of the trustees' renunciation of powers that might validate the trustees' action and generate the marital deduction), and TAMs 9818005 (an effort to qualify a pre-1982 trust failed because the trustees could not bind the beneficiaries and had no power to relinquish prohibited powers), 8729002 (S as trustee renounced a power to distribute corpus to children; this was ineffective because it would not bind a successor trustee), and PLR 8605004 (similar, because the trustee could not relinquish the power to make distributions to children). Regarding disclaimers that attempt to purge trust interests that otherwise affect the marital deduction see also §§ 13.4.2.3.1 n.44 (involving the passing requirement), 13.5.2 n.8 (relating to §2056(b)(5) power of appointment trusts), and 13.5.6.1.4 n.118 (relating to §2056(b)(7) trusts that may make corpus distributions to third parties), and accompanying text in each case.

> degree of enjoyment is given only if it was [D's] intention, as manifested by the terms of the trust . . . that the trust should produce for [S] . . . such an income, or that [S] should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation. The designation of [S] as sole income beneficiary for life . . . will be sufficient to qualify the trust unless the terms of the trust and the surrounding circumstances considered as a whole evidence an intention to deprive [S] of the requisite degree of enjoyment.

It is immaterial whether the requisite degree of enjoyment is effected by rules specifically stated in the trust instrument or by principal and income rules supplied by state law,[33] provided that the rules for allocation of receipts and expenses between income and principal are considered in relation to the nature and expected productivity of trust assets, the nature and frequency of expected receipts, and any provisions as to changes in the form of investments.[34]

The regulation embraces a relaxed definition of fiduciary accounting income that reflects allocations between income and principal in a fiduciary's discretion in a total return trust investment environment, and the modern shift of beneficial interests from traditional income interests to unitrust entitlements made appropriate by the total return concept. Specific state laws, or trust document authority or directions pursuant to general authority under state law, may call for equitable adjustments between traditional fiduciary accounting income and principal to ensure that income and remainder beneficiaries are treated fairly. Those provisions may not depart fundamentally from traditional income and principal concepts, but the same reasonable reallocations found in §643(b) are permitted. Moreover, these state laws (or state law authorized trust document provisions) may substitute a 3 to 5% (of annual or blended FMV) unitrust entitlement as the functional equivalent of an all-income-distribution mandate.

In addition, Example 1 of Rev. Rul. 69-56[35] specifies that the following powers or directions relating to allocation or apportionment of receipts and expenditures to or between income and principal safely may be conferred on the trustee of a marital deduction trust without reducing or losing the deduction:

(1) to apportion (or not) between successive beneficial interests interest income and expense, rental income and expense, real estate taxes, or other items of periodic income or expense;

(2) to treat ordinary cash dividends as income based on the time when received, regardless of the declaration or record date;

(3) to treat extraordinary cash dividends, stock-on-stock dividends, and capital gains dividends of regulated investment companies as principal;

(4) to charge fiduciary commissions, legal and accounting fees, and similar administration expenses to income or principal; and

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33 See, e.g., PLR 8411049 (trustee discretion over income distributions was deemed to qualify under the all-income-annually requirement because it was determined that the highest court of the relevant state would construe the trust to require distribution of all income to S).

34 Treas. Reg. §20.2056(b)-5(f)(3).

35 1969-1 C.B. 224.

(5) to maintain reasonable reserves for depreciation, depletion, amortization, and obsolescence, and to amortize (or not) premia and discounts with respect to interest-bearing bonds and similar obligations.

The ruling assumed that the exercise of powers such as these may be authorized by state law. It also recognized that there may be no state law authority in some cases, or that state law may deny authority unless the trust specifically bestows such powers. The ruling assumed, however, that the trust instrument contained no provisions directing the fiduciary to favor other trust beneficiaries over S.

The question of which items properly are allocable to fiduciary accounting income – and thus are subject to the all-income-annually requirement – cannot be answered definitively in every case. Thus, reasonable discretion usually may be exercised under state law in determining whether an item of receipt or expenditure properly is credited or charged to income.[36] Nevertheless, local principal and income act requirements should be regarded as the lodestar.

In Example 2 of Rev. Rul. 69-56 the governing instrument granted the fiduciary a general power to determine the manner in which receipts and disbursements will be allocated or apportioned between income and principal. Because a fiduciary's determination must fairly balance the interests of the income beneficiary and the remainder beneficiaries under state law, that power was not deemed to evidence an intention to deprive S of the beneficial enjoyment required by the statute, nor did it result in disallowance or diminution of the marital deduction.

In Example 4 of Rev. Rul. 69-56 the governing instrument conferred administrative powers not pertaining to the allocation or apportionment of receipts and disbursements, such as powers to retain cash without investment for any period of time the fiduciary deemed advisable (for example, it was inadvisable to invest that cash), and to make distributions in cash or in kind (or partly in each) at current values, allocating specific assets to particular distributees and, for these purposes, to make reasonable determinations of current values. These powers also were not deemed to evidence an intent to deprive S of the beneficial enjoyment required by the statute, provided that they were subject to reasonable limitations under applicable state law.

§13.5.2.2.2 Unproductive Property

Some clients may seek to minimize the income payable to S, believing that it may exceed the survivor's needs (as the client views that issue) or wrongly thinking that it is cheaper (for income tax purposes) to accumulate the income for ultimate payment to other beneficiaries (it could not be distributed to others currently without violating the all-income-annually or exclusive benefit requirements).

To avoid conflict in this respect, or efforts to accomplish indirectly what the client could not do directly, inherent in the regulations[37] is a requirement that the trust may not invest in

[36] Treas. Reg. §20.2056(b)-5(f).
[37] Treas. Reg. §20.2056(b)-5(f)(5).

unproductive[38] assets without S's consent.[39] A provision that reflects this requirement might read something like: "Unproductive property shall not be held as an asset of the trust for more than a reasonable time during the lifetime of S without [his/her] written consent." Alternatively, it would suffice to provide that "S shall have the right by written notice to require the trustee to convert unproductive property in the trust to productive property within a reasonable time."[40]

A far less common third alternative is to provide that the fiduciary must distribute sufficient corpus to compensate for inadequate income production,[41] and a fourth variation is to allow S to withdraw corpus to the extent of any deficiency in income production. These alternatives may be preferable in many cases in which the corpus is nonmarketable, making conversion undesirable (and meaning that giving the spouse a portion of the corpus is of slight significance).

The government addressed the unproductive property issue in TAM 8638004, in which D's will authorized the trustee of a marital deduction trust[42] to retain property, notwithstanding that it might not be productive of income. No provision directed the fiduciaries to invest in productive property, nor did the will require S's consent to hold unproductive property. The government nevertheless advised that this trust would qualify for the marital deduction, based on state law that required consideration of probable income in making new investments and the fact that, at the time the question was raised, the estate consisted entirely of productive property.

Rev. Rul. 66-39[43] and TAM 9237009 advised that language that did not restrict the sale of trust assets but instead authorized the trustee to hold uninvested cash (in the Ruling), or assets including over 50% in art "without regard to the laws now or hereafter governing investment by trustees" (in the TAM), did not disqualify otherwise permissible QTIP trusts due to an overriding state law prudent

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38 Unresolved is whether the trust may be invested in significantly *under* productive assets (for example, returning 1% when average investments return 7%). The regulation refers to "property which is not likely to be income producing during the life of S," which may mean that the likelihood of income production at a reasonable rate at any time during S's overlife expectancy prevents disqualification under this regulation.

39 See, e.g., PLR 8931005 (the income requirement was satisfied even though the marital trust was funded solely with stock of D's wholly owned corporation and the nonmarital trust was granted a right of first refusal in the stock, because the trustee must dispose of unproductive or underproductive property at S's request); PLR 9125016 (the income requirement was met even though there was a delay of several years in funding the trust due to the estate's need to sell illiquid real estate, as long as the delay resulted from ordinary and necessary administration of the estate). Another solution to this problem is the estate trust, discussed at §13.5.5.

40 Treas. Reg. §20.2056(b)-5(f)(4). It doesn't happen often, but in Sturgis v. Stinson, 404 S.E.2d 56 (Va. 1991), upon S's motion a state law requirement to convert unproductive property was enforced to require the trustee to sell property (a family farm) that essentially was unproductive (income was $1,266 annually, which was .084% of the farm's $1.5 million FMV). Similarly, In re Van Dusen Marital Trust, 834 N.W.2d 514 (Mn. Ct. App. 2013), enforced a surviving spouse’s right to compel conversion of unproductive property that comprised 16% of the value of a marital deduction trust, notwithstanding the trustee’s argument that a total-portfolio-return approach to investing would look at income and capital appreciation as two legitimate components of prudent investment and, curiously, the court never indicated that it was aware that the unproductive property provision in the trust was a reflection of the tax qualification requirement and the court also never considered whether the trustee’s performance was inadequate in terms of the all-income-annually requirement.

41 See PLR 9418013 (the trustee was directed to distribute corpus to S in an amount equal to the annual interest accruing – but not being paid or distributed to S – on notes with balloon interest payment provisions).

42 The trust involved was a QTIP trust but the ruling should be the same for a §2056(b)(5) trust because the all-income-annually requirement is the same under each provision. See Treas. Reg. §20.2056(b)-7(d)(2).

43 1966-1 C.B. 223.

person investment standard and duty of impartiality requirement.[44] The lack of an unproductive property provision in these documents was not regarded as sufficient to disqualify either trust.[45] Similarly, Hutchens Non-Marital Trust v. Commissioner[46] rejected the government's assertion that authority granted to the trustee evidenced an intent to deprive S of the requisite enjoyment to qualify for the marital deduction, stating that state fiduciary law principles imposed sufficient limits on the trustee's discretion to preclude actions that might disqualify the deduction.

Boilerplate language in D's trust in TAM 9537004 authorized the trustee to retain initial trust investments without regard to any lack of diversification, and to invest without regard to constraints of state law. The TAM rejected the taxpayer's argument that this provision disqualified the trust for marital deduction purposes,[47] stating that it was standard boilerplate that did not evidence an intent to deprive S of the beneficial enjoyment of income as required by the Code. "Although the trustee is granted broad discretion, we doubt that [the trust] intended . . . to excuse the trustee from the broad application of the prudent investor rule or the fiduciary duty of impartiality" imposed by state law. Nor was it regarded as sufficient to excuse the state law duty to exercise reasonable care, good faith, sound judgment, and prudence.[48]

These TAMs probably cannot be read to authorize a marital deduction in situations in which significant unproductive property already exists, the trust or state law fails to require consent of S to

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44 See also Robertson v. Central Jersey Bank & Trust Co., 47 F.3d 1268 (3d Cir. 1995) (the settlor was a director of the trustee, which retained the settlor's investment in the trustee's stock, notwithstanding that it constituted as much as 95% of the trust corpus), which held that the authority in this kind of provision never is absolute, regardless of the extent of the authority and any exoneration provision; authority may enhance the trustee's discretion, but the trustee always must exercise due diligence (a term not defined or applied, the court merely reversing a summary judgment in favor of the trustee).

45 As personal use property the art did not need to produce income, so the TAM may not be a reliable precedent with respect to other types of property that do not offer the implied enjoyment element of value. See text accompanying §13.5.2.2.2 n.50 and accompanying text.

46 66 T.C.M. (CCH) 1599 (1993). To the same effect see Estate of Robinson v. United States, 46 A.F.T.R.2d 6185, 6188 (E.D. Tenn. 1980) (broad investment powers and possession of closely held stock did not suffice to disqualify the marital deduction because "any power granted to the trustees to 'retain' non-income-producing assets is subject to 'applicable rules of administration of the trust [that] require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use ... '."

47 Quaere why – it is not stated why the taxpayer was arguing against the marital deduction.

48 See also TAMs 200339003 and 8745003 (both involving QTIP marital deduction trusts that authorized the trustee to retain non-income-producing assets, to allocate income and principal in its discretion, and one to obtain insurance with trust assets; the marital deduction was allowed because D expressly stated the intention that the trust qualify for the marital deduction and that the instrument be construed in the light of that intention, the later specifying that no other provision would override that intent and the earlier because S, as personal representative of the estate, could control the assets reaching the trust initially and, under controlling Texas law, could prevent the trustee from retaining non productive assets or allocating income to principal or buying life insurance, thereby precluding actions that would deprive S of the required income. Said the earlier: "Based on local law standards governing fiduciaries and the overall intention of the testator as expressed in [the] will, we conclude that the provisions of the trust granting discretionary powers to the trustee do not infringe upon S's entitlement to all the income of the trust"); TAM 8727001 (a trust provision that prohibited sale of farmland without permission of a remainder beneficiary did not disqualify a QTIP marital deduction because the farmland inherently was productive and S could protect the income entitlement by requiring the trustee to use the trust property to generate a reasonable rate of return); TAM 8721001, which directed the trustee to retain low income producing realty as a major portion of the trust but did not disqualify the deduction because, consistent with Treas. Reg. §20.2056(b)-7(h) Example 2, local law allowed S as income beneficiary to require the trustee to use the property to generate a reasonable rate of return.

continue holding those assets, and the trust also fails to give S a power to direct that trust investments be converted into income-producing assets or gives S a right to receive corpus equal to any deficiency in income production.

For example, in TAM 9139001 D's trust precluded the trustee from selling stock in D's closely held corporation and vested voting power over the stock in D's son as long as he was managing the corporation. In addition, if the son was unwilling or unable to continue managing the business, the trustee was directed to offer the stock for sale to the son at its book value, which was only approximately 80% of FMV at D's death. Although the corporation had been reasonably profitable it paid no dividends, and the son's control over the stock allowed him to control the dividends – which gave him the opportunity to continue stockpiling earnings to increase the value of the corporation, thereby making his option to purchase even more valuable. The government advised that the trust could not qualify as a QTIP trust because S was not entitled to income that was adequate and S could not alter this situation, because of the restrictions over sale of the stock. Because of the son's right of first refusal, a power in S to require sale of the stock would not have been adequate to salvage the trust.[49]

The requisite saving clause or boilerplate provision also will not always salvage the deduction, either. For example, D's QTIP marital deduction trust involved in TAM 9717005 contained an unproductive property provision of the type permitted by Treas. Reg. §20.2056(b)-5(f)(4) to prevent disqualification of a marital deduction trust under the all-income-annually requirement. The particular provision involved, however, excluded timber property from the reach of S's power to demand conversion of unproductive property into assets producing a reasonable return, and timberland was nearly 100% of D's estate.

Indeed, it didn't quite hold timberland either. It owned a right to receive timberland that was inherited from a prior decedent in whose estate a §6166 deferral of estate tax payment election was made. During the full period for payment of that tax, D's timber interests were held in a trust that permitted the trustee to use income earned from timber sales to pay the §6166 deferred tax and interest. Thus, D's QTIP marital trust received only an interest in this trust and, by virtue of the unproductive property provision and the terms of the timber trust, there was no guarantee that the QTIP trust would receive any income until the §6166 deferral period for the prior decedent ended. Although it was not certain that the exclusion from the unproductive property provision for timber property would apply

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[49] In a case that almost certainly is the same as that involved in TAM 9139001, the court in Estate of Rinaldi v. United States, 97-2 U.S. Tax Cas. (CCH) ¶60,281 (Ct. Fed. Cl. 1997), upheld the government. To the same effect on similar facts is TAM 9147065, in which for two reasons D's estate could not qualify for the marital deduction to the extent of closely held business stock allocated to a marital deduction trust. First, that stock had a dividend history indicating that it was not productive of income, and it could not be sold without the consent of a child. Second, that stock was subject to a sweetheart purchase right in D's children, allowing them to acquire it for below its FET value and to pay for the stock with a note with a predetermined interest rate. Although the marital trust contained standard language prohibiting retention of unproductive property without S's consent, the provision disallowing sale without the child's consent was deemed to override this prohibition, making the trust fail the all-income-annually requirement. And the sweetheart purchase price gave the children a right to appoint the property to themselves in violation of the exclusive benefit requirement. Moreover, a minimum value for marital deduction qualification could not be ascertained for any stock allocable to the marital trust because the loan provision made it impossible at D's death to determine the FMV of any consideration paid in the form of a note. Thus, "even if the option had specified a strike price that happened to equal FMV on the date of death, the marital deduction would still be disallowed."

to the trust's interest in another trust, which held the timber property, the government nevertheless opined that S's inability to compel sale and reinvestment in income-producing property prevented qualification for the deduction.

On the other hand, a personal residence and other non-income-producing but *personal use* property may be held in a marital deduction trust even though it will not produce income,[50] because personal enjoyment is as valuable to S as is the receipt of income from some other asset. But many other forms of investment may trigger an unproductive property provision, including unimproved land, assets like gold bullion that are held solely for their appreciation potential, stock in a closely held business that has a history of reinvesting earnings instead of declaring dividends, and life insurance.

An investment in insurance (such as a survivor life policy) may not produce income (dividends are a return of excess premiums paid, not a "return" on the investment),[51] and may divert other income to pay premiums. Thus, usually insurance should be avoided in a marital deduction trust of the §2056(b)(5) or §2056(b)(7) all-income-annually variety unless S may require conversion.[52] Furthermore, to avoid diversion of trust income from S, premium payments must be made only from principal.

§13.5.2.2.3 Timing of Payments

In the usual case a marital deduction trust is not established for some time after D's death, pending administration of D's estate. An interest in trust does not fail to satisfy the income payment requisite merely because S is not entitled to income from estate assets for the period before distribution of those assets by the personal representative, unless the delay is authorized or directed by D's will beyond a period reasonably required for administration of the estate.[53]

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50 Treas. Reg. §20.2056(b)-5(f)(4); Treas. Reg. §20.2056(b)-7(h) Example 1. See Petition of Sackler, 564 N.Y.S.2d 977 (Surr. Ct. 1990), in which the court determined that S was entitled to possess and display artwork held in a marital deduction trust if S assumed the cost of insuring and transporting those objects; PLRs 9242006 and 8952024 (notwithstanding its non-income-producing nature, a legal life estate in artwork, not in trust, qualified as QTIP property because it was coupled with a power to sell, lease, encumber, or assign the lifetime interest).

51 See §8.5 n.13 and accompanying text.

52 See, e.g., Halsted v. Commissioner, 28 T.C. 1069 (1957), acq., 1958-2 C.B. 3; Estate of Smith v. Commissioner, 23 T.C. 367 (1954); cf. TAM 7916006 (power to invest in insurance did not disqualify the deduction because of an overriding provision that no power was exercisable to the extent it would impair qualification for the marital deduction).

53 Treas. Reg. §20.2056(b)-5(f)(9), which does not absolve the need ultimately to pay income earned during administration – and it only applies to an interest transferred in trust. See §13.4.2.3.3. The separate share rule provides a less desirable result for payment of interest instead of a share of estate income, so a special provision may be desirable in drafting outright marital bequests to address these concerns.

Rev. Rul. 77-346, 1977-2 C.B. 340, applied the same rule to an inter vivos trust, the division of which into two portions was delayed pending payment of administration expenses in D's probate estate. Because the marital trust in this situation springs into existence upon the settlor's death, however, an accounting of the income from the trust may be necessary, and it may be risky to rely on the regulation to permit allocation of the delayed income to a beneficiary other than S. The same wisdom may also apply to probate administration, especially to an outright bequest to S. See §13.4.2.3.3 nn.67 – 71 and accompanying text.

Income must be payable (or be subject to withdrawal by S) at least annually, in the year earned.[54] It is customary (and usually desirable) to provide that trust income shall be distributed "at least annually," or more frequently. However, no problem is presented if the trust merely states that the trustee shall distribute the trust income to S for life, without a literal statement that the payments must be made at least annually, because the frequency of payment requirement is satisfied unless applicable local law or the trust terms permit payment to be made less frequently than annually.[55] Even if state law is silent on the issue of frequency of payment, general common law principles require that income be paid in "reasonable intervals," such as quarterly or semiannually.[56]

In addition to the frequency of payment issue, accrued but undistributed income at S's death either must be paid to S's estate or be subject to a general testamentary power of appointment in a §2056(b)(5) trust.[57] Under this rule, income in respect of S as a decedent will not avoid estate tax when S dies.

§13.5.2.3 Specific Portion Requirement

The right to all income annually and the general power of appointment in a §2056(b)(5) trust must pertain to the same "specific portion" of the trust. Normally this is not a problem because the typical estate plan that uses a marital deduction trust creates (at a minimum) two trusts. One is a nonmarital trust and the other is a marital deduction trust, with the full marital deduction trust granting both the requisite income interest and, if §2056(b)(5) is relied upon, the all-events general power of appointment. That §2056(b)(5) marital deduction trust typically is designed to fully qualify for the marital deduction. Partial qualification of the estate as a whole for the marital deduction is

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54 Treas. Reg. §20.2056(b)-5(f)(8). See Rev. Rul. 72-283, 1972-1 C.B. 311 (disqualification occurred because the trust directed payment of one year's income the following year, which the government regarded as failing the current distribution requirement).

55 Treas. Reg. §§20.2056(b)-5(e) and 20.2056(b)-7(g), both providing virtually verbatim that:
To determine whether the frequency of payment requirement ... is satisfied where a trust instrument is silent, provisions of local law should be taken into account. Silence of a trust instrument on this issue will not be regarded as a failure to satisfy the condition that the income must be payable to S annually or more frequently, unless applicable local law permits payment to be made less frequently than annually.

See, e.g., TAMs 8724005, 8721001, and 8435002, and PLRs 9148018, 8834009, and 8450018 (permitting QTIP treatment even though no state statute or case decision expressly addressed the issue of frequency of payment of income if the trust is silent; the government noted that nothing in the governing state's laws authorized payment of income less frequently than annually); PLR 9038031 (the QTIP trust met the all-income-annually requirement even though the will was silent on the frequency of income payments; the testator intended payments to be made at least annually); TAM 8705002 (the same result applied to a legal life estate as well as a trust); PLR 8309030 (authority to distribute income monthly or "other convenient installments" did not constitute authority to distribute less frequently than annually). See also Estate of Wilson v. Commissioner, 64 T.C.M. (CCH) 576 (1992) (involving the same requirement in a §2056(b)(5) trust). In some cases state law may expressly provide that distributions of income must be at least as often as annually, in the absence of a provision to the contrary. See, e.g., Fla. Stat. §737.3053.

56 See 3 Scott, Fratcher, & Ascher, Scott & Ascher on Trusts §17.14 (5th ed. 2007); TAM 8951003 (general common law principles were relied on because state law was silent on the issue of frequency of payment); TAM 8715004 (taxpayers secured a state court decree interpreting the document to require at least annual payments, which probably would not have carried the day under the *Bosch* doctrine had the government not independently concluded that state law would so require). See generally, Verbit, State Court Decisions in Federal Transfer Tax Litigation: Bosch Revisited, 23 Real Prop., Prob. & Tr. J. 407 (1988).

57 Cf. Estate of Shelfer v. Commissioner, 103 T.C. 10 (1994), rev'd, 86 F.3d 1045, 96-2 U.S. Tax Cas. (CCH) ¶60,238 (11th Cir. 1996); Estate of Howard v. Commissioner, 91 T.C. 329 (1988), rev'd, 910 F.2d 633 (9th Cir. 1990). As developed in §13.5.6.1.2, a different rule applies for a QTIP marital deduction trust.

effected by making the nonmarital trust contain the portion of the estate as to which the marital deduction is not desired.

Sometimes, however, it is desirable to create only one trust (a "single fund marital" trust) of which only a portion (the "marital portion")[58] qualifies for the deduction through an overlap of the income interest and the general power of appointment. One approach to an intentionally created single fund marital is to grant all income from the entire fund to S and permit appointment pursuant to a general power over that portion as to which the marital deduction is desired. As to this appointable portion the two interests overlap and qualify for the deduction.

> *Example 1:* A trust grants S a right to receive half the income and a power to appoint three-fourths of the corpus at death. The marital deduction will be allowed with respect to half the value of the trust, not just three-eighths (half of three-fourths).[59]

To qualify in this manner as a specific portion for marital deduction purposes the power must be over a fractional or percentage portion of the trust, not a specified dollar amount,[60] which precludes estate freezing of the type illustrated by the following example:

> *Example 2:* D created a trust of $200,000 that pays all the income from $100,000 of trust corpus to S for life and grants S a general testamentary power to appoint $100,000. Before S dies the trust corpus doubles in value.

Because the power of appointment applies only to $100,000, if this approach was permitted the remaining $300,000 would pass tax free at S's death. A trust that complied with the fractional or percentage requirement would grant the income and power of appointment with respect to half of the trust and the amount of income payable to S and the amount of trust corpus includible in S's gross estate would grow proportionately as the trust appreciated (only $200,000 would pass tax free at S's death). Any identifiable portion is sufficient, such as a fraction of which the numerator is the amount of the deduction desired and the denominator is the size of the fund against which the fraction is applied.[61] But some less sophisticated planning also would be permissible.

> *Example 3:* D created a trust that paid all the income to S annually and granted S a general power to appoint one-third of Greenacre and a specified number of shares of stock held as corpus.

Because Greenacre and the stock are identifiable and separable from the balance of the corpus, a marital deduction is allowable for one-third of the value of Greenacre and for the value of the specified number of shares of stock.[62] All appreciation in the stock and one-third of the appreciation in Greenacre would be subject to inclusion in S's gross estate, so no estate freeze would be accomplished. Had the power to appoint extended only to a specified dollar amount, however, changes in the value of the trust or its assets would not be reflected in the includible amount and the

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58 See §13.7.10.
59 Treas. Reg. §20.2056(b)-5(c)(5) Example 2.
60 §2056(b)(10) and Treas. Reg. §20.2056(b)-5(c).
61 As illustrated in §13.7.7.
62 See Treas. Reg. §20.2056(b)-5(d).

abuse the regulation is meant to preclude would be available.[63] That form of specific portion would be invalid.

§13.5.3 Legal Life Estate with General Power of Appointment

The §2056(b)(5) marital deduction is allowable for the full value of property in which S is given a legal life estate not in trust, if coupled with a general power to appoint the property underlying the legal life estate.[64] Many estate planners eschew this approach because of the difficulty of appending a power of appointment to a legal life estate, and because the rights of a surviving spouse as the holder of a legal life estate often are less clear or beneficial under state law than those of an income beneficiary of a trust.[65]

For example, in Estate of Foster v. Commissioner,[66] D transferred a legal life estate in personal property to S with a power in S to use principal for the needs of S and their children. The court determined that the interest transferred did not qualify for the marital deduction because the power of invasion granted to S was limited under state law by a standard of good faith. As a substitute for a general power of appointment in S, that power of consumption did not grant the degree of absolute discretion necessary to permit qualification for the deduction under §2056(b)(5).[67] It may, however, suffice to generate §2041 general power of appointment inclusion in S's gross estate at death, which usually would be the worst possible result: double inclusion and no deduction (with the only potential relief being the §2013 previously taxed property credit).

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63 In Estate of Alexander v. Commissioner, 82 T.C. 34 (1984), the taxpayer created a §2056(b)(5) trust granting S a right to receive all income annually and a general power to appoint a specific dollar amount of corpus at death. The government disallowed the marital deduction, citing Treas. Reg. §20.2056(b)-5(c). Relying on the factually distinguishable Northeastern Pennsylvania Nat'l Bank & Trust Co. v. United States, 387 U.S. 213 (1967) (the element in *Northeastern Penn* that did not comply with the specific portion regulation was S's income entitlement, which was limited to a guaranteed payment of $300 per month; the court permitted a marital deduction for that amount of corpus needed to produce this guaranteed income entitlement), the Tax Court in *Alexander* held the regulation invalid to the extent it disallowed the marital deduction. The court so held notwithstanding its recognition of the tax abuse made possible by its ruling and the fact that *Northeastern Penn* was distinguishable because S possessed a general testamentary power to appoint the full corpus of the trust, meaning that at death there would be no estate freeze and the full amount of the trust would be includible in S's gross estate.

The government served notice that it did not accept *Alexander* by promulgating Treas. Reg. §20.2056(b)-5(c)(5) Example 3 and Congress legislatively overruled both *Alexander* and *Northeastern Penn* by adopting §§2056(b)(10) and 2523(e) (last sentence) and 2523(f)(3) for purposes of §§2056(b)(5), 2056(b)(6), 2056(b)(7)(B)(iv), 2523(e), and 2523(f).

64 Treas. Reg. §20.2056(b)-5(a); Rev. Rul. 77-30, 1977-1 C.B. 291.

65 Drafting an appropriate document enumerating the rights and powers of the life tenant may be more difficult than drafting a traditional trust, in large part because it is not very common and thus may hold more risk of error and require more time. See Casner, Legal Life Estates and Powers of Appointment Coupled with Life Estates and Trusts, 45 Neb. L. Rev. 342 (1966); Schuyler, Drafting Provisions for Legal Life Estates and the Marital Deduction, 44 Ill. B.J. 452 (1956).

66 725 F.2d 201 (2d Cir. 1984).

67 See also Evans v. United States, 719 F.2d 201 (6th Cir. 1983) (involving a legal life estate in personal property, permitting S "use as she so desires," which did not constitute a sufficient unlimited power of appointment to qualify for the §2056(b)(5) exception); Duca v. United States, 236 F. Supp. 747, 750 (D. Md. 1964) (the power to sell and encumber the property during life was not adequate as the requisite general power because state law did not permit use for S's own purposes "in complete disregard of the rights of the remainderman").

In Estate of Hatchett v. Commissioner[68] D's will left S a legal life estate and granted a power permitting S to consume or dispose of the property for S's "comfort, maintenance or convenience." This would have qualified the transfer for the §2056(b)(5) marital deduction if the power was deemed to be exercisable in all events as required.[69] The estate conceded that "comfort and maintenance" were too restrictive to qualify, but no prior case had construed "convenience" in the context of a power to consume or appoint. On the basis of its dictionary definition, the court denied the marital deduction because it concluded that "convenience" was "nearly synonymous" with comfort and did not change the otherwise too restrictive nature of the power to consume or appoint.

Not mentioned by *Hatchett* was the fact that a power to appoint for "comfort" and, presumably, for "convenience" is a general power of appointment not limited by an ascertainable standard.[70] Thus, the life estate property would be includible in S's gross estate, even though it did not qualify for the marital deduction in D's estate. That unfortunate result would have been avoided by proper drafting of the power of appointment, either by making the life estate qualify for the marital deduction (for example, as QTIP or upgrading the power of appointment) or by avoiding classification as a §2041 general power of appointment.

Bone v. United States[71] and PLR 9435014 allowed the marital deduction because state law and the document were regarded as granting S unlimited power to consume the property. But problems with the legal life estate approach are more common, as illustrated by several rulings. For example, TAM 9023004 denied a §2056(b)(5) marital deduction for an interest passing pursuant to joint and mutual wills under which the spouses left their property to each other with a lifetime power to dispose of the property and, on the death of the survivor, remainder to their children. The government reasoned that, despite S's unlimited right to dispose of the property during life, that interest was a conditional or defeasible fee under state law, not a fee simple, and that S did not have a general power to appoint the property. Similarly, TAM 9021002 advised that a lifetime power to use and consume property subject to a legal life estate did not create an unlimited §2056(b)(5) general power of appointment because D intended that there be a remainder after the legal life estate terminated.[72]

Attaching a general power of appointment to a legal life estate probably is not a desirable alternative[73] because a legal life estate can be QTIP elected without more. Moreover, either a QTIP trust or a more traditional trust granting a general power of appointment will provide protection against S's incapacity, provide management of the property, and grant spendthrift protections, all lacking in the legal life estate context, while still avoiding probate in S's estate. Given that S may be

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68 58 T.C.M. (CCH) 801 (1989).

69 Treas. Reg. §§20.2056(b)-5(a)(4), 20.2056(b)-5(g)(3).

70 See Treas. Reg. §20.2041-1(c)(2), considered in §12.3.2.4.

71 238 F. Supp. 97 (W.D. Ark. 1965).

72 See also Estate of McMillan v. Commissioner, 670 F.2d 788 (8th Cir. 1982) (the right to use corpus "to the best of her ability" did not permit divestment of the remainder beneficiaries), and PLRs 7838116 and 7831009 (powers to consume for support or comfort were deemed to be limited under state law).

73 Perhaps these cases were an effort to give S the ability to benefit third parties during S's overlife without giving S that degree of control represented by an all-events inter vivos general power of appointment. Because an inter vivos power to appoint to a third party will preclude a QTIP election (see §13.5.6.1.4) this would have been a viable plan if a general testamentary power of appointment *also* had been granted. But the middle ground – a power that would preclude §2056(b)(7) QTIP and fall short of §2056(b)(5) – is not an adequate alternative.

designated as trustee of such a trust, if desired, it would seem that a client must have a *very* strong aversion to trusts before the legal life estate alternative would be desirable.

§13.5.4 Life Insurance or Annuity Payments with General Power of Appointment

As a virtual clone of §2056(b)(5), §2056(b)(6) allows life insurance proceeds or the proceeds of an endowment or annuity contract to qualify for the marital deduction if the same requirements are met regarding: (1) exclusivity of benefit in S during life; and (2) the all-events, no-restriction general power of appointment.[74] There are, however, differences between §§2056(b)(5) and 2056(b)(6) in the lifetime payment requirement.

If not paid in a lump sum, the three basic insurance policy settlement options are interest options, installment payments, and life annuity options.[75] Under an interest option the proceeds are left with the insurer, which is obligated to pay a guaranteed rate of interest to S as beneficiary.[76] Under an installment option the insurer makes regular payments of principal and interest according to a predetermined schedule until principal is exhausted. The terms of the option also may give S, as beneficiary, a right to take the remaining installment payments at their commuted value at any time. An annuity settlement may provide a periodic guaranteed payment for S with or without refund, or it may provide some form of joint and survivor annuity.[77]

None of these options would fail to qualify for the marital deduction if, after S's death, any remaining installments or principal is payable to S's estate.[78] Otherwise, §2056(b)(6) provides that the proceeds qualify for the marital deduction if the exclusive benefit and general power of appointment requirements found in §2056(b)(5) are met, *plus* the proceeds are held by the insurer subject to an agreement to pay installments or interest solely to S for life, in annual or more frequent distributions beginning no later than 13 months after D's death.[79] The installment or interest requirements are satisfied if, under the terms of the contract, S has the right exercisable annually (or more frequently) to require distribution of installments and otherwise the proceeds or interest are to

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[74] See Moore v. United States, 70-2 U.S. Tax Cas. (CCH) ¶12,715 (N.D. Ohio 1970); Estate of Fiedler v. Commissioner, 67 T.C. 239 (1976); Estate of Jennings v. Commissioner, 39 T.C. 417 (1962).

[75] See Budin, Life Insurance, 826-2d Tax Mgmt. (BNA) Estates, Gifts, and Trusts Port. (2008), for additional discussion. The marital deduction is allowable without more if the proceeds are paid or payable in a lump sum and S elects to leave them with the insurance company under an alternate option. See, e.g., Puchner v. United States, 274 F. Supp. 704 (E.D. Wis. 1967) (proceeds were turned over to the insurer in compliance with a prenuptial agreement between S and D, which might raise §2056(b)(4) issues that were not addressed).

[76] Compare Estate of Jennings v. Commissioner, 39 T.C. 417 (1962), and Estate of Cornwell v. Commissioner, 37 T.C. 688 (1962), acq. to both, 1964-2 C.B. 3, with Estate of Werbe v. United States, 178 F. Supp. 704 (S.D. Ind. 1958), reflecting the current litigated conclusion that payment under the withdrawal right – a version of general power of appointment – incident to an interest option may be subject to certain conditions that will not disqualify the deduction, including that withdrawals could be deferred until proof of death is provided and notice is given of the intent to make a withdrawal, and withdrawals could be made only on certain dates and only in multiples of specified amounts).

[77] See Rev. Rul. 77-130, 1977-1 C.B. 289, regarding the valuation of the marital deduction for annuity payments under a policy that also paid an annuity to a child, with a determination as if two separate policies were being settled.

[78] Treas. Reg. §20.2056(c)-2(b)(3)(iii).

[79] An agreement will satisfy these conditions if it permits S to select among settlement options, one or more of which qualifies under §2056(b)(6). See Estate of Fiedler v. Commissioner, 67 T.C. 239 (1977), acq., 1977-2 C.B. 1.

be accumulated and held by the insurer pursuant to the terms of the contract. Moreover, a contract will not be disqualified merely because S must comply with certain formalities to obtain the first payment (for example, furnishing proof of the insured's death).[80]

§13.5.5 Estate Trusts

A marital deduction "estate trust" is the only form of trust qualifying for the marital deduction under §2056 that does not require annual payment of all trust income to S for life. Instead, the estate trust can provide for the discretionary payment of income to S or its total accumulation, because the remainder passes to S's estate at death.[81] If properly drafted, the estate trust avoids the nondeductible terminable interest rules of §2056(b) entirely, because nothing passes to a third party after S's death. Instead, all accumulated income, along with principal, is distributed to S's estate at death (hence the name of the trust).[82] As a result, this is not a nondeductible terminable interest at all, and therefore need not qualify for any exception to §2056(b)(1).

The principal characteristic of an estate trust must be considered carefully in evaluating its advantages. Like an outright marital bequest, this approach gives S control of the property at death, which makes it subject to predators as well as to S's caprice. Nevertheless, there are several reasons to employ an estate trust in lieu of an outright distribution or one of the other forms of qualified marital deduction trust:

The estate trust allows accumulations of income not needed by S during his or her overlife, which can avoid the need to distribute and then manage any money that is beyond S's needs or capabilities.

Because S need not receive all income annually, there is no danger in an estate trust if assets are underproductive of income. Recall that, if the corpus of either a §2056(b)(5) trust or a QTIP trust includes unproductive property (for example, raw land or closely held stock), S must be given one of the four options noted in §13.4.2.2.2 at text accompanying nn. 36 – 38.[83] D may not want to grant S any of those alternatives.

A perceived advantage of accumulating income in an estate trust to be taxed at the trust's rates was sharply undercut when the income tax bracket thresholds applicable to trusts were

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80 Treas. Reg. §20.2056(b)-6(d). The proceeds will *not* qualify for the deduction if payments to S are conditioned on being alive when the insurer receives the proof of D's death, unless they are payable to S's estate if S predeceases payment. Rev. Rul. 54-121, 1954-1 C.B. 196.

81 See Treas. Reg. §20.2056(c)-2(b)(1)(iii); Commissioner v. Ellis, 252 F.2d 109 (3d Cir. 1958) (an all-income entitlement that lacked a general power of appointment still qualified to the extent the remainder was payable to S's estate); Rev. Rul. 72-333, 1972-2 C.B. 530; Rev. Rul. 68-554, 1968-2 C.B. 412; TAM 9109003. PLR 9634020 allowed the marital deduction for a trust paying $2,500 per month for 10 years to S and then distributed to S. The trust was deemed to be an estate trust because there was no remainder over to a third party even if S died within 10 years.

82 Payment to S's heirs is not the equivalent of payment to S's estate and will not qualify; those persons' receipt of an interest after termination of S's interest would constitute the trust as a nondeductible terminable interest. See Rev. Rul. 77-170, 1977-1 C.B. 290, holding that nonqualification for the marital deduction was because S lost control over disposition of the trust corpus that is inherent in the estate trust. That control rationale is a wrong minded vision of the marital deduction qualification requirements but the government nevertheless reached the right result under the law.

83 Treas. Reg. §20.2056(b)-5(f)(4).

> compressed and reduced to their current levels, but the relative rates may be adjusted again to favor trust accumulations and S's rates may be no lower, which makes accumulation for other reasons harmless.

One negative attribute of the estate trust is illustrated by Rev. Rul. 75-128,[84] in which the government ruled that an estate trust may not grant a general testamentary power of appointment to S. According to the government, permissible appointees under the power of appointment are persons other than S to whom the property passes from the settlor after S's enjoyment terminates, making the trust a nondeductible terminable interest. Because S is not entitled to all income annually, the trust also is not a qualified exception to the nondeductible terminable interest rule under §2056(b)(5) or §2056(b)(7).

That ruling is unfounded – because a general power of appointment is the equivalent of paying the remainder to S's estate[85] and then disposing of it under S's testamentary directive. Nevertheless, prudence dictates that the flexibility sought by the planning in Rev. Rul. 75-128 not be granted in an estate trust unless this issue is litigated favorably to taxpayers. That being the case, the estate trust also suffers from inflexibility, which is a malady of no small proportions in today's estate planning environment.

§13.5.6 QTIP

The following disposition would not have qualified for the estate tax marital deduction before 1982:

> The trustee shall pay the trust income to S in convenient installments, at least annually, for life. On the death of S the trustee shall distribute the trust estate, including any accrued but undistributed income, to such of my descendants as S may appoint by will. To the extent this power is not validly exercised, on the death of S the trustee shall distribute the balance of the trust estate per stirpes to my then living descendants.

This disposition creates a terminable interest because S is granted only a naked life estate that terminates at death, and because an interest in the property (the remainder interest) passes to someone other than S or S's estate after S's death. Although S is granted a power of appointment, it is a nongeneral power that cannot be exercised in favor of S or S's estate. Therefore, this trust does not qualify as an exception to the nondeductible terminable interest rule under §2056(b)(5).

Before enactment of the unlimited marital deduction rule in 1981 all other dispositive vehicles to secure the marital deduction (outright gifts, §2056(b)(5) power of appointment arrangements, §2056(b)(6) insurance settlements, and estate trusts) required that S be given control that could alter devolution of the property after S's death. Specifically considering the situation of a subsequent marriage and children of D by a former spouse (who S might not favor),[86] Congress enacted the

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[84] 1975-1 C.B. 308.

[85] On the constructional problems that may be erected by paying a remainder to a person's estate, see Fox, Estate: A Word to Be Used Cautiously, If at All, 81 Harv. L. Rev. 992 (1968); Huston, Transfers to the "Estate" of a Named Person, 15 Syracuse L. Rev. 463 (1964).

[86] See Senate floor debate on §2056(b)(7), 127 Cong. Rec. 17289 (7/24/81) (statement of Sen. Symms); and see H.R. Rep. No. 201, 97th Cong., 1st Sess. 159 – 160, 1981-2 C.B. 352, 377 – 378.

§2056(b)(7) exception to the nondeductible terminable interest rule to permit marital deduction qualification without granting S testamentary control over the deductible property.

This exception causes the illustrated trust to qualify for the marital deduction unless D's personal representative elects to opt out of automatic QTIP treatment. Otherwise, property settled in an otherwise qualifying trust and scheduled on D's estate tax return as marital deduction property will generate a marital deduction in D's estate under §2056(b)(7) and, by virtue of §§2044 and 2519, will be wealth transfer taxed to S upon release or assignment of the income interest during life or its termination at death, all notwithstanding that S has been given only a naked life estate.[87]

Some controversy has surrounded §2044. The government's position is that §2056(b)(7) qualification for the marital deduction requires §2044 inclusion of the QTIP trust corpus in the estate of S, even if the government was wrong to permit the marital deduction. But taxpayers, seeking to whipsaw the government, have argued that QTIP qualification and §2044 inclusion should be considered independently, such that estate tax inclusion to S is avoidable if the QTIP requirements are not met.

Thus, S's estate made numerous arguments in Estate of Cavenaugh v. Commissioner[88] that the government should not have granted the marital deduction in the estate of D and that the QTIP trust corpus therefore was not includible in S's gross estate at death. The court nevertheless held that property for which a QTIP deduction was allowed is includible in S's estate, notwithstanding the dual requirement in §2044 that a deduction was allowed with respect to the property and that S "had a qualifying income interest for life" in the trust.

That element was spotlighted in Estate of Shelfer v. Commissioner,[89] in which the Tax Court, over three dissenting opinions, held that failure to meet the QTIP requirements[90] meant that §2044 inclusion was precluded. In essence, the government was whipsawed because it allowed the marital deduction, meaning that the property escaped tax in both spouses' estates.

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87 Estate tax inclusion under §2044 essentially is the clone of §2041 inclusion of a §2056(b)(5) trust, and §2519 is the counterpart for gift tax purposes of §2514. As discussed in §13.5.6.6, a right of reimbursement exists under §2207A for the taxes caused by either section, much the same (although with important differences) as §2207 applies to §2041. In addition, §1014(b)(10) provides a basis adjustment at S's death, and §2044(c) regards property includible under §2044 as passing from S for all wealth transfer tax purposes. No similar provision appears in §2519, presumably because the legislative history of §2056(b)(7) indicates that Congress thought that S cannot make a transfer of the corpus in a QTIP trust during life. See §13.5.6.1.4.

88 100 T.C. 407 (1993), aff'd in relevant part, 51 F.3d 597 (5th Cir. 1995). Accord, TAM 9446001, in which the QTIP election was made improperly, as to only "the value of [S's] life interest in [the] trust," which was computed as a dollar amount but converted by the government into a percentage partial election. Consistent with Treas. Reg. §20.2044-1(c), the government concluded that this portion was includible, rejecting the contention of S's personal representative that nothing should be includible under §2044 because the election was made for the value of S's life estate only and that interest became valueless at S's death. See also PLR 9848041, in which D's estate improperly and unnecessarily made a QTIP election with respect to both the marital and nonmarital trusts and sought relief with respect to the latter, which the government rejected on the grounds that no election was required and that claiming the deduction alone is adequate to constitute property as QTIP. Today Rev. Proc. 2016-49 would generate the result sought by the taxpayer. See §13.5.6.3.1 n.162.

89 103 T.C. 10 (1994), rev'd, 86 F.3d 1045 (11th Cir. 1996).

90 First raised in Estate of Howard v. Commissioner, 91 T.C. 329 (1988), rev'd, 910 F.2d 633 (9th Cir. 1990), this particular QTIP qualification issue related to the stub income issue that is now addressed in Treas. Reg. §§20.2044-1(d)(2) and 20.2056(b)-7(d)(4). See §13.5.6.1.2 n.100 et seq. and accompanying text.

Cavenaugh held that allowance of the marital deduction under §2056(b)(7) or §2523(f) is all that is required to cause subsequent §2044 or §2519 inclusion to the donee spouse. Arguing against inclusion because S did not receive a qualifying income interest for life produces the wrong result, even if the government improperly allowed the deduction, and will produce litigation if the government is aware that the deduction was granted but inclusion is contested.

For example, Talman v. United States[91] rejected the taxpayer's effort to whipsaw the government and TAMs 9548002 and 9537004 effectively articulate an equitable estoppel or duty of consistency argument that essentially was adopted in Letts v. Commissioner,[92] in which the marital deduction was claimed on D's estate tax return and allowed by the government, which did not audit that return. When S died the position was taken (and fully disclosed) on S's estate tax return that the trust was not includible because it did not qualify as a QTIP trust.

Stating that "[t]he duty of consistency prevents a taxpayer who has benefited from a past representation from adopting a position inconsistent with that taken in a year barred by the statute of limitation,"[93] the Tax Court held that spouses "can have interests so closely aligned that one may be estopped under the duty of consistency by a prior representation of the other"[94] and that the duty of consistency can be applied "to bind one person to a representation made by another where the two are deemed to be in privity."[95] Further, the court held that the estates of these spouses "were a single economic unit" and had a "sufficient identity of interests" that the duty should apply.

Moreover, S and a child were executors of D's estate and that child also was an executor of S's estate. According to the court, "[t]he duty of consistency can bind a beneficiary of an estate to a representation made on an estate tax return if the beneficiary was a fiduciary of the estate."[96] Most interestingly, the court concluded that D's estate, by claiming the marital deduction, effectively made a representation that the marital trust itself was not a terminable interest – otherwise it could not have qualified for the deduction – and, having made that representation, S must live with an inclusion result that is consistent with it.[97]

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91 97-1 U.S. Tax Cas. (CCH) ¶60,270 (Ct. Fed. Cl. 1997).

92 109 T.C. 290 (1997), aff'd in an unpublished opinion (11th Cir. 2000).

93 109 T.C. 290 at 296.

94 109 T.C. 290 at 298.

95 109 T.C. 290 at 297.

96 109 T.C. 290 at 298. See also Estate of Buder v. United States, 372 F. Supp. 2d 1145 (E.D. Mo. 2005), aff'd, 436 F.3d 936 (8th Cir. 2006), and prior litigation found at 7 F.3d 1382 (8th Cir. 1993), citing O'Brien v. United States, 766 F.2d 1038, 1050 (7th Cir. 1985), as "gathering numerous cases and stating that courts have found sufficient identity of interest between sole beneficiary of estate and trustees of estate, husband's estate and surviving spouse, husband's estate and wife's estate, decedent and his estate, and estate and all beneficiaries of the estate," the court concluded that spouses' estates were sufficiently connected to apply the duty of consistency; Warner v. United States, 2006 U.S. Dist. LEXIS 61290 (C.D. Cal. 2006); TAMs 200407018 and 200244002, the latter asserting a different issue but both applying a duty of consistency notion based on privity between estates of spouses and the fact that S was named cofiduciary under the first decedent's will. Said the 2004 TAM, "for transfer tax purposes, the two estates are treated as a single economic unit." Hoffer, Hobgoblin of Little Minds No More: Justice Requires an IRS Duty of Consistency, 2006 Utah L. Rev. 317 (2006).

97 *Letts* clearly is the "right" result. Nevertheless, Estate of Posner v. Commissioner, 87 T.C.M. (CCH) 1288 (2004), reveals that the duty of consistency *does* have its limits. It involved that unique situation in which the government allowed the estate tax marital deduction to D's estate but the marital property properly was not subject to pay-back inclusion in S's estate. The government simply messed up, either when it granted the marital

§13.5.6.1 Requirements

There are four requirements to the §2056(b)(7) exception to the nondeductible terminable interest rule:

(1) the property must pass from D;

(2) S must be entitled to a §2056(b)(5) qualifying income interest for life;

(3) no other beneficiary may have any rights in the trust during S's overlife; and

(4) an irrevocable QTIP election must be made.

§13.5.6.1.1 Passing

The passing requirement is the same as for all other marital deduction purposes.[98]

§13.5.6.1.2 Qualifying Income Interest for Life

The QTIP exception requires that S receive an income interest that qualifies under the §2056(b)(5) requirements. "The principles of §20.2056(b)-5(f) ... apply in determining whether S is entitled for life to all of the income from the property regardless of whether the interest passing to S is in trust."[99] Thus, all of the well-established §2056(b)(5) rules with respect to guaranteeing the income interest are adopted by reference (for example, unproductive property should not be held for more than a reasonable time without S's consent, income should be paid at least annually, and an income interest that terminates on remarriage does not qualify).

One notable difference between the §2056(b)(5) and QTIP income requirements spawned some controversy notwithstanding governmental efforts to be QTIP accommodating. Unlike a §2056(b)(5) qualifying trust, in which S must be given a general power to appoint any accrued but undistributed income at death ("stub" income earned before S's death but not yet distributed under the fiduciary's periodic distribution procedure), the QTIP regulations provide that stub income of a QTIP trust at S's

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deduction after audit in D's 1975 (pre-QTIP) estate, or when it stipulated in the estate litigation involving S that the marital trust did not include the requisite substantive provisions to create the critical general power to appoint (essentially an admission of its prior error) *or* when it stipulated that the duty of consistency does not apply to mutual mistakes of law (which is how the Tax Court characterized the errors made by all the parties involved).

It wasn't even possible to fault S's estate in *Posner* for taking inconsistent positions. The executor filed S's estate tax return reporting the marital trust as includible and took the position in a bona fide will contest in state court that a general power did exist. But when that position was rejected by the state court the estate filed a claim for refund on the ground that it therefore was not subject to §2041 inclusion. As a prudent fiduciary, it probably had a duty to claim its prior payment (based on its assumption that the marital trust was includible) was in error, and in no way was the ultimately inconsistent tax treatment a matter of overreaching or underhanded action by the estate. As an equitable doctrine, in this case there was little to recommend application of the duty of consistency as it has been enforced in other marital deduction situations in which the survivor's estate denied liability for the pay-back tax liability. The best that can be said is that the government simply made a mistake (maybe a number of them).

[98] See §13.4.2.3 for a detailed discussion of this requisite.

[99] Treas. Reg. §20.2056(b)-7(d)(2). See §13.5.2.2.

death need not be subject to such a power, nor must it be paid to S's estate.[100] Instead, although the stub income is subject to §2044 inclusion in S's estate at death[101] (along with the rest of the QTIP trust property), it may be distributed in the same manner as the QTIP trust corpus.[102] As a result, S need not be given control of its devolution, nor must an estate administration be opened for S to dispose of this item. Trusts that fail to address the stub income issue should not fail to qualify for the QTIP marital deduction.

Unfortunately, notwithstanding that it is favorable to most taxpayers, the validity of the stub income regulation is subject to doubt. The government's position was declared invalid while still in its proposed form,[103] the Tax Court stating in Estate of Howard v. Commissioner[104] that there is no statutory support for the government's treatment and the entire marital deduction will be disallowed under §2056(b)(7) absent payment of the accrued income to S's estate or it being made subject to S's control through a general testamentary power of appointment.[105] Based on legislative history to the effect that the §2056(b)(7)(B)(ii)(I) all-income-annually requirement was meant to mirror the same requirement under §2056(b)(5), the Tax Court simply held that the proposed regulation was inconsistent with established §2056(b)(5) rules. Finding no indication in the legislative history of a congressional intent to deviate from the §2056(b)(5) income requirements, the court declared the regulation invalid and the marital deduction improper. Since the regulation became final the court stated the same result in the even more egregious *Shelfer* case discussed below. Thus, this issue has not been resolved, making the appellate court review of *Howard* all the more significant.

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100 Treas. Reg. §20.2056(b)-7(d)(4).

101 Treas. Reg. §20.2044-1(d)(2). See PLRs 8429057 and 8403102, articulating this result long before it was articulated by the regulation.

102 No mention is made whether the accrued income will be subject to §652 (which governs the income taxation of simple trusts) as if it had been paid to S before death. It is believed that such income should be subject to the normal income distribution rules that would apply to the next income beneficiary, as that beneficiary's income, and arguably could be treated as §691 income in respect of (S as) a decedent and taxed, accordingly, to the ultimate recipient thereof. That result would be beneficial to the next recipient because – as income to someone – the §691(c) deduction would be the only consequence of an IRD characterization, and that treatment benefits the taxpayer.

103 Prop. Treas. 20.2056(b)-7(c)(1).

104 91 T.C. 329 (1988), rev'd, 910 F.2d 633 (9th Cir. 1990).

105 The genesis of *Howard* and the litigation posture of the parties was somewhat perverse. Mrs. Howard died less than three weeks after Dr. Howard's personal representative filed his estate tax return, which claimed a QTIP marital deduction. After running some computations, the personal representative of Mrs. Howard's estate determined that almost $675,000 less tax would be paid over both estates if Dr. Howard's estate did not qualify for the marital deduction and instead incurred tax in his estate that would support a §2013 previously taxed property credit in Mrs. Howard's estate based on the value of her life estate in the trust. See §13.2.6.
Because she died within 10 months after his death, income paid to her pursuant to that life estate increased the value of her estate very little but, under the applicable actuarial tables, generated a significant credit for a portion of the taxes caused by inclusion of the trust assets in Dr. Howard's estate. Therefore, his estate sought to reverse the QTIP election. Because it could not revoke that irrevocable election, Dr. Howard's personal representative filed an amended return claiming that the trust did not qualify as QTIP property because a provision in the trust instrument specified that accrued but undistributed income at Mrs. Howard's death would be paid to the next income beneficiary of the trust. The government argued that the trust did qualify because, under the proposed regulation, this income need not be paid to her estate or be made subject to a general power of appointment.

In reversing the Tax Court, the Court of Appeals for the Ninth Circuit upheld the government's regulatory position as a valid interpretation of the Code, consistent with the legislative history behind §2056(b)(7), stating:[106]

> As long as the income is payable at least annually and the spouse is entitled to all regular distributions as long as she lives, the statutory test is met....
>
> The statute did not impose ... the requirement that the spouse hold a power of appointment over the stub income. All that was required was that the spouse be entitled to all the income at the time of its annual or more frequent distribution . . . .
>
> The whole purpose of the QTIP provision was to dispense with the requirement of a power of appointment as a condition of entitlement to the marital deduction. Since the power of appointment is not required, there is no need to require a power of disposal of the undistributed income.

Notwithstanding the logic of this holding, the Tax Court again held in Estate of Shelfer v. Commissioner[107] that failure to pay the stub income to S's estate or make it subject to a general power of appointment in S meant that the marital trust failed to meet the QTIP requirements. As a consequence, the court held that §2044 inclusion would not occur.

The irony in *Shelfer* is that the government went out of its way to allow the marital deduction notwithstanding that *Howard* had not yet been reversed on appeal. The government had responded to taxpayer concerns about the effect of *Howard* by promulgating Notice 89-4,[108] which contained an "interim settlement procedure" by which the government and taxpayers could settle estates in which the stub income issue arose. It was pursuant to this Notice that the government allowed the *Shelfer* marital deduction. The government simply adhered to its position that the stub income is includible in S's gross estate under §2044 but need not be paid to S's estate or be subject to a general testamentary power of appointment to qualify the QTIP trust for the marital deduction. The taxpayer repaid that favor by arguing that the payback inclusion rule in §2044 did not apply.

The good news is that the government's position in the regulation is binding on it. Thus, taxpayers who want the marital deduction need not worry about disallowance of the deduction, even if the stub income is not payable to S's estate or subject to a general power of appointment.

Moreover, if a QTIP trust is silent about the stub income issue, the state Principal and Income Act may cover the issue and mandate distribution of the stub income to S's estate, meaning this issue may exist only in documents that alter state law by specifically addressing the issue.

§13.5.6.1.3 No General Power of Appointment Is Required

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[106] 910 F.2d 633, 635, 636 – 637 (9th Cir. 1990).

[107] 103 T.C. 10 (1994), rev'd, 86 F.3d 1045 (11th Cir. 1996).

[108] 1989-1 C.B. 624, extended by Notice 90-46, 1990-2 C.B. 337.

Unlike the §2056(b)(5) trust, D need not give S a general power to appoint QTIP trust corpus. Thus, the QTIP trust is attractive to many clients who want to "handcuff" S while at the same time qualifying for the marital deduction.

This does not preclude a decedent from granting S a power to appoint the property at death[109] (but not during life)[110] to or among a class of permissible appointees specified by D. Nor does it preclude giving S a power to withdraw QTIP trust corpus during life, provided that there is no restriction on withdrawal that S must make a gift and that therefore constitutes a constructive power of appointment in violation of the statute.

A general power of appointment in the form of a withdrawal right during life or a testamentary power might make the trust a §2056(b)(5) marital trust. The marital deduction would be available, but a §2056(b)(5) trust automatically qualifies for the deduction so partial QTIP election planning would be lost. In addition, the §2652(a)(3) reverse QTIP election for GST tax purposes may not be available, nor would certain valuation opportunities.[111] Thus, it would be wise to be certain that any power of appointment granted to S would fail to qualify for §2056(b)(5) purposes, such as by imposing a delay before it becomes available[112] or by requiring a third party's consent to exercise.

TAM 8943005[113] states that it is permissible to give S an *inter vivos general* power of appointment in a QTIP trust, notwithstanding the §2056(b)(7)(B)(ii)(II) prohibition on just such an authority. Presumably any kind of general power would be permissible, again including one exercisable only with the consent of a nonadverse party (such as the trustee). This may give S enough flexibility to, for example, make annual exclusion transfers from the marital trust, without bestowing greater control than D prefers and without converting the QTIP trust into a §2056(b)(5) trust.[114] As discussed next below, however, such planning on the basis of current authority would be aggressive.

In any event, a client who is willing to grant S some control may create as broad or as narrow a nongeneral testamentary power (but *not* an inter vivos general or nongeneral power) as the client wants S to possess, without any of these fears.

§13.5.6.1.4 No Other Beneficiaries During S's Overlife

The second primary requisite to qualify as a QTIP trust is that no one (according to the legislative history, *not even S*)[115] may have a power to divest S of any interest in the trust. This requirement is really just a subset of the all-income-annually requisite in §2056(b)(7)(B)(ii). It

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109 Authorized under §2056(b)(7)(B)(ii) (flush language).

110 Prohibited by §2056(b)(7)(B)(ii)(II).

111 See §§7.3.8 and 10.5.4.

112 See §13.5.2.1.

113 Discussed in detail in §13.5.6.1.4.

114 TAM 8943005 did not even mention the possibility that a general power of appointment in a QTIP trust might cause the trust to be regarded as a §2056(b)(5) trust, with a concomitant loss of the QTIP advantages. But a primary reason for the taxpayer's request in PLR 202152006 (involving a court reformation of a trust to correct a scrivener's error that otherwise might have caused the government to conclude that the spouse had a general power of appointment) was to ensure that the trust qualified as QTIP and that a reverse QTIP election was valid.

115 H.R. Rep. No. 201, 97th Cong., 1st Sess. 161 (1981), states that "there must be no power in any person (*including the spouse*) to appoint any part of the property subject to the qualifying income interest to any person other than the spouse during the spouse's life" (emphasis added). See also Treas. Reg. §20.2056(b)-7(h) Example 4.

precludes any one from having the ability to disfranchise S's income entitlement by distributing trust corpus, and the income it produces, to another person.

The limits of this restriction are quite uncertain. For example, Rev. Rul. 85-35[116] provides that a standard facility of payment provision does not disqualify a §2056(b)(5) marital deduction trust, and TAMs 8706008 and 8503009 drew the same conclusion for QTIP trusts. Thus, if S is unable to manage normal affairs, the trustee properly may pay income for S's benefit (rather than directly to S) and even may distribute income to a next friend or guardian for use on S's behalf. According to the government, "the purpose of the ... facility of payment clause is to make certain that the beneficiary has the beneficial ownership of the trust income and to provide protection and assistance to the beneficiary"[117] rather than to deny or divert ownership or enjoyment of the beneficial interest. Similarly, TAM 8526009 determined that a power granted to the trustee to distribute principal to S "for her comfortable support, maintenance, health and/or [sic] education *and that of the settlor's issue under her care and supervision*" (emphasis added) would not disqualify an otherwise valid QTIP trust. The government noted that distributions could be made only to S (notwithstanding the determination of needs used to measure the amount to be distributed) and S could choose to retain the funds or disburse them in S's sole discretion.

Unfortunately, TAM 8701004 retracted TAM 8526009 because, under state law, the government determined that S was deemed to be under a fiduciary obligation with respect to distributions made for the needs of the settlor's issue. Therefore S could be compelled to use funds received from the trust for the exclusive benefit of those individuals. Accordingly, because those indirect beneficiaries were not persons to whom S necessarily owed an obligation of support, the government determined that "[t]he terms of the ... Trust authorized the trustee to appoint trust property to persons other than the spouse" in violation of §2056(b)(7)(B)(ii)(II).[118]

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116 1985-1 C.B. 328. See also Merchants Nat'l Bank v. United States, 326 F. Supp. 384 (N.D. Iowa 1971) (authority to "use, apply, expend or accumulate" income in the trustee's discretion for S in the event of incapacity was regarded as a facility of payment provision and was deemed to require payment quarterly of income not so applied or distributed); TAM 8108005 (involving a statutory facility of payment provision under state law).

117 1985-1 C.B. at 329. See §13.6.2.3 regarding facility of payment provisions and marital deduction qualification.

118 To the same effect is TAM 9005002 and PLR 8319009 (QTIP deductions were disallowed because the trusts authorized trustee distributions for S and dependents who might not be persons to whom S owed a legal obligation of support). But see TAM 8913003, allowing the §2056(b)(7) deduction, notwithstanding authority in the trustee to make distributions to D's children while those children were minors. Involved was a trust with a three stage distribution to S. The first installment was payable when the children were minors and that portion of the trust was deemed to qualify for the marital deduction because invasions for the needs of the children would indirectly benefit S. The power to invade for the children after their majority prevented qualification of the other two installments.

In Rev. Rul. 90-110, 1990-2 C.B. 209, a trustee's attempt to disclaim a power to distribute corpus to the settlor's grandchild was invalid because the grandchild did not consent to the disclaimer and did not attempt to disclaim on his own behalf. The same result was reached in PLRs 8409024 and 8331066 because disclaimers, respectively, by the trustee of the power to make distributions or by the children of the right to receive them were not effective in the former case or qualified under §2518 in the latter. Therefore, in each case these disclaimers were not effective to cure defects for marital deduction qualification purposes. Similar results would have been reached in TAMs 9003007 and 8443005 and PLRs 9119047, 9010068, 8906036, 8817031, and 8815038 if descendants had not effectively disclaimed their right to receive distributions.

See also PLRs 8638016, 8544019, and 8543009 (QTIP elections would have been allowed if children had disclaimed their rights to receive corpus distributions); TAM 8618067 (a disclaimer by S as trustee of a power to distribute principal to children was effective to qualify the trust for the marital deduction because the children

The marital deduction should be allowed if the distribution power is limited to distributions measured by the needs of persons S is obliged to support, or if the trust negates any fiduciary obligation otherwise imposed on S to pass any distributions received along to the descendants whose needs were the measure of those distributions.[119] If there is no obligation on S to pass along distributed funds, TAM 8526009 would authorize an attractive planning opportunity because it expands the flexibility of QTIP trusts. For example, it could permit S to dissipate trust corpus through annual giving without running afoul of the prohibition against S or the trustee having a prohibited power of appointment or disposition.[120]

Clearly impermissible in a QTIP trust, however, is the power addressed in PLR 8527009 to distribute income or principal "for the support and maintenance of my wife, except that such portions of the income and principal may be used as may be necessary to furnish my children with a college or university education."[121] Estate of Manscill v. Commissioner[122] involved a similar power to distribute corpus to a child, but it was exercisable only with S's consent. Still the court held that this constituted a prohibited power to divert corpus to someone other than S. It was not limited to the amount of S's legal obligation to support the child, and it could not be purified by requiring S's consent (which, at best, would convert it to a prohibited power of appointment in S). Similarly prohibited would be the form of power permitted by Rev. Rul. 72-154 in a (b)(5) trust[123] because it constitutes a direct power in S to appoint inter vivos.

PLR 200106008 shows that there may be hope in cases such as these. The government allowed a marital deduction notwithstanding that the marital trust authorized principal invasions for descendants. A state court reformed the trust to rectify that alleged error, by removing that provision to the nonmarital trust where it was meant to apply.

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consented to that release of the power); cf. PLR 9521032 (the converse situation in which S as trustee renounced a power to make distributions and individually disclaimed the right to receive them, resulting in acceptance that the trustee's power was eliminated). See §§7.1.6.6 (regarding disclaimers by fiduciaries in general as being ineffective), 13.5.2 n.8 (relating to §2056(b)(5) power of appointment trusts), and 13.5.2.2 n.32 (relating to §2056(b)(7) trusts that may distribute income to third parties), and accompanying text in each case.

119 See Parasson v. United States, 87-1 U.S. Tax Cas. (CCH) ¶13,708 (N.D. Ohio 1987).

120 Even if TAM 8701004 (which revoked TAM 8526009) is circumvented, it may not be wise to make S the trustee of the QTIP trust with this distribution provision, because the power would constitute a general power of appointment if held by S.

Some planners want S to be trustee (they use the QTIP trust for postmortem planning, not to tie S's hands), and want to give S some of the control that otherwise is missing in a QTIP trust. The power involved here would be regarded as a general power, even if the standard for invasion was "ascertainable," because that standard would relate to the needs of the dependents, not to the needs of the powerholder. If this was a general power of appointment, the result would not be loss of the marital deduction because the trust would be either a QTIP or a §2056(b)(5) trust. Instead, if the government chose to regard the trust as a §2056(b)(5) rather than a QTIP trust, there would be an unfortunate loss of the valuable benefits of QTIP qualification noted in §13.6.1.1. See TAM 8943005, discussed in text following note 125 immediately below, in which a limited inter vivos general power of appointment was permitted in a QTIP trust with no mention of the possibility that §2056(b)(5) would apply instead of §2056(b)(7).

121 See also Estate of Bowling v. Commissioner, 93 T.C. 286 (1989) (the trust did not qualify under §2056(b)(7) because the trustee could invade corpus for "any emergency needs which effect the support, maintenance and health needs of any beneficiary," which the court read to contemplate distributions to the remainder beneficiaries during S's overlife); TAM 9005002.

122 98 T.C. 413 (1992).

123 See §13.5.2 n.9 and accompanying text.

Other provisions can be equally harmful in a QTIP trust. For example, in TAM 8843004 the government correctly ruled that a provision authorizing D's child to purchase QTIP trust property for less than its FMV and to borrow from the trust at below-market rates to finance the purchase also would prevent marital deduction qualification. The first power was deemed an improper power to divert trust assets to someone other than S and the latter was deemed to make the child an improper beneficiary of the QTIP trust income.[124]

Some flexibility is, however, available in a QTIP trust. For example, S may be given a withdrawal right during life, and anyone may have a power of appointment exercisable at or after S's death,[125] all without violating the sole beneficiary restriction.

In addition, in a surprising technical advice, the government advised that S may be given a general inter vivos power of appointment without losing QTIP status. In TAM 8943005 D granted S an annually exercisable, inter vivos, general power to appoint to third parties the greater of $5,000 or 5% of the value of a QTIP trust. The TAM concluded that the power was proper in a QTIP trust without even suggesting that the power of appointment converted the trust into a §2056(b)(5) all income, general power of appointment trust – even with respect to a portion of the trust – with concomitant loss of the postmortem flexibility and advantages of a QTIP trust.

The government noted that the logic underlying the §2056(b)(7)(B)(ii)(II) prohibition against powers of appointment in favor of anyone other than S is to "insure that the value of the property not consumed by S is subject to tax upon S's death (or earlier disposition) ..." and stated that this logic is not violated by a general power because wealth transfer tax is not avoided. It concluded that denying this power

> would be unnecessarily restrictive.... [W]e believe the better reading of the legislative history would preclude a spousal power of appointment only where the exercise of the power would not be subject to transfer taxation; i.e., where the power is not a general power of appointment as defined in §2514 of the Code. An interpretation requiring that a spouse must first take physical possession of the property prior to a transfer to a third party would focus too much

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124 To the same effect are TAMs 9147065, 9139001, and a case that almost certainly is the same as that involved in TAM 9139001, Estate of Rinaldi v. United States, 97-2 U.S. Tax Cas. (CCH) ¶60,281 (Ct. Fed. Cl. 1997), all as discussed in §13.5.2.2.2 in the context of the all-income-annually requirement. See also PLR 8318071 (D's estate plan gave a child the right to select one piece of realty from among assets that otherwise passed to S; the marital deduction was allowed for the full amount of the assets passing to S, reduced by the most valuable parcel available for selection by the child).

125 See §2056(b)(7)(B)(ii) (flush language). For an interesting application of a nongeneral testamentary power of appointment that permitted S effectively to make gifts from a QTIP inter vivos, see PLR 9418013 (a QTIP trust provided for loans to children at the §7872 applicable interest rate but authorized balloon rather than periodic payment of the interest; the marital deduction nevertheless was allowed and the government was not concerned about the fact that S was going to exercise a testamentary power of appointment in that trust to distribute at death the notes of various children to the maker of the note, meaning that the loans and the accrued interest never would be paid, because the full amount of accrued interest and the face amount of the notes nevertheless would be includible in S's gross estate at death and therefore did not present nonqualification problems).

It is uncertain whether a power exercisable by a third party before S's death but only effective at or after S's death is permissible. See Joint Committee on Taxation, General Explanation of Economic Recovery Tax Act of 1981, 97th Cong., 1st Sess. 235 (1981).

attention on the form of transaction. It is sufficient that the exercise of the power by the spouse in favor of a third party would be subject to transfer taxation.

The same result also might apply if S, as trustee of the marital trust, has powers not limited by a §2041(b)(1) restriction (joint power with an adverse party) or an ascertainable standard. Possible application of §2519 should not be a problem, however, notwithstanding that appointment of corpus would carry income away from S, because an outright distribution to S followed by an outright gift would not invoke §2519 (which is the analogy the TAM used). Moreover, the abuse to which §2519 is aimed is an assignment of income permitting avoidance of wealth transfer tax on corpus, which is not presented under the general inter vivos power of appointment scenario.

Caution is appropriate, however, for a number of reasons. First, it is not clear whether the general power of appointment might be deemed to create a §2056(b)(5) general power of appointment trust,[126] in which case an estate might lose the ability to do postmortem planning through exercise or withholding of the QTIP election and also lose the ability to make a §2652(a)(3) reverse QTIP election.[127] In addition, this is the only known situation in which the government authorized that planning, and it is not citable precedent. It may be that the government is not concerned with the §2056(b)(5) versus §2056(b)(7) issue, and that the QTIP sole-benefit requirement is not meaningful if transfer tax will not be avoided. Nevertheless, practitioners should be cautious, first because qualification for the marital deduction under §2056(b)(5) is automatic, whereas qualification under §2056(b)(7) is subject to the requisite QTIP election. And second because loss of the marital deduction entirely would be a difficult result to explain to S. A general power of appointment in a QTIP trust would provide useful planning flexibility, so this is an issue that deserves continued scrutiny.

§13.5.6.1.5 The QTIP Election

The final requirement to qualify as a QTIP disposition is made necessary because, unlike the §2056(b)(5) trust, qualification for the §2056(b)(7) QTIP marital deduction is not meant to be automatic. For the transfer to be treated as QTIP, an election is contemplated under §2523(f)(4) by the donor spouse on a gift tax return if the transfer is made during life, and under §2056(b)(7)(B)(v) by D's personal representative on the estate tax return if the transfer is made at death.

The requisite election to be treated as a QTIP marital deduction trust is necessary because, without it, this form of trust would not necessarily be includible in S's estate, the only other major

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126 PLR 9018022 addressed the issue of QTIP treatment for a trust granting S a general testamentary power of appointment, the subject power reading: "On the death of the surviving spouse, if a QTIP election is made, the principal of the Marital Election Trust will pass as the surviving spouse appoints. If no QTIP election is made, the property passes to one or more ... children, as the surviving spouse appoints ...." The Ruling made no mention of the all-income, general power of appointment marital deduction rules of §2056(b)(5) or whether a general power in a QTIP trust automatically constitutes the trust as a §2056(b)(5) (rather than QTIP) trust. Nor did the ruling question whether the subject power was general under state law (which it appears to be from the quoted language). PLR 200024015 involved a trust with a partial QTIP election that granted a general testamentary power to appoint the entire trust. The ruling respected a reformation that cut the power back to just the elected portion. See §12.1 n.13. It also opined that the power would cause §2041 inclusion when S dies but did not mention §2044 QTIP trust inclusion, nor did it state whether any reimbursement right for taxes attributable to inclusion would be under §2207 or §2207A.

127 Along with loss of any other advantages of QTIP trusts. See §13.6.1.1.

requirement imposed on the trust for qualification being that S be entitled to receive all income annually. Although that mandatory income entitlement is common to other forms of marital deduction disposition, it alone in a QTIP trust would not identify the trust as marital deduction property or cause estate or gift tax inclusion to S when a subsequent transfer of the trust corpus occurs.

Because there have been so many problems with QTIP elections, the current position is the reverse of the statutory expectation. QTIP treatment is automatic unless the donor or the personal representative elects out of that treatment. Because the election is irrevocable once made, and because of the importance of this election, it is discussed separately and in detail in §13.5.6.3.

§13.5.6.2 Legal Life Estates Can Qualify for QTIP Treatment

A QTIP disposition need not be in trust. A devise of Blackacre "to S for life, and on S's death per stirpes to my descendants" would be in qualifying form[128] and would constitute QTIP marital deduction property if listed on Schedule M of Form 706 or line 8 of Schedule A of Form 709. Thus, although legal life estates rarely are used in estate planning because of their inflexibility and uncertainties about the rights and duties of a life tenant, qualification for the marital deduction is a function of S receiving that degree of enjoyment and control commensurate with exclusive lifetime enjoyment of the property.[129]

For example, TAM 8948002 allowed a QTIP marital deduction for a bequest of a legal life estate in D's real and personal property, the major asset of which being stock in two corporations that had not paid dividends previously. Subsequent to filing the estate tax return, the controlling state adopted a statute entitling a surviving spouse as a life tenant to make property productive in which a life estate existed or to convert it into income producing property. The statute by its terms was retroactive to a date that preceded D's death. The TAM concluded that even the common law rule in effect prior to enactment of the statute permitted a life tenant holding a legal life estate to sell real or personal property in which a life estate existed to make the life estate reasonably productive. The statute merely codified this common law rule and the QTIP income requirement was deemed met.

PLR 9046031 held that a personal residence passing in trust to a spouse for lifetime use qualified under §2056(b)(7) because obligations imposed on S were consistent with obligations ordinarily imposed on a life tenant. Similarly, in Estate of Novotny v. Commissioner,[130] the Tax Court allowed QTIP treatment for a life estate in real property that would terminate if S failed to pay various property expenses, including taxes, payments under a deed of trust note (which S had

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128 See Treas. Reg. §20.2056(b)-7(h) Example 1.

129 See, e.g., TAM 9040001 (S's right to occupy a residence for life, coupled with a right to receive 50% of the sale proceeds upon vacating the residence before death, qualified 50% of the residence for QTIP treatment); PLR 8908027 (a QTIP deduction was allowed for D's devise to S of all income from eight properties for life and a life estate in D's residence); TAM 8733005 (S's power to make oil and gas leases and to receive all bonuses, rents, and royalties was regarded as the requisite income interest); PLR 8352062 (QTIP treatment was granted for a testamentary gift of all the income for life from a ranching operation and grain farming corporation because S was given "absolute and unrestricted control over the payment of income"); PLR 8351141 (QTIP treatment was available for real property that S could "use for any purpose, demolish or modify existing buildings or construct new buildings"); PLR 8351098 (S's right "to have, hold, possess and enjoy the rents, interests, dividends, and profits thereof for and during the full time of her natural life" allowed QTIP treatment).

130 93 T.C. 12 (1989).

cosigned), maintenance expenses, and repairs, because these conditions on the life estate were substantially the same as conditions that existed independently in the deed of trust note and under local law (for example, payment of taxes).

Disposition of a marital residence to residuary heirs with a reserved right of a surviving spouse "to occupy said property for as long as he desires" qualifies for the QTIP marital deduction if S's right to occupy the property includes the right to all income from the property if he does not reside in the property.[131] Thus, PLR 9126020 ruled that a bequest of a vacation home to a trust as to which D's surviving spouse was *not* the sole beneficiary nevertheless qualified for the QTIP marital deduction because S was entitled to the full use and enjoyment of the property and, when not using the property, S could rent it and receive the income therefrom. In addition, the rights of all other permissible users were subject to S's "superior right of usage." The government determined this to mean that, under state law, these other users could use the property only as S permitted in the exercise of an absolute and unrestricted discretion.

Drafters effecting similar plans are wise to spell out the aspects of full and superior use needed to qualify for the marital deduction, rather than relying on state law to satisfy those requirements. For example, TAM 9033004 advised that S's right to occupy a condominium (which she had owned as tenants in common with D) was not a §2056(b)(7)(B) qualifying income interest for life because, under local (Missouri) law, the devise of a right to occupy a property does not convey the right to sell or lease it. And in TAM 9229004 S was granted a right to occupy D's personal residence that resembled the nonqualifying homestead interest in Estate of Kyle v. Commissioner.[132] It would terminate upon failure to occupy the property, there was no right to convey the lifetime right to occupy the residence, and S could not obtain rental income from the property when not personally in possession.[133]

Moreover, for the first time, in states that still recognize the common law dower estate or provide a comparable statutory substitute (a life estate in an undivided one-third of D's lands), the dower estate may qualify for the marital deduction if a QTIP election is made, without having to commute the value and pay that amount as a lump-sum settlement.[134] And, by virtue of the last clause

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[131] Estate of Peacock v. United States, 914 F.2d 230 (11th Cir. 1990), rev'g 90-2 U.S. Tax Cas. (CCH) ¶60,050 (N.D. Ala. 1989).

[132] 94 T.C. 829 (1990). To the same effect were TAMs 8736004 (holding that a surviving spouse's Texas homestead interest is not a qualifying income interest for life because it would be lost if S moved to another state and bought a home with the intention that it be a permanent residence, which made it something less than a life estate) and 8742001 (S was entitled to use the residence only for as long as it was maintained as S's home for at least one month of each calendar year, which made the life estate subject to an impermissible termination condition).

[133] The QTIP marital deduction was denied notwithstanding an agreement by the remainder beneficiaries that purported to upgrade S's entitlement to an unrestricted life estate, which was regarded as ineffective to qualify for the marital deduction because the agreement was not a qualified disclaimer, it was not in settlement of a bona fide controversy involving D's estate plan, nor was it a product of S asserting an enforceable entitlement under the state law spousal right of election. But see PLR 9242006 (a life estate in art was deemed to be QTIPable because S was not responsible for the cost to insure or for losses due to theft or damage and could license photographs or other reproductions).

[134] See §13.4.2.3.2.

of §2056(b)(7)(B)(ii)(I), even the Louisiana form of usufruct in consumable or nonconsumable property qualifies for QTIP treatment if it is for S's life.[135]

§13.5.6.3 The QTIP Election

The statutory presumption in §§2056(b)(7)(B)(v) and 2523(f)(4) is that transfers to QTIP trusts will not automatically qualify for the marital deduction – an affirmative election is required to qualify. Nevertheless, the government encountered so much trouble[136] with returns that computed the deduction but failed to make the requisite election[137] that the current administrative position is exactly opposite the statutory presumption. Today, unless an affirmative election out of QTIP

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[135] See Darby v. Rozas, 580 So. 2d 984 (La. Ct. App. 1991), explaining the difference between a "conventional" (testamentary or contractual) usufruct for life and the more limited "legal" usufruct that terminates on death or remarriage of S. And see TAM 9223006, explaining the amount includible in S's estate with respect to a usufruct, citing the Conference Committee Report accompanying the Deficit Reduction Act of 1984, H.R. Rep. No. 861, 98th Cong., 2d Sess. 1238; PLR 8325056.

[136] It would require a lengthy exegesis to recount the substantial refinement of the government's attitude regarding QTIP elections, beginning with an initial uncompromising – almost hostile – approach to requests for relief if the election was not properly or timely made, and all the trouble generated by that approach, and ending with the current posture that is the polar opposite. The full historical development is presented in Supp. §13.2.8 n.5 (5th ed.) for the benefit of readers who need to review the older developments.

[137] Before the November 1987 version of the Form 706 estate tax return moved the QTIP election to Schedule M (Bequests to Surviving Spouse), page 2 of Form 706 included six elections, of which the fourth was for "a marital deduction for an otherwise nondeductible interest under §2056(b)(7)," and Schedule M required only an inventory of items passing to S that qualified for the election. That separation of the election from Schedule M created many problems, and eventually the election was moved to Schedule M. Even there it was not uncommon for the return preparer to claim the deduction but not check the box to formally make the election. For some time the government's position was illustrated by TAM 8427004, in which the executor used a pre-1981 Form 706, which did not have a box for making the QTIP election. Notwithstanding that the terminable interest property was listed on Schedule M and a marital deduction was claimed, the government denied the deduction, stating: The mere listing of the trust property on Schedule M does not constitute a clear manifestation that the executor is selecting between two alternatives that have such significant tax consequences. Rather, we believe the executor's actions in listing the property as a deductible interest, with no other explanation, was an equivocal act that could be subject to several interpretations.

Much more common were situations in which the executor checked "no" in the QTIP box on page 2 but listed a terminable interest on Schedule M and claimed a deduction for it. See, e.g., Estate of Robinson v. United States, 90-2 U.S. Tax Cas. (CCH) ¶60,045 (S.D. Ga. 1990) (the QTIP deduction was denied because of a failure to make an affirmative election on the estate tax return); Estate of McCants v. Commissioner, 61 T.C.M. (CCH) 2038 (1991) (the QTIP deduction was denied because the estate checked "no" to the QTIP question on the estate tax return); TAM 8427007 (the government determined that "there was no clear manifestation that the executor made an election that has such significant tax consequences" and denied the deduction).

A third kind of error was illustrated by TAM 9117007, which also denied the marital deduction for failure to check the QTIP box on line 2 of Schedule M of the November 1987 version of Form 706. The estate claimed the marital deduction for the QTIP assets, but listed them on Part I of Schedule M, without referring to the QTIP election. The government now accepts that listing property on Schedule M and making a tax payment (or no tax payment) reflecting the marital deduction is a sufficiently "clear manifestation" of intent. See, e.g., PLR 202134010 (personal representative hired attorney who filed Form 706 but failed to list property constituting one marital trust, and reported property constituting two other marital trusts as having been distributed to S; the PLR granted an extension to make proper QTIP elections); PLR 202115002 (personal representative originally advised not to file Form 706, subsequently did file and reported marital trust assets as “all other property” on Schedule M but “reported no ‘QTIP property.’ A marital deduction was claimed for all other property and a corresponding DSUE election accounted for this deduction.” It is not clear why the presumption of a QTIP election did not apply, but the PLR granted a 120 day extension “to make a QTIP election with respect to [the] Marital Trust.”

treatment is made the forms presume the election if property is scheduled on the estate tax return as deductible and if the tax is computed with that deduction reflected.[138]

Naturally this only applies with respect to transfers that otherwise are "QTIPable" because they would qualify if the election was made. As to those interests the government has gone so far as to presume at S's death that any interest that *was* QTIPable did qualify and produce a deduction in D's estate. Therefore, such an interest is presumed to be §2044 includible in S's gross estate, unless all of these presumptions are proven to the contrary.[139] Because the government may attempt to deny the marital deduction entirely if the QTIP election affects who takes an interest in the property,[140] it is imperative that S receive an income interest in the property in all events, which means that the only consequence of the election is to fix the tax consequences to the donor or D's estate and, later, to S. Viewed in this light, the government's administrative position favoring the deduction is not unreasonable, notwithstanding the statutory discordance.

For estate tax marital deduction purposes, any executor appointed, qualified, and acting in the United States is responsible for the §2056(b)(7)(B)(v) election with respect to all property includible in D's gross estate, including property not in the executor's possession (property passing outside of probate).[141] Only if there is no such United States executor is the person in possession of electable property responsible for the election.

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138 For example, the Form 706 estate tax return specifies on Schedule M that

> If a trust (or other property) meets the requirements of qualified terminable interest property under §2056(b)(7), and
>
> a. The trust or other property is listed on Schedule M, and
>
> b. The value of the trust (or other property) is entered in whole or in part as a deduction on Schedule M,
>
> then unless the executor specifically identifies the trust (all or a fractional portion or percentage) or other property to be excluded from the election, the executor shall be deemed to have made an election to have such trust (or other property) treated as qualified terminable interest property under §2056(b)(7).
>
> If less than the entire value of the trust (or other property) that the executor has included in the gross estate is entered as a deduction on Schedule M, the executor shall be deemed to have made an election as to a fraction of the trust (or other property). The numerator of this fraction is equal to the amount of the trust (or other property) deducted on Schedule M. The denominator is equal to the total value of the trust (or other property).

On Schedule M there is no QTIP election box (other than to elect out of §2056(b)(7)(C) automatic QTIP treatment for annuities includible under §2039); indeed, "QTIP" is not even mentioned on the first three pages of the return.

139 See Treas. Reg. §20.2044-1(c). The comparable gift tax rule is in Treas. Reg. §25.2519-1(b).

140 See §13.5.6.4.

141 Treas. Reg. §20.2056(b)-7(b)(3). For gift tax marital deduction purposes, Treas. Reg. §25.2523(f)-1(b)(4) establishes the time for making the election as a timely filed gift tax return. This includes any authorized §6075(b)(2) six month automatic extension to file and, if the donor died during the calendar year of the transfer, it means the time for filing the estate tax return, including extensions. Unfortunately, the IRS may not grant a request for an extension beyond the six-month period allowed automatically by Treas. Reg. §301.9100-2 because the time for filing an inter vivos QTIP election also is expressly prescribed by §2523(f)(4) and the IRS's authority to grant discretionary extensions applies only to requests for extensions of time fixed by regulations or other published guidance. See Treas. Reg. §§301.9100-1, 301.9100-3; PLRs 200314012 and 9641023. Nevertheless, PLR 201025021 *did* grant a request for an extension of the time to make the gift tax QTIP

In PLR 9444026, for example, D's gross estate included only assets of an inter vivos revocable trust and property passing to S by operation of law. There was no probate estate and therefore there was no personal representative. Pursuant to Treas. Reg. §20.2056(b)-7(b)(3), the government ruled that the trustees and S were the proper parties to make the QTIP election, because they were all the persons in actual or constructive possession of property includible in D's estate.

Because there is no box to check on the estate tax return to indicate that the election is being made, it is the fact of listing the property on Schedule M and claiming the deduction that constitutes the election. Therefore, it makes sense that the person who is responsible for filing that return is deemed to be the person who is responsible for the election.[142] Similarly sensible is that the time for making the estate tax election is the *last* estate tax return that is *timely* filed, including extensions. If *no* return is *timely* filed, then the deadline is the *first* estate tax return filed *after* the due date.[143] Curiously and somewhat confusingly, however, an election made on a timely filed return may be revoked or modified by a subsequent return that also is timely filed, but "no subsequent election may be made with respect to other properties included in the gross estate after *the return*" is filed.[144] Presumably the intent is that only the last timely filed return counts.

TAM 8501005 illustrates the government's position that neither reasonable cause to amend, mistake of law or fact, change of mind, nor other factors are cause to deviate from the rule that the election is irrevocable once made (or is deemed made because the property is scheduled and the deduction claimed).[145] Thus, in the situation presented, only two pages of D's will were found and admitted to probate, but two additional pages containing a marital deduction provision were later

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election, which some commentators applauded and believed to be a proper exercise of the government's discretion. See the letter written by Kaufman, Siegler, Zaritsky, and Franklin, published at 128 Tax Notes 500 (August 2, 2010). Nevertheless, PLR 201109012 subsequently retroactively retracted PLR 201025021, making it clear that issuance was an error that presumably will not occur again. Although PLR 201233011 precluded retroactive application of the retraction, that relief was limited to the one case that was involved. Otherwise the taxpayer would have suffered economic detriment because, in reliance on the original PLR and before its retraction, the taxpayer released the firm that was responsible for the original error from malpractice liability.

Note also that Treas. Reg. §25.2523(f)-1(b)(4)(ii) as drafted makes it appear that the election is irrevocable only if it relates to a donor who dies in the year of the transfer, but §2523(f)(4)(B) states that any donor's election is irrevocable once made, which may indicate that the regulation contains an unintended formatting or drafting error.

142 These results are informed by and defined consistently with §§6018(a) (the executor files the estate tax return) and 2203 ("executor" defined for estate tax purposes).

143 Treas. Reg. §20.2056(b)-7(b)(4). Treas. Reg. §301.9100-2(b) grants an automatic extension of six months from the due date of the return (excluding extensions) to make a QTIP election, presumably requiring that a replacement original or an amended return listing the property and claiming the deduction must be filed within the six month extension period. Note, however, PLR 202133010, which stated that no estate tax return was timely filed, notwithstanding that the due date was extended by six months, and no QTIP election was made with respect to property passing to a marital deduction trust; the PLR granted an extension of the time to make a QTIP election without saying whether that would occur on a return that was yet to be filed.

144 Treas. Reg. §20.2056(b)-7(b)(4)(ii) (emphasis added). Unexplained is why the quoted language applies to an appointed executor but not if there is no executor appointed, qualified, and acting under state law. Presumably this allows nonprobate property to be included in the election if there is no coordinated administration, but it ought to be permissible for a duly qualified executor to add nonprobate property, for example, if the time for filing has not expired. These inconsistencies probably are not significant, given the limited number of returns that are filed early and then amended before the filing deadline has passed.

145 This did not, however, preclude S from disclaiming the life interest and preventing QTIP qualification for the marital deduction in Rev. Rul. 83-26, 1983-1 C.B. 234.

discovered. The government denied the personal representative's request to file an amended return electing QTIP treatment for the newly discovered marital deduction provision. In PLR 200612001 the government similarly denied relief to an estate that made a QTIP election that enumerated properties meant to qualify and later sought to include assets that the executor improperly thought were effectively disclaimed by S and as to which the estate subsequently wanted the marital deduction. In denying each request, the government placed a heavy premium on making the election properly, the first time, and only after all relevant facts have been ascertained.

Nevertheless, the government allows some flexibility in describing the QTIP assets on Schedule M. As illustrated by TAM 9116003, an estate need not specify the particular assets used to fund a marital deduction bequest of a preresiduary optimum marital deduction amount. Rather than describing the assets on Part 2 of the then-applicable Schedule M, the estate was permitted to state that the election was being made for a specific portion of the estate "represented by a fractional share that is required to reduce the federal estate tax on the decedent's estate to zero . . . ."[146] And TAM 9217005 stated the government's recognition and acceptance of the fact that:

> As a practical matter, the pecuniary amount of the property passing to the marital trust, the value of the property subject to the election, and the assets the executor selects to fund the marital trust will not be known until the value of the gross estate for estate tax purposes is finally determined and administration of the estate is complete. Further, any increase in the valuation of estate assets pursuant to an audit would, under the terms of the trust and formula election, increase the pecuniary amount passing to the trust, the value of the property subject to the election, the quantity of estate assets needed to fund the trust, and the election portion.

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[146] That position now is reflected in Treas. Reg. §20.2056(b)-7(b)(2)(i).To the same effect is TAM 9312002, in which the executor itemized assets that it expected to allocate to a QTIP trust but failed to make the QTIP election for the trust interest itself (the return preparer apparently thought the form was asking for an election that listed "property" rather than a list of "property interests"), and the government ruled that the deduction was permissible because it was clear that it was the trust proper as to which the election was being made and that it would be subject to §2044 inclusion at S's death.

In TAM 9116003 the property interest elected was S's interest in the trust and the personal representative was not required to identify the particular assets that would be used to fund the trust. The TAM recognized that the amount of a bequest, and the identity and value of each asset allocated in satisfaction thereof, cannot be known until any audit changes have been reflected, the FET value of the estate and every asset in it has been determined, and administration of the estate is completed. The TAM also stated that "[w]e note that any underfunding of the marital trust as a result of the valuation of estate assets, or otherwise, would have gift tax consequences as discussed in Rev. Rul. 84-105, 1984-2 C.B. 198, or alternatively, could result in an additional inclusion under section 2044 on S's death." See §13.7.3.2.2 nn.44 – 47 and accompanying text with respect to funding and the Rev. Rul. 84-105 gift issue.

The result stated is necessary due to the realities of marital deduction funding, making the request for technical advice somewhat curious; no similar issue appears to have been raised previously. Indeed, it was not clear why the QTIP election was made as it was, although it seems likely that the personal representative was attempting to follow the requisites of Prop. Treas. Reg. 20.2056(b)-7(a) (now see Treas. Reg. §20.2056(b)-7(b)(2)), which requires that the QTIP election "must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in the value of the entire property" for subsequent estate or gift tax to S. The statement regarding underfunding also was a bit surprising, the Rev. Rul. 84-105 deemed gift being supportable under existing authority, but not the suggestion that additional estate tax liability could result as if the marital bequest was fully funded and S thereafter died with that amount of property subject to estate tax.

Thus, a QTIP formula election of "that percentage interest up to 100 percent of the below described [QTIP trust]" was proper to qualify for the marital deduction, and the regulation now also permits formula elections.[147]

§13.5.6.3.1 Remedying Defective Elections

By a little publicized 1985 TAM,[148] field offices were instructed to allow a closing agreement to cure defective elections for the marital deduction, if the personal representative, the trustee of any involved marital deduction trust, S, and all affected remainder beneficiaries consented to the agreement. That sort of agreement provides one avenue for relief to taxpayers and their advisors in cases in which qualification is precluded by administrative glitches, such as an inadvertent failure to elect the marital deduction properly.

Also available to remedy a defective effort to qualify for the QTIP marital deduction are the procedures under Treas. Reg. §§301.9100-1 through 301.9100-3. These allow taxpayers an extension of time in certain circumstances to cure administrative defects such as defective QTIP elections or reverse QTIP elections by filing an amended return after expiration of the time for filing the original estate tax return. An automatic six month extension of time to make these elections is available if corrective action (filing a replacement original or an amended return listing the property and claiming the deduction) is taken within the six month period.[149]

If a request for an extension of time does not meet the requirements for an automatic extension, the Commissioner has discretion to grant an extension if the taxpayer acted reasonably and in good faith and granting relief will not prejudice the interests of the government.[150] Reasonable action is

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147 Treas. Reg. §20.2056(b)-7(b)(2). See also PLRs 200430002 and 199902014, which accepted as valid QTIP elections made on timely filed returns for 100% of the assets reported on particular schedules and passing in a trust, even though the fiduciary incorrectly calculated the value or amount passing or, in the 2004 Ruling, failed to timely discover and report all of the assets properly includible in the estate, noting that incorrect calculations did not affect the amount properly passing to the marital trusts under the terms of the governing instruments.

148 Issued in July 1985, the TAM was discussed in Bay, QTIP Election on the 706, 14 Prob. & Prop. 6 (July/August 1985).

149 Previously, the QTIP election did not qualify for the six month automatic extension because Treas. Reg. §20.2056(b)-7(b)(4) (which requires that the QTIP election be made on "the last estate tax return filed by the [decedent's] executor on or before the due date of the return including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date") is not a statutorily mandated or prescribed requirement and Rev. Proc. 92-85, 1992-2 C.B. 490, allowed automatic extensions only for elections whose deadlines were pegged by statute to the due date of the return (including extensions). Treas. Reg. §301.9100-2 as finally adopted made Rev. Proc. 92-85 obsolete.

150 Treas. Reg. §§301.9100-1(a) and 301.9100-3. The regulation adopts the standards for reasonableness and good faith that applied under Rev. Proc. 92-85, 1992-2 C.B. 490, modified and clarified by Rev. Proc. 93-28, 1993-2 C.B. 344. See, e.g., PLR 201641018 (it is not stated whether the six-month element was met, and the facts were a bit unusual, in that D's estate made a timely portability election under §2010(c)(5)(A), thinking that the estate was below D's basic exclusion amount; it later was determined that an included asset was worth more than originally reported so an amended return was filed and a request was granted to elect QTIP treatment for a marital trust that was required under the terms of D's estate plan); PLR 199915015 (the discretionary extension was granted to make a partial QTIP election to reduce the deduction claimed on a timely filed return that was prepared with the assistance of counsel, because the executor was not made aware of the availability of a partial election).

presumed[151] if the request is made before the government discovers the failure to timely elect[152] and prejudice is deemed to exist only if granting the requested relief gives the taxpayer a lower tax liability than if the election had been timely made.[153]

In a long series of TAMs and PLRs[154] the government frequently agreed to requests for relief under Treas. Reg. §301.9100-1, most often with respect to defective QTIP elections, stating in the earlier cases that the FET return identified the trust corpus and deducted the value thereof on Schedule M but failed to "unequivocally manifest an affirmative intent to make the QTIP election with respect to the return" – which meant the QTIP election box on the return was not checked – and further stating that "[t]he taxpayer has satisfactorily demonstrated to us that, at the time the return was filed, the taxpayer had the requisite intent to make the election." This later element was a required showing under Rev. Proc. 79-63,[155] which established the then applicable "evidence standard."

Treas. Reg. §301.9100-1 relief no longer is strictly limited to deadlines prescribed only by regulation, ruling, procedure, notice, or announcement (administrative pronouncements). Relief now is available with respect to elections that are required by statute and regulation to "be made by the due date of the taxpayer's return ... including extensions" and certain statutory and regulatory extensions are automatic.

In addition to curing defective QTIP elections, the government also has allowed §2652(a)(3) reverse QTIP election relief in situations in which Schedule R showed allocation of D's GST exemption to a QTIP marital deduction trust but the box was not checked on Schedule R to indicate the reverse QTIP election (or Schedule R was not filed at all).[156] And the government has granted an

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151 Treas. Reg. §301.9100-3(b)(3) states affirmatively that "a taxpayer is deemed to have not acted reasonably and in good faith if the taxpayer (i) Seeks to alter a return position for which an accuracy-related penalty ... could be imposed ... or ... (iii) Uses hindsight in requesting relief." The government is allowed to consider qualified amended returns in determining whether an accuracy related penalty may be imposed.

152 Treas. Reg. §301.9100-3(b)(1)(i). The remainder of Treas. Reg. §301.9100-3(b) sets out specifics that must be shown to prove reasonable action by the taxpayer if the defective election is discovered by the government before a relief request is made. Included is reasonable reliance on a tax professional, and Treas. Reg. §301.9100-3(b)(2) defines reasonable reliance for this purpose.

153 Treas. Reg. §301.9100-3(c)(1)(i). Treas. Reg. §301.9100-3(c)(1)(ii) states that the interests of the government ordinarily are prejudiced if "any tax years ... affected ... are closed by the period of limitations on assessment," which is more likely to involve income tax issues than those elections under the wealth transfer taxes. It is not clear whether relief was requested and rejected, but consider whether it would have been available in Wells Fargo Bank New Mexico v. United States, 319 F.3d 1222 (10th Cir. 2003), in which the donor spouse created an inter vivos QTIP trust but failed to make the requisite election. Unexpectedly the donor spouse died first (the inter vivos QTIP vehicle typically is used to shelter the donee spouse's unified credit in case the donee dies first, as noted in §13.5.6.5) and the taxpayer sought to exclude the transfer from the donor's adjusted taxable gifts base by arguing that the transfer was incomplete because it lacked state law donative intent. The court rejected the argument because the federal gift tax does not require donative intent. So the gift was complete and then estate taxes properly were computed.

154 See, e.g., TAMs 9246003, 9243004, and 9224003, and PLRs 9503019, 9422037, and 9414017. The government indexes these rulings under Uniform Issue List (UIL) §§2056.07-01 and 9100.00-00 and a complete list of relevant rulings can be obtained by reference to the UIL sections.

155 1979-2 C.B. 578, superseded by Rev. Proc. 92-85, 1992-2 C.B. 490, modified by Rev. Proc. 93-28, 1993-2 C.B. 344.

156 See §11.4.3.2.

extension of time to make the QDOT election or to allow a non-United States citizen surviving spouse to irrevocably assign property to a QDOT.[157]

Not all cases will qualify for discretionary relief to cure a defect, however. For example, the government denied Treas. Reg. §301.9100-1 relief in PLRs 9218041 and 9218018 because the personal representative in each situation thought S received a fee simple interest in property and did not intend to make a QTIP election for property in which it only later was determined that S received only a life estate. The request for an extension of time to make an election in the first instance – rather than to correct a defective election – was denied.

Similarly, PLR 9226019 denied relief because the personal representative claimed the marital deduction under §2056(b)(5) and only later determined that S was not granted the requisite general power of appointment. Relief to amend the return to make the QTIP election was denied because the personal representative did not intend to elect QTIP treatment on the original return. Further, PLRs 9222037 and 9219028 denied relief because the personal representative did not claim the marital deduction in computing the tax, in addition to failing to make the QTIP election itself.[158] But PLR 200026007 granted relief for an estate that merely listed the marital deduction on the recapitulation for Form 706 but made no QTIP election. And consistent with the presumption in favor of allowing the marital deduction, PLRs 201903014 and 200143013 granted relief to estates that discovered assets that the return preparer failed to list on the Form 706 but that were includible in the estate and that otherwise did qualify for the marital deduction.

TAM 9224003 denied Treas. Reg. §301.9100-1 relief because the estate properly made the QTIP election and wanted an extension to reduce the amount of marital deduction it claimed, to shelter more of D's unified credit. And PLR 9526015 denied an extension of time to change the amount of a properly-made QTIP election. The estate sought the extension after S died because a partial QTIP election would save taxes in S's estate.[159] The revised election might have been allowable if the automatic six month extension under Treas. Reg. §301.9100-2(b) had been available at the time of S's death and the amended return was filed within the six month period, because an election may be "revoked or modified on a subsequent return filed on or before the due date of the return, including extensions actually granted."[160] In any event, the availability of the six month extension would have given D's estate additional time to assess S's health before making the QTIP election decision.

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157 The government does not have discretion under Treas. Reg. §§301.9100-1 to 301.9100-3 to grant an extension of time to make the statutory election under §2056A after the time prescribed by the statute for making the election has expired. See, e.g., PLR 9843030. Nevertheless it has done so. See, e.g., PLRs 200146015 and 9352003, TAM 9228001. See §13.5.7.3 regarding QDOT qualification.

158 Note, however, that Treas. Reg. §301.9100-3 no longer requires a showing that the estate intended to make the election on the original return. See, e.g., PLR 200211028, in which relief was granted for failure to make a QTIP election in a case in which *no* Schedule M was even filed.

159 Without citing Treas. Reg. §20.2056(b)-7(b)(4)(ii), the government nevertheless held consistent with it that relief under Treas. Reg. §301.9100-1"is not available because a proper election was already made and no extension of time is needed. As provided for by §2056(b)(7)(B)(v), an election under §2056(b)(7), once made, shall be irrevocable."

160 Treas. Reg. §20.2056(b)-7(b)(4)(ii).

Rev. Proc. 2016-49[161] grants limited relief in cases in which (1) D's taxable estate without the marital deduction was less than the exclusion amount (meaning that no marital deduction was needed to avoid imposition of estate tax) or (2) the estate was divided into marital and credit shelter trusts and the election was made improperly with respect to both rather than just for the marital trust alone.[162] Relief is not available if it is clear that the estate wanted to qualify for QTIP marital deduction treatment based on the facts at the time of the election and, on the basis of subsequent developments, sought to reverse that position.[163] For example, if an executor made a §2010(c)(5)(A) portability election along with the QTIP election, the implication is that the marital deduction was intended to reduce taxes and preserve D's exclusion amount, which the portability election then allocated to S. In addition, no relief is allowable if a partial election was necessary to reduce tax liability and the estate simply made an election with respect to more property than necessary.[164]

Most appropriately, PLR 200832011 also allowed relief in a case that reveals that the gist of the irrevocable election rule is that – once made – an election cannot be *reduced*, but an election made may be *increased*, to claim a larger marital deduction than originally sought. Such was the case involving an attorney who assisted in preparation of the Form 706 and who erred by using the (higher) exclusion amount for the year of filing, rather than the (proper, lower) amount for the year of D's death. Based on a too-large exclusion amount, the estate calculated a too-small marital deduction amount needed to reduce D's estate tax liability to zero. The estate filed a Supplemental Form 706 to correct this error upon receipt of a deficiency notice from the government, following audit of the

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161 2016-42 I.R.B. 462, superseding Rev. Proc. 2001-38, 2001-1 C.B. 1335.

162 See, e.g., PLRs 201615004 (QTIP election was not necessary to reduce estate tax liability to zero), 201131011 (federal QTIP election was made solely to qualify for the state death tax marital deduction, to reduce state tax to the lowest amount possible; relief was granted because no marital deduction was needed at the federal level because the estate was below the federal exclusion amount); 200918014 and 200318039 (no election was needed because the estate was below the exclusion amount; listing assets on the estate tax Schedule M constituted an election that the government allowed the estate to reverse), 200448038 (a bizarre application of essentially the same result, holding that the taxpayer never made a QTIP election because terminable interests for which the marital deduction was claimed were listed on the wrong part of the estate tax return *and* no marital deduction was needed because the estate was too small; the net result was a conclusion that an amended return was needed but that no relief was appropriate and that it apparently didn't matter because the estate was nontaxable), 200403093 (in addition to acknowledging an underfunding of the nonmarital trust and that an outright bequest to S did not require a QTIP election, the government allowed relief for election of the nonmarital trust because no estate tax would be incurred even if no election was made for that trust), 201022004, 200535026, 200243030, and 200236021 (in which the election made for both marital and nonmarital trusts was unnecessary for the latter and relief was granted), 201112001 and 200729028 (no election was needed, not for the nonmarital trust, nor for the marital trust because it was a general power of appointment variety), 201036013, 201024035, and 200226020 (in which the marital was not in trust but otherwise the same situation existed and an unnecessary election for the nonmarital was ignored), and 200323010 (in which the election was made for both and the unnecessary election on the nonmarital was ignored, *plus* a miscalculation produced the wrong tax result, which the government also allowed the taxpayer to correct).

163 See, e.g., PLR 200219003 (relief denied to alter QTIP election after S died).

164 PLR 200422050 (request to alter an election that failed to fully shelter D's unified credit rejected because the predecessor to Rev. Proc. 2016-49 applied only if *no* QTIP election was needed, rather than if a partial election was required). But see TAM 200223020, in which relief was granted to correct an error in an election that failed to reduce the marital deduction claimed by the amount of a credit shelter bequest; a 100% election for the marital trust was correct, but the amounts shown on the return were in error because of the mathematical oversight.

return, and sought relief to increase the marital deduction as well.[165] Although the irrevocable nature of the QTIP election might suggest that no change to increase *or* decrease the marital deduction should be allowed, the reality is that the government appears to be concerned only by an estate using hindsight to lower the deduction and thereby reduce the amount subject to inclusion in S's estate. That not being the goal here, the request in this case was granted.

§13.5.6.3.2 Protective QTIP Elections

A personal representative may make a protective QTIP election if, but only if, there is a bona fide issue when the FET return is filed and it concerns whether an asset is includible in D's gross estate, or the amount or nature of the property S is to receive.[166] The protective election is irrevocable[167] and must identify either the specific asset, group of assets, or trust to which it applies and the specific basis for the protective election (such as because there is an ongoing will contest action that makes the marital bequest uncertain).[168]

The Preamble to the final regulations under §2056(b)(7) stated that the government deemed it unnecessary to provide for a protective QTIP election for a trust that fails to meet the requirements of §2056(b)(5) because of changes made to Schedule M.[169] Presumably this refers to the fact that listing assets on Schedule M is an adequate indication of intent to constitute QTIP if all other requirements are met. Thus, if property is itemized, improperly thinking it meets the §2056(b)(5) requirements, it nevertheless will be deemed to have been elected under §2056(b)(7)(B)(v) by virtue of the mere itemization.[170]

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165 Although the Ruling does not state, presumably the supplemental estate tax return was filed after the due date for the original return, because the last *timely* filed return governs the QTIP election and no relief would be required to revise an election on a second, albeit still timely, return.

166 Treas. Reg. §20.2056(b)-7(c). See, e.g., TAM 8937001 (pre-1982 will with a pecuniary bequest equal to the maximum marital deduction allowable "provided, however, that said amount shall not exceed the amount necessary to reduce federal estate tax payable as a result of my death to zero"; a protective election was deemed proper with respect to a residuary trust in case the formula clause produced only the greater of $250,000 or half of the adjusted gross estate).

TAM 8730004 involved a personal representative that listed on the estate tax return specified items of property as terminable interest property for which the §2056(b)(7) election was made. Subsequently, the personal representative sought to add an additional item to the listed terminable interest property, which the TAM disallowed because §2056(b)(7)(B)(v) provides that the QTIP election is irrevocable. "The election made was complete and unambiguous. This case is not a situation where an election was made that was incorrect, ambiguous, or did not accurately describe the qualified terminable interest property." The TAM noted that, if the election applies to individual properties, identification of the properties involved is essential for a valid election.

167 Treas. Reg. §20.2056(b)-7(c)(2).

168 For example, the government granted Treas. Reg. §301.9100-1 relief for making a protective QTIP election in PLR 9520038. The estate claimed a marital deduction on its original return for property passing outright to S. After disinherited heirs initiated litigation, the personal representative filed a protective election under §2056(b)(7) and Treas. Reg. §20.2056(b)-7(c) and the government granted an extension of time to make the election.

169 59 Fed. Reg. 9643 (1994).

170 As an early illustration, TAM 8841001 allowed a QTIP marital deduction for a portion of a residuary testamentary trust of which S was trustee. The estate tax return stated that, if the half did not qualify as a power of appointment marital deduction trust, then the personal representative elected to qualify it as a QTIP trust. According to the TAM, "[a]n election under section 2056(b)(7)(B)(v) of the Code that is conditional upon the property that is subject to such election not otherwise qualifying for a marital deduction under section 2056 is not the equivalent of a revocable election" and therefore was permissible.

§13.5.6.3.3 Authorizing the Election

D's estate plan appropriately might direct the executor to make the §2010(c)(5)(A) election to allocate any §2010(c)(2)(B) DSUE amount to S. Otherwise the executor might be exposed to complaint by a disaffected beneficiary. But it probably is not wise in most cases for a decedent to direct the personal representative regarding the QTIP election itself, dictating whether and to what extent it should be made. Rather, to the extent any statement is thought to be appropriate, the governing document could contain precatory language suggesting factors the personal representative may consider in deciding whether to make a total, partial, or no election at all.

For example, it would be particularly unfortunate to direct an election if the spouses die in quick succession and equalization would be the best tax-oriented result.[171] A fine-tuned partial election could be used instead to minimize the estates' taxes, especially to under-utilize the marital deduction in D's estate and thereby produce estate taxes that would permit a §2013 previously taxed property credit in S's estate.[172] Similar results can be generated by partial disclaimer if the will directed the personal representative to make the QTIP election. But other impediments may interfere with that plan as well.[173] Thus, the election ought to be left to the personal representative's judgment in most cases because drafting documents today for operation potentially many years in the future makes it difficult to know all the elements that may affect the proper postmortem planning election.

Complicating this issue, however, is the notion that a fiduciary's duty to maximize D's estate by minimizing its taxes may make it imprudent for a personal representative ever to make a partial election if the effect is to cause D's estate to pay tax. The personal representative's duties run only to the single estate represented, making it necessary to view D's estate alone. Making an election that results in payment of an avoidable tax arguably is against the estate's interest (even though it may be prudent when viewing both spouses' estates together).[174]

The point is that, although partial elections are contemplated by the Code and regulations,[175] they might not be permissible under state fiduciary law principles unless D's document grants this authority.[176] Thus, many well drafted documents authorize the personal representative to exercise the election in its discretion and hold the personal representative harmless for the effects of this decision on any beneficiary.[177] By way of example:

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171 See §13.2.4.

172 See §13.2.6.

173 See §13.1.4.2.

174 See Ascher, The Quandary of Executors Who Are Asked to Plan the Estates of the Dead: The Qualified Terminable Interest Election, 63 N.C. L. Rev. 1, 48 (1984).

175 See §2056(b)(7)(B)(iii) and (iv), and Treas. Reg. §20.2056(b)-7(b)(2), providing that any partial election is made as to a "specific portion" of a trust, as dictated by §2056(b)(10).

176 In addition, as discussed in §13.5.6.4, the document also should authorize severance of the elected and nonelected portions following a partial election.

177 The clause recommended by Ascher, 63 N.C. L. Rev. 1, 48 (1984) reads:

> I hereby authorize my executor, in his sole discretion, to elect that none, any part, or all of any amount passing under this trust be treated as qualified terminable interest property for purposes of qualifying for the marital deduction allowable in determining the federal estate tax and any state death tax on my estate, regardless of the fact that such taxes are thereby increased or that there is a change in the proportions in which various persons (including my executor) share in my estate. The decision of my executor shall be

> Qualification for Marital Deduction: To the extent my personal representative so elects, it is my intent that the marital deduction bequest and the property comprising this trust estate shall qualify for the federal estate tax marital deduction applicable to my estate. No power or discretion with respect to allocations of property to this trust or administration of the trust shall be exercised or exercisable inconsistent with this intent.[178] I expect that my personal representative will make an election to treat some part or all of this trust as qualified terminable interest property, although I recognize that circumstances could arise in which such an election would not be in the best interests of the beneficiaries of my estate. The decision whether and to what extent to make that election shall be in the sole discretion of my personal representative, whose decision shall be conclusive on all concerned and who shall have no personal liability for any consequences of that election. The election, even if not made, shall be deemed to have been made with respect to the entire trust for purposes of determining the amount of the bequest to this trust.

It probably is advisable to put this language in the QTIP trust provisions, rather than in a clause appearing elsewhere in the document dealing with tax elections generally. This is an important matter relating to the marital deduction and there is less likelihood of using the wrong clause in the wrong form if all QTIP related provisions are in one place (or, worse, of overlooking something because it does not appear where the personal representative might be looking).

The last sentence of the sample clause specifies that the amount of the marital deduction bequest will be determined pursuant to the formula clause regardless of the extent to which the personal representative makes the QTIP election, as if the election was made with respect to the entire trust. The corresponding balance of the estate passing into the nonmarital trust will be computed accordingly. Without this provision, the personal representative would not know the relative size of these trusts because it would be unclear whether the formula direction to reduce taxes to the lowest possible amount had been met.

Sophisticated postmortem estate planning presents the personal representative with an array of elections, including whether to elect §2032 alternate valuation or §2032A special use valuation, whether to make the §642(g) swing item election, choosing the appropriate income tax year for the estate, determining the best size of any partial QTIP election, whether to allocate D's unused exclusion amount to S, and whether to allocate any part of D's GST exemption to the QTIP trust, just to name some of the most common.

Each election can affect the size of the marital deduction, the amount of income and estate taxes incurred, and ultimately the size of various entitlements. Liability to beneficiaries who feel wronged by these elections can be significant, and the personal representative's task is made all the more sensitive by the constant threat of litigation. As a consequence, many well drafted estate plans also include a provision, such as the following, that addresses the chore of making these elections.

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binding and conclusive upon all persons interested in my estate, and my executor shall have no liability as a result of such decision.

178 The general "saving clause" language regarding D's intent with respect to the marital deduction bequest makes sense, merely to resolve any doubts in favor of deductibility. On the advisability of using such a clause, see Johanson, The Use of Tax Saving Clauses in Drafting Wills and Trusts, 15 U. Miami Inst. Est. Plan. ¶2100 (1981), and the discussion on saving clauses in §13.6.3.

Tax Elections: In determining the wealth transfer and income tax liabilities related to my estate, my personal representative's decision as to all available tax elections shall be conclusive on all concerned and my personal representative shall have no personal liability for any consequences of any election. The marital deduction bequest shall not be construed as requiring that the personal representative exercise any tax election[, other than the election to have the marital deduction gift treated as qualified terminable interest property,][179] only in such manner as will result in a larger allowable estate tax marital deduction than would be obtained if a contrary election had been made. No adjustment shall be made between principal and income or in the relative interests of the beneficiaries to compensate for the effect of any elections or allocations made by my personal representative.[180] If my personal representative joins with S in filing income tax returns, or consents for gift tax purposes to having gifts made by either of us during my life considered as made half by each of us, any resulting liability shall be borne by my estate and S in such proportions as they may agree.

§13.5.6.4 Partial QTIP Elections

Partial QTIP elections are anticipated by the Code and regulations and they should be authorized by the estate plan so that postmortem planning may evaluate and adjust the size of the appropriate election. Several practical aspects of this planning are how the election should be described to identify the portion as to which the election is made, and the ancillary consequences of a partial election (including coordinated allocation of any DSUE amount under §2010(c)). It is permissible and advisable to make partial elections by formula,[181] which may protect against the consequences of using a specific fraction or percentage if values or other factors change on audit, in which case the desired tax results might not be achieved. This is significant because, once made, the election is irrevocable.[182]

Generally self-adjusting formula fractional elections are preferable. The numerator is that amount of marital deduction desired and the denominator is the value of the fund against which the fraction is applied.

TAM 9327005 illustrates the importance of this principle for partial QTIP election planning. As required by §2056(b)(10),[183] the estate stated its desire to qualify a specified dollar amount of a trust for the marital deduction by converting the numerical amount into a percentage of the total. That dollar amount was based on the value of property subject to a buy-sell agreement, which the government successfully challenged. Because that value changed, the amount of marital deduction needed to produce the desired tax result also changed, which the estate argued would occur

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179 This bracketed provision is to be used only if the will mandates that the QTIP election be made, which normally is not recommended.

180 See §§5.8.4 and 13.3.6 regarding tax election adjustments.

181 Treas. Reg. §20.2056(b)-7(b)(2)(i) provides: any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying §2044 or §2519. The fraction or percentage may be defined by formula.

182 §2056(b)(7)(B)(v). See §13.5.6.3. Similar issues can arise for state death tax marital deduction purposes. For example, Providence Bank & Trust Co. v. Raoul, 2022 WL 628629 (Ill App. Ct.) (allowing estate to alter its state QTIP election within the extended time for filing the state death tax return, to reflect an audit adjustment) likely would have been avoided if the state QTIP election had been made by self-adjusting formula.

183 See §2056(b)(7)(B)(iv), Treas. Reg. §20.2056(b)-7(b)(2)(i), and the discussion in §13.5.2.3.

automatically under its partial QTIP election. The government rejected that allegation, however, because the percentage election was not made by a formula clearly stated on the estate tax return.

A self-adjusting fraction or percentage election would specify the result sought (such as to reduce the estate tax incurred in the estate to the lowest amount possible without increasing state death taxes) rather than specifying the dollar amount or the fixed percentage of an estate based on the return as filed.[184] To better illustrate that too much specificity also can be troublesome, consider TAM 8722010, which involved a nonmarital trust as to which the personal representative made a formula election of that

> fractional share of up to 100 percent ... that is required to reduce the federal estate tax on the decedent's estate to zero *based upon* finally determined federal estate tax values, after *taking into consideration* all other items deducted on the federal estate tax return, the allowable state death tax credit (to the extent it does not increase the amount of death taxes payable to any state), and the unified credit. [Emphasis added]

The problem was that the estate tax return showed that this produced an election of 69.34%. The personal representative proposed to increase the percentage elected to offset the tax generated by a previously unreported adjusted taxable gift that was discovered during audit of the estate tax return. The government denied the increase, stating that the formula failed to consider items such as administration expenses and prior gifts and that "[t]he terms of the formula chosen by the executor are clear and unequivocal in defining the part of the by-pass trust to which the election applies."[185]

In other words, irrevocable means irrevocable and specific means "you're stuck" with the percentage stated. This drafter's mistake was by noting some items to consider and not being fully inclusive, or by not just stating the general result sought and leaving it to the personal representative to work out the details. As advised by the government in TAM 8728005, a miscalculation, oversight, or misunderstanding of the law is not sufficient to mitigate the irrevocable nature of a QTIP election.[186]

TAM 9017001 illustrates another danger of an improper irrevocable QTIP election. When D's surviving spouse died within six months after D's estate tax return was filed it was discovered that D's estate was overvalued. A supplemental estate tax return was filed and accepted for the reduced

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[184] It may occur that the estate tax value of included property will exceed the actual amount received on a forced sale under a buy-sell agreement, in which case the estate will have insufficient funds to satisfy the full marital bequest based on a self-adjusting fraction or percentage and, thus, a formula election may call for more marital deduction than the estate can satisfy. In such a case the marital deduction may be reduced to the full amount available in the estate as of D's death, and it may be that the residue of the estate must abate to satisfy a self-adjusting marital bequest. This latter consequence may be inconsistent with D's overall objectives in the estate plan, and a uniform mechanism for making partial QTIP elections or marital deduction bequests therefore cannot be stated.

[185] This holding probably was wrong if any of D's unified credit was available to offset any gift taxes incurred on that prior adjusted taxable gift, because the effect of the audit change would be to reduce the available unified credit and the unified credit *was* a factor that could be considered. If this assumption is not correct, the question should have been moot, because no increase in the marital deduction at death would effectively eliminate the taxes otherwise caused by addition of that prior adjusted taxable gift.

[186] That said, however, consider the relief offered in certain cases, as noted in §13.5.6.3, particularly the discussion in §13.5.6.3.1 of PLR 200832011, which granted relief to correct a too-small QTIP election, rather than one that was too large.

value. The question considered was the proper amount includible in S's gross estate under §2044. One option was a fraction of the proper value of D's estate of which the numerator was the original marital deduction election amount and the denominator was the original FET value of D's estate.

> *Example:* D's estate originally was valued at $17.5 million. A fractional partial QTIP election qualified 42.9% of the entire estate for the marital deduction to produce a $10 million optimum marital deduction result. Later it was determined that the proper value of D's estate was $17.25 million and a proper portion (to produce the same result) would be about 42% of that amount.

If the government selected the option noted the original 42.9% election would dictate the amount includible in S's gross estate, making $3,110,250 (42.9% × $7.25 million) includible, rather than the $3,045,000 (42% × $7.25 million) desired.

Fortunately, because the amount elected was based on a self-adjusting formula, the TAM concluded that the proper inclusion should be based on the fraction using the reduced value of D's estate, which reduced the amount includible in S's gross estate by the full amount of the reduction in D's gross estate under the proper valuation. The fractional election would have produced the wrong result for marital deduction purposes and for subsequent inclusion in S's gross estate if this had involved a partial QTIP election of a specific fraction of D's estate using the mistaken value of D's estate.

The regulation[187] provides models for provisions making partial elections:

> D's executor elects to deduct a fractional share of the residuary estate under §2056(b)(7). The election specifies that the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary trust (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate).

> The facts are the same . . . except that, rather than defining a fraction, the executor's formula states: "I elect to treat as qualified terminable interest property that portion of the residuary trust, up to 100 percent, necessary to reduce the Federal estate tax to zero, after taking into account the available unified credit, final estate tax values and any liabilities and specific bequests paid from the residuary estate." The formula election is of a fractional share . . . equivalent to the fractional share determined in [the prior example].

Similarly, PLR 9043015 approved the use of a fractional share formula election of which the numerator was the smallest §2056(b)(7) deduction that would result in zero FET, after using the maximum unified credit available, and the denominator was the FET value of all trust assets. The government noted that the proposed formula satisfied the purpose of the partial share requirements because the elected part will reflect its proportionate share of the increment or decline in the property for §§2044 and 2519 purposes.

There are several planning defects in these examples that might need correction in some circumstances. For example, it may not be appropriate to utilize the net residue denominator

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[187] Treas. Reg. §20.2056(b)-7(h) Examples 7 and 8.

employed by the government's fraction rather than a gross residue approach.[188] And neither of these examples would be useful in an estate that seeks to pay some taxes in D's estate to secure a §2013 previously taxed property credit in S's estate or to equalize the estates and thereby minimize taxes paid over both spouses' estates.[189]

Drafting formula partial election clauses that adjust to changed values on audit and that produce the optimum amount of tax on S's death is a distinctive (and challenging) undertaking. Nevertheless, the government will approve elections pursuant to formula clauses.[190] The regulation permits elections that qualify a different portion of a fund – for example, an uncommon approach that is illustrated would be the portion necessary to produce a specified dollar amount of income annually.[191] And it should be acceptable to make a formula partial election that produces a specified dollar amount of tax payable rather than a reduce-taxes-to-zero approach.

§13.5.6.4.1 Separate Shares Permitted

In addition to drafting a formula partial election properly, it is necessary to consider the effect of the partial election on other portions of the document. For example, what will be the effect of a partial election on the tax apportionment provision? Is it clear that the tax imposed under §2044 when S dies will be payable only out of the elected portion of the trust, and that taxes caused on D's death by virtue of making only a partial election will be paid out of the nonelected portion of the trust?[192] To ease the determination of these issues the regulation[193] permits separate trusts to be created by a partial election:

> Division of trusts – (A) In general. A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law. Any such division must be accomplished no later than

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188 See §13.7.7.2.

189 See §§13.2.4 and 13.2.6.

190 See, e.g., PLRs 8440037, 8432032, and 8350028.

191 Treas. Reg. §20.2056(b)-7(h) Examples 11 and 12; and see Treas. Reg. §§20.2056(b)-5(c)(3) and 20.2056(b)-5(c)(5) Example 1 (relating to power of appointment trusts), all reflecting and following the holding in Northeastern Pennsylvania Nat'l Bank & Trust Co. v. United States, 387 U.S. 213 (1967), as discussed in §13.5.2.3.

TAM 9021001 involved a trust directing the payment of $2,500 per month to S from income and, if necessary, from corpus. The government applied the interest rate generally applicable to the valuation of annuities at D's death to determine the dollar amount of corpus needed to produce this monthly annuity (rather than the discounted present value of the annuity payments themselves). Then it relied on §2056(b)(7)(B)(iv) for the proposition that a QTIP election with respect to that dollar amount of corpus would be treated as an election with respect to a specific fractional portion of the trust of which the numerator was this amount of corpus and the denominator was the total value of the trust. Finally, it advised that, because "such separate property is not severed from the balance of the trust corpus, it follows that an undivided portion of the trust corpus represents the includible separate property for purposes of §§2044 and 2519" on a later taxable event.

This pre-§2056(b)(10) application of the specific portion requirement may not apply with respect to post-§2056(b)(10) annuities, although that issue remains under advisement, all because the government limited the examples under §2056(b)(7) to pre-§2056(b)(10) trusts. It did this because it had not yet decided how to apply the specific portion rule to annuities. The point here, however, is that any partial election authorized in this respect will more appropriately be made by a formula that self-adjusts to accommodate valuation disputes, changes in the government's application of interest rate assumptions, or mortality tables.

192 See §§3.3.15.2 and 13.5.6.4.2.

193 Treas. Reg. §20.2056(b)-7(b)(2)(ii).

the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.

(B) Manner of dividing and funding trust. The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.[194]

If separate trusts are not created but a partial election is made, the regulation[195] makes it clear that principal invasions can be charged against the portion as to which the QTIP election was made, before invasions reduce the nonelected share. Thus, the property included in S's gross estate is reduced by invasions from the QTIP trust as though no invasions were made from the nonelected portion and no distributions were made from the nonmarital trust.[196]

To accomplish this form of planning, the following format is thought to qualify on the basis of the present state of the law:

A portion of the Marital Trust, herein referred to as the "qualified terminable interest portion," shall qualify for the federal estate tax marital deduction. The value of the qualified terminable interest portion at any time may be determined by multiplying the value of the trust estate at that time by the fraction then in effect. Commencing with my death, and until the first distribution of principal pursuant to the provisions of §[*], the numerator of the fraction shall be equal to [the amount or formula-determined deduction desired], and the denominator shall be the value as finally determined for federal estate tax purposes of all interests in property included in the Marital Trust. At the time of each payment of principal pursuant to the provisions of §[*], the fraction shall be adjusted, first by restating it so that the numerator and denominator are the values of the qualified terminable interest portion and of the trust estate, respectively, immediately prior to the payment, and then by subtracting the amount of the payment from each of the numerator and the denominator, except that the numerator shall not be reduced below zero.

Also as authorized by regulation,[197] the last sentence of this provision creates a "rolling fraction," which has the effect of treating any invasions of principal for S's benefit (pursuant to §[*], permitting discretionary distributions by the trustee or withdrawals by S), as coming from the elected QTIP portion. The effect is to reduce the amount of property includible under §2044 on termination or §2519 on disposition of S's income interest.

Example: In 2001 when the exclusion amount was $1 million the initial fund consisted of $1.25 million and the initial fraction was one-fifth (which produced an optimum marital deduction at that time). A distribution of assets worth $100,000 is made to S when the trust is valued at $1.3 million. The fraction immediately before the distribution, restated to reflect current values, is 260,000/1,300,000 (1/5 of $1.3 million) and, immediately after the distribution, the fraction is 160,000/1,200,000 (2/15). The amount that would be includible in S's estate if S dies when the

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194 See Treas. Reg. §20.2056(b)-7(h) Example 14 for an illustration of this provision.
195 Treas. Reg. §§20.2044-1(d)(3) and 25.2519-1(c)(3).
196 See Treas. Reg. §20.2044-1(e) Example 4.
197 Treas. Reg. §20.2044-1(e) Example 4.

balance of the trust is valued at $1.8 million would be $240,000 (2/15 of $1.8 million). Had the fraction not been adjusted, the inclusion amount would have been $360,000 (1/5 of $1.8 million). Thus, the effect of the rolling fraction adjustment is to take all of the distribution to S from the marital portion rather than just 20% of it.

The practical problem in the administration of a trust with a rolling fraction is that the fraction first must be restated to reflect current values before it can be adjusted. Thus, every asset in the fund must be revalued, which may create a difficult, time-consuming, and potentially expensive administrative chore.[198] Consequently, most planners direct division of the original fund into two separate shares following a partial election,[199] which accomplishes the same result as the rolling fraction, without the need to engage in the administrative chore of periodically adjusting the fraction.

The rolling fraction may be wise planning because division into separate shares has the disadvantage of requiring administration of multiple separate entities, including: (1) the nonmarital trust, (2) any nonelected portion of the QTIP trust, (3) any reverse QTIP GST exempted portion of the estate tax elected portion of the QTIP trust, as required by the "all or nothing" rule in §2652(a)(3)(B),[200] and (4) the balance of the estate tax elected portion of the QTIP trust. The rolling fraction also may be useful if the trust owns difficult to sever assets, such as the right to receive distributions from an IRA or a qualified retirement benefit plan.

On the other hand, it may be preferable to sever and pursue different investment strategies (for example, "high yield" for the elected portion and "growth" for the nonelected portion) that would not be possible in a single trust using the rolling fraction. If the rolling fraction approach is used, however, it makes sense to direct that distributions of principal to S be made first from that portion of the estate tax elected portion of the QTIP trust (item 4, above) that is not also the reverse QTIP elected portion meant to shelter D's GST exemption (item 3 above), as authorized in PLR 9002014.

§13.5.6.4.2 Paying Taxes from Nonelected Portion

The equitable result may be for all taxes generated by a partial QTIP election to be paid out of the nonelected portion of the QTIP trust.[201] By proper accounting in estate plans that embrace the concept of equitable apportionment, this decision will not affect the amount includible at S's subsequent death because taxes in D's estate are not paid from the qualified portion of the QTIP in

198 Before promulgation of final regulations some planners were wary of the rolling fraction approach, believing that any portion of the marital trust not qualified for the deduction by the partial election must be subject to exactly the same provisions as the elected portion. Because Treas. Reg. §§20.2044-1(d)(4), 20.2056(b)-7(b)(2)(ii), and 20.2056(b)-7(h) Example 9 allow severance of the qualified and nonqualified portions and reduction of the qualified portion first by distributions to S, and because Treas. Reg. §20.2044-1(e) Example 4 reflects a single fund with a partial election and a rolling fraction that charges the qualified share first with any distributions made, it appears that these cautions need not be reflected any longer. Cf. PLR 9002014 (division of a QTIP trust for a reverse QTIP GST exemption allocation was respected, notwithstanding a trust provision directing the order for invasions of trust property).

199 A court may grant a request to make the severance even if neither the document nor state law provides express authority therefor. See, e.g., In re Estate of Case, 585 N.Y.S.2d 1004 (Surr. Ct. 1992).

200 See §11.4.3.2.

201 See §3.3.15.2.

any event.[202] Instead, the issue here is whether to pay these taxes from the nonmarital portion of D's estate or from the nonelected portion of the QTIP trust.

Each choice has advantages, so some gambling is required. For example, the government has shown extreme antipathy to estate plans that permit nonelected portions of a QTIP trust to pay less than all income annually to S.[203] Although it appears to have ceased litigating the issue of qualification following a partial election, that antipathy may arise again in some unexpected manner in the future, which prompts some planners to direct the payment of all income to S from both the elected and non elected portions of a QTIP trust, while a nonmarital trust may permit accumulations of income.

Payment of taxes from the nonelected portion of the QTIP trust thus effectively reduces the income subsequently generated and payable to S in these plans, thereby potentially reducing income taxes during S's overlife (if that income otherwise is distributable to lower income taxable beneficiaries) and the amount subject to inclusion in S's gross estate at death (if excess income is not distributed to S). On the other hand, if S may die within 10 years after D and if the nonelected portion of the QTIP trust must direct the payment of all income annually, then generally the trust will produce a §2013 credit that a discretionary income nonmarital trust may not.[204]

More importantly, payment of the tax from the nonelected portion of the QTIP trust, rather than from the nonmarital trust, guarantees that the ultimate beneficiaries of the QTIP trust will pay the tax under a partial election. They are the beneficiaries who would have paid the tax when S dies if a QTIP election had been made for the entire property, and making them pay any tax attributable to a partial election maintains this apportionment. The only effect of the partial election is whether a portion of those taxes will be incurred at D's death instead of all tax being paid at S's death.

This consequence can be important if the QTIP and nonmarital trusts pass to different remainder beneficiaries and reflects the fact that §2207A effectively apportions against the QTIP trust any tax on the QTIP trust incurred at S's death (or earlier, under §2519). In most cases this tax apportionment should not change just because a particular QTIP election causes a portion of the tax to be incurred when D dies. Furthermore, preventing payment from the nonmarital trust avoids the use of potentially GST exempt property to pay estate taxes if the nonmarital trust was the first fund to which the GST exemption was allocated.

Although it should not be necessary to physically segregate the elected and nonelected portions of the QTIP trust following a partial election, a division might make it easier for the fiduciary to account for each portion and identify the taxes apportioned to the nonelected portion without jeopardizing the marital deduction for the elected portion. Thus, the client probably should decide whether taxes should be paid from the nonelected portion and, if so, then the drafter should decide whether to direct that the QTIP be severed into two portions.[205]

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202 See §13.4.2.3.3.

203 See §13.5.6.4.3.

204 See §13.2.6.

205 PLR 8517036 illustrates that it is important to draft the nonelected portion provisions in a way that clearly makes taxes payable only from the nonelected portion, without affecting qualification of the elected portion for the marital deduction. The estate attempted to qualify a trust that contained a tax payment provision for the marital

§13.5.6.4.3 Contingent Income

Most estate plans direct that property not passing pursuant to a marital deduction bequest be held in a nonmarital trust and many nonmarital trusts contain discretionary income distribution provisions. Some plans also provide that any nonelected portion of a QTIP trust pours over to the nonmarital trust, which the government at one time asserted violates the all-income requirement if the nonmarital trust income is not guaranteed to S. Thus, the government's position was that a nonelected QTIP pour-over provision to a discretionary income trust would disqualify the entire QTIP trust for marital deduction purposes under §2056(b)(1), even if the personal representative made a 100% QTIP election.

The government's argument was that, on the happening of an event or contingency (the executor's partial QTIP election), S's mandatory income interest terminated or failed and an interest in the QTIP trust passed under D's estate plan to someone other than S or his or her estate. Put another way, the government argued that failure to preserve the same dispositive provisions without regard to whether the QTIP election was made violated the government's interpretation that S's right to receive income cannot be contingent on the election being made. That issue created quite a saga, although it now appears to be resolved in the taxpayer's favor.[206]

Representative of the case law is Estate of Clayton v. Commissioner,[207] in which D's estate plan provided for nonelected QTIP property to pour-over to a nonmarital trust that did not guarantee payment to S of all income annually. The Tax Court rejected the taxpayer's argument that, by making the QTIP election, the property qualified for the marital deduction and did not pour-over to the nonqualifying trust, stating that the Code requires that the income interest must qualify for the marital deduction independent of the QTIP election being made.

PLR 9224028 then expansively interpreted *Clayton*, stating that the marital deduction was not available for an otherwise QTIPable trust because any nonelected property was distributable to a nonmarital trust. According to the government, if the personal representative did not make the QTIP election, S would be divested of any interest in the QTIP trust. This made the personal representative's power not to elect QTIP treatment tantamount to an impermissible power in the personal representative to appoint the QTIP property in violation of §2056(b)(7)(B)(ii)(II) (no person may have a power to appoint QTIP property to anyone other than S). Without mentioning whether the nonmarital trust allowed distributions of corpus to anyone other than S, or whether it provided for the payment of all income to S annually, the government simply held that this power to control the QTIP trust corpus alone was sufficient to preclude a QTIP marital deduction.

A factually similar case, Estate of Robertson v. Commissioner,[208] decided within two weeks after release of PLR 9224028, reached the same result for the same reason. And Estate of Spencer v.

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deduction. There would have been no taxes and the provision authorizing payment of taxes from the trust would have had no effect if the government allowed the 100% QTIP election sought by the estate. The government ruled, however, that §2056(b)(4) required reduction of the otherwise allowable marital deduction by the full amount of taxes that could have been paid from that trust, as if no marital deduction QTIP election had been made. See §13.4.2.3.3.

206 For a full exegesis see Supp. §13.2.8 n.8 (5th ed.).

207 97 T.C. 327 (1991), rev'd, 976 F.2d 1486 (5th Cir. 1992).

208 98 T.C. 678 (1992).

Commissioner[209] similarly disallowed the marital deduction because any nonelected property was treated as a separate trust as to which S was not the sole beneficiary.

The Court of Appeals for the Fifth Circuit ultimately reversed *Clayton*,[210] the Court of Appeals for the Eighth Circuit reversed *Robertson*,[211] and the Court of Appeals for the Sixth Circuit reversed *Spencer*.[212] In a lengthy decision that detailed the policy underlying the QTIP exception to the nondeductible terminable interest rule, the *Clayton* court on appeal essentially held that the QTIP election relates back to the date of D's death so that nothing in the document diminishes the all-income entitlement of S after the election is made and elected property is identified as remaining in the QTIP trust. As stated by the *Robertson* court on appeal, "it is irrelevant to inquire what would have happened had the election not been made."[213]

Both courts rejected the government's argument that the full property *available* for election is the property as to which S must have the requisite income interest and as to which no one may have a prohibited power of appointment. Each court essentially held that it is only the portion as to which the deduction is granted that must comply with those requirements. As stated by the *Clayton* court on appeal, "the property being tested for eligibility is the same property to which the election made . . . applies."[214]

The Tax Court reversed itself when the issue came to it again in Estate of Clack v. Commissioner.[215] Reflecting its track record on appeal, without adopting the rationale of any of the three prior court of appeals decisions that had reversed it, and specifically avoiding a question whether the QTIP election relates back or is tested as of the time when the estate tax return is filed, the Tax Court simply stated that it "will no longer disallow the marital deduction for interests that are contingent upon the executor's election under §2056(b)(7)(B)(v), where the election is actually made under facts similar to those in the instant case."[216] Ultimately the government promulgated a new regulation throwing in the towel on this issue.[217]

There is a reason to be aware of the course of this development. The opinion on appeal in *Clayton* regarded the QTIP election as relating back to the date of death. Thus, if the right to income was guaranteed with respect to the elected portion it was deemed to be guaranteed at all times after

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209 64 T.C.M. (CCH) 937 (1992).

210 976 F.2d 1486 (5th Cir. 1992), rev'g 97 T.C. 327 (1991).

211 15 F.3d 779 (8th Cir. 1994), rev'g 98 T.C. 678 (1992).

212 3 F.3d 226 (6th Cir. 1995), rev'g 64 T.C.M. (CCH) 937 (1992).

213 15 F.3d at 784.

214 976 F.2d at 1496. The court also deflated the government's power of appointment argument. 976 F.2d at 1498 – 1499. And it stated that the effect of the election related back to D's death for qualification purposes. 976 F.2d at 1498.

215 106 T.C. 131 (1996) (a reviewed opinion in which 16 judges essentially joined in or concurred in the court's decision), acq. in result only, AOD 1996-011, 1996-2 C.B. 1. See generally Johnson, Qualified Terminable Interest Property: Discussion of the Alternate Bequest Approach in Clayton v. Commissioner, 18 So. Ill. U. L.J. 159 (1994).

216 106 T.C. at 141.

217 Treas. Reg. §20.2056(b)-7(d)(3)(i):

> [A] qualifying income interest for life that is contingent upon the executor's election under section 2056(b)(7)(B)(v) will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse.

D's death. *Spencer* regarded that holding as an unnecessary legal fiction. Instead, *Spencer* stated that qualification for the marital deduction is to be determined "upon the date of the QTIP election," rather than at the date of D's death. Some planners will read *Spencer* as standing for the proposition that a trust will qualify for the deduction if the trust did not qualify for the marital deduction at D's death but it can be reformed before the QTIP election is required to be made. Although a marital deduction reformation procedure would be a sensible addition to the Code, it took legislative action to provide its counterpart in §2055(e) and it is unlikely that it will be deemed to exist by judicial fiat following *Spencer*.[218] Nevertheless, in a pinch, reliance on a *Spencer* argument may be an appropriate litigation strategy.

§13.5.6.5 Inter Vivos QTIPs

Prior to 2010 estate planning for spouses with disparate wealth often led to the suggestion that the more wealthy spouse make a gift to the less wealthy spouse to cover the contingency of "deaths out of order."[219] Often a planning concern in noncommunity property states, the tax-sheltering benefit of one unified credit (and a full use of that spouse's GST exemption) may be lost if the nonpropertied spouse dies first and no inter vivos intraspousal gifts were made. Adoption in 2010 of §2010(c)(2)(B) portability of any DSUE amount moderates this concern, although the discussion in §13.1.1 reveals that portability is not the most efficient use of D's unified credit. The following discussion is about other avenues, although the complexity involved likely dictates against this planning in garden variety situations.

Until the advent of the inter vivos QTIP trust, the only ways to address this concern were by outright life time gift to the less wealthy spouse, by an inter vivos general power of appointment marital deduction trust (which gave the donee spouse power to dispose of the transferred property), or by a §2513 inter vivos split gift to a third party (which took the property out of the marital coffers entirely).

Since its enactment in 1982, §2523(f) allows the propertied spouse to create an irrevocable inter vivos QTIP trust to pay income to the donee spouse for life, with the remainder passing as the donor spouse originally designated in the trust, or as the donee may appoint pursuant to a nongeneral testamentary power of appointment, if granted by the trust.[220] The donor spouse may make an inter vivos QTIP election under §2523(f)(4), making the initial transfer gift-tax free and, on the donee spouse's death, corpus will be includible in the donee spouse's gross estate, thus sheltering that spouse's unified credit, taking advantage of the donee spouse's GST exemption, or taking advantage

218 Estate of Rapp v. Commissioner, 71 T.C.M. (CCH) 1709 (1996), sidestepped the issue whether *Spencer* is tantamount to a postmortem judicial reformation authority, the court holding that a postmortem state court reformation of a defective QTIP trust (it only paid income in the trustee's discretion) was not adequate to qualify the trust for the marital deduction because the state court proceeding was not binding on the federal government and, therefore, the trust failed to qualify regardless of when the all-income-annually test was applied: at death or when the QTIP election was made. A similar provision, state court order, and denial of the marital deduction were involved in TAM 8721002. But see PLRs 200919003 and 200045004, in which the trust drafters admitted to mistakes in drafting (inclusion of a nongeneral power in the later case, reversing the order of marital and nonmarital trusts in the former), state courts rectified the errors, and the government accepted these reformations as effective.

219 See §13.2.4.

220 See §§2523(f)(3) and 2056(b)(7)(B)(ii) (flush language).

of any available bracket run in the donee spouse's estate – all without giving the donee spouse more control over the trust property than the donor chooses.

If control is not a concern and if bifurcation of the wealth between the two spouses to create a chunk for each is not viable or desirable, a different alternative discussed in §13.2.4 may exist. The spouses create two separate trusts or, if they own property together (such as community property or tenancy by the entirety or joint tenancy property), they may create one joint settlor trust. Each may revoke whatever transfer he or she makes while both spouses are alive, and D is given a power to appoint trust property sufficient to cause estate tax inclusion of some portion of S's property in D's estate, to take advantage of D's unified credit and GST exemption.

According to the government, (1) their initial contributions to these trusts are not taxable gifts because of their retained powers to revoke; (2) any inter vivos distribution to either spouse constitutes a gift of the distributed property by the nonrecipient spouse to the recipient of the distribution, which qualifies for the gift tax marital deduction; (3) trust property is includible in D's estate, either under §2038 due to the transfer with retained power of revocation or under §2041 due to the power of appointment; (4) when D dies S is deemed to make a gift to D of the §2041 includible property, which also is deemed to qualify for the gift tax marital deduction; and (5) inclusion to D causes that property to be treated as passing from D, meaning that S does not suffer §2036(a)(1) retained interest inclusion of any part of that trust when S dies.

The government essentially regards S as making a completed gift to D immediately before D's death, as if the spouses had figured out who would die first and placed title to their properties entirely in D's name.[221] Inclusion in S's gross estate is avoided much like the position taken in Treas. Reg. §25.2523(f)-1(f) Example 11 regarding the effect of §2044 inclusion of an inter vivos QTIP trust in the estate of the donee spouse, followed by a secondary life estate in the surviving donor. Either treatment avoids §2036(a)(1) inclusion when the original donor spouse dies second, because estate tax inclusion in the donee spouse's estate cleanses the survivor's involvement with the trust.

All of this addresses the important inquiry in any inter vivos QTIP trust context whether S may enjoy a life estate in all of the trust property after D's death. In such a plan the question is whether that secondary life estate in what essentially is a nonmarital trust will cause §2036(a)(1) to apply when S subsequently dies. The government's PLR position is that trust property includible in D's gross estate at death under §2041 is regarded as if D was the transferor and any secondary life estate in S is deemed to have been created by D, rather than having been retained by S.[222] Under this vision, §2036(a)(1) would not apply at the surviving donor's subsequent death.

There is a bit of uncertainty in the inter vivos QTIP context because an inter vivos transfer into a QTIP trust that reserves a secondary life estate to the donor spouse is the subject of §2523(f)(5)(A). If the donor dies *first*, that provision specifies that "(i) such property shall not be includible in the

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221 If the spouses could do this more than one year before D's death the §1014 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) is applied to preclude their attempt to adjust the basis in S's half. As explained in more detail in §13.2.5, the government held that the property deemed gifted by S to D should be viewed as being returned to S under D's credit shelter and marital deduction plan, which would trigger application of §1014(e), denying a basis increase on S's half of the trust corpus.

222 See the discussion in §13.2.4.

gross estate of the donor spouse, and (ii) any subsequent transfer by the donor spouse shall not be treated as a transfer for purposes of" the gift tax. Thus, the donor is protected against inclusion of the trust property under §§2036 and 2038.[223] But §2523(f)(5)(B) limits this exclusion to periods before any estate or gift taxable transfer by the donee, which appears to mean that this protection is lost if the donee dies first and the donor's reserved secondary life estate becomes possessory.[224]

Notwithstanding the seemingly clear language of the Code, the government has determined to apply the same result following inclusion of the trust property in the donee spouse's gross estate under §2044 as it did when inclusion results under §2041. Thus, ignoring §2523(f)(5)(B) and Treas. Reg. §25.2523(f)-1(d)(2), Treas. Reg. §25.2523(f)-1(f) Example 11 states that §2044 inclusion to the donee effectively cleanses the trust in the same manner as §2041, meaning that the donor's retained interest will not cause inclusion to the donor regardless of the order of deaths.[225]

Although it is contrary to what appears to be the law, this result is not likely to be challenged by taxpayers, and the government is bound by the regulations. Thus, at least with respect to the inter vivos QTIP these results appear to be reliable and make inter vivos intraspousal transfer planning easier.[226]

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223 Or the otherwise appropriate estate or gift tax liability if the donor dies or releases the secondary life estate before the donee spouse incurs tax under §2044 or §2519, notwithstanding the donor's retention of an interest.

224 Notice that §2523(b)(2) precludes the donor from retaining any power to appoint an interest in an inter vivos QTIP trust, even if that power is not exercisable until after the donee's death, and that the exceptions in §§2523(f)(1)(B) and 2523(f)(5) apply only with respect to §2523(b)(1) and the donor's retained interests, not to powers that are the subject of §2523(b)(2). As a consequence, although it hardly makes sense that a retained interest may be permissible but a retained power not, it is not advisable that the donor retain any power to control or appoint the inter vivos QTIP trust. See Blattmachr, Zeydel, & Gans, The World's Greatest Gift Tax Mystery, Solved, 115 Tax Notes 243 (2007), suggesting that §2523(b)(2) does not apply to "retained" powers at all, but only to powers in the donor that were created by a third party (making the terminology itself bizarre but avoiding the noted incongruity).

225 PLRs 9309023 and 9140069 predicted this result, and PLR 9437032 followed it. Informative was that the donor retained a nongeneral testamentary power to appoint that trust if the donor was S, which was not even discussed, notwithstanding that §2523(b)(2) by its terms appears clearly to apply and would disallow the inter vivos QTIP marital deduction. The Ruling also made no mention of Estate of Sullivan v. Commissioner, 66 T.C.M. (CCH) 1329 (1993), discussed in §13.5.6.5 at text accompanying n.227 and in §7.3.4.2 n.156 et seq. and accompanying text.

226 Caution may be in order, however, because of some quirky rulings and decisions in this arena. For example, in PLR 9141027, the donor proposed to create an inter vivos trust for the donee spouse and adult children, including a specific prohibition against use of income or principal in satisfaction of any legal or other obligation of the donor. That trust granted the donee a nongeneral power of appointment, which the Ruling stated the donee proposed to exercise in favor of a trust created by the donee for the benefit of the donor. The government declined to rule on whether the prohibition regarding discharge of obligation distributions would protect against §2036(a)(1) indirect retention of enjoyment by the donor, but concluded that the donor would be treated as having retained an interest in the transferred property because there was "an implied agreement" that the transferred property would be settled by the donee for the donor's enjoyment, resulting in a retained interest subject to §2036(a)(1) by virtue of Treas. Reg. §20.2036-1(a). The donor would be regarded as having retained any interest created by the donee's exercise in a state that adheres to the "relation back" doctrine regarding interests created by exercise of a nongeneral power of appointment. This is because the holder of a nongeneral power of appointment is regarded as the agent of the donor of the power and interests created by exercise are deemed to have been created ab initio by the donor, not by the powerholder's exercise. See 1 Scott, Fratcher, & Ascher, Scott and Ascher on Trusts §3.1.2 (5th ed. 2006).

Making this planning slightly uncertain is one case that mangled one of the most misunderstood elements of the estate tax. The theory found under §§2036 and 2041 is that a person who is obliged to support a beneficiary is indirectly benefited by trust distributions to that beneficiary. This "discharge of obligation" theory was evaluated in Estate of Sullivan v. Commissioner,[227] which involved an irrevocable inter vivos trust created by D for D's second spouse.[228] The government argued that the trust was includible in D's gross estate under §2036(a)(1) under a discharge of obligation theory.[229] The court did not evaluate the underlying assumption that, under state law, a spousal support obligation can be discharged by trust distributions of the type involved in this case, and ultimately found that §2036(a)(1) was triggered by the authority lodged in the trustee to make discretionary principal distributions to the donee. That conclusion is wrong but not easily avoidable,[230] which actually may be good because inclusion would generate a new basis under current law, with §2056(b)(7) to ameliorate that inclusion, so proper planning could turn the government's improper theory into a taxpayer benefit.

In addition to sheltering both spouses' tax benefits, another situation in which inter vivos QTIP planning might be useful is a negotiated divorce settlement. Here the donor intentionally might retain a reversion if the donee dies first. The donor thus could provide for the donee for life, as required under a divorce settlement, but could reacquire the property at the donee's death or control devolution of the property if the donor predeceases the donee. Thus, income would be payable to the donee (soon-to-be ex-spouse) for life and on the donee's death the trust principal would revert to the donor, if living, otherwise to those remainder beneficiaries designated by the donor under the original trust terms. If the donor survives the donee the donor reacquires ultimate enjoyment and control over it and is willing to incur estate tax for the privilege.[231] If the donor predeceases the donee, the donor controls the property's devolution after the donee's death. Despite the retained interest, §2523(f)(5)(A) ensures that the property will not be includible in the donor's gross estate if the donor dies first.

In addition, and unlike a more traditional inter vivos QTIP under which §§672(e) and 677 would cause the donor to be taxed on trust income for income tax purposes, §682(a) and Treas. Reg. §1.1361-1(k)(1) Example 10(ii) appear to confirm that the income tax liability of the donor ceases following divorce and instead the donee is required to report that income. So there is no income tax disincentive in traditional or in divorce settlement use of the inter vivos QTIP trust. This conclusion does not appear to change following repeal of §682 for divorces after 2018.

One final caution is in order. One regulation specifies that an income interest in the donee spouse cannot support a QTIP election for marital deduction purposes if that income interest does not begin coterminously with creation of the trust, meaning that the donee's income interest cannot

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227 66 T.C.M. (CCH) 1329 (1993), discussed in full in §7.3.4.2 n.156 et seq. and accompanying text.

228 The trust did not qualify for the then-applicable marital deduction because it denied S control and predated enactment of the QTIP trust provision, and there is no indication whether the trust was qualified for or actually elected QTIP treatment after D's death. The case nevertheless is instructive with respect to the creation of inter vivos QTIP trusts and is of interest particularly if the donor spouse dies first.

229 Treas. Reg. §20.2036-1(b)(2).

230 See §7.3.4.2 nn.175 – 176 and accompanying text.

231 Under these circumstances, the donor probably would rather reacquire the property and pay the resultant estate tax on it if the donee dies first, but the donor could retain just a secondary life estate and avoid that subsequent inclusion.

follow an interest in anyone else.[232] No case has ever indicated that this planning somehow cannot qualify for the marital deduction, presumably because the typical trust is includible in the donor's gross estate at death and an estate tax marital deduction is generated. Taken literally, however, the regulation provides that no marital deduction is available for the value of the trust remainder if a donor creates an inter vivos trust to pay income to the donor and then provides that the remainder after termination of the donor's interest will be held as a QTIP trust paying income to the donor's spouse for life. If the donor incurs gift tax on creation of the trust (for example, because the trust is irrevocable), the marital deduction should be available, regardless of whether the trust might be includible in the donor's estate at death,[233] but the regulation appears to provide otherwise.

The rationale given in the preamble to the regulation for this unusual proposition is that

> the statute requires that the spouse must be entitled to receive the trust income for the spouse's life. An income interest that commences at some time in the future, if the spouse survives until that time, is not payable to the spouse for life.... Further, if such an interest were allowed to qualify under §2523(f), it is problematical whether, in the event the donee spouse predeceased the donor spouse, the IRS could sustain inclusion of the trust corpus [presumably less the value of any outstanding prior interest] in the gross estate of the donee spouse under §2044 (or sustain treating the assignment of the spouse's interest as a disposition under §2519), since ... it is questionable whether such an interest constitutes a qualifying income interest for life.

The last statement is tautological, because the regulation defines a qualifying income interest, and nothing in §2044 or §2519 would preclude taxation of the value of the trust remainder interest (following the lead interest) to a spouse who dies before another beneficiary of the trust.

A careful reading of §2523(f) does not support the government's position, nor does the definition of a qualifying income interest as found only in §2056(b)(7)(B)(ii) justify this result. Indeed, good tax policy supports exactly the opposite position, because a trust remainder interest following a prior entitlement is not a nondeductible terminable interest and does not require special qualification to meet the marital deduction requirements if it passes free of trust to the donee. An identical remainder interest held in trust for the donee's life does not become a nondeductible terminable interest simply by virtue of it following a lead interest in someone else. As a result, it should not be necessary to alter the donee's entitlement in that respect. Stating that the donee must receive the income for life begs the question of when the donee's interest must begin and the life

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232 Treas. Reg. §25.2523(f)-1(c)(2). This is a curious position, given that a remainder interest following a life estate in trust is not a terminable interest at all and therefore need not meet any special requirements to qualify for the marital deduction; the rules in §2523 ought not to apply or be concerned with this issue at all. See §13.4.3.3.2 n.99 and accompanying text. Imagine that a remainder interest is not paid to the donee outright but, instead, is held in a QTIP trust for the benefit of the donee for life, with remainder to yet another party. A terminable interest problem is not created by the time when the donee's interest *begins*. Rather, it exists only because it terminates in favor of a third party. The regulation begs the question of when a QTIP trust begins, which is best illustrated by the fact that many taxpayers create inter vivos trusts for themselves during their lives that become QTIP trusts following their deaths.

233 Although it is not stated, presumably the government would not hazard to suggest that this provision applies before the trust becomes irrevocable, but Treas. Reg. §25.2523(f)-1(f) Example 9 shows that the government will apply it even before termination of the donor's exposure to estate tax inclusion, in that case involving an irrevocable inter vivos trust in which the donor retained a life estate.

estate requirement does not support the notion that the starting time for that interest must be accelerated.

As a practical matter, in the case of a donor retained interest followed by a life estate in the donee, it would be easy for the donor to retain the property for the desired term and make a gift into a QTIP trust when the desired enjoyment ends, with clear marital deduction qualification. The problem with waiting until that time is the possibility that the donor may not be able to make that subsequent transfer, although a durable power of attorney authorizing this gifting may permit this planning even if the donor no longer is competent when the time arrives.

Another circumstance in which a delayed income interest in a donee spouse might be desirable is if the donor wants to continue to support a third party until some event (such as a dependent elder's death or a child's college graduation), and then have the trust property benefit the donee spouse for life. There is no abuse in this planning, which might become more common as individuals find themselves supporting, for example, elderly parents who might survive them, and want for a variety of reasons to establish the trust mechanism to provide for this support during their own lives. Especially telling is the fact that there is no corresponding immediate income requirement if the donor waits until death to create a two-tier trust for the benefit of a third party, followed by a life estate in the donor's surviving spouse. It should not be that the same planning created at death is subject to different qualification rules from that created inter vivos, although conceivably the government's position would be that the sole beneficiary requirement in §2056(b)(7)(B)(ii)(II) precludes that testamentary planning as well. The regulations do not so provide, nor would they be proper if they did. In addition, Treas. Reg. §25.2523(f)-1(c)(2) was never subjected to comment as a proposed regulation and it seems ripe for challenge.

§13.5.6.6 Estate and Gift Tax Attributable to QTIP Trust

Absent a contrary provision in S's will or trust, §2207A provides that any tax (and any interest and penalties ancillary thereto) attributable to inclusion of QTIP trust corpus in S's gross estate under §2044 is recoverable from the corpus of the QTIP trust.[234] The amount of tax attributable to the QTIP trust is computed under §2207A(a)(1) as the difference between the amount of the actual estate tax in S's estate and the amount of estate tax that would be due if the corpus of the QTIP trust was not includible. Thus, §2207A allows a recovery of the amount by which S's estate tax is increased by inclusion of the QTIP, sometimes referred to as the "incremental" tax attributable to the QTIP.[235] However, no recovery is granted for any amount of S's unified credit exhausted by the inclusion

[234] See §3.3.5 n.63 et seq. and accompanying text.

[235] An unexpected inequity can result under §2207A because QTIP property is taxed at the highest estate tax rate applicable to S's estate. Assume, for example, that D and S each have children by prior marriages and that they agree that their respective assets will be held for S for life and then pass to their respective families when the survivor dies. If D uses a QTIP trust to accomplish this agreed plan, §2207A will cause the QTIP property passing to D's remainder beneficiaries to incur a higher rate of tax than S's own property passing to the survivor's beneficiaries, upsetting the parties' intended equality based on the mistaken assumption that the aggregate tax burden would be shared proportionately. The only way to overcome this result is for S to alter the recovery right under §2207A. D cannot accomplish this unilaterally, notwithstanding that it is D who should be concerned about this inequity. Note that a counterbalance to the inequity is that both spouses' children enjoy the tax reduction attributable to S's unified credit, whereas any nonmarital trust for the exclusive benefit of D's children obtained the exclusive benefit of D's unified credit. It also is not very important when the amount of progressivity is slight, as is true under the regime currently in effect.

(because §2207A is for tax paid, not for tax payable),[236] nor for any state estate or inheritance taxes attributable to the QTIP trust.

S's estate is entitled to recover the tax from the distributees if it seeks recovery of the tax after the trust property has been distributed to the remainder beneficiaries.[237] And, if there is more than one QTIP disposition includible in S's estate (for example, because S was beneficiary of both a QTIP trust and a QTIP-elected legal life estate), the right to recover with respect to each disposition is a pro rata share of the total tax attributable to inclusion of all the QTIP assets.[238]

Failure of S's estate to exercise the right to recover the tax under §2207A is a taxable gift "from the persons who would benefit from the recovery" (usually S's residuary beneficiaries) "to the persons from whom the recovery could have been obtained" (the QTIP remainder beneficiaries).[239] This gift may be negated, however, to the extent S's beneficiaries cannot compel recovery because S waived the right.[240] Although waiver might avoid nasty gift tax problems, it also may be inappropriate if S's estate otherwise is unable to pay its estate taxes.[241]

A surviving spouse who assigns all or any part of a QTIP income interest makes a gift under §2519 of the full value of the remainder interest in the QTIP trust, in addition to the §2511 gift of the value of the assigned income interest. S is liable for the gift tax on both transfers, but is entitled under §2207A to recover only the §2519 gift tax attributable to the gift of the remainder interest from "the person receiving the property," which is the trustee if the property continues to be held in trust.[242] Failure of S to exercise this right of recovery may result in a taxable gift to the persons who are benefited by that failure.[243]

The regulations recognize that the donee of property subject to this right of reimbursement receives less value than if the right of reimbursement did not exist.[244] Therefore the value of any §2519(a) gift to the donee is calculated as a net gift,[245] reducing the FMV of the property subject to §2519(a) by the amount of the §2207A(b) reimbursement.[246] Thus, the QTIP result is the same as if

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236 Treas. Reg. §§20.2207A-1(a)(1) (last two sentences) and 20.2207A-1(b).

237 Treas. Reg. §20.2207A-1(d).

238 Treas. Reg. §20.2207A-1(c).

239 Treas. Reg. §20.2207A-1(a)(2).

240 Treas. Reg. §20.2207A-1(a)(3). For more detail regarding waivers see §3.3.16.1.

241 Waiver does not, however, constitute a constructive addition to the QTIP trust for GST purposes, if the trust was the subject of a §2652(a)(3) reverse QTIP election. See Treas. Reg. §§26.2652-1(a)(3) and 26.2652-1(a)(5) Example 7, §§11.4.3.2 n.68 et seq. and 11.4.16.1 n.321 et seq. and accompanying text.

242 Treas. Reg. §25.2207A-1(e). As illustrated only obliquely by Treas. Reg. §25.2207A-1(f), the §2207A right of reimbursement for gift taxes does not extend to any tax imposed under §2511 on the gift of the income interest.

243 Treas. Reg. §25.2519-1(c)(4) establishes the principle that the gift under §2519 is the value of the corpus less the amount of any §2207A reimbursement to which S was entitled. And Treas. Reg. §25.2207A-1(b) establishes the proposition that S makes an added gift of the amount of the reimbursement if it was not collected. See, e.g., PLR 200530014. Treas. Reg. §20.2207A-1(a)(2) continues to state that the beneficiaries of an estate make a similar gift if the estate fails to collect reimbursement, although Treas. Reg. §20.2207A-1(a)(3) provides that this gift occurs even if recovery is impossible but it does not occur to the extent the beneficiaries cannot compel recovery because S waived the recovery right by will. See §3.3.5. The regulation also should reference S's waiver by a provision in a revocable trust.

244 See Treas. Reg. §25.2519-1(c)(4).

245 See §6.3.3.10.

246 The gift tax under §2519(a) is S's obligation, just as much as if S had received the property outright and then made a gift of it. The statutory structure is that the gift tax is imposed on S, with a right of reimbursement from

S was given marital deduction property outright and made a gift of a portion of it, retaining the balance to pay the gift tax.[247]

Given these rights of reimbursement, the beneficiaries of a QTIP trust are intimately affected by tax computations and payment by S's estate. Yet they may have no protection if S's personal representative files a return with generous values for non-QTIP assets to obtain a high basis for those assets, while causing a higher incremental tax attributable to the QTIP beneficiaries.

To illustrate the possible conflicts that may arise in a similar context, consider Estate of Dixon v. Commissioner,[248] in which D's estate disputed a deficiency assessed for the undervaluation of its major asset, corporate stock. S moved to intervene, asserting an interest in the proceeding adverse to the estate. It was in S's interest to have the adjusted gross estate valued as high as possible because the higher the estate tax value, the more S would receive under a pre-1982 maximum allowable marital deduction bequest. The bequest was to be satisfied out of assets other than the corporate stock and S's share was to be free of any estate taxes, so an inflated value of that stock also would not work to S's ultimate detriment.

Affirming the Tax Court's refusal to grant intervention on the ground that doing so would "open Pandora's box," the court on appeal held that the Tax Court had discretion to grant or deny intervention and that the Tax Court's decision could be reversed on appeal only if an abuse of discretion was shown. The court was most persuaded by the government's arguments that allowing intervention might cause a "flood" of motions for intervention by beneficiaries adversely affected by Tax Court valuations, and that S's underlying concern was the proper division of the trust corpus, which is a matter of state law. Thus, the beneficiaries' only remedy in a case in which an alleged overvaluation occurs, especially one involving valuation of a QTIP trust for §2207A reimbursement purposes, appears to be a state court proceeding asserting a violation of fiduciary duties.

§13.5.6.7 Annuities, Retirement Benefit Payments, and IRAs

An annuity generally will qualify for the marital deduction if there is no refund or survivor benefit payable (other than to S's estate) that would cause the annuity to be a nondeductible terminable interest.[249] QTIP qualification will salvage the marital deduction if the annuity is a

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the gifted property, provided in this case because the QTIP trust may be the only source of liquidity available to S, who otherwise may not have control over the QTIP.

247 See Treas. Reg. §25.2207A-1(b), as discussed in §3.3.5.
Applying this vision, Estate of Morgens v. Commissioner, 133 T.C. 402 (2009), aff'd, 678 F.3d 769 (9th Cir. 2012), held that S's death within three years of these events causes application of the §2035(b) gross-up rule, as if S had withdrawn the amount of the gift tax from the QTIP trust, made a gift of the balance, and paid the tax directly. Based on the analysis in Estate of Sachs v. Commissioner, 88 T.C. 769 (1987), aff'd on the issue herein, 856 F.2d 1148 (8th Cir. 1988). See §§7.2.5; 7.3.7.

248 82-1 U.S. Tax Cas. (CCH) ¶13,448 (9th Cir. 1982).

249 See §13.4.3.3.2 n.94 and accompanying text; PLR 9052015 (D's IRAs qualified for the marital deduction because, under the distribution option, the account balance at D's death was distributable in installments over a term of years corresponding to S's life expectancy, with no refund or contingent remainder benefit).

Courts have struggled with this concept, as illustrated by First Trust Co. v. United States, 89-1 U.S. Tax Cas. (CCH) ¶13,805 (D. Mont. 1989), rev'd in an unpub. op. (9th Cir. 1990) (a $20,000 annual annuity payable to S for life from a testamentary trust that provided that the corpus was distributable to a charity on S's death). The court found that "the annuity is not a nondeductible terminable interest" because S was the only beneficiary of the annuity and no one else received any interest in the annuity. As a consequence, under the authority of

terminable interest because there is an interest in a beneficiary other than S. And QTIP qualification is automatic if the annuity was includible in D's gross estate under §2039 and S is the sole beneficiary during S's overlife.[250]

The marital deduction was allowed for the amount of corpus needed to produce the annual annuity payment if the transfer was made before the effective date of §2056(b)(10) (generally, for

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Treas. Reg. §20.2056(b)-1(b), the court simply treated the annuity as a terminable interest that is not nondeductible and allowed the marital deduction, citing Rev. Rul. 77-404, 1977-2 C.B. 333, and Rev. Rul. 79-420, 1979-2 C.B. 335. It is impossible to tell from the opinion whether the deduction allowed was the value of the annuity alone or the value of the corpus in the trust that produced it ("the annuity which passed to S to receive annual payments from the corpus of the testamentary trust qualifies for the marital deduction") although presumably it was the discounted present value of the $20,000 annual stream of payments. The court never mentioned §§2055 and 2056(b)(8) and, without indicating why, the court on appeal reversed *First Trust*. Estate of Leach v. Commissioner, 82 T.C. 952 (1984), aff'd, 782 F.2d 179 (11th Cir. 1986), involved similar facts and disallowed the marital deduction. At least one ruling the court cited in support of its opinion, however, was distinguishable (because there was no remainder beneficiary that would receive corpus after S's death terminated the annuity obligation). See also Rev. Rul. 79-224, 1979-2 C.B. 334 (a right to receive a purchase price payable in installments is a deductible albeit terminable interest).

250 See §2056(b)(7)(C), applicable unless the personal representative affirmatively elects out of this automatic QTIP qualification. Such a §2039 includible annuity could not have been created by D at death or purchased by D's fiduciary at D's direction after D's death, and therefore cannot run afoul of §2056(b)(1)(C).

The decedent in PLR 9016084 was an insurance agent who elected to receive renewal commissions in the form of an annuity payable to S for life and to their children. The value of the annuity was uncertain because the insurance company paying these renewal commissions was entitled to recalculate the annuity 10 years after D's death, based on a persistency factor and its interest experience. Nevertheless, the annuity was deemed to qualify automatically for the QTIP marital deduction under §2056(b)(7)(C) as a survivor annuity payable under an agreement, arrangement, or contract entered into by D during life and includible in D's gross estate under §2039. The deduction allowed was for the value of S's annuity determined under §§2031 and 7520, not the full value includible in D's gross estate. The Ruling gave no indication of how the 10 year revaluation would be reflected or even whether it would affect the value for marital deduction purposes. See generally Treas. Reg. §20.2056(b)-7(h) Example 11 regarding the §7520 valuation aspect illustrated in the Ruling.

PLR 9152015 determined that an annuity was includible in D's gross estate under §2039 and would qualify for the marital deduction automatically under §2056(b)(7)(C), both using a value determined by comparing the interest rate guaranteed on each annual annuity payment against the §7520 assumed interest rate. The beneficiary designations in three qualified retirement benefit plans did not comply with the §401(a)(11) spousal annuity rules and, because S did not consent to those designations, the death benefits were paid to S instead. In this context, TAM 9008003 concluded that these payments also qualified automatically under §2056(b)(7)(C) for the marital deduction because the benefits were includible under §2039 and were paid to S (notwithstanding D's wishes). And automatic QTIP treatment was granted in PLR 9204017 because the trustee beneficiary was required to distribute to S all payments received from the qualified plan in the year of receipt. The same result was reached in PLR 9352015, which involved winning lottery ticket annuity payments that were treated like any other §2039 annuity and again they qualified as automatic QTIP property under §2056(b)(7)(C) because all amounts received by the trustee of a QTIP trust as beneficiary were immediately payable to the winner's surviving spouse.

A corresponding automatic gift tax marital deduction applies under §2523(f)(6) if the annuity begins making joint annuity payments during the participant's life. It specifies that no amount will be includible in the estate of a nonparticipant spouse who dies before the participant. In essence the gift tax result is to ignore any rights created in the nonparticipant spouse with respect to a joint and survivor annuity. Regulations have not been issued on this aspect of the QTIP marital deduction rules, Treas. Reg. §20.2056(b)-7(f) being specifically reserved for a later promulgation. "Rules governing the application of section 2056(b)(7)(C), as well as section 2523(f)(6), will be prescribed under regulations to be proposed under those sections at a later date." 59 Fed. Reg. 9643 (1994).

decedents who died before October 25, 1992).[251] The government has not yet decided, however, how to deal with annuities under §2056(b)(10).[252] Reflecting the last sentence of §2056(b)(7)(B)(ii),[253] the regulations reserve judgment regarding the ability to make a QTIP election in cases in which an annuity rather than a straight income interest is payable to S.[254] The important issue is whether a sufficiently large percentage annuity payment (such as 3 to 5% annually) may be treated as the functional equivalent of an all-income entitlement.[255] This might qualify the entire annuity for marital deduction treatment rather than just a portion determined under some formula as the amount needed to produce that annual payment based on some presumed annual income yield, such as under §7520.

The regulations also reserve guidance on qualification of a joint and survivor annuity as commonly found in retirement benefit plans that meet the §401(a)(11) spousal annuity rules. The regulations[256] deem the annuity in an IRA to qualify for the marital deduction under §2056(b)(7)(B)(ii) without regard to the automatic qualification rule of §2056(b)(7)(C) because the

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[251] See Treas. Reg. §§20.2056(b)-7(e) and 20.2056(b)-7(h) Example 11.

[252] As revealed by a statement in the Preamble to the Regulations that the government "invites comments on the application of [§2056(b)(10)] to the treatment of annuities." 59 Fed. Reg. 9643 (1994). The implication is that the government believes that the adoption of §2056(b)(10) may have affected the qualification of annuities in the form of a specified dollar amount payable annually or an annuity or unitrust interest like that found in a §664 qualified CRT or under state law legislation that alters the meaning of "all income annually" in a total return trust context (consistent with the Uniform Prudent Investor Rule) to mean some fixed percentage of the annually determined FMV of the trust.

Treas. Reg. §20.2056(b)-7(e)(2) authorizes a marital deduction for only the amount of corpus deemed necessary to produce the annuity payments guaranteed to the marital deduction trust or directly to S annually. (However, these “guaranteed” and “annually” elements may mean that a “net income” unitrust, with or without a make-up provision, as allowed in a NICRUT or a NIMCRUT for charitable deduction purposes might not qualify). The regulation may be useful if it is not essential to D's estate plan that the full value of D's account balance qualify for the marital deduction, and if the special transition rule for annuities not subject to §2056(b)(10) is applicable. Thus, for example, Estate of Sansone v. United States, 2001-1 U.S. Tax Cas. (CCH) ¶60,399 (C.D. Cal. 2001), aff'd in an unpublished opinion, 2002-2 U.S. Tax Cas. (CCH) ¶60,442 (9th Cir. 2002), confirmed that an inflation adjustment in an annuity payable to S for life is not "guaranteed" in a manner that would permit it to be ascertained and therefore would not increase the marital deduction. See also TAM 8446006 and PLRs 9152015 and 9204017. Based on the applicable valuation tables under §7520, this amount may not be as large as the amount includible in D's gross estate under §2039. If, however, the corpus exceeds that §2039 amount, Treas. Reg. §20.2056(b)-7(e)(2) limits the marital deduction to the amount includible in the participant's gross estate. To illustrate, see PLR 9016084, as discussed in n.250.

[253] "To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified)."

[254] As illustrated by Treas. Reg. §§20.2044-1(e) Example 7, 20.2056(b)-5(c)(3), 20.2056(b)-7(e), 20.2056(b)-7(h) Examples 11 and 12, 20.2056(b)-8(b), 25.2519-1(g) Example 6, 25.2523(e)-1(c)(3), 25.2523(e)-1(c)(5) Example 1, 25.2523(f)-1(c)(3)(i), 25.2523(f)-1(f) Examples 6 and 7, and 25.2523(g)-1(b). If the transfer creating the annuity predated October 25, 1992 (which reflects the effective date of §2056(b)(10)) the regulations permit such annuities to generate a marital deduction for the amount of corpus needed to produce the annuity if no distributions may be made to any other person during S's enjoyment. See, e.g., TAM 9409005, which denied the deduction because income in excess of that needed to pay the annuity was distributable to a third party, and the government held that the income therefore attributable to that portion of the trust deemed to be producing the annuity was not necessarily payable to S, nor was it to be accumulated to ensure future payment, and might not be reflected in the amount includible in S's gross estate under §2044. Therefore, it held that the annuity could not properly be characterized as a qualifying income interest for life.

[255] See Treas. Reg. §20.2056(b)-5(f)(1) (embracing the Treas. Reg. §1.643(b)-1 safe harbor of a state law that provides for a unitrust amount of between 3 to 5% of annual or blended FMV as the functional equivalent of an all-income-annually entitlement).

[256] Treas. Reg. §20.2056(b)-7(h) Example 10.

posited payout includes all income earned in the account annually plus an amortizing distribution of corpus. Curious is a statement in the Preamble that "the arrangement ... may also qualify, *at least in part*, for the automatic election and deduction under section 2056(b)(7)(C), and this question will be considered in regulations to be proposed ... at a later date."[257]

These forms of qualification cover many annuity situations, leaving as a major category only §408(a) IRAs in which a QTIP trust is the sole designated beneficiary during S's overlife but a remainder benefit is payable to a third party after S's death.[258] Rev. Rul. 2006-26[259] establishes the requirements to qualify such an IRA (or a similar payout from a qualified plan) for marital deduction QTIP election purposes.[260]

The marital deduction qualification issue is straightforward if S individually is named as the beneficiary of an IRA or qualified plan.[261] The marital deduction qualification issue is even easier if S possesses a lifetime power to accelerate payments by making a complete withdrawal, because that power satisfies the all-income-annually requisite of either a (b)(5) or a QTIP trust[262] and constitutes a general power of appointment for §2056(b)(5) purposes as well.[263] Qualification also is easy if whatever remains in the IRA or plan account passes to the estate of S at death because the estate trust qualification for marital deduction treatment would apply and nondeductible terminable interest problems would not exist.[264] So the discussion here is most significant with respect to IRA or qualified plan designations of a QTIP trust as beneficiary in which the power of complete withdrawal is not available.

For most purposes the real significance of Rev. Rul. 2006-26 therefore, and the reason for its issuance, is §2056(b)(7) QTIP qualification, which turns on the all-income-annually requirement.

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257 59 Fed. Reg. 9643 (1994) (emphasis added). With the income payment provision specified, it is not clear why the annuity arrangement would qualify only *in part* under §2056(b)(7)(C), or why the government thinks that it needs to devote additional thought to permitting the marital deduction for annuities in general. The government ought to be willing to rely on the valuation regime applied in the CRT environment to determine the value of a lead annuity or unitrust to determine the marital deduction for the value of the interest passing to S.

258 With respect to these IRAs, Treas. Reg. §20.2056(b)-7(h) Example 10 complicates the issue of annuity qualification because it presumes an uncommon annuity installment payment during S's overlife of the IRA corpus plus annual payment of an amount equal to all income earned by the entire undistributed IRA balance. This added income distribution is not customary and the government has made clear that the illustrated payout is not the exclusive method of qualifying IRAs or other terminable interest annuities for the marital deduction. Planners therefore need not agonize over duplicating the unusual payout illustrated in those authorities.

259 2006-1 C.B. 939, which modifies "and, as modified, supersedes" Rev. Rul. 2000-2, 2000-1 C.B. 305.

260 In the process, the Ruling signals several potentially useful conclusions about IRA beneficiary designations that are discussed in §§9.3.3 and 9.4.

261 See Treas. Reg. §20.2056(b)-7(h) Example 10, which treats IRA payments directly to S as qualifying for the marital deduction without regard to §2056(b)(7)(C). That example may be unusual because it posits that S has no power of withdrawal over the IRA, which may not be the case in routine situations. It should be remembered that the §401(a)(9) qualified plan and §408(a)(6) IRA requirements establish *minimum* distribution requirements, not *maximum* limitations. Any restriction on withdrawal would be imposed by the plan or IRA agreement, not by the tax law, and should not be assumed.

262 Treas. Reg. §§20.2056(b)-5(f)(6); 20.2056(b)-7(d)(2).

263 This is true even if the withdrawal right is available for only a limited time, if S is in control of that election. See Estate of Neugass v. Commissioner, 555 F.2d 322 (2d Cir. 1977); Estate of Tompkins v. Commissioner, 68 T.C. 912 (1977), acq., 1982-1 C.B. 1; Estate of Mackie v. Commissioner, 64 T.C. 308 (1975).

264 See §13.5.5 regarding the estate trust qualification of an interest held for life, with no need to pay all income annually or otherwise worry about the kinds of qualification issues addressed next.

Like any typical QTIP trust, S was entitled to all income of the QTIP trust, which was the designated beneficiary of the IRA or qualified plan in that Ruling. More critical then was that S was given a power by the QTIP trust to compel the QTIP trustee to withdraw from the IRA or plan annually an amount equal to all the income earned by the IRA assets or qualified plan during that year and distribute that same amount to S as income beneficiary of the QTIP trust. The QTIP trustee would receive the annual RMD amount if S did not exercise that withdrawal right. If S *did* exercise the right, however, the Ruling states that the QTIP trust will receive the greater of the RMD amount *or* the amount of the IRA or plan account income for the year.[265]

In that context, and put another way, the only issue is income earned in an IRA or qualified plan account in excess of the RMD amount (because the RMD amount will come out of the IRA or plan in all events). A glance at the mortality tables reveals that the likelihood of the IRA or plan account having income in excess of the RMD amount declines as the designated beneficiary (S in this case) ages. By way of example, relying on tables applicable after 2021, if the designated beneficiary is over age 52, then a 3% to 5% unitrust regime authorized under state law would be deemed the equivalent of all income annually under Treas. Reg. §§1.643(b)-1 and 20.2056(b)-5(f)(1).

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[265] Note that the all-income-annually requirement is a "real income" fiduciary accounting notion. In this respect Rev. Rul. 2006-26 clarifies that a state law that resembles the Uniform Principle and Income Act §409(c) allocation regime that existed in 2006 will not suffice to meet the marital deduction requirement. As a result, the Uniform Act subsequently was amended to address this issue. First, §409(c) remains unchanged. It specifies that:

> If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not required to be made to the extent that it is made because the trustee exercises a right of withdrawal.

No mention was made in the ruling of §409(d), which provided at the time that "If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction." This provision subsequently was amended to provide that it will not apply and instead new subsections (f) and (g) will apply if payment is made from a separate fund to a QTIP or to a §2056(b)(5) marital trust. Which makes the following new subsections (f) and (g) critical.

> (f) A trustee shall determine the internal income of each separate fund ... as if the separate fund were a trust .... Upon request of the surviving spouse, the trustee shall demand that the person administering the separate fund distribute the internal income to the trust. The trustee shall allocate a payment from the separate fund to income to the extent of the internal income of the separate fund and distribute that amount to the surviving spouse. The trustee shall allocate the balance of the payment to principal. Upon request of the surviving spouse, the trustee shall allocate principal to income to the extent the internal income of the separate fund exceeds payment made from the separate fund to the trust during the accounting period.
>
> (g) If a trustee cannot determine the internal income of a separate fund but can determine the value of the separate fund, the internal income of the separate fund is deemed to equal [insert number at least three percent and not more than five percent] of the fund's value .... If the trustee can determine neither the internal income of the separate fund nor the fund's value, the internal income of the fund is deemed to equal the product of the interest rate and the present value of the expected future payments, as determined under Section 7520 ... for the month preceding the accounting period for which the computation is made.

With these changes it is expected that marital deduction qualification is assured. A wise drafter might also disable any statutory provision to the extent it is inconsistent with the all-income-annually requirement. Indeed, some marital deduction saving clauses do just this, specifying that no law or provision that would interfere with qualification shall apply.

Thus, the minimum required distribution to a surviving spouse who is at least age 53 will satisfy these requirements for marital deduction purposes with no special drafting concerns. This is because a surviving spouse who is at least age 53 has a §72 life expectancy of 33.4 years, which would require slightly more than 3% of the value of the account to be distributed annually as the minimum amount required to be distributed. Because a minimum of 3% is regarded as all income under the unitrust equivalence regime, no special drafting about distribution of the greater of all income or the RMD would be needed.

Nevertheless, many cautious drafters will state the annual distribution as the Ruling encourages, just as a reminder to the fiduciaries involved and a salve to any government watchdog. Consider that a surviving spouse may have a RMD amount larger than the income that is earned by most fiduciaries annually, meaning that the RMD amount will exceed the income amount and all the issues addressed here similarly disappear.

Assuming, however, that there is an excess income issue, the question is whether the IRA or plan qualifies as QTIP-elected marital deduction property. Rev. Rul. 2006-26 concludes that a surviving spouse is entitled to all income annually from the IRA or plan account (as well as from the trust) by virtue of a power in S to compel the QTIP trustee to make withdrawals from the IRA of the excess income.

Rev. Rul. 2000-2 also stated that both an IRA and a QTIP trust are subject to §§2519 and 2044. Indeed, "[b]ecause the trust is a conduit for payments equal to income from the IRA to [S, the] executor needs to make the QTIP election . . . for both the IRA and the testamentary trust." In effect, this double election mandate makes it clear that the government views *the IRA itself* or the plan account as QTIP, as opposed to thinking of the IRA as just a proper asset of or making payments to a QTIP trust. That is an important vision because most observers think of an IRA plan account as merely an asset owned by or payable to the QTIP trust. The government instead elevates the IRA or plan account to the same status as the QTIP trust and, most importantly, requires a separate QTIP election with respect to both the trust and the IRA or plan account.

The same marital deduction qualification result would apply if S may demand that the QTIP trustee make withdrawals from the IRA or qualified plan, or the trust simply requires the trustee to withdraw from the IRA or qualified plan annually an amount equal to the excess income earned by the IRA or plan account assets and distribute that amount to the spouse. Although not quite as easy to picture, presumably the notion regarding that trust mandate is that the trustee is acting as S's agent as well as conduit, still requiring a QTIP election with respect to the IRA or plan account itself and not just the trust.

A hard question for planners is which approach to follow, given the reality that a power in S to compel the QTIP trustee to make a withdrawal from the IRA or plan account could lapse, from which all sorts of issues may flow. Indeed, making the demand to make the withdrawal would be counterproductive if maximum income tax deferral is sought.[266] So perhaps the better approach, all

[266] For example, does S become a transferor to the QTIP trust, or to the IRA itself? If so, there would be completed gift and annual exclusion issues, §2702 valuation possibilities, estate tax inclusion concerns (if the inclusion provision is §2036(a)(1), for example, instead of §2044, which could inform different estate tax right of reimbursement entitlements), and potential GST transferor issues. There are a host of income tax qualification

around, is to forsake any perceived income tax benefits of leaving the excess income in the IRA or plan account and just ensure that the QTIP trustee is obliged to obtain from the IRA or plan account any excess income amount. Another alternative not noted by the Ruling is for the QTIP trust simply to require the trustee to distribute or permit S to withdraw corpus equal to any difference between the RMD and the IRA or plan account income amount. That also will qualify under the all-income-annually requirement as found in Treas. Reg. §20.2056(b)-5(f)(5).

For marital deduction purposes alone, knowing that the government requires the double QTIP election (both the trust and the IRA or plan account) makes compliance easy and predictable. How to make qualified plan benefits satisfy the marital deduction QTIP requirements entails more difficult questions regarding how much income is earned annually by an IRA or a qualified plan held for a participant's account and payable to S. Because those and other questions may remain, the following material preserves discussions of guidance from the government that was promulgated before the release of Rev. Ruls. 2006-26 and, before it, 2000-2.[267]

Rev. Rul. 89-89[268] involved a required distribution of an IRA to a QTIP trust in equal annual installments over S's life expectancy and required income earned on the undistributed portion of the account balance to be distributed to the trust annually. The trust met the QTIP all-income-annually requirement because (1) each installment of the IRA balance paid to the trust would become trust corpus and (2) both the income earned on the undistributed portion of the IRA balance and the income earned by the trust on the distributed portion of the IRA were payable currently to S as income beneficiary of the trust.[269]

Similarly, in PLR 9038015, the trustee of a QTIP trust was directed to distribute to S an amount of each annual IRA distribution equal to the income earned by the entire IRA for the year. If distributions from the IRA in any year were less than that amount, the QTIP trustee was authorized to demand an additional IRA distribution equal to the difference. Thus, S always received an amount annually that was equal to all income earned by the IRA account.[270] This IRA also was deemed to qualify for the marital deduction. PLR 9040029 involved a nonqualified deferred compensation plan payable to a QTIP trust that was required to allocate receipts from the plan to trust income in an amount no less than the unpaid balance of the plan multiplied by the §7520 assumed interest rate (as

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and ownership questions in addition to all of those wealth transfer tax problems if lapse of S's power to compel withdrawal is regarded a contribution to the IRA itself.

267 Indeed, both Rev. Ruls. 2006-26 and 2000-2 left a number of questions unanswered, so readers may find that some of this prior guidance will be useful to acquire a full sense of the issues that exist. It may be that the following discussion of pre-existing authority is not useful at all (certainly it is not likely probative any longer with respect to most IRA issues), but it might be helpful with respect to issues not addressed by Rev. Ruls. 2006-26 or 2000-2. Nevertheless, this reading is not critical to the extent the issue is qualification of an IRA payable to a QTIP trust for the marital deduction.

268 1989-2 C.B. 231, made obsolete by Rev. Rul. 2000-2, itself superseded by Rev. Rul. 2006-26.

269 PLRs 9245033 and 9229017 differed only because, of each installment payment from the IRA to the QTIP, a portion was allocated to income (equal to the income earned for the year in the IRA) and therefore was payable currently. In addition, the beneficiary designation for the IRA required distributions to the trust equal to the greater of all income earned in the account for the year or the RMD amount based on annual installments payable over the life expectancy of S.

270 PLRs 9052015 and 9043054 held that an IRA payable to a QTIP trust would qualify for the marital deduction because the IRA was required to distribute the greater of an amount equal to all income in the account or the amount otherwise distributable under the payment method selected.

a surrogate for knowing the precise income of the plan account). This plan also was deemed to qualify for the marital deduction.[271]

Although the QTIP regulations did not address the issue of an IRA payable to a QTIP trust, PLR 9317025 provided a veritable road map of how to draft an IRA with a QTIP trust as beneficiary to qualify for the marital deduction. (1) The IRA itself required annual distribution of an amount no less than all income generated in the IRA for the year. (2) The QTIP trustee was directed to demand distributions from the IRA of no less than this amount if that mandate was not met. (3) S was given a power to compel the QTIP trustee to make that demand. (4) The QTIP trustee was directed to allocate to trust income distributions received from the IRA equal to the income earned in the IRA. (5) S was given a power to compel the QTIP trustee to convert underproductive property. Or (6) to distribute QTIP trust amounts at least equal to the income that would be earned by assets producing reasonable income. Subsequent Rulings have shown that not all of these factors are necessary.[272]

As shown by Rev. Rul. 2006-26, these IRA developments also are informative for qualified plan purposes and they reveal a consistent pattern in the government's interpretation of the all-income-annually requirement to qualify retirement benefit annuity payments to a QTIP trust for the marital deduction. For example, PLR 9232036 involved a qualified plan and less specificity than the IRA Rulings, but essentially required distribution of the same "greater of" the RMD amount or all income and also allowed the QTIP marital deduction.

Earlier inconsistency and vagueness in the government's statements regarding the QTIP election itself was disconcerting and the failure to address these questions in the regulations now may be "resolved" by Rev. Ruls. 2006-26 and 2000-2, although the position is a bit curious. A QTIP election with respect to the trust itself is adequate with respect to other assets, which makes it odd that a separate QTIP election is required with respect to an IRA payable to a QTIP trust. No rationale for that position has been articulated. It may be a simple notion that the IRA is QTIP, as opposed to

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[271] A similar approach and result were involved in PLR 9040029.

[272] PLRs 9544038, 9322005, and 9321032 (all QTIPs that were QDOTs under §2056A) qualified with items (1) – (5); PLRs 9830004, 9704029, 9416016, 9324024, 9321059, and 9321035 were the same except they were not also QDOTs; PLR 9229017 entailed items (1), (2), and (4); PLR 9043054 involved item (1) alone; and PLR 9038015 involved item (1) and a modified item (2). PLR 9830004 allowed the marital deduction on the basis of items (2) and (3) alone, and PLR 9320015 held that an IRA payable to a QTIP trust would qualify for the marital deduction on the basis of items (2), (4), and (5) (that is, without specifying whether the IRA contained item (1) and even though S was not given items (3) and (6)). The net requirement is pretty similar to Rev. Ruls. 2006-26 and 2000-2.

Unusual about Rev. Rul. 2000-2 was that it involved a form of IRA beneficiary designation that is desirable but seldom addressed in Rulings involving the marital deduction qualification issue. S was the primary IRA beneficiary, receiving distributions outright. The trust was only a contingent beneficiary, receiving distributions only to the extent S disclaimed any part of the IRA, and the trust would make a QTIP election only to the extent S disclaimed more than the maximum amount needed to shelter D's unified credit. A similar plan was involved in PLRs 9551015 and 9537005, in the earlier of which S also disclaimed a nongeneral power of appointment in the trust so that impermissible control was not retained with respect to the disclaimed IRA benefits, and in the latter of which the trustee did not appear to have the power to compel the IRA to convert assets to produce a reasonable amount of income.

PLR 9348025 contained item (4), directing allocation of IRA distributions to trust income, and a slight modification of item (3) in that S was given the power to compel the trustee to directly withdraw the requisite amounts from the IRA, and it too qualified. PLR 9348025 also qualified with only items (3) and (4). For a summary of the law prior to 1992, see Holding, Getting QTIP Treatment For IRAs And Qualified Retirement Plans, 131 Trusts & Estates 26, 30 (Feb. 1992).

being made to qualify as an asset *of* a QTIP trust. It is unknown whether a similar QTIP election for a qualified plan account is possible. Fortunately, it should not be a problem to make dual elections on returns in the future if the intent to qualify for the marital deduction exists.

In juxtaposition to all these different qualification situations, TAM 9220007 illustrates a QTIP trustee's unsuccessful attempt to qualify an IRA for the marital deduction, and is instructive in how *not* to comply with the government's all-income-annually concerns. The beneficiary designated for D's IRA was a QTIP marital deduction trust and the IRA provided three distribution options, all keyed to the §401(a)(9) RMD rules. None of those options required distribution of at least all income earned in the IRA annually. Moreover, the IRA provided that distributions need not commence until D would have reached age 70½ if the designated beneficiary was D's surviving spouse, and it was not clear whether this provision applied.[273] D died at age 68 and the TAM assumed that "the payments to the surviving spouse would have been delayed for 2 years" by virtue of the commencement date provision. Presumably because it recognized the marital deduction problems posed by these facts, and hoping to qualify the IRA for the marital deduction, the QTIP trustee directed the IRA to distribute the greater of all "internal earnings of the IRA" or the RMD under the payout option it selected. In addition, the QTIP trust required allocation to income of "interest or other income earned ... after D's death." Unfortunately, unlike unproductive property provisions found in typical QTIP trusts, the trust only gave S a power exercisable "if a *substantial amount* of the property in the trust shall become unproductive of a *reasonable amount* of income, to *request* that the trustee distribute from the principal of the trust an amount equal to that which [S] would have received had the property produced income."

The government disallowed a claimed marital deduction for the IRA because: (1) enjoyment of the IRA by S was subject to delay under the commencement date provision; (2) not all income was distributable annually under any distribution option available to the QTIP trustee; and (3) the settlement option selected postmortem, directing distribution of all income annually, did not satisfy the requirement that a marital deduction bequest must qualify as of the date of D's death. Furthermore, even if the IRA allowed the QTIP trustee to withdraw the full account balance – which would be common and might explain how the trustee was able to direct postmortem that annual distributions be made of no less than an amount equal to all current income earned in the IRA – S lacked the power to make the IRA produce a reasonable amount of income or to compel the QTIP trustee to generate that result or to compensate S accordingly.

§13.5.6.8 Qualified Plan Spousal Annuity Issues

Qualified retirement benefit plans are required[274] to create spousal annuities for the benefit of surviving spouses of plan participants. These annuities may be waived[275] if the participant's spouse consents to a different beneficiary designation, but Congress failed to consider the tax consequences of the consent. For example, §2523(f)(6) provides that (1) a participant's retirement locks in a spousal joint and survivor annuity, which automatically qualifies for the gift tax marital deduction as QTIP property (unless the participant affirmatively elects out of this treatment), and (2) §2044 will not

[273] The government stated that the QTIP trust was the designated beneficiary but also that D identified S "as the 'designated beneficiary' of the trust interest (i.e., the benefits payable to the trustee as beneficiary of the IRA)," whatever that means.

[274] See §401(a)(11).

[275] See §417(a).

apply to include the annuity in the nonparticipant spouse's gross estate if the nonparticipant spouse predeceases the participant. Similar automatic QTIP treatment is provided by §2056(b)(7)(C) if the participant dies and a qualified preretirement annuity locks in for S's benefit.

Unresolved, however, are the tax consequences (1) if the nonparticipant spouse dies before the participant retires, or (2) when the participant retires and the annuity locks in for the benefit of the participant for life. Does the nonparticipant spouse have any kind of property interest in the plan by virtue of the spousal annuity rule? Is there a wealth transfer from or to either spouse in either of these events? If so, does that transfer qualify for the gift or estate tax marital deduction? These unanswered questions may be exacerbated in community property jurisdictions because it seems even more likely that each spouse owns a portion of the participant's retirement benefit.[276]

TAM 8943006 considered the estate tax consequences of a nonparticipant spouse's community property interest in a qualified retirement benefit plan (D's surviving spouse was the plan participant). A portion of the value of the plan was includible in D's gross estate under §2039 by virtue of D's community property interest in the plan and D's will gave all D's community property to D's children. Nevertheless, the government concluded that, under state law, no part of the qualified plan would pass to anyone other than the surviving participant spouse.[277] Thus, D's nonparticipant interest in the plan was held to qualify for the estate tax marital deduction.

If D had been the plan participant the TAM noted that §2056(b)(7)(C) normally would qualify S's interest in the plan for the marital deduction. So essentially the TAM provided the same treatment in the reverse situation presented, with respect to any portion of a plan that is includible in a nonparticipant's gross estate.

The TAM did not mention the amount of the deduction permitted. Presumably it was equal to the amount includible in the deceased nonparticipant's gross estate. No mention was made of the form of payout specified in the plan, and no question was raised whether that payout might disqualify the marital deduction. These developments seem to clarify that the qualified plan entitlement created in a participant or the participant's spouse automatically qualifies for the marital deduction under §§2523(f)(6) and 2056(b)(7)(C) (unless D's personal representative elects otherwise).

Although it is not yet clear whether a nonparticipant spouse in a noncommunity property state *has* a property interest in such a plan that is includible under either §2033 or §2039, TAM 8943006 should clarify that any amount that *is* includible will qualify for the marital deduction. Neither the

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[276] §2056(b)(7)(C) recognizes a nonparticipant spouse's interest by providing that the nonparticipant spouse's interest in an annuity arising under state community property laws that is included in the nonparticipant spouse's gross estate under §2033 and passes to the surviving participant spouse qualifies as QTIP property. See also §9.2 n.16 and accompanying text.

[277] That result is confirmed by Boggs v. Boggs, 520 U.S. 833 (1997) (a 5-to-4 decision that a participant's predeceased spouse could not transfer any entitlement under a qualified plan because ERISA pre-empts any state property law community property interest; because the participant had remarried and was survived by that new spouse, and because the opinion speaks in terms of the ERISA protection for S, it is not clear whether state community property law would be pre-empted if the nonparticipant's interest was limited to a community interest in whatever remains after the death of the last to die of the participant and any surviving spouse of the participant). The Conference Report states that §2056(b)(7)(C) is not intended to modify the result in *Boggs.* H.R. Rep. 220, 105th Cong., 1st Sess. 77 – 78 (1997).

QTIP regulations nor §2056(b)(7)(C) specifically answer the inclusion/deduction question.[278] It also is unclear whether a nonparticipant spouse makes a gift to a participant spouse when the participant spouse retires and, if so, whether that gift qualifies for the gift tax marital deduction.[279] Presumably the appropriate result is that the nonparticipant spouse in a noncommunity property jurisdiction has no property interest whatsoever for tax purposes.[280]

§13.5.6.9 QTIP and CRTs

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

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

(2) is the only beneficiary who is not a charitable beneficiary[281] (other than the donor, if a lifetime transfer is involved).

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

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

> The general rules applicable to qualifying income interests may provide similar treatment where a decedent provides an income interest in the spouse for her [sic] life and a remainder interest to charity. If the life estate is a qualifying [§2056(b)(7)(B)(ii)] income interest, the entire property will ... be considered as passing to the spouse. Therefore, the entire value of the

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278 See Treas. Reg. §20.2056(b)-7(f).

279 Consistent results dictate that the answer to the second question should be yes to the full extent of any gift the nonparticipant spouse is deemed to make, but these gift tax issues also were reserved under Treas. Reg. §25.2523(f)-1(c)(4).

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

281 Nor an ESOP beneficiary (as defined in §2056(b)(8)(B)(ii)).

> property will be eligible for the marital deduction and no transfer tax will be imposed. Upon the spouse's death, the property will be included in the spouse's estate [under §2044] but, because the spouse's life estate terminates at death, any property passing outright to charity may qualify for a charitable deduction.[282]

Thus, for example, a trust might provide that "the trustee shall pay the trust income to S at least quarterly for life. On S's death the trustee shall distribute the trust principal to [qualified charitable organization]." Being a QTIP trust interest, the §2056(b)(7)(B)(v) QTIP election automatically would apply to the extent D's estate reports the value of the trust principal on Schedule M of its Form 706. The entire trust corpus would qualify for a marital deduction in D's estate, it would cause §2044 inclusion in S's gross estate, and it would qualify for a §2055 charitable deduction in computing S's taxable estate.[283] Again, there would be no tax in either estate.

The QTIP alternative is preferable to the §2056(b)(8) qualified CRT approach because it is not necessary to draft within the complicated confines of the §664 CRT rules,[283.1] and corpus distributions may be made to S from the QTIP trust. Alternatively, the §2056(b)(8) split interest trust approach provides a number of advantages over the QTIP alternative.

For example, if created inter vivos, the §2523(g) inter vivos version of the §2056(b)(8) trust generates a §170 income tax deduction that the QTIP alternative would not generate. In addition, the tax character of the trust precludes ordinary income, capital gains, and income in respect of D from being subject to income tax to the extent not carried out to S as beneficiary of the lead split interest trust payment. Nor must the trust distribute all its income annually to S or worry about satisfying the qualified income interest rules.[284] Indeed, under the authority of §664(f), the trust may be drafted to distribute to the qualified charitable remainder beneficiary prior to S's death, either because S's interest is limited to a term of years[285] or is made terminable on a contingency (such as remarriage).[286]

Note, however, that TAM 8730004 underscores a significant limitation on the availability of the §2056(b)(8) planning alternative (although it is not likely to be relevant in garden variety estate planning). D created a 5% CRUT for S for life, followed by a similar interest for another private beneficiary, followed by a remainder to charity. This unitrust did not qualify for the combined marital deduction and charitable deduction under §2056(b)(8) because the statute requires that S be the only private beneficiary (other than the settlor, in an inter vivos application) prior to the charity's

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

283 By virtue of §2044(c), the remainder in a QTIP trust qualifies for a charitable deduction in S's estate because the interest is deemed to pass to the charity from S, in whose estate it is includible.

283.1 Confirmed by PLR 201831009, none of “the provisions of sections 4941, 4943, 4944, and 4945” are applicable during the life of S, nor “for a reasonable period of settlement” of the QTIP trust following the death of S, “so that the trustees . . . may perform the ordinary duties of administration necessary for the settlement” of the QTIP trust.

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

285 Not, however, to exceed 20 years. Treas. Reg. §20.2056(b)-8(a)(2).

286 See PLR 9511029. Although §664(f)(2) precludes the contingent acceleration of the charitable remainder from being reflected in valuing the remainder for charitable deduction purposes, it nevertheless may be D's desire to terminate S's enjoyment on the happening of such a contingency.

interest.[287] Thus, the personal representative elected §2056(b)(7) QTIP treatment for the entire trust, presumably assuming that the marital deduction would exclude the value of the entire trust from D's taxable estate and correspondingly cause inclusion of the entire value of the trust in S's gross estate, thereby allowing S's estate to qualify for a charitable deduction equal to the value of the remainder after the intervening annuitant's interest.

The TAM's denial of the §2056(b)(7) election raised doubts about the interchangeability of §§2056(b)(7) and 2056(b)(8) to accomplish essentially the same result. The TAM stated:

> In the case of a *qualified* charitable remainder trust, Congress limited the allowance of the §2056 marital deduction to those trusts that satisfy the §2056(b)(8) requirements ... [and] there is nothing in the legislative history of §2056(b)(8) to suggest that Congress intended §2056(b)(7) to be available in such cases. In the case of a qualified charitable remainder trust, with an annuity trust interest or a unitrust interest payable to the surviving spouse, no marital deduction is allowable for any portion of a qualified charitable remainder trust under §2056(b)(7) of the Code.... The existence of a charitable remainder interest in [the] Trust ... precludes the estate from making a §2056(b)(7) election. [Emphasis added.]

In essence, the government assumed that the taxpayer fell in an unintended crack between §§2056(b)(7) and 2056(b)(8). The former did not apply because this two life split interest trust was a qualified CRT, notwithstanding that it failed to satisfy the sole beneficiary requirement for §2056(b)(8) qualification as well.

Presumably to prevent this improper result in the future, the regulation now is worded slightly differently: "If an interest in property qualifies for a marital deduction under §2056(b)(8), no election may be made with respect to the property under §2056(b)(7)."[288] But "[i]n the case of a charitable remainder trust where the decedent's spouse is not the only noncharitable beneficiary ..., the qualification of the interest as qualified terminable interest property is determined solely under §2056(b)(7) and not under §2056(b)(8)."[289] This appears to mean that a trust can be a qualified charitable split interest trust but not satisfy the §2056(b)(8) requirements and therefore not be precluded from qualifying for the §2056(b)(7) QTIP exception. The net result is that the regulation now appears to say that §2056(b)(8) overrides §2056(b)(7) only if both provisions otherwise might apply.

What the regulation fails to specify is that §2056(b)(7) also is available in other circumstances in which the requirements of §2056(b)(8) are not met for reasons that do not relate to the sole beneficiary element. It still is possible for defective drafting or administration of a decedent's estate

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287 See §2056(b)(8)(A) and Treas. Reg. §20.2056(b)-8(a)(1), and compare PLRs 200832017 and 200813006, in which the trustees were authorized to distribute the lead income interest among the settlor, the settlor's spouse, and qualified charities and the trusts qualified both as CRTs and for the gift tax marital deduction. PLR 201117005 also allowed the trustee to allocate an 80% portion of the lead unitrust interest between the surviving spouse and charity in the trustee's discretion (and disqualified the spouse from receiving any part of that portion following remarriage), with no qualification problem. Caution, however: CCM 202233014 addressed a similar lead interest and disallowed marital and charitable deductions for the portion that the trustee, in its discretion, could distribute either to the spouse or to charity, and expressly stated (in a footnote) that "[t]he position in these earlier rulings no longer reflects the position of this office."

288 Treas. Reg. §20.2056(b)-8(a)(1).

289 Treas. Reg. §20.2056(b)-8(b).

to result in loss of the marital deduction under both provisions.[290] But additional rulings make it clear that qualification for the marital deduction under §2056(b)(7) is available if §2056(b)(8) does not apply because, for example, the trust is not a qualified CRT, and it does not appear to be the government's intent to create a trap for the unwary.[291]

§13.5.7 QDOTs

A surprising number of estate planners report that an unexpected number of their clients' spouses are not United States citizens. And it is not just practitioners with an international clientele or who practice in locales with an international community who encounter this phenomenon. It occurs throughout the United States, with respect to clients from varying walks of life and with experiences as varied as "we met while we were students," or "when I was in the Service," or "while I was on assignment overseas," or "when we both were working in New York/San Francisco/Miami/etc.," or "my in-laws immigrated when my spouse was a child." Notwithstanding the frequency of these types of situations, however, unless the client happens to mention S's citizenship to the estate planner, this fact might not be considered as part of the estate planning process, and this will cause a serious problem.

The issue presented by a client whose spouse is not a United States citizen was created in 1988 when Congress adopted §§2056(d) and 2056A to address what it perceived to be an abuse of qualifying property for the marital deduction notwithstanding that D's surviving spouse is not a United States citizen and, therefore, may remove the property from United States taxing jurisdiction before it is subject to United States wealth transfer taxation. In 1988 the §2056(a) requirement that D be a United States citizen or resident to qualify for the estate tax marital deduction was relaxed if D complies with the marital deduction requirements, but a citizenship requirement was imposed on S.

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290 For example, a CRAT interest in S may not qualify for the marital deduction under §2056(b)(7), because automatic QTIP treatment under §2056(b)(7)(C) is limited to annuities that are includible in D's gross estate under §2039. Further, the §2056(b)(10) issue as it relates to annuities created after October 24, 1992, makes it questionable whether D may create a life annuity for S and qualify any part of the underlying trust corpus for the QTIP marital deduction. See §13.5.6.4. A unitrust interest may qualify for the QTIP marital deduction, notwithstanding that S's unitrust interest is neither a guaranteed annuity (it fluctuates from year to year), nor is it an entitlement to any specific portion of all income from the trust payable annually.

291 But see TAM 8742001, which involved a decedent's devise of a life estate in a personal residence to S, with remainder to charity, and the government went out of its way to state that "[a] marital deduction for the value of S's annuity or unitrust interest in a qualified charitable remainder *trust* is allowable only under §2056(b)(8)" (emphasis added). Because this situation did not involve a trust, much less a qualified CRT, it appeared at the time that perhaps the government was announcing a position that it intended to assert in the future. Numerous authorities indicate that it now seems to have backed away from creating such a trap. See, e.g., PLRs 8952024 (S received a legal life estate, not in trust, in artwork, with remainder to charity; although it was not a qualified charitable split interest arrangement S's lifetime use and enjoyment, coupled with a power to sell, lease, encumber, or assign the lifetime interest, made the artwork permissible QTIP property notwithstanding the charitable remainder, as discussed in §13.5.2.2.2 nn.43 – 45); and 9323039, 9144016, 9122029, 9101010, 9047016, 9043016, 9036040, and 9008017 (all QTIP marital deduction trusts with remainders to charity, none in qualified CRT form; despite not complying with §2056(b)(8), the marital deduction was available under §2056(b)(7) for the full value of the trust corpus, with §2044(c) inclusion and a §2055 charitable deduction available when S dies). As shown by PLR 200540003, however, a 100% QTIP election is required and Treas. Reg. §301.9100 relief is not available if a partial election is made for just the income interest and the requisite time has expired to file a timely return that would alter that otherwise irrevocable election.

§13.5.7.1 Citizenship Requirement

Prior to adoption of §2106(a)(3) in 1988, §2056(a) (through §2001(a)) required D to be a United States resident or citizen to qualify for the marital deduction. Prior to 1988 no provision required that S be either. Apparently Congress was persuaded that there is a significant possibility of a decedent's estate qualifying for the marital deduction and then being removed from the United States' taxing jurisdiction before a noncitizen surviving spouse's death, which would escape paying estate tax as the payback for marital deduction qualification in D's estate.[292] Thus, §2056(d)(1) was enacted in 1988 to provide that the marital deduction under §2056(a) is not available if S is not a United States citizen unless the special requirements of §2056A are met.

In addition, the §2040(a) consideration furnished rule was made applicable by §2056(d)(1)(B) to cause inclusion of joint tenancy property held by a decedent and a noncitizen surviving spouse based on their respective contributions to the property, instead of including half the value of qualified joint property under §2040(b).[293] Consideration furnished by D is deemed consideration furnished by S to the extent it was regarded as a §2511 gift or D elected to treat it as such under former §2515.[294]

This rule is not entirely consistent with the rules of §2040(b) and it is not clear whether the regulations mean to override all other rules with respect to jointly owned property. Normally contributions are determined according to (1) any actual consideration furnished and (2) any consideration deemed furnished, to the extent creation of the tenancy was (or would have been, if the donor had been a United States citizen) treated as a gift under the rules of former §§2515 and 2515A (which were repealed in 1981).[295] The regulations cite but never address or apply §2515.

If it is necessary or appropriate to appreciate these repealed rules, it will be necessary to distinguish between spousal joint tenancies in real and in personal property and, in some cases, to identify when a tenancy was created (before 1977, after 1976 and before 1982, after 1981 and before July 14, 1988, and after July 13, 1988. These being the relevant dates because former §§2515 and 2515A were in effect only after 1976 and before 1982, and the changes in the marital deduction were effective after July 13,1988). Treas. Reg. §20.2056A-8 makes none of these distinctions, although Treas. Reg. §25.2523(i)-2 does, leaving in doubt the extent to which the government intends to apply §2056(d)(1)(B) as opposed to §2523(i)(3).[296]

PLRs 9521031 and 9151044 illustrate the operation of the §2040(a) joint property rules to property acquired by noncitizen spouses. In the later Ruling S had provided all the consideration for acquisition of tenancy by the entireties property in the form of proceeds from the sale of another asset, all the consideration for which S also provided. Because §2056(d)(1)(B) specifies that §2040(b)

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[292] See, e.g., Conf. Rep. to accompany H.R. 4333, H.R. Rep. No. 1104 at 114 – 115, indicating that special requirements under §§2056A(a)(1) and 2056A(a)(3) ensuring collection of the tax were a special concern of Congress.

[293] By virtue of this provision, only that portion of a joint tenancy that is includible in D's gross estate under §2040(a) may meet the special §2056A rules to qualify for the marital deduction. Treas. Reg. §20.2056A-8(a)(3).

[294] Treas. Reg. §20.2056A-8(a)(2).

[295] See Technical and Miscellaneous Revenue Act of 1988 §7815(d)(16).

[296] For a detailed discussion of former §§2515 and 2515A, see Danforth, Taxation of Jointly Owned Property, 823-2d Tax Mgmt. (BNA) Estates, Gifts, and Trusts Port. (2008); Siegler, Transfers to Noncitizen Spouses, 842 Tax Mgmt. (BNA) Estates, Gifts, and Trusts Port. (2009).

does not apply and §2103 provides that normal inclusion rules do, §2040(a) applied and no part of this property was includible. As to another parcel, 15% of its value was includible because S provided only 85% of the consideration for its acquisition. In the earlier Ruling, half of a joint brokerage account to which both spouses had contributed was includible, but a residence acquired in 1977 as tenants by the entirety using D's sole funds and as to which no former §2515(c) election had been made was treated as entirely includible in D's gross estate.

Historically, creation of a spousal joint tenancy in real property was taxable as a gift and would generate a deemed consideration furnished result under the rules of former §2515 to the extent: (1) the joint tenancy was created after 1976 and before 1982; (2) and the consideration furnished by each was not equal; (3) provided that the interests of the spouses were unilaterally severable under local law; (4) and an election was made under former §2515(c). D was regarded as having provided all the consideration because the last two requirements were not met in the ruling, which caused inclusion of the full value of the property in D's gross estate and therefore would require compliance with the §2056A rules with respect to the entire property.

S disclaimed the accretive half of the property within nine months after D's death and was held to have made a qualified §2518 disclaimer, notwithstanding S's continued occupation of the residence – which is not a prohibited retention of benefits in disclaimed property, due to an exception under Treas. Reg. §25.2518-2(d)(1). That exception was not lost when S conveyed the remaining half to a QDOT to generate a marital deduction.

Regulations apply the disclaimer principles once applicable to spousal tenancies in real property subject to former §2515 to spousal tenancies in real property now subject to §2523(i). Under Treas. Reg. §25.2518-2(c)(4)(ii) the noncitizen surviving spouse may disclaim any portion of the property that is includible in D's gross estate under §2040 if the disclaimer is made within nine months of D's death.[297]

Creation of a joint tenancy in personal property after 1953 and before 1977 was a gift to the extent: (1) the interests of the spouses were unilaterally severable under local law; and (2) the consideration furnished by each was not equal. No former §2515(c) election was required. If unilateral severance was not available, however, then creation of the joint tenancy was deemed to be a gift to the extent consideration furnished by one tenant exceeded the actuarial value of the interest acquired by that tenant, based on the respective life expectancies of each tenant.

After 1976 and before 1982, creation of a spousal joint tenancy in personal property was taxable as a gift under former §2515A only to the extent the spouses' actual contributions were not equal. Severability with respect to these spousal joint interests was irrelevant, as were actuarial computations.

After 1981 and before July 14, 1988, creation of a spousal joint tenancy in personal property was not taxable as a gift because of the unlimited gift tax marital deduction.

After July 13, 1988, creation of a spousal joint tenancy in personal property has been subject to the §2523(i) noncitizen spouse rules.

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297 See also Treas. Reg. §25.2518-2(c)(5) Example (9).

Joint tenancies and tenancies by the entireties in personalty created after 1954 and before 1982, subject to the former §2515(c) election, and after 1981 but before July 14, 1988, regardless of election, are regarded as owned by or attributable to original consideration provided by each tenant to the extent creation was treated as a gift.[298] No gift occurs on termination of these tenancies to the extent each receives proceeds proportionate to his or her respective contributions.[299]

These rules are partially illustrated in PLR 9551014 in the context of tenancy by the entirety property acquired at various times. With respect to the parcel acquired in 1979 and as to which no election was made under former §2515, S provided consideration only in the form of a joint note outstanding at D's death. That amount was deemed to be a fraction of the date of death FMV of the property of which the numerator was half of the outstanding debt at D's death and the denominator was the original purchase price of the property. The remaining portion of the property was includible in D's gross estate under the principles of §2040(a). With respect to properties acquired after 1981 when §2515 no longer was effective and before July 14, 1988, S was deemed to be the contributor to the acquisition to the extent D's acquisition was reported as a gift, which should have been half the purchase price. For properties acquired after July 13, 1988, the amount includible was deemed to be 100% of the value of the property except to the extent S was able to prove consideration furnished.

According to PLR 9021037, it is not adequate for S to apply to become a citizen before D's estate tax return is filed. To overcome disallowance of the marital deduction, §2056(d)(4) requires S actually to become a United States citizen before filing that return.[300] A return may be filed late and S may qualify if he or she becomes a citizen before the return is filed.[301] The penalty for late filing may be worth incurring to avoid the §2056A QDOT rules if it is anticipated that S will soon become a United States citizen.

For purposes of the §2056(d)(4)(B) requirement that S was a resident at D's death and until becoming a citizen the regulation[302] adopts the wealth transfer tax[303] definition of residence: domicile in the United States, which is acquired by living in a place "for even a brief period of time, with no

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[298] Treas. Reg. §25.2523(i)-2(b)(2)(ii).

[299] See Treas. Reg. §25.2523(i)-2(b)(2)(i) with respect to tenancies by the entireties and joint tenancies created between 1955 and 1981, as to which the former §2515(c) election was not made, and all those created after July 13, 1988, as to which the deemed consideration treatment does not apply.

[300] Treas. Reg. §20.2056A-1(b) relaxes this rule by providing that a return filed early is deemed filed on the last date it is required to be filed, including extensions.

[301] Late filing should not be a problem under the election requirements of §2056A(a)(3) and Treas. Reg. §20.2056A-3(a) because the election is adequate if made on the first late filed return. However, §2056A(d) requires that a late return must be filed within one year after the time prescribed by law (including extensions). More important, no election would be required by virtue of meeting the §2056(d)(4) exception to §2056(d)(1) disqualification. See Estate of Liftin v. United States, 754 F.3d 975 (Fed. Cir. 2014), aff'g 111 Fed. Cl. 13 (2013), concluding that it was reasonable to rely on the advice of counsel to file and pay a reasonable time after the decedent's surviving spouse was naturalized as a United States citizen, to take advantage of the §2056A marital deduction. The estate paid estimated tax adequate to cover its liability as if no marital deduction was allowable, and was granted an extension of the time to file. But it was not reasonable to further delay an added nine months until claims involving that spouse's entitlement in the estate were resolved and the amount of the marital deduction could be established with certainty. In that regard, see §3.3.19 n.250 et seq. and accompanying text.

[302] Treas. Reg. §20.2056A-1(b).

[303] Treas. Reg. §20.0-1(b)(1), rather than the §7701(b) income tax definition, which is relevant only to the extent income tax residency ever speaks to the question of estate tax residence.

present intention of later removing therefrom." However, "[r]esidence without the requisite intention to remain indefinitely will not suffice."

Also enacted in 1988, §2523(i) provides that the gift tax marital deduction is not allowable if the donor's spouse is not a United States citizen, with no §2056A-type exception to permit inter vivos marital deduction qualification. In its place, however, the §2503(b) gift tax annual exclusion was increased from $10,000 to $100,000 (indexed for inflation after 1998) per year,[T] for gifts made to a spouse who is not a citizen, provided only that the gift otherwise would qualify for the normal gift tax marital deduction and meets the gift tax annual exclusion present interest requirements.[304] The trade-off for this "super" inflated annual exclusion benefit is loss of the §1014 basis adjustment that otherwise would be available if D held the property until death, but inter vivos super annual exclusion treatment is advantageous if the gifted property is not suited to QDOT ownership or administration.[305]

§13.5.7.2 Exceptions

The §2056(d) disallowance of the marital deduction if D's surviving spouse is not a United States citizen is subject to several exceptions. For example, transfers governed by wealth transfer tax treaties are governed by whichever of the treaty or §2056A (but not both) is selected by the taxpayer.[306] More importantly, §2056(d)(2) permits the estate tax marital deduction if a §2056A QDOT is utilized. Under this exception, property passing from a decedent directly to a QDOT will

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304 See §7.1.1.1. Treas. Reg. §25.2523(i)-1(d) Examples 3 and 4 reveal an interesting twist on this entitlement (in the latter example denying the super annual exclusion because a life estate in trust does not qualify for the marital deduction as QTIP property because no election is made and denying the inflated annual exclusion because the election could not be made). PLR 200240020 also reflects potentially strategic planning; in that situation D transferred a residence to noncitizen S and continued to live there, with no §2036(a)(1) inclusion at death because living with your own spouse is not regarded as a retention of enjoyment for estate tax inclusion purposes. See §7.3.4.1 at text accompanying n.123. The consequence was that no §2056A QDOT qualification was required and, presumably, a better overall result applied if the super annual exclusion would cover the value of the inter vivos gift.

305 §2523(i)(3) also restored the former §§2515 and 2515A joint tenancy rules for gift tax purposes that were repealed in 1981 when the unlimited gift tax marital deduction was adopted. In general, under these rules, creation of a joint tenancy (other than a revocable joint tenancy, such as a bank account) is a gift to the extent consideration furnished by each tenant is not equal. In a revocable joint tenancy the gift occurs on withdrawal by any tenants of amounts in excess of their contributions, and that gift may qualify for the super annual exclusion. On termination of a joint tenancy, a gift occurs to the extent the property is not distributed in the same proportions as the consideration furnished, with the added proviso that gift taxation on creation subsequently authorizes treatment of the donee as having provided an equal share of the consideration. Joint interests in realty created before 1982 and after July 13, 1988 are excepted from the gift tax rule, meaning that no gift occurs on creation but may occur upon termination, and no joint tenancy exclusively between spouses is to be valued based on life expectancies. Any gift on termination counts against the super annual exclusion amount for that year. For a more detailed exegesis, see Plaine & Siegler, The Federal Gift and Estate Tax Marital Deduction for Non-United States Citizen Recipient Spouses, 25 Real Prop., Prob. & Tr. J. 385, 436 – 443 (1991). For a much too cursory treatment see Treas. Reg. §25.2523(i)-2(b), which may reveal that the government does not care to get into these issues.

306 Treas. Reg. §20.2056A-1(c). Unfortunately, no additional guidance exists currently although the preamble to the proposed regulation stated that the Treasury Department "may conclude treaty negotiations that may supplement the rules contained in [the] regulations ... [and] the Service is considering issuing additional guidance on the application of [the] special treaty rules." The preamble to the final regulations added only that the regulations do not conflict with existing treaties.

qualify for the estate tax marital deduction. So too will property passing[307] to a surviving spouse who then transfers or irrevocably assigns it[308] to a QDOT before D's estate tax return is filed and before the QDOT election is required.[309]

D need not create the QDOT.[310] An example in the regulation[311] dramatically illustrates the consequences of a surviving spouse receiving property outright that S contributes to a QDOT. The example concludes that the transfer constitutes an immediate gift of a remainder interest that does not qualify for the gift tax annual exclusion.[312] Because the property is transferred to a trust in which

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307 The wording of Treas. Reg. §20.2056A-4(b)(3) is not clear (and deletion of the word "initially" from before "owned" in its penultimate sentence confuses the question). But it appears that property includible in D's gross estate although owned by S at D's death (for example, because D's inter vivos transfer to S triggered §2036(a) or §2038(a) inclusion at death) meets the passing test in §2056(c) and may be contributed by S to a QDOT.

308 A transfer or assignment to a QDOT must be in writing and, if only an assignment occurs before the estate tax return is filed, it must be irrevocable and must be followed by an actual transfer before administration of D's estate is completed or one year after the return was due (including extensions) if there is no administration of the estate. See Treas. Reg. §20.2056A-4(b)(6), which also allows D's personal representative to request a PLR extending or waiving the conveyance period or requirement entirely "under specified circumstances," which are not identified. See, e.g., PLR 201243012 involving delayed assignment of a profit sharing plan naming S as beneficiary and delayed assignment by S to an IRA "caused by intervening events beyond Spouse's control." No further elaboration is given.

According to Treas. Reg. §20.2056A-4(b)(2), specific assets, a fractional share of property, or a pecuniary amount may be assigned or transferred, including by formula, but an assignment or transfer of specific assets must entail property included in D's gross estate (S may not fund a QDOT with property initially owned by S, as opposed to property or the proceeds of property acquired from D). See, e.g., PLR 199917045, in which assets excluded by treaty from inclusion in D's gross estate and as to which no marital deduction was claimed were not QDOT property and therefore would not be subject to tax when distributed or when S subsequently died. A pecuniary assignment or transfer must specify that assets distributed must be worth no less than the pecuniary amount on the date of distribution or, if not valued on that date, must be fairly representative of appreciation or depreciation in value between the valuation date (date of death or the §2032 alternate valuation date, if elected) and the date of the actual transfer "of all property available for transfer to the QDOT." Treas. Reg. §20.2056A-4(b)(4). The quoted provision may prove problematic if D left property in several forms that might be transferred or assigned to the QDOT. In addition, special rules deal with filing and election problems if multiple QDOTs exist or are created. See §2056A(b)(2)(C) and Treas. Reg. §§20.2056A-9 and 20.2056A-11(d) regarding allocation of the liability for payment of the tax.

309 Treas. Reg. §§20.2056A-2(b)(2) and 20.2056A-4(b)(1). The election is described in §2056A(d) and Treas. Reg. §20.2056A-3(a) as timely if made on the last timely filed estate tax return (including extensions) or on the first return filed not more than one year late. The requirement that the assignment or transfer occur within the time for making the election is not authorized by §2056(d)(5), but this legislative restriction would not be relevant unless the return was more than one year late. The restriction is sensible because, even after a transfer, an election would be required to qualify for the deduction and the one year limitation on election is authorized by §2056A(d) (last sentence).

310 Treas. Reg. §§20.2056A-2(b)(2) and 20.2056A-4(b)(1) list S, D, and D's personal representative as potential creators of a QDOT (and, although not explicit, the latter regulation arguably creates a list that is limited to these three potential settlors) to receive such property (although income tax grantor trust and other tax consequences may flow from S being the settlor or transferor).

311 See Treas. Reg. §§20.2056A-4(b)(5) and 20.2056A-4(d) Example 5.

312 As revealed in Treas. Reg. §20.2056A-4(d) Example 1, however, this gift would be incomplete and no gift tax would be incurred if S retained a testamentary power of appointment over the trust. Example 5 was amended between proposed and final form and Treas. Reg. §25.2702-1(c)(8) was added to specify that this transfer will not satisfy the qualified interest rules of §2702. Thus, the gift tax value of the transferred remainder ordinarily would be the entire value of the property transferred, and not just the value of the remainder interest. Nevertheless, an exception is granted to preclude this §2702 disaster. Thus, the gift tax consequences, if any, of S's transfer to the trust constituting a gift of a remainder interest should be manageable or avoidable.

S enjoys an income interest for life, the full value of the transferred property will be includible in S's gross estate under §2036(a)(1) (with the appropriate §2001(b) adjustment to avoid any double tax incurred). This only means that S cannot effect a valuation freeze by inter vivos transfer to a QDOT. Further, S is the transferor (rather than D, from whom S received property that is being added to the QDOT), so the §2652(a)(3) reverse QTIP election is not available to take advantage of D's GST exemption. Overall, examples illustrate that relatively poor results are produced by contributions to a QDOT by S. This places importance on ascertaining citizenship in the planning stage and crafting the estate plan to create and fully fund a QDOT without the need for action by S.

Similar to a protective election provision,[313] protective assignments are permitted if there is a bona fide issue with respect to whether property passing to S is includible in D's gross estate or regarding the residency or citizenship of D, the citizenship of S, or S's entitlement.[314] These elections and assignments must be irrevocable, meaning for example that the election binds and the assignment must be fulfilled, if the elected or assigned asset is includible. Even if it becomes clear that marital deduction planning based on hindsight more appropriately would not qualify the property for the QDOT marital deduction.[315] In addition, a nonqualifying trust can be reformed to qualify under a procedure specified in §2056(d)(5).[316]

An "ordinary" trust can meet the QDOT requirements,[317] and entities such as qualified retirement benefit accounts apparently may be made to qualify. A special approach also may be used to qualify "nonassignable annuities and other arrangements," such as an IRA or a retirement benefit spousal annuity payable to a surviving spouse who is not a United States citizen.[318] Before this approach became available Private Letter Ruling 9151043 presented the government with a relatively easy variation of the potentially controversial question whether the marital deduction can be generated if D's non-United States citizen surviving spouse is the beneficiary of D's retirement benefits. The government allowed the marital deduction because S was the outright beneficiary of D's IRAs and proposed to irrevocably designate a QDOT as beneficiary thereof. As a consequence the government did not need to address questions such as whether Rev. Rul. 89-89[319] applied or

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313 Treas. Reg. §20.2056A-3(c). See §13.5.7.3 n.337.

314 Treas. Reg. §20.2056A-4(b)(8). See PLR 200910019.

315 Treas. Reg. §20.2056A-4(b)(1) specifies that the terms of the QDOT to which a transfer or assignment is made by S need not be in a form that would qualify for the marital deduction under §2056(a), but this must be read in conjunction with Treas. Reg. §20.2056A-2(b)(1) and §2056(d)(2)(B), which specify that property in a QDOT that passes directly from D must qualify for the marital deduction. Thus, only with respect to property that passed originally to S and was transferred or assigned to a QDOT is this "need not qualify" rule applicable. The QDOT must meet the qualified trust requirement in its entirety if that property is commingled with property passing directly from D to the QDOT.

316 Treas. Reg. §20.2056A-4(a) is the only provision dealing with reformation and adds scant substance to the minimal guidance provided by §2056(d)(5).
PLRs 199904023 and 9017015 permitted QDOT treatment under §2056A for trusts reformed under local probate court orders entered prior to the due date for filing those decedents' estate tax returns. And PLR 9043070 permitted reformation of an inter vivos trust in which the noncitizen donee spouse had an interest, observing that §2056(d)(2)(B)(ii) is appropriate to allow reformation of a trust to qualify for QDOT treatment, even though it was intended to cover property passing directly from D to S under a will or as nonprobate property.

317 Treas. Reg. §20.2056A-2(a), which adopts the Treas. Reg. §301.7701-4(a) definition.

318 See Treas. Reg. §§20.2056A-4(b)(7) and 20.2056A-4(c), and PLR 200821030.

319 1989-2 C.B. 231, subsequently superseded by Rev. Rul. 2000-2 and it by Rev. Rul. 2006-26, all as discussed in §13.5.6.7.

whether S could assign those benefits or otherwise designate the trust as beneficiary thereof.[320] There was no suggestion that this irrevocable assignment might constitute a §691(a)(2) income tax acceleration event, and it should not.

In PLR 9623063, a non-citizen S accomplished a §408(d)(3)(A) qualified rollover of D's community property interest in D's IRAs and achieved a marital deduction for the IRAs by creating a QDOT to hold the IRAs. S was the sole designated beneficiary of D's IRAs and rolled over D's IRA balances into trusteed IRAs established in S's name. S had the right to make withdrawals at any time from the rollover IRAs and the sole power to designate beneficiaries.

The rollover IRAs (the initial corpus of the QDOT) were subject to the QDOT agreement. The QDOT trustee served as the custodian of the IRA and was given the right to withhold the tax imposed by §2056A from any distribution under the account agreement (other than a distribution of income). Under the QDOT agreement, amounts rolled over by S from D's IRA to the trustee of the rollover IRA were considered principal to the extent of the date-of-rollover value of D's IRA. To the extent of the trust's current income available for distribution (income earned during the calendar year) amounts distributed under the rollover account agreement were to be considered a distribution of income for §2056A(b)(3)(A) purposes. Income earned but not distributed during the calendar year was to be added to trust principal.

The QDOT agreement provided that the trustee was to comply with any applicable rules established by statute, temporary or final regulations (including Treas. 20.2056A-2T), or revenue rulings necessary to maintain the trust as a QDOT under §2056A and an IRA under §408. S and the trustee also both had the right and duty to make any amendments as may be required to maintain the trust estate as a QDOT. As in PLR 9151043, because D's IRA passed outright to S the IRS ruled that the QDOT need not meet the requirements for a power of appointment, QTIP, or estate trust (as long as no other property is transferred to the QDOT).[321]

Special provisions[322] also address qualification of "[p]roperty passing under a nontransferable plan or arrangement," which is not expressly limited to employment-related survivorship annuities payable to a participant's surviving spouse and that are not assignable or otherwise alienable. Required is that the personal representative make the QDOT election and file the requisite information statement and Agreement to Pay the tax, and that S make one of two alternative agreements to: (1) roll over (within 60 days of receipt) the "corpus portion" of every annuity or other periodic payment to a QDOT created before D's estate tax return is filed and within the QDOT election period; or (2) pay the deferred estate tax by April 15 annually on the same "corpus portion"

[320] See also PLR 9235015, which allowed QDOT treatment for S's contribution to a trust of the proceeds of a qualified thrift plan paid in a lump sum. The government also ruled consistent with Treas. Reg. §20.2056A-5(c)(3)(iv) that §2056A(b)(15) would apply to distributions to S by the trustee of amounts equal to the income tax incurred by S on receipt of the lump sum that was assigned to the corpus of the trust. PLR 9713018 permitted noncitizen S to roll over a beneficial interest in a §403(b) annuity to an IRA created by S and maintained by a domestic corporation.

[321] In addition, because S will be considered the individual for whose benefit the rollover IRA is maintained, the government ruled that S will be deemed the account holder under §401(a)(9) for purposes of the required distribution rules. See generally §9.3.5.

[322] Treas. Reg. §§20.2056A-2(b)(3), 20.2056A-4(b)(7)(ii), 20.2056A-4(b)(7)(iii), and 20.2056A-4(c).

received in the prior calendar year.[323] In both cases, an information statement[324] and a rollover or a deferred payment agreement[325] must be filed. The "corpus portion" is determined in what amounts to a five step computation:[326]

1. The annual payment amount must be determined.[327]

2. The discounted present value of the annuity must be determined, using the §7520 interest rate and mortality tables applicable for the month of D's death.

3. The expected annuity term is computed using the same tables but with a rounding that increases the term to the next higher (not the closer) whole number.[328] Because a greater number produces a smaller corpus portion, this rounding is favorable to the taxpayer.

4. The discounted present value is divided by the expected term (from step 3) to determine the "corpus amount."

5. The corpus amount is divided by the annual payment (from step 1) to determine the "corpus portion."

§13.5.7.3 QDOT Qualification Requirements

It probably is easiest to think of a §2056A(a) QDOT created by D as a §2056(b)(5), §2056(b)(7),[329] §2056(b)(8),[330] or estate[331] trust[332] that meets the §2056A(a)(1) requirements that

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323 See Treas. Reg. §§20.2056A-4(c)(1), 20.2056A-4(c)(2), 20.2056A-4(c)(3), and 20.2056A-4(c)(7).

324 Dictated by Treas. Reg. §20.2056A-4(c)(5).

325 Dictated by Treas. Reg. §20.2056A-4(c)(7)(ii) or §20.2056A-4(c)(6)(ii), respectively. See PLR 201647002 granting relief from the timing requirements applicable to the rollover option.

326 See Treas. Reg. §§20.2056A-4(c)(4) and 20.2056A-4(d) Example 4, which describe four explicit steps that follow a required but unstated first step that applies if payments are not on an annual basis.

327 This is not as simple as, for example, merely multiplying a monthly payment by 12. Instead, the proper adjustment factor must be used to convert a monthly or other periodic payment into an annual payment equivalent.

328 Treas. Reg. §20.2056A-4(c)(4)(ii)(B) (last sentence).

329 "Including joint and survivor annuities under §2056(b)(7)(C)," according to Treas. Reg. §20.2056A-2(b)(1). See the nonassignable annuity rules in Treas. Reg. §20.2056A-4(c).

330 See Treas. Reg. §§20.2056A-2(b)(1) and 20.2056A-6(b)(3), and PLR 9244013.

331 Under Treas. Reg. §20.2056A-2(b)(1), which refers to Treas. Reg. §20.2056(c)-2(b)(1).

332 §2056A(c)(3) grants the Treasury regulatory authority to treat as trusts for purposes of QDOT qualification any legal arrangements that have substantially the same effect as trusts. The recognition of nontrust arrangements is intended to permit qualification for estates of decedents whose nonresident spouses reside in countries in which the use of a trust is prohibited (as it may be in some civil law countries).

The Conference Report states that regulations, if any, would only permit a marital deduction with respect to nontrust arrangements under which the United States would retain jurisdiction and adequate security to impose United States transfer tax on transfers by S of the property transferred by D, listing as possible arrangements (1) the adoption of a bilateral treaty that provides for the collection of United States transfer tax from the noncitizen S or (2) a closing agreement process under which S waives treaty benefits, allows the United States to retain taxing jurisdiction, and provides adequate security with respect to transfer taxes. H.R. Rep. No. 220, 105th Cong., 1st Sess. 719 (1997). Similarly, it is anticipated that regulations waiving the United States trustee requirement under §2056A(a)(1)(A), if any, will provide an alternative mechanism under which the United States would retain jurisdiction and adequate security. H.R. Rep. No. 220 at 720 – 721.

1. except as provided in regulations, at least one trustee must be a United States citizen,[333] or domestic corporation,[334] and

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

In addition, for qualification purposes

3. all income must be payable to the noncitizen spouse annually[335] (unless an estate trust is being used),[336]

4. an election must be made on D's last timely filed estate tax return or first late return,[337]

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333 An individual trustee "must have a tax home ... in the United States" to meet the United States citizen requirement. Treas. Reg. §20.2056A-2(d)(2). See §911(d)(3).

334 Under Treas. Reg. §20.2056A-2(c), a domestic corporation is "a corporation created or organized" under state or federal law and, for reasons revealed in Treas. Reg. §20.2056A-2(d)(1)(ii)(A), is likely to be a bank as defined in §581 (a bank, trust company, or savings and loan). A United States branch of a foreign bank may serve as a trustee but must have a cotrustee that is a United States trustee (a citizen individual or a domestic corporation) under the "bank" trustee security arrangement alternative for larger than $2 million QDOTs. Although other security arrangement options exist, a United States trustee (domestic corporation or citizen individual) always is required. According to PLR 199918039, classification of the trust as a §7701(a)(31)(B) foreign trust will not affect qualification as a QDOT.

335 The trustee's power to withhold the tax from the distribution will not cause the trust to be a nondeductible terminable interest under §2056(b)(5) or §2056(b)(7). See §2056A(b)(14).

336 See Treas. Reg. §20.2056A-2(b)(1). An estate trust was authorized in PLR 9235015, which was unusual in that the trust required payment of all income annually to S notwithstanding that it was an estate trust when S died.

337 Treas. Reg. §20.2056A-3(a). Note that §2056A(d) allows a late return to make the election only if it is no more than one year tardy; that limitation is reflected only obliquely, in the first clause of the regulation, reading "subject to the time period prescribed in §2056A(d)." TAM 9228001 granted a Treas. Reg. §301.9100 request for an extension of time to make the requisite election in a case in which the Form 706 that was filed (and its instructions) for D's estate provided no QDOT information. PLRs 200910019, 200821030, 200146015, and 9352003 allowed extensions with no indication that the form or instructions were incomplete, PLR 201830001 permitted an extension in a case involving assets discovered after filing Form 706, and PLRs 201634018 and 201103004 allowed an extension with a statement that the accountant who prepared the estate tax return simply failed to make the election.

Protective elections are authorized under Treas. Reg. §20.2056A-3(c), including by formula election, but only if a bona fide issue regarding inclusion of property or rights thereto or regarding D's residency or citizenship, S's citizenship, or S's entitlement makes it infeasible to file the irrevocable election. The protective election must identify the specific property to which it applies (although a formula election is allowable) and the reasons justifying the protective election.

Partial QDOT elections are not allowed, but a trust may be severed "in accordance with the applicable requirements of Treas. Reg. §20.2056(b)-7(b)(2)(ii) before the due date for the election" and then only one of the trusts may be elected. Treas. Reg. §20.2056A-3(b). Treas. Reg. §20.2056(b)-7(b)(2)(ii) requires that severance be authorized under state law or the document itself and occur before administration of the estate is complete; if it has not occurred when the return is filed, the intent to do so also must be signified "unequivocally" on the return.

5. the QDOT also must comply with any "requirements ... prescribe[d by regulations] to ensure the collection of any tax imposed" by §2056A(b),[338] and

6. a bifurcated rule imposes the requirement that a trust either

   - employ at least one trustee that is a §581 United States bank or trust company (a domestic law firm or other citizen acting as trustee will not suffice),[339]

   - furnish a bond or letter of credit in an amount equal to 65% of the §2031 or §2032 FET value of the trust corpus,[340] or

   - if the §2031 or §2032 value is no more than $2 million[341] the trust instrument must prohibit investment of more than 35% of the annually determined FMV in real estate located offshore.[342]

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338 §2056A(a)(2).

339 Treas. Reg. §20.2056A-2(d)(1)(i)(A). As an alternative to the United States bank or trust company, this exception may be met if a United States branch of a foreign bank is cotrustee with a United States trustee – which could be a citizen individual. The preamble to the proposed and temporary regulations issued on August 22, 1995, stated that the government was considering whether an attorney or law firm that actively administers fiduciary estates may suffice under this alternative and stated that ruling requests on the issue would be considered if adequate security arrangements were provided. No guidance was given as to which might be deemed adequate, and the final regulations and their preamble (T.D. 8686, 61 Fed. Reg. 60551), issued on November 29, 1996, made no reference to this issue.

PLR 8952005 involved a United States citizen decedent whose surviving spouse was a United States resident but not a citizen and who proposed to establish a trust and transfer to it all nonprobate property received from D. As personal representative of D's estate, S planned to make the requisite QDOT election under §2056A(a)(3), and the trust otherwise met the QDOT requirements. The fact that S reserved the right to become trustee after becoming a naturalized United States citizen did not preclude the government from ruling that the trust would qualify as a QDOT for marital deduction purposes.

340 Treas. Reg. §§20.2056A-2(d)(1)(i)(B) and 20.2056A-2(d)(1)(i)(C). The valuation requirement must be met without regard to debt on the property, under-valuation principles are established in Treas. Reg. §20.2056A-2(d)(1)(i)(D), and specific trust and either bond or letter of credit drafting requirements are specified in the regulation. In each case a requirement that the United States trustee provide a written statement with the bond or letter of credit specifying the assets and their values that will be used to fund the QDOT may be silly or impossible to satisfy because this must accompany the return and, at that time, it may not be known how large the QDOT will be or how much various assets are worth for FET purposes. See TAM 9116003.

341 Treas. Reg. §20.2056A-2(d)(1)(ii), again determined without regard to debt and with undervaluation and valuation fluctuation principles and procedures. Treas. Reg. §20.2056A-2(d)(1)(ii)(A) requires aggregation of multiple QDOTs for the same surviving spouse to determine whether the $2 million threshold has been exceeded. Although not stated, presumably these trusts must relate to the same decedent's marital deduction. That is, aggregation with respect to a noncitizen who survived several different spouses should not be required.

342 Although there was no statutory or regulatory support at the time for it, PLR 9043070 required that the trustee of a QDOT be prohibited from investing in realty not situated in the United States and that all trust assets be held by the United States trustee in the United States. PLRs 9235015, 9148021, 9109021, 9101034, and 9044072 by their own terms similarly prohibited the QDOT trustee from investing in property located outside the United States or in the stock or any other interest in a foreign corporation. And the trust in PLR 9151044 provided that all trust assets must be physically situated in the United States. These rulings did not indicate as much, but they predicted a requirement imposed by Prop. Treas. Reg. §20.2056A-2(d)(3) that all assets other than realty be held in the United States. That provision was deleted from the final regulation. And see PLR 9032014, which approved a QDOT that held stock in a foreign corporation.

Under any of these options, the trust may be required to file annual reports that include information about trust investments and their annually determined FMV.[343] A special rule may apply to facilitate qualification for the small trust or the bond or letter exceptions to the bank trustee requirement. It ignores up to two personal residences and their "related furnishings" to the extent of $600,000 of value in the aggregate.[344] Alternative arrangements to assure collection of the tax (or a request for a complete waiver of the requirement) may be submitted, but the regulations give no clue regarding the potential parameters of an acceptable proposal.[345]

These rules permit functionally or expressly irrevocable trust instruments to provide for or require various items through incorporation by reference.[346] In addition, some drafters create normal marital deduction trusts that impose the additional QDOT requirements only if S is not a United States citizen when D dies. The regulation does not indicate whether this approach is acceptable.[347]

An entity passthrough rule is applied in Treas. Reg. §20.2056A-2(d)(1)(ii)(B) to determine the ownership of assets held by corporations or partnerships with 15 or fewer shareholders or partners, and a §267 related party attribution rule is applied to determine the number of shareholders or partners, all presumably to preclude the use of entity ownership of assets to avoid the offshore investment limitations. A QDOT that owns more than 20% of such an entity will be deemed to own a pro rata share of those assets for purposes of these rules. A similar paranoia is exhibited in Treas. Reg. §20.2056A-2(d)(1)(ii)(C), which refers generally to "other entities (such as ... a trust)" in which a QDOT owns an interest. And Treas. Reg. §20.2056A-2(d)(1)(v) goes another step by specifying that a QDOT "immediately ceases to qualify ... if the trust utilizes any device or arrangement that has, as a principal purpose, the avoidance of liability for the [deferred] estate tax ... or the prevention of the collection of the tax." The example given is of a thinly capitalized bank created by S or family members to act as trustee.

343 Treas. Reg. §20.2056A-2(d)(3).

344 See Treas. Reg. §20.2056A-2(d)(1)(iv). Applicable for purposes of the $2 million threshold and the 65% of value security rule, but not for purposes of the 35% offshore realty rule. The §1034 definition of principal residence is used in the regulation for one residence and one other may qualify if used as a personal residence and it is available to S at all times (meaning it cannot be rented to others at any time). Certain rare or valuable tangibles (and all automobiles) are excluded, and rollover of proceeds and cessation of use rules apply. §1034 was repealed by P.L. 105-34, §311(b), and conforming amendments were made to various Code sections to substitute the definition of principal residence used for purposes of §121 for the §1034 definition but the §2056A regulation has not been updated.

345 Treas. Reg. §20.2056A-2(d)(4). Rev. Proc. 96-54, 1996-2 C.B. 386, provides sample language the government specifies as satisfying all the governing instrument requirements of Treas. Reg. §§20.2056A-2(d)(1)(i)(A), (B), (C), and 20.2056A-2(d)(1)(ii).

346 Treas. Reg. §§20.2056A-2(d)(6)(ii) and 20.2056A-2(d)(6)(iii) by parenthetical references. See also Treas. Reg. §20.2056A-2(d)(1)(i) (last sentence). The will of a 1994 decedent in PLR 9620015 directed that the QDOT election be made and required the United States trustee to meet the requirements prescribed by regulations to ensure collection of the tax, granting the United States trustee authority to amend the trust to make it a QDOT. The trustee amended the trust to comply with additional security requirements in Prop. and Temp. Treas. Reg. §20.2056A-2T(d)(1) and the IRS ruled that the trust met the statutory requirements for a QDOT.

347 TAM 9228001 granted a §9100 request for an extension of time to make the requisite election in a case in which the Form 706 that was filed (and its instructions) for D's estate provided no QDOT information. PLR 200211021 granted an extension to file the QDOT election and fund the trust, all based on discovery of the issue and timely filing of an amended return (within the §2056A(d) one year window after the time for filing the original return; see §13.5.7.3 n.337). PLRs 202146008, 9816010, 9623044, and 9547005 allowed extensions of time to make the requisite assignment of property to a QDOT and then the required election, but PLR 200352005 denied a similar request with respect to joint tenancy property that passed to S because the estate included only 50% of the value of that property in D's gross estate, apparently having overlooked that §2056(d)(2)(B) makes §2040(b) inapplicable. PLR 9834013 allowed an extension to actually convey assets previously assigned to a QDOT. PLR 9803020 granted an extension to make the election with respect to a trust created by S within one year after D's death. And PLR 9803017 granted an extension of time to file the requisite bond, not to make the election.

§13.5.7.4 Taxation of QDOTs

Wealth transfer tax is imposed on QDOTs in an unusual manner. Effectively, §2056A(b) treats a QDOT as not really qualifying for a normal estate tax marital deduction in the estate of D but, rather, as merely deferring D's tax from D's death until a later triggering event. That is, the tax imposed under §2056A(b)(2)(A) is computed as if D had died at the time of the later triggering event and the taxable property was then includible in D's gross estate.[348] Like a gift tax computation, the amount by which D's taxes would have been increased by inclusion of such property is the amount of tax that is to be paid by the QDOT,[349] with no imposition of interest for the deferral inherent in the delay between D's death and the triggering event. In addition, although the tax is paid by the QDOT trustee (and is treated as a distribution to S, which may trigger additional tax, as discussed below), it is treated under §2056A(b)(7) as paid by D's estate.

With proper planning the deferred estate tax under §2056A might be attractive in one respect. Normal marital deduction planning shelters D's unified credit and "stacks" the balance of D's property on top of S's estate in the form of a marital deduction bequest, causing taxation of that property at S's marginal estate tax rates. This estate stacking does not occur in the same manner with the QDOT approach because D's property is taxed at D's rates. Thus, in effect, D enjoys a full "run through the brackets" and S enjoys a second run through the brackets.

Overall, less tax may be paid under the QDOT approach if the estates are large enough to benefit from separate bracket runs. On the other hand, if S does not have sufficient independent assets to fully utilize S's unified credit, this regime requires that the spouses engage in inter vivos planning to shelter S's unified credit or rely on portability (if available).[350] Because there is no gift tax QDOT option, if portability is not available, then credit shelter planning must occur either through the enlarged gift tax annual exclusion for gifts to S or by gifts to third parties that the spouses split for gift tax treatment.

QDOT property normally will be taxable in S's estate as well (because a QDOT created by D must comply with the normal marital deduction trust rules and will be subject to United States taxation if still in existence at S's death). Double tax under the QDOT regime is meant to be precluded by §2056(d)(3), which is only partially successful. It grants a special §2013 credit to the estate of the noncitizen S for application against any estate tax incurred in S's gross estate. This credit is based on taxes deemed paid by D's estate with respect to QDOT property – all without the §2013(a) percentage limitation, which normally reduces the available credit based on the time elapsed between deaths. This credit is only for taxes paid after reflecting the unified credit available in D's estate. This regime does not accomplish optimum planning to the extent inclusion of the QDOT in S's estate bumps S's

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[348] See, e.g., Treas. Reg. §20.2056A-6(a); §2032 alternate valuation or §2032A special use valuation is allowed if the triggering event is death of S. Treas. Reg. §§20.2056A-5(b)(2), 20.2056A-6(b)(5).

[349] The trustee must file the return (Form 706-QDT) and pay the tax. It would be wise to be sure D's tax payment provision cannot be construed to require payment of this tax, which might necessitate keeping D's estate open for a significant time waiting for the §2056A tax to be imposed. The due date is April 15 of the year following the year in which the taxable transfer was made. §§2056A(b)(5)(A), 2056A(b)(6).

[350] Portability in §2010(c) may be available if S's estate will incur tax under §2001 rather than §2101, with a unified credit determined under §2010 rather than under §2102. The key is whether S is both a nonresident and a noncitizen (as to which §2101 et seq. is applicable rather than §2001 et seq.). Note the disconnect, because §§2056(d) and 2056A apply if S is a noncitizen, without regard to residence status.

estate into a higher tax bracket than otherwise might apply. Fortunately that is not as likely to apply under the current 40% maximum estate tax.

The special QDOT previously taxed property credit is allowed if the property taxed in S's estate qualified for the marital deduction in D's estate and subsequently generates deferred estate tax during S's life or at S's death.[351] This credit also is available if the property did not qualify for the marital deduction at all and therefore produced actual estate tax at D's death.[352] Tax effectively is paid at whichever marginal bracket (D's or S's) is the highest, meaning that effective planning in this respect would ensure that D's plan will preserve both bracket runs.

Also reflecting the reality that a QDOT created by D must be such as would qualify for the marital deduction under normal circumstances and therefore also is subject to tax in S's estate, §2056A(b)(10) makes available benefits to S's estate as if S was a citizen or resident under §§303, 2011 and 2014,[353] 2032,[354] 2032A,[355] 2055, 2056, 2058, 6161(a)(2),[356] and 6166.

The triggering events for imposition of the §2056A(b) tax are

1. death of S,[357]

2. any termination of the qualified status of the trust,[358]

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351 Or both, as anticipated in Treas. Reg. §20.2056A-7(a)(1).

352 Treas. Reg. §20.2056A-7(b).

353 See Treas. Reg. §20.2056A-6(b)(4). Under §2056A(b)(10)(A), state and foreign death tax credits or deductions for state or foreign taxes (under §§2058 and 2014, respectively) paid by S's estate are allowed against the estate tax on QDOTs, if the property is includible in S's gross estate (or would have been includible if S was a United States citizen).

354 For §2032 qualification purposes, Treas. Reg. §20.2056A-6(b)(5)(ii) interprets the rules to require only that the value of the QDOT and the deferred tax on that property be reduced, and not that either D or S's estate and other taxes be reduced.

355 See Treas. Reg. §20.2056A-6(b)(5)(i). Notwithstanding that the computation is as if D's tax was involved, the §2032A(a)(1)(A) requirement that D be a citizen or resident at the time of death is addressed by a provision that deems S to be a resident regardless of actual fact. The last sentence of Treas. Reg. §20.2056A-6(b)(5)(i) provides that it is S's status that is relevant for §2032A qualification under the deferred estate tax computation, making D's citizenship irrelevant. See also Treas. Reg. §20.2056A-6(b)(5)(iii), which does not go quite as far as saying that S is treated as the decedent for material participation purposes but it gives that impression. No coordination between §2032A with respect to the non-QDOT property of D or S is required and the regulation allows a full $750,000 reduction in FMV (with no reference to an inflation index adjustment) with respect to just the QDOT property, regardless of any other §2032A election by either D or S.

356 See Treas. Reg. §20.2056A-11(c).

357 §§2056A(b)(1)(B) and 2210(b)(2).

358 §2056A(b)(4).

3. any distribution from the QDOT during S's overlife[359] except mandatory distributions of income required to qualify as a QDOT[360] and distributions of corpus "on account of hardship."[361]

The QDOT tax also is not imposed on any distribution to reimburse S for federal income tax paid on an item of QDOT income to which S is not entitled under the QDOT's terms (for example, capital gains that are taxable to S).[362]

Lifetime distributions to S attract tax like an estate tax computation because the trustee must pay the tax on those distributions and that tax payment is regarded as another taxable distribution to S. The net result is that taxes paid by the trust by virtue of the distribution are subjected to the tax itself.[363] Unfortunate about the procedure established by the regulation is that the trustee's payment of tax from trust funds is regarded as an additional taxable distribution in the year the tax is paid,[364] meaning that a distribution in year one followed by trustee payment of tax in year two will yield a tax liability that the trustee might pay in year three that itself will generate another tax payment in year four, ad nauseam.

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359 §§2056A(b)(1)(A).

360 §2056A(b)(3)(A). Treas. Reg. §20.2056A-4(c)(4) defines the "corpus amount" with respect to nonassignable annuities and several general bromides in Treas. Reg. §20.2056A-5(c)(2) provide that income has the same meaning as in §643(b) – except that it does not include capital gains – and that income does not include items that would be allocated to corpus under applicable local law governing trust administration, irrespective of any specific trust provision to the contrary. General principles such as those found in the Uniform Principal and Income Act or the Restatement of Trusts or recognition of a unitrust entitlement as the functional equivalent of an all-income-annually right will be applied absent specific statutory or case law to govern the particular QDOT. One specific exclusion from income for §2056A(b)(3)(A) is any item of IRD as defined in §691.

361 §2056A(b)(3)(B). Treas. Reg. §20.2056A-5(c)(1) adopts an expanded version of the hardship definition found in Treas. Reg. §1.401(k)-1(d)(2)(i), allowing distributions that respond to an immediate and substantial financial need relating to S's health, maintenance, education, or support, or the health, maintenance, education, or support of any person S is legally obligated to support, but only to the extent other resources (such as personally owned publicly traded stock or a certificate of deposit that could be cashed in) are not reasonably available. The regulation specifies that assets such as closely held business interests, real estate, and tangible personalty are not considered reasonably available sources. Although not taxable, hardship distributions nevertheless must be reported as if they were, which allows the government to audit the claimed exemption.

The estate in PLR 9411023 tried to avoid the hardship distribution limitation by arguing that principal distributions from a QDOT to S were subject to transition rules under which transfers to noncitizen spouses remain eligible for the marital deduction if a treaty provision was inconsistent with §2056(d). The government ruled that no estate tax treaty was applicable, which subjected the distribution to the QDOT tax.

362 §2056A(b)(15). Treas. Reg. §20.2056A-5(c)(3) defines "miscellaneous" items that are not taxable distributions, such as payment of trust expenses (including bond premiums or letter of credit fees), payment of income or other taxes properly imposed on the trust (for example, income tax on capital gains properly allocable to corpus), property transactions involving trust corpus made for full and adequate consideration in money or money's worth, and amounts paid to S in reimbursement of income tax (such as that incurred under §691(a)(1)(B) on IRD) paid by S with respect to nonassignable annuities rolled over to the QDOT under Treas. Reg. §20.2056A-4(c)(3) or a lump sum distribution from a qualified plan that S assigned to the QDOT. See PLR 9235015 (S was the lump sum beneficiary of a qualified thrift plan, which was contributed by S to a QDOT and qualified under §2056A), confirming that §2056A(b)(15) is applicable to the trustee's distribution to S of an amount needed to pay the income tax on the lump sum that was allocable to corpus.

363 Treas. Reg. §20.2056A-5(b)(1).

364 This is different from the approach adopted in Treas. Reg. §26.2612-1(c) for GST taxable distribution purposes but is consistent with Treas. Reg. §20.2207A-1(a)(2).

Under §2056A(b)(13), the tax incurred on an inter vivos distribution to S generates only a §1015 basis adjustment for the tax attributable to appreciation, rather than a §1014 basis adjustment to FMV. In this respect the tax on lifetime distributions is regarded as a substitute for S's gift tax, rather than D's deferred estate tax.[365]

The amount of tax is defined as "the tax which would have been imposed under §2001 on the estate of the decedent if the taxable estate of the decedent had been increased by" the amount of the triggering distribution or the value of the trust property at S's death.[366] This tax is computed using the §2001 rates that were in effect at D's death.[367] The tax that would be imposed under §2001 is the "net tax after allowance of any allowable credits."[368] This is consistent with the overall pattern of the deferred tax, which functions as if D had not left the property at all to S and instead paid tax using D's own credits. The net tax result preserves those entitlements to D in this deferred tax computation.[369]

The tax computation rules can be avoided if S becomes a citizen.[370] Only limited additional administrative requirements[371] must be met if S was a resident at, and at all times after, D's death, or if no taxable distributions were made to S before becoming a citizen. S still may make a special

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365 See Treas. Reg. §§20.2056A-12 and 1.1015-5(c)(4).

366 §2056A(b)(2)(A)(i).

367 Treas. Reg. §20.2056A-6(a), as if the specific language found in §2056A(b)(2)(B)(i) was contained in §2056A(b)(2)(A) as well. Computation of tax on a triggering event if D's estate tax liability has not been finally determined when the triggering event occurs "shall be determined by using the highest rate of tax in effect under §2001 *as of the date of the decedent's death*" (emphasis added). The lack of this italicized language in §2056A(b)(2)(A) is not taken to mean that, in a normal situation, the §2001 rates at the time of the tax computation will control. Under §2056A(b)(2)(B)(ii), if the highest rate imposed exceeds the tax that normally would be incurred, a refund is allowed if a claim therefor is made within one year after the final determination of D's estate taxes. The trustee of the QDOT, if still acting after S's death, or the distributee of the QDOT corpus, must be vigilant in this respect to ensure that a refund is secured by filing a timely request.

368 Treas. Reg. §20.2056A-6(a). Presumably this could include any §2010(c)(4) unused exclusion amount of D's predeceased spouse that was made available to D through portability. This is because remarriage to S does not cause a loss of the portable exclusion amount if S does not die before D, and because the ultimate calculation of D's tax is deemed to occur as of D's actual date of death. See Treas. Reg. §§20.2010-2(c)(4)(i), -2(c)(5) Example 3, and -3(a)(3)

369 Note that, in the tax computation example in Treas. Reg. §20.2056A-6(d), the penultimate line is a reduction for the tax "that *would have been* imposed on [D's] actual taxable estate" (emphasis added), which appears to mean "the tax that *was* imposed," because that tax already was paid. Perhaps the more convoluted language is meant to reflect the tax rates that would have been in effect at D's actual death, although that modifier does not seem necessary because the subtraction is of tax paid (or payable, if it has not yet been remitted) on D's actual taxable estate. To confirm this analysis of the proposed computation, merely reverse the figures used in the example to show a marital deduction of only $500,000 and a taxable estate at D's death of $700,000, with $37,000 of tax paid on D's death and an additional tax of $198,000 that should be due when the deferred tax is imposed.

370 §2056A(b)(12).

371 Treas. Reg. §20.2056A-10, which details filing requirements and other technical rules. One such requirement is that the U.S. trustee notify the government that S became a citizen, by April 15 of the year following that event. PLRs 202202006, 201903012, 201640006, 201628011, 201622025 and -021, 201516055, 201431019, 201431004, 201406003, 200949009, 200309006, and 200132013 granted relief to trustees who did not timely file. In the 2001, the earliest 2014, and several of the 2016 cases the trustee represented that it had no knowledge that S became a citizen; in the 2009, the later 2014, and the last 2016 cases S and the trustees properly relied on a qualified tax professional who failed to advise them to file the notice; in the earlier 2016 and the 2015 cases the spouse was a cotrustee but relief still was granted because the U.S. Trustee has the obligation to notify the government.

election with respect to taxable distributions already made (they are treated as if they were gifts made by S) if these modest conditions are not met.[372]

To be in a position to comply with all of these requirements, estate planners need client questionnaires or interviews that specifically inquire whether a client's spouse is a United States citizen. The significance of this should not be underestimated, given the number of clients whose spouses are not citizens and the unnecessary loss of tax deferral if a QDOT is not employed.

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[372] Treas. Reg. §20.2056A-10(b).

§13.7 FUNDING MARITAL DEDUCTION TRANSFERS

Marital deduction funding is one of the three major aspects of planning for the marital deduction.

The funding issue viewed through a marital deduction lens must be resolved after the amount of any marital bequest has been determined and the form of disposition – outright, general power of appointment trust, QTIP, or whatever other disposition suits D's fancy – has been selected. The issue now is how that bequest is to be transferred to that distributee.

§13.7.1 Types of Marital Deduction Formula Clauses

There are numerous variations available to express the nature and amount of any bequest, but there are only two basic categories of bequests for funding purposes: pecuniary and fractional.

A pecuniary bequest makes *a gift of money*, often using a formula provision like:

> I give the smallest pecuniary amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death.

This form of gift is analogous to a bequest of "$10,000 to my alma mater," although this marital pecuniary bequest is determined pursuant to a formula[1] and the amount of the bequest is likely to be a tad larger. The document also likely authorizes satisfaction of the bequest with assets in kind in lieu of in cash only.[2]

A fractional share bequest makes *a gift of assets*, often using a provision like:

> I give a fractional share of my residuary estate of which (a) the numerator is the smallest amount that, if allowed as a federal estate tax marital deduction, would result in the least possible federal estate tax being payable by reason of my death, and (b) the denominator is the value of my residuary estate as finally determined for federal estate tax purposes.

This form of gift is analogous to a bequest of the residuary estate "to my children, A and B, in equal shares," but the marital fractional share usually is determined pursuant to a formula and the fraction is not likely to be as clean as½ or ⅓. Instead, it may be something like:

$$\frac{\$\ 6{,}745{,}663.38 \text{ (optimum marital deduction sought)}}{\$16{,}745{,}663.38 \text{ (fund after debts, expenses, taxes)}} = 40.283\%$$

1 **§13.7** This pecuniary gift could have been produced by a fraction applied against a fixed fund, such as ½ of D's gross estate or even ½ of $50,000. The existence of a fraction in the determination of the formula pecuniary dollar amount does not convert this gift of a cash amount into a fractional gift (as next described).

2 The traditional common law notion is that the personal representative is obliged to convert to cash all property in the estate not specifically bequeathed and to distribute that cash, as with a pecuniary gift in the more traditional form of a specific (versus a formula determined) dollar amount. See generally 5 Scott, Fratcher, & Ascher, Scott and Ascher on Trusts §34.6 (5th ed. 2008). Typically the document grants the personal representative authority to distribute assets in kind, including allocations in whole or in part that do not reflect a pro rata division of all estate assets that matches the size of the formula amount relative to the available fund.

This gift differs from a pecuniary bequest that is determined by applying a formula[3] because the fund against which the fraction is applied is not a fixed amount. This multiplicand fluctuates in value as various activities occur, such as paying taxes, making tax elections, or incurring valuation changes or investment gains and losses.[4] As this material demonstrates, administrative and mathematical problems can result under a fractional share approach. Unfortunately, as the discussion of the separate share regulations also will reveal, those administrative and mathematical problems may visit pecuniary funding alternatives as well.

Within these two basic approaches – fractional or pecuniary – there are at least five basic types of pecuniary formula clauses and two types of formula fractional bequests, all tied to different mechanisms for accomplishing the funding. As shown in the provisions above, the expression of the amount of the formula marital deduction bequest itself essentially is the same, whether determined under the fractional or pecuniary clause. The difference among them lies in the provisions governing asset allocations – funding – and those differences can be significant. Thus, the funding alternative is an important aspect of marital deduction planning or any other endeavor that entails division of an estate.

§13.7.1.1 Available Funding Mechanisms

In resolving the issues that surround the funding question, the alternative funding mechanisms explored in detail here include:

1. The pecuniary marital approach, which may utilize one of three funding options:

   - A true worth pecuniary gift, under which assets distributed in kind are valued at their date of distribution values.

   - A fairly representative pecuniary gift (also called an FET or Rev. Proc. 64-19 pecuniary), under which each asset is valued for funding purposes at its basis for federal income tax purposes. Under §1014, usually basis is the FET value of assets included in D's estate, but this would change if carryover basis became the law (and marital funding still was relevant). Rev. Proc. 64-19 requires that the assets selected for distribution be fairly representative of the appreciation and depreciation between D's death and the date(s) of funding of all assets available for distribution.

   - A minimum worth pecuniary gift, under which each asset is valued for funding purposes at the lesser of its date of distribution value or its FET value, which is the asset's basis for federal income tax purposes under the §1014 new-basis-at-death rule) sometimes with an added requirement under a "New York" style provision that the total FMV of all assets distributed be approximately equal to the size of the deduction.

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[3] See §13.7.1 n.1.

[4] A fractional entitlement applied against a fixed dollar fund is not common and is not discussed further here. It can confuse issues because it may look something like a fractional bequest but it is treated essentially like a pecuniary bequest. Avoiding uncertainty about the nature of the gift created is an essential planning function, because the tax and other consequences of these alternatives can be severe, as this discussion illustrates.

2. The residuary marital pecuniary approach, under which the pecuniary gift is made to the trustee of the nonmarital trust and the residuary estate comprises the marital deduction gift. This form of clause is also called the credit consuming, front-end credit shelter, or reverse pecuniary marital. In terms of funding, this pecuniary could conceivably take any of the three forms (true worth, fairly representative, or minimum worth) indicated above for a pecuniary marital, but only the first two approaches are safe for marital deduction qualification purposes.

3. The fractional marital approach makes a gift of a fractional share of the residuary estate as the marital deduction bequest. A fractional marital bequest may utilize either "pro rata" allocation in funding or "pick-and-choose" funding.

4. A single fund marital requires no actual funding at all, but is considered along with the rest because it is an available option to consider when selecting among funding alternatives. It essentially occurs whenever a partial QTIP election is made if the nonelected portion is not carved off to be administered and distributed separately.

§13.7.12 Conclusions Regarding Marital Deduction Funding

No funding alternative is entirely without disadvantages. The estate planner's task, therefore, is to consider numerous factors in making the most appropriate selection for a particular situation, balancing considerations such as the following:

- loss of flexibility in funding;
- risk of incurring gain or loss in funding, or accelerating IRD under §691(a)(2);
- risk (or advantage) of overfunding the marital bequest;
- any need to ratably apportion appreciation or depreciation generated during the period of administration;
- administrative difficulties, such as revaluation of assets to fund, or periodic readjustments to fractions to reflect distributions made and application of the separate share rule for DNI calculation and carryout purposes; and
- minor factors, such as carrying out DNI on distributions and the ability to pass through §642(h) excess deductions and losses.

The most significant consequences of each approach that should be considered in weighing their various advantages and disadvantages are summarized below:

- 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 and IRD acceleration in funding and the need to do some revaluations in the funding process.

- The *fairly representative pecuniary* avoids gain or loss but not IRD acceleration, and risks 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) and accelerates IRD, with 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 minimizes gain or loss or IRD acceleration in 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 but not IRD acceleration. It requires compliance with the separate share rule and with Rev. Proc. 64-19.

- The *pro rata fractional* avoids gain or loss and IRD acceleration 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 or IRD acceleration in 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.[5]

The following chart provides a quick comparison of the various factors recommending the marital funding alternatives.

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[5] For several excellent additional resources on the marital deduction funding question see the titles cited in §13.7.8 n.113.

	Traditional Up-Front Pecuniary			Credit Shelter Pecuniary		Fractional		
	True Worth	**Fairly Rep**	**Minimum Worth**	**True Worth**	**Fairly Rep**	**Pro Rata**	**Pick and Choose**	**Single Fund**
Is the marital share frozen?	Yes	No	NO	NO!	No	No	No	No
Does funding incur gain or loss?	Yes	Yes, but is zero under §1014 and §1040	Gain=0 Loss may be denied under §267	Yes	Yes, but is zero under §1014 and §1040	No	No	No
Does funding accelerate IRD?	Yes	Yes	Yes	Yes	Yes	No	No	No
Is the marital an income tax separate share?	Yes, but DNI may be zero	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
How much revaluation is required?	Only assets distributed	All assets	Only 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?	Plenty	Plenty	Rolling fraction
Flexible?	Yes	Doubtful	Yes	Yes	Doubtful	None	Yes	None

§13.9 PLANNING IN CONTEMPLATION OF MARRIAGE

In addition to any prenuptial agreement planning that may be appropriate when a client is planning to marry,[1] a number of other relatively simple premarital planning options might be considered. One nonromantic notion is to settle in a separate trust any property that the client wishes to insulate from the potential elective share of an intended spouse, the notion being that most elective share statutes do not reach trust property settled prior to the marriage.[2] Conversely, with respect to any property the client intends to transfer to S, often it makes better sense to wait until the nuptials have been completed, so as to qualify for the inter vivos marital deduction.

One exception to that statement may entail planning that involves transfers that could trigger the provisions of Chapter 14 of the Code, which might better be undertaken before the parties are spouses and therefore constitute family members. Greater options typically apply under Chapter 14 if the planning does not entail family members and therefore never triggers those provisions.

Finally, both parties to the expected marriage may own personal residence real property that may qualify for §121 capital gain relief. If either anticipates liquidation of that property they may be wise to sell prior to the marriage, so as to maximize the benefits of their respective entitlements.

1 **§13.9** See §3.4.6.
2 See §§3.4.2 and 4.3.

APPENDIX
FULL TABLE OF CONTENTS FOR PENNELL CHAPTER 13

§13.0 Introduction
- §13.0.1 Importance of the Marital Deduction in Estate Planning
- §13.0.2 Historical Background
- §13.0.3 Transition Date Rule: Pre-1982 Wills Containing Formula Clauses
- §13.0.4 Importance of Advising Clients with Dated Estate Plans

§13.1 Basic Marital Deduction Planning
- §13.1.1 Basic Structure of Estate Planning for Spouses
- §13.1.2 Tax Sensitive Outright Dispositions to S
- §13.1.3 A Note About Community Property
- §13.1.4 Drafting in Contemplation of Disclaimer

§13.2 Planning and Drafting for Larger Estates: Omitted
- §13.2.1 Advantages of Deferral
- §13.2.2 Disadvantages of Deferral
- §13.2.3 The Time-Value of Money Rationale for Deferral
- §13.2.4 Sheltering D's Unified Credit
- §13.2.5 Using the Previously Taxed Property Credit
- §13.2.6 A Note About Formula Clauses and Computations

§13.3 Specialized Situations that Affect Proper Size of Marital Bequests
- §13.3.1 Deferred Tax Payment Under §6166
- §13.3.2 GST Exemption
- §13.3.3 Alternate Valuation Election Under §2032
- §13.3.4 State Death Taxes and Nondeductible Charges
- §13.3.5 Reflecting Other Credits
- §13.3.6 Administration Expenses and the Swing Item Election
- §13.3.7 Summary

§13.4 Qualification Requirements
- §13.4.1 In General
- §13.4.2 The Easy Qualification Requirements
- §13.4.3 The Nettlesome Qualification Requirement: The Interest Must Be Deductible
- §13.4.4 Exceptions to the Nondeductible Terminable Interest Rule

§13.5 Forms of Dispositions
- §13.5.1 Special Dispositions that Qualify
- §13.5.2 Marital Deduction Power of Appointment Trust
- §13.5.3 Legal Life Estate with General Power of Appointment
- §13.5.4 Life Insurance or Annuity Payments with General Power of Appointment
- §13.5.5 Estate Trusts
- §13.5.6 QTIP
- §13.5.7 QDOTs

§13.6 Selecting and Drafting Marital Deduction Trusts: Omitted
- §13.6.1 Selecting the Type of Marital Trust
- §13.6.2 Drafting Considerations
- §13.6.3 Marital Deduction Saving Clauses

§13.7 Funding Marital Deduction Transfers: Truncated
- §13.7.1 Types of Marital Deduction Formula Clauses

§13.7.2 Funding the Pecuniary Marital – In General
§13.7.3 True Worth Pecuniary
§13.7.4 Fairly Representative Pecuniary
§13.7.5 Minimum Worth Pecuniary
§13.7.6 Funding the Reverse Pecuniary Marital – In General
§13.7.7 Funding the Formula Fractional Share
§13.7.8 Pro Rata Division of Assets
§13.7.9 Pick-and-Choose Fractional Share Funding
§13.7.10 Single Fund Marital
§13.7.11 GST Aspects of Marital Funding
§13.7.12 Conclusions Regarding Marital Deduction Funding
§13.7.13 Food for Thought – Funding with Split Interests
§13.8 Planning in Contemplation of Divorce: Omitted
§13.9 Planning in Contemplation of Marriage
§13.10 Ethics Considerations: Omitted
§13.11 Planning for Unmarried Cohabitants: Omitted