

**OF SHOES AND SHIPS AND SEALING WAX, OF CABBAGES
AND KINGS - THROUGH THE LOOKING GLASS OF
DISCOUNTS AND PREMIUMS IN MARITAL DEDUCTION
FUNDING**

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1. PURPOSE

The Economic Recovery Tax Act of 1981 (ERTA) established not only the concept of the unlimited marital deduction, but also the concept of qualified terminable interest property, both of which constituted major philosophical as well as legal changes in the taxation of estates of married decedents. The immediate reaction to the passage of ERTA was that the estate planner had become a dinosaur in the tax field, since it was now possible simply to leave "everything to my spouse" and avoid all tax. Obviously, since Congress never adopts the simple approach to anything, the rumors of the death of the estate planning practice were greatly exaggerated. If anything, the last fifteen plus years have been a tribute to the ability of taxpayers, counsel, the government, and the courts to invest the simplest of concepts with the most complex and Byzantine results.

2. SCOPE

In an area which should, after more than a decade and a half, be developing some certainty, there is now more uncertainty than ever. Part of this is brought about by the increased emphasis on valuation techniques [particularly in light of Chapter 14, about which the only really good thing that can be said is that it is better than § 2036(c)¹], part is brought about by the interaction of discounts and premiums in funding, part is brought about by counsel who seek to stretch the law in every direction for the benefit of one client without regard to the impact on the overall administration of the tax laws, and part of which is brought about by constant legislative change, the most recent example of which is §2033A.

This paper deals with some of what the author believes to be the "hottest" issues in the marital deduction area, both in pre-mortem and post-mortem planning. Although a body of case law is slowly beginning to develop, it is through published rulings and private letter rulings that much of the "law" in this area has developed and is developing. Further, some passing comments are made with respect to drafting, but no attempt is made to provide forms or deal in detail with drafting language and techniques.

AUTHOR'S NOTE: Throughout the course of this paper I will discuss several tax and planning strategies which impact who bears the tax or how trusts are funded. While it is well and good to try to develop strategies to minimize taxes, **DO NOT FORGET** that almost every decision has an economic impact, and that the beneficiary who is adversely affected may not think as highly of the idea. In other words, many of these tax planning ideas carry the potential of fiduciary liability.

3. THE MARITAL DEDUCTION

In order to understand and analyze the qualified terminable interest property provisions, an examination of the overall statutory scheme must be undertaken.

¹ All Section references are to the Internal Revenue Code of 1986, unless otherwise indicated.
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1. Traditional Marital Deduction Provisions

It is easy to view the qualified terminable interest property provisions as creating an entirely new and different form of marital deduction, and to forget that those provisions simply create a relatively narrow exception to the terminable interest rule. The general rules which have long surrounded the marital deduction apply to the qualified terminable interest property provisions as well.

1. Property "Passing" to Spouse

In order to qualify for the marital deduction, §2056(a) requires that property must "pass" to the surviving spouse in a qualifying manner. Detailed regulations deal with what property has passed from the decedent to his surviving spouse or to persons other than the surviving spouse of the decedent.² Property interests claimed as curtesy, dower, or an elective share are treated as having passed from the decedent; but not property acquired by agreements among the heirs and beneficiaries which change the character and quality of such amounts.³ The character and quality may change if there has been a bona fide dispute.⁴

2. Terminable Interest Rule

Under §2056(b) the interest passing to the spouse is considered a terminable interest, and thus not qualified for the marital deduction, if the lapse of time, the occurrence of an event or contingency, or the failure of an event or contingency to occur will cause the interest to terminate. There are two primary types of disposition which satisfy this rule and which existed prior to ERTA's creation of a qualified terminable interest concept.

3. General Testamentary Power of Appointment Trust

A trust in which all of the income is payable to the surviving spouse no less often than annually, and which is subject to a general power of appointment by the spouse during the spouse's life and/or by will, and which power is exercisable alone and in all events by such surviving spouse qualifies for the marital deduction under §2056(b)(5). Treas. Reg. §20.2056(b)(5) elaborates upon the definitions and application of the various provisions required for the general testamentary power of appointment trust. Capital gains during the term of this trust are taxed to the trust itself, the entire trust is includible in the surviving spouse's estate and the surviving spouse has the absolute authority to control the devolution of the property. It is

² See Treas. Reg. §20.2056(e)-1- §20.2056(e)-3. See also *Estate of Allen*, 160 T.C.M. 904 (1990).

³ P.L.R. 91-01-025 (Oct. 10, 1990).

⁴ P.L.R. 91-01-034 (Oct. 11, 1990). See also P.L.R. 90-40-032 (July 6, 1990) (dealing with trusts required to be established by prenuptial agreement).

this absolute control, more than any other feature, which caused concern among estate planners as to the use of this trust, especially in a second family situation.

4. Estate Trust

Although the statute requires that the income from a trust be payable to the surviving spouse not less often than annually during the life of that spouse, the regulations provide that a trust will satisfy the requirements of the statute if the trust income may be accumulated or paid out for the life of the surviving spouse, and then must be paid to that surviving spouse's estate.⁵ The ability to use a trust which accumulates income now has distinct income tax disadvantages, since the trust in 1998 will reach the 39.6 percent bracket after only \$8,350 of income (adjusted for inflation). The fact that the trust must be paid to the estate of the surviving spouse causes the assets to have to pass through probate again, and clearly subjects them to the claims of creditors of the spouse's estate.

5. Power in Spouse to Compel Conversion In order to attain the goal of essential ownership of the property, the marital deduction rules require that any interest passing in trust to the surviving spouse (whether under the general testamentary power of appointment trust, the estate trust or a QTIP trust) must be subject to a power in the surviving spouse to cause any non-income producing property to be converted to income producing property or require the distribution of principal to compensate for the income lost as a result of the property being non-productive.⁶

2. Qualified Terminable Interest Provision

ERTA added §2056(b)(7) to the Internal Revenue Code. This provision, as noted above, creates an additional exception to the terminable interest rule which essentially allows life estates, unaccompanied by a general power of appointment, to qualify for the marital deduction. The new flexibility added by the QTIP provisions and the additional control left in the hands of the testator created and continues to create several new opportunities for more responsive planning.

1. Testator's Control of Ultimate Disposition

Under the QTIP rules, the testator can devise the property to the surviving spouse for life or in a trust with a qualifying income interest, and provide that the property will pass to persons named under the deceased testator's will at the death of the surviving spouse. The surviving spouse can also be given a special testamentary power of appointment exercisable at death only. CAVEAT: The surviving spouse cannot be given a general testamentary power of appointment,

⁵Treas. Reg. §20.2056(e)-2(b)(1)(iii).

⁶Treas. Reg. §2056(b)-5(f)(4)-(5).

nor can the property be left to the spouse's estate, since this would automatically qualify the trust for the marital deduction as either a general testamentary power of appointment trust or an estate trust, thereby taking away the ability of the executor to elect partial or total exclusion of the property from the marital deduction.

2. Especially Useful in Second Marriage

In the second marriage situation, the testator was sometimes unwilling to take advantage of the marital deduction because it meant giving the surviving spouse a power to appoint the property to anyone the survivor chose, thereby leaving open the possibility that the property would be diverted from the decedent's children. With the advent of the qualified terminable interest property rules, however, the testator is able to take advantage of the marital deduction, provide for the surviving spouse, and still control the ultimate disposition of the property.

3. Allows Determination of Amount

The use of the old general testamentary power of appointment provisions or the estate trust provisions forced the testator to determine the amount which would qualify for the marital deduction at the time of drafting of the will, which could be several years prior to and in extremely different circumstances from those existing at the date of death. One major benefit of the QTIP rules is the fact that they allow the determination to be made as to how much property to qualify for the marital deduction based upon the facts as they exist at the time of the death of the first spouse to die. Thus, the estate plan can effectively be crafted when many more facts are known than were known at the time the will was executed.

3. Non-Citizen Spouses

A donor or a decedent's estate cannot utilize the marital deduction if such donor's spouse or decedent's spouse is not a citizen of the United States except through the creation of a Qualified Domestic Trust (QDT) under the provisions of §§2056A, 2106 and 2523. A detailed discussion of QDT's is one of the many things beyond the scope of this paper.

2. QTIP ELECTIONS

1. Requirements for Election

Obviously, no tax election would be complete unless there were a plethora of technical requirements surrounding qualification for the special treatment provided by the election. This is also true of the QTIP election.

1. Qualifying Income Interest for Life

The surviving spouse must be entitled to all the income during the term of the trust, payable not less often than annually.⁷ Note that the requirement is not that the income must be

⁷§2056(b)(7)(B)(ii)(I).

paid out annually, but rather that the spouse must be entitled to all the income.⁸ If a court has the power to change beneficial interests, then the trust will not qualify.⁹ While facility of payment clauses do not in themselves violate this requirement,¹⁰ they can cause problems if the ability of the spouse to withdraw terminates on disability.¹¹ Although the "all-income" requirement has been around since 1948, there still appears to be a substantial number of taxpayers and draftsmen who stumble over this requirement, and then try (most unsuccessfully) to remedy that shortcoming.

1. State Law The proposed regulations permit the all income test to be satisfied by the provisions of state law even if the instrument does not make it clear.¹² However, the taxpayers often do not succeed in asserting this position.¹³

⁸Treas. Reg. §20.2056(b)-(5)(f)(8). *See also* P.L.R. 90-30-001 (March 3, 1990), in which the Service permitted QTIP treatment where the spouse was entitled to require that the trustee pay out all the income, and any not paid out was to be accumulated.

⁹P.L.R. 93-25-002 (Feb. 26, 1993).

¹⁰P.L.R. 87-06-008 (Oct. 21, 1986), citing Rev. Rul. 85-35, 1985-1 C.B. 328, to the same effect with respect to general testamentary power of appointment trusts.

¹¹P.L.R. 96-44-001 (Nov. 4, 1996).

¹²Treas. Reg. §20.2056(b)-7(g). *See also* P.L.R. 84-50-018 (Oct. 1, 1984), P.L.R. 85-28-009 (Apr. 10, 1985) and P.L.R. 91-01-9047 (Jan. 21, 1991).

¹³*See Estate of Nicholson v. Commissioner*, 94 T.C.M. 666 (1990) and *Wisely v. United States*, 893 F.2d 660 (4th Cir. 1989).

In *Estate of Peacock v. Commissioner*,¹⁴ the court found that Alabama law allowing the surviving spouse to occupy the residence was sufficient to satisfy the QTIP requirements.¹⁵

b. Spouse as Trustee

Taxpayers have also tried, again most unsuccessfully, to create a marital deduction when the surviving spouse is trustee with discretion as to income distributions. The courts point to the fact that the spouse may not always be trustee, and therefore disallow the marital deduction.¹⁶

2. Accrued but Undistributed Income

Treas. Reg. §20.2056(b)-7(d)(4), as did the proposed regulations, provides that income accrued from the date of the last required distribution to date of death is not required to be distributed to a surviving spouse or subject to a power in such spouse, even though it must be included in that spouse's estate under §2044.¹⁷ The Tax Court, however, upheld the taxpayer's contention that the proposed regulation was nothing more than the opinion of the Service, and that the QTIP election was not available where the accumulated income did not pass to the surviving spouse's estate.¹⁸ In *Howard*, a QTIP election was made in the estate of the first spouse to die. The second spouse died very unexpectedly a short time thereafter, within the statute of limitations on the first estate. The executors sought to, in effect, revoke the election by contending that it should not have been allowed. They hoped to gain two things: (i) the assets of the first spouse would not be stacked in the estate of the second; and (ii) the TPT credit under §2013 would be available for the income interest in the estate of the second spouse. *Howard* led to the initiation of a remedial procedure by the Service so that taxpayers who had relied on the proposed regulation would not lose the ability to claim the marital deduction. Fortunately, the Ninth Circuit reversed the Tax Court's hyper-technical and logically mystifying holding.¹⁹

¹⁴ 914 F.2d 230 (11th Cir. 1990).

¹⁵ See P.L.R. 91-01-047 (Jan. 21, 1991) (to the same effect under Pennsylvania law); P.L.R. 90-46-031 (Aug. 20, 1990) (Hawaiian law). But see *Estate of Kyle v. Commissioner*, 94 T.C.M. 289 (1990) holding that a Texas homestead did not qualify; P.L.R. 90-33-004 (May 11, 1990) (holding that a mere right to occupy is not sufficient).

¹⁶ *Estate of Ellingson v. Commissioner*, 96 T.C.M. 760 (1991), following *Estate of Doherty v. Commissioner*, 95 T.C.M. 446 (1990), *Wells v. U.S.*, 746 F. Supp. 1024 (D. Haw. 1990); *Bowling v. Commissioner*, 93 T.C.M. 286 (1989); See also P.L.R. 89-01-005 (Sept. 18, 1988).

¹⁷ Treas. Reg. §20.2044-1(d)(2).

¹⁸ *Howard v. Commissioner*, 91 T.C.M. 329 (1988).

¹⁹ *Estate of Howard v. Commissioner*, 910 F.2d 633 (9th Cir. 1990).

However, the Tax Court still clung to the old interpretation of the rules involving the proposed regulations, even though the result was that the Internal Revenue Service got whipsawed (which did not happen in *Howard*) because the deduction was allowed in the first estate (as to which limitations had run) but the property was not included in the survivor's estate.²⁰ *Shelfer* was reversed by the 11th Circuit, with the Court finding that the Commissioner's interpretation comported with the meaning and intent of the statute.²¹

NOTE: The really important message in both *Shelfer* and *Howard* is that the Tax Court is perfectly willing to let the taxpayer profit in both estates based upon a technical interpretation of the statute. This attitude, while apparently pro-taxpayer, may only encourage the Service to take technical positions to deny the marital deduction in the first estate in order to protect itself. The Service's present rule appears to be simple and justifiable -- if the deduction was allowed in the first estate, then inclusion is required in the second estate. This would appear to be a proper construction of §2044 as discussed below. (At least one practitioner has suggested, on the Internet, that he might start putting "very subtle (but fatal) flaws" into his QTIP trusts to take advantage of the failure of the courts to adopt the obvious construction. Another commentator suggested that the first practitioner engage in asset protection planning before doing so.)

In a reversal of form, the Tax Court recently reached the opposite result in a *Shelfer* type situation. In *Estate of Letts v. Commissioner*²² taxpayer's husband predeceased her. On his estate tax return, a marital deduction was claimed for certain property which was clearly terminable interest property, but it was not described as such on Schedule M. Additionally, husband's executor checked "no" in the box which asked if a QTIP election was made as to any property. No copy of the will was filed with the tax return. Taxpayer died after the statute of limitations had run on husband's estate and did not include the property as to which a marital deduction was allowed on the husband's estate tax return, arguing that no QTIP election had been made. The Tax Court relied upon the duty of consistency to require the taxpayer's estate to include the property in her estate. The court first found that the relationships between the two estates (*e.g.*, identity of beneficiaries, some identity of fiduciaries) allowed it to apply the duty of consistency. The court set forth the elements of the duty of consistency as follows:

²⁰*Estate of Shelfer v. Commissioner*, 103 T.C. 10 (1994). The Tax Court acknowledged the final regulations at Treas. Reg. §20.2056(b)-7(d)(4), but held them inapplicable since the survivor died prior to their effective date on March 1, 1994. What the Tax Court will do in the case of a decedent dying after that date remains to be seen.

²¹*Shelfer v. Commissioner*, 83 F.3d 1045 (11th Cir. 1996). See also P.L.R. 95-37-004 (June 13, 1995), in which the taxpayer raised the *Howard* and *Shelfer* arguments among others.

²²109 T.C. No. 15 (Filed 11/24/97).

1. The taxpayer made a representation of fact or reported an item for tax purposes in one year. As to this element, the court found that by deducting the property as marital deduction property, the estate represented that the property was not terminable interest property.

2. The Commissioner acquiesced in or relied on that fact for that year. The court decided that the estate had not furnished the Commissioner any information by which he could determine that the property was not terminable interest property, and therefore the Commissioner had relied upon the information furnished.

3. The taxpayer changes its position in a later return after the statute of limitations had expired. Enough said.

Basically, the Tax Court stated that if the marital deduction were allowed in the first estate, inclusion was required in the second estate. In this regard, note that President Clinton's 1998-1999 budget proposals would adopt such a rule by statute by amendment of §2044.

2. No Power to Appoint to Third Party

No one, including the surviving spouse, may have a power to appoint the property at any time during the life of the surviving spouse to any one other than the surviving spouse.²³ The avowed purpose of this rule is to prevent the spouse from transferring the property during the spouse's life without incurring a gift tax, although this seems unnecessarily inflexible. There should be no reason why the surviving spouse should not have the power to appoint to third parties during his or her life so long as such transfer would be subject to the gift tax.

3. Election by Executor

Property passing to the spouse which meets all of the requirements of the qualified terminable interest property rules is nonetheless not subject to the marital deduction unless the executor elects to make it so.²⁴

4. Can Disposition Be Contingent?

²³ §2056(b)(7)(B)(ii)(II). *See also* Treas. Reg. §20.2056(b)-7(d)(6) and Treas. Reg. §20.2056(b)-7(h), Example 4.

²⁴ §2056(b)(7)(B)(v), except as to joint and survivor annuities.
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The Service long maintained that the distribution of income from or other disposition of the trust cannot be contingent upon whether the executor makes the election. According to the Service's position, a will cannot provide that if the executor fails to elect QTIP treatment as to part or all of the trust, the income distribution standard will be converted from a mandatory income to spouse to a spray power in the trustee among spouse and children, or that the property will pass to a different trust. Such a provision, according to the Service, would disqualify the trust. This was the position taken in Treas. Reg. §20.2056(b)-7(c), and it is reiterated in Treas. Reg. §20.2056(b)-7(h), Example 6.²⁵

The Tax Court consistently agreed with the Service on this position. However, the three appellate courts that have dealt with this issue have disagreed and have reversed the Tax Court on each occasion.²⁶ After three losses at the appellate level, the Tax Court finally conceded.²⁷ In *Clack* the majority opinion (joined in by nine judges) simply stated that with three appellate opinions against it, the Tax Court would accede to the appellate courts without attempting to determine which circuit follows the appropriate rationale. Three concurring judges thought the result was correct, but would adopt the Sixth Circuit's rationale in *Spencer*. There were three other concurrences, one of which was only to contradict certain arguments made by one of the two dissenters.²⁸ On July 15, 1996, the Service issued AOD 1996-011, in which it acquiesced in result only in *Clack* and stated that the Service would no longer disallow the marital deduction in *Clack* type situations for decedents dying before March 1, 1994 (the effective date of the final regulations).

²⁵ See also P.L.R. 86-11-006 (Jan. 8, 1986) (QTIP election not available where trust not to be funded unless executor made election); T.A.M. 91-04-003 (Sept. 14, 1990) (QTIP election not available if executors can appoint to someone other than surviving spouse). *But see* P.L.R. 86-31-005 (Mar. 23, 1986) (QTIP election available where executrix/spouse had sole power to determine amount of assets to be allocated between QTIP trust and non-qualifying trust), which is discussed below. See also P.L.R. 90-18-022 (Feb. 1, 1990), allowing a marital deduction to a trust giving a spouse a general testamentary power of appointment if a QTIP election is made, but only a special power if the election is not made.

²⁶ *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992); *Estate of Robertson v. Commissioner*, 15 F.3d 779 (8th Cir. 1994); and *Estate of Spencer v. Commissioner*, 43 F.3d 226 (6th Cir. 1995).

²⁷ *Estate of Clack v. Commissioner*, 106 T.C.M. No. 6 (1996).

²⁸ There was also an issue in *Clack* as to whether the appeal would lie to the 5th Circuit (where the decedent resided) or to the 7th Circuit (which was the domicile of the personal representative). The dissent by Judge Parker and the concurring opinion by Judge Beghe discuss this issue at length.

Finally, on February 18, 1997, the Treasury Department issued Temporary and Proposed Regulations.²⁹ The regulations provide, “However, an income interest for life (or life estate) that is contingent upon the executor’s election under section 2056(b)(7)(B)(v) will not, on that basis, fail to be a qualifying income interest for life.” While some are concerned that the phrase “on that basis” is an attempt to limit what appears to be a total agreement by the Service, it would appear that the proposed and temporary regulations in reality bless the type of disposition in *Clayton* and its progeny. However, this technique should be used with care in the planning process because it creates a fiduciary election problem for the executor, which might result in a real shift of beneficial interest. There are some who feel that a power of appointment issue exists if the spouse is also the executor. In short, while this regulation may provide relief for inadvertent errors, *Clayton* type dispositions should be used in planning only after careful consideration.

2. Making the QTIP Election

As noted above, qualification of qualified terminable interest property for the marital deduction is not automatic, but results from the executor's election.

1. Who May Make the Election

§2056(b)(7)(B)(v) provides that the election is to be made by the executor on the return of tax required by §2001. The final regulations make it clear that the election shall be made by the executor as defined in §2203 and the regulations under that Section whether or not the executor is in possession of the qualified terminable interest property. Only if there is no executor duly appointed, acting and qualified within the United States can the person in possession of the QTIP property make the election.³⁰ Thus, in a funded inter-vivos trust with a pour-over will, even though the bulk of the assets are in the trust, the executor of the will (if it is admitted to probate) still makes the QTIP election.

2. How the Election is Made

Although there has been substantial difficulty in the past making the election, it can now be made with relative ease.

1. Made on Return

²⁹TD 8714, 62 F.R. 7156, publishing Treas. Regs § 20.2056(b)-7T(d)(3)(ii). The Temporary Regulations are also Proposed Regulations.

³⁰Treas. Reg. §20.2056(b)-7(b)(3).

§2056(b)(7)(B)(v) provides that the election is to be made on the return required by §2001, and that the election, once made, is irrevocable.

2. Timing

The regulations provide that the election is to be made on the last estate tax return filed by the executor on or before the due date of the return (including extensions), or if no timely return is filed, then on the first estate tax return filed by the executor after the due date.³¹ Thus, the election can be made on a delinquent return if no timely return has been filed. In fact, even if a timely return has been filed, the regulations very clearly state that the election is the one made on the last timely return filed before the due date including extensions.³² If the estate fails to make an election on its original return, it cannot make the election on an amended return if the time for filing the original return has passed.³³ It should be standard practice, particularly in an optimal marital where no interest cost is involved, to wait the full fifteen months (including a six month extension) so that the determination as to whether to make the election can be made with as many facts as possible. Not only could this avoid a potential "stacking" of the estates, but it could also generate a TPT credit under §2013. A life estate can trigger the credit in the survivor's estate.³⁴

3. Identify on Schedule M

There was previously a box which had to be checked in order to make a QTIP election, and the taxpayer was previously required to identify QTIP property separately. The return has now been greatly simplified. If the property interest is identified on Schedule M, and if the deduction is taken on Schedule M and shown on Page 3, then the QTIP election is deemed to be made. This solves a lot of problems and removes hyper-technical traps for the unwary. Since it may not be possible to ascertain at the date of filing the return what property is to be used to fund the qualified terminable interest property trust, the Service permits the elected property to be identified simply as that passing under the provision of the will creating the QTIP, along with the amount of such property.³⁵

³¹Treas. Reg. §20.2056(b)-7(b)(4)(i).

³²Treas. Reg. §20.2056(b)-7(d)(4)(ii). *See* T.A.M. 85-23-006 (Mar. 27, 1985).

³³*Robinson v. U.S.*, 90-2 U.S.T.C. ¶60,045 (S.D. Ga. 1990).

³⁴Rev. Rul. 59-9, 1959-1 C.B. 232.

³⁵T.A.M. 91-16-003 (Dec. 27, 1990).

4. Defective Election

With the removal of many technical requirements, the problems with defective elections are much reduced. In fact, the problem may well be that the election is so easy that it may be inadvertently made when it is not necessary. The taxpayer is then in the position of trying to figure out a reason that the election was not available.

5. Protective Election

The regulations provide for a protective election but limit the circumstances under which it can be made to situations in which the executor reasonably believes that there is an issue as to whether an asset is includible in the estate or as to the amount or nature of the property the surviving spouse is to receive. The protective election must identify either the specific assets or trust to which the election applies and the basis for the election. The protective election, once made, cannot be revoked. For example, if a protective election is made based upon whether an asset is included, if that asset is included, then the election is applicable.³⁶ Although the language of the regulation seems restrictive, it is hoped that this provision will be broadly interpreted. Since the taxpayer is hung with the election once the issue is resolved, there is no room for playing games. The election should always be made if the value of the assets is subject to question and if the estate desires to avoid tax if the values are increased.³⁷

3. Other Property to Which Election Applies Although the classic QTIP property is that placed into a trust, there are other types of transfers which constitute qualified terminable interest property.

1. Usufructs

The statute was amended retroactively to provide that a Louisiana usufruct interest is qualified terminable interest property.³⁸

2. Life Estates

³⁶Treas. Reg. §20.2056(b)-7(c).

³⁷See P.L.R. 95-20-038 (Feb. 21, 1995) in which the Service granted an extension of time to file under Treas. Reg §301.9100-1.

³⁸§2056(b)(7)(B)(ii)(I). See P.L.R. 88-35-015 (June 3, 1988).

Legal life estates qualify for qualified terminable interest property treatment. Treas. Reg. §20.2056(b)-7(d)(2) specifically permits legal life estates to qualify provided that they meet the income tests set out in Treas. Reg. §20.2056(b)-5(f). A power of sale in the life tenant would clearly qualify the interest. The regulations state, by example, that an unrestricted right to use a principal residence qualifies for QTIP treatment.³⁹ Perhaps those regulations need to be clarified to spell out what rights a life tenant must have. A life tenancy deliberately created by will should spell out the burdens and benefits accruing to the life tenant.⁴⁰ However, the burdens must not be in excess of those imposed under state law.⁴¹ Life estates in tangible personal property such as works of art may also be QTIPed.⁴² While one commentator suggests that local law be allowed to fill in the duties and burdens of the life tenant, I think that the better approach (so that disagreements among the life tenant and remainderman can be minimized) is for the draftsman to spell those duties out, being careful not to exceed local law. A savings clause may be helpful here.

3. Joint and Survivor Annuities

Joint and survivor annuities did not qualify for QTIP treatment in most cases because of the difficulty in meeting the “all income” test, especially if the annuity was for a term certain with a refund feature. Code §2056 was amended in 1988 by the addition of Code §2056(b)(7)(C) which provides that the interest of the surviving spouse in a joint and survivor annuity qualifies for the marital deduction if no one other than the surviving spouse has the right to receive payments before death. In an interesting variation on the election requirements, this interest automatically qualifies unless the executor elects out on the federal estate tax return. This election, once made is irrevocable. Note that the annuity payable to the surviving spouse need not come up to any standard other than that such spouse receive all payments thereunder during the spouse’s life.

4. Includibility in Surviving Spouse's Estate (§2044)

Section 2044(b)(1)(A) provides that property in which the surviving spouse had a

³⁹Treas. Reg. §20.2056(b)-7(h), Example (1).

⁴⁰See P.L.R. 84-44-099 (July 16, 1984).

⁴¹*Estate of Novotny*, 93 T.C.M. 12 (1989).

⁴²P.L.R. 92-42-006 (July 15, 1992) ; P.L.R. 92-37-009 (May 21, 1993); P.L.R. 89-52-024 (Sept. 14, 1989).

qualifying income interest for life is included in the surviving spouse's estate if a deduction was allowed under §2056(b)(7) or §2523(f) to the estate of the first spouse to die. The regulations clarify that two requirements must be met - that the deduction was allowed and that the interest was a qualifying income interest for life.⁴³ It would simplify everyone's life, and would actually benefit the government, if the rule were that if the first estate got the deduction, whether erroneously or not, the second estate must include the property. Game playing should not be the order of the day.

1. Passed From

⁴³Treas. Reg. §20.2044-1(a) -1(d).
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Section 2044(c) provides that property included in the estate of the surviving spouse under §2044 is deemed to have passed from that surviving spouse for purposes of the estate tax and the generation skipping transfer tax, and the regulations specifically refer to special use valuation provisions (§2032A), the charitable deduction (§2055), the marital deduction (§2056) and installment payment of tax (§6166). Property is also considered to have passed from the surviving spouse for purposes of the basis adjustments under §1014, thereby eliminating a problem as to whether or not such property received a basis adjustment at the death of the surviving spouse.⁴⁴ Property is not deemed to have passed from the surviving spouse for purposes of the reverse QTIP election under the generation skipping transfer tax under §2652(a)(3).

2. Presumption of Deduction

If the interest held by the surviving spouse was qualified terminable interest property, then it is presumed that a 100 percent marital deduction was taken on the appropriate estate tax return or gift tax return for that transfer, thereby causing inclusion under §2044.⁴⁵ The burden is on the executor to show that no deduction (or only a partial deduction) was taken. While the proposed regulations did not give any guidelines as to how the executor is supposed to rebut the presumption created therein, the final regulations provide that the presumption can be rebutted by producing a copy of the return on which the deduction was or was not claimed, or by showing that no return was required. It is to be hoped that the Service will assist with producing a copy if one cannot be found.

CAVEAT: Some credit shelter trusts may qualify for the QTIP election, and thus it would be necessary for the executor to show that no QTIP election had been made with respect to such interest. Obviously, the executor must use reasonable diligence in obtaining proof that the election was not made.

3. Amount Includible

⁴⁴Treas. Reg. §20.2044-1(b).

⁴⁵Treas. Reg. §20.2044-1(c).
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The amount includible under §2044 with respect to qualified terminable interest property as to which the election was made is the value of that property at the date of death of the surviving spouse. If the value was incorrect, and such error is discovered before the trust is funded, then the amount includible under §2044 is the corrected value.⁴⁶ The regulations further provide that if the election was made with respect to only a portion of the property which was eligible for the election, then only that portion is includible at the death of the surviving spouse.⁴⁷ Unless the elected share is segregated, if distributions from the estate are made during the lifetime of the surviving spouse out of the elected share, and if only a portion of the trust was made subject to the election, then re-evaluation must occur at the date of such distribution to determine the new fraction to be used in computing the amount includible at date of death. For example, the total trust was valued at \$1,000,000 at date of death and an election was made with respect to 50 percent of such trust. During the lifetime of the surviving spouse, a distribution of \$100,000 was made from the elective share at the time the entire trust was valued at \$1,100,000. The new fractional share subject to inclusion under §2044 would be 45 percent ($\$550,000 - \$100,000 / \$1,100,000 - \$100,000$).⁴⁸ This problem is very similar to the problems raised in the administration of fractional share bequests when there are partial non pro rata distributions of the fractional share bequest.

4. Calculation and Payment of Tax

⁴⁶P.L.R. 90-19-001 (Nov. 30, 1989).

⁴⁷Treas. Reg. §20.2044-1(d)(1).

⁴⁸Treas. Reg. §20.2044-1(d)(3) and Treas. Reg. §20.2044-1(e), Example (4).
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The tax on §2044 inclusion is based upon the incremental rate at which such property is taxed. The estate tax is calculated with the §2044 property and without it, and the difference between the two is the amount of tax attributable to such property. The executor of the surviving spouse's estate is allowed to recover the tax from the trustee of the QTIP trust unless the surviving spouse "otherwise directs by will."⁴⁹ No specific reference to §2207A is necessary to override its operation. The authorities differ on whether a direction in the survivor's will to pay the taxes out of the residue is sufficient to constitute such a direction. The cases in this area which hold that a direction to pay all taxes out of the residue is not an "otherwise" direction apply the public policy that all beneficiaries are to bear their portion of the taxes unless the testator specifically directed otherwise. They also find that intent is the guiding principle and that the testator could not have intended to wipe out the residuary gift. In *Estate of Gordon*, the facts were particularly aggravated.⁵⁰ Husband died naming two of his sisters as executors and all four of his sisters as remainder beneficiaries of a QTIP trust. His spouse's will left her entire residuary estate to charity and directed that all taxes be paid from the residue. Wife predeceased the filing of Husband's federal estate tax return, the sisters made a QTIP election and then argued that the Wife's estate should bear all the tax on that under the directions in her will. The surrogate had little trouble in forcing the QTIP to pay its share. The other line of cases is either less judicial activism or less judiciousness, depending upon your point of view. These cases simply hold that the words of the testator mean what they mean, regardless of the result that produces.⁵¹ The *Gordon* view appears to be the developing majority view. There are several states that have enacted statutes requiring that the federal law requirement of §2207A be specifically waived if taxes are to be borne by the residue.⁵²

⁴⁹ §2207A(a).

⁵⁰ 510 N.Y.S.2d 815 (Surr. N.Y. 1986). *See also Firststar Trust Co. v. First National Bank of Kenosha*, 541 N.W.2d 467 (Wis. 1995) in which the payment of the taxes on the QTIP from the residue would have wiped out the residue, all of which was passing to charity.

⁵¹ Compare *Estate of Miller*, 595 N.E.2d 630 (Ill. App. Ct. 1992) with *Estate of Vahlteich v. Commissioner*, 95-2 U.S.T.C. ¶60,218 (6th Cir. 1995 - not for publication).

⁵² *E.g.*, Michigan, North Carolina, Ohio, New York, and Virginia.

3. Partial Elections

Partial elections must be made as to a "specific portion" of the property.⁵³ The regulations require that partial elections relate to a "fractional or percentile" share of the property so that the elective part will reflect its proportionate share of the increment or decline in the whole of the property for purposes of applying §2044 or §2519.⁵⁴

1. Formula Clause

A partial QTIP election may be made with a formula provision similar to that used in drafting the pecuniary marital bequest under a will. This means that any change in valuation upon audit or the choice of taking deductions on the estate tax or income tax returns would not affect the marital deduction if the formula clause were designed to reduce the tax to the lowest possible tax.⁵⁵

2. Division into Separate Shares or Trusts

⁵³ §2056(b)(7)(B)(iv).

⁵⁴ Treas. Reg. §20.2056(b)-7(b)(2)(i).

⁵⁵ Treas. Reg. §20.2056(b)-7(h), Examples (7) and (8). *See also* P.L.R. 90-43-015 (July 26, 1990).
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In a partial election, the marital and non-marital trust can be segregated if authorized under the governing instrument or otherwise permitted under local law. If the trust has not been divided by the time the return is filed, the intent to divide must be "unequivocally signified" on the return. This division must occur, however, no later than the close of the administration of the estate.⁵⁶ Presumably, if the settlement of the estate occurred through a revocable trust, that division could occur at the time the administration would have been closed had those assets been subject to probate. The regulations also make it clear that specific assets may be allocated to the elective and nonelective shares so long as the fiduciary is required either by state law or by the governing instrument to divide the trust according to the fair market value of the assets of the trust at the time of the division.⁵⁷ Thus, a complete fractionalization of each asset is not required when the trusts are severed.⁵⁸ In the case of legal life estates, an election may be made on an asset by asset basis.⁵⁹

3. Invasion of Marital Share

The marital share may be invaded for the benefit of the surviving spouse prior to the invasion of the nonmarital share, and such invasion may even be subject to different standards.⁶⁰

4. Definition of Specific Portion

⁵⁶Treas. Reg. §20.2056(b)-7(b)(2)(ii)(A).

⁵⁷See e.g., Tex. Prob. Code §378A(b) (West 1996).

⁵⁸Treas. Reg. §20.2056(b)-(7)(b)(2)(ii)(B) and (C) and Treas. Reg. §20.2056(b)-(7)(h), Example (14).

⁵⁹P.L.R. 90-43-029 (July 27, 1990).

⁶⁰Treas. Reg. §20.2056(b)-7(h), Example (9).
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In *Estate of Alexander v. Commissioner*,⁶¹ the Tax Court, relying on *Northeastern Pennsylvania National Bank and Trust Company v. U.S.*,⁶² held that the regulations at §20.2056(b)-5(c) were invalid in limiting the "specific portion" language to a fractional or percentage share. In that case, Mrs. Alexander was given a testamentary power of appointment "over that portion of this trust which shall be EQUAL IN AMOUNT to my wife's share." (emphasis added). Thus the effect that Mr. Alexander sought to achieve was to eliminate the appreciation of the marital share from taxation in his wife's estate. In the Energy Policy Act of 1992, the Congress added §2056(b)(10) and a new sentence to §2523(e) to codify the language of the regulations. §2523(f)(3) was also amended to make the rules of §2056(b)(10) applicable to gifts. In its final QTIP regulations, the Service recognized that *Alexander* was the law prior to October 24, 1992, the effective date of the Energy Policy Act of 1992.⁶³ Those rules apply to decedents dying on or before October 24, 1992, with a transitional rule for property passing to a spouse under documents in existence on October 24, 1992, and unchanged thereafter: (i) if the decedent was under a mental disability from which he never recovered, and if the decedent did not dispose of "such property," or (ii) if the decedent died before October 24, 1995.⁶⁴

CAVEAT: Examples 11 and 12 of Treas. Reg. §20.2056(b)-7(h) no longer represent interests as to which a QTIP election is allowable unless the transitional rule applies. Because the specific portions are not expressed in fractional or percentage shares, they cannot qualify after October 24, 1992. However, there is no cautionary note in the regulations. Example 11 begins, "D dies prior to October 24, 1992." Example 12 begins, "The facts are the same as in Example 11." Because of the date of death, the old rules apply. Mighty peculiar for regulations written in 1994!

4. Reverse QTIP Elections

§2652(a)(3) permits a separate QTIP trust to be created to which generation skipping transfer tax ("GSTT) exemption can be allocated so that the surviving spouse will not be treated as the transferor for GSTT purposes. The reverse QTIP trust must be a separate trust and the

⁶¹82 T.C.M. 34 (1984), (*aff'd*) (4th Cir. 1985) (unpublished opinion). (affirmed "for the reasons expressed by the Tax Court majority")

⁶²387 U.S. 13.

⁶³Treas. Reg. §20.2056(b)-7(e).

⁶⁴Treas. Reg. §20.2056(b)-7(e)(5).

regulations prescribe the method for severing the trust into separate trusts if the instrument does not do so.⁶⁵ If the trust is a pecuniary trust, it may be funded either at date of distribution values (if appropriate interest is required to be paid) or under the “fairly representative” standard.⁶⁶ The allocation of GSTT exemption must be made on a timely filed return or the exemption will be automatically allocated under §2632(c). This would mean that a portion of the exemption would be automatically allocated to other gifts and the reverse QTIP trust will have an inclusion ratio of more than zero and less than one. Relief for a late allocation may be available under Treas. Reg. §301.9100.

3. FUNDING THE MARITAL BEQUEST - IN GENERAL

At the conclusion of the administration of the estate, the executor must distribute assets to and among the beneficiaries. In the good old days, the executor only had to take into consideration such things as the type of bequest with which the executor was dealing, the general composition of the property, and the funding standard set forth in the will. Now, in many situations, the most critical factor to be considered is the valuation of the assets used to fund the trust, particularly in those situations in which discounts have been taken in valuing the asset on the estate tax return or might be allowed (or imposed) upon funding of the various trusts. This section will proceed from the simple to the terribly complex and sometimes unfathomable.

1. Types of Marital Bequests

Most marital deduction bequests fall into some sort of formula category. There are basically three types of formulae which are used in establishing an optimal marital deduction or minimum marital deduction bequest. Pecuniary marital bequests are most frequently used in smaller estates for reasons discussed below.

1. Pecuniary Marital

This is probably the most common type of formula used. The essence of a pecuniary bequest is the bequest of an amount rather than a share of assets. In essence then, the formula marital deduction pecuniary bequest provides that the marital is to be funded with the minimum amount which would still produce the lowest or zero federal estate tax.

2. Pecuniary Exemption Equivalent

This is the flip side of the pecuniary marital. This bequest generally provides that the exemption equivalent or credit shelter portion of an optimal marital formula is funded with the amount equal necessary to bring the taxable estate up to the point where it produces a zero estate tax after taking into account the unified credit and the state death tax credit (if the use of that

⁶⁵Treas. Reg. §26.2654-1(b).

⁶⁶Treas. Reg. §26.2654-1(a)(1)(ii).

credit does not produce an additional estate tax). As is discussed more fully below, the funding of a pecuniary bequest may carry with it an income tax impact to the estate if appreciated property is used to fund the bequest. Using the pecuniary exemption equivalent in larger estates (and the pecuniary marital deductions in smaller estates) will minimize the effect of the income tax cost on appreciation of assets. A natural result of that choice, however, is to shift all of the appreciation to the non-pecuniary share. The reverse is, of course, also true. If the estate depreciates in value, then all of the depreciation is borne by the non-pecuniary share.

3. Fractional Share

The third type of bequest is a fractional share. This is also a formula bequest, but rather than dealing in amounts, this deals in fractional or percentile shares. Although fractional shares were once the most popular kind of bequest, they fell into disuse because of administrative problems created by disproportionate distributions. However, partial QTIP elections have tended to create many fractional share type problems, and attorneys and executors are becoming more familiar with how to deal with such problems. The fractional share is income tax neutral and spreads the appreciation and depreciation ratably between the marital and non-marital share.

2. Funding Standards

While the funding of a marital deduction bequest is normally an income tax problem, it can have estate tax implications also. The funding standard selected can be income tax neutral or can create an income tax.

1. "True Worth"

The true worth funding standard is one which utilizes date of distribution values in determining the assets used to fund the pecuniary gift. If the assets have appreciated, then income tax is generated upon the funding of the pecuniary bequest.⁶⁷ Thus, for income tax purposes, the bequest is treated as if the estate had sold the assets and then used the cash proceeds to fund the bequest. Therefore, the estate recognizes gain.⁶⁸ The gain is calculated as the difference between the fair market value at date of distribution and the income tax basis of the asset as determined for federal estate tax purposes, because the asset achieved a new basis under §1014. Further, any gain is automatically taxed as long term capital gain under

⁶⁷This method is especially useful if §2032A property is involved in a pecuniary marital situation, since the size of the marital bequest is determined using the special use valuation, but funding occurs at fair market value. Note that the opposite result may be produced if the pecuniary gift is the exemption equivalent; *i.e.*, all the "excess value" could fall into the marital share.

⁶⁸Treas. Reg. §1.1014-4(a)(3).

§1223(11), even though the funding occurred less than 12 months after death. However, if the funding occurs less than 18 months after death, it would appear that the gain would be taxed at a 28% rate rather than the 20% rate under §1(h) as amended by the Taxpayer Relief Act of 1997. This glitch appears to be unintended, and would have been fixed by the Technical Corrections Act which was not passed. Hopefully, it will be cured some time in the future.

Obviously, since the distribution is based on the value of the asset at the date of distribution, all assets to be allocated to the pecuniary gift must be revalued at such time. Except for a true fractional share bequest, this is true of all other funding methods also. Distribution of assets in satisfaction of a pecuniary bequest also carries out distributable net income (DNI) with the bequest. Thus, the estate recognizes taxable gain on the distribution of appreciated property, but gets an income tax deduction to the extent of the lesser of its DNI or the fair market value of the assets distributed. Even though specific bequests normally do not carry out DNI, the Revenue Service has long taken the position that a pecuniary marital distribution is not sufficiently specific under §663(a)(1) to avoid that result.⁶⁹ Further, if property constituting income in respect of a decedent (IRD) under §691 is distributed in satisfaction of a pecuniary bequest the IRD is accelerated upon distribution, causing all of the IRD to be treated as income in the year of distribution even though it would not be required to be recognized then absent such distribution.⁷⁰

2. Federal Estate Tax Value

A second standard funds the trust at the value of the assets at the date of the decedent's death (or the alternate valuation date, if applicable). Under this method, no income tax is generated on the distribution. The bequest still carries out DNI and, if IRD is used to fund the bequest, it will accelerate the IRD. If the assets in the estate have appreciated, this method of funding causes the pecuniary bequest (whether it is the exemption equivalent or marital bequest) to be over funded. If the marital is the pecuniary bequest, there exists a true potential for abuse by selecting assets which have depreciated in value and using them to fund the marital while shifting the gain away to the non-marital bequest. In order to avoid this abuse, the Revenue Service promulgated Revenue Procedure 64-19.⁷¹ As a prerequisite to obtaining the marital deduction, this Revenue Procedure requires that the assets be valued at date of distribution

⁶⁹ *But see* Rev. Rul. 86-105, 1986-36 I.R.B. 15, holding that a bequest similar to a marital deduction bequest does not carry out DNI.

⁷⁰ *But see* P.L.R. 96-30-034 (Apr. 30, 1996), in which a disclaimer of an interest in an IRA, construed to be a pecuniary disclaimer, did not accelerate IRD.

⁷¹ 1964-1 C.B. 682

values, or, if valued at federal estate tax values, then the assets used to fund the marital and non-marital share in a pecuniary bequest must be "fairly representative" of the appreciation and depreciation of all of the assets of the estate. Thus, another judgment of the executor is required. The Revenue Service can challenge the funding of these bequests based upon whether it believes that the distribution meets the fairly representative standard. Because of such standard, the entire estate must be revalued so that the executor can make the determination of what aggregate appreciation and depreciation has occurred. This makes distributions under this standard very inflexible, and many executors simply choose to allocate assets on a ratable basis, thus converting this type of bequest more to a fractional share than a true pecuniary. Lack of flexibility and administrative burdens render this method difficult to use.

3. Minimum Worth Funding

This third method once again avoids an income tax on the funding of pecuniary bequests, but still carries out DNI, and accelerates IRD. This method requires that pecuniary bequests be funded at the lower of federal estate tax values or date of distribution values and, in my opinion, can only be used when the marital is the pecuniary gift. It requires the revaluation only of the assets distributed in satisfaction of the marital bequest, and relieves the executor of trying to apply the fairly representative standard. However, the marital is almost guaranteed to be over funded. The executor has tremendous latitude to benefit the surviving spouse at the expense of the other beneficiaries (if any). Depending upon the asset mix, the minimum worth funding standard could result in a complete abatement of the exemption equivalent gift. This method will become even less frequently used because of the limitation in the GSTT regulations in determining the applicable fraction (and thus the inclusion ration).⁷²

4. Fractional Share Funding

As mentioned earlier, the funding of a fractional share bequest requires the allocation of an undivided interest in each asset to the respective shares. While this bequest still carries out DNI, it does not accelerate IRD, nor does it produce an income tax. However, most draftsmen do not give sufficient attention to drafting the fractional share bequest, and thus fail to specify what happens to the fractions after a significant event occurs during administration; *e.g.*, after the taxes are paid. For instance, assume a \$4,000,000.00 estate with a fractional share of 50 percent to a third party and 50 percent to the spouse. The taxes of \$1,000,000.00 are to be paid out of the non-marital share. The fraction at date of death is 50 percent to the marital share and 50 percent to the non-marital share. Once the taxes are paid, the fraction shifts to 1/3 to the non-marital share and 2/3 to the marital share. The question then becomes whether the income should be allocated 2/3 - 1/3 from date of death, whether it should be 50/50 from date of death until the

⁷²Treas. Reg. §26-2642-2(b)(2).

taxes are actually paid and thereafter 2/3 - 1/3, or whether the fraction should never change. There is little law on this type of bequest in most jurisdictions, and the problems become even more complex if the values change or if income distributions are made disproportionately throughout the course of administration.⁷³ Thus, one can see the difficulty in administering fractional share bequests, especially when the instrument does not give guidance as to the allocation of income. Further, the guidance must comport closely enough with the marital deduction rules so that the value of the marital is not reduced because of the inability of the spouse to receive income from the date of the bequest. A detailed discussion of fractional share funding and the allocation of postmortem gains and income is beyond the scope of this paper.⁷⁴

5. Pick and Choose Fractional

⁷³In 1993, Texas enacted Tex. Prob. Code §378B (West 1996) which deals with allocation of income during the administration of the estate if the instrument makes no provision therefor. That statute seeks to answer this difficult question by mandating the executor to reallocate income after a significant event, but leaving it in the executor's discretion as to when and how often such reallocation should take place.

⁷⁴For an excellent and still timely treatise on this work, see Thomas Cantrill, Fractional or Percentage Residuary Bequest: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 University of Notre Dame Estate Planning Institute, Chapter 4 (1985).

A variation on the standard fractional share bequest is a fractional share bequest which allows the executor to allocate specific assets to either share. This looks and feels very much like a pecuniary bequest, and could conceivably result in gain whereas the normal fractional share funding does not. It may further result in an acceleration of IRD. In funding this type of bequest, it would seem that the entire estate would have to be revalued, and the fraction applied to the new value. Note that the QTIP regulations permit a pick and choose fractional approach in severing the elective and non-elective share of a QTIP trust.⁷⁵

6. §643(e) Problem

Section 643(e) of the Internal Revenue Code provides an election for the executor when appreciated property is distributed from the estate. This section does not apply to a pecuniary bequest, because a distribution in satisfaction of a pecuniary bequest is treated as in-kind funding of the bequest automatically triggering gain or loss, rather than as a distribution. The section does, however, apply to distributions in-kind in satisfaction of fractional share bequests or other residuary bequests. The executor can elect to recognize gain, in which case the beneficiary receives a stepped-up basis in the asset. If the executor does not elect to recognize gain, then the beneficiary receives a carryover basis in the asset. The estate will receive a distribution deduction, and the beneficiary will recognize income to the extent the estate has DNI equal to or less than the lesser of the fair market value of the asset or its basis in the hands of the estate (adjusted by any gain recognized if an election was made). The election cannot be made on an asset by asset basis, but must be applied to all distributions during a taxable year. Given bracket compression and the high rates on estates, this election is virtually useless in today's environment.

3. Closely-Held Stock

The surviving spouse must be given the power to cause non-income producing property to be converted to income producing property, or to require that the lost income be satisfied out of other assets of the trust.⁷⁶ That being the case, if the QTIP is funded with stock in the family business, the power in the surviving spouse (particularly in a second marriage) to cause the stock to be converted to income producing property could well prove disastrous to the economic well being of the family as a whole. Thus, care must be taken in deciding to provide QTIP treatment if the principal asset will be non-income producing and if the spouse may elect to require that such property be converted. See also the valuation problems and opportunities raised by this particular class of asset discussed below.

4. Allocation of Income to Pecuniary Bequests

⁷⁵ Treas. Regs. §20.2056(b)-7(b)(ii)(B).

⁷⁶ Treas. Reg. §20.2056(b)-5(f)(5).

During the administration of the estate, the question arises as to how to allocate the income among the various gifts, and particularly what effect that allocation might have upon the marital deduction. If the marital is an outright pecuniary bequest, the Regulations provide that such bequest will not fail to satisfy the conditions for obtaining the marital deduction "merely because the spouse is not entitled to the income from estate assets for the period before distribution of those assets by the executor."⁷⁷ But then the Regulation goes on to add, ". . . as to the valuation of the property interest passing to the spouse in trust where the right to income is expressly postponed, see §20.2056(b)-4." The cited Regulation provides in part as follows: "In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property." In many states, pecuniary bequests earn interest after some reasonable period of time, rather than sharing in the income of the estate. So long as income is paid in accordance with state law, and begins to accrue without unreasonable delay, there should be no impact on valuation. If the will provides for an extended delay in income to the marital share, there should not be a qualification issue, only a valuation issue. (See discussion of *Estate of Hubert*, below.)

5. Failure to Fund

In the real world, all too often, the marital trust (as well as the exemption equivalent trust) might never be funded. This is especially true where the spouse is the executor and the income beneficiary of both trusts and in states with independent administration rules which do not require a detailed final accounting and UPC states. In other cases, there may be at least a partial failure to fund, due many times to valuation errors.

1. Total Failure

If the marital gift is never funded, then how is the executor of the estate of the surviving spouse to measure the QTIP trust for §2044 purposes? This problem is compounded if the surviving spouse has remarried and has failed to keep the property brought into the second marriage segregated. If the beneficiaries of the QTIP Trust and the survivor's estate are not identical, still further problems are present.

2. Partial Failure

⁷⁷Treas. Reg. §20.2056(b)-5(f)(9).
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A Revenue Ruling and a case illustrate some of the problems created if the marital bequest is under funded. In Rev. Rul. 84-105,⁷⁸ the Service ruled that the under funding of the marital trust did not cause a reduction in the marital deduction, but rather was a gift from the surviving spouse to the non-marital takers under the will. This gift occurred when the statute of limitations ran on the ability of the spouse to sue for the shortfall, which was clearly shown on the final accounting approved by the court without any objection by the spouse. Would the result be the same if there were a spendthrift trust provision? Does this ruling present some delayed partial election opportunities? And finally, who asks for rulings like this anyway?

In *Bergeron v. Commissioner*,⁷⁹ the question took on a slightly different twist. In this case, the under funding of the marital trust fell into the bypass trust, of which the spouse was the income beneficiary. Thus, the value of the gift was the value of the interest reduced by the value of the retained income interest of the spouse. (Obviously, this was a gift of a future interest as to which no annual exclusion was available.) The consequence of this result, however, was to make the spouse a grantor as to part of the bypass trust, with the retained income interest causing a partial inclusion in the spouse's estate.

4. THE NEW BOGEYMAN IN MARITAL DEDUCTION PLANNING -- §2033A — FAMILY OWNED BUSINESS EXCLUSION

In one of its most misguided efforts, Congress has decided to save family owned businesses from decimation by the federal estate tax by giving them an impossibly complex (and dangerous) statute in the form of new §2033A added by the Taxpayer Relief Act of 1997.⁸⁰ A complete discussion of the scope and problems with §2033A is well beyond the scope of this outline. Much has been written about drafting under this statute and what to do to put your client in a position to take advantage of this statute, even though many commentators feel that it is very difficult to plan to use this statute.

1. Summary of §2033A

This section is bottomed on §2032A, and indeed incorporates much of that section by

⁷⁸1984-2 C.B. 197.

⁷⁹52 T.C.M. 1177 (1986).

⁸⁰The ABA Sections of Taxation and the Real Property, Probate and Trust Law Section have already called for the repeal of §2033A. As this outline is being written, the American College of Trust and Estate Counsel (“ACTEC”) has a task force working on revising that section.

reference. This is truly unfortunate for two basic reasons — (i) §2032A is a section which the Internal Revenue Service has tried to apply in an extremely technical manner, and thus has produced litigation and uncertainty, and (ii) §2032A is a *valuation* section while §2033A grants an *exclusion*, and thus the two sections are inherently incompatible.

If the family owned business interest meets certain tests (*e.g.*, it exceeds 50% of the adjusted gross estate, if the decedent meets certain ownership and material participation tests), then it is a qualified family owned business interest (“QFOBI”). If the personal representative of the estate so elects, the value of the QFOBI may be excluded from the taxable estate up to the difference between \$1,300,000 and the applicable exclusion amount. Thus, for 1998, the amount excludible under §2033A would be \$675,000, generating a maximum tax benefit of \$371,250. Each year, as the applicable exclusion amount rises, the benefit decreases.⁸¹ There are multiple variables in valuing the business interest itself (*e.g.*, excess liquidity, passive assets), gift bring-backs (*e.g.*, gifts to family members and certain gifts to spouses), and adjustments for debts in calculating the value of the QFOBI for the purpose of the 50% of the adjusted gross estate test. Assuming there is a QFOBI, then the interest must pass to a qualified heir (as defined in §2032A) and all persons having an interest must consent to the election. If all or a portion of the interest is disposed of within 10 years, then a recapture tax is imposed (with a phase out in the last 4 years). Unlike §2032A, however, the recapture tax bears interest *from the due date of the original estate tax return*

2. The Exclusion Is Not Asset Specific

Although some have suggested that the exclusion must be asset specific (*i.e.*, the exclusion follows the QFOBI), most commentators, myself included, believe that the exclusion is simply an amount based upon the value of the QFOBI. A fair reading of §2033A(a) is that the value of the estate shall not include an *amount* equal to the exclusion granted thereunder. Thus, no specific devise of the QFOBI is required to utilize the exclusion amount.

3. Effect on Traditional Marital Deduction Drafting

Much has already been written about whether §2033A should cause draftsmen to revisit all their marital deduction clauses. First, remember that this applies only to estates with a certain type of asset. Therefore, most marital deduction planning is probably still all right. Second, remember that all of the traditional funding problems are still present, and the §2033A problems are add-ons to an already complex set of issues.

1. Pecuniary Marital Deduction

⁸¹The proposed Technical Corrections Act would have adjusted the benefits so that the maximum exclusion would have remained at \$675,000 while the applicable exclusion amount would not increase. It is expected that this change will be made. The difference, of course, is that the exclusion comes off at the top bracket, while the applicable exclusion amount uses the lower brackets.

If a pecuniary marital deduction is used, then there is probably no need to change the form presently in use. The excluded amount of the QFOBI should automatically fall into the bypass trust, and the value of that trust will be \$1,300,000 assuming that the value of the QFOBI is at least \$675,000. Assuming, as we all seem to do now, that the value of the estate will increase (or at least not decrease) during administration, then a true worth funding method will achieve optimum results and force appreciation to the non-marital or bypass share. In this day of appreciating assets, the pecuniary marital is probably the more popular, even, or perhaps especially in large estates, despite the potential income tax problems generated by funding a pecuniary bequest with appreciated assets. But with a 20% capital gains rate, and a minimum estate tax rate at 37% (after the applicable exclusion amount), the trade-off is probably worthwhile, even considering the time value of money.

2. Pecuniary Bypass Trust

If the pecuniary formula is a bypass trust, then your language must be reviewed. Many formulae relate only to the unified credit. This may cause the excluded amount to pass to the residual marital share, thereby wasting the exclusion. This could be cured with a partial QTIP election, assuming that the marital share is eligible for the QTIP. If the marital share is a general power of appointment trust or an outright disposition, a disclaimer might be considered. Again, the exclusion from tax is not the sole consideration, and primary consideration must always be given to the actual devolution of the property. The choice as to the funding method is more difficult here, in that true worth values may force at least part of the QFOBI into the marital share.

3. Fractional Share

In fractional share bequests, the ability to allocate the amount excluded under §2033A is more or less automatic if the formula allocates such amount to the credit shelter share. Use of pecuniary gifts would appear to be easier even if the fractional is pick and choose. Review of fractional share formulas is recommended.

4. Use of Specific Language

1. Tax Considerations

While the temptation may be to do detailed drafting for §2033A in every document, most problems can be solved by fairly general language in the formulas. While at least one commentator advises that the QFOBI should be specifically devised to the non-marital share, I would, in most cases, prefer leaving funding choices to the personal representative. If it is probable that the estate will use the exclusion, then more detailed drafting may be in order. Also, if it is probable that the QFOBI exclusion will be used in conjunction with §2032A special use valuation, then specific bequests of those interests with a view to meeting the material participation requirements might be the better course. It is still unclear as to whether both a

valuation discount and the special use valuation can be used,⁸² but it would seem that the value used for the QFOBI in determining the exclusion should be the value after discounting.

2. If Beneficiaries of Shares Are Different

In certain fact situations, specialized drafting and careful thought are absolutely required. This is particularly true in a fairly typical situation in which there is a desire to leave the bypass amount to the children of the first marriage, but those children are not involved in the family business.⁸³ Thus, the QFOBI amount should be allocated away from the bypass share going to the children by the first marriage if the desire of the testator is to limit the amount passing to them to the unified credit. Here the proposed Technical Corrections Act would really make for an interesting drafting problem. The choices would seem to be to create a separate “bypass trust” for the QFOBI if the election is made with the present family as the beneficiary thereof. However, an alternative might be to authorize the executor to divide the marital trust into two shares, one of which would hold the QFOBI amount. A partial QTIP presents all of the problems of a fractional share funding formula in that the allocation must be made on a pro-rata basis.

4. Consideration Concerning the Marital Deduction

Funding of the QFOBI into the marital share can cause some interesting results that vary depending upon whether the marital share is outright or in a QTIP trust.

1. QTIP Qualification Problem

If the QFOBI is placed into a QTIP trust, then the payment (or even liability for) the recapture tax may create qualification problems because the recapture tax is personal to the remaindermen. Is this a power to appoint to someone other than the spouse in derogation of the provisions of §2056(b)(7)(B)? This type of lien (to secure the recapture tax) should not be different than any other property subject to a lien. The recapture tax is really nothing more than a contingent liability, and thus should not result in disqualification.⁸⁴

2. Use of Exclusion in Second Estate

The choice between QTIP marital dispositions and other forms of marital dispositions seems to be a regional preference. In certain parts of the country, clients almost always use

⁸²See *Maddox v. Commissioner*, 93 T.C. 228 (1989) and *Estate of Hoover v. Commissioner*, 69 f.3d 1044 (10th Cir. 1995).

⁸³Obviously it would be better to solve gifts to children by the prior marriage through non-testamentary gifts, but that is not always possible.

⁸⁴See P.L.R. 94-09-018, withdrawing P.L.R. 91-13-009.
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outright dispositions, while in other areas almost all dispositions utilize QTIPs. In an outright or general testamentary power of appointment marital disposition to which the QFOBI is allocated, the interest is included in the surviving spouse's estate. The QFOBI thus would be included for purposes of the 50% test and would again qualify for exclusion in the survivor's estate if the mechanical tests were met. In that event, as much as \$2,600,000 may pass transfer tax free from one generation to the next. Of course, the potential exclusion must be balanced against projected appreciation of the QFOBI.

If the disposition is into a QTIP, the availability of the exclusion is more problematical. While the Internal Revenue Service argues that minority interests in a QTIP must be aggregated with the assets of the surviving spouse for valuation purposes, will the Service take the same position in this area. And at least one court has held that a QTIP cannot be aggregated with the assets of the survivor for determining valuation discounts and premiums, and thus logically for purposes of meeting the 50% test. *Estate of Bonner v. U.S.*, *infra*. (See discussion below at Article VI.C.1.d.)

3. Generation Skipping Tax and Reverse QTIP

If the exclusion amount is allocated to the bypass trust (as it should be), then the amount of the bypass trust will exceed the generation skipping transfer tax exclusion, at least for several years until indexing catches up. In that event, the bypass trust should include a direction to the trustee to bifurcate the trust into an exempt share and non-exempt share. Does this obviate the need for reverse QTIP provisions as standard provisions in documents? Obviously not.

4. When Does the Recapture Period End

The recapture period extends for ten years, with a phase out of the recapture amount in years 7 through 10. The recapture period also ends at the death of the qualified heir. If the QFOBI passes to the credit shelter or to a QTIP, does the death of the spouse terminate the recapture period? Such death would not appear to end the recapture period because of the successive interest rule. One can only presume that the rule would be the same in the §2033A area. However, if the gift were outright or in a general testamentary power of appointment trust, the recapture period would end at the surviving spouse's death.

5. A Final Word

While it is tempting to think of §2033A as a tax section, remember that the allocation of the QFOBI can create a significant shifting in wealth. Additionally, the recapture problems impose a serious burden on the parties signing the election. At the risk of being redundant, tax considerations must not be the sole consideration.

5. THE PANDORA'S BOX OF VALUATION PROBLEMS

Perhaps the most significant series of decisions to be made by the executor are those decisions concerning the valuation of the assets of the estate. This has always been an area rife with controversy. In fact, the legislative history of ERTA estimated that approximately 500,000 disputes involving valuation existed at the time of the passage of ERTA.⁸⁵ It is in this area that the executor must exercise the utmost care and diligence in assuring that the valuations reported on the federal estate tax return are valid.⁸⁶ Among the most difficult of assets to value is the decedent's interest in closely-held business entities. The discussion below relates to such valuation problems.

1. A Little Historical Perspective

As with many issues of its kind, the valuation problems can also be viewed as opportunities, but opportunities fraught with great risk both from a tax and fiduciary liability standpoint. As will be discussed more fully below, the discounts which may now be available to taxpayers in the gift tax area could become dangerous weapons for the Service in the estate tax area, and perhaps even in the income tax area. Over the past decade or so, Congress and the Service have worked diligently to eliminate many of the estate planning opportunities that we knew and loved. The game has now boiled down to the greatest rewards being available in valuation, both by inter-vivos and post-mortem strategies. With the advent of family limited partnerships and increased emphasis on the concept of control premiums and minority discounts, this area has become an even more fertile ground for planning and disputes. The misguided and not lamented §2036(c), and the terribly complex and dangerous Chapter 14 are examples of legislation in this area.

The issues revolve around valuation discounts for a minority interest and valuation premiums for control. Different standards are applied in the gift tax than in the estate tax. The gift tax focuses solely on the value of the transfer in the hands of the donee. However, the estate tax valuation has two components, the value for inclusion in the gross estate and the value at the funding of the bequests.

2. Valuation for Gift Tax Purposes

The valuation issues in the gift tax area, as noted above, revolve around the value of the transfer in the hands of the donee.

⁸⁵H.R. Rep. No. 201, at 243 (1981).

⁸⁶See Formal Opinion 335 (February 2, 1974) which, while dealing with securities transactions, can easily be applied to the estate tax area.

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1. Minority Discount - Rev. Rul 93-12 Taxpayers have long contended that a transfer of a minority interest in a closely held business was entitled to a discount even though the transfer was to a family member; *i.e.*, no aggregation should occur, but rather the transferred interests should be valued without reference to the relationship of the transferor to the donee(s), or the donees one to the other. After a series of losses in the courts,⁸⁷ the Service apparently conceded the issue in Rev. Rul. 93-12.⁸⁸ In that ruling, the Service revoked Rev. Rul. 81-253⁸⁹ and abandoned its long held position that gifts to family members were not entitled to a minority interest discount, stating that it would no longer apply aggregation in determining the value of interests transferred among family members. In that ruling, Donor owned 100 percent of the stock of a corporation. He transferred 20 percent of such stock to each of his five children. The Service ruled that each block was to be valued separately and since no block represented control, each was entitled to a minority discount.⁹⁰ However, one should not be too smug in one's belief that the ruling really signals a surrender by the Service, which has already indicated that Rev. Rul. 93-12 is limited to its facts.⁹¹

2. Control Premium

The corollary to the minority discount is the control premium. If a minority interest is entitled to a reduced value for lack of control, then a controlling interest carries with it a proportionately larger value. For an egregious attempt to avoid the application of a control premium and to establish a minority discount, *see Estate of Murphy*,⁹² in which the decedent made a death bed transfer of a minute percentage of her controlling interest in the family businesses.

3. “Swing Vote” Premium

⁸⁷*Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981); *Propstra v. Commissioner*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982).

⁸⁸1993-7 I.R.B. 13.

⁸⁹1981-2 C.B. 187.

⁹⁰See also T.A.M. 94-49-001 (March 11, 1994), reaching the same result with respect to gifts to 11 donees.

⁹¹See *LeFrak v. Commissioner*, 66 T.C.M. 1297 (1993), which was decided after the issuance of Rev. Rul. 93-12.

⁹²60 T.C.M. 73 (1990).

In one of the first major limitations on Rev. Rul. 93-12, the Service promulgated T.A.M. 94-36-005 (May 26, 1994). In that situation, Donor was the owner of 100 percent of the stock of a corporation. He transferred 30 percent of the stock to each of his three sons, 5 percent to his wife, and retained 5 percent for himself. He took a minority interest discount in valuing the transfers to his spouse and children. The Service ruled that in addition to a minority discount, each transfer of a 30 percent interest carried with it a “swing vote” premium since any two, banding together, could create a control block. This theory does not rely on the relation of the shareholders, but rather on the fact that a willing buyer in possession of all relevant facts would know who the other shareholders are and how the voting balance lines up.⁹³

The TAM relies heavily on *Estate of Winkler v. Commissioner*,⁹⁴ in which the decedent owned a 10 percent block of stock, and the other two shareholders owned 40 percent and 50 percent respectively. The court found that while a minority discount was appropriate, there was also a 10 percent premium for the fact that the decedent’s block held control for one shareholder and a deadlock for the other. The Service also relies on *Estate of Bright, supra*. That reliance is misplaced in that *Bright* did not uphold the swing premium concept, but merely discussed the fact that some early cases recognized it.

The taxpayer argued that a gift of one 30 percent block would not carry the “swing vote” premium, and that only the second gift could, under the Service’s theory, carry such a premium. The Service responded that the second gift would carry control through the “swing vote,” and that transfer constituted an indirect transfer to the first donee.

If the “swing vote” theory is accepted, it raises several issues. (1) Suppose Rev. Rul. 93-12 had been gifts of 40%-20%-20%. Would all three blocks carry a premium? The two 20 percent blocks alone could do nothing, but either combined with the 40 percent gives control. (2) The logical extension would be that any minority shareholder would have a premium added to the value of his stock if it could combine with another minority block to give control. (3) It would seem that there is some sort of “compulsion to buy” in this situation, since there is an assumption that the willing buyer ultimately will be one of the other shareholders in order to protect or increase the value of his block. This contravenes the hypothetical willing buyer element of fair market value. Would a third party pay a premium on the chance he could combine with another shareholder to create a control block? I think not. Also, it assumes, incorrectly, that a hypothetical willing buyer would get involved at all in a closely-held family situation.

⁹³See also T.A.M. 94-49-001 (March 11, 1992), in which the Service held that the value of a gift was determined in the hands of the donee. The Service notes, “The percentage of control represented by the block transferred to the donee (including potential swing vote value)” (Emphasis added.)

⁹⁴57 T.C.M. 232 (1989).

3. Estate Tax Issues

1. Valuation in the Gross Estate

In contrast to a gift, for gross estate purposes, the decedent's interest in the property is valued without regard to the identity of the beneficiary.

1. Minority Discounts

In *Estate of Bright v. United States*,⁹⁵ the decedent and her husband owned a 55 percent block in a corporation as community property. The estate took a minority discount in valuing the stock, asserting that the estate owned only a 27-½ interest in the corporation. The Service argued that in valuing the stock under the willing buyer-willing seller formulation, the willing buyer would recognize that the balance of control was owned in an individual capacity by the trustee of the testamentary trust owning the estate's interest. The Court rejected this argument, holding that the identity of the legatee was immaterial. The only relevant inquiry is the value of the property actually included in the estate.⁹⁶ Thus any discount for gross estate purposes must be based upon the decedent's interest.⁹⁷

2. Blockage Discount

Because a large block of stock (even in a publicly traded corporation and even if it represents less than control) may be more difficult to sell, a discount is allowed, which is a separate discount from the minority interest discount.

3. Control Premium

The corollary to the minority discount is the control premium, and this too is determined at the estate level. If a minority interest is entitled to a reduced value for lack of control, then a controlling interest carries with it a proportionately larger value.

4. Aggregation of Interests to Create Control

⁹⁵658 F.2d 999 (5th Cir. 1981).

⁹⁶The Court also (correctly, I think) rejected the Service's argument that the entire 55 percent block should be valued and then one-half the value should be included in the estate.

⁹⁷S. 20 T.A.M. 94-49-001 (Mar. 11, 1994).

The Service has taken the position that the interest owned by a decedent outright must be aggregated with an interest in the same entity held in a QTIP trust for Decedent. In T.A.M. 91-40-002 (June 18, 1991) decedent owned 62-1/2 percent of certain real property in his own right, and 37-1/2 percent was held by a QTIP trust. Relying on old contemplation of death cases under §2035 and Rev. Rul. 79-7,⁹⁸ the Service reasons that the decedent is treated as the owner of the property in the QTIP trust because it is included in his estate. However, the analogy between §2044 and §2035 is flawed. §2035 depends on the prior ownership of the interest by the decedent and a transfer by the decedent within the proscribed time frame.⁹⁹ The decedent never owned the §2044 property in his own right and therefore could never have made a transfer of the property. The property is included under §2044 solely because the decedent had a qualifying income interest for life in the property and a deduction was allowed under §2056(b)(7) or §2523. The Service reiterated that position in T.A.M. 95-50-002 (Aug. 31, 1995), in which the QTIP trust created under the will of Decedent's spouse held 150 shares of the 500 shares outstanding in a corporation. Decedent owned an additional 200 shares outright, thereby giving Decedent and the QTIP trust together 70 percent of the corporation's outstanding stock. In addition to its secondary reliance on Rev. Rul. 79-7, the Service primarily reasons that §2044(c)¹⁰⁰ causes the assets in the QTIP trust to be treated for purposes of the estate tax and generation skipping transfer tax as having passed from the decedent.¹⁰¹ Treas. Reg. §20.2044-1(b) treats the property as passing from the decedent for specific purposes -- the charitable deduction, the marital deduction, special use valuation under §2032A, and the §6166 payout. The Service states that the property is treated for estate tax purposes as having passed from Decedent's spouse to Decedent, and then from Decedent to the beneficiaries of the QTIP trust, thereby causing the Decedent to be treated as the outright owner. However, neither §2044 nor the regulations indicate that the decedent is to be treated as the "owner" for purposes of valuing the assets in the QTIP trust. Decedent never owned the property and his control over the passage of the property is limited by the terms of the QTIP trust.

The Fifth Circuit ringingly rejected the government's position in *Estate of Bonner*

⁹⁸ 1979-1 C.B. 294.

⁹⁹"...[T]he value of the gross estate shall include shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer during the 3-year period ending on the date of the decedent's death." §2035(a).

¹⁰⁰"For purposes of this chapter [Chapter 11] and Chapter 13, property includible in the gross estate of the decedent under subsection (a) shall be treated as passing from the decedent."

¹⁰¹The T.A.M. also applies that section to the gift tax, but the statute does not.

v. U.S.¹⁰² Mrs. Bonner devised her undivided interest in certain property to a QTIP trust. At the death of Mr. Bonner his estate claimed an undivided interest discount of 45 percent for his estate's interest in the same assets held in part by the QTIP trust. The government sought to aggregate those interests, thereby denying an undivided interest discount. The Fifth Circuit, relying on *Estate of Bright, supra*, emphatically rejected the government's arguments:¹⁰³

¹⁰²84 F.3d 196 (5th Cir. 1996).

¹⁰³The Court remanded to the district court to determine the size of the discount.
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"Although §2044 contemplates that the QTIP property will be treated as having passed from Bonner for estate tax purposes, the statute does not require, nor logically contemplate that in so passing, the QTIP assets would merge with other assets. The assets in the QTIP trust could have been left to any recipient of Mrs. Bonner's choosing, and neither Bonner nor the estate had any control over their ultimate disposition. The estate of each decedent should be required to pay taxes on those assets whose disposition that decedent directs and controls, in spite of the labyrinth of federal tax fictions"¹⁰⁴

The court simply rejected the argument that "treated as property passing from the decedent" in §2044(c) equates to ownership for valuation purposes.

The Service has been equally unsuccessful in two subsequent cases. *Estate of Mellinger*¹⁰⁵ involved stock in Frederick's of Hollywood, Inc. ("FOH"). Mr. and Mrs. Mellinger owned as community property a 54.7% interest in FOH. At Mr. Mellinger's death, he left his community interest in a QTIP trust for the benefit of his wife during her life with remainder to her children. She subsequently placed her remaining one-half interest in a revocable trust. At her death, the appraisers hired by her estate appraised the stock in the QTIP trust as one block of minority stock and the stock in the revocable trust as a separate block of minority stock. The Service argued that the two blocks should be aggregated, creating one control block. Chief Judge Cohen wrote the opinion and determined that each block was to be valued separately. In rejecting the Service's first argument Judge Cohen wrote that there was nothing the statute or the legislative history that indicated that §2044 required that the surviving spouse was to be treated as the owner of the property in the QTIP, thereby creating an aggregation of interests. The Court pointed to several sections of the Code (§§267, 318, 544) which required aggregation, indicating that Congress knew how to require that if it so desired. In her analysis, Judge Cohen treated the interests in Mrs. Mellinger's revocable trust as being includible under §2033 rather than under §2036 or §2038. It is doubtful that this error affected the reasoning or the outcome.

The Service also argued that *Propstra, supra*, and *Bright, supra*, are distinguishable in that each of those situations involved the death of the first spouse and whether the deceased spouse's community interest should be aggregated with the surviving spouse's community interest for valuation purposes. Neither involved §2044. The Court's reply was that the principal was the same. §2044 was designed to assure that the property as to which taxation was deferred at the death of the first spouse did not ultimately escape taxation, not to create ownership in the survivor. The survivor neither owned nor controlled the property, and therefore

¹⁰⁴*Id.* at 198-199.

¹⁰⁵112 T.C. 4 (1999)
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it should not be included in the survivor's estate for the purpose of valuation.

The Court also rejected the Service's argument that §2044(c), requiring that the QTIP property be treated as passing from the decedent, was itself a valuation section.

In a second case, *Estate of Nowell*¹⁰⁶, Mr. and Mrs. Nowell had each created a revocable trust to contain their respective one-half of the community.¹⁰⁷ At Mr. Nowell's death, his trust was divided into a bypass trust, an exempt QTIP trust and a non-exempt QTIP trust. The trusts then formed two family limited partnerships with the Mrs. Nowell's trust. At Mrs. Nowell's death, the Service sought to aggregate the family partnership interests held in the QTIP trusts with those held in the survivor's revocable trust. Judge Cohen reached the same result as in *Mellinger*. Interestingly enough, the opinion recited that Mrs. Nowell was a co-trustee of all the trusts, when in fact her grandson was the sole trustee of the QTIP trusts. Additionally, the opinion failed to recite the fact that Mrs. Nowell had a special power of appointment over the QTIP trusts. Both *Bonner* and *Mellinger* had apparently relied in part on the fact that the surviving spouse had no control over the disposition of the QTIP trust.

These decisions, which do much to take the air out of the Service's arguments regarding aggregation, still leave some questions unanswered, particularly with regard to the facts in *Nowell*. Where there is more than one QTIP trust, should the QTIP trust be aggregated. My tentative answer is "yes" because of the commonality of attributes, and because it would prevent much game playing which cannot really be justified as a matter of policy. Second, how important, if at all, should it be that the survivor has some control over the ultimate disposition of the QTIP. There I believe that such a power should have no effect on the aggregation issue. the analysis that §2044 does not create ownership is still valid, and thus a special power held by the spouse should have no effect.

2. Valuation When Funding Specific Bequests

¹⁰⁶T.C. Memo 1999-15 (1999)

¹⁰⁷There is no way that this can really be accomplished. One spouse cannot transfer his or her community interest in the absence of a partition. For example, in Texas, a spouse (say the wife) who has management rights over community property may dispose of such property. However, if she attempts to dispose of her community one-half interest in the property, what is left is still community property of her and her husband.

The problems that may be encountered in funding specific bequests and the valuation of assets were highlighted in *Chenoweth v. Commissioner*.¹⁰⁸ The decedent's will gave 51 percent of the shares of stock in his corporation (in which he owned all the stock) outright to his spouse. Although the Service and the estate's representatives agreed on the value of the corporation, they disagreed on whether the spouse's 51 percent of the shares were entitled to a control premium for valuation purposes when calculating the marital deduction. The Tax Court denied the Service's motion for summary judgment, holding that the spouse's 51 percent was entitled to a control premium and remanding to determine the amount. The Tax Court declined to follow *Provident National Bank v. United States*,¹⁰⁹ in which the court held that the value for inclusion purposes and for the marital deduction must be the same. Instead, the Tax Court chose to follow *Ahmanson Foundation v. United States*,¹¹⁰ in which the court held that the value of a charitable deduction consisting of entirely non-voting stock was less than the prorata interest in the corporation. Thus, a marital gift involving a controlling interest can be valued at more than its pro rata value in funding the marital deduction. The reverse side of *Chenoweth* can be seen in T.A.M. 90-50-004 (Oct. 14, 1993) in which the son's trust received 51 percent of the stock and the marital trust received 49 percent. In calculating the marital deduction, the Service ruled that the estate must discount the minority value assigned to the wife's trust. Thus, when the will bequeathed the preferred stock to the bypass trust and the common stock to the marital share, the marital deduction was required to be computed at a reduced value reflecting the loss in voting power.¹¹¹ To understand the impact of *Chenoweth*, a specific example may be helpful. This example will be carried forward into future discussions also. Assume that the corporation in *Chenoweth* had a total value of \$2,000,000 with 10,000 shares outstanding, thereby producing a value per share of \$200. At this point, because the decedent owned all the shares, no discount or premium issues arise beyond those inherent in the basic valuation.¹¹² But, once the funding occurs, then these issues arise. Assume for purposes of this illustration that the control premium and the minority discount are both 30 percent.¹¹³ Applying these assumptions to the *Chenoweth*

¹⁰⁸88 T.C. 1577 (1987).

¹⁰⁹581 F.2d 1081 (3d Cir. 1978).

¹¹⁰674 F.2d 761 (9th Cir. 1981).

¹¹¹To the same effect, see T.A.M. 94-03-005 (Oct. 14, 1993), which held that the gross estate valuation of both common and preferred combined was higher than the valuation of either share because as a block they had more value than each share alone.

¹¹²The *Chenoweth* court assumes that the valuation of a 100 percent interest carries a control premium but then goes on to indicate that an additional control premium attaches when the stock is split into its component parts.

rationale, the following results:

Bequest of 51% of \$2,000,000 to spouse	\$1,020,000
Control premium (30%)	<u>306,000</u>
Value of marital deduction	<u>\$1,326,000</u>
Bequest of 49% of \$2,000,000 to son	\$ 980,000
Minority discount (30%)	<u>294,000</u>
Value of minority interest	<u>\$ 686,000</u>
Total "value" distributed	<u>\$2,012,000</u>

The basis in the hands of the wife should be \$1,326,000 while the basis in the hands of the son should be its discounted value since arguably those values are the values included in the gross estate.

While the *Chenoweth* court stated that the total value after applying control premiums and minority discounts could not exceed the value included in the gross estate, that would seem to depend upon the discounts and premiums applied. There is a certain logical appeal to the proposition that the whole cannot be greater than the sum of its parts, or *vice-versa* and thus some modification to the above example may be required.

3. Where Does All This Premium and Discount Leave Us?

While the use of premiums and discounts in funding bequests is not entirely new, it has suddenly assumed center stage, and the extensions of the rationale originally urged by taxpayers will certainly take some unanticipated twists and turns. In a world in which "be careful what you wish for, you may get it" must be the watchword, we have really wished ourselves into a mess. Some of the issues which may arise are:

1. Funding of Pecuniary Bequests.¹¹⁴

In all of the cases and administrative interpretations, the premium or discount arose from a specific bequest of a control or minority interest. But, does the will itself have to direct the apportionment of control and minority interests, or are the values of the marital and non-marital share affected by the funding decisions of the executor? Both *Ahmanson* and *Chenoweth* would

¹¹³In the reported cases, the minority discount is usually greater than the control premium. Additionally, although a discussion of valuation methods is beyond the scope of this paper, it should be noted that the size of the block can impact the premium or discount; *e.g.*, a 2/3 block may carry a higher premium than a 51 percent block because, under the laws of many jurisdictions, it takes a 2/3 vote to dissolve the corporation or to sell substantially all the assets of the corporation. Blockage discounts and lack of marketability discounts also play into the ultimate valuation process.

¹¹⁴See the discussion of funding marital bequests, *supra*.

hold, correctly, that the decisions of the executor in distributing assets would not affect the amount of the marital deduction except as to a distribution in satisfaction of specific bequests. However, even though the executor's funding decisions would not be relevant in valuing the bequest, it would affect the funding of pecuniary bequests. Thus, if there were a pecuniary marital bequest funded with a "true worth" (date of distribution) value, the allocation of 51 percent or more to the marital share should result in more assets (other than the closely held stock) being diverted to the exemption equivalent share because less of the other assets would be needed to fund the marital share. Conversely, if the credit shelter or bypass gift is the pecuniary gift, funding the gift with less than control should cause a minority discount to apply to the stock, thereby enabling more of the other assets of the estate to be shifted to the credit shelter and away from the residuary marital gift. While at first blush this does not seem like the correct result, it follows logically from the control premium and minority discount analysis. Note that in both cases, the marital share, when valued at the death of the surviving spouse, contains a control premium unless some post-mortem planning is done.

CAVEAT: While all the tax considerations described below are important, the asset being manipulated (for lack of a better word) may well be a principal source of the family unit's wealth and income, and considerations of control from a business standpoint should probably predominate over tax considerations. Fiduciary duties also impact these decisions.

Using the same corporation and premium and discount as in the above example, also assume an optimum marital deduction plan, with a true worth funding clause, but the decedent owns only 60 percent of the entity, and no allocation of that interest is made by the will. The fact that the decedent owned less than 100 percent puts an interesting spin on the analysis. The basic calculation of value for inclusion in the gross estate should be:

CALCULATION FOR INCLUSION	
Total value of corporation	\$2,000,000
Percent owned by decedent	<u>60%</u>
Value includible before premium	
premium	\$1,200,000
Plus 30% premium ¹¹⁵	<u>360,000</u>
Total value includible in gross estate	<u>\$1,560,000</u>
Value per share	

¹¹⁵While it may at first blush seem strange that a 100 percent interest is calculated without a control premium when a 60 percent interest carries such a premium, that analysis is the very essence of this valuation approach, in that the whole is 100 percent, but its component parts may be more or less than that, because the value per share varies with the relation of the size of the block. To maintain some degree of simplicity, the calculations do not include any blockage or lack of marketability discount.

(\$1,560,000/6,000 shs)

\$260/share

Now, some further assumptions are necessary to indicate the effect on funding of the marital and bypass gifts. For purposes of this analysis, it does not matter whether the marital deduction gift is outright or in trust. Assume that the taxable estate before the marital deduction in an optimal marital deduction plan, exclusive of the closely held stock, is \$3,000,000. The calculation of the marital deduction would be as follows irrespective of whether the marital share is pecuniary or residuary:

CALCULATION OF MARITAL DEDUCTION

Assets other than	
closely held stock	\$3,000,000
Closely held stock @ \$260/share	1,560,000
Less: Bypass gift ¹¹⁶	<u>-600,000</u>
Marital deduction gift	<u>\$3,960,000</u>

If the bypass share is the pecuniary gift, then funding such gift with anything less than 51 percent of the outstanding stock of the corporation will (should?) arguably cause the stock to be valued at a discount, thereby shifting value away from the marital share by increasing the value of other assets to be allocated to the bypass gift. To analyze this, we must return to the basic example of \$2,000,000 as the value of the corporation as a whole with 10,000 shares outstanding. Thus, the unadjusted value per share is \$200. If there is a 30 percent discount for a minority interest, then the discounted value per share is \$140. If the bypass is fully funded with shares of stock, two minority blocks are created. Under the example, 4,285 shares at the discounted value of \$140/share are required to fully fund the bypass ($\$600,000 \div \$140/\text{share} = 4,285$ shares), with the following result in funding the marital deduction:

Value of shares allocated to marital share:

Total shares in estate	6,000 shs
Shares used to fund bypass	<u>4,285 shs</u>
Shares allocated to marital deduction	1,715 shs
Multiplied by discounted value per share	<u>\$140/sh</u>
Value of shares allocated to marital gift	<u>\$240,100</u>

¹¹⁶ Assumes death occurred in 1997.
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When the funding of the marital deduction is calculated, it is apparent that substantial value has been shifted away from the marital deduction share. This will make no difference until the marital share is valued upon the death of the surviving spouse.¹¹⁷

Value of shares allocated to marital gift	\$ 240,100
Value of other assets	<u>3,000,000</u>
Total value of marital share	\$3,240,100
Marital deduction allowed	<u>3,960,000</u>
Value which has “vanished”	<u>\$ 719,900</u>

While the result may seem a bit bizarre, it is consistent with the gift tax analysis discussed above. In valuing the gross estate, how the property passes is not considered, but in funding pecuniary bequests, the value of the property passing to each bequest is taken into consideration. While the regulations limit the marital deduction to the property actually “passing” to the spouse, this change in value should be treated no differently than other adjustments in market value.¹¹⁸

If, on the other hand, the marital share is the pecuniary gift, transferring at least 51 percent or more of the stock to the marital share will (should?) arguably cause the premium that was used in valuing the stock in the decedent’s estate to be used in valuing the marital gift, thereby preventing an over-funding of the marital deduction. Assume that all the stock in decedent’s estate were allocated to the pecuniary marital deduction gift:

Marital deduction	\$3,960,000
Value of stock	<u>1,560,000</u>
Non-stock assets required	\$2,400,000
Non-stock assets available	<u>3,000,000</u>
Assets available to fund bypass	<u>\$ 600,000</u>

¹¹⁷The same is true if a control block happens to end up in the marital share.

¹¹⁸See P.L.R. 91-13-009 (Dec. 21, 1990), discussed *supra*. See also T.A.M. 86-42-007 (July 3, 1986), T.A.M. 86-49-002, and P.L.R. 88-26-078 (Apr. 7, 1988) dealing with whether a pecuniary bypass using true worth funding would permit the residue to qualify for the marital deduction.

Note that the allocation of the stock with a control premium to the marital deduction does not allow more value to be shifted to the bypass. It simply avoids underfunding the bypass trust, as would be the case if stock with less than control were allocated to the pecuniary marital gift because more “other assets” would be required to be allocated to the marital share. This funding approach will, as noted above, place stock with a control premium in the survivor’s estate. Some planning should thereafter be done to dispose of the control block during the survivor's lifetime. Then, at the survivor's death, isn't the inclusion that of a discountable minority interest (assuming no aggregation with stock owned by the surviving spouse) so that in effect the control premium has disappeared, and a discount has been created? Under the rationale of Rev. Rul. 93-12 *supra*, even if the beneficiary of the exempt trust and the QTIP trust at the survivor's death is the same, so that control is ultimately reestablished, they should not be aggregated.

Note, also, that if stock carrying control premium is not allocated to the marital deduction share, an underfunding of the bypass will result. In fact, in the above example, if the discounted value is correct, less than 51 percent cannot be allocated to the marital deduction because the other assets will not fully fund the marital.

Marital Deduction	\$3,960,000
4,950 sh @ discounted value of \$140/sh	<u>693,000</u>
Amount of other assets to fund marital	3,267,000
Other assets available	<u>3,000,000</u>
Shortfall	<u>\$ 267,000</u>

When the shortfall is made up from stock, over 51 percent is then allocated to the marital deduction share, creating a control premium and producing the result of funding the bypass at \$600,000. (This ignores the possible difference in control premium between a 60% block and a lesser block.)

If the standard for funding the pecuniary bequest is federal estate tax value, the answer is even less clear. Logically, the generated discount should be treated as any diminution in value, and the Rev. Proc. 64-19, *supra*, standard should take care of any problems. If the standard for funding the pecuniary bequest is minimum worth, then it would appear that the discount for minority interest would always cause the marital to be over funded.¹¹⁹

Suppose the gift to be funded is a fractional gift. The value of the estate as to which the fraction is determined is the value at date of death, which includes the control premium. In funding a true fractional share, using the above examples, if the fraction going to the bypass

¹¹⁹ It is unlikely that the minimum worth standard will continue to be used because of the GSTT regulations. Treas. Regs. §26.2642-2(b)(2).

causes more than 10 percent of the stock to pass to that share, the marital share will automatically have a discounted value at the second death (again assuming no aggregation). If, however, the fractional is a pick and choose fractional, then you may well get the same result as a pecuniary bequest.

2. Can the Whole be Different from the Sum of Its Parts?

It would seem that if the controlling interest passes to multiple beneficiaries, each of which receives only a minority interest, the whole can be greater than the sum of its parts. This possibility is implied in *Ahmanson*, and despite the *dictum* in *Chenoweth*, clearly exists. It can be graphically illustrated in a situation similar to P.L.R. 94-03-005 (Oct. 7, 1994). The estate contains as its sole assets (in excess of the exemption equivalent amount) two blocks of stock which together constitute control, but which separately constitute minority interests. If one block is bequeathed to charity and the other is bequeathed to the surviving spouse, then both the charitable deduction and the marital deduction are reduced by minority discounts. Thus, where both gifts are fully deductible, a tax is nonetheless created. To say this logically cannot be so is probably correct. To say, "It ain't so, Joe" may not be.

How is this possible? If you assume that a decedent owned 80 percent of the stock of a company, and that a control premium of 35 percent is applied, how can the 80 percent interest be worth 108 percent of the value of the company? The answer to that logical conundrum lies in the fact that there is almost always a blockage or lack of marketability discount (as opposed to a minority discount) applicable to a control block, and that discount must be taken with the control premium to produce something less than 100 percent of the value.¹²⁰

3. The Community Property Problem

The surviving spouse would always own an interest in the entity in his or her own right in a community property situation. Under the *Bright* rationale, such interest in the estate of the decedent would always be eligible for a minority discount, thereby causing both the gross estate and the funding of each gift to be discounted. This situation is further complicated by the fact that the minority discounts may vary depending upon the size of the minority block; *i.e.*, a 10 percent block may carry a greater discount than a 49 percent block.¹²¹ Another problem which apparently has surfaced in California deals with basis in a non-taxable community property estate. There, an agent in an income tax audit has apparently asserted a gain based upon the fact that the community interest in the estate of the decedent should have been discounted under

¹²⁰ See *e.g.*, *Lewis G. Hutchens Non-Marital Trust v. Commissioner*, 66 T.C.M. 1599 (1993).

¹²¹ One commentator suggests the use of two marital trusts with the stock split between them to create two minority interests. Would that be effective, and even if it were, would they remain minority interests or be aggregated at the death of the survivor? Would it make a difference if the beneficiaries were different? This device is beyond my risk tolerance level.

Bright, thereby changing the basis in both halves of the community, and reducing the value of the stock below its undiscounted fair market value. If *Bright* is good law (and I would argue that it is) doesn't this mean that in every community estate there is a discount required to be taken to determine basis of any asset constituting an undivided interest or minority interest?

4. Basis Problems

For purposes of income tax basis, §1014 provides that the basis of property passing from the decedent shall be the fair market value at date of death.¹²² Since the property passing to the spouse in these situations may have either a control premium or a minority discount at date of death, the fair market value used for basis should be its date of death value and not "funding" value. This is consistent with the treatment of any asset which changes value during the course of administration. Thus, funding a pecuniary bequest with stock which carries a premium greater than its inclusion value would arguably trigger a gain.

If the funding is of a pecuniary bequest so that it is an event which causes a recognition of income, there can no longer be a loss on funding because of the reduction in value below the gross estate value if the bequest is to a trust. The Taxpayer Relief Act of 1997 amended §267 to include an executor of an estate and a beneficiary in the class of related persons among whom losses cannot be recognized.

Suppose a taxpayer and spouse own 100 percent of a corporation as community property. Husband is terminal and wife makes a gift of 1 share to husband before his death. He would then own a majority interest subject to a control premium (since valuation would not be dependent on the community or separate character of the stock). Would his wife's interest then receive a step-up based upon that value in the estate?

As a final note on this matter, it must be observed again that the complications of dealing with closely held business interests is only in part a tax issue. The greater issue is the business reality of control of the enterprise.

4. Does 2033A Make a Difference

The analysis does not change merely because of a §2033A election. Assuming that the Decedent owned 100% of the QFOBI, a pecuniary marital deduction to which more than 51% was funded would pack more value into the bypass because of the control premium *a la Chenoweth*. Likewise, if a minority block were funded to a pecuniary bypass, more value would be "sucked into" the bypass, thereby reducing the property passing to the residuary marital.

¹²²See Treas. Reg. §1.1014-3(a).

5. Penalties

As if the problems were not already difficult enough, § 6662(g) imposes substantial penalties for undervaluations for estate and gift tax purposes. Although subject to a reasonable cause exception in §6664(c)(1), there is little or no guidance as to how the penalty provisions will be applied in discount situations.

6. PURCHASE OF REMAINDER INTEREST IN QTIP TRUST

Under §2519, the transfer by the surviving spouse of his or her income interest creates a gift of the remainder interest, and this fact may have some appeal in some planning situations. A device, for lack of a better term, that has now been circulating for several years, is the suggestion that the surviving spouse might purchase the remainder interest in the QTIP trust using his or her own assets. Since the entire value of the QTIP trust will be included in the estate of the survivor, the result of this transaction, if successful, would be to remove the survivor's own assets while not incurring a transfer tax. For example, assume that the fair market value of the QTIP is \$8,000,000 and the actuarial value of the remainder interest is \$2,000,000. The surviving spouse buys the remainder interest from the remainderman, and as a result, the \$2,000,000 purchase price and all the income therefrom and the appreciation thereon has been removed from the survivor's estate. Plus, the remainder beneficiary now has \$2,000,000 currently rather than having to wait until the death of the survivor. It has a seductive simplicity about it, and there is no clear statutory or regulatory prohibition. However, the Internal Revenue Service has recently promulgated Rev. Rul. 98-8¹²³ in which it applied §2519 analysis to create a gift of the value of the QTIP at the time of the purchase of a remainder interest. The Ruling reasoned that the purchase of the remainder by the surviving spouse was, in effect, a commutation of the QTIP interest, and thus was a disposition of the income interest. While some might argue with the analysis, it has a certain appeal and internal logic and clearly signals the Service's intention with respect to this type of transaction.¹²⁴

7. ALLOCATION OF ADMINISTRATION EXPENSES TO INCOME

¹²³I.R.B. 1998-6 (2/6/98)

¹²⁴For a discussion of the case of *Estate of Olsten* in which this transaction was actually done, see Golden, 31 Heckerling Institute ¶ 1600, ¶1607.
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There has been a spate of activity recently concerning whether administration expenses should be deducted on the federal income tax return rather than on the federal estate tax return. Taxpayers noted that the administration expenses provided no immediate tax benefit when deducted on the Form 706 in optimal marital deduction planning, whereas they would provide an immediate income tax deduction if such expenses could be claimed on the estate's federal income tax return. However, there was the nagging issue as to whether taking the income tax deduction would decrease (or perhaps even cause the bequest not to qualify for) the marital or charitable deduction. The resolution of that issue depends upon the effect such choice will have on the marital deduction or the charitable deduction since the highest federal income tax rate is only slightly more than the lowest marginal federal estate tax rate after considering the unified credit. The Code permits the executor to deduct the reasonable expenses of administration (§2053) and losses incurred during administration (§2054) from the gross estate. Certain of those deductions, commonly known as "swing items," can be deducted on either the income tax return for the estate or the estate tax return.¹²⁵

1. If the Deductions Are Taken on the Federal Estate Tax Return

Traditionally, even in optimal marital plans, administration expenses have been deducted on the federal estate tax return. The results are certain and the calculations are easy.

(i) In an optimal marital plan, the deductions will reduce the marital share because the exemption equivalent share will always equal the exemption equivalent amount, whether it is the residuary or pecuniary bequest.

(ii) In other than optimal marital plans, the deductions will reduce the share to which allocated, either by the will, by statute or common law of the decedent's domicile.

2. If the Deductions Are Taken on the Income Tax Return

If the decision is made to seek a current income tax deduction for all or part of the administration expenses on the income tax return, then the considerations become much more complex, and the tax results differ markedly depending upon whether the expenses, although deducted for income tax purposes, are charged to income or principal.

¹²⁵To be deductible for income tax purposes, the deduction must be one allowable under either §165 or §212. Treas. Reg. §1.212(g)-1. The executor is required by regulations to file an election under §642(g) to take the deductions on the income tax return. That election is irrevocable and waives the right to claim such amounts on the estate tax return. Treas. Reg. §1.642(g)-1.

1. Deductions Charged to Principal

If the deductions taken on the income tax return are charged to principal, then the document or state law will govern the bequest to which such expense is charged. In an optimal marital plan, the document should charge such item to the credit shelter share. While this reduces the amount passing estate tax free at the survivor's death, it does not generate an immediate estate tax. If the document or state law charges the expense to the marital or charitable share, the marital or charitable share is reduced and a tax (or increased tax) is created, and (assuming that taxes are also charged to the marital or charitable share) this in turn creates more tax because the share is further reduced by the taxes to be paid therefrom. Thus, an interrelated algebraic computation must be performed to calculate this tax on a tax.

2. Deductions Charged to Income

If the deductions are charged to income, and if that allocation is effective for federal estate tax purposes, then an immediate income tax deduction is achieved with no concomitant increase in estate tax or decrease in the credit shelter share. The Treasury Department has, in the past and despite its own regulations, taken the position that if the deductions are charged to income, the marital share must be reduced by the amount of such charge.

It would seem that the income of the estate could be, and logically should be, burdened with that portion of the administration expenses necessarily incurred to earn that income. If the income were turned over to the trustee to manage, the trustee would clearly charge the income account with a portion of its fees. As a matter of policy, a portion of the executor's fees should be allocable to income while the executor is serving as a surrogate trustee.¹²⁶ The deduction of certain fees as income tax expenses is the flip side of the proposition that certain trustee's fees and certain trust administration expenses are deductible for federal estate tax purposes under §2053.¹²⁷ However, this is not the issue with which the courts have dealt directly, and the approach of the courts has less to do with logic and equity than it does with the precise language of the regulations.

C. The Confusion in the Lower Courts

While the Tax Court has been consistent, the appellate courts have been all over the map with different rationales.

¹²⁶Texas law, for example, follows this common sense approach by permitting "fees of an attorney, accountant, or other professional advisor, commissions and expenses of a personal representative, court costs, and all other similar fees and expenses relating to the administration of the estate" to be allocated between income and principal as the executor determines to be just and equitable. Tex. Prob. Code §378B(a) West (1996).

¹²⁷Treas. Reg. §20.2053-3(b)(3) and §20.2053-8(a).

The Tax Court has consistently taken the position that if either the instrument or state law permits the charge of certain administrative expenses against income, then the election to take those items on the 1041 and to charge them against income will not cause a diminution of the charitable or marital deduction, particularly if the document contains a savings clause. *Estate of Street v. Commissioner*.¹²⁸

¹²⁸56 T.C.M. 774 (1988), reversed in part and affirmed in part, 974 F.2d 723 (6th Cir. 1993). *See also Estate of Horne* 91 T.C. 100 (1988), in which the executor's commissions were paid out of income and deducted on the estate's income tax return in an attempt to increase the estate tax charitable deduction while decreasing the estate's income tax liability. The Tax Court disallowed the allocation based on South Carolina law.

In *Estate of Richardson v. Commissioner*,¹²⁹ the Tax Court held that interest on unpaid taxes could be charged to income. In *Estate of Street*, the appellate court affirmed the Tax Court's position in *Richardson* as to interest on taxes, but held that other administration expenses could not be charged to income, directions in the instrument or state law notwithstanding. The Revenue Service has now determined that interest on death taxes may be deducted for income tax purposes without diminution of the marital deduction even if state law requires that such expense be paid from the marital share.¹³⁰ What is bizarre, however, is the appellate court's basis for that distinction when it "reasoned" that "[A]dministrative expenses accrue at date of death, but interest expenses accrue after death." HUH? The Tax Court, in *Estate of Hubert v. Commissioner*,¹³¹ dealt with this absurd argument in holding that estate expenses could not accrue at date of death, and that state law governed the allocation subject to the valuation requirement in the regulations.¹³²

¹²⁹89 T.C. 1193 (1987).

¹³⁰Rev. Rul. 93-48, 1993-25 I.R.B. 9. See also P.L.R. 93-26-002 (Mar. 18, 1993).

¹³¹101 T.C. 314 (1993).

¹³²See also *Estate of Allen*, 101 T.C. 351 (1993) applying Oklahoma law, and maintaining the Tax Court's position that the issue is controlled by state law and the instrument.

In *Burke v. United States*,¹³³ the court enunciated its rationale for the disallowance of what it termed a “double deduction.” The residuary beneficiary in *Burke* was a charity. The estate charged the bulk of the administration expenses to the post-mortem income of the estate. *Burke* found that the source of payments is irrelevant, and all administrative expense deductions must be charged to the gross estate and accounted for with respect to the gross estate. Additionally, the court states that the same deduction is being allowed twice - the deduction for administration expenses under §2053, which the estate elected to take on the income tax return, and the charitable deduction under §2055. What this line of reasoning ignores is the fact that the income tax and the estate tax do not stand *in pari materia*. The former is a tax levied on gross income and the latter is an excise tax on the right to transfer property. The availability of a deduction under one tax does not affect the ability to deduct that item under the other unless the statute and the regulations specifically so provide. In this area, the ability to deduct administration expenses for income tax purposes should not affect the specific deductions allowed under §§2055 and 2056. *Burke* also gives a clue as to why the *Street* court (which issued its opinion first) felt the need to deal with the issue as to when administration expenses accrue. The legislative history of the marital deduction in 1948 provides that the marital deduction cannot be increased by paying CLAIMS from income.¹³⁴ Claims, of course, accrue before death and may be deductible for both estate tax and income tax purposes depending upon the nature of the claim.

The *Street* court adopted a different rationale, saying, "Instead, Treasury Regulations §20.2056(b)-4(a) controls the tax treatment of administrative expenses paid from income regardless of state law or the dictates of decedent's will."¹³⁵ Those regulations provide in pertinent part:

The marital deduction may be taken only with respect to the net *value* of any deductible interest as if the amount of a gift to the spouse were being determined.

In determining the value of the interest in property passing to the spouse account must be taken of any material limitations on her right to income from the property. An example is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the

¹³³994 F. 2nd 1576 (Fed.Cir. 1997) cert. den. 114 S. Ct. 546 (1997). The *Burke* court rejected the holding in a Fifth Circuit case which is probably confined to its facts. After contentious litigation in which literally millions of dollars of legal fees were paid, the court permitted the parties, by settlement agreement which settled the entire lawsuit, to allocate charges to income and principal without reducing the charitable bequest. *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993).

¹³⁴S. Rep. No. 1013 at II-6 (1948).

¹³⁵974 F.2d 723 at 729.

decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate." (Emphasis added).¹³⁶

The *Street* court then held that those regulations require that the marital bequest must be reduced dollar for dollar.

In *Estate of Hubert v. Commissioner*,¹³⁷ the 11th Circuit relied on the above regulation in finding that there was no material limitation on the spouse's right to receive income and thus no reduction of the marital deduction.

The court's analysis was that the income reduction to the spouse because of the administration expenses was not material in relation to the income which would be generated over her life expectancy. Thus, the court found that the issue was one of fact, and that an automatic dollar for dollar reduction was not contemplated.

D. The Supreme Court Adds to the Confusion

¹³⁶Treas. Regs. 20.2056(b)-4(a).

¹³⁷63 F.3d 1083 (11th Cir. 1995).
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On March 18, 1997, the United States Supreme Court issued its opinion in *Commissioner v. Estate of Hubert*¹³⁸, which unfortunately sheds more heat than light on this issue. There were four opinions in the case -- a plurality opinion by Justice Kennedy, a concurring opinion by Justice O'Connor, and dissenting opinions by Justice Scalia and Justice Breyer. Only one thing is truly clear from the opinions, and that is that the allocation of administration expenses is a valuation not a qualification issue.

Justice O'Connor noted in the concurring opinion:

“Logic and taxation are not always the best of friends.” *Sonneborn Brothers v. Cureton*, 262 U.S. 522 (1923) (McReynolds, J. concurring). In cases like the one before us today, they can be complete strangers. That our tax laws can at times be in such disarray is a discomfoting thought.¹³⁹

The plurality opinion states that the marital deduction is not to be reduced in this case because the allocation of administration expenses to income does not constitute a material limitation on the marital gift. However, the test proposed by the plurality is, to say the least, somewhat difficult to apply. The plurality would require that the marital deduction be valued at date of death by taking into account anticipated administration expenses and anticipated income. It states:

Where the will requires or allows the estate to pay administration expenses from income that would otherwise go to the surviving spouse, our analysis requires that the marital deduction reflect the date-of-death value of the expected future administration expenses chargeable to income if they are material as compared with the date-of-death value of the expected future income. Using this approach to valuation, the estate will arrive at the “net economic interest received by the surviving spouse.”¹⁴⁰ (emphasis added.)

The reality would be that the enunciated test, which appears to require a gift of prophesy, will result in the application of 20-20 hindsight. The observation of the plurality that this foresight test is no more difficult to administer than the valuation of closely-held business interests is simply not grounded in reality. What sort of evidence will need to be produced to

¹³⁸ ___ U.S. ___ (1997); 117 S. Ct. 1124; 1997 U.S. Lexis 1920

¹³⁹ 1997 U.S. Lexis 1920, at p. 13

¹⁴⁰ *Id.*, at p. 11-12

show the calculation of the marital deduction as of date of death? The plurality also found that the allowance of an income tax deduction did not create a double deduction because the marital deduction was valued after taking into account that fact.

It is important to remember that five of the nine justices (the concurring and dissenting justices) believed that the allocation of \$1.5 million to income in this case constituted a material limitation. However, the concurring justices felt compelled to uphold the Tax Court because the Commissioner failed to introduce any evidence as to the materiality of the reduction and relied solely on the argument that the reduction of the valuation of the marital deduction was a dollar for dollar reduction. Further, the concurring justices felt that the Commissioner's own regulations were unclear and did not sustain the Commissioner's position. The concurring justices then went on to invite the Commissioner to resolve this problem in the future by promulgating new regulations:

The question presented is simple and its answer should have been equally straightforward. Yet we are confronted with a maze of regulations and rulings that lead at times in opposite directions. There is no reason that this labyrinth should exist, especially when the Commissioner is empowered to promulgate new regulations and make the answer clear. Indeed, nothing prevents the Commissioner from announcing by regulation the very position she advances in this litigation.¹⁴¹

Justice Scalia basically felt that \$1.5 million was material by any test, and would remand to the Tax Court to deal with the valuation issue. Further, both dissenting Justices felt that the test enunciated by the majority was unadministrable.

E. The Service's Response

Answering the call of the plurality, the Internal Revenue Service has issued Notice 97-63¹⁴² with a view to issuing new regulations. In that Notice, the Service asked for comments concerning three approaches to the allocation of administration expenses to income:

- (i) Only expenses which were not "properly chargeable to principal" under Treas. Regs. §20.2053-3 could be allocated to income without being a material limitation.
- (ii) A *de minimis* safe harbor based upon a percentage of income earned during administration or a flat dollar amount. Any payments in excess of the safe harbor would be considered a material limitation.

¹⁴¹ *Id.*, at p. 18

¹⁴² 1997-47 I.R.B. 6 (11/24/97)

- (iii) A dollar for dollar reduction of the marital deduction for any amount of administration expenses charged to income.

There would appear to be little practical difference between the tests in (i) and (iii). How different the second test would be depends upon the percentage or amount chosen. ACTEC has indicated a preference for the second test along with the suggestion that the percentage selected should not be a token amount. The College recognizes the administrative difficulties in using a percentage of income over a prolonged administration, but still finds this approach preferable. At the time of this writing, the ABA sections have not taken a position.

Treasury also requested comments on “(1) whether the test for materiality under section 20.2056(b)-4(a) should be a quantitative test based on a comparison of the relative size of income and expenses charged to income; (2) whether materiality should be determined based on projections as of the date of death rather than on facts developed afterwards; and whether present value principles should be applied and, if so, how the practical difficulties of a present value calculation can be overcome.”

A quantitative test based on relative size of income and expenses would clearly be the best test. Basing this test on estimates could lead to real practical problems even greater than those occasioned by relying on actual but changing facts. The use of present value, as suggested by the Supreme Court, would inject a degree of complexity that is just not warranted, while not producing any greater fairness. As noted above, however, present value principles would seem to indicate that there is no material limitation assuming that the survivor does not die shortly after the death of the first spouse.

F. What To Do in the Meantime

The economic analysis supports the contention that the real economic interest of the spouse is not affected by the allocation of administration expenses to income. In analyzing the results of these cases, there are some points which come clear. If one assumes that the spouse will consume all the income, then, if the spouse lives several years, the spouse will eventually receive more income because the principal is larger. If the spouse is to reinvest all income, then ultimately the spouse will come out better since the first year total of income and principal will be larger because of the income tax deduction. There is almost no scenario, other than a very short survival period by the spouse, which will result in the spouse receiving materially less. And indeed, if the income tax deduction causes the imposition of an estate tax, the amount to the spouse will be smaller because of the tax on a tax calculation.

In light of that analysis, it would seem reasonable to allocate a portion of administration expenses to income. However, following the old Wall Street maxim about bulls and bears getting rich and pigs getting slaughtered, if you elect to charge administration expenses to income, you should allocate those expenses between income and principal in a reasonable manner based upon the facts in the particular estate. Under no circumstances should all

administration expenses be allocated to income.

8. FORMATION OF LIMITED PARTNERSHIP

Because of the discounts available in transferring limited partnership interests, the creation of a limited partnership is often viewed as an inter-vivos planning device. However, there is no reason that they cannot be used after death as well. The surviving spouse could form a limited partnership with the trustee of the QTIP trust as well as perhaps other family members which could produce a huge savings at the death of the surviving spouse. The regulations make it clear that the QTIP is included in the estate of the survivor at its fair market value at the date of the survivor's death.¹⁴³ There is no trigger under §2519 for the sale or transfer of assets so long as it does not result in a disposition. It is this kind of situation, however, in which the requirement that the spouse must have the right to require the trustee to make property productive arises. Some care must be exercised in the drafting, and there may be a necessity for the protection of the trustee to get the court to bless the transaction, depending upon the identity of the remaindermen. After all, there may be a real question of prudence if the trustee exchanges fee interests in assets for a limited partnership interest. And all of the arguments available to the Internal Revenue Service concerning the creation of Family Limited Partnerships are available here, including the argument that the creation of the partnership is in itself a gift, thereby potentially triggering §2519. As noted above, counsel must always be aware that tax planning techniques sometimes create fiduciary liability problems which must also be solved.

9. CONCLUSION

What seemed extremely simple a little over a decade and a half ago has, not surprisingly, proved a good deal more complex. Some of the problems not contemplated by the original draftsmen of the statute have surfaced, and each passing day brings an increased realization to how multi-faceted the unlimited marital deduction and the QTIP provisions are. Further, the administration of marital deduction bequests and the elections required in such administration abound with uncertainties, and traps for the unwary executor proliferate. In the administration of estates, we have only begun to scratch the surface of the problems, especially in light of the growing instability of the family unit and the increased focus on fiduciary liability. Added to all of the other problems is the fact that tax reform constantly impacts marital deduction planning either directly or indirectly. All of the problems, all of the complexities proclaim the need for an ever-increasing degree of proficiency and professionalism, inevitably demonstrating that in the fast changing world of tax and probate law, nothing is certain but uncertainty.

¹⁴³Treas. Reg. §20.2044-1(d).