BACK TO THE FUTURE - THE MARITAL DEDUCTION
FROM BEFORE ERTA TO AFTER ATRA

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I. 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 (QTIP)\(^1\), both of which constituted major philosophical as well as legal changes in the taxation of estates of married decedents. The idea of tax deferral until the second death was immediately popular, even though that deferral might produce a higher overall tax due to the combined effects of “stacking” of the two estates and inflation. The stacking problem has been virtually eliminated due to the compressed brackets, but the effect of inflation (should it reoccur) and potentially higher tax rates still looms. The idea of paying no tax before its time still rules the day. However, even more than three decades after its enactment, some old problems still remain, and new ones have surfaced due to changes in the law over that period. 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in light of Chapter 14, about which the only really good thing that can be said is that it is better than the now repealed § 2036 (c)], the interaction of discounts and premiums in funding, and constant legislative change, the most recent example of which is portability of the unified credit\(^2\).

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 of just saving taxes. In other words, many of these tax planning ideas carry the potential of fiduciary liability.

II. A VERY IMPORTANT OBSERVATION

When dealing with drafting in this new age of $5,000,000 plus exemptions and portability, it is of the utmost importance that the reader keep in mind this not so obvious fact – THE AVAILABILITY OF INCREASED EXEMPTIONS DID NOT SIMPLIFY OUR LIVES

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1. §2056 (b)(7). All Section references are to the Internal Revenue Code of 1986, as amended unless otherwise indicated.

2. §2010 (c)(5).
OR THOSE OF OUR CLIENTS. It will take at least 2 or 3 years for skilled practitioner to sort through all of the problems and permutations before being able to feel comfortable with the “default” positions for clients with estates under $10,000,000 and those with estates under $5,000,000. As will be seen in that discussion, there are many questions and few answers. And every solution has its own issues.

III. PORTABILITY – THE NEW FRONTIER

§2010(c) brought into the law the concept of portability and the Deceased Spouse Unused Exemption (“DSUE”) amount, and the American Taxpayer Relief Act of 2012\(^3\) made it permanent. The concept of portability is simple enough, but the application is surrounded by a plethora of detailed rules. In its simplest form, portability is meant to allow the use of any federal unified credit which is unused by the first spouse to die. Thus the DSUE amount is reduced by any property passing to third parties (other than to charities which qualify for a deduction under §2055) or for the benefit of the spouse in a manner which does not result in a marital deduction. For example, if all of the deceased spouse’s property passes to or for the benefit of the survivor in a manner which qualifies for the marital deduction, then the deceased spouse’s unified credit will be available to the survivor.

A. Portability As A Planning Technique.

Whether or not to plan with portability is multi-faceted issue requiring an entirely new approach to analysis. The essential issues are control of devolution of assets by the deceased spouse, asset protection for the surviving spouse, generation skipping planning and what basis the assets will have in the survivor’s estate versus increasing the survivor’s estate for estate tax purposes.\(^4\)

1. All Outright to Spouse with Disclaimer.

There are those who advocate leaving the entire estate to the surviving spouse with a possibility of disclaimer in estates which in aggregate, will probably never be taxable, \(i.e.\) estate’s below $5,000,000.00. In this way, if the spouse does not disclaim, the assets will be included in the surviving spouse’s estate, receive a new basis at that spouse’s death and be covered by the DSUE amount, and the use


\(^4\) See Page 11 and the following pages for a graphic analysis of planning with portability.
of a bypass trust can be avoided. Of course, with no disclaimer, this sacrifices the
creditor protection of the bypass trust, as well as the ability of the deceased spouse
to control the devolution of the property, especially in the event of remarriage.
Equally as important, if not more so, if the surviving spouse does disclaim, the
surviving spouse will not be able to have a special power of appointment to deal
with changing conditions. It also assumes that the “last deceased spouse” rule
(discussed below) will not affect the measure of the DSUE amount. And, because
GSTT exemption is not portable, if there is no disclaimer, the decedent’s
exemption is lost. A variation on this theme would be that the spouse takes the
outright gift, donates the property to a grantor trust of which the spouse is not a
beneficiary, and uses the deceased spouse’s DSUE amount to cover the gift. (In
many cases, there is not a high probability this would be done even if the spouses
had discussed it.

2. Use of QTIP.

If the deceased spouse’s estate is left in a QTIP trust, then creditor
protection may be able to be achieved, GSTT exemption can be allocated by a
reverse QTIP election, the deceased spouse can control devolution at the second
death (or give the surviving spouse, a power of appointment which can actually be
exercised), and there is an increase in basis at the second death. The downsides
are that a mandatory income distribution may not be desirable (although this
might be limited by a 3% unitrust) and that the surviving spouse’s estate will be
increased especially if the assets appreciate during the interval between deaths.
Additionally, the last deceased spouse issue is also present.

3. Use of Traditional Bypass.

In traditional bypass there is no mandatory income distribution and
persons other than the surviving spouse can be beneficiaries. On the other hand
there is also no new basis at the second death. Balancing the loss of a new basis is
the fact that the bypass assures that the deceased spouse’s exemption will be used
to the extent of that spouse’s estate, irrespective of the repeal of portability (not
likely) and the last deceased spouse rule. And, to the extent that the first spouse’s
estate is less than the basic exclusion amount (defined below), portability will be
available to that extent.

Retirement benefits represent a large portion of many estates, and present unique difficulties in using traditional trust planning. Assuming that the intended beneficiary of the IRA is a spouse, portability presents the ability to leave such property outright to the spouse, thus obviating a need to use a bypass trust in order to prevent loss of the basic exclusion amount with respect to this asset in the surviving spouse’s estate. The surviving spouse would have the credit from the deceased spouse over what is essentially a wasting asset with a built in income tax liability that cannot be taken into account in valuing the asset for estate tax purpose.


It is important to note that GSTT exemption is not portable, and that the DSUE Amount is not adjusted for inflation. In states with state inheritance or estate taxes, the state tax is also not part of the portability regime. Thus, it is important to consider using exemption equivalents necessary to use up the state exemptions because failure to do so will increase the surviving spouse’s estate for state tax purposes.

AUTHOR’S NOTE: Experienced and thoughtful estate planners are still trying to adjust to all the issues and subtleties of the new paradigm of a $5,000,000 plus exemption equivalent and portability. The difficulties in explaining these matters to clients have increased exponentially, beginning with the decision as to whether to elect portability or not, and proceeding with increasing difficulty from there.


See Golden, “It Should Not Be This Hard: A Look at Trusts as Beneficiaries of Retirement Benefits,” 36 ACTEC LAW JOURNAL 399 (Fall 2010).

Estate of Smith v. US, 391 F.3d 621 (5th Cir. 2004)
With current exemption levels, the vast majority of estates will not be taxable and will not use all of their unified credit. Thus portability may be available and the deceased spouse will have unused exemption ("DSUE"). In order to claim DSUE, the deceased spouse’s estate must file a *timely* federal estate tax return. Because that generates additional expense, determinations must be made as to whether such expense is warranted, and, if so, who must pay for it - the estate or the surviving spouse? The decision as to whether the survivor can compel such filing and who should pay for it should be memorialized in the Will. Mandating that the executor file such return causes a loss of flexibility, and cause an expense in estates that probably will never be subject to the estate tax. In many cases, however, the surviving spouse is the principal beneficiary, so such spouse will pay for it either directly or indirectly. Several ACTEC Fellows have suggested that the portability is much like many other tax election that the executor must make, so why not just leave it to the executor and file the return if the executor decides to elect portability. (As with any other general rule, it must be considered in light of the client’s factual setting – e.g., suppose a child by the first marriage is executor and might refuse to make the election simply because she dislikes her surviving step-parent?)

1. **The Estate Tax Regulation Definitions.**

The Internal Revenue Service has issued Proposed and Temporary Regulations regarding portability. For purposes of portability, Treas. Reg. §20.2010-1T contains definitions in subsection (d). It is perhaps worth noting that what is being defined is certainly not an “exclusion”.

   **a) Applicable Credit Amount.**

The Applicable Credit Amount is determined by applying the applicable exclusion amount to the table determining the unified credit if the tentative tax is computed based on the applicable exclusion amount.

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7 Because the executor must collect fair market value information in any event so that the beneficiaries will have the basis of the inherited property, collecting such information on the Form 706 would seem to be convenient way to do so. Therefore, preparation of a Form 706 would be only marginally expensive.

8 Treas. Reg. §20.2010-1T(c)(1).
b) **Applicable Exclusion Amount.**

The applicable exclusion amount is the sum of the basic exclusion amount and the DSUE amount in the case of the surviving spouse.

c) **Basic Exclusion Amount.**

The basic exclusion amount is $5,120,000 for 2012 and $5,250,000 for 2013.

d) **Deceased Spousal Unused Exclusion Amount.**

DSUE amount is the unused portion of the deceased spouse’s unused applicable exclusion amount in effect for the year of the spouse’s death.

e) **Last Deceased Spouse.**

The last deceased spouse is the mostly recently deceased individual who was married to the surviving spouse at the death of such person.

2. **The Substantive Portability Regulations.**

Substantive requirements exist to allow the surviving spouse to use the DSUE amount. Treasury has tried to make this complex area as easy as possible, but the technical requirements must be followed.

a) **Election on Tax Return.**

9 Treas. Reg. §20.2010-1T(c)(2).
10 Treas. Reg. §20.2010-1T(c)(3).
13 Treas. Reg. §20.2010-1T(c)(5).
14 Treas. Reg. §20.2010-2T.
Portability must be elected by the executor (as defined in §2203) on a complete and timely filed return, including extensions. Upon the filing of such return, such election is deemed made unless the executor affirmatively elects out on a timely filed return. (Why one would file a return to elect out is a real puzzle, since the election out is automatically made if no timely return is filed.) Once made, the election is irrevocable unless a contrary election is made on a subsequent return filed before the due date of the original return.


The Internal Revenue Service issued this Revenue Procedure which provided relief from an “unnecessary QTIP election” in the first spouse’s estate if the election did not benefit that estate because the estate was below the available exemption equivalent. Without the Rev. Proc., the “QTIP” trust would be included in the estate of the surviving spouse under §2044. Some commentators have suggested that the QTIP election on the return electing portability will be disregarded under this procedure. The obvious purpose of the Rev. Proc. is to protect the surviving spouse. It is difficult to see how this would be applied because the election, far from being unnecessary, is the very essence of the portability election.

c) What Constitutes Complete Return.

The Regulations begin by defining a “complete return” as one which complies with the instructions and with §6018. However, the Regulations then relax certain requirements. The value of property subject to the marital deduction or the charitable deduction is not required to be reported so long as the identity of

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16 The only reason for such a filing would be if such a return would start the statute of limitations running. Whether that is so is an unanswered question. See §6213(g)(1) defining a “return” as a document filed “with respect to any tax imposed by Subtitle A or B....”


18 The Real Property, Probate, Trust and Estate Section of the American Bar Association has filed a well reasoned comment to the Proposed and Temporary Portability Regulations, asking the IRS to clarify the Rev. Proc. 2001-38 will not be applied to make QTIP elections for portability ineffective.

the beneficiary and other facts necessary to establish the deduction are disclosed. One would think that attaching the Will or other dispositive document and claiming the deduction in the case of a QTIP would be enough.

Values must be reported, however, if (i) the value related to, affects or is needed to determine the value passing from the decedent to another recipient; (ii) the value is needed to determine the estate’s eligibility for 2032, 2032A, 6166 or another provision of the Code; (iii) less than the entire value of the property is marital deduction property or charitable deduction property; or (iv) a partial disclaimer or partial QTIP election is made. The executor must include a good faith estimate of the gross estate, under penalties of perjury.

d) **Computation of DSUE Amount.**

The DSUE amount is the lesser of the basic exclusion amount or the excess of the decedent’s applicable exclusion amount over the taxable estate plus adjusted taxable gifts. To the extent gift taxes were paid, adjusted taxable gifts are reduced by the amount on which gift taxes were paid in the calendar year of the gift. Generally, the spouse cannot use the DSUE amount until the termination of the QDT or the spouse’s death. But, there are rules allowing the DSUE amount to be applied to certain gifts by the surviving spouse in the year of the spouse’s death or the termination of the QDT. The Regulations contain several helpful examples regarding the application of these rules. The Internal Revenue Service is allowed to audit the return of the first spouse but only for purposes of determining the DSUE amount without regard to any statute of limitations.

3. **Last Deceased Spouse Rules - Gift Tax**

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21 Treas. Reg. §20.2010-2T(c).

22 Treas. Reg. §25.2505-2T(d)(2)


24 Treas. Reg. §25.2505-2T.
As a general rule, it is only the DSUE of the last deceased spouse (as defined above) of the surviving spouse which is available to such spouse in determining that spouse’s applicable exclusion amount. If the last deceased spouse did not make, or was not eligible to make a portability election, then the surviving spouse has no DSUE amount, even if the spouse prior to the last deceased spouse had DSUE.\(^{25}\) However, the broad definition in certain fact situations must be clarified.

\textbf{a) Identity of Last Deceased Spouse Unchanged by Marriage or Divorce.}\(^ {26}\)

If the surviving spouse remarries, the former spouse remains the last deceased spouse if the new spouse is living at the date of the gift by the surviving spouse or if the marriage to the new spouse is dissolved by divorce or annulment.

\textbf{b) Order of Application.}\(^ {27}\)

In applying unified credit to a gift, the donor first applies the last deceased spouse’s DSUE amount before applying the donor’s own basic exclusion amount.

\textbf{c) Multiple Deceased Spouses.}\(^ {28}\)

Suppose H1 dies in early 2011 with a DSUE amount $5,000,000 and surviving spouse makes a gift in 2013 of $2,000,000 to her children, leaving her with an applicable exclusion amount of $8,250,000 ($3,000,000 of DSUE and her basic exclusion amount). W remarries H2. It is irrelevant whether this is before or after the gift. H2 then dies with a DSUE amount of $2,000,000. H2 is the last deceased spouse of W. W’s DSUE is the $2,000,000 from H2 PLUS the $2,000,000 of H1’s DSUE which she applied to the gift, giving her an applicable exclusion amount of $9,250,000.\(^ {29}\) While at first blush this may seem surprising,

\(^{25}\) Treas. Reg. §25.2505-2T(a)(1) and (2).

\(^{26}\) Treas. Reg. §25.2505-2T(a)(3).

\(^{27}\) Treas. Reg. §25.2505-2T(b).

\(^{28}\) Treas. Reg. §25.2505-2T(c).

\(^{29}\) See also Treas. Reg. §20.2010-3T(b)(2) Example.
C. The QTIP and Portability.

If a QTIP Trust rather than an outright disposition is utilized to achieve portability, then there is a potential for abuse if the beneficiaries of the QTIP trust differ from the beneficiaries of the surviving spouse’s estate. For example, Decedent dies in 2010 and leaves decedent’s entire estate in a QTIP trust. Now, surviving spouse has a DSUE amount of $5,000,000. Surviving spouse makes a gift of $5,000,000, using up the DSUE. At surviving spouse’s death in 2013, to the extent the surviving spouse’s estate (without the QTIP) exceeds $5,250,000, the tax on the QTIP is 40%, but must be paid out of the QTIP under $2207A. Had the deceased spouse used a bypass trust, his or her heirs would have benefitted from the tax free transmission of that wealth at the second death, rather than having it subjected to the highest marginal rate in the survivor’s estate. However, there is some potential income tax savings due to the new basis at the second spouse’s death.

IV. DRAFTING IN THE NEW AGE OF UNCERTAINTY

The events of 2010 revealed that formula clauses and the uncertainty of the amount (or even existence) of unified credit could pose unanticipated issues. For example, assume that the formula clause was a pecuniary marital deduction (“the least amount necessary to reduce the taxable estate to zero”) with a residuary bypass, that the beneficiaries of the Bypass Trust were other than the surviving spouse, and that the decedent died in June of 2010 with an estate of $7,000,000. At the date of the decedent’s death, there was no amount necessary to reduce the taxable estate to zero, because there was no taxable estate. But, as of December 17, 2010, the amount necessary to reduce to zero was $2,000,000, assuming that the estate did not “opt out” of the estate tax regime. At the moment of death, state law would have vested all the property in the trustee of the Bypass Trust, subject to administration. Should a retroactive change in federal tax law alter the substantive rights of the parties fixed at the time of death?

30 The potential

The same issues arises with respect to a specific bequest of the unused GSTT exemption. Additionally, some attorneys have suggested that the same size of the exemption was not

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recurrence of these issues, or as yet unanticipated issues, have caused some practitioners to reexamine how they draft or optimum marital deduction planning.31

A. Other Considerations of Increased Importance

In past years, with lower exemption levels and an automatic use of bypass trusts, planning revolved around HEMS distribution standard or a discretionary standard with an independent trustee. The goal, of course, was to allow accumulation of income in the bypass trust because it would be protected from transfer tax at the second death. This was true even though trusts reached the maximum income tax bracket at a much lower income level, because transfer tax rates were higher.

1. Federal Income Taxes

With trusts reaching the top bracket at $11,950 of income and with the advent of a 39.6% top bracket and a 3.8% net investment income tax, planners are having to consider income tax consequences when drafting the distribution standard for any trust other than the marital trust.32 Additionally, as discussed below, trying to achieve a new basis at the second death has also become more important with long term capital gains rates at 20% (or 23.8%, depending upon taxable income and Net Investment Income.)

2. State (and even City) of Residence.

anticipated and leaving that much to the Bypass Trust violates the intent of the testator. That argument would seem to be doomed to fail.

31 To avoid the inconvenience of using “he/she” or similar reference, I have assumed that the husband has died first.

32 And that does not take into account state income taxes.
As is graphically illustrated in the Appendix, where the client lives can have a real impact on what kind of planning should be done. \( ^{33} \) Page 5, “Dispersion Across the States”, illustrates the effect of the state tax structure on overall tax burdens. Page 6, “The Gap Map”, is a state by state illustration of the idea presented on Page 5 as to how state inheritance/estate taxes and income taxes (or the absence thereof) can affect the approach to planning. \( ^{34} \)

3. Estate Planning has Become More Multi-Faceted.

As shown on Page 11 of the Appendix, there are now many more factors to be taken into account than in the pre-2011 paradigm. (The author has no idea what the algorithm means or how it is applied, and is willing to testify as an expert witness that such failure is not below the accepted standard of practice for an ACTEC Fellow.) This requires more intensive fact gathering, and makes explanation of what the client needs to consider more difficult, along with the client’s decision becoming more difficult.

B. All To Spouse With Disclaimer.

This approach (used in unitary families) \( ^{35} \) leaves it up to surviving spouse as to whether any of the property passes to the Bypass Trust. While not focused on the availability of portability, that availability adds another dimension to the disclaimer decision. This approach suffers from all the infirmities discussed when analyzing portability as a planning technique, plus a couple more. First, the spouse when advised of the advantages of a disclaimer, may decide that she would rather just own the property outright, reasoning, correctly, that the estate tax is the children’s problem and that outright ownership is better, if for no other reason.

\( ^{33} \) The Appendix contains graphs from a Webinar sponsored by Bernstein Global Wealth Alliance and were prepared by Paul S. Lee. The author is grateful for the permission granted to use these materials.

\( ^{34} \) “Large Gap” states are those where the gap between transfer taxes and income taxes are the greatest.

\( ^{35} \) This technique probably would not work at all in the case of “blended” families. And, as a colleague of mine reminded me, “All it takes is one death or one marriage to make a functional family dysfunctional.”
than there are no remainder interests to question her decisions. Presumably, the testator is all right with that decision assuming he was advised of the possibility that the surviving spouse might really make that decision irrespective of the tax consequences. Second, if the spouse disclaims, then she has given up the right to have a special power of appointment, over the disclaimed portion. Third, the time for decision making has been shortened from 15 months to 9 months.

C. “One Lung Trust”.

This is a variation on the all to spouse with disclaimer approach. It provides the testator with more control over ultimate devolution of the property. In this approach, all of the estate is left to a trust which qualifies for QTIP treatment. The executor is then given the authority to make a QTIP election as to the entire trust, a partial QTIP election, or no QTIP election at all, effectively determining to some extent the testator’s estate plan based upon the facts existing at the first death. Under any scenario, the surviving spouse can be given a special power of appointment over the trust(s).

1. If QTIP Treatment Elected for Entire Trust.

In this case, the entire trust simply remains subject to all the QTIP rules. A reverse QTIP election can be made for GSTT purposes. A new basis is also achieved at the surviving spouse’s death. This has the advantage (or disadvantage) of requiring that all income be distributed currently. Such distribution avoids the penalty-like tax rates of trusts. It may also allow the surviving spouse to impose the taxes on the QTIP discussed above by using the decedent’s DSUE amount for gifts. The last surviving spouse issue also comes into play.

2. If Trust Is Divided into Elective and Non-Elective Shares.

36 Treas. Reg. §25.2518(e)(2). See also Treas. Reg. §25.2518(e)(5), Examples (4), (5) and (6).

37 §2652(a)(3).
Under this approach, the QTIP is simply divided into elective and non-elective shares, with all of the provisions of the original trusts applying to both halves. The advantage here is that the spouse retains the entire income interest. The disadvantage, of course, is that the income cannot be accumulated in the non-elective portion (although that is probably not desirable unless the spouse is in the highest marginal tax rate) and the non-elective portion does not get a new basis at the second death. Reverse QTIP election for GSTT may also be used to the extent desired.

3. If Non-Elective Share Passes to Trust With Different Terms.

It is possible, under the authority of Clayton\textsuperscript{38} and its progeny to cause the non-elective portion to pass to a trust with “traditional” bypass terms; e.g., income to spouse (and possibly descendants) on a HEMS standard or a purely discretionary standard with an independent trustee. GSTT exemption can be allocated, but there will not be a basis adjustment for the non-elective share at the second death without special planning. Additionally, the planner must reconsider the use of a HEMS standard if it is determined that it would be more advantageous to increase the spouse’s estate by the income than to pay income tax at the trust level. One might use a HEMS standard which allows the trustee to consider or not consider the spouse’s other income,\textsuperscript{39} even if the surviving spouse were the trustee. And, usually, descendants, who may be in a lower tax bracket, will be permissible beneficiaries.


If the surviving spouse is the trustee of any trust in which the surviving spouse is also the sole trustee, creditor protection may not be available in certain jurisdictions. Under Restatement of the Law of Trusts (Third), where the trustee

\textsuperscript{38} Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992)

\textsuperscript{39} Treas. Regs. \textsection 20.2041-1(c)(2). The Regulation speaks in terms of “exhausting” income. This leaves open the question as to whether one can have an ascertainable standard if the spouse’s resources (not limited to income) are not considered. Logic (if it has any place) would dictate that if one did not have to consider other income, one should not have to consider the asset base either. Many practitioners use a clause which allows other resources to be ignored.
and the beneficiary are identical, the trust is not exempt from claims of creditors, even though distributions are limited by an ascertainable standard. This represents a change to existing law in most jurisdictions, and only time will tell whether a state will follow the Restatement (Third) position. Some states, such as Texas, have passed a statute negating the Restatement (Third) position.

5. Gift Tax Issues with a Clayton Approach if Surviving Spouse Is Executor

Is there a gift tax issue if the person making the Clayton-like election is the surviving spouse? By making the election, the surviving spouse has given up his or her mandatory income interest in exchange for something less (even though in certain circumstances the result may be the same) and has usually included beneficiaries who would not otherwise be permissible in a QTIP trust. In most cases, the Clayton-type trust will have a special testamentary power of appointment in the surviving spouse. Several major firms and some smaller firms have determined that there is a sufficient risk in having the spouse make the election that they will not use this approach if the spouse is the executor. Valuation of the “gift” is certainly an issue because the surviving spouse (who is often the trustee) may make distributions for his or her own benefit, especially if other resources may be ignored.

a) §2702 Issues

§2702(a)(2) deals with transfers among family members and values at zero any retained interest which is not a “qualified interest” as defined in §2702(b), which does not include a HEMS standard distribution. However, the statute provides an exception for an incomplete gift. Treas. Regs. §25.2702-2(d)(1), Ex.

40 §60, Comment g.
41 Texas Trust Code §112.035(f)(1)(A)(ii)
42 These observations were made to the author upon direct inquiry, and the author does not feel comfortable attributing these very clear statements to specific firms.
43 As pointed out above, disparity in rates between trusts and individuals may make forcing out income desirable.
44 §2702(3)(a)(i).
4 states that a gift with a retained special power over principal is an incomplete gift, thus apparently taking this type of trust out of the ambit of §2702. In a somewhat dubiously reasoned pronouncement dealing with retained testamentary special powers of appointment, the IRS opined that a retained testamentary power was an interest in property, but was not a qualified interest. Therefore, the value of the retained interest was zero thereby making the entire gift taxable under the valuation rules of §2702. Arguably, then, by retaining a special power over the non-elective portion, the surviving spouse has made a completed transfer.

b) §2036 and §2038 Issues

If the surviving spouse, as executor, makes the Clayton type election, and if such election is deemed to be a gift, then the spouse has retained an interest which would cause the non-marital share to be included in the surviving spouse’s estate.

6. Arguments For and Against Election

Creating a Gift

It would seem that the argument concerning whether the spouse/executor has made a gift revolves around the issue as to whether a tax election resulting in the spouse receiving less than a mandatory income interest for life is properly treated as being identical in substance, if not in form, to a grant of a special power of appointment to the surviving spouse.

a) Election Not Taxable Gift

The power in the executor to make such election is held in a fiduciary capacity, while a special power of appointment is held in a non-fiduciary capacity. In form and in substance, the power in a fiduciary to make such election is not a transfer of any property right from the decedent, but a special power of  

45 CCA 201208026. The Service stated, “Section 25.2702-2(a)(4) provides that an interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift. Accordingly, under § 25.2702-2(a)(4), the Donors' retained testamentary powers are interests, and the value of their retained interests is zero. Therefore, the value of the Donors’ gift is the full value of the transferred property.”
appointment would be a property right.\textsuperscript{46} Even if the analogy is correct, the U.S. Court of Claims has held that the exercise of an inter-vivos power of appointment as to the principal of the trust was not a gift of the mandatory income interest of the donee of the power, but rather simply extinguished that income interest.\textsuperscript{47}

\textbf{b) Election Is Taxable Gift}

The fact that the power is held in a fiduciary capacity should be ignored, as this power to elect is in substance a special power of appointment by which the spouse is transferring away the mandatory income interest for life in exchange for a lesser interest – distributions under a HEMS standard. Or, phrased another way, one should look only to the effect such election would have on the rights of the spouse. The Tax Court rejected the Court of Claims approach in \textit{Self} and held that the exercise of a special power of appointment over principal of the trust in which the power holder had a mandatory income interest for life was a gift of the income interest.\textsuperscript{48} The Service again rejected the reasoning in \textit{Self} by opining that the exercise of a special power of appointment was a completed gift, even when the holder of the power only had a right to receive income in the very broad discretion of an independent trustee, including the ability in the independent trustee to spray such income to descendants of the power holder.\textsuperscript{49}

\textbf{7. Another Alternative – The “Waterfall” Disclaimer.}

Assume that the best solution for a client may be the ability to create an old fashioned bypass trust (discretionary income and principal to spouse and descendants), but the client would like to postpone that decision until the first death. However, the client is concerned about the possibility of the imposition of

\textsuperscript{46} See discussion under §2702, above.


\textsuperscript{49} Priv. Ltr. Rul 200243026 (10/25/2002). The Service acknowledges the difficulty in valuing the gift, but cites Rev. Rul. 75-550, 1975-2 C.B. 357, which deal with valuation for purposes of the tax on prior transfers credit under §201, and is really not very helpful in the situation outlined in the Private Letter Ruling.
a gift tax. One possible approach would be the creation of a non-exempt trust through the failure to elect QTIP treatment, but with no change in the terms of the QTIP Trust. The document could further provide that if the surviving spouse disclaims, the disclaimed portion would pass into a trust with traditional bypass terms. Other than the complexity of this kind of approach (and explaining it to the client both at the planning stage and at the death of the first spouse) is that the spouse must relinquish the ability to have a special power of appointment over the disclaimed property.


As pointed out several times in this paper, what may seem to be essentially tax driven elections have real effects on beneficial interests. Care must be taken in drafting the “one lung” provisions to assure that the executor may make such elections with adequate protection for so doing. The draftsperson may either grant the executor total discretion or give the executor a group of factors to consider, such as estate tax savings including the likelihood that there will be any, the costs of administering multiple trusts, the income tax effects of accumulations versus distributions. So long as the executor can show that the executor considered those factors, there should be no breach of fiduciary duty. If the spouse is the executor, the factors to be considered are almost a necessity. While it might not avoid a claim of self dealing, unfettered discretion offers no protection at all. Exculpation would also certainly be in order and perhaps even an in terrorem clause if the executor’s decision is challenged. (The latter may well be overkill.)

D. Traditional Formula Clause.

Many (if not most) lawyers are sticking with their standard formula clause. In that case, if a pecuniary bypass provision is used, some thought should be given to capping the amount which can pass to the bypass. Of course, that cap must be periodically reviewed in light of changing family finances or changing laws.

E. Possible Drafting Solutions.

Even with a standard formula clause, it is likely that most, if not all of the estate will pass under the bypass trust, thereby losing the new basis at the second death.
1. Formula General Power of Appointment Clause.

Robert N. Grant, an ACTEC Fellow from Palo Alto, California, has suggested a clause that much resembles the formula clause used in GSTT planning, with a general power of appointment over assets that will not cause an increase in the estate tax of the surviving spouse, with the balance of the trust subject only to a special power of appointment. Mr. Grant’s clause is as follows:

Testamentary Powers Of Appointment

Upon the death of the Surviving Trustor the Trustee shall distribute the balance then remaining of The By-Pass Trust or any part thereof as follows:

I. General Power of Appointment

a. The Trustee shall distribute a portion of The By-Pass Trust as hereinafter defined to such one or more persons or entities, including the Surviving Trustor's own estate, and on such terms and conditions, either outright or in trust, as the Surviving Trustor shall appoint by a will specifically referring to and exercising this general power of appointment.

b. The portion of The By-Pass Trust subject to this general power of appointment shall be the lesser of the following:

I. Those assets of The By-Pass Trust which would receive an increase in basis pursuant to Section 1014 of the Internal Revenue Code by reason of inclusion in the estate of the Surviving Trustor, and


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50 Used with permission, with one slight modification suggested by Howard Zaritsky. This is the second version of this clause. It was modified at the suggestion of Carlyn McCaffrey, an ACTEC Fellow from New York, who felt the first attempt might run afoul of Kurz v. Commissioner, 68 F.3d 1027 (7th Cir. 1995), a case dealing with powers of appointment which could be modified by the surviving spouse’s documents.
ii. The largest portion of the assets of The By-Pass Trust which would not increase any federal estate tax payable by the estate of the Surviving Trustor without taking into consideration any charitable or marital gift by the Surviving Trustor that would be deductible by the estate of the Surviving Trustor pursuant to Section 2055 or Section 2056 of the Internal Revenue Code.

c. If the limitation of paragraph __1.b.ii of this Article would preclude some, but not all, of the assets of The By-Pass Trust described in paragraph __1.b.i from being subject to this general power of appointment, then the asset which would have the largest increase in basis will be first subject to this general power of appointment and the asset with the next largest increase will then be subject to this general power of appointment and continuing similarly until the limitation of paragraph __1.b.ii is reached.

2. Special Power Of Appointment

The Trustee shall distribute the portion of The By-Pass Trust not subject to the general power of appointment provided for in paragraph __1 of this Article [ALTERNATIVE A: BROAD POWER] to such one or more persons or entities, other than the Surviving Trustor, the Surviving Trustor's estate, the Surviving Trustor's creditors, or the creditors of the Surviving Trustor's estate, and on such terms and conditions, either outright or in trust, as the Surviving Trustor shall appoint by a will specifically referring to and exercising this special power of appointment.

[ALTERNATIVE B: DESCENDANTS ONLY] to such one or more of the group consisting of the descendants of the Predeceased Trustor and on such terms and conditions, either outright or in trust, as the Surviving Trustor shall appoint by a will specifically referring to and exercising this special power of appointment.
Some issues arise with respect to this approach. The suggested provision specifically identifies the property subject to the general power as those with the lowest basis. This kind of identification may be necessary to avoid the contention that, if the power holder can pick and choose the property subject to the general power, such choice could create a situation in which the exercise of the power would be treated as a sale. It also provides a means to determine which assets get a new basis, avoiding an allocation among all assets of the trust. And, because the power must be exercised by Will, it would be impractical to exercise it on an asset by asset basis. However, this automatic provision may cause an exercise over an asset that is not really one that would be desirable at the second death.\(^{51}\) Additionally, if the power holder has made large annual exclusion gifts in trusts, the GSTT exemption may be less than the estate tax exemption including the DSUE amount.

2. Delaware Tax Trap.\(^ {52}\)

The “Delaware Tax Trap” comes into being when a beneficiary possesses a power of appointment over property if the exercise is (a) by will, or (b) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, the property would be includible in the decedent’s gross estate under sections 2035 through 2037\(^ {53}\). The trap is sprung when the power of the donee is exercised to cause the creation of another power which may be exercised without regard to the original date of the transfer or (if the Rule Perpetuities is stated in terms of suspension of alienation or ownership) suspends absolute ownership or the power of alienation.\(^ {54}\) Because the property is now in the spouse’s estate, the property gets a new basis at date of death.

\(^{51}\) Realistically, it is not contemplated the power will be exercised, but, of course, that will not always be the case.

\(^{52}\) \$2041(a)(3)

\(^{53}\) Treas. Reg. \$20.2041-3(e)(i)

\(^{54}\) Treas. Reg. \$20.2041-3(e)(ii)
3. **Appointment of Trust Protector with Power to Grant General Power of Appointment.**

Some have suggested the appointment of Trust Protector with the power to grant the surviving spouse a general power over a limited amount of assets, which would not increase such spouse’s estate.

4. **Comparison of Techniques.**

All three of these techniques have their pitfalls and shortcomings. The Delaware Tax Trap requires the spouse to spring the Delaware Tax Trap by exercising the power in such spouse’s Will and requires a somewhat sophisticated planner to recognize the availability of the trap and to spring it. Care must be taken that the trap can even be used in the governing jurisdiction because the trap relies on the existence of a Rule Against Perpetuities. On the other hand, insertion of the provision granting a general power in certain fact situations requires no action on the part of the surviving spouse unless the spouse wants to exercise the power. However, it pushes the decision date as to inclusion in the surviving spouse’s estate back to the date of the execution of the first spouse’s Will. The trust protector technique relies on (i) the ability to find someone to exercise the power, (ii) the survival of such person, and (iii) deciding when to grant it, which may involve knowing when the surviving spouse is going to die. While this postpones the decision to a later date (always better planning), it seems the least likely to succeed in most cases.

V. **REMAINDER PURCHASE MARITAL TRUST**

Remainder Purchase Marital Trust (“RPM”), while sounding very much like the Purchase of Remainder Interest, above, is a very different technique – basically a split interest purchase. The transaction involves a trust established for

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55 This discussion is based on Akers, “Heckerling Musings 2012”. The technique is expanded upon by David Handler.

56 *See Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997) in which the court stated that the sale of a remainder interest for full and adequate consideration avoided the application of §2036. While the Remainder Purchase Trust does not implicate a retained interest issue, the reasoning is the same.
the donor’s spouse which has either an all income distribution standard or, preferably, an annuity either for life or for a term of years. This is a requirement in order to value spouse’s income interest under IRS tables. There can be no distributions of principal. The remainder interest is purchased at its actuarial value by a grantor trust (which might be GST exempt) for the spouses’ descendants, so that such grantor trust becomes the remainder beneficiary. The trust which purchases the remainder interest should be “old and cold”.

A. Transfer Tax Results

No QTIP election is made with respect to the RPM, but it still qualifies for the marital deduction in that is not a non-deductible terminable interest. §2523(b) provides that an interest is a non-deductible terminable interest if the trust provides that the interest will pass to someone else at some point in time “for less than an adequate and full consideration in money or money’s worth.” In this transaction, the remainder interest was purchased for full consideration, so it is NOT a non-deductible terminable interest and thus the life interest (which is the only gift) qualifies for the gift tax marital deduction. There is no estate tax (or gift tax) at the termination of the trust because the donor retained no interest and the spouse did not have a general power of appointment and no QTIP election was made.

B. Advantages of RPM Annuity Trust

The RPM annuity trust works much like an almost zeroed out Grantor Retained Annuity Trust (“GRAT”) by valuing the income interest so that it is almost the full value of the transfer, but one which is exempt for GSTT purposes. However, there is no mortality risk as there is with a GRAT, so the trust may be structured for a longer term and does not necessarily need to be structured for a fixed term. Additionally, the annuity payments could be back-loaded.

C. Disadvantages of RPM Trust

57 §2702

58 This, of course, is less efficient in a low interest environment,
This can only be used in a stable marriage situation when divorce is not a realistic possibility as the spouse will continue to enjoy the distributions. In order to assure the correct valuation, easy to value assets must be used. Perhaps the biggest disadvantage is that this is a “non-standard” transaction. While the underlying principles seem sound enough, the RPM Trust is not for the faint of heart.

VI. CONCLUSION

What seemed extremely simple a little over three decades ago has, not surprisingly, proven a good deal more complex. Each passing day and each change in laws other than those directly dealing with the marital deduction bring 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 still 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 and 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.