ESTATE PLANNING FOR PERSONS WITH LESS THAN $5 MILLION

Introduction

Individuals in the "modest" wealth category face special hurdles in estate planning. This article will assume that the "modest" wealth category includes individuals whose net worth exceeds the amount of taxable gifts that may be protected by the unified credit (the equivalent of $1,000,000 and herein referred to as the "gift tax exemption"), but does not exceed approximately $5 million.

In general, people of modest wealth may not easily be able to afford to give up significant levels of their net worth during lifetime to achieve estate planning goals. However, the lifetime transfer of wealth is one of the most useful ways to reduce estate taxes. Unlike individuals whose wealth is small enough that it most likely will be protected from tax by reason of credits or exemptions (for 2006, for example, the Federal estate tax exemption equivalent is $2 million) or those whose wealth is so large that an achieved lifestyle almost certainly will continue regardless of how much is transferred during lifetime, individuals of modest wealth face a real tension between opportunities to reduce taxes and protect assets from other claims which may arise, on the one hand, and the need to preserve an adequate base of wealth to ensure the maintenance of a current standard of living on the other. The advisor to these individuals should carefully consider which planning steps are most appropriate and what level of transfers the individual reasonably can afford to make. Certainly, different problems and potential solutions will arise for each individual and the plan must be tailored to each person's unique circumstances and goals. Nonetheless, such individuals need estate and financial planning as much as anyone

else does, perhaps even more so. These individuals, in a real sense, cannot afford to "lose" as much of their wealth to taxes, professional fees, claims and costs of administration as more wealthy people can. This article will focus on estate planning techniques which may be particularly useful to individuals in the modest wealth category.

Assign Life Insurance and Other Non-Income Producing Assets

As noted above, a person of more modest wealth faces a tension between making lifetime transfers of wealth which will reduce the taxes which will be imposed upon death and his or her desire to maintain a chosen lifestyle. Nevertheless, many individuals even of somewhat modest net worth consume their income but not their capital. This presents a planning opportunity. However, giving away property while retaining the right to income usually does not achieve any tax reduction or protection of assets from claims of creditors. *See, e.g.*, I.R.C. § 2036(a)(1); Restatement (3d) of Trusts, §§ 57 – 60; Stephanie J. Willbanks, Federal Taxation of Wealth Transfers 241 (2004). On the other hand, many persons own assets that likely never will produce income. A common example is a life insurance policy. Although life insurance in certain circumstances can be made to be an excellent income producing asset (where it has a cash or investment component), most individuals do not "cash-in" on that feature of the policy. Rather they allow the investment component to be maintained within the policy because most policies are structured so that the investment component is constantly being substituted for an ever-decreasing term insurance component.[1] In such a case, an insurance policy may be an ideal subject of a gift by the insured.[2]

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[1] *See* "Some Advanced Considerations and Uses of Life Insurance in Estate Planning," especially Chart 3, *The Chase Review* (Winter 1997).

[2] For a wealthier individual who is willing to make only a rather limited level of lifetime gifts, a gift of an asset other than an insurance policy may be more appropriate for several reasons. First, often the policy lapses (*e.g.*, is ...(continued)

The purposes for which the insurance is being maintained (such as to replace earnings lost upon the death of the insured, to pay a debt which will become due or will be payable upon the death of the insured, or to fund estate taxes) usually can be as readily achieved if someone other than the insured owns the policy. If the insured holds no "incident of ownership" in the policy at or within three years of death, the proceeds should not be includible in the insured's estate for Federal estate tax purposes except to the extent they are payable to the estate of the insured. I.R.C. §§ 2042, 2035(d)(2). However, if the insured does hold any incident of ownership at or within three years of death, the proceeds--even if paid to someone other than the insured's estate -- may be subject to estate tax at rates of 50% or more, even if the total estate does not exceed $5 million.

The most effective way to avoid having insurance proceeds included in the estate of the insured is to have them acquired initially by someone other than the insured (typically, a trust). Alternately, if the insured already holds an incident of ownership (*e.g.*, because he or she currently owns the policy), it is generally most effective for the insured to assign all incidents of ownership to someone else at least three years prior to death. Usually, the simplest route is to have the policy already owned or assigned to the individuals whom the insured wishes to benefit from the proceeds, such as children or grandchildren (or a trust for their benefit).

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terminated by failure to pay premiums) before the death of the insured. In such a case, there will be no reduction of estate tax because the subject of the gift (*i.e.*, the life insurance policy) will have lapsed prior to the death of the insured donor. Second, as a general matter, it is preferable to give those assets which have the greatest potential for growth. Many insurance policies are designed to emphasize preservation of value rather than high growth. These are just two of many reasons why an asset other than a life insurance policy may be a preferred subject of a gift by an individual of more substantial wealth. For a more detailed discussion of lifetime gifts of insurance policies and other estate planning with insurance, see Jonathan G. Blattmachr, The Complete Guide to Wealth Preservation and Estate Planning 545-621 (1999).

A more effective strategy may be to sell life policies the insured owns to a trust that would be excluded from his or her estate. If the trust is a so-called "grantor trust" for income tax purposes, if the insured's death is not imminent and the policies are sold for their full fair market value, such a sale appears to avoid income tax recognition and the transfer-within-the-three-years-of-death rule of I.R.C. § 2035(a).[3]

Having policies owned by one or more individuals may complicate matters in the long run. That may occur, for example, when a child of the insured who owns the policy dies before the insured person. The child's interest in the policy may pass to someone whom the insured does not wish to own the policy, such as a former spouse of the predeceased child. The solution to this problem is to have the policy owned by a trustee of a trust created by the insured. If the trust is properly structured, the policy proceeds will be used for the purposes intended by the insured and will not be included in his or her estate. Although there initially may be more expense involved, trust ownership of the policy may be the more effective and, in the long run, most efficient method to avoid estate taxes on the proceeds and to guarantee that the proceeds will benefit only those selected by the insured. For example, trust ownership of the policy will permit the use of a so-called "back-up" marital deduction provision. This provision will allow the proceeds to qualify for the estate tax marital deduction if the insured is survived by his or her spouse and the proceeds are includible in insured's estate (because, for example, the insured dies within three years of assigning them).[4]

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[3] See, e.g., Mitchell M. Gans & Jonathan G. Blattmachr, "Life Insurance and Some Common 2035/2036 Problems: A Suggested Remedy", 139 *Trusts & Estates* 58 (May 2000).

[4] Usually, it will be best for the estate tax includible insurance proceeds to pass under the irrevocable life insurance trust agreement into a trust which can qualify for the marital deduction, by election under I.R.C. § 2056(b)(7), as qualified terminable interest property (QTIP). That way, the insured's executor can determine, by the election, how much should be made to qualify for the marital deduction. *See, generally*, Jonathan G. Blattmachr & Georgiana J.

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On the other hand, it is appropriate to emphasize that unless the life insurance is a cash value policy that has been specifically acquired to fund estate taxes, it often lapses prior to the death of the insured. If that occurs, the creation of the trust and the use of gift tax annual exclusions with respect to the transfer of the policy to the trust and payments of subsequent premiums would be "wasteful." However, individuals of more modest wealth who have borne transaction costs of establishing such a trust may be vigilant in maintaining the policy so it does not lapse.

Arranging for another person or entity to own insurance almost certainly will require the insured to make a taxable gift. Both the assignment of the ownership of a policy of insurance to another and the payment of premiums on a policy owned by another constitute gifts for gift tax purposes. As a general rule, these gifts can be made to qualify for the gift tax annual exclusion if the policy is assigned to individuals or to a trust.[5] Because many individuals of modest wealth do not make significant annual exclusion gifts because they feel they cannot afford to give up income producing assets, contributions to a life insurance trust are an excellent way of using annual exclusions if they will not be used otherwise.

Another category of assets which may be appropriate to give away under the protection of the annual exclusion are items of tangible personal property that have significant intrinsic value and that the owner is willing to transfer before death. This may include, by way of example, jewelry, works of art, antiques and collections. However, in order to remove the

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Slade, "Building an Effective Life Insurance Trust," 129 *Trusts & Estates* 29 (May 1990). In addition, special considerations will arise if the surviving spouse is not a citizen of the United States. I.R.C. § 2056(d).

[5] *See* "Building an Effective Life Insurance Trust," *supra* note 4.

items from the donor's taxable estate, gifts need to be "complete" for estate tax purposes.[6] For example, the items should no longer be stored in the donor's home or otherwise be under the control of their former owner. Also, the new owner should acquire and pay for the insurance on those items. Certainly, if donor wants to continue to use certain objects (such as jewelry), the donor should not given them away.

Recreational real estate is another excellent example of the type of property which could be the subject of a lifetime gift. Although the property may be too valuable to give away at one time under the protection of the annual exclusion under I.R.C. § 2503, smaller gifts of undivided interests in property can be made and, in fact, may be valued at a discount (*i.e.*, the value of the fractional interest is worth less than an aliquot share of the value of the whole).[7] However, continued use of the property should be consistent with the relative ownership of the property. For example, if the original owner gives away an undivided 25% interest in the property, the recipients of the 25% interest should pay for a quarter of the cost of maintaining the property and should exercise ownership rights and use over a quarter of the property. In the case of recreational property which constitutes a residence, use of a qualified personal residence trust (discussed in more detail below) also should be considered.

Estate Building and Income Tax Sheltering with Life Insurance

Certain types of life insurance policies provide greater opportunities to build wealth while sheltering income from taxation. Specifically, so-called "variable" insurance contracts allow the policy owner to direct how the cash or investment value of the policy is to be

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[6] A gift is complete when under the principles of Reg. § 25.2511-2(c) the donor has given up dominion and control of the property. Even if the gift is complete under those principles, the property nonetheless may be included in the donor's gross estate at death on account of a retained interest or power. See IRC §§ 2036, 2037 and 2038.

[7] *Cf. Lefrak v. Commissioner*, T.C.M. 1993-526.

invested among a variety of mutual funds. The fund alternatives usually include a blue chip stock fund, a government bond fund, an international stock fund and so forth. In some cases, these funds may provide significantly better yields when compared to the yields in traditional cash value policies. Yet as long as the policy is a life insurance contract under I.R.C. § 7702, the earnings will accumulate income tax-free. In addition, as long as the policy does not constitute a "modified endowment contract" under I.R.C. § 7702A (essentially, a single premium or limited premium payment policy), cash up to the extent of basis[8] may be withdrawn free of income tax[9]. Even the income earned "inside" such a policy may be borrowed without income tax effect. In essence, this allows the insured to access the income without paying any income tax. The policy's yield thereby increases and thereby providing the owner of the policy has additional flexibility for estate and other financial planning. In addition, if an adequate amount of premium is allocated to the cash or investment component, it is possible to have future term premiums paid with the income earned under the policy. Essentially, then the term premiums are paid with pre-tax income that will never be subject to income tax, even if the policy is canceled prior to death.[10]

Note that if the insured has access to the cash or investment component of the policy, all of the proceeds paid upon death may be includible in the insured's estate at death, even if the insured only has an interest in the cash or investment component and someone else (such as the trustee of an irrevocable life insurance trust) holds all incidents of ownership with

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[8] Basis generally will equal the sum of premiums paid, including that portion used to pay for the term insurance protection, reduced by amounts previously withdrawn.

[9] Not all variable policies permit withdrawals. Universal type policies usually do. In any case, some insurance companies impose charges (called "surrender charges") on amounts withdrawn. It is important to consider whether commissions, premium taxes and "management" fees are so significant that they offsite the benefits of the income tax build-up "inside" the policy.

[10] This technique is described in detail in the Winter 1997 issue of The Chase Review.

respect to the term component of the policy. Rev. Rul. 82-165, 1982-1 C.B. 117. It is possible, however, to structure the ownership of a policy through a split-dollar arrangement so that the insured may be able to benefit (at least indirectly) from the policy's cash value without causing the term insurance component to be includible in the insured's tax estate. *See, e.g.*, PLR 9636033 (Mar. 12, 1996) (not precedent). Under a split-dollar arrangement, an irrevocable life insurance trust "owns" the term component and the insured's spouse or an investment company (such as a corporation) "owns" the cash (or investment) component. Upon the insured's death, the proceeds attributable to the term insurance component should not be includible in the taxable estate of the insured. The insured might own no more than 50% of the voting stock of the corporate owner of the policy's cash value component (even if the insured holds more than 50% of the total equity). In such a case, the incidents of ownership held by the corporation should not be attributed to the insured shareholder. Treas. Reg. § 20.2042-(c)(6). Alternatively, the cash value owner might be a limited partnership of the insured is a limited partner. The incidents of ownership held by the partnership (which may be structured be a disregarded entity for income tax purpose) should not be attributed to the insured limited partner. Rev. Rul. 83-147, 1983-2 C.B. 158. Although the corporation or the partnership could make tax-free withdrawals or borrowings from the cash value component of the policy (provided it was not a modified endowment contract), the distributions to the insured as a shareholder or partner may be subject to income tax.[11]

To avoid the taxation of the tax-free withdrawal, an Alaska or Delaware (or other jurisdiction providing that self-settled trusts may be free of the claims of the grantor's creditors)

[11] If the partnership is an entity that is disregarded for Federal income tax purposes under Treas. Reg. 301.7701-3, the withdrawal will not otherwise be subject to income tax.

trust to could own the policy, including the cash value component. The trust should be structured so that no incidents of ownership held by the trust will be attributed to the insured even if the insured grantor is eligible to receive distributions (which may include cash withdrawn by the trustee from the policy) from the trust. *Cf.* PLR 9434028 (May 31, 1994) (not precedent) (incidents of ownership held by trust not attributed to beneficiary who was not a trustee but whose life was insured under policy owned by the trust).

Qualified Personal Residence Trusts

As a general matter, under I.R.C. § 2702, for purposes of determining the value of a gift of a remainder in property to family members, the value of an income or use interest retained in that property is treated as zero, causing the entire value of the property to be treated as the gift. In other words, no reduction in value of the gift is made on account of the interest retained because the entire value is attributed to the remainder. However, an exception is provided where the remainder transferred is in a personal residence the use of which is retained. I.R.C. § 2702(a)(3)(A). This exception permits, by way of example, the owner of a personal residence to give a remainder interest to take effect after a term of years expires and to value the remainder based upon the normal actuarial principles under I.R.C. § 7520. Usually, the gift of the remainder is made by transferring the home to an irrevocable trust under which the grantor retains the right to the exclusive occupancy and use of the home as a personal residence for a period of years. Such a trust is known as a personal residence trust or qualified personal residence trust depending on its terms. *See* Treas. Reg. § 25.2702-5.

To illustrate, assume that a 70-year old woman makes a gift to her child of a remainder interest in her $1,000,000 home. Assume also that the transfer is made through a qualified personal residence trust that takes effect in 10 years (*i.e.*, the current owner retains the

right to use the property as a personal residence for 10 years). The trust further provides that the property will revert to the estate of the donor if the donor dies during the retained ten-year term. If all of these conditions are met, the gift the property owner would be making upon the creation of the qualified personal residence trust would be $368,450, if the IRS interest rate used to determine the value of the interest of such a trust (determined under I.R.C. § 7520) were 6.0%, as it was for September 2006. If the trust has been structured properly and the term-holder survives the 10-year retained term, the property automatically will be transferred to or held in further trust for the remainder beneficiaries without any additional gift tax and without any estate tax.

One "problem" with an effective qualified personal residence trust is that the grantor's entitlement to use the property must end before the he or she dies. If death occurs during the retained term, the trust is includible in the grantor's estate under I.R.C. § 2036(a). That means that the transfer of the remainder will not be free from any additional tax liability. Also, the client must be aware that once the retained term ends, he or she no longer has any right to occupy the property. The client must be in a position where he or she can afford at the end of the fixed term to vacate the property or rent it from the remainder beneficiaries at a fair market value.[12]

Another possible application of the personal residence exception under I.R.C § 27072(A), is a "split-purchase trust"[SM]. This arrangement is a particular form of qualified personal residence trust in which parents typically purchase life estates in a new home (such as a retirement home) and a generation-skipping trust that is a grantor trust with respect to one of the parents purchases the remainder interest in the home. Under this arrangement, the parents have

the use of the home for life, need not pay rent and, it seems, do not have to survive for any particular time. Also, unlike a QPRT, a split-purchase trust arrangement can "leverage" the GST exemption of the parents.[13]

Effective Use of the (Balance) of Annual Exclusions

The annual exclusion may not have an enormous impact on reducing taxes with respect to a person of extraordinary wealth. In fact, for such an individual, other gifts to family members (such as automobiles, payment for vacations and similar transfers) often absorb the entire sum of annual exclusions available for them. In the case of a person of more modest means, however, if the annual exclusion is being used for other transfers, such as the payment of premiums on a life insurance contract owned by others, an unused portion of the annual exclusion may remain. For instance, a married person with two children, each of whom is married and has two children of their own, may give up to $160,000[14] to them each calendar year under the protection of annual exclusions coupled with "gift splitting" under I.R.C. § 2513 by the spouse (that is to say $20,000 to each of these eight individuals). Over a five year term, such transfers would remove from the client's estate $800,000 and the subsequent income and growth on the gifted property. If the property grew at 8% a year compounded annually, for example, a total of about $930,000 would be removed from the client's taxable estate in just five years. That could represent a large percentage of the client's wealth. Hence, the use of annual

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[12] The IRS has rules privately (not precedent pursuant to I.R.C. § 6110(j)) that renting the home to the grantor after the retained use period ends will not cause the value of the home to be includible in the grantor's estate if the grantor pays full and adequate rent. PLR 9626041 (Apr. 2, 1996); PLR 9425028 (Mar. 28, 1994).

[13] See, generally, J. Blattmachr, "Split-Purchase Trusts Vs. Qualified Personal Residence Trusts," *Trusts & Estates* (February 1999).

exclusions can produce exceptionally effective estate planning results for persons of modest wealth.

On the other hand, that effectiveness highlights the tension that may arise when the client may wish to make such maximum use of his or her annual exclusions, but the individual does not own sufficient non-income producing property with which to make the transfers. If that is the case, a client would have to make annual exclusion gifts of income-producing assets. If the client does so, then neither the gifted assets nor the income they produced may be made available directly to the donor. The individual simply may not be able to afford such a loss of income so gifts of income–producing property must be considered carefully. However, the individual might be able to continue to benefit indirectly from the income of the gifted property without causing estate tax inclusion by transferring assets under the protection of the annual exclusion to a trust, the income of which the trustee is permitted to distribute to the grantor's spouse. The spouse then in his or her discretion, could use the assets for the benefit of the grantor. In fact, there is no reason that the grantor needs even to name the precise person who is a beneficiary of the trust. The grantor could define his or her spouse in such a trust "as the person to whom the grantor is married at the time such distribution is made."[15]

Although a spouse may not "gift-split" with respect to gifts made to himself, herself or a trust of which he or she is a beneficiary, the non-donor spouse can gift-split transfers

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[14] Although the annual exclusion under I.R.C. § 2503(b) is $12,000, the exclusion must cover not only what might be called "estate planning" gifts but holiday, birthday and similar gifts. Hence, these examples assume only $10,000 is available for the estate planning gifts.

[15] *See* Rev. Rul. 80-255, 1980-2 C.B. 272; *Estate of Tully v. United States*, 78-1 U.S. Tax Cas. (CCH) ¶13,228 (Ct. Cl. 1978).

to a Crummey trust[16] for the benefit of the gift-splitting spouse and others are beneficiaries (as long as a Crummey power). Treas. Reg. § 25.2513-1. This is because the gift to the Crummey trust is treated for gift tax purposes as made to the individuals who hold the power to withdraw the property transferred to the trust, rather than as a gift to the spouse, even though the spouse is a beneficiary of the trust. Hence, the grantor could continue to enjoy the trust property to the extent it is made available to (and through) his or her spouse. Of course, when that spouse dies, the property no longer would be available (via the spouse) for the grantor.

While it is true that each spouse could create such a trust for the other, the trusts should be structured so that the benefits and controls granted to the spouses are sufficiently different in order to avoid application of the so-called "reciprocal trust" doctrine.[17] Under that doctrine, the trusts may be "uncrossed," with the effect that each spouse is being treated as though he or she created the trust for his or her own benefit. This will cause estate tax inclusion to the extent that inclusion would have occurred if the spouse who is the trust beneficiary had created that trust. *U.S. v. Grace*, 395 U.S. 316 (1969). With careful drafting, it is possible to structure the trusts so that the benefits and controls granted to the spouses are sufficiently different so that the reciprocal trust doctrine will not apply. *Cf. U.S. v. Green, KTC*, 68 F.3d 151 (6th Cir. 1995). Nevertheless, it does mean that upon the death of the first spouse to die only one-half of the assets will remain in trust for the benefit of the surviving spouse, unless the trust continues for the benefit of the spouse who created that trust. However, that continuing benefit, as a general rule, will cause that trust to be includible in the estate of the grantor on account of

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[16] A trust, transfers to which qualify for the annual exclusion by reason of the power of the beneficiaries immediately to withdraw the property transferred, is often called a "Crummey trust" after the well known case of *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

[17] See, generally, Georgiana J. Slade. "The Evolution of the Reciprocal Trust Doctrine Since Grace and Its Application in Current Estate Planning," *Tax Mgt Estates, Gifts & Trusts*. (May 1992).

the "creditors' rights" doctrine. Generally speaking, the creditors of the grantor can attach trust assets to the extent the trustee must or, in the exercise of discretion, may distribute them to the grantor. *See* Restatement (3d) of Trusts, §§ 57-60. To that extent, the trust assets will be includible in the grantor's estate. Rev. Rul. 77-384, 1977-2 C.B. 198.

Self-Settled Trust Options

A few states including Alaska, Delaware, Nevada, Oklahoma, Rhode Island, South Dakota and Utah as well as several "offshore" jurisdictions (subject to limitations in some cases and somewhat differing rules), have adopted legislation that provides that a trust created under that jurisdiction's law is not subject to claims by creditors of the grantor, even if the grantor is eligible, in the exercise of the discretion of another person acting as trustee, to receive distributions from the trust, provided, however, that among other conditions, the transfer to the trust must not have been for the purpose of defrauding creditors. Because the trust assets are not subject to the claims of the grantor's creditors, an Alaska trust, for example, of which the grantor is a discretionary beneficiary should not be includible in the grantor's gross estate for Federal estate tax purposes unless the grantor retains some other power that otherwise causes the trust to be includible in his or her estate.[18]

Under the laws of states that permit these types of self-settled trusts, an individual could make annual exclusion gifts to a discretionary trust for the benefit of family members and himself or herself, and yet still keep the assets out of his or her taxable estate. Note, however, that estate tax inclusion can be triggered if the grantor receives all the income or if the trustee makes regular distributions that are nearly equal to the trust's income. In such cases, the Internal

Revenue Service and the courts may find that there was an understanding between the grantor and the trustee to pay income to the grantor and so the property will be included in the grantor's estate on the grounds that the grantor retained possession, income or enjoyment of the property the trust.[19]

Potential Use of the Gift Tax Exemption and the GST Exemption

As indicated, many individuals of more modest wealth cannot afford to make large gifts because they cannot afford to give up the income from the assets which would be given away. Yet a transferor can benefit indirectly (through a spouse) from the income from property transferred to the trust (by using the self-settled trust option in a state such as Alaska, the transferor can remain eligible to receive distributions from gifted property) and nonetheless exclude its value from his or her gross estate. Hence the grantor could make gifts in excess of the amount covered by the annual exclusion, such as the amount of any remaining gift tax exemption, without losing the benefit of that income. This opens up certain attractive estate planning options.

For example, the final generation-skipping transfer tax regulations allow the immediate allocation of GST exemption to a lifetime QTIP trust described in I.R.C. § 2523(e), even though no gift tax will be paid upon the transfer if the QTIP election is made on a timely-filed gift tax return.[20] Treas. Reg. § 26.2652-2. A QTIP trust that one spouse creates for the other will not be includible in the estate of the grantor-spouse if the grantor-spouse retains a

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[18] See Rev. Rul. 76-103, 1976-1 CB 293; *Estate of German v. United States*, 7 Ct. Cl. 641 (1985); Priv. Ltr. Rul. 9837007 (not precedent).

[19] *See, e.g.*, IRC § 2036(a)(1); see also *Estate of Skinner v. U.S.*, 197 F. Supp. 726 (E.D. Pa. 1961).

[20] However, if the donor's spouse is not a U.S. citizen, the transfer cannot qualify for the gift tax marital deduction. I.R.C. § 2523(i)(1).

secondary income interest in the trust, unless the estate of the beneficiary spouse elects for any continuing trust to qualify for QTIP treatment in his or her own estate (or unless the spouse creating the trust otherwise held a general power of appointment described in I.R.C. § 2041). The creation of such a lifetime QTIP trust will permit the effective use of the grantor's GST exemption.

Notwithstanding the GST benefits, creation and funding of a QTIP trust will not permit the effective use of the grantor's gift tax exemption (unified credit). Transfers to a QTIP trust will qualify for the gift tax marital deduction, so will not make use of the grantor's unified credit. In planning, use of the unified credit may be more important than the use of the GST exemption.[21] If so, the property owner could create a trust for his or her spouse which intentionally does not qualify for the marital deduction but which will not generate gift tax on account of the use of the unified credit. In this case, the grantor should not retain a secondary income interest following the death of his or her spouse because the retention of such an interest will cause the trust to be includible in the grantor's estate under I.R.C. § 2036(a)(1), effectively nullifying the grantor's use of his or her unified credit. In fact, in virtually all American jurisdictions (except those like Alaska, discussed above), the mere eligibility (as opposed to entitlement) to receive distributions from the trust will cause estate tax inclusion on account of the creditors' rights doctrine discussed earlier.

The potential estate tax inclusion again points to the self-settled trust option. A property owner could transfer an amount equal to his or her unused gift tax exemption equivalent

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[21] The early use of the unified credit is important because it otherwise can be "lost" once total transfers exceed $10 million. *See* I.R.C. § 2001(c)(2). Although that seems unlikely to occur for individuals of more modest wealth, "inflation" or "appreciation" could cause that to occur. For example, $5 million will grow to more than $10 million in under 10 years at seven percent growth. Also, because the generation-skipping transfer tax usually can be ...(continued)

to, for example, an Alaska or Delaware trust, remain eligible in the discretion of the trustee to receive distributions, and still make a completed transfer for estate and gift tax purposes. Rev. Rul. 76-103, *supra*. Additionally, Alaska, Delaware and several other jurisdictions effectively have repealed the rule against perpetuities, thus permitting the trust to be unlimited in duration. In Alaska and certain other states, the trust generally only will be subject to state income tax to the extent the income is allocable either to a grantor who is subject to that tax (such as under the grantor trust rules under I.R.C. §§ 671 et seq.) or to a beneficiary who is subject to a state income tax.[22] Otherwise, the trust will not be subject to the state income tax. This can result on substantial savings over the term of the trust.

Accessing Income Tax-Free States

Only seven states have no income tax: Alaska, Florida, Nevada, South Dakota, Texas, Washington (State), and Wyoming. Of course, an individual can move to one of those states and avoid income taxation, but in many cases that may not be practicable, desirable or even effective from a holistic perspective. If the individual's children or other chosen objects of bounty live in states (or locations) with income taxes, income generated on any property transferred to them will be subject to the applicable state (and local) income tax. However, by creating trusts under the laws of one of the seven listed states, it may be possible to avoid income tax on trust income which is not currently distributed to such beneficiaries even if the beneficiaries live in a state (or locality) with an income tax.

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postponed for a much longer period of time than can gift and estate tax, use of the GST exemption may be viewed as having less immediate benefit than use of the unified credit.

[22] Some states impose income tax on trust income if the grantor, trustee or beneficiary resides in that state. See, e.g., New York Tax Law §605. Also, states with income taxes generally impose their income taxes on income earned in that state.

If a trust is created in a state with an income tax, careful planning may reduce or minimize the trust's and the beneficiaries' state and local income tax liabilities. For example, New York is effectively a state income tax haven for trusts created by individuals who reside out of that state. Except for New York source income (essentially income derived by the operation of a business in New York), New York imposes a tax on trust income only if the grantor was domiciled in the state at the time the trust became irrevocable. N.Y. Tax Law §§ 601, 605(b)(3). New Jersey has a similar rule. N.J. Stat. Ann. §§54A:2-1. Delaware, in contrast, does not impose an income tax on income retained in a trust sited there unless the beneficiary is a Delaware resident. Del. Code Ann. 30 § 1131 *et. seq.* Of course some states have far-reaching income tax rules that seek to tax trusts created in other jurisdictions. For example, California imposes income tax on a trust created by a non-resident if a trustee is a resident of that state. *See, e.g.*, California Rev. & Tax Code § 17742. In fact, California attempts to impose its income tax on the retained income of a trust created by a non-resident if *any* beneficiary is a resident of California, even if none of the trustees are California residents. California Rev. & Tax Code § 17742.

Using a Charitable Remainder Trust to Build Wealth and Generate Income

In the case of clients who are charitably inclined, charitable remainder trusts described in I.R.C. § 664 may provide two benefits for individuals in the modest wealth category. First, an income, gift, or estate tax deduction may be allowed for the actuarial value of the remainder interest committed to charity. Second, and often more significant by, the trust is exempt from income tax for any year in which it does not have unrelated business taxable income. I.R.C. § 664(c). This may, for example, allow for a grantor to contribute to a trust

appreciated assets that the trustee later sells without imposition of income tax, provided that: (i) no unrelated business taxable income is received in the year of sale by the trust and (ii) the gain is not attributed to the grantor. *See, e.g.*, PLR 9452026 (Sept. 29, 1994) (not precedent) (gain recognized by the trust on appreciated assets contributed to the trust will be attributed to the grantor only if the trustee legally is obligated to sell the transferred assets). Being able to sell assets without paying tax on the gain provides an enhanced base of wealth for the taxpayer. The size of the annual payment from a charitable remainder unitrust to the designated non-charitable beneficiaries will be directly proportional to the value of the trust. Hence, by avoiding the imposition of tax on gain recognized and retained by the trust, a larger base of wealth is available to generate payments to the individual beneficiaries.

One common perception about charitable remainder trusts is that they may benefit only the grantor and, perhaps, the grantor's spouse. The reason is that all (or a significant part) of the trust will be includible in the estate of the grantor upon his or her death by reason of the retention of the annuity or unitrust payments. *See, e.g.*, Rev. Rul. 82-105, 1982-1 C.B. 133. Also if the trust is only for the grantor or the grantor's spouse, then no gift tax will be owed with respect to the initial transfer to the trust and no or estate tax will be owed with respect to assets includible in the grantor's estate at death.[23] Yet just as a charitable remainder trust can benefit the grantor's spouse after the death of the grantor, the trust may also be continued for the benefit of the grantor's descendants. If descendants are trust beneficiaries, it is necessary to structure the trust so that the remainder interest for charity is at least equal to 10% of the initial net fair market value of the property placed in the trust. IRC § 664(d)(2)(D). By retaining the power to

[23] I.R.C. § 2056(b)(8) and 2055(a). Special rules apply if the spouse is not a citizen of the United States. *See* I.R.C. § 2056A.

terminate the interests of all or any of the grantor's descendants by the grantor's Will, no gift tax will be payable upon the creation of the trust. Treas. Reg. §§ 1.664-2(a)(3), 25.2511-2(c). The trust, however, will be includible, in the grantor's estate. IRC § 2038. Where the grantor's spouse and descendants or the grantor's descendants alone are beneficiaries of the trust, the grantor's estate pays tax on the present value (calculated as of . . .) of the interest in the trust committed to such successor individual beneficiaries.

Whether grantor will want to continue the trust after his or her death for the benefit of his or her descendants will depend upon a variety of factors. For example, if the interest of the grantor's spouse in the trust is anticipated on an actuarial basis to be minimal (e.g., the grantor's spouse is older or the grantor is willing to make the grantor's spouse a mere discretionary beneficiary), continuing the trust for the benefit of the grantor's descendants may be advantageous from an economic perspective. Although estate tax will be payable upon the death of the grantor (because the successor interest of the grantor's spouse and descendants will be fully subject to estate tax and no marital deduction will be available), the interest for the benefit of the grantor's descendants in the trust is likely to be substantial. Furthermore, on a future-value basis, the descendants' interest likely exceeds what the descendants would have received if the value of the property had been bequeathed directly to them (after taking into account the estate tax liability and the future income tax liability on earnings from the transferred property). However, if the grantor's spouse's interest in the trust is likely to be substantial (e.g., the grantor has given the spouse a fixed interest in the trust and the spouse is young), it may not make economic sense to give the property directly to the grantor's descendants. The present value of the successor beneficiaries' interest in the trust property will be subject to estate tax, and all the property received from the trust by the surviving spouse (to the extent not expended by

him or her) will be included in the surviving spouse's estate upon his or her subsequent death, and likely will be subject to estate tax. In this scenario, the grantor's descendants are unlikely to receive a substantial benefit from the trust, especially, in light of the 10% minimum value of the charitable remainder requirement.

A net income charitable remainder unitrust (with or without "makeup" provisions) that pays the lesser of the unitrust amount or trust income can provide an opportunity for taxable income to accumulate tax-free in effect, until such time as the trustee decides to invest the assets to generate current trust income that can be distributed to the grantor or other trust beneficiaries.[24] The tax-free build-up may provide an enhanced base of wealth for the grantor (and, if appropriate, the grantor's spouse and other family members). This enhanced base of wealth could provide the grantor with a degree of financial comfort that will make the grantor feel more financially secure in making gifts of other assets to remove them from his or her estate.

Medical Care and Tuition Payments

Direct payments to a health care provider for the medical care of another person and direct payments of tuition to an educational institution for another person are not subject to gift tax. I.R.C. § 2503(e). This means that a grandparent for example may pay the tuition for a child, a grandchild or any other individual from nursery school to post-graduate education free of gift tax. Combined with any annual exclusion gifts that such grandparent may make, these transfers over time can remove significant amounts from the donor's estate tax base. Furthermore, even though the payments for medical care and tuition must be made directly to the health care provider or educational institution to fall under the exclusion, there are some

convenient ways to effect such payments. For example, a property owner might open a joint checking account with each of his or her adult children. The creation of such account is not considered a gift to the child even though the account is in joint name. Treas. Reg. § 25.2511-1(h)(4).[25] Only to the extent that the child draws on the account will the gift be complete. If the child draws on the account only by writing a check directly to the provider of medical care or the educational institution, the transfer should not be subject to gift tax under I.R.C. § 2503(e). Any amounts reimbursed, such as by medical insurance, could be contributed to that account and withdrawn by the person who opened the account.

Limited Liability Entities for Asset Protection and Tax Planning

A family holding company, whether in the form of a limited partnership, limited liability company, business trust or other entity may provide asset protection and tax benefits for the property owner and his or her family. Contribution of assets to such an entity changes the nature of the assets. For example, the contribution of real estate to a limited partnership in exchange for limited partnership units changes what is owned from real estate to limited partnership units. As a general rule, such limited partnership units are less marketable than is the underlying real estate. This reduction in marketability has two important effects.

First, partnership assets of lesser value are less attractive. As a general rule a partnership agreement may provide that anyone who attaches a partnership interest does not

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...(continued)

[24] If a charitable remainder trust with a make up provision is chosen, then deficiencies are made up in subsequent years in which trust income exceeds the unitrust amount.

[25] In those states where the opening of a joint account may be a completed gift, it might be appropriate to have the joint tenants enter into an agreement that the non-contributing tenant may draw on the account only as an attorney-in-fact for the contributing tenant and only for purposes of paying medical care and tuition payments under I.R.C. § 2503(e). Accordingly, there will be no completed gift from the contributing tenant to the non-contributing tenant on

...(continued)

become substituted as a limited partner for purposes of voting and management decisions (to the extent they are granted to the limited partners under the terms of the partnership agreement or local law), but becomes instead a naked assignee of the economic interests that the units represent. Such an assignee probably will be taxed on a pro rata portion of the partnership's income as though he or she were a partner. *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971); Rev. Rul. 77-137, 1977-1 C.B. 178, *but see* GCM 36960 (Dec. 20, 1976) (distinguishing *Evans* and suggesting that a transferee is treated as a tax partner only if the transferee has "dominion and control" over the transferred partnership interest). In a circumstance where regular distributions are not made, the units could become a liability for the assignee (because income taxes will be due on income attributed to the assignee without a corresponding receipt of property from the partnership to pay those taxes) with no corresponding economic benefit. Creditors therefore tend to stay away from limited partnership interests.

A second effect of the reduced marketability of partnership interests (in comparison with the underlying property) is an almost certain corresponding reduction in value. Lower valuation, as a general rule, means lower gift, estate or generation-skipping transfer taxation. Unfortunately it usually also means a lower income tax-free step-up in basis under I.R.C. § 1014(a) upon the transfer at death because the basis of most inherited assets is equal to their estate tax values.

...(continued)
the opening of the account since withdrawals will only be for the benefit of the contributing tenant or will qualify for the exclusion under I.R.C. § 2503(e).

Special Care in Handling Interests in Qualified Plans, IRAs and Other IRD

Despite the fact that the income tax basis of most property passing at death is equal to its estate tax value, a number of exceptions exist. The most common is for "income in respect of a decedent," typically referred to by its initials "IRD." *See* I.R.C. §§ 691(a), 1014(c). IRD consists of income to which the decedent was entitled at death but which is not properly includible in the decedent's pre-death income tax return. Accrued interest on a bond, certain declared but unpaid dividends, the inherent profit in certain installment sale notes and deferred compensation are common types of IRD. Interests in qualified plans and IRAs, which often represent a significant portion of the worth of a person of modest wealth, almost always represent IRD. As a consequence, they could be exposed to estate tax and income tax as well as other taxes. *See, generally*, J. Blattmachr & M. Gans, "Planning for IRD After Elimination of the State Death Tax Credit," 33 *Estate Planning* (March 2006) pg. 3. In many cases from 75% to over 100% of the value in such qualified plans and IRAs may be eroded by taxes.

Because of the significant income tax exposure, persons of modest wealth should consider the possibility of making qualified plans and IRAs payable upon the death of the "owner" of a charitable remainder trust. Unfortunately for taxpayers this may effectively avoid the *income* tax on the contributed property, but it will marginally reduce or have no impact on the estate tax due to the inclusion the interest in the descendant's estate. Hence, the ability to pay those estate taxes, such as with life insurance proceeds, must exist if one makes the qualified plan and IRA proceeds payable to a charitable remainder trust. Use of a charitable remainder trust can result in a substantial increase in the net value of the economic benefit in such plan and thus the interests to which the decedent's beneficiaries will succeed.

Conclusion

Estate planning for individuals of more modest wealth is challenging because they face significant estate taxes but they do not have such a large base of wealth that they can "afford" to make significant lifetime gifts or other transfers to reduce those estate taxes. However, careful planning using any number of the techniques described herein often may help to reduce these taxes.

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WTPDECEMBER2006NEWSLETTERCARRYOVERBASIS

Thinking About the Impossible for 2010: No Estate Tax and Carryover Basis

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Introduction

Under current law, the Federal estate tax will be eliminated for the year 2010. The income tax "step-up" in basis rule for most property included in a decedent's estate also is eliminated for that year. Rather, the decedent's basis "carries over" to those who succeed to the property subject to special rules. Although many if not most estate planners thought the chance of zero estate tax with carryover basis for one year was extremely unlikely—perhaps, even less likely than permanent repeal and carryover basis—it may be that 2010 will be known as the one year without estate tax.

It seems appropriate to think about that possibility in planning now. Perhaps certain clients (such as those who own property with liabilities in excess of income tax basis or what is called "negative basis" property) should be warned about the prospects of carryover basis. It also seems sensible to consider the carryover basis issues for many married clients who just might die in that year with a surviving spouse. This article will focus on how certain estate planning documents (e.g., Wills and revocable trusts) might be structured in light of the possibility of a year without estate tax.

How Big Is the Formula Marital Deduction If There Is No Marital Deduction?

Usually, the estate plan for a married person who wants to maximize the use of his or her unified credit (or Federal estate tax exemption) provides for his or her estate to be divided into two broad

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shares: one equal to the amount of the Federal estate tax exemption and the balance in a form qualifying for the estate tax marital deduction. Generally, there are three broad ways to effect this division: (1) make the amount of the Federal exemption a fixed sum of money; (2) make the amount of the marital deduction a fixed sum of money; (3) make each a fractional share. But, in each case, a word formula will be used to define at least one of them. Sometimes, it will define the Federal exemption—and although there are several variants, all essentially say to determine the maximum taxable estate the married person could have at death without paying Federal estate tax on account of the unified credit (and, perhaps, other credits). Other times, it will define the amount of the marital deduction. Again, there are several ways to phrase it but essentially it says to determine the minimum amount necessary as the Federal estate tax marital deduction to reduce the Federal estate tax to zero. Experience teaches that defining either the Federal exemption or the marital deduction that way works "just fine" for estate tax purposes.

But just what does either word formula produce if there is no Federal estate tax in effect when someone dies? If there is no Federal estate tax, what is the maximum *taxable* estate one can have without increasing his or her Federal estate tax? The concept makes no sense because there will no longer be a concept of taxable estate. Alternatively, what is the minimum marital deduction necessary to reduce the Federal estate tax to zero when there is no concept of the marital deduction or Federal estate tax? Again, the concept makes no sense if there is no marital deduction. One can imagine, in a case where the spouse of a second marriage succeeds to the marital deduction amount and children from a prior marriage of the decedent succeed to the exemption amount, that the widow(er) and the children would take diametrically different positions as to what each receives.

Even if there is no dispute among the surviving family members (e.g, they all agree everything passes under the disposition of the exemption share), the IRS may not agree. And it will have an interest in the outcome in at least two ways. First, it is likely that the exemption share will pass into a trust and the income earned thereon will not necessarily be taxed to the surviving spouse or to other family members. If the property passes to the surviving spouse (or to a marital deduction trust), the income will be taxed to the surviving spouse (except trust

income allocated to corpus and not distributed). Second, the IRS will have a keen interest in the surviving spouse receiving more because the survivor likely will die in a later year when there is an estate tax. Certainly, some practitioners will contend that whatever the result, it can be resolved post-death by a disclaimer. For example, they will contend that the whole estate can pass under the Federal exemption disposition by having the widow(er) disclaim any marital deduction disposition under section 2518 of the Internal Revenue Code of 1986 as amended ("Code"). But if the proper construction is that there is no such disposition (that is, everything passes into the marital deduction share if the decedent's spouse survives and nothing passes as part of the Federal exemption disposition), the disclaimer will not produce the desired result. In any case, experience indicates that many a surviving spouse is reluctant to disclaim.

Perhaps, the judges who will decide this issue will be consistent. But most would agree that a better choice is to let the clients decide. There seem to be two broad choices. One choice is to provide that, in the event there is no Federal estate tax in effect when the first spouse dies, the entire estate passes pursuant to the marital deduction disposition and rely on the surviving spouse disclaiming that disposition if it "makes sense" to do so. But, as indicated above, and as Professor Jeff Pennell has observed "among the world's greatest lies are: (1) 'The check is in the mail'; (2) 'I'm from the government and I want to help you'; and (3) 'Of course I'll disclaim if it will save taxes'." Tax Mgt Portfolio No. 843-2nd: Estate Tax Marital Deduction, at II.E.3, n. 55.

An alternative is to direct that the entire estate passes pursuant to the disposition of the exemption amount. In such a case, it no doubt makes sense to insure that the surviving spouse is a beneficiary of that trust, either entitled to income or eligible to receive income and corpus. The widow(er) might be given the right to demand property from that trust for his or her health, education, maintenance and support (although in some states this may subject to trust assets to the claims of creditors of the surviving spouse. See Matter of Flood, New York Law Jl, Vol. 219, No. 4, p. 32, col. 3, March 11, 1998, aff'd, 26 AD 2d 643 (2d Dept. 1999). In addition, the survivor could be granted the right to direct where the trust is to pass upon his or her death and the trustee may be authorized to consider the needs of the surviving spouse as more

important than those of other beneficiaries including remainder beneficiaries.

One more complication: the decedent's estate may still be subject to state estate tax even if there is no Federal tax. Hence, the practitioner must decide if the "traditional" division between an exemption share and a marital deduction share should be used to take advantage of the state exemption and to avoid state death tax (by also using the state estate tax marital deduction). Some practitioners likely will decide that it is preferable to pay a relatively small state estate tax (by having the entire estate of the spouse dying in 2010 passing into an estate tax exemption or credit shelter trust) than potentially increasing the estate of the surviving spouse who is likely to die after the Federal estate tax has come back into effect.

In any case, where the married client decides that his or her entire estate (except for specific or dollar bequests, perhaps) should pass as would the Federal exemption (e.g., into a so-called "credit shelter" or "bypass" trust), the following language might be considered (adding the first bracketed language *in italics* if expressed as a fractional share rather than a sum and adding the other bracketed language *in italics* if reference should be made to state estate tax if there is no Federal estate tax in effect) :

A. If my spouse survives me, I give a sum/fractional share of my estate as determined after payment of transfer taxes, expenses and any other preresiduary gift but before payment of this gift, [*the numerator of which shall be equal to my Estate Tax Exemption and the denominator of*] which shall be equal to the value, as finally determined for Federal estate tax purposes *[(or, if there is no Federal estate tax in effect at the time of my death, as finally determined for death tax purposes under the law of the state of my domicile)*] of my estate as so determined to the Trustee of the Credit Shelter Trust under this Will, to be disposed of under the terms of that trust. This gift is intended to equal [*the smaller of*]

my available Federal estate tax exemption [*or my state estate tax exemption under the laws of my domicile*].

B. My "Estate Tax Exemption" means the largest amount that can pass to the Credit Shelter Trust without increasing the Federal estate tax [*and without increasing the state death taxes due by reason of my death, or, if I die when there is no Federal estate tax, without increasing my state of domicile's death tax if my state of domicile's death tax law permits an unlimited exemption or deduction for transfers to a surviving spouse and an exemption or credit against the state death tax regardless of the person to whom property passes*], and shall mean my entire estate, to the extent not effectively disposed of by the provisions of this Will preceding this gift, if there is no Federal estate tax [*and, under the law of the state of my domicile, if there is no state death tax*] in effect at the time of my death.

Carryover Basis Matters

With respect to persons dying in 2010 (whether or not married), some consideration ought to be given to the carryover basis rules. Those rules are found in section 1022 of the Code, which is to become effective if the currently enacted estate tax repeal rule is not changed before 2010.

Under section 1022, the basis of assets acquired from a decedent will not equal their estate tax values for any year that there is no Federal estate tax in effect. During that time, the decedent's basis will "carry over" to those who succeed to the property upon the decedent's death (although in no event can the basis exceed its fair market value at death).

There are exceptions and special rules. Under one of these, the executor/personal representative may allocate up to $1.3 million to

increase the basis of assets up to their fair market value. (The $1.3 million amount is increased by certain pre-death losses of the decedent. Different thresholds apply for a non-citizen non-domiciliary of the United States.) For example, assume a decedent owns a piece of real estate worth $5 million on her death with respect to which her basis is $800,000. Under section 1022, the decedent's $800,000 basis would remain the basis in the real estate when she dies. The executor/personal representative may increase the basis of the land to $2.2 million by allocating the entire $1.3 million basis increase to that asset.

Authorize Executor/PR to Allocate to Non-Probate Assets. Because the executor is a fiduciary under the decedent's Will and has no direct authority or responsibility with respect to non-probate assets, it may be that a beneficiary under the Will would contend that the executor must allocate, to the extent possible, the $1.3 million basis increase to probate assets. In that event, the beneficiary would also undoubtedly contend that an executor who allocates basis to property outside the probate estate, without specific authorization, would be subject to removal, surcharge or loss of commissions. Hence, it may be best to provide expressly in the client's Will that the executor/personal representative may allocate part or all of the $1.3 million basis increase allowed under section 1022 to any asset or assets in the decedent's gross estate including those passing outside of the Will. Of course, this provision must be contained in the Will as it is the executor who makes the allocation (and not, for example, the trustee of any revocable trust created by the property owner, even if such as trust is the principal estate planning document used to transmit wealth when the property owner dies). The following is a sample provision that might be inserted in Will so the executor/personal representative is expressly authorized allocate any basis increase (including the $3 million spousal basis increase discussed below) to non-probate property.

> Adjustments to Basis. I authorize my Executor/Personal Representative, in the exercise of sole and absolute discretion, to make any adjustment to basis authorized by law, including but not limited to increasing the basis of any property included in my estate, whether or not passing under my will, by allocating any

amount by which the basis of assets may be increased. My Executor/Personal Representative shall be under no duty and shall not be required to allocate basis increase exclusively, primarily or at all to assets passing under this instrument as opposed to other property included in my estate. I waive any such duty that otherwise would exist. Any such allocation shall not cause my Executor/Personal Representative to be liable to any person or to be subject to removal or forfeiture of commissions or other compensation.

Authorize Executor/PR to Allocate to Own Assets. Whether or not the executor/personal representative is authorized to allocate the $1.3 million basis increase allowed under Code Sec. 1022 to any asset or assets in the decedent's gross estate including those passing outside of the Will, the question arises as to whether the executor/personal representative may allocate basis to property the fiduciary is "inheriting" individually or as a trustee, as opposed to being required to allocate all or a pro rata portion of the basis step up to property others receive. Hence, it may be appropriate for the property owner's Will to provide expressly that the executor/personal representative may or may not allocate that basis increase to assets that the executor/personal representative is receiving. A sample provision permitting that might be written as follows:

My Executor may elect, in the exercise of sole and absolute discretion and without permission of any court or other authority, to allocate basis increase to one or more of all assets that any Executor receives or in which the Executor have a personal interest to the partial or total exclusion of other assets with respect to which the election could be made. Any such allocation shall not cause my Executor to be liable to any person or to be

subject to removal or forfeiture of commissions or other compensation.

An ancillary issue is that if, under the Will or governing law, the executor has the discretion to allocate basis increase to assets he or she is receiving, the fiduciary who does not do so might be treated as making a taxable gift, bestowing tax benefit away from himself or herself to another. Of course, that issue arises with respect to other tax options and elections as well. See, generally, J. Blattmachr, M. Gans & S. Heilborn, "Gifts By Fiduciaries By Tax Options and Elections", *Probate & Property*, November/December 2004, Vol. 18 No. 6; republished in *Digest of Tax Articles* (March 2005). A sample provision that might be inserted in an instrument to attempt to avoid having a fiduciary be deemed to have made a gift by the manner in which a tax election or option is exercised (or not exercised) might read something like the following:

> No individual fiduciary hereunder shall participate in any decision with respect to any tax election or option, under Federal, state or local law that could enlarge, diminish or shift his or her beneficial interest hereunder from or to the beneficial interest hereunder of another person. Any such tax election or option shall be made only by a fiduciary or fiduciaries that do not have a beneficial interest hereunder or whose beneficial interest could not be enlarged, diminished or shifted by the election or option. If the only fiduciary or fiduciaries who otherwise could exercise such tax election or option hold beneficial interests hereunder that could be so enlarged, diminished or shifted, another individual or a bank or trust company (but not an individual, bank or trust company that is related or subordinate within the meaning of Code Sec. 672(c) to any acting fiduciary hereunder) shall be

appointed by the fiduciary or fiduciaries by an acknowledged instrument delivered to the person so appointed and the fiduciary so appointed shall alone exercise any such election or option.

Make Bequest to Use Spousal Basis Increase. In addition to the $1.3 million basis increase the executor/personal representative may allocate to assets, that fiduciary is authorized to allocate up to $3 million to increase the basis of assets that are received by the property owner's surviving spouse or a QTIP (qualified terminable interest property) trust. For example, assume that the decedent bequeaths a piece of real estate worth $5 million to her husband. Also assume that her basis in the property was $800,000. Under Code Sec. 1022, the decedent's $800,000 basis would remain the basis in the real estate when she dies and is inherited by her husband. However, the executor/personal representative may increase the basis of the land to $3.8 million, by allocating the entire $3 million spousal property basis increase to that asset.

There is a "tie in" here between the estate tax repeal and carryover basis that ought to be consider for several married persons who might die in 2010. As indicated above, it may well be that a Will or revocable trust that provides for an "optimum" marital deduction (that is, the part of the estate equal to the Federal estate tax exemption passes one way and the balance qualifies for the marital deduction) will be construed as having all the property pass as part of the Federal exemption share such as to a "credit shelter trust." Unless that trust just happens to be in the form of a QTIP trust, there may well be insufficient assets in the decedent's estate to be able fully to use the special $3 million spousal property basis increase. And it is unlikely that a disclaimer even by all the beneficiaries of the credit shelter trust will "save" the day—the disclaimed assets may not pass to the marital deduction disposition because that disposition never could come into effect based upon the construction of the instrument. (Maybe, just maybe, if the disclaimed property passes into intestacy and the surviving spouse is the only heir-at-law or all other heirs disclaimer—a complicated matter to say the least—it will pass to that spouse and there will be property to which the $3 million spousal property basis increase may be allocated.)

One simple way to insure there is enough property to which the special $3 million spousal basis increase can be allocated is to bequeath all assets to the surviving spouse. However, as indicated above, a married property owner may not want to have his or her entire estate pass to the surviving spouse for several reasons. One reason is that if the estate tax is reenacted by the time the surviving spouse dies, assets the survivor has inherited outright presumably would be included in the survivor's gross estate for Federal estate tax purposes. Hence, the married property owner may want his or her entire estate to pass into a trust which will not be included in the gross estate but from which the surviving spouse may benefit. For several reasons (including creditor protection for the surviving spouse and to permit maximum income shifting among surviving family members), the married property owner may want the assets placed in a trust from which the trustee may distribute property to the surviving spouse or to the property owner's descendants. But such a trust is not the type to which any portion of the special spouse $3 million spousal property basis increase may be allocated. Hence, either an outright bequest to the spouse or to a QTIP trust (from which all income must be paid to the spouse for life) must be created to be able to make that allocation.

Outright or QTIP Trust? An initial question is whether, in making such a disposition to ensure use of the $3 million spousal basis increase, the disposition should pass outright to the surviving spouse or to a QTIP trust. It is at least arguable that a QTIP trust is preferable. One reason relates to estate tax inclusion when the surviving spouse dies. Certainly, anything he or she inherits will be in his or her estate when he or she later dies (and the estate tax likely back in effect). But the QTIP trust may not be so included. At least under current law, that QTIP trust created by a married person while no Federal estate tax is in effect would not be included in the estate of the surviving spouse. Although a QTIP trust is included under section 2044 of the Code in the estate of the spouse for whom it was created, that section applies only if the spouse who created it got the benefit of an estate or gift tax marital deduction. Since there would have been no estate tax in effect when it was created, it should not be included in the estate of the surviving spouse. Therefore, using a QTIP may be the better choice to take advantage of the $3 million spousal property basis increase.

How Much Must Pass to Use the $3 Million Spousal Basis Increase? The disposition to or for the spouse to which the executor/personal representative is to allocate the $3 million spousal property basis increase may be structured in several ways. It is important to realize that it is a $3 million *increase in basis* and *not* just an allocation to $3 million *worth of assets* to which the allocation applies. An example may help to illustrate this principle. Assume a married woman dies in 2010 when there is no Federal estate tax bequeathing her husband stock worth $3 million in which her basis was $1.4 million, a piece of land worth $2 million in which her basis was $100,000, and a painting worth $4 million of which her basis was $1 million. The inherent gain in the assets are (1) $1.6 million in the stock, (2) $1.9 million in the land, and (3) $3 million in the painting. Suppose the executor wants to increase the basis in the stock to its $3 million fair market value. The executor would not allocate the entire $3 million basis increase to the stock even though it is worth $3 million, but would allocate only $1.6 million. The carryover basis of $1.4 million plus the allocation of an additional $1.6 million of basis to the stock will increase its basis to $3 million, its fair market value when the property owner died. (Note again that the executor cannot allocate more to an asset than will increase its basis to its fair market value at the decedent's death). The executor will allocate the balance of the $3 million spousal basis increase (such balance being $1.4 million) to the other assets. For example, the executor might allocate this balance to the painting, bringing its basis up from $1 million to $2.4 million. Alternatively, the executor might allocate the entire $3 million basis increase to the painting, bringing its basis up from $1 million to its full fair market value of $4 million.

Ways to Structure the Marital Bequest. There seem to be two principal ways to structure the bequest to the spouse or a QTIP trust. One is to minimize the amount that will be transferred to the spouse or the marital trust. The other is to maximize income tax savings. Here is an illustrative comparison. A married man dies with two assets. One is a $4 million vacant parcel of land in which his basis is $1 million. The inherent profit in the land is long-term capital gain. The other asset is commercial building worth $10 million with a basis of $7 million with respect to which he has taken accelerated depreciation for tax purposes. A portion inherent profit in the inventory will be tax at higher than the 15% long-term capital gains tax rate. Both assets have inherent

untaxed profit of $3 million but the gain in the vacant land will face a lower tax than will the commercial building. So allocating the $3 million spousal basis increase to the commercial real estate will save more income tax but it may put more in the spouse's estate (although, as mentioned, any asset given to a QTIP trust while the carryover basis rules are in effect should not be included in the estate of the surviving spouse at least as the law is now written).

Clients need decide whether their principal goal is to minimize what the surviving spouse receives (or will be paid to a QTIP trust for the survivor) while still being able to use the entire $3 million spousal property basis increase, or to minimize potential income taxes even if it means the survivor (or the QTIP trust) will receive more. Here is a sample provision that might be considered to minimize what the surviving spouse receives to fully use the basis increase allowed for qualified spousal property:

> Qualified Spousal Property Gift. If I die when there is no Federal estate tax in effect, I give to the Trustee of the QTIP trust hereunder the lesser of (i) all carryover basis property passing hereunder and not disposed of by the foregoing provisions of this instrument, or (ii) those assets, not effectively disposed of by the foregoing provisions of this instrument, having the lowest combined value as of my date of death as finally determined for Federal estate tax purposes to which my Executor may allocate the entire basis increase allowable, after reducing such basis increase allowable, as of my date of death under Code Sec. 1022(c), by the basis increase that could be allocated to any other assets otherwise constituting qualified spousal property and otherwise passing to my Spouse or a qualified terminable interest property trust within the meaning of Code Sec. 1022(c), whether under this instrument or otherwise. The purpose of this gift is to

take maximum advantage of the basis increase allowed under Code Sec. 1022(c) if I die when the carryover basis rules are in effect, but minimize the amount of property passing to the qualified terminable interest property trust and I direct that this provision be construed to achieve that result. For purposes of this paragraph, the term "carryover basis property" means property with respect to which the additional basis increase under Code Sec. 1022(c) could be made if it were acquired by my Spouse.

And here is a sample provision that might be considered to maximize income tax saving through the use of the basis increase allowed for spousal property:

Qualified Spousal Property Gift. If I die when there is no Federal estate tax in effect, I give to the Trustee of the QTIP trust hereunder the lesser of (i) all carryover basis property passing hereunder and not disposed of by the foregoing provisions of this instrument, or (ii) those assets not effectively disposed of by the foregoing provisions of this instrument, having the lowest combined value as of my date of death as finally determined for Federal tax purposes that would produce the greatest income tax (taking into account the nature of the inherent gain) if sold for such value to which my Executor may allocate the entire basis increase allowable, after reducing such basis increase allowable as of my date of death under Code Sec. 1022(c) by the amount that could be allocated to any other assets otherwise constituting qualified spousal property and otherwise passing to my Spouse or a qualified terminable interest property trust within the meaning

of Code Sec. 1022(c). The purpose of this gift is to reduce potential income taxes attributable to inherent gain in carryover basis property passing hereunder while attempting to minimize the amount of property passing to the qualified terminable interest property trust and I direct that this provision be construed to achieve that result. For purposes of this paragraph, the term "carryover basis property" means property with respect to which the additional basis increase under Code Sec. 1022(c) could be made if it were acquired by my Spouse.

Summary

While most would probably place the chances at less than fifty percent that the year 2010 will bring a repeal of Federal estate tax and its companion carryover basis, it is far from impossible. It seems prudent to plan for repeal of Federal estate tax and carryover basis now by having a decedent's estate planning documents structured to maximize flexibility and savings. Additionally, married clients need to decide how much should pass into a non-marital deduction trust and how much, if any, should pass to (or in a QTIP trust for) the surviving spouse. Although from an overall perspective it seems appropriate to minimize what the survivor inherits if there is no estate tax, the carryover basis provisions suggest that a sizable disposition to the spouse (or, perhaps, better yet, to a QTIP trust) to take advantage of the $3 million spousal increase in basis rule under section 1022. Also, executors/personal representatives should be specifically authorized to make such allocations of basis increase as they think best.

Making Spousal Estate Tax Exemptions Transferable

By Mitchell M. Gans and Jonathan G. Blattmachr

Under the Internal Revenue Code of 1986, taxpayers are permitted a federal gift tax exemption and an estate tax exemption. Although technically not exemptions but more in the nature of exemption "equivalents" that entitle taxpayers to a credit, each is more easily understood as an exemption. The gift tax exemption, as so understood, is $1 million for each taxpayer and is not scheduled to increase. The estate tax exemption, as also so understood, is $1 million for 2005 and is scheduled to become $2 million in 2006, 2007, and 2008 and reach $3.5 million in 2009. There will be no estate tax for individuals dying in 2010. Beginning in 2011, the estate tax exemption drops to the gift tax exemption level of $1 million.

Tax Exemptions of Married Persons

As indicated, each individual has his or her own gift and estate tax exemption. It is not portable: one taxpayer cannot transfer his or her unused exemption to another. Even though the Code can be understood as treating married couples as one economic unit for certain transfer-tax purposes, as per the one-economic-unit theory, a surviving spouse's estate may not use the other spouse's unused exemption. Nonetheless, in the case of lifetime gifts, a couple may share, at least to a limited degree, exemptions by "gift splitting" under Code § 2513, which permits one spouse to consent to be treated as though he or she made one-half of the gifts made by the other spouse (except for gifts made to or for the other spouse). When this section is operative, one consequence is that it permits the spouse making the gift to apply the other spouse's exemption. For example, a wife gives $2 million to her child. Her husband, whether or not he is the father of the child, may consent under Code § 2513 to be treated as though he made half of the gift for federal gift tax purposes. If the election is made, he will report the half attributed to him on his own gift tax return and will use any remaining portion of his gift tax exemption. (In addition, if the gift could be subject to generation-skipping transfer tax, such as a gift to a grandchild, the gift-splitting spouse—the husband in the foregoing example—is also treated as the transferor for generation-skipping transfer tax purposes. That may have the effect of permitting the spouse who made the transfer also to use the GST exemption of the other spouse.)

As suggested, sharing of unused exemptions by spouses for estate tax purposes is not permitted, although such portability has been long proposed. As a result, and to avoid wasting the exemption, so-called credit shelter trusts are commonly used. Such trusts are structured to use exactly the federal estate tax exemption of the spouse dying; they typically provide benefits for the surviving spouse but are structured so as not to be included in the gross estate for federal estate tax purposes of the surviving spouse. These trusts entail financial and psychological costs, such as the cost of drafting and administering the trust and the loss of control over the trusts' assets by the surviving spouse. A portable exemption, under which the surviving spouse would be permitted to enjoy his or her spouse's unused exemption, would obviate the need for credit shelter trusts entirely (although a trust might be used for creditor protection and other reasons). If, for example, under current law, one spouse died and bequeathed the entire estate to the other spouse, the exemption would be wasted. If the Code permitted portable exemptions, however, the surviving

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spouse's exemption would be increased by the unused exemption of the other spouse. An interesting issue if such portability were allowed is whether only the estate tax exemption of the surviving spouse would be increased or also the gift tax exemption of that spouse.

Although Congress has thus far refused to address the issue, the IRS has begun issuing private letter rulings and national office technical advice memorandums (which under Code § 6110(k)(3) may not be cited or used as precedent) that diminish the planning problems some taxpayers face because of the nonportable nature of the exemption. The principal focus of the rulings appears to be the case in which a spouse dies with insufficient assets to use his or her estate tax exemption in full—a situation that becomes more common as the exemption increases. In such a case, the unused exemption is wasted, of course, even though the surviving spouse may have wealth that is greater than his or her exemption. With proper planning, the waste of the exemption could be avoided by having the wealthier spouse make a gift to the less wealthy spouse. This could be accomplished either by an outright gift or by creating a qualified terminable interest property or QTIP trust described in Code § 2523(f) for the benefit of the less wealthy spouse. This kind of planning, however, may encounter objections from clients who are unwilling to relinquish control over assets to their spouses.

PLR Strategy: Creating a General Power in the Deceased Spouse

In the rulings, the IRS has approved a plan that permits clients who have such control concerns to avoid wasting the exemption at the death of the less wealthy spouse. See, e.g., PLR 200403094 (single grantor revocable trust) and PLRs 200210051, 200101021 (joint grantor trust). Under the plan, the wealthier spouse creates a revocable trust that grants the other spouse a testamentary general power of appointment over sufficient assets such that there will be no waste of the exemption in the less wealthy spouse's estate. And because the wealthier spouse is able to revoke the trust at any time, the plan does not entail any surrender of control. To illustrate, assume the less wealthy spouse died in 2005 with $500,000 in assets and had a testamentary general power of appointment over $1 million in assets under the other spouse's revocable trust. The gross estate, under the rulings, would be $1.5 million. In other words, even though the general power could have been revoked by the other spouse, it is nonetheless a general power within the meaning of Code § 2041, and the gross estate is, therefore, $1.5 million.

> Sharing of unused exemptions by spouses for estate tax purposes is not permitted, although such portability has been long proposed.

If the less wealthy spouse exercises the power of appointment in favor of his or her estate and then directs in the will that it be placed in a credit shelter trust for the benefit of the wealthier spouse, the exemption is not wasted. It is, of course, critical that the surviving spouse not be viewed as the transferor of the assets passing into the credit shelter trust. For if that were the case, there would be two negative consequences: (1) the wealthier spouse could be viewed as having made a taxable gift to the other beneficiaries under the credit shelter trust at the death of the less wealthy spouse; and (2) the corpus of the trust could be included in the wealthier spouse's estate under Code § 2036 or § 2038, depending on the nature of the interests or powers conferred on the surviving spouse. Most critical, the rulings conclude that the wealthier spouse should not be viewed as the transferor. That may seem somewhat surprising. After all, one could easily imagine that the IRS would be inclined to invoke the step-transaction doctrine and thereby treat the wealthier spouse as the true transferor—or to argue, similarly, that, under state law, the wealthier spouse is considered the transferor for purposes of analyzing creditors' rights and that Code § 2036 or § 2038 should therefore apply at the wealthy spouse's death. See *Griffin v. United States*, 42 F. Supp. 2d 700 (W.D. Tex. 1998); *Estate of Cidulka v. Commissioner*, 71 T.C.M. (CCH) 255 (1996); *Heyen v. United States*, 945 F.2d 359, 363 (10th Cir. 1991); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986). Presumably, because of a sensitivity to the difficulties that nonportability creates, the rulings do not take this approach.

The rulings take a taxpayer-friendly approach on another critical issue, the gift-tax marital deduction. For the plan to work, the wealthy spouse must not be viewed as having made a taxable gift to the less wealthy spouse. It is, of course, clear that no completed gift occurs as long as the trust remains revocable. Treas. Reg. § 25.2511-2(c) (second sentence). The rulings acknowledge as much. But the more controversial question is whether a taxable gift occurs at the death of the less wealthy spouse. The rulings conclude that the marital deduction applies and, therefore, no taxable gift is made. As such, a gift tax marital deduction is not permitted under Code § 2523(i) for a transfer to a spouse who is not a U.S. citizen, nor is an estate tax marital deduction permitted under such circumstances unless the transfer is in the form of a qualified domestic trust, described in Code § 2056(d). To be sure, the IRS might have taken a less taxpayer-friendly position. It could have denied the marital deduction on the ground that the gift does

not occur until the death of the less wealthy spouse, reasoning that the marital deduction contemplates a living donee. Cf. *Estate of Dove Gordon v. Commissioner*, 70 T.C. 404 (1978), acq. 1979–2 C.B. 1. Treas. Reg. §§ 20.2056(b)-2 ex. 8 and 20.2056(b)-4(e) support the position taken in the rulings by indicating that payments to the spouse's estate qualify for the marital deduction, but in each instance the spouse survived. In contrast, Code § 2056(b)(3)(A) permits a marital deduction when the bequest to a spouse will terminate as a result of the death of the "surviving" spouse in a common disaster. The IRS might also have taken the position in the case in which the less wealthy spouse allows the power to lapse that the marital deduction might possibly be denied on the ground that it constitutes a terminable (nondeductible) interest within the meaning of Code § 2523(b). But, here again, policy concerns about nonportability likely helped to drive the outcome.

One final issue implicated in the rulings is the question of income tax basis. Under Code § 1014, it would seem, at first blush, that the assets passing into the credit shelter trust should qualify for a change in basis. Code § 1014(e), however, provides that the section is inapplicable—no change in basis is permitted—when the asset is gifted to the decedent within one year of death and the asset then passes back to the donor at the death of the decedent. Relying on Code § 1014(e), the rulings conclude that the assets in the revocable trust will not qualify for a change in basis to the extent that the surviving spouse receives property from the decedent as a result of the exercise of the power (or its lapse). In concluding that Code § 1014(e) is triggered, the rulings take the view that the gift is made to the deceased spouse at the moment of death and, therefore, falls within the provision's one-year time frame. In effect, the rulings analogize to the gift-tax regulations. In other words, just as the gift does not occur for gift-tax purposes until the death of the less wealthy spouse because the wealthier spouse retains a revocation power, so, too, the gift is not deemed to occur for purposes of Code § 1014(e). That kind of analogy seems to be a sensible one and could certainly be adopted in regulations. At the present time, however, there is no regulation under the section.

If the conclusion that the gift occurs within the one-year time frame is correct, the question becomes how to compute basis. Although the more recent rulings give no guidance on this question, PLR 9321050 suggests that the determination be made by focusing on the actuarial value of the wealthy spouse's interest in the trust. In other words, if the wealthier spouse is given an income interest in the trust that has a value equal to, say, 40% of the value of the trust's assets, then 40% of the trust's assets should not be eligible for a change in basis under Code § 1014 (the remaining 60% would be eligible). This approach raises two questions: (1) how to determine which assets in the trust are eligible for a change in basis and (2) how to value the wealthy spouse's interest in the trust when it is discretionary. The first question may arise, for instance, when the revocable trust may have more assets than the amount over which the surviving spouse has the general power of appointment. It might be possible to specify the order in which the assets in the revocable trust will be used to satisfy the general power property if the power is exercised. But it seems likely that there is some question about which assets in the revocable trust are included in the gross estate of the deceased spouse on account of his or her general power. In reference to the second question, as a general rule, a truly discretionary interest may have no actuarial value. For example, the standard Code § 7520 income factor may not be used to value an income interest in property when the governing instrument permits trust corpus to be withdrawn for another person's benefit. Treas. Reg. § 20.7520-3(b)(2)(ii)(B)(2). However the calculation is made, it does seem that taxpayers will be able to enjoy some change in basis under the rulings—at least for the portion of the trust deemed to pass to the beneficiaries other than the surviving spouse.

Other Applications of the PLR Strategy

Inappropriate Assets Available to Fund the Credit Shelter Trust

There are two additional contexts in which the new rulings may be useful in planning. First, a spouse may have sufficient assets to use the exemption, but the assets may not be an ideal candidate for a credit shelter trust. For example, when a spouse has pension or IRA assets that could be used to apply the exemption but no other assets, or when the spouse may have insufficient assets other than qualified (pension) plan or IRA assets to use his or her exemption in full, the couple must decide whether to secure the estate tax advantage of making it payable to a credit shelter trust to avoid wasting the exemption. If the credit-shelter approach is used, there is an offsetting income-tax disadvantage: the deferral period for reporting the distributions will be shortened. See generally Natalie B. Choate, *Life and Death Planning for Retirement Benefits* (2003), at 14–26, 56–58, 144–53, for an excellent discussion of "fixed" versus "recalculated" life expectancy methods and income tax free spousal "rollovers." In addition, if they opt for the credit-shelter approach, the estate-tax outcome is sub-optimal: when dealing

If the credit-shelter approach is used, there is an offsetting income-tax disadvantage.

with pension-type assets, which generally will represent the right to income in respect of a decedent (IRD), the surviving spouse's estate tax can be reduced by making the benefit payable to the spouse, rather than to the trust. The right to IRD is not entitled to the change in basis under Code § 1014(a). See Code § 1014(c). Deferred compensation, such as interests in a qualified (pension) plan or individual retirement account (IRA), represent the right to IRD as a general rule. See *Hess v. United States*, 271 F.2d 104 (3d Cir. 1959). The advantage, in other words, that the credit shelter trust offers, when the trust is funded with the right to IRD, is eroded by the income tax on the distributions that the trust must bear. Whereas, if the benefit is made payable directly to the spouse, the income tax paid by the spouse reduces the amount even-

The strategy approved in the rulings permits the couple to use as much of the exemption of the first of them to die as is possible.

tually subject to estate tax at his or her death. If, however, the plan approved in the rulings is used, the couple can avoid wasting the exemption without suffering that erosion and without shortening the deferral period for income tax purposes.

To illustrate, assume that a wife has $1.5 million in her IRA and no other assets and that the husband has $1.5 million in non-IRD assets. Ideally, these assets of the husband would be of the type entitled to the change in basis under Code § 1014(a). Assets other than the right to IRD also may be denied a change in basis under the section. E.g., Code § 1014(b)(5) and (d). If the wife were to die in 2005 survived by her husband, she could direct that her IRA pass into a credit shelter trust to avoid wasting her $1.5 million exemption. But this would, as indicated, shorten the deferral period. And, given the erosion resulting from the trust's income tax liability, it also would not be as estate-tax effective as making the benefit payable to her husband. If the approach approved in the rulings were adopted, however, an optimal outcome could be achieved: the wife would simply make her husband the beneficiary of the IRA, and he would transfer his assets to a revocable trust under which she was given a general power of appointment. Under this arrangement, the husband's non-IRD assets would be used to fund the credit shelter trust created at the wife's death, and the IRA would pass directly to the husband—thus producing no waste of the exemption, no shortening of the deferral period, and no erosion. But it should be noted that the advantage of using the surviving spouse's assets may be eroded if Code § 1014(e) applies to them, as suggested by the private letter rulings. Nevertheless, as explained, it seems that some change in basis under Code § 1014(a) should occur.

Insufficient Assets Available to Fund Both Exemptions

The second context in which the rulings could prove to be helpful is when the couple wants to take full advantage of their exemptions but does not have sufficient aggregate wealth to secure this outcome. For example, assume that a couple has an aggregate wealth of $2.5 million and that they want to use available exemptions fully because they believe that they will eventually have very substantial estates. In 2005, with an exemption of $1.5 million, the couple presumably would be advised to title $1.5 million of their assets in the name of the spouse with the shorter life expectancy. But, of course, the order of death typically is not easily forecast. And if the spouse with the longer life expectancy were to die immediately with an estate of $1 million, part of the exemption ($500,000) would be wasted. Under the rulings, that result can be avoided. If each spouse were to create a revocable trust that conferred a general power on the other, the entire $1.5 million exemption would be used irrespective of the order of their deaths. It may be that the couple together does not have enough combined wealth even to use one exemption fully. For example, the husband has $500,000 and the wife has $750,000, for combined wealth of $1.25 million, which is less than the available exemption for the years 2005 through 2009. Nevertheless, the strategy approved in the rulings permits the couple to use as much of the exemption of the first of them to die as is possible.

A Conservative Approach to Adopting the PLR Strategy

In all of these cases, the rulings solve the problems of nonportability. The IRS obviously resolved all of the legal uncertainties in the rulings in favor of taxpayers to reach a salutary outcome in policy terms. And, although the IRS should be applauded for taking this policy-driven approach, taxpayers will continue to entertain doubts about relying on the rulings until published guidance is provided.

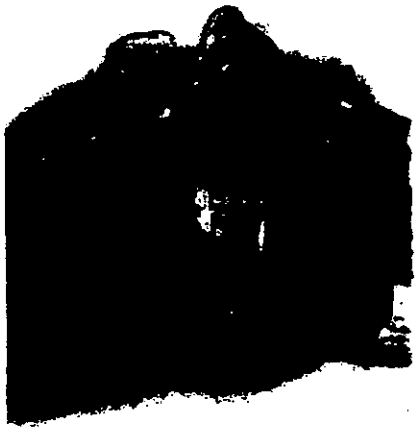
Given the nonbinding nature of private letter rulings and the difficulties practitioners face, as a consequence, it may be prudent to take a conservative approach in terms of drafting and planning to minimize the risk that the IRS would succeed were it to disavow the rulings. Practitioners who implement the approach approved in the rulings, perhaps, should consider adopting the three recommendations that follow.

First, the spouse who receives a general power should exercise it, rather than allowing it to lapse. Although the rulings do not require this, it would seem that the IRS could argue that a spouse who receives a power of appointment and

allows it to lapse has received a terminable interest that does not qualify for the gift-tax marital deduction. On the other hand, if the power is exercised, the terminable-interest argument would appear to be foreclosed. See Rev. Rul. 82–184, 1982–2 C.B. 215.

Second, the surviving spouse should be given a special power of appointment under the credit shelter trust that is created through the exercise of the other spouse's general power. The special power should be exercisable during life and at death. Under this structure, it would seem that the IRS could not argue that the surviving spouse has made a taxable gift of the remainder interest at the other spouse's death. For even if the IRS changes its position and takes the view that the surviving spouse is the transferor, no taxable-gift argument can be made successfully when the transferor has a special power that is immediately exercisable, because the gift of the remainder would be incomplete. Treas. Reg. § 25.2511–2(c). This is illustrated in *Goldstein v. Commissioner*, 37 T.C. 897 (1962), in which the court intimated that a taxable gift might occur if the time for exercising the special power is delayed.

Third, the grantor of the revocable trust should give the other spouse a mandatory income interest that qualifies the property over which the deceased spouse has the general power for QTIP treatment. The general power granted to the first spouse to die might cause the property to qualify for the marital deduction under Code § 2523(e) (a general power of appointment trust) rather than Code § 2523(f) (a QTIP trust). But for the trust to qualify under Code § 2523(e), the general power must be exercisable by the spouse alone and in all events. Treas. Reg. § 25.2523(e)–1(a)(4). Some condition could be built in: for example, the spouse can only exercise the power if he or she is under the age of 115 at the time of death. The built-in condition should prevent it from qualifying for the marital deduction under Code § 2523(e), so an election may be made to have it qualify under Code § 2523(f), in order that the trust will not be included in the surviving spouse's estate under Code § 2036 or § 2038. In addition, the credit shelter trust created for the benefit of the grantor through the exercise of the general power at the death of the first spouse should limit the trustee's discretion in terms of distributions to the grantor (an ascertainable standard relating to health, education, maintenance, and support should be



used). If this suggestion is implemented, it would seem that the IRS would be precluded from including the trust in the estate of the surviving spouse (the grantor of the revocable trust) on a creditors' rights theory. See *Paolozzi*, 23 T.C. at 182; *Paxton*, 86 T.C. at 785. In other words, even if, under state law, creditors of a transferor can reach trust assets when the trustee has discretion to make distributions to the transferor and even if the grantor would be viewed as the transferor of the credit shelter trust—on the rationale that the exercise of the general power by the other spouse should be ignored as a prearranged step designed to give the transferor access to the trust's assets—inclusion in the grantor's estate would nonetheless appear to be precluded. For, under the QTIP regulations, once the QTIP beneficiary has died, neither Code § 2036 nor § 2038 can apply at the death of the spouse who created it even if he or she has a beneficial interest in the trust or a power over it. See Treas. Reg. § 25.2523(f)–1(f) ex. 11. And while Code § 2041 might interact with a creditors' rights theory under state law to produce inclusion in the surviving spouse's estate, the use of an ascertainable standard should eliminate this possibility. In summary, neither Code § 2036 nor § 2038 can apply even if the surviving spouse is treated as having created the credit shelter trust because it will have been treated as a QTIP trust for the spouse dying first. That is so even if the so-called creditors' rights theory of *Paolozzi*, 23 T.C. at 182, and similar precedent is invoked—those cases cause Code §§ 2036 and/or 2038 to apply—because the QTIP regulation cited above forecloses the application of those sections. Moreover, a power exercisable only under an ascertainable standard described in Code § 2041 forecloses the power from being a general power of appointment. Hence, the credit shelter trust should not be included in the gross estate for federal estate tax purposes of the surviving spouse, despite the interests and powers the survivor will hold over the trust. Thus, even if the IRS were to abandon its taxpayer-friendly approach and invoke a creditor's rights theory, documents drafted in the manner suggested would likely produce a favorable outcome.

Some Additional Practical Points

The surviving spouse should file a gift tax return and any applicable state gift tax return, disclosing the gift to the other spouse and claiming QTIP marital-deduction treatment. Assuming adequate disclosure under Code § 6501(c)(9), the statute of limitations for the IRS to challenge the allowance of the marital deduction will expire in three years when there is not a greater than 25% omission from the return. See Code § 6501(e)(2). That means that, if no timely and successful challenge to

the allowance of the marital deduction is made by the IRS, the credit shelter trust should be excluded from the surviving spouse's estate.

Conclusion

The recent rulings produce a taxpayer-friendly outcome in many cases in which the nonportable nature of the estate-tax exemptions makes planning and drafting difficult. But, until published guidance is issued on some of the complicated issues that the rulings resolve in favor of taxpayers, practitioners may find it prudent to draft conservatively and, therefore, implement some of the suggestions made in this article.

Implementing the Strategy

To implement the strategy approved in the rulings, each spouse creates a revocable trust or the couple creates a joint revocable trust. The trusts or trust must be funded with a sufficient amount of property before either spouse dies to ensure that the spouse who dies first has a general power of appointment (causing estate tax inclusion under Code § 2041) over an adequate level of property such that his or her exemption will be used optimally. For example, if each spouse has $1 million titled in his or her name and they have an additional $500,000 in assets, the $500,000 sum could be placed in the revocable trust so the first to die will have an estate for federal estate tax purposes of $1.5 million. Of course, the key is the amount of the taxable estate of the spouse dying first, not the gross estate. Also, values in the trust will vary over time and the federal estate tax exemption is scheduled to increase over the years. Hence, it probably is preferable for the spouses to transfer substantially more to the revocable trust than the minimum expected to be needed to avoid wasting the exemption in the estate of the first spouse to die.

The provision that would be added to the revocable trust might be similar to the following, which is sample language derived from Wealth Transfer Planning™, a computer software system of which Mr. Blattmachr and Michael L. Graham are co-authors and that is published by InterActive Legal Systems (www.ilsdocs.com), which has granted its permission for the language to be reproduced here.

> **Grant of General Power of Appointment.** If the Grantor's husband/wife predeceases the Grantor, then upon the death of the Grantor's husband/wife if the Grantor's husband/wife is then under the age of 115 years, the trustees acting hereunder shall transfer the lesser of (a) all property held hereunder at the time of the death of the Grantor's husband/wife or (b) a [SUM\FRACTIONAL SHARE] of all property then held hereunder, which shall be the amount, if any, by which (i) the Unused Applicable Exclusion Amount of the Grantor's husband/wife exceeds (ii) the value of the taxable estate of the Grantor's husband/wife (determined by excluding the value of property subject to this general power of appointment) to such one or more persons (including the estate of the Grantor's husband/wife) on such terms as the Grantor's husband/wife may appoint by a Will specifically referring to this power of appointment. (If the lesser of "(a)" and "(b)" is "(b)" and if the trustees hold property that would represent the right to income in respect of a decedent within the meaning of Code Sec. 691 at the death of the Grantor's husband/wife, then the power of appointment hereby granted to the Grantor's husband/wife shall be applied first to property that does not represent the right to income in respect of decedent and shall be exercisable with respect to property that does represent the right to income in respect of a decedent only to the extent necessary to permit the Grantor's husband/wife to be able to exercise the power in full to the extent of the lesser of "(a)" and "(b)".) The "Unused Applicable Exclusion Amount of the Grantor's husband/wife" means the largest taxable estate the Grantor's husband/wife could have at the time of his/her death without incurring any Federal estate tax. To the extent this power of appointment is not effectually exercised by the Grantor's husband/wife, the property subject to the power shall be paid over to the Executor under the Will [*change to "personal representative of the estate" if appropriate*] of the Grantor's husband/wife to become part of his/her estate. If the Grantor's husband/wife (or the Executor of the Will of the Grantor's husband/wife) disclaims the general power of appointment granted under this paragraph, that power shall be expunged as of the date of death of the Grantor's husband/wife and treated as though never granted.

The language for a joint revocable trust (that is, one created by both spouses) might be similar to the following:

> **Grant of General Power of Appointment.** Upon the death of the First Decedent [*many practitioners, in drafting "joint" revocable trusts, refer to the husband and wife as "Trustors" as they both create the trust. Others refer to the "husband and wife," the "Settlors," the "Grantors" or some other term. The term in this provision should be modified in accordance with the "naming" convention for the husband and wife used in the joint revocable trust*], the trustee acting hereunder shall transfer upon the death of the First Decedent, if the First Decedent is then under the age of 115 years, the lesser of (a) all property held hereunder at the time of the death of the First Decedent consisting of the Surviving Spouse's separate property and the Surviving Spouse's one-half interest in community property [*remove the reference to "community*

property" if appropriate] or (b) a {SUM\FRACTIONAL SHARE] of the Surviving Spouse's separate property and the Surviving Spouse's one-half interest in community property then held hereunder equal to the amount, if any, by which (i) the First Decedent's Applicable Exclusion Amount exceeds (ii) the value of the First Decedent's taxable estate (determined by excluding the value of property subject to this power) to such one or more persons (including First Decedent's estate) on such terms as the First Decedent may appoint by a Will specifically referring to this power of appointment. (If the lesser of "(a)" and "(b)" is "(b)" and if the trustees hold property that would represent the right to income in respect of a decedent within the meaning of Code Sec. 691 at the death of the First Decedent, then the power of appointment hereby granted to the First Decedent shall be applied first to property that does not represent the right to income in respect of decedent and shall be exercisable with respect to property that does represent the right to income in respect of a decedent only to the extent necessary to permit the First Decedent to be able to exercise the power in full to the extent of the lesser of "(a)" and "(b)".) The First Decedent's "Unused Applicable Exclusion Amount" means the largest taxable estate the First Decedent could have at the time of the First Decedent's death without incurring any Federal estate tax. To the extent this power of appointment is not effectually exercised by the First Decedent, the property subject to the power shall be paid over to the Executor under the Will of the First Decedent to become part of his or her estate. If the First Decedent (or the Executor of the Will of the First Decedent) disclaims the general power of appointment granted under this paragraph, that power shall be expunged as of the date of death of the First Decedent and treated as though never granted.

As mentioned above, it seems preferable for the spouse dying first to exercise the general power of appointment. Here is a sample of how the exercise might be described in that spouse's will:

> **Exercise of Power of Appointment.** Under [*describe trust agreement*], I may hold a power to appoint certain property held thereunder at the time of my death. I hereby exercise that power and direct that all property subject to that power of appointment be added to my estate to become a part thereof. ■

Supercharged Credit Shelter Trust[SM]

Introduction

Many married individuals adopt an estate plan designed to avoid estate tax upon the death of the first spouse to die while taking maximum advantage of the so-called "unified credit" (also known as the applicable exclusion amount). The plan typically involves setting apart the amount sheltered by the unified credit (the "credit shelter" amount) separately, and providing that only the portion of the estate in excess of the credit shelter amount will pass in a manner that qualifies for the marital deduction. Frequently, the credit shelter amount is set apart in trust so that the surviving spouse may benefit from the property if needed without causing those assets to be included in the surviving spouse's estate for estate tax purposes. A credit shelter trust not only preserves the unified credit of the first spouse to die, but also provides an opportunity to leverage the unified credit of the first spouse to die during the lifetime of the surviving spouse: To the extent there is appreciation and/or accumulated income in the trust, it passes upon the surviving spouse's death free of estate tax (and free of generation-skipping transfer tax, assuming an allocation of GST exemption to the trust). The amount in the trust passing tax-free at the surviving spouse's death is enhanced, of course, if trust distributions to the surviving spouse are minimized. The amount in the trust would be further enhanced if the credit shelter trust were the surviving spouse's grantor trust: The surviving spouse's payment of tax on the trust's income would permit the trust estate to grow income tax free. The trust, in other words, would be supercharged. This article will suggest that a lifetime QTIP trust should be used in order to supercharge the credit shelter trust. Given the advantage offered by the Supercharged Credit Shelter Trust[sm], practitioners may wish to consider adopting this drafting approach in many cases.

Background

The unified credit is typically conceptualized as a Federal estate tax exemption or exemption equivalent. The exemption has increased from $60,000 (when it was a true exemption) for many years before 1977 to the current amount of $2 million (and it increases in 2009 to $3.5 million). Under current law, there is no Federal estate tax in

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2010 (so one could view the exemption as unlimited for that year). After 2010, the exemption would revert to $1 million. See section 2010 of the Internal Revenue Code of 1986 as amended ("Code" or "IRC").

In a conventional plan, the first spouse to die does not bequeath all of his or her assets to the surviving spouse via a bequest or other disposition that qualifies for the marital deduction. Were such an approach used, the first spouse's exemption would be wasted. Rather, the exemption amount is typically bequeathed in trust, with the surviving spouse as a beneficiary. As long as the surviving spouse is not given a general power of appointment, its assets will be excluded from the surviving spouse's gross estate for Federal estate tax purposes.

Credit Shelter Trusts

Typically, the plan fully to use the exemption of the first spouse to die is implemented through a "formula" bequest, under which an amount equal to the spouse's unused Federal estate tax exemption is placed in a trust for the benefit of the surviving spouse and descendants. The trust shelters the assets used to fund the exemption from inclusion in the surviving spouse's gross estate for Federal estate tax purposes: Neither section 2036 nor 2038 of the Code can apply because the surviving spouse makes no transfer to the trust; and, if properly drafted, the surviving spouse does not have a general power of appointment over trust assets. Because the trust shelters the amount based upon the unified credit (i.e., the unused exemption) from estate tax in this fashion, it is commonly referred to as a "credit shelter trust."

Structure and Benefits of the Credit Shelter Trust

Some clients may insist on mandating distributions of trust income to the surviving spouse from the credit shelter trust. Although that may provide a sense of psychological and economic security, it is inefficient from a tax viewpoint. Amounts distributed to the surviving spouse, to the extent not expended, will have the effect of increasing his or her gross estate, whereas amounts accumulated in the trust will pass, as indicated, free of estate tax at the surviving spouse's death. In addition, distributions to the surviving spouse will have the effect of depleting a tax exempt trust when it might be possible to provide for the spouse out of what would be estate taxable assets. Moreover, during the surviving spouse's lifetime, income could be distributed to descendants without incurring gift tax. For example, if the trust mandated income distributions to the surviving spouse and he or she then gifted the income received to a child, a taxable gift would occur (to the extent not protected by the annual exclusion under section 2503 of the Code). But, if authorized in the instrument, the income could be distributed by a disinterested trustee directly to the child without generating a taxable gift. (An interested trustee, that is one who is a beneficiary of the trust, could also make the distribution without generating a taxable gift if the trust instrument permits distributions to be made in accordance with an ascertainable standard, such as health, maintenance, support and education.) In addition, the income distribution to the child might produce an income tax savings: the distribution should be taxable for income tax purposes to the child; and, if

the child is in a lower income-tax bracket than the surviving spouse, the difference in bracket will result in a savings. Even if the income is accumulated in the trust, a savings may be achieved: Whereas a distribution to the spouse could generate state or local income tax, it is possible that the trust might not be subject to such a tax.

Where the surviving spouse has sufficient resources, he or she should not receive distributions from the trust. In other words, in order to achieve an optimal tax outcome for the entire family, the surviving spouse should expend his or her own assets (or those in the marital deduction trust) rather than receive distributions from the credit shelter trust. To illustrate, assume that the surviving spouse has access to the following categories of assets: assets held outright by the surviving spouse; assets held in the credit shelter trust; and assets held in one or more marital deduction trusts. Because only the assets held in the credit shelter trust will pass estate-tax free at the surviving spouse's death, it would be preferable to use principal in the marital deduction trust (as it is generally the case that the marital deduction trust will mandate income distributions), rather than principal or income in the credit shelter trust, to enable the surviving spouse to maintain an appropriate standard of living. Under this approach, the assets in the marital deduction trust (estate taxable when the surviving spouse dies) "vanish" while the assets in the credit shelter trust (not estate taxable when the surviving spouse dies) grow. This can be accomplished if the trustee is authorized to distribute principal from the marital deduction trust(s) to the surviving spouse and to accumulate income in the credit shelter trust (in addition, as suggested, it may be helpful from a planning perspective if the trustee of the credit shelter trust were authorized to make distributions to descendants). Where it is anticipated that the credit shelter and marital deduction trusts will be so administered, it may be appropriate to provide detailed authorization to the trustees and, indeed, to encourage them to use this approach. A sample provision might read as follows:

Estate Tax Efficient Shares

I have provided in this instrument, if my spouse survives me, for my estate to be divided into what I perceive to be estate tax efficient shares for those who may succeed to property disposed of hereunder upon the death of my spouse. I understand that the relative size of those shares is dependent upon the tax law in effect at the time of my death and upon elections or other decisions made by my executors/personal representatives. I acknowledge that the interest of my spouse in the shares created hereunder may not be the same and that, if there is no death tax in effect at the time of my death, no estate tax marital deduction share may be created for my spouse. Because benefiting my spouse is one of my primary concerns, I request, but do not direct, that the Trustees of any trust hereunder in which my spouse has an interest benefit my spouse therefrom in a manner that will eliminate or minimize the economic effect upon my spouse of the division of property into separate shares; provided, however, that only a Trustee other than any Trustee who is or in the future may become a beneficiary of a trust hereunder who is referred to herein as a "Interested Trustee" shall participate in any such decision. Without limiting the discretion granted to the Trustees hereunder, without granting my spouse any right to compel the Trustees to do so, and without

imposing any obligation for the Trustees to do so, and solely by way of illustration and not limitation, I authorize the Trustees (other than any Interested Trustee) to pay principal to my spouse from any trust that qualifies for the Federal and/or state estate tax marital deduction while accumulating income in any other trust in which my spouse may have an interest in a manner that the Trustees (other than any Interested Trustee) determine may provide my spouse with approximately the same net benefit (taking into account income taxes and any other factors the Trustees (other than any Interested Trustee) deem appropriate) my spouse would have received had all income or a reasonable unitrust amount, as determined by the Trustees (other than any Interested Trustee), from all trusts in which my spouse has an interest hereunder been paid to my spouse.

Supercharging the Credit Shelter Trust

As suggested, in a conventional plan, the credit shelter trust is created by bequest. Under Subchapter J of the income tax provisions of the Code, unless the trust is a grantor trust under Subpart E of Part 1 of Subchapter J, the income taxation of trust's income is based on the concept of distributable net income (DNI). Under those DNI rules, the trust's income is taxable to the beneficiaries or the trust depending on the amount of distributions made each year. See sections 651-662. Thus, if income distributions to the surviving spouse are mandated or made in the discretion of the trustee, they will be taxed under the DNI rules to the spouse, as a general rule. If, on the other hand, the trust's income is either accumulated or distributed to descendants, it will, of course, not be taxed to the spouse. Suppose, however, the DNI rules could be displaced with the grantor trust rules so that the trust's income, therefore, would be made taxable to the spouse even if no distributions are made to the spouse. (Under the grantor trust rules, the income, deductions and credits against tax of the trust are attributed directly to the grantor as though the trust does not exist and the trust assets were owned directly by the grantor.) If this could be accomplished, the trust would grow income tax free and thus, in effect, would be enhanced by the spouse's income-tax payments. And, assuming an allocation of GST (generation-skipping tax) exemption were made to the trust, the enhancement attributable to the spouse's payment of the income tax could inure to the benefit of lower-generation beneficiaries on a completely transfer-tax-free basis. The credit shelter trust would thus become "supercharged."

How might one structure a credit shelter trust in order to supercharge it? At bottom, the concept rests on Rev. Rul. 2004-64, 2004-2 C.B. 7. In the ruling, the IRS considered the gift tax implications of a grantor trust. In the case of a Grantor Trust, the DNI rules do not apply. Instead, the trust is ignored for income tax purposes and its income is taxed to the grantor. See Rev. Rul. 85-13, 1985-1 C.B. 184. In Rev. Rul. 2004-64, the IRS concluded that the grantor's payment of the tax on the income of a grantor trust does not constitute a taxable gift. For a discussion of the ruling, see M. Gans, S. Heilborn & J. Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," Estate Planning, Vol. 31 No. 10, at 467 (October 2004). Thus, if a credit shelter trust could be structured so that it was the surviving spouse's grantor trust for

income tax purposes while still functioning as a credit shelter trust for transfer-tax purposes (no inclusion in the surviving spouse's estate), it would be supercharged.

The difficulty, however, is that, under conventional planning, the surviving spouse is not the grantor of the credit shelter trust. The trust is created by bequest under the will (or revocable trust) of the first spouse to die and, therefore, cannot be viewed as the surviving spouse's grantor trust. Nonetheless, under section 678, the trust could qualify as the surviving spouse's grantor trust if he or she were given the right to withdraw the trust principal. While this would be effective in terms of making the trust's income taxable to the spouse, it would be ineffective in terms of the estate tax: Such a withdrawal power is a general power of appointment that would cause the trust's assets to be included in the surviving spouse's gross estate under section 2041 (and a release or lapse of the power during the surviving spouse's life would trigger a taxable gift under section 2514 to the extent not saved by the "five-and-five" exception in section 2514(e)). The critical question, therefore, is how to make the credit shelter trust the surviving spouse's grantor trust without relying on section 678.

Lifetime QTIP Trust for the Spouse Dying First

This can be achieved through the use of a lifetime QTIP trust. To illustrate, assume the wife creates a lifetime QTIP trust for her husband with sufficient assets to use his entire estate tax exemption when he dies. She elects QTIP treatment for the trust on her United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709). (Note that it will not qualify for the marital deduction if the spouse for whom the QTIP is created is not a U.S. citizen. See IRC § 2523(i).) Thus, no gift tax is payable when the trust is created, and the entire trust will be included in the gross estate of the husband when he dies under section 2044 of the Code. While both spouses are alive, the trust is the wife's grantor trust (assuming her husband is a beneficiary with respect to both trust income and principal, the trust is deemed wholly owned by the wife). See IRC §§ 676, 677. Therefore, all of the trust's income (whether allocated to accounting income or to principal) would be taxed to the wife without regard to the DNI rules.

Upon the husband's death, as indicated, the assets in the lifetime QTIP trust created by the wife for the husband are included in his gross estate under section 2044. But estate tax will be avoided to the extent of his remaining Federal estate tax exemption (and as to the entire trust if any assets in excess of the husband's remaining exemption pass in a form that qualifies for the marital deduction for estate tax purposes in his estate). And, assuming the trust is properly drafted, its assets (to the extent of the husband's estate tax exemption) should not be included in the wife's gross estate at her later death. Even though she may be a permissible (or even mandatory) beneficiary of the credit shelter trust created from the lifetime QTIP trust, it will not be included in her gross estate as long as she does not have a general power of appointment and as long as the husband's executor does not make a QTIP election. While, under section 2036, trust assets may ordinarily be included in the grantor's gross estate where the grantor is a beneficiary, the QTIP regulations explicitly preclude the IRS from invoking section 2036 or section 2038 in the surviving spouse's estate in the case of such a lifetime QTIP. See

Reg. § 25.2523(f)-1(f), Example 11. Thus, even if the credit shelter trust is drafted to permit distributions to the wife, it will not be included in her gross estate. In effect, the trust functions exactly as would a credit shelter trust formed from assets in the husband's own estate: A trust using his exemption would be excluded from the wife's gross estate at her later death.

Nonetheless, for income tax purposes, the trust can continue to be treated as the wife's grantor trust after the husband's death, provided the trustee has discretion to make distributions of income and principal to the wife. Regardless of the way in which the trustee in fact exercises this discretion, the trust's taxable income will continue to be attributed to the wife under the grantor trust rules by reason of the wife's discretionary interest in trust income and principal. See sections 676, 677. Most critically, the wife is viewed as remaining the grantor of the trust for income tax purposes – thus triggering section 676 and/or 677 -- even though, at her husband's death, it was included in his gross estate under section 2044. See Reg. §1.671-2(e)(5) (no change in identity of the grantor unless someone exercises a general power of appointment over the trust). As a result, the wife's payment of the tax on the trust's income does not constitute a taxable gift. See Rev. Rul. 2004-64, supra. Thus, even assuming the trustee accumulates the income or distributes it to the descendants, the wife is required to pay the income tax and is not treated as making a taxable gift when she does so. In short, the credit shelter trust is supercharged. And if GST exemption is allocated to the lifetime QTIP trust as is permitted in Treas. Reg. §26.2632-1(c)(2)(ii)(C) and as explained in J. Blattmachr, "Selected Planning and Drafting Aspects of Generation-Skipping Transfer Taxation," The Chase Review (Spring 1996), the transfer tax savings will be further enhanced (although Rev. Rul. 2004-64 does not make explicit reference to the GST, its conclusion that no taxable gift occurs by reason of the grantor's payment of the income tax should likewise apply for GST purposes, see Reg.§26.2652-1).

It is appropriate parenthetically to discuss the allocation of GST exemption in a bit more detail here. As explained in The Chase Review article cited above, the spouse who creates the lifetime QTIP trust may make the so-called "reverse QTIP" election under section 2652(a)(3) when the lifetime QTIP trust is created. In other words, the GST exemption of the first spouse to die will not be allocated to the credit shelter trust formed from that lifetime QTIP trust. Rather, the GST exemption of the spouse who created it will be allocated and allocated earlier in time than will estate tax exemption of the spouse dying first. An example may help illustrate this concept. It is quite certain the husband will die before the wife will. She creates a $2 million lifetime QTIP trust for him. Although she makes the QTIP election to make the trust qualify for the gift tax marital deduction under section 2523(f) of the Code, she "reverses" that election under section 2652(a)(3) for GST tax purposes. Hence, her GST exemption begins to "work" as soon as she creates the trust. Assume that when the husband dies, the lifetime QTIP trust is worth $3 million. The first $2 million goes into a credit shelter trust for the surviving spouse and is GST exempt by reason of *her* allocation of *her* GST exemption to the trust. The extra $1 million in the lifetime QTIP trust the wife created for the husband goes into a QTIP trust for her which the husband's executor will elect to qualify for the estate tax marital deduction under section 2056(b)(7). And it too will be GST exempt,

again by reason of the wife's allocation of GST exemption to the lifetime QTIP trust when she created it. The husband's GST exemption will be allocated to other assets in his estate—these other assets presumably will pass into a so-called "reverse" QTIP trust for the wife. Hence, this strategy not only supercharges the estate tax exemption of the spouse who dies first but, as explained in The Chase Review article, "extra" supercharges the GST exemption of the surviving spouse. Of course, as with all lifetime uses of tax exemptions, there is a risk that exemption is wasted if the assets decline in value. If, in the foregoing example, the assets decline to $1,5 million, the husband's estate tax exemption will remain intact, but a portion of the wife's GST exemption may be wasted.

Creditors' Rights Doctrine

Under the law of most, but not all, states, a grantor's creditors may attach assets in a trust the grantor has created and from which he or she is entitled or eligible in the discretion of a trustee to receive distributions. See, e.g., New York Estates, Powers & Trusts Law 7-3.1; Restatement (3d) Trusts, sections 57-60. The question becomes whether estate tax inclusion in the estate of the spouse who created the QTIP that becomes a credit shelter trust for that spouse might result if, under state law, her creditors could reach the trust's assets.

Because the wife in the above example is the grantor of the lifetime QTIP trust and will also be a permissible beneficiary of the resulting credit shelter trust, it is at least arguable that, under state law, her creditors could attach the trust's assets. Ordinarily, the ability of a grantor's creditors to reach trust assets triggers inclusion in the gross estate under section 2036. See, e.g., Outwin v. Commissioner, 76 T.C. 153 (1981), acq., 1981-2 C.B. 1; Palozzi v. Commissioner, 23 T.C. 182 (1954), acq. 1962-1 C.B, 4; Estate of Paxton v. Commissioner, 86 T.C. 785 (1986); Rev. Rul. 77-378, 1977-2 C.B. 348. As indicated, however, the QTIP regulations explicitly preclude the IRS from invoking section 2036 and 2038 in this context. See Reg. § 25.2523(f)-1(f), example 11 (foreclosing the application of sections 2036 and 2038 in the surviving spouse's gross estate with respect to a QTIP trust previously included in the other spouse's gross estate under section 2044).

Is it nonetheless possible that the IRS could successfully argue that, because of the right of the wife's creditors to reach the trust's assets, she has a general power of appointment triggering inclusion in her estate under section 2041? While the QTIP regulations render sections 2036 and 2038 inapplicable in the wife's estate, they do not rule out the possible application of section 2041. (See, also, Reg. § 20.2041-1(b)(2).) Thus, if under applicable state law, the wife's creditors could reach the trust's assets, the possible resulting application of section 2041 in her estate would make this strategy unworkable because it would cause the credit shelter trust to be included in her gross estate. It is critical, in other words, that the plan be structured so that section 2041 cannot apply in the wife's estate with respect to the credit shelter trust for her benefit formed out of the lifetime QTIP trust she created for her husband.

This can be accomplished in one of two ways. First, section 2041 can be negated through the use of an ascertainable standard relating to health, education, maintenance or support. For example, if distributions from the credit shelter trust to the wife were limited by such a standard, section 2041 could not apply in her estate even if her creditors could access the trust's assets under state law. In those states permitting creditors access, the creditors can only reach the amount that the trustee could distribute to the grantor under a maximum exercise of discretion. See, e.g., Vanderbilt Creditor Corp. v. Chase, 100 AD 2d 544, 437 NYS 2d 242 (2d Dept. 1984); comment f to Restatement (3d) Trusts, section 60. Thus, if the trustee may make distributions only to the extent necessary for the grantor's health, education, maintenance and support, the grantor's creditors are similarly limited. They can only reach the trust's assets to the extent the trustee could properly make payments to the grantor for such purposes. And since Section 2041 of the Code excludes from the definition of a general power of appointment a right to property circumscribed by such a standard, including an appropriate standard in the instrument would preclude the IRS from invoking section 2041 even if the trust were located in a state permitting creditors access. (Further limitations might also be incorporated, such as requiring the trustee to consider other resources prior to making distributions.)

Second, the trust could be formed under the laws of a state that does not permit the grantor's creditors to access trust assets. Where the law of such a state controls (Alaska, Delaware, Nevada, Rhode Island, South Dakota, Utah and, to a limited extent, Oklahoma), it will be respected for Federal estate tax purposes. See, e.g., Estate of German v. United States, 7 Ct. Cl. 641 (1985) (no estate tax inclusion in estate of grantor who was eligible to receive income and corpus from the trust because her creditors could not attach the trust property under the law under which the trust was created); see also Rev. Rul. 2004-64.

In sum, when using a Supercharged Credit Shelter Trust℠, it is critical to (a) include an appropriate standard in the instrument and/or (b) locate the trust in a state where the grantor's creditors cannot reach trust assets. Failure to do so could potentially result in inclusion of the trust in the surviving spouse's estate. If the suggested approach is used, the lifetime QTIP trust becomes a credit shelter trust with respect to the first spouse to die for transfer tax purposes while remaining the surviving spouse's grantor trust for income tax purposes, thereby permitting the credit shelter trust to appreciate on an income tax free basis. Given the substantial amount of additional wealth that can be transferred tax-free with the supercharged version of the credit shelter trust (see the accompanying illustration), practitioners should give the approach serious consideration in all cases in which the spouses are willing to consider committing assets to a lifetime trust arrangement.

Reciprocal Lifetime QTIP Trusts: Estate Tax

Under the proposal, instead of creating testamentary credit shelter trusts under the wills or revocable trusts of both spouses, each spouse creates a lifetime QTIP for the benefit of the other, with sufficient assets in each trust fully to utilize the beneficiary-

spouse's exemption. This, of course, raises the question whether the "reciprocal trust doctrine" will undermine the effectiveness of the strategy.

In United States v. Estate of Grace, 395 U.S. 316 (1969), the Supreme Court applied the doctrine to the following facts. A husband had created a trust under which the wife was entitled to receive the income for life; the wife was given a special power of appointment exercisable in favor of their descendants and the husband. Fifteen days later, the wife created a similar trust containing the same dispositive provisions for the benefit of the husband. Emphasizing the fact that the trusts were identical and created in the same time-frame, the Court held that, at the husband's death, the trust created by the wife should be included in his gross estate under an earlier version of section 2036. While a trust created for the benefit of the decedent by another party is not includible in the decedent's estate under section 2036, the Court nonetheless invoked the section on the theory that, in substance, the husband was the grantor of the trust nominally created by the wife. In other words, the husband, in substance, created the trust under which he was the income beneficiary. And, under section 2036(a)(1) of the Code, a trust is included in the estate of the grantor if the grantor retained the right to the income for life. It is important to note that, had the Court respected the form of the transaction, neither trust would have been subject to estate tax: the trust created by the husband could not be included in his estate because he did not retain the right to its income, and it could not be included in the wife's estate because, although she had the right to income, she was not the grantor (under a parallel analysis, the trusts created by the wife would similarly be excluded from both estates). For a further discussion of Grace and the reciprocal trust doctrine, see G. Slade, "The Evolution of the Reciprocal Trust Doctrine Since Grace and Its Current Application in Estate Planning," 17 Tax Mgmt Est. Gifts &Tr. Jl (1992).

At first blush, it would seem that the reciprocal trust doctrine should apply where husband and wife simultaneously create lifetime QTIP trusts for each other. Indeed, the case for applying section 2036 in this context may not even depend on the applicability of the doctrine. For if the surviving spouse is entitled to receive income from the trust he or she created after the death of the other spouse, the section applies without regard to the doctrine. See Reg. § 20.2036-1 (applying the section where the grantor retains the right to the income after the income interest given to another person terminates). On closer analysis, however, section 2036 cannot apply in the QTIP context, whether based on the reciprocal trust doctrine or otherwise. As indicated, the QTIP regulations preclude the IRS from invoking section 2036 in the surviving spouse's estate. See Reg. §25.2523(f)-1(f), Example 11. Thus, the doctrine cannot be used for the purpose of including a QTIP trust created by the surviving spouse in his or her estate. Indeed, given the QTIP regulations, the doctrine is entirely irrelevant for transfer tax purposes in the case of simultaneously created QTIP trusts. It would appear, moreover, to be irrelevant in this context for a second, independent reason: Whereas, in Grace, neither trust would have been subject to estate tax had the form been respected, section 2044 requires that each QTIP trust be included in the estate of the beneficiary/spouse. Thus, unlike Grace, there is no need to disregard the form in order to prevent a problematic estate-tax outcome. For an argument that the doctrine cannot apply where the trust will otherwise be included in one of the spouse's estates, see R. Covey, Practical Drafting (October 1993) at 3402.

There is at least one other reason why the reciprocal trust doctrine may not apply. The "uncrossing" of the lifetime QTIP trusts is unimportant in and of itself as far as estate tax inclusion is concerned as one of those trusts will be included in the gross estate of the first spouse to die (under section 2044 if the doctrine does not apply and under section 2036(a)(1) if it does) and the other in the estate of the surviving spouse (also under one of those sections), as discussed above. The real issue is whether the application of the doctrine would cause the credit shelter trust to be included in the gross estate of the surviving spouse. As indicated, the doctrine applies only where there are two trusts (which under the doctrine are "uncrossed"). But there would not be two credit shelter trusts formed from the lifetime QTIP trusts, but only one. And this trust, at least under general tax principles, is a separate trust from the lifetime QTIP trust that precedes it. Because there is only one credit shelter trust, there is nothing for it to be reciprocal to. Moreover, as explained above, the credit shelter trust, in fact, is created by the surviving spouse, raising the possibility of estate tax inclusion under section 2041 on account of the creditors' rights doctrine (which is "blocked" by limiting distributions to that spouse under an ascertainable standard). If the doctrine applies with respect to the lifetime QTIP trusts *and also to* the successor credit shelter trust from the lifetime QTIP trust, then surviving spouse is not treated, for estate tax purposes, as creating the credit shelter trust—rather the credit shelter trust will be treated as created by the spouse dying first—and that, of course, should totally foreclose the possibility of estate tax inclusion (although, as discussed below, it could destroy the "supercharged" aspect of the arrangement if the doctrine were applied for grantor trust purposes as well.)

Reciprocal Lifetime QTIP Trusts: Gift Tax

The gift-tax analysis is, however, different. If the QTIP trusts are not drafted properly, the reciprocal trust doctrine could present a significant gift tax risk. The IRS could apply the doctrine for the purpose of arguing that the QTIP election is invalid. Consider the QTIP created by the husband, which requires that income be paid to the wife for life. If, as a matter of substance, the wife is viewed as the grantor of the trust, the election would presumably be disregarded: Given the requirement that the grantor's spouse be entitled to the income for life, an election should not be available where the income is payable to the grantor. See T. Herbst, "Lifetime Funding of Reverse QTIP Trusts Enhances GST Planning," 32 Est. Plan. 28 (2005) (raising a question about the applicability of the reciprocal trust doctrine in the context of lifetime QTIP trusts simultaneously created for the purpose of making an early allocation of GST exemption via reverse QTIP elections). And if the election is disregarded, a taxable gift equal to the entire amount contributed to the trust could result. The reason is the potential application of section 2702. That section provides, in general, that when a property owner creates a trust in which he or she has retained the right to income, he or she is deemed to have made a gift of the entire property contributed to the trust because the retention of an income interest may not be subtracted from the value of the property transferred for gift tax purposes. However, section 2702 does not apply if the transfer in trust is an incomplete gift in its entirety for Federal gift tax purposes. Hence, to ensure that section 2702 cannot apply, the QTIP trusts should be drafted to give the beneficiary-spouse a

special testamentary power of appointment. That will render both the income interest and the remainder interest incomplete gifts. See Reg. §25.2511-2 (indicating that, where the donor retains an income interest and such a special power, the gift is rendered incomplete). And, most important, no adverse estate tax consequence would ensue: If the reciprocal trust doctrine does not apply, then Example 11 to Treas. Reg. §25.2523(f)-1(f) will foreclose the application of either or both of sections 2036 and 2038; on the other hand, if the QTIP election proves to be invalid on the basis of the reciprocal trust doctrine, the trust actually created by his wife but deemed under the reciprocal trust doctrine as created by the husband for his own benefit would still be included in his estate but under section 2036 and/or 2038 rather than under section 2044 (with the trust for the benefit of the wife similarly included in her estate on the same rationale rather than under section 2044) and it would still use his Federal estate tax exemption when he dies survived by his wife. Thus, any gift-tax risk that the doctrine poses is easily negated by the special power of appointment without a negative estate tax consequence.

Reciprocal Trust Doctrine and the Grantor Trust Rules

While, as suggested, the reciprocal trust doctrine should not create any estate or gift tax threat, the question remains whether it could lead to a problematic denial of grantor trust status. The key to the success of a Supercharged Credit Shelter Trust[tm] is that the QTIP created by the surviving spouse constitute that spouse's grantor trust. Were this to prove not to be the case by reason of the doctrine, the trust would not be supercharged. The income of the credit shelter trust, in other words, would not be attributed to the surviving spouse under the grantor trust rules. If, for example, the wife survived and the husband were viewed, in substance, as the grantor of the QTIP (and the successor credit shelter trust) she had created, its income would not be attributed to her under the grantor trust rules. As a result, if she were to pay the tax generated by the credit shelter trust's income, the payment would constitute a taxable gift. Before turning to the question whether the doctrine can be applied to deny the surviving spouse the desired grantor trust status, it is important to emphasize the absence of any downside risk: If the surviving spouse cannot treat the trust as his or her grantor trust, the only adverse consequence is that its income will remain subject to the DNI rules, which is of course the way in which conventional credit shelter trusts are taxed. Thus, if the strategy works, the trust is supercharged; and if it does not, it produces the same outcome as a conventional credit shelter trust. (If the surviving spouse pays the income tax on the trust income because she believes it is a grantor trust with respect to her, but it turns out not to be her grantor trust, Rev. Rul. 2004-64 would not apply to prevent those tax payments from being gifts to the trust. But if the surviving spouse's powers over the trust include a power to veto distributions to others during her lifetime and a testamentary special power of appointment, those powers would render any gift incomplete although her powers would cause the portion of the trust attributable to those gifts made by her tax payments to be added back into her gross estate, which is the same result as if she had not made the payments of income tax.)

More important than the absence of downside risk, it would seem that the reciprocal trust doctrine should not result in a failure in the desired grantor trust status.

The doctrine has been applied in the context of the grantor trust rules. See Krause v. Commissioner, 497 F.2d 1109 (6th Cir. 1974), aff'g, 57 T.C. 890 (1972); see also PLR 8813039 (not precedent), applying the reciprocal trust doctrine for grantor trust purposes which caused the trusts created by a husband and by a wife for each other to be treated as self-settled grantor trusts and thus qualified subchapter S shareholders. However, the doctrine should not be problematic with respect to lifetime QTIP trusts for two reasons. First, both QTIP trusts are grantor trusts; the only question is whether the husband should be treated as owning the trust he created or the one created by his wife (with a parallel question concerning the wife). This is to be distinguished from Krause, where, absent the doctrine, the IRS would have been unable to characterize either trust as a grantor trust (in Krause, the IRS sought to tax the trust's income to one of the spouses). Second, regulations issued in 2000 appear to have abandoned the doctrine for grantor trust purposes. Reg. §1.671-2(e)(1) provides: A "person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under" the grantor trust rules." Under this regulation, the person who makes the reimbursement is the trust's owner for grantor trust purposes. See Reg. §1.671-2(e)(6), Example 3. Thus, unless the person who creates the trust receives a "direct reimbursement," the creator of the trust is treated as the grantor for grantor trust purposes. In the case of simultaneously created QTIP trusts, no such direct reimbursement occurs. Assuming again that the husband is the surviving spouse, he is treated both before and after his wife's death, under the regulation, as the grantor of the QTIP he had created for her benefit because she did not directly reimburse him. At worst, she might could be viewed as having indirectly reimbursed him (by creating the QTIP for his benefit). As a final observation about the regulation, the seeming decision to abandon the doctrine in this context -- and thereby narrow the number of cases in which a trust is treated as a grantor trust -- is not surprising. After all, at the time this regulation was promulgated, the IRS had already come to fully appreciate the fact that the grantor trust provisions are more helpful than harmful to taxpayers. Lastly, even if the QTIP trusts are deemed reciprocal, it does not necessarily follow that the doctrine applies to the credit shelter trust. Not only is the credit shelter trust a separate and distinct trust created upon the death of the spouse first to die (and only one credit shelter trust is created), but at that point, there is no other grantor trust that it could be reciprocal to because the other grantor has died. Therefore, it seems impossible, even if the QTIP trusts were treated as reciprocal for grantor trust purposes, to find that the credit shelter trust is reciprocal, and thus not a grantor trust with respect to the surviving spouse who created it.

Why Take Any Risk?

Although it seems reasonably clear that simultaneously created QTIP trusts can be used to create a Supercharged Credit Shelter Trust℠ and that the reciprocal trust doctrine does not pose any serious threat to this strategy, it is probably prudent to draft the documents so that there is no risk of failure. This can be accomplished in one of two ways. First, if the remainder interests are not identical, the doctrine may be rendered inapplicable. In Levy v. Commissioner, TC Memo 1983-453, a husband and wife created

trusts on the same day, giving each other an income interest. One trust gave the beneficiary/spouse a special power of appointment; and the other did not. As a result of this difference in the terms of the trusts, the reciprocal trust doctrine was not applied. In reaching this result, the court referenced the following language in Grace: "The reciprocal trust doctrine does not purport to reach transfers in trust which create different interests and which change the effective position of each party vis a vis the [transferred] property ...," Indeed, perhaps, of even greater importance, the IRS had conceded that, if valid, the special power of appointment in the wife prevented the two trusts from being interrelated and, therefore, subject to the reciprocal trust doctrine. Although the IRS contended that the provision creating the special power of appointment was invalid under state law (New Jersey) or otherwise worthless, the court concluded otherwise. It should be noted that the wife's power of appointment was currently exercisable, which is, of course, not permitted in a QTIP trust. Nevertheless, Levy does endorse the proposition that, where the trusts have different terms, they are not interrelated and are, therefore, not subject to the reciprocal trust doctrine. And although it is arguable that the Tax Court in Levy was wrong in insisting that, under the doctrine, the terms must be identical, see Estate of Green v. U.S., 68 F.3d 151 (6th Cir. 1995) (Jones, J., dissenting), the IRS has embraced Levy. See PLR 200426008 (not precedent). Second, even assuming that the terms of the two trusts are identical, the doctrine should still not apply if they are not created in the same time-frame. See Grace (emphasizing that the trusts were interrelated because of the parallel terms and because created within a fifteen-day period).

Thus, in order to eliminate any risk that the strategy might fail, the trusts should be created at two different points in time (separate by months, not by days as in Grace). In addition, they could be drafted differently. So, for example, as in Levy, one trust might contain a special power of appointment while the other would not (although, as suggested, it may be preferable to include the power in both trusts in order to negate any taxable gift should the IRS argue that the QTIP election is invalid, but the power could be exercisable in favor of different classes of appointees and, perhaps, might be exercisable only with the consent of a non-adverse party). One trust might provide that an invasion could only be made after the spouse's other resources are taken into account, while the other might direct that the existence of such resources is irrelevant. Other differences might relate to the income interest. For example, one lifetime QTIP trust might incorporate a unitrust approach while the other would preclude the trustee from using this approach. Also, having different trustees under the two instruments may further help block the application of the doctrine as may funding each trust with different assets and with different values. Given Grace, and the Tax Court's application of Grace in Levy, it would seem that either a difference in timing or a difference in terms should suffice to eliminate the threat of the doctrine. Nonetheless, cautious practitioners may choose to vary both the timing and the terms.

Summary and Conclusions

Given the additional wealth the supercharged credit shelter provides for descendants, as compared to the amount of wealth provided under a conventional credit shelter trust, it probably should be considered in all cases where the spouses have

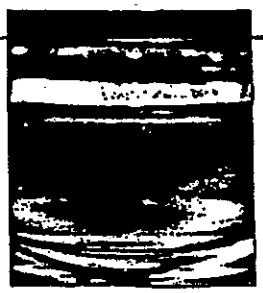
sufficient net worth. Although the reciprocal trust doctrine may be perceived as posing a threat to the viability of the strategy, with proper drafting it does not create any additional estate or gift tax risk, it poses no downside risk for income tax purposes, but most importantly, the application of the doctrine may be effectively avoided by varying the timing and provisions of the two trusts. Thus, the strategy provides a sound means significantly to enhance the effectiveness of the Federal estate tax exemption of the spouse dying first and, through reverse QTIP elections with respect to each lifetime QTIP trust at the time each is created, the GST exemptions of both of spouses .

Chart

Amount in Credit Shelter Trust at Death of Surviving Spouse
Assumptions: $2 million initial funding; 8% annual return; 25% effective income tax on undistributed income

Amount in Trust (in Millions)

Years Between Deaths of Spouses	Payment to Spouse Each Year @ 4%	No Payment to Spouse (Spouse Not Taxed)	No Payment to Spouse (Spouse Pays Income Tax)
5	$2.32	$2.68	$2.94
10	$2.69	$3.58	$4.32
15	$3.12	$4.79	$6.34
20	$3.61	$6.41	$9.32
25	$4.19	$8.58	$13.7



Quadpartite Will: Decoupling and the Next Generation of Instruments

The authors suggest a number of innovative planning strategies (such as an additional QTIP trust) for married individuals domiciled in a state that has an estate tax exemption which is less than the federal exemption.

MITCHELL M. GANS AND JONATHAN G. BLATTMACHR, ATTORNEYS

As a result of the reduction beginning in 2002 and complete elimination, effective beginning in 2005, of the state death tax credit allowed under IRC Section 2011, the cost of estate or inheritance tax imposed by many states has increased. In fact, some states, such as New York, that had not imposed any effective estate tax because the state tax was made equal to the amount that was allowed as such a credit, now impose an additional estate tax because the state system imposes a tax equal to the amount that would be allowed as a credit if the credit had not been reduced or eliminated. In other words, the state system is no longer coupled exactly to the amount of the credit actually allowable but rather, to what was allowable before the state death tax credit began to be phased out under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").[1]

That means the cost of dying domiciled in such a state has increased. In some cases, the additional state death tax may more than offset the reduction in federal tax attributable to the lowering of the federal estate tax rates which have dropped from a top rate of 55% in 2000 to 47% now, and the top rate is scheduled to drop to 45% beginning in 2007. Some other states that had not limited their estate or inheritance taxes to the state death tax credit amount under IRC Section 2011 continue to impose additional tax burdens on the estates of certain of their domiciliaries.

Furthermore, several states now have a smaller estate tax exemption than that allowed under federal law,[2] which has now risen to $1.5 million[3] and is scheduled to rise to $2 million in 2006 and to $3.5 million for 2009.[4] That may also increase the cost of dying domiciled in such a state (as compared to dying domiciled in a state that allows the same level of exemption). It may mean, for example, that the estate of an individual who dies with a taxable estate no greater than the amount of his or her federal estate tax exemption may owe state death tax.

The smaller state exemption presents new challenges in planning for a married person who otherwise would be inclined to divide his or her estate between a so-called optimum credit shelter (or federal estate tax exemption) share and a

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marital deduction share. It even presents problems for individuals who die domiciled in a state that imposes no state death tax or allows a exemption equal to the federal exemption if that individual owns real or tangible personal property situated in a state with a state death tax and/or a smaller exemption than that allowed under the federal estate tax system.

This article will explore some planning steps that may be considered for married individuals domiciled in a state having an exemption that is less than the federal exemption. This problem may "disappear" (or be reduced) in 2011, when the changes to the Internal Revenue Code made by EGTRRA "sunset" (i.e., at that time, pre-EGTRRA provisions become effective, resulting in the restoration of the state death tax credit and the reduction in the federal estate tax exemption to $1 million). In other words, in many cases, the problems attributable to the smaller state estate tax exemption relative to the federal exemption are only temporary.

Married persons in states with smaller exemptions

As a result of EGTRRA, in many states, the federal and state estate tax exemptions are no longer in lockstep.[5] For example, in New York, the exemption remains $1 million even though the federal exemption is currently $1.5 million and is scheduled to increase over the next five years.

The resulting lack of parallelism between the two systems has complicated estate planning for many married couples. For instance, in New York (or any state providing an exemption that is less than the federal exemption), a couple adopting an estate plan designed to minimize their federal estate tax liability must in effect agree voluntarily to pay a toll charge in the form of a state estate tax at the death of the first spouse. And, as the federal exemption increases, the toll charge will increase.

As a matter of conventional planning, a married person typically divides her estate into two portions (more accurately, three portions in order to fully use the generation-skipping transfer ("GST") tax exemption). One portion, consisting of the estate-tax exemption amount, is placed in a credit shelter trust. The second portion, the balance of the estate, is gifted to the spouse, either outright or in trust, in order to qualify for the marital deduction.

Assume, for example, that a wife has $2.5 million in assets and dies in 2005. If the will divides her estate in this typical manner, the husband will receive a bequest of $1 million, and the other $1.5 million in assets will be placed in a credit shelter trust. The plan accomplishes two objectives. It prevents the $1.5 million in assets contributed to the credit shelter trust from being taxed in the husband's estate on his later death, and it defers the estate tax through the use of the marital deduction on the remaining $1 million until the husband's subsequent death. Most significantly, both these objectives are accomplished without paying any estate tax at the death of the wife.

In a state with an exemption that is less than the federal exemption, this plan would produce a state tax at the wife's death. If $1.5 million of the wife's assets is bequeathed to the credit shelter trust and the remaining $1 million is bequeathed to the husband, in New York, a tax of $64,400 would be payable at the wife's death. The tax is produced by the disparity in state and federal exemptions ($1.5 million for federal purposes and $1 million for New York state purposes). In other words, to achieve the optimal outcome for federal tax purposes, the wife's exemption of $1.5 million should be placed in the credit shelter trust. But this produces a suboptimal outcome for state purposes. Given that the state exemption is only $1 million and given that assets bequeathed to the credit shelter trust will not qualify for the marital deduction, placing $1.5 million in a credit shelter trust constitutes an "underutilization" of the marital deduction for New York purposes and results in the New York tax of $64,400. In effect, the New York tax is a toll

[1] See, generally, Blattmachr and Detzel, "Estate Planning Changes in the 2001 Tax Act—More Than You Can Count," 95 J. Tax'n 74 (Aug. 2001). For a further discussion of these issues, see Fox, Pomeroy, and Abbott, "Ramification for Estate Planners of the Phase-Out of the Federal State Death Tax Credit: Boom, Bust or Unknown?," ACTEC J. (Summer 2003).

[2] There is no federal estate tax exemption. There is a unified credit (a/k/a applicable credit) under Section 2010. The credit can be viewed, in some ways, as an exemption equivalent. However, it does not function as an exemption. For example, if the decedent had made certain taxable gifts after 1976, the credit will not protect as much property from tax as the exemption equivalent would indicate. The reason is that the exemption equivalent represents the amount that could be protected from tax if no such taxable gift had been made. Also, the unified (or applicable) credit itself is reduced if the decedent made a gift between 9/8/76 and 12/31/76, and used part or all of the specified gift tax exclusion then allowable under Section 2511. Section 2010(b).

[3] It is possible that the exemption equivalent could, in fact, be greater if credits other than the unified (applicable) credit were allowed. See, e.g., Section 2013 relating to a credit for estate tax paid on property previously included in the gross estate of another person from whom the decedent has inherited property.

[4] Under current law, the federal estate tax is repealed for 2010. It is to be restored beginning in 2011 as it was prior to EGTRRA, but with a $1 million exemption equivalent.

[5] At least the following states are or appear to be "decoupled": Maine, Massachusetts, Maryland, Rhode Island, New Jersey, New York, Oregon, Tennessee, Minnesota (through 2007), Ohio, Wisconsin, Illinois (only in 2009) and the District of Columbia (Washington). Oregon, Ohio, Tennessee, Massachusetts, and Rhode Island permit a "state-only" QTIP election. The Supreme Court of Washington State has held that that state's estate tax is "coupled." Estate of Hemphill v. State, 2006 Wash. LEXIS 89 (Wash., 2006), Docket 74974-4 (2/3/06). Legislation to allow a state-only QTIP election has been introduced in at least Maine and New York.

charge imposed on couples seeking an optimal federal outcome.

The wife's will could be drafted to defeat the toll charge, but only at the cost of a greater federal tax at the husband's death. To illustrate, the wife's will could place only $1 million in the credit shelter trust, with the remaining assets of $1.5 million bequeathed to the husband in a form that would qualify for the marital deduction. While this would defeat the toll charge, the additional $500,000 bequest to the husband would increase his gross estate. Because the federal and state tax attributable to the inclusion of this additional amount (together with any return it produces in his hands) in the husband's estate will in all likelihood significantly outweigh the estate toll charge, many advisors will recommend against this approach—or will, more likely, draft the wife's will to permit the decision about paying the toll charge to be made after her death.

Some options to eliminate tax when the first spouse dies

Change of domicile before death. Probably, the most certain way to reduce the extra state death tax burden is for the individual to change domicile to another jurisdiction that has a lower or no state death tax or has a state death tax exemption equal to the federal exemption.[6] Changing domicile, of course, may have other far-reaching effects, including those relating to income tax, intangible property tax, spousal and possibly other family rights both during lifetime (e.g., in the event of divorce) or at death, appointment of fiduciaries, and many others. But the most important change typically caused by a switch in domicile is one of lifestyle. Almost certainly, the individual will have to spend more time in the newly established domicile than in the old one. Other steps, although perhaps not as life altering, also should be taken to establish that domicile has been changed.[7] Moreover, there is a danger that the decedent will have been found domiciled in the "old" state as well as the "new" one for state death tax purposes.[8]

Change in domicile may produce other benefits. For example, moving from a jurisdiction with state and, perhaps, local income tax to one with no income tax probably would be viewed by most individuals as beneficial. Cost-of-living charges may also be reduced. Even if such beneficial changes occur, the individual presumably would have already changed domicile if, in the aggregate, circumstances compelled such a change. Perhaps, for some individuals, the additional state death tax their estates will face will constitute the proverbial "straw that broke the camel's back" and cause them to effect a change in domicile. Nevertheless, changing domicile is so life altering that probably few individuals will voluntarily make such a change just because of the additional state death tax, especially if it is temporary; as indicated above, in many states, the extra state death tax burden will be eliminated or substantially reduced in 2011 when the state death tax credit is restored and the federal exemption drops back to $1 million.

One case where the change of domicile might be effected only on account of the additional state estate tax the individual's estate would face is where the individual is incompetent and institutionalized and will not understand that a life alternating change has occurred. Although an incompetent individual may not be able to form the requisite intent to change domicile, the guardian of the incompetent or a court having jurisdiction over the individual may order a change in domicile, which probably will be binding on the state tax authority within that state.[9]

Pre-death gift. In some states, a pre-death gift may eliminate the difficult choice a married person faces of paying state death tax by using the full federal estate tax exemption or avoiding both state and federal estate taxes at the death of the first spouse to die but exposing considerably more property to estate tax when the surviving spouse dies. For instance, suppose that a married New Yorker who has never used any of her federal exemption makes a $500,000 gift to an inter vivos credit-shelter-type trust, leaving her estate in effect with a $1 million federal estate tax exemption. It might seem that, because the remaining federal exemption is now equal to the state exemption, she

[6] Also, any real or tangible personal property located in the "old" domicile state should be "removed" before death as a state may impose its death tax on real and tangible personal property located there. See Curry v. McCanless, 307 U.S. 357, 31 AFTR 937 (S.Ct. 1939).

[7] Among other factors that may be considered in determining an individual's domicile are where the individual spends most of her time, where her more substantial home is situated, whether a home is owned or rented, where the individual is registered to vote and whether she actually votes there in person, whether the individual has executed and/or revoked a declaration of domicile (if available), what location the individual has declared to a census taker to be her principal residence, what IRS service center the individual has used to file her U.S. income and gift tax returns, where she has filed resident and nonresident income tax returns (if any), where her automobiles and other vehicles (e.g., boats) are registered, in what state(s) she holds resident driving, fishing and other licenses, where the individual has made plans to be buried, where her principal place of business is located, the states in which she holds any professional licenses (e.g., medicine or law), where her immediate family members (e.g., spouse and minor children) spend most of their time, where any minor children go to school, and what address is used in her passport and similar documents. See, generally, Restatement of Conflict of Laws § 11.

[8] See In re Dorrance's Estate, 115 N.J. Eq. 268, 170 Atl. 601 (1934); *aff'd* 116 N.J.L. 362, 184 Atl. 749 (1935), *cert. den.*; In re Dorrance's Estate, 309 Pa. 151, 163 Atl. 303 (1932).

[9] See, e.g., In re Seyse, 353 N.J. Super. 580, 803 A.2d 694 (2002); N.Y. State Tax Comm'n Advisory Opinion TSB-A-86(13)I, 1986 WL 31399 (N.Y. Dept. Tax. Fin., 1986); First Trust and Deposit Co. v. State Tax Comm'n, 3 N.Y. 2d 410 (1957).

could divide her estate into the "classic" two portions (a credit shelter trust, equal to her remaining $1 million federal exemption, and a marital deduction portion equal to the balance of her estate) without paying any federal or New York estate tax. But New York estate tax will still be due. The reason is that New York's estate tax is equal to the lesser of: (1) the pre-EGTRRA state death tax credit, and (2) the federal estate tax that would be due based on an assumed (contrary-to-fact) federal estate tax exemption of $1 million (computed based on the sum of the taxable estate and adjusted taxable gifts).

The state death tax credit on a taxable estate of $1 million (the amount passing to the credit shelter trust at death given the $500,000 lifetime gift) under pre-EGTRRA Section 2011 is equal to $33,200.[10] The actual federal estate tax due will be zero even though the federal estate tax will be calculated by imposing the tax on the sum of the decedent's $1 million taxable estate (the amount passing into the credit shelter trust at death) and the $500,000 adjusted taxable gift that passed into the lifetime credit shelter trust.[11] No tax is due because the federal exemption is $1.5 million.

But, as indicated, New York requires that, *for purposes of computing the New York estate tax,* the federal tax on the $1.5 taxable amount is computed on the assumption that the federal exemption is only $1 million. Under this assumed calculation, the federal estate tax would be $210,000. Because the pre-EGTRRA Section 2011 credit is only $33,200, that smaller amount is paid to New York. Thus, although counterintuitive, the estate must pay New York tax even though the taxable estate is only $1 million; New York permits an exemption of $1 million; and, under pre-EGTRRA Section 2011, adjusted taxable gifts are not considered in determining the credit.

To eliminate the New York tax, the taxable estate would have to be reduced to $100,000 (i.e., under Section 2011, the credit on a taxable estate of this amount would be zero). Given the current federal exemption of $1.5 million, a gift of $1.4 million would be necessary to reduce the taxable estate to $100,000 (assuming no prior adjusted taxable gifts).[12] And as the scheduled increases in the federal exemption become effective, reducing the taxable estate to $100,000 would require even greater inter vivos gifts (e.g., in 2009, when the federal exemption will be $3.5, an inter vivos credit-shelter gift of $3.4 would be necessary to optimally fund the credit shelter trust for federal purposes while not permitting the taxable estate to exceed $100,000). The difficulty, however, with making gifts in excess of $1 million is that they will generate federal (and, in some states, state) gift tax. Consequently, the value of using inter vivos gifts in order to reduce state tax liability is limited: gifts that generate federal gift tax liability should not be made for this purpose.[13]

It is important to note that any inter vivos gift designed to reduce the taxable estate could create an adverse income tax consequence. The basis of property included in a decedent's estate generally is equal to its estate tax value.[14] The basis of property given away during lifetime is the donor's basis adjusted for federal gift tax paid on inherent appreciation.[15] Hence, unless the individual has assets with which the gift could be made that have no inherent appreciation that would be eliminated on death on account of the change in basis to the estate tax

[10] The credit under Section 2011 is computed on the "adjusted taxable estate," which is the taxable estate less $60,000.

[11] See Section 2001(b).

[12] For example, if the taxpayer had previously made adjusted taxable gifts of $600,000, she would need to make an additional taxable gift of $800,000 in order to reduce her taxable estate to $100,000. As an alternative, she could increase the amount passing under the protection of the marital deduction, but that would "overuse" the marital deduction by underutilizing the federal exemption.

[13] To illustrate, assume that a gift of $1.4 million is made shortly before death in order to reduce the taxable estate to $100,000. Such a gift would generate a federal gift tax liability of $167,000. Because the federal gift tax liability exceeds the state toll charge of $33,200 were a gift of $1 million made instead (which would generate no gift tax liability), a gift in excess of $1 million makes no sense. And reducing the marital bequest to avoid wasting the gift tax payment would not be effective inasmuch as this would cause an increase in the taxable estate and therefore an increase in the New York tax. Moreover, any federal gift payment would then be included in the gross estate under Section 2035 if death occurs within three years, thereby causing an increase in the taxable estate and an increase in the New York estate tax. Parenthetically, it is worth noting that a taxpayer who has not made any prior adjusted taxable gifts could generate a federal gift tax by making a gift of only $1 million. If the taxpayer had made a taxable gift prior to 1976, a current gift of $1 million would generate a federal gift tax liability because the applicable tax bracket on the current gift is determined by taking into account the prior gift.

[14] See Section 1014.

[15] See Section 1015.

value rule, there may be an income tax cost of such a gift that probably should be considered in determining if avoiding the problem of the smaller state death tax exemption is worthwhile. It may turn out that the individual holds property that has an income tax basis greater than its current fair market value. Lifetime gifts of such property may preserve such higher basis (at least for purposes of measuring gain).

If inherent gain that would be eliminated for income tax purposes by death is imbedded in the only assets that are realistic gift candidates, the married person could borrow. But typically that will result in additional cost for interest, advice, and other expenses. Such borrowing, unless it is from a family member or entity, may not be cost-efficient.

Waiting until death. Whether it would be preferable to limit the credit shelter disposition to the lesser of the federal and state estate tax exemptions and pay a larger tax when the survivor dies, or to use the full federal estate tax exemption even though a state toll charge would be due when the first spouse dies, may depend on factors that will not be known until that spouse dies. For example, if the surviving spouse has an extremely short life expectancy, it may be better to use the full federal estate tax exemption in the estate of the spouse dying first because that may reduce overall taxes on the estates of both spouses.[16] Generally, it may be preferable to wait until the first spouse dies to make a decision as to how much of the federal exemption to use. Several options are available that may accomplish this.

First, the credit shelter disposition could be limited to the lesser of the federal or state estate tax exemption, with the balance passing in a form that qualifies for the marital deduction. The surviving spouse could make a qualified disclaimer,[17] within nine months of the death of the spouse dying first, of a sufficient amount of the portion of the estate qualifying for the marital deduction to make fuller or complete use of the federal exemption. One limitation in using such a strategy may be the reluctance of the surviving spouse to disclaim because of the reduction in economic benefits the surviving spouse would otherwise enjoy.[18]

An alternative is to use a so-called Clayton QTIP.[19] This is a disposition that passes into a QTIP trust to the extent—but only to the extent—that the executor elects QTIP treatment under Section 2056(b)(7), but passes otherwise (such as to a credit-shelter-type trust) to the extent QTIP is not elected. The executor, by controlling how much qualifies for the marital deduction, controls how much estate tax exemption (federal and state) is used.

Although a similar result can be achieved by merely making a partial QTIP election, the Clayton QTIP offers the "advantage" that the portion with respect to which the QTIP election is not made may pass into a trust that may authorize distributions to descendants as well as the surviving spouse, which may provide opportunities to reduce income taxes (such as by making distributions of trust income to descendants) and to avoid gift tax (as distributions from such a trust are not subject to gift tax but distributions to the surviving spouse, followed by gifts of such distributions by the survivor to his or her descendants, may be subject to such tax). A disadvantage of the Clayton QTIP, however, is that, if the property not elected for QTIP treatment passes in a form over which the surviving spouse does not have an income interest, the effective use of the prior transfer credit under Section 2013 may be diminished or eliminated.[20]

Alternative: Separate QTIP trust equal to excess federal exemption

In any event, many married individuals who reside in states that have smaller state death exemptions than permitted for federal estate tax purposes will not be willing to change domicile or make such large gifts for a variety of reasons. But the creation of a special QTIP trust by them under their estate planning documents may provide another way to avoid the problems of the smaller state death tax exemption. In other words, they could create a QTIP trust equal (subject to refinements discussed below) to the excess of the federal estate tax exemption available to the decedent's estate over the amount that may pass free of both federal and state death taxes by reason of the federal and state death tax exemptions. Examples will help illustrate the effect of this special QTIP equal to the "excess" federal estate tax exemption.

Assume that a married New Yorker dies in 2005 with an adjusted gross estate[21] of $2.5 million, never hav-

[16] In fact, if it is anticipated that the surviving spouse may die soon after the other spouse, it may be preferable to make the taxable estate of the spouse dying first even greater than the federal estate tax exemption on account of the allowance of the prior transfer credit under Section 2013.

[17] See Section 2518. If the surviving spouse is under age 21, the nine-month period within which he or she may disclaim commences upon his or her 21st birthday.

[18] Professor Jeffrey Pennell lists "Darling, I promise I will disclaim if it will save taxes" as one of the three "great" lies. Pennell, 843-2nd T.M. (BNA), *Estate Tax Marital Deduction*, p. A-12, n. 55.

[19] Reg. 20.2056(b)-7(d)(3).

[20] See Rev. Rul. 67-53, 1967-1 CB 265.

[21] The adjusted gross estate was defined under Section 2056(c)(2), before the effective date of the Economic Recovery Tax Act of 1981 which made the marital deduction "unlimited," as the gross estate reduced by debts and administration expenses that are deductible under Section 2053. A slightly different definition is still contained in Section 6166(b)(6). The adjusted gross estate as used in this article refers to its meaning under now repealed Section 2056(c)(2).

ing used any of her federal estate tax exemption of $1.5 million. All estate administration expenses are deducted for federal estate tax purposes.[22] Her adjusted gross estate is divided into three portions: a credit shelter trust equal to the maximum amount that can pass free of tax without generating any federal or state estate tax, a QTIP trust equal to the excess of the federal exemption over the state exemption, and a disposition of the balance in a form so that it will qualify for the federal and state marital deduction.

The amount passing to the QTIP is the excess of the federal exemption of $1.5 million over the state exemption of $1 million, or $500,000. Assuming her executor elects for the QTIP trust to qualify for the marital deduction under IRC Section 2056(b)(7), her taxable estate will equal the amount of the state exemption, which is assumed to be $1 million and which is the amount passing to the credit shelter trust. In other words, the marital deduction will be $1.5 million, consisting of the $500,000 QTIP and the balance of her estate (that is, that part of her adjusted gross estate not passing into the $1 million credit shelter trust or into the $500,000 QTIP) of $1 million. Thus, with a marital deduction of $1.5 million and a taxable estate of $1 million, no federal tax is due.

Nor is any New York estate tax due. The amount of state death tax credit under IRC Section 2011 is $33,200. But the federal estate tax due on the $1 million taxable estate, based on an assumed federal exemption of $1 million, is zero. Because the estate is required to pay New York estate tax equal to the lesser of the state death tax credit amount under Section 2011 ($33,200) or the amount of federal tax due using only a $1 million exemption (zero), no New York estate tax is due.

The problem, at least from a federal estate tax perspective, is the underutilization of the federal exemption or, conversely, the overutilization of the marital deduction. That, as explained above, may have two adverse consequences. First, if the full federal estate tax exemption had been used, an additional $500,000 could have been added to the credit shelter trust (which may permit distributions to beneficiaries other than, or in addition to, the spouse). That could possibly reduce income taxes (if such other beneficiaries are in lower income tax brackets than the surviving spouse or the trust) and may reduce the level of taxable gifts the surviving spouse makes: distributions from the credit shelter trust to beneficiaries other than the spouse are not subject to gift tax. If the $500,000 is in a QTIP trust, the trustee may not make distributions to anyone other than the surviving spouse. Although the trustee may be permitted, under the terms of the deceased spouse's will, to distribute property to the spouse who, in turn, could give it to the beneficiaries of the credit shelter trust, the surviving spouse would be making gifts in doing so.

The second problem, mentioned above, likely will arise when the surviving spouse dies. Because property that qualifies for the marital deduction in the estate of the first spouse to die is included in the gross estate of the survivor, the survivor's gross (and, perhaps, taxable) estate will be increased by the amount now passing to the QTIP rather than the credit shelter trust, unless it is consumed or dissipated by the survivor. This tax could be significant. At a 55% tax rate (the top bracket that is to be restored beginning in 2011), an additional $275,000 of tax would be due.[23]

The additional marital deduction transfer of $500,000 in the foregoing example need not have passed into a QTIP trust. The same result could be achieved by making a transfer of that amount in any other form that would qualify for the marital deduction, such as an outright bequest. But the use of a QTIP trust may have ameliorated the problem of having to pay additional estate tax on this marital deduction amount when the surviving spouse dies. At least some states (such as Massachusetts and Oregon) permit an executor to make a state-only QTIP election. In other words, the executor would not elect for the $500,000 QTIP trust to qualify for the federal estate tax marital deduction under IRC Section 2056(b)(7). The executor would elect for the trust to qualify for the marital deduction only for state death tax purposes. Under this approach, the QTIP trust should not be included in the surviving spouse's estate for federal purposes, but only for state purposes.[24]

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22 If the expenses are not deducted for estate tax purposes under Section 2053, they will "use up" part of the federal estate tax exemption unless they constitute certain "management" expenses within the meaning of Reg. 20.2056(b)-4(d). See, generally, Gans, Blattmachr, and McCaffrey, "The Anti-Hubert Regulations," 87 Tax Notes 969 (5/15/00). Also, beginning this year, state death tax paid is deductible for federal estate tax purposes under Section 2058. This tax may not be deducted for certain state death tax purposes.

23 Of course, the QTIP trust will not likely remain at $500,000 for the balance of the survivor's lifetime. It may decline or grow in value. Although the additional $275,000 in estate tax will not be due until the survivor dies, one may view this as the present value cost (above the state death tax that would be due if the enhanced marital deduction transfer were not made) if one assumes that the QTIP trust will grow at the same rate as the discount rate that would be used to determine the present value cost of the additional tax that will be due when the survivor dies.

24 Property that has qualified for the marital deduction by the QTIP election under Section 2056(b)(7) is included in the gross estate of the surviving spouse under Section 2044. If the QTIP election under the former section is not made, there will be no gross estate inclusion under the latter section, although it is conceivable that the trust might be included in the survivor's estate by reason of the survivor having been granted a general power of appointment described in Section 2041.

Unfortunately, most states that have limited the state death tax exemption do not permit a state-only QTIP election. But an opportunity to effect such a state-only election may be achieved under Rev. Proc. 2001-38.[25] In fact, the use of this Revenue Procedure may produce a better result for the estate of the surviving spouse than would a state-only QTIP election.

Not infrequently, apparently, the executor of a decedent's will elects for more property to qualify for the estate tax marital deduction than is necessary to reduce the federal estate tax to zero. For example, assume a married man died in 2004 with a federal adjusted gross estate of $2.5 million, and gave all his property to a trust that would qualify as a QTIP. His executor makes the QTIP election with respect to the entire trust, even though a partial election would have eliminated the federal tax because of the $1.5 million federal exemption.

As to his estate's federal estate tax, the QTIP election for the entire trust, as opposed to only the minimum amount necessary to reduce his federal estate tax to zero, is unimportant. But it may have a dramatic estate tax consequence in the wife's estate. The entire trust will be included in her estate under IRC Section 2044. His executor needed to make the QTIP election for only 40% (that is, $1 million) to reduce his federal estate tax to zero; and if such a partial election had been made, only 40% of the trust would be included in the wife's gross estate under Section 2044.

In Rev. Proc. 2001-38, the IRS granted relief where the executor of the first spouse to die "over-elected" QTIP treatment and thereby failed to use the available federal estate tax exemption of that spouse. Specifically, the Revenue Procedure allows the executor of the surviving spouse to request that the QTIP election made in the estate of the first spouse to die be "undone" to the extent the estate would have been able to avoid paying any federal estate tax by reason of the unused federal estate tax exemption of the first spouse to die. But that relief may not be requested if the QTIP election was a partial election, should have been a partial election, was made pursuant to a word formula (e.g., "the executor hereby elects for that portion of the trust equal to the decedent's remaining GST exemption to qualify for the estate tax marital deduction pursuant to Section 2056(b)(7) of the Internal Revenue Code"), or was a protective election (for example, the executor says the election is being made if—but only if—the property is included in the decedent's gross estate).

Consequently, in the example just considered, where the executor elected to have the entire $2.5 million trust qualify for the marital deduction, the relief would not be granted because a partial election should have been made and relief is not made available in this context. Suppose, instead, that the husband had divided his estate into two shares, one (the marital bequest) equal to the minimum amount necessary to reduce the federal estate tax to its minimum, and the other share equal to the balance of his estate, both shares passing into a trust described in Section 2056(b)(7). Also assume that his executor had elected for both shares to qualify for the marital deduction as QTIP trusts. In that case, relief would be granted under Rev. Proc. 2001-38 in the surviving spouse's estate to "undo" the election with respect to the second share as it was equal to the remaining federal estate exemption and, therefore, its election for QTIP treatment was unnecessary to reduce the federal estate tax to zero.

The Revenue Procedure seems to provide an opportunity to divide the federal estate tax exemption into two parts—one equal to the state death tax exemption, which will pass as the credit shelter portion, and the balance of which will pass into a QTIP trust. This second part is the excess of the federal estate tax exemption over the state exemption. A QTIP election may be made for this second part (equal to the excess federal estate tax exemption) to qualify for the marital deduction under Section 2056(b)(7). Even though the QTIP election for this second part was unnecessary to reduce the federal estate tax to zero, it was necessary to reduce the state estate tax to zero. When the surviving spouse dies, the executor of that spouse's will may request relief under Rev. Proc. 2001-38 (which should be granted) to exclude the trust equal to the excess federal exemption from the survivor's gross estate for federal estate tax purposes because its election for QTIP purposes in the estate of the first spouse to die was entirely unnecessary to reduce the federal estate tax to zero (and it was not a partial, protective, or word formula election).[26]

[25] 2001-1 CB 1335.

[26] Some might question whether taxpayers may rely on the Revenue Procedure. If, for example, the QTIP election were made at the death of the first spouse, could the Service refuse to grant relief at the death of the second spouse and thereby include the QTIP in the second spouse's gross estate for federal purposes? Revenue Procedures that set forth procedural rules, rather than substantive interpretations of the Code, are not binding on the Service. See, e.g., Estate of Shapiro, 111 F.3d 1010, 79 AFTR2d 97-2152 (CA-2, 1997). Where, however, the refusal to follow such a Revenue Procedure constitutes an abuse of discretion, the courts will not permit the Service to disavow it. See *id.* In a series of recent cases, the courts have been unwilling to permit the Service to disavow taxpayer-friendly published guidance, holding the government bound without making an abuse-of-discretion inquiry. See Ravenhorst, 119 TC 157 (2002); Dover Corp. and Subsidiaries, 122 TC 324 (2004); Baker, 122 TC 143 (2004). Whether this line of cases could be invoked in the context of a taxpayer-friendly Revenue Procedure setting forth procedural rules remains unclear. In other words, further clarification is required regarding the extent to which the distinction between procedural rules and substantive interpretations made in earlier cases such as *Shapiro* has been overtaken by these more recent cases. In any event, it would seem that, even if the Revenue Procedure is not binding, there is no reason to believe that the Service would withhold the relief the Revenue Procedure contemplates.

It also seems, at least in some states, that relief granted to exclude the trust from the federal gross estate of the surviving spouse may also result in its exclusion for state death tax purposes. In New York, for example, Tax Law section 961 provides that a final federal determination as to the inclusion of property in the gross estate controls for state purposes unless it is shown to be erroneous by a preponderance of the evidence. Certainly, the allowance of the marital deduction for federal estate tax purposes in the estate of the spouse dying first for the amount equal to the excess federal estate tax deduction is not incorrect. In fact, it is binding on the estate of both the spouse who dies first as well as the estate of the surviving spouse unless the survivor's estate qualifies for and requests relief under Rev. Proc. 2001-38. Similarly, its exclusion from the federal gross estate with respect to the surviving spouse, if that relief is requested and granted under the Revenue Procedure, is correct. Therefore, it would seem controlling for New York estate tax purposes as well.[37]

How the excess federal estate tax exemption should be described

Suppose that a married person, who is domiciled in a state with a smaller estate tax exemption than allowed for federal estate tax purposes, wishes to avoid all estate tax if his or her spouse survives and also wishes to minimize tax when the survivor dies. In this situation, the estate planning documents could take one of two approaches. One approach would provide for the credit shelter disposition to be a preresiduary bequest of a fixed sum of money: (1) a credit shelter disposition (such as a trust for the spouse and descendants) equal to the largest sum that can pass as such disposition without causing any federal or state estate tax to be due, (2) a QTIP equal to the excess of the federal estate tax exemption over the sum so passing as the credit shelter disposition, and (3) a marital deduction disposition (such as a second QTIP or an outright bequest to the spouse) of the balance of the estate.

The alternative would provide for the marital deduction shares to be a preresiduary bequest of a fixed sum of money: (1) a disposition in a form (such as outright) to or for the surviving spouse that will qualify for the marital deduction equal to the minimum sum necessary as the marital deduction to reduce the federal (but not necessarily the state) estate tax to its minimum, (2) a QTIP equal to the sum necessary as the marital deduction to reduce both the federal and the state death taxes to their minimums (taking into account the first marital deduction disposition), and (3) a credit shelter disposition of the balance of the estate. Another option would be to make each of the three dispositions fractional shares of the decedent's estate.

In fact, it may be that there should be a quadpartite will or revocable trust: (1) to the credit shelter disposition, the sum (or fractional share) equal to the maximum that may pass as the credit shelter disposition without increasing the federal or the state death taxes, (2) to the first QTIP, the sum (or fractional share) equal to the excess of the federal estate tax exemption over the amount of the credit shelter disposition, (3) to a second QTIP,[38] a sum (or fractional share) equal to the excess of the decedent's unused GST exemption under IRC Section 2652 over the sum of the amounts disposed of under "(1)" and "(2)," and (4) to the spouse or to a trust in a form qualifying for the estate tax marital deduction, the balance of the estate.

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[37] As indicated, once the Service grants relief under the Revenue Procedure, it is controlling for New York purposes unless the federal determination is shown to be incorrect by a preponderance of the evidence. This standard implies that only questions of fact can be challenged once a federal determination is made. See Matter of Weaver's Estate, 410 N.Y.S.2d 777, 410 N.Y.S.2d 777 (Surr. Rensselaer County, 1978), *aff'd* 74 A.D.2d 678, 424 N.Y.S.2d 789 (3rd Dept., 1980) (requiring the state to present factual evidence, not legal argument, in order to satisfy the preponderance standard in New York Tax Law section 961). Thus, it would seem that, if the Service concedes a legal issue, New York is precluded from taking a contrary view. See Marx v. Bragalini, 6 N.Y.2d 322 (1959) (precluding a challenge by the state after emphasizing that the Service had conceded the legal issue in a Revenue Ruling—with this decision forming the basis for later enactment of New York Tax Law section 961). Since the question of whether an unnecessary QTIP election should be treated as valid at the death of the second spouse is legal, not factual, the Service's concession should control. Thus, as long as the statute of limitations in New York is closed with respect to the first estate at the time of the second spouse's death, making the QTIP election and then seeking relief under the Revenue Procedure should be effective. And while New York might argue that the second spouse's estate should be estopped under a duty-of-consistency theory from treating as a nullity a QTIP election the state had accepted in the first spouse's estate, the controlling nature of the Service's resolution under the Revenue Procedure should be determinative. In terms of the statute of limitations, to be sure, New York does permit an assessment even if the limitations period is otherwise closed where a federal change occurs. See N.Y. Tax Law §§ 979, 990, and 683. Where, however, relief is sought under the Revenue Procedure, no federal change occurs in connection with the marital deduction claimed on the earlier return. If, in other words, the federal statute of limitations is closed with respect to the earlier return, New York could not maintain that a federal change had occurred. Thus, the federal-change provisions in New York law would appear to be irrelevant with respect to the earlier return.

[38] As a general rule, the last individual who is treated as transferring property for estate or gift tax purposes (that is, the last person who has made a gift for federal gift tax purposes or in whose gross estate the property is included) is the "transferor" for federal GST tax purposes. That is the person whose GST exemption under IRC Section 2652 may be allocated to the property. Although the spouse who creates a QTIP trust is the initial transferor of the property in that trust, the other spouse will become the transferor when that spouse makes a gift of the property during lifetime or at death when it is included in his or her estate under Section 2044. However, Section 2652(a)(3) allows the spouse who creates the QTIP trust that is made to qualify for the marital deduction by election under Section 2523(f) or 2056(b)(7) to be treated as the transferor of the property for GST tax purposes by "reversing" that election for such tax purposes. That permits that spouse's GST exemption to be allocated to the QTIP trust. See, generally, J. Blattmachr, D. Hastings, and D. Blattmachr, "The Tripartite Will: A New Form of Marital Deduction," 127 Tr. & Est. 47 (Apr. 1988).

For example, assume a married New Yorker dies in 2005 with an estate of $4 million, having made $300,000 of taxable gifts after 1976 and having used no part of her GST exemption. Her remaining federal estate tax exemption is $1.2 million. Her New York estate tax exemption is $1 million. Now it might seem that, if the credit shelter disposition were $1 million, with a resulting taxable estate of $1 million, there could be no federal or state tax. But, because of the prior taxable gift, a taxable estate of $1 million would produce a New York tax.

The reason, as explained above, is that the federal estate tax is imposed under IRC Section 2001 on the sum of the taxable estate plus the decedent's adjusted taxable gifts, here, $1.3 million. Although no federal estate tax would be due (because the federal exemption is $1.5 million), a state death tax would be due. The reason is that New York imposes a tax equal to the lesser of: (1) the state death tax credit amount determined under IRC Section 2011 (in this case, $33,200, which is the amount on a taxable estate of $1 million); and (2) the federal estate tax on $1.3 million but on the assumption that the federal exemption is only $1 million (which, in this case, is $124,000). Accordingly, the estate would owe $33,200 of New York estate tax.

To avoid the New York tax, the credit shelter amount (which will equal the taxable estate) must be reduced so that, when it is added to the adjusted taxable gifts, no federal estate tax would be due even if the federal exemption were limited to the New York exemption of $1 million. In this case, that would be a credit shelter amount (or taxable estate) of $700,000. When that amount is added to the $300,000 of adjusted taxable gifts, the tax base for federal estate tax calculation purposes is $1 million, which is offset by the assumed $1 million federal exemption.

Therefore, her $4 million adjusted gross estate would be divided into the following four parts: (1) a credit shelter trust of $700,000; (2) a first QTIP equal to the excess of the remaining federal exemption of $1.2 million allowable to the estate over the credit shelter amount (that is, the smallest amount that could pass to the credit shelter trust without increasing the federal or the state death tax) of $700,000, or $500,000 [i.e., $1.2 million minus $700,000]; (3) a second or so-called reverse QTIP equal to the excess of the decedent's unused GST exemption of $1.5 million over the sum of the credit shelter trust and the first QTIP of $1.2 million, or $300,000; and (4) a disposition (such as another QTIP trust) of the balance of the adjusted gross estate, or $2.5 million. Her taxable estate, assuming her executor makes the appropriate QTIP elections, would be $700,000, the amount of the credit shelter disposition.

To which QTIP does the Rev. Proc. apply?

As in the foregoing example, an estate may have more than one QTIP, raising the question which QTIP is entitled to the relief of Rev. Proc. 2001-38. In a sense, it seems that each QTIP may have wasted use of the federal estate tax exemption of the spouse first to die. Fortunately, the Revenue Procedure seems to allow the relief to be granted to that QTIP which is equal to the otherwise unused federal estate

Practice Notes

When the surviving spouse dies, the executor of that spouse's will may request relief under Rev. Proc. 2001-38 (which should be granted) to exclude the separate QTIP trust equal to the excess federal exemption from the survivor's gross estate for federal estate tax purposes.

tax exemption even if there is more than one QTIP.

Rev. Proc. 2001-38 states that, in order to qualify for relief, it must be established that: "the election was not necessary to reduce the estate tax liability to zero." In the above example, that would be the election for the first QTIP. That conclusion is supported by a series of private letter rulings.[29] For example, in Ltr. Rul. 200243030, the first spouse to die created a credit shelter trust that was in the form of a QTIP trust equal to his unused federal estate tax exemption, and placed the balance of his estate also in a QTIP trust. His executor elected under Section 2056(b)(7) for both trusts to qualify for the marital deduction. Relief under Rev. Proc. 2001-38 was granted to the surviving spouse's estate to exclude the credit shelter trust from her gross estate.

Why the survivor's estate may not request the Rev. Proc. relief

It might seem that the estate of the surviving spouse would always want the "unnecessary" QTIP not to be included in his or her estate under Section 2044. But that may not be the case in circumstances where the change in basis under Section 1014 is more "valuable" than estate tax exclusion from the survivor's estate. For example, the assets in the unnecessary QTIP may have inherent gain in them at the time of the survivor's death but the survivor's estate, even including that QTIP, may be less than the survivor's estate tax exemption. In such a case, the relief granted to the survivor's estate by Rev. Proc. 2001-38 presumably would be adverse.

Specific language

As mentioned above, specific language to "deal" effectively with the smaller state exemption, and to place the estate of the surviving spouse in a position to request relief under the Rev. Proc., is necessary. First, the "credit shelter" or "estate tax exemption" must be limited to no more than the maximum that will result in neither federal nor state death tax. Second, the excess federal exemption special QTIP must equal no more than the unused federal exemption after taking into account the credit shelter or estate tax exemption gift and all other factors, including adjusted taxable gifts or other transfers that reduced the available federal exemption.[30] Here are some sample provisions[31]:

> *Estate Tax Exemption Gift.* If my Husband/Wife survives me, I give a sum/fractional share[32] of my estate, as determined after payment of transfer taxes, expenses and other preresiduary bequests made before this bequest, equal to my Estate Tax Exemption to the Trustee/s of the trust under Article [*put in number of the Article that contains the "Credit Shelter" Trust*] of this document to be disposed of under the terms of that trust.
>
> My "Estate Tax Exemption" means the largest amount that can pass to the Trustee/s of the trust under Article [*put in number of the Article that contains the "Credit Shelter" Trust*] without increasing the Federal estate tax and without increasing the state death tax due under the law of the state of my domicile by reason of my death.
>
> *Excess Federal Exemption QTIP Gift.* If my Husband/Wife survives me, I give a sum/fractional share[33] of my estate equal to the excess, if any, of (i) my Unused Federal Estate Tax Exemption over (ii) the Estate Tax Exemption Gift to the Trustee/s of the QTIP Marital Trust under Article [*put in number of the Article that contains the QTIP Trust*] of this document, to be disposed of under the terms of that trust and held as a separate trust. "My Unused Federal Estate Tax Exemption" means the largest amount that could pass to the Trustee/s of the trust under Article [*put in number of the Article that contains the "Credit Shelter" Trust*] of this document without increasing the Federal estate tax due by reason of my death. ■

[29] Under Section 6110(k)(3), neither a private letter ruling nor a National Office technical advice memorandum may be cited or used as precedent.

[30] Because both federal and state death taxes are reduced to zero, the deductibility of state death taxes under IRC Section 2058 seems academic. But state death tax may be due on account of real or tangible property located in another state. The sample provisions have been crafted to take even that possibility into account.

[31] These are derived from *Wealth Transfer Planning* and are published here with the permission of Interactive Legal System. See www.ilsdocs.com.

[32] Some practitioners may wish to provide for a specific numerator and denominator of the fraction if a fractional share bequest is made.

[33] *Id.*

Quadpartite Will Redux: Coping With the Effects of Decoupling

The disparity between federal and state death tax exemptions presents additional challenges in planning for married persons. The authors suggest sample language that will be appropriate even if the state exemption exceeds the federal exemption.

MICHAEL L. GRAHAM, MITCHELL M. GANS, AND JONATHAN G. BLATTMACHR, ATTORNEYS

"Quadpartite Will: Decoupling and the Next Generation of Instruments," published in the April 2005 issue of ESTATE PLANNING,[1] suggested new will and revocable trust drafting techniques for married persons domiciled in "decoupled" states. In this context, the word "decoupled" refers to a state with a death tax exemption which is different from the federal estate tax exemption. The assumption for the April article was that the state death tax exemption would be smaller than the federal exemption.

Married taxpayers in decoupled states (with a smaller state exemption) face a dilemma in implementing a traditionally "optimal" estate plan—one that would fully use the federal estate tax exemption equivalent ("estate tax exemption") of the first spouse to die (i.e., "the first decedent") and leave the balance of the first decedent's estate in a manner qualifying for the federal estate tax marital deduction. Traditionally, such a structure has been used to fully postpone federal estate tax until the death of the surviving spouse.

In a decoupled state with a smaller exemption, full use of the federal estate tax exemption in the first decedent's estate will result in state death tax being due upon the first decedent's death (a result of the smaller state exemption). Conversely, if use of the federal estate tax exemption is limited in the first decedent's estate to the (smaller) state exemption, then more federal (if not state) estate tax will likely be due upon the death of the surviving spouse. Limiting use of the exemption in the first estate will increase the federal estate tax marital deduction for that decedent, and property qualifying for a marital deduction in the first decedent's estate will usually be included in the federal taxable estate of the surviving spouse.

The April article suggested creating a separate trust (called an "Excess Exemption QTIP Trust") that could qualify (by election) for the federal estate tax marital deduction as qualified terminable interest property ("QTIP") under IRC Section 2056(b)(7). Property passing to the Excess Exemption QTIP Trust would have a value equal to the amount by which the federal estate tax exemption exceeded the state death tax exemption.

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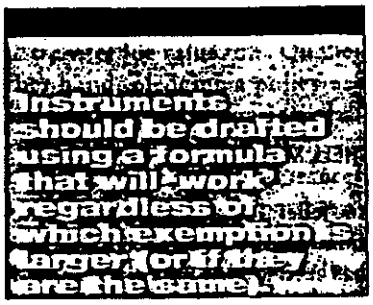
For states (such as Rhode Island) that permit an independent marital deduction election for state purposes, without regard to whether a federal marital deduction election has been made, the separate state election would be made for the Excess Exemption QTIP Trust. For other states (such as New York) that do not permit a state-only QTIP election, it was recommended that the first decedent's estate elect QTIP treatment for the Excess Exemption QTIP Trust for both federal and state death tax purposes, but have the estate of the surviving spouse seek relief from that election under Rev. Proc. 2001-38.[2] That Revenue Procedure appears to permit the estate of the surviving spouse to have the QTIP election made in the estate of the first decedent "undone" so that the Excess Exemption QTIP Trust would not be included in the estate of the surviving spouse. The April article included sample language for wills and revocable trusts to implement either strategy.

Further refinement for a very few states

The earlier article was based on the fact that, in most states which have a death tax exemption different from the federal estate tax exemption, the federal estate tax exemption is larger than the state death tax exemption. That disparity will grow as the federal exemption increases from $1.5 million this year to $2 million beginning in 2006 and then to $3.5 million for 2009. Although the federal exemption is scheduled to drop back to $1 million beginning in 2011, it will still exceed the exemption then scheduled to be permitted in some states. (There is no federal estate tax for those who die in 2010.)

However, in some states the opposite can occur: the state exemption can exceed the federal exemption. That would be the case in Connecticut, for example, where recent legislation establishes a state death tax exemption of $2 million.[3]

Another more common situation in which the state death tax exemption will be larger than the federal estate tax exemption occurs where the taxpayer makes lifetime gifts using the federal gift tax exemption.[4] For example, assume a married Tennessean made a taxable gift of $1 million in 2004, using up her entire federal gift tax exemption. The resulting adjusted taxable gift means that if she were to die in 2005, a credit-shelter bequest in excess of $500,000 would produce



a federal estate tax.[5] In effect, the 2004 gift reduced her remaining federal exemption to $500,000. Yet her available state death tax exemption will be $950,000.[6] (Tennessee does not impose any gift tax; lifetime transfers do not have any effect on the amount of the optimal credit-shelter bequest in terms of the state tax.)

No federal estate tax or state death tax will be due if our married donor is the first decedent and the credit-shelter bequest is limited to the effectively available federal exemption ($500,000). Moreover, no "unnecessary" federal estate tax will be due when the surviving spouse dies on account of "overuse" of the federal estate tax marital deduction (the federal estate tax marital deduction having been limited to the minimum amount necessary to reduce to the federal estate tax to zero). But when the surviving spouse dies, state death tax may be due on account of the "extra" use of the marital deduction in terms of the state death tax (the marital deduction having been in excess of the amount necessary to eliminate the state estate tax).

Applying numbers to the above example, assume that the wife dies in 2005, dividing her $4 million estate (after debts and expenses) into a marital portion and a credit-shelter portion based on a formula clause that is geared to her federal estate tax profile. The marital bequest would equal $3,500,000, and the credit-shelter bequest would equal the balance of $500,000.

However, her $4 million estate only needs a marital deduction equal to $3,050,000 in order to reduce her Tennessee estate tax to zero. Assuming her husband remains a Tennessean until his death, his Tennessee taxable estate likely will be larger than if the marital deduction had been so limited for state purposes. However, if only a $3,050,000 marital deduction were used for both state and federal purposes, federal estate tax would be due when the first spouse died because, as stated, the available federal exemption was only $500,000.

This "overuse" of the marital deduction for state purposes may be easily cured in those states that

[1] See Gans and Blattmachr, "Quadpartite Will: Decoupling and the Next Generation of Instruments," 32 ETPL 3 (Apr. 2005).

[2] 2001-1 CB 1335.

[3] Public Act 05-251, House Bill 6940.

[4] See Sections 2505 and 2010 (providing the federal unified credit for federal gift and estate tax purposes, respectively).

[5] As discussed in the April article, other factors (such as taxable gifts in excess of the federal gift tax exemption or use of the "old" lifetime gift tax exemption with respect to gifts made between 9/8/76 and 12/31/76) also may reduce the amount of allowable federal estate tax exemption equivalent.

permit an independent QTIP election (i.e., an election for state purposes that does not mirror the federal election). In such a state, the executor would make a federal but not state QTIP election for a separate Excess Exemption QTIP Trust.

That strategy will not work, however, in those states (such as New York) that do not permit an independent QTIP election.[7] In those states, the federal QTIP election is binding for state purposes as well.

Uncertain which exemption will be larger?

Unless the state and federal exemption amounts are equal and the estate tax effect of lifetime gifts is the same for federal and state purposes, difficulties will arise in determining the optimal marital and credit-shelter bequests. In most instances, it will not be possible to determine with any certainty whether the remaining federal exemption or the state exemption will be larger.

To deal effectively with this uncertainty, instruments should be drafted using a formula that will "work" regardless of which exemption is larger (or if they are the same). The following language, which creates an optimal Excess Exemption QTIP Trust, is offered to achieve that result:

Sample Disposition[8]

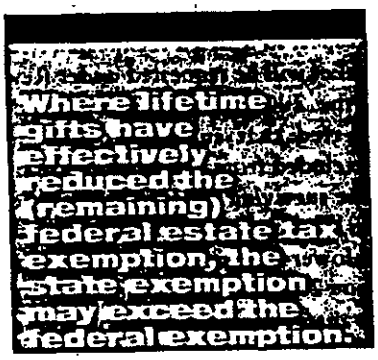
If my Wife survives me, I give a sum equal to my *Excess Exemption QTIP Gift* to the Trustee of the Marital Trust under this Will, to be disposed of under the terms of that trust and to be held as a separate trust. This separate trust shall be called the Excess Exemption QTIP Trust.

Accompanying Definitions

My "Excess Exemption QTIP Gift" means the amount, if any, by which what my Optimum Marital Deduction Gift would have been if that term meant the greater of (a) the minimum amount necessary as the federal estate tax marital deduction in my estate to reduce the federal estate tax due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift) and (b) the minimum amount necessary as the marital deduction in my estate under the death tax laws of the state of my domicile to reduce such state death taxes due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift), exceeds my Optimum Marital Deduction, calculated as provided below.

My "Optimum Marital Deduction" means the lesser of (a) the minimum amount necessary as the federal estate tax marital deduction in my estate to reduce the federal estate tax due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift) and (b) the minimum amount necessary as the marital deduction in my estate under the death tax laws of the state of my domicile to reduce such state death tax due by reason of my death to the lowest possible amount (determined without regard to the Excess Exemption QTIP Gift).

Using the above formula requires an independent state QTIP election if the state exemption is larger than the federal exemption. Accordingly, if it is certain that the taxpayer will die domiciled in a state that does not permit an independent QTIP election, then the foregoing sample language need not be included in the instrument. Rather, the simpler language suggested in



the April article may be used. But it seems that there is "no harm" in using the more complicated language. Additionally, because an independent QTIP election could become available in the future (through a change of domicile or change of state law), the more complicated language offers a potential upside.

Coordination of distributions and management of the trusts

If an Excess Exemption QTIP Trust is created, there may be at least two, if not three, virtually identical QTIP trusts created under the decedent's will or revocable trust: The Excess Exemption QTIP Trust, a Reverse QTIP Trust (to use up an otherwise unused GST exemption of the first decedent), and another QTIP trust for the balance of the estate.[9] If there is, or may be, more than one QTIP trust, it may be appropriate to permit them to be managed

[6] Tenn. Code Ann. § 67-8-316.

[7] See, e.g., N.Y. Tax Law § 952.

[8] This language is derived from Wealth Transfer Planning℠ published by Interactive Legal Services (www.ilsdocs.com) and is reproduced here with its permission.

[9] See, e.g., Section 2056(b)(5). Such a trust, nevertheless, might have provisions during the surviving spouse's lifetime that are identical to those of a QTIP trust. Hence, providing for such a trust to be managed *in solido* with QTIP trusts under the same instrument may be appropriate to consider.

together (essentially, be managed *in solido*) although each should be treated as a separate trust. The fourth trust for the spouse, to hold the applicable estate tax exemption (taking into account both the federal and applicable state death tax exemptions) must also be coordinated with the (up to) three QTIP trusts.

In addition, coordination of distribution provisions should be addressed. For example, absent other factors, any invasion of corpus from the QTIP trusts should be made last from any QTIP trust with respect to which it is expected that relief will be requested under Rev. Proc. 2001-38, because it is anticipated that such trust will be excluded from the gross estate of the surviving spouse; and second to last from any QTIP trust that has a lower inclusion ratio under Section 2631 for generation-skipping transfer tax purposes (such as a reverse QTIP trust may) than any other QTIP trust.

Years after 2005

Beginning in 2006, the federal estate tax exemption is scheduled to reach $2 million. Since the federal gift tax exemption remains at $1 million, will it be possible for a state exemption to exceed the federal exemption? Certainly it seems that the minimum available federal estate tax exemption would always be at least $1 million. Thus, unless the applicable state exemption is greater than $1 million (as will be the case in Connecticut), one might conclude that the state exemption could not exceed the remaining federal estate tax exemption. But that is not necessarily so. As in the case of the earlier example involving a decedent who died in 2004, lifetime gifts made by a decedent dying after 2005 may cause the remaining estate tax exemption to be less than the state exemption (even where the state exemption is $1 million).

An example may be helpful. Assume that a taxpayer made a taxable gift in 1977 of $3 million, and thereafter made no other taxable gifts. Assume he dies in 2006, when the maximum federal estate tax exemption is $2 million, with a taxable estate of $2 million. Although his taxable estate is the same as the maximum federal estate tax exemption for the year of his death, federal estate tax will still be due. This taxpayer's federal estate tax is determined by adding the $3 million adjusted taxable gift to his $2 million taxable estate.[10]

The net federal estate tax, after the allowance of the credit under Section 2010 (and before any other credit that might be allowed) and the credit for the gift tax payable with respect to the adjusted taxable gift, is $485,000. Hence, he should not view his federal estate tax exemption as $2 million but rather as $945,652.[11] That is less than the exemption permitted by several states, including New York and Tennessee (as well as Connecticut).[12] Hence, for at least the years 2005 through 2008, the available state estate tax exemption may exceed the available federal exemption, suggesting that an Excess Exemption QTIP Gift should be based on the principles discussed above.

Practice Notes

Creating a separate QTIP trust, equal to the difference between the federal estate tax exemption and the state death tax exemption may be both appropriate and advantageous.

Conclusion

The disparity between federal and state death tax exemptions presents additional challenges in planning for married persons. In many cases, the federal exemption will exceed the state exemption. But in some situations, especially where lifetime gifts have effectively reduced the (remaining) federal estate tax exemption, the state exemption will exceed the federal exemption. Creating a separate QTIP trust, equal to the difference between the federal estate tax exemption and the state death tax exemption may be both appropriate and advantageous. The sample language set forth earlier in this article provides for both eventualities and should be considered. ■

[10] See Section 2001(b).

[11] The maximum credit allowed under Section 2505 for federal gift tax purposes is $345,800 (essentially, the tax computed on the first $1 million of taxable gifts). The maximum credit for the years 2006 to 2008 allowed under Section 2010 for federal estate tax purposes is $780,800 (essentially, the tax computed on a taxable estate of $2 million assuming no adjusted taxable gifts were made). The excess of the federal estate tax credit of $780,800 for 2006 over the federal gift tax credit of $345,800 is $435,000. Hence, adjusted taxable gifts may "use up" up to $345,800 of the federal estate tax credit. As a result, as little as $435,000 of the federal estate tax credit may be available to use against the taxable estate. In such a case, the federal estate exemption (or, in other words, the maximum taxable estate the decedent could have without paying any federal estate tax by reason of the credit under Section 2010) is; therefore, determined by multiplying the taxable estate (T) by 46% to produce a gross estate tax of $435,000, or .46T = $435,000; so T = $945,652. See Section 2001(b).

[12] It will not matter for New York estate tax purposes that the state exemption is greater than the federal exemption. To reduce his federal estate tax to its minimum, the taxpayer will limit the credit shelter amount to the lower federal exemption and have the balance of his or her estate pass under the protection of the marital deduction. Whatever qualifies for the federal marital deduction will automatically qualify for the state marital deduction, in effect. Therefore, there is no opportunity for a married New Yorker to use the strategy discussed in this article where the state exemption is larger than the federal exemption.

Making Spousal Estate Tax Exemptions Transferable

By Mitchell M. Gans and Jonathan G. Blattmachr

Under the Internal Revenue Code of 1986, taxpayers are permitted a federal gift tax exemption and an estate tax exemption. Although technically not exemptions but more in the nature of exemption "equivalents" that entitle taxpayers to a credit, each is more easily understood as an exemption. The gift tax exemption, as so understood, is $1 million for each taxpayer and is not scheduled to increase. The estate tax exemption, as also so understood, is $1 million for 2005 and is scheduled to become $2 million in 2006, 2007, and 2008 and reach $3.5 million in 2009. There will be no estate tax for individuals dying in 2010. Beginning in 2011, the estate tax exemption drops to the gift tax exemption level of $1 million.

Tax Exemptions of Married Persons

As indicated, each individual has his or her own gift and estate tax exemption. It is not portable: one taxpayer cannot transfer his or her unused exemption to another. Even though the Code can be understood as treating married couples as one economic unit for certain transfer-tax purposes, as per the one-economic-unit theory, a surviving spouse's estate may not use the other spouse's unused exemption. Nonetheless, in the case of lifetime gifts, a couple may share, at least to a limited degree, exemptions by "gift splitting" under Code § 2513, which permits one spouse to consent to be treated as though he or she made one-half of the gifts made by the other spouse (except for gifts made to or for the other spouse). When this section is operative, one consequence is that it permits the spouse making the gift to apply the other spouse's exemption. For example, a wife gives $2 million to her child. Her husband, whether or not he is the father of the child, may consent under Code § 2513 to be treated as though he made half of the gift for federal gift tax purposes. If the election is made, he will report the half attributed to him on his own gift tax return and will use any remaining portion of his gift tax exemption. (In addition, if the gift could be subject to generation-skipping transfer tax, such as a gift to a grandchild, the gift-splitting spouse—the husband in the foregoing example—is also treated as the transferor for generation-skipping transfer tax purposes. That may have the effect of permitting the spouse who made the transfer also to use the GST exemption of the other spouse.)

As suggested, sharing of unused exemptions by spouses for estate tax purposes is not permitted, although such portability has been long proposed. As a result, and to avoid wasting the exemption, so-called credit shelter trusts are commonly used. Such trusts are structured to use exactly the federal estate tax exemption of the spouse dying; they typically provide benefits for the surviving spouse but are structured so as not to be included in the gross estate for federal estate tax purposes of the surviving spouse. These trusts entail financial and psychological costs, such as the cost of drafting and administering the trust and the loss of control over the trusts' assets by the surviving spouse. A portable exemption, under which the surviving spouse would be permitted to enjoy his or her spouse's unused exemption, would obviate the need for credit shelter trusts entirely (although a trust might be used for creditor protection and other reasons). If, for example, under current law, one spouse died and bequeathed the entire estate to the other spouse, the exemption would be wasted. If the Code permitted portable exemptions, however, the surviving

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spouse's exemption would be increased by the unused exemption of the other spouse. An interesting issue if such portability were allowed is whether only the estate tax exemption of the surviving spouse would be increased or also the gift tax exemption of that spouse.

Although Congress has thus far refused to address the issue, the IRS has begun issuing private letter rulings and national office technical advice memorandums (which under Code § 6110(k)(3) may not be cited or used as precedent) that diminish the planning problems some taxpayers face because of the nonportable nature of the exemption. The principal focus of the rulings appears to be the case in which a spouse dies with insufficient assets to use his or her estate tax exemption in full—a situation that becomes more common as the exemption increases. In such a case, the unused exemption is wasted, of course, even though the surviving spouse may have wealth that is greater than his or her exemption. With proper planning, the waste of the exemption could be avoided by having the wealthier spouse make a gift to the less wealthy spouse. This could be accomplished either by an outright gift or by creating a qualified terminable interest property or QTIP trust described in Code § 2523(f) for the benefit of the less wealthy spouse. This kind of planning, however, may encounter objections from clients who are unwilling to relinquish control over assets to their spouses.

PLR Strategy: Creating a General Power in the Deceased Spouse

In the rulings, the IRS has approved a plan that permits clients who have such control concerns to avoid wasting the exemption at the death of the less wealthy spouse. See, e.g., PLR 200403094 (single grantor revocable trust) and PLRs 200210051, 200101021 (joint grantor trust). Under the plan, the wealthier spouse creates a revocable trust that grants the other spouse a testamentary general power of appointment over sufficient assets such that there will be no waste of the exemption in the less wealthy spouse's estate. And because the wealthier spouse is able to revoke the trust at any time, the plan does not entail any surrender of control. To illustrate, assume the less wealthy spouse died in 2005 with $500,000 in assets and had a testamentary general power of appointment over $1 million in assets under the other spouse's revocable trust. The gross estate, under the rulings, would be $1.5 million. In other words, even though the general power could have been revoked by the other spouse, it is nonetheless a general power within the meaning of Code § 2041, and the gross estate is, therefore, $1.5 million.

> Sharing of unused exemptions by spouses for estate tax purposes is not permitted, although such portability has been long proposed.

If the less wealthy spouse exercises the power of appointment in favor of his or her estate and then directs in the will that it be placed in a credit shelter trust for the benefit of the wealthier spouse, the exemption is not wasted. It is, of course, critical that the surviving spouse not be viewed as the transferor of the assets passing into the credit shelter trust. For if that were the case, there would be two negative consequences: (1) the wealthier spouse could be viewed as having made a taxable gift to the other beneficiaries under the credit shelter trust at the death of the less wealthy spouse; and (2) the corpus of the trust could be included in the wealthier spouse's estate under Code § 2036 or § 2038, depending on the nature of the interests or powers conferred on the surviving spouse. Most critical, the rulings conclude that the wealthier spouse should not be viewed as the transferor. That may seem somewhat surprising. After all, one could easily imagine that the IRS would be inclined to invoke the step-transaction doctrine and thereby treat the wealthier spouse as the true transferor—or to argue, similarly, that, under state law, the wealthier spouse is considered the transferor for purposes of analyzing creditors' rights and that Code § 2036 or § 2038 should therefore apply at the wealthy spouse's death. See *Griffin v. United States*, 42 F. Supp. 2d 700 (W.D. Tex. 1998); *Estate of Cidulka v. Commissioner*, 71 T.C.M. (CCH) 255 (1996); *Heyen v. United States*, 945 F.2d 359, 363 (10th Cir. 1991); *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986). Presumably, because of a sensitivity to the difficulties that nonportability creates, the rulings do not take this approach.

The rulings take a taxpayer-friendly approach on another critical issue, the gift-tax marital deduction. For the plan to work, the wealthy spouse must not be viewed as having made a taxable gift to the less wealthy spouse. It is, of course, clear that no completed gift occurs as long as the trust remains revocable. Treas. Reg. § 25.2511-2(c) (second sentence). The rulings acknowledge as much. But the more controversial question is whether a taxable gift occurs at the death of the less wealthy spouse. The rulings conclude that the marital deduction applies and, therefore, no taxable gift is made. As such, a gift tax marital deduction is not permitted under Code § 2523(i) for a transfer to a spouse who is not a U.S. citizen, nor is an estate tax marital deduction permitted under such circumstances unless the transfer is in the form of a qualified domestic trust, described in Code § 2056(d). To be sure, the IRS might have taken a less taxpayer-friendly position. It could have denied the marital deduction on the ground that the gift does

not occur until the death of the less wealthy spouse, reasoning that the marital deduction contemplates a living donee. Cf. *Estate of Dave Gordon v. Commissioner*, 70 T.C. 404 (1978), acq. 1979–2 C.B. 1. Treas. Reg. §§ 20.2056(b)-2 ex. 8 and 20.2056(b)-4(e) support the position taken in the rulings by indicating that payments to the spouse's estate qualify for the marital deduction, but in each instance the spouse survived. In contrast, Code § 2056(b)(3)(A) permits a marital deduction when the bequest to a spouse will terminate as a result of the death of the "surviving" spouse in a common disaster. The IRS might also have taken the position in the case in which the less wealthy spouse allows the power to lapse that the marital deduction might possibly be denied on the ground that it constitutes a terminable (nondeductible) interest within the meaning of Code § 2523(b). But, here again, policy concerns about nonportability likely helped to drive the outcome.

One final issue implicated in the rulings is the question of income tax basis. Under Code § 1014, it would seem, at first blush, that the assets passing into the credit shelter trust should qualify for a change in basis. Code § 1014(e), however, provides that the section is inapplicable—no change in basis is permitted—when the asset is gifted to the decedent within one year of death and the asset then passes back to the donor at the death of the decedent. Relying on Code § 1014(e), the rulings conclude that the assets in the revocable trust will not qualify for a change in basis to the extent that the surviving spouse receives property from the decedent as a result of the exercise of the power (or its lapse). In concluding that Code § 1014(e) is triggered, the rulings take the view that the gift is made to the deceased spouse at the moment of death and, therefore, falls within the provision's one-year time frame. In effect, the rulings analogize to the gift-tax regulations. In other words, just as the gift does not occur for gift-tax purposes until the death of the less wealthy spouse because the wealthier spouse retains a revocation power, so, too, the gift is not deemed to occur for purposes of Code § 1014(e). That kind of analogy seems to be a sensible one and could certainly be adopted in regulations. At the present time, however, there is no regulation under the section.

If the conclusion that the gift occurs within the one-year time frame is correct, the question becomes how to compute basis. Although the more recent rulings give no guidance on this question, PLR 9321050 suggests that the determination be made by focusing on the actuarial value of the wealthy spouse's interest in the trust. In other words, if the wealthier spouse is given an income interest in the trust that has a value equal to, say, 40% of the value of the trust's assets, then 40% of the trust's assets should not be eligible for a change in basis under Code § 1014 (the remaining 60% would be eligible). This approach raises two questions: (1) how to determine which assets in the trust are eligible for a change in basis and (2) how to value the wealthy spouse's interest in the trust when it is discretionary. The first question may arise, for instance, when the revocable trust may have more assets than the amount over which the surviving spouse has the general power of appointment. It might be possible to specify the order in which the assets in the revocable trust will be used to satisfy the general power property if the power is exercised. But it seems likely that there is some question about which assets in the revocable trust are included in the gross estate of the deceased spouse on account of his or her general power. In reference to the second question, as a general rule, a truly discretionary interest may have no actuarial value. For example, the standard Code § 7520 income factor may not be used to value an income interest in property when the governing instrument permits trust corpus to be withdrawn for another person's benefit. Treas. Reg. § 20.7520-3(b)(2)(ii)(B)(2). However the calculation is made, it does seem that taxpayers will be able to enjoy some change in basis under the rulings—at least for the portion of the trust deemed to pass to the beneficiaries other than the surviving spouse.

Other Applications of the PLR Strategy

Inappropriate Assets Available to Fund the Credit Shelter Trust

There are two additional contexts in which the new rulings may be useful in planning. First, a spouse may have sufficient assets to use the exemption, but the assets may not be an ideal candidate for a credit shelter trust. For example, when a spouse has pension or IRA assets that could be used to apply the exemption but no other assets, or when the spouse may have insufficient assets other than qualified (pension) plan or IRA assets to use his or her exemption in full, the couple must decide whether to secure the estate tax advantage of making it payable to a credit shelter trust to avoid wasting the exemption. If the credit-shelter approach is used, there is an offsetting income-tax disadvantage: the deferral period for reporting the distributions will be shortened. See generally Natalie B. Choate, *Life and Death Planning for Retirement Benefits* (2003), at 14–26, 56–58, 144–53, for an excellent discussion of "fixed" versus "recalculated" life expectancy methods and income tax free spousal "rollovers." In addition, if they opt for the credit-shelter approach, the estate-tax outcome is sub-optimal: when dealing

If the credit-shelter approach is used, there is an offsetting income-tax disadvantage.

with pension-type assets, which generally will represent the right to income in respect of a decedent (IRD), the surviving spouse's estate tax can be reduced by making the benefit payable to the spouse, rather than to the trust. The right to IRD is not entitled to the change in basis under Code § 1014(a). See Code § 1014(c). Deferred compensation, such as interests in a qualified (pension) plan or individual retirement account (IRA), represent the right to IRD as a general rule. See *Hess v. United States*, 271 F.2d 104 (3d Cir. 1959). The advantage, in other words, that the credit shelter trust offers, when the trust is funded with the right to IRD, is eroded by the income tax on the distributions that the trust must bear. Whereas, if the benefit is made payable directly to the spouse, the income tax paid by the spouse reduces the amount even-

The strategy approved in the rulings permits the couple to use as much of the exemption of the first of them to die as is possible.

tually subject to estate tax at his or her death. If, however, the plan approved in the rulings is used, the couple can avoid wasting the exemption without suffering that erosion and without shortening the deferral period for income tax purposes.

To illustrate, assume that a wife has $1.5 million in her IRA and no other assets and that the husband has $1.5 million in non-IRD assets. Ideally, these assets of the husband would be of the type entitled to the change in basis under Code § 1014(a). Assets other than the right to IRD also may be denied a change in basis under the section. E.g., Code § 1014(b)(5) and (d). If the wife were to die in 2005 survived by her husband, she could direct that her IRA pass into a credit shelter trust to avoid wasting her $1.5 million exemption. But this would, as indicated, shorten the deferral period. And, given the erosion resulting from the trust's income tax liability, it also would not be as estate-tax effective as making the benefit payable to her husband. If the approach approved in the rulings were adopted, however, an optimal outcome could be achieved: the wife would simply make her husband the beneficiary of the IRA, and he would transfer his assets to a revocable trust under which she was given a general power of appointment. Under this arrangement, the husband's non-IRD assets would be used to fund the credit shelter trust created at the wife's death, and the IRA would pass directly to the husband—thus producing no waste of the exemption, no shortening of the deferral period, and no erosion. But it should be noted that the advantage of using the surviving spouse's assets may be eroded if Code § 1014(e) applies to them, as suggested by the private letter rulings. Nevertheless, as explained, it seems that some change in basis under Code § 1014(a) should occur.

Insufficient Assets Available to Fund Both Exemptions

The second context in which the rulings could prove to be helpful is when the couple wants to take full advantage of their exemptions but does not have sufficient aggregate wealth to secure this outcome. For example, assume that a couple has an aggregate wealth of $2.5 million and that they want to use available exemptions fully because they believe that they will eventually have very substantial estates. In 2005, with an exemption of $1.5 million, the couple presumably would be advised to title $1.5 million of their assets in the name of the spouse with the shorter life expectancy. But, of course, the order of death typically is not easily forecast. And if the spouse with the longer life expectancy were to die immediately with an estate of $1 million, part of the exemption ($500,000) would be wasted. Under the rulings, that result can be avoided. If each spouse were to create a revocable trust that conferred a general power on the other, the entire $1.5 million exemption would be used irrespective of the order of their deaths. It may be that the couple together does not have enough combined wealth even to use one exemption fully. For example, the husband has $500,000 and the wife has $750,000, for combined wealth of $1.25 million, which is less than the available exemption for the years 2005 through 2009. Nevertheless, the strategy approved in the rulings permits the couple to use as much of the exemption of the first of them to die as is possible.

A Conservative Approach to Adopting the PLR Strategy

In all of these cases, the rulings solve the problems of nonportability. The IRS obviously resolved all of the legal uncertainties in the rulings in favor of taxpayers to reach a salutary outcome in policy terms. And, although the IRS should be applauded for taking this policy-driven approach, taxpayers will continue to entertain doubts about relying on the rulings until published guidance is provided.

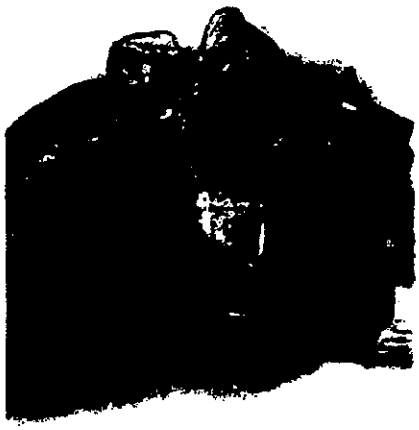
Given the nonbinding nature of private letter rulings and the difficulties practitioners face, as a consequence, it may be prudent to take a conservative approach in terms of drafting and planning to minimize the risk that the IRS would succeed were it to disavow the rulings. Practitioners who implement the approach approved in the rulings, perhaps, should consider adopting the three recommendations that follow.

First, the spouse who receives a general power should exercise it, rather than allowing it to lapse. Although the rulings do not require this, it would seem that the IRS could argue that a spouse who receives a power of appointment and

allows it to lapse has received a terminable interest that does not qualify for the gift-tax marital deduction. On the other hand, if the power is exercised, the terminable-interest argument would appear to be foreclosed. See Rev. Rul. 82–184, 1982–2 C.B. 215.

Second, the surviving spouse should be given a special power of appointment under the credit shelter trust that is created through the exercise of the other spouse's general power. The special power should be exercisable during life and at death. Under this structure, it would seem that the IRS could not argue that the surviving spouse has made a taxable gift of the remainder interest at the other spouse's death. For even if the IRS changes its position and takes the view that the surviving spouse is the transferor, no taxable-gift argument can be made successfully when the transferor has a special power that is immediately exercisable, because the gift of the remainder would be incomplete. Treas. Reg. § 25.2511–2(c). This is illustrated in *Goldstein v. Commissioner*, 37 T.C. 897 (1962), in which the court intimated that a taxable gift might occur if the time for exercising the special power is delayed.

Third, the grantor of the revocable trust should give the other spouse a mandatory income interest that qualifies the property over which the deceased spouse has the general power for QTIP treatment. The general power granted to the first spouse to die might cause the property to qualify for the marital deduction under Code § 2523(e) (a general power of appointment trust) rather than Code § 2523(f) (a QTIP trust). But for the trust to qualify under Code § 2523(e), the general power must be exercisable by the spouse alone and in all events. Treas. Reg. § 25.2523(e)–1(a)(4). Some condition could be built in: for example, the spouse can only exercise the power if he or she is under the age of 115 at the time of death. The built-in condition should prevent it from qualifying for the marital deduction under Code § 2523(e), so an election may be made to have it qualify under Code § 2523(f), in order that the trust will not be included in the surviving spouse's estate under Code § 2036 or § 2038. In addition, the credit shelter trust created for the benefit of the grantor through the exercise of the general power at the death of the first spouse should limit the trustee's discretion in terms of distributions to the grantor (an ascertainable standard relating to health, education, maintenance, and support should be



used). If this suggestion is implemented, it would seem that the IRS would be precluded from including the trust in the estate of the surviving spouse (the grantor of the revocable trust) on a creditors' rights theory. See *Paolozzi*, 23 T.C. at 182; *Paxton*, 86 T.C. at 785. In other words, even if, under state law, creditors of a transferor can reach trust assets when the trustee has discretion to make distributions to the transferor and even if the grantor would be viewed as the transferor of the credit shelter trust—on the rationale that the exercise of the general power by the other spouse should be ignored as a prearranged step designed to give the transferor access to the trust's assets—inclusion in the grantor's estate would nonetheless appear to be precluded. For, under the QTIP regulations, once the QTIP beneficiary has died, neither Code § 2036 nor § 2038 can apply at the death of the spouse who created it even if he or she has a beneficial interest in the trust or a power over it. See Treas. Reg. § 25.2523(f)–1(f) ex. 11. And while Code § 2041 might interact with a creditors' rights theory under state law to produce inclusion in the surviving spouse's estate, the use of an ascertainable standard should eliminate this possibility. In summary, neither Code § 2036 nor § 2038 can apply even if the surviving spouse is treated as having created the credit shelter trust because it will have been treated as a QTIP trust for the spouse dying first. That is so even if the so-called creditors' rights theory of *Paolozzi*, 23 T.C. at 182, and similar precedent is invoked—those cases cause Code §§ 2036 and/or 2038 to apply—because the QTIP regulation cited above forecloses the application of those sections. Moreover, a power exercisable only under an ascertainable standard described in Code § 2041 forecloses the power from being a general power of appointment. Hence, the credit shelter trust should not be included in the gross estate for federal estate tax purposes of the surviving spouse, despite the interests and powers the survivor will hold over the trust. Thus, even if the IRS were to abandon its taxpayer-friendly approach and invoke a creditor's rights theory, documents drafted in the manner suggested would likely produce a favorable outcome.

Some Additional Practical Points

The surviving spouse should file a gift tax return and any applicable state gift tax return, disclosing the gift to the other spouse and claiming QTIP marital-deduction treatment. Assuming adequate disclosure under Code § 6501(c)(9), the statute of limitations for the IRS to challenge the allowance of the marital deduction will expire in three years when there is not a greater than 25% omission from the return. See Code § 6501(e)(2). That means that, if no timely and successful challenge to

the allowance of the marital deduction is made by the IRS, the credit shelter trust should be excluded from the surviving spouse's estate.

Conclusion

The recent rulings produce a taxpayer-friendly outcome in many cases in which the nonportable nature of the estate-tax exemptions makes planning and drafting difficult. But, until published guidance is issued on some of the complicated issues that the rulings resolve in favor of taxpayers, practitioners may find it prudent to draft conservatively and, therefore, implement some of the suggestions made in this article.

Implementing the Strategy

To implement the strategy approved in the rulings, each spouse creates a revocable trust or the couple creates a joint revocable trust. The trusts or trust must be funded with a sufficient amount of property before either spouse dies to ensure that the spouse who dies first has a general power of appointment (causing estate tax inclusion under Code § 2041) over an adequate level of property such that his or her exemption will be used optimally. For example, if each spouse has $1 million titled in his or her name and they have an additional $500,000 in assets, the $500,000 sum could be placed in the revocable trust so the first to die will have an estate for federal estate tax purposes of $1.5 million. Of course, the key is the amount of the taxable estate of the spouse dying first, not the gross estate. Also, values in the trust will vary over time and the federal estate tax exemption is scheduled to increase over the years. Hence, it probably is preferable for the spouses to transfer substantially more to the revocable trust than the minimum expected to be needed to avoid wasting the exemption in the estate of the first spouse to die.

The provision that would be added to the revocable trust might be similar to the following, which is sample language derived from Wealth Transfer Planning™, a computer software system of which Mr. Blattmachr and Michael L. Graham are co-authors and that is published by InterActive Legal Systems (www.ilsdocs.com), which has granted its permission for the language to be reproduced here.

> **Grant of General Power of Appointment.** If the Grantor's husband/wife predeceases the Grantor, then upon the death of the Grantor's husband/wife if the Grantor's husband/wife is then under the age of 115 years, the trustees acting hereunder shall transfer the lesser of (a) all property held hereunder at the time of the death of the Grantor's husband/wife or (b) a [SUM\FRACTIONAL SHARE] of all property then held hereunder, which shall be the amount, if any, by which (i) the Unused Applicable Exclusion Amount of the Grantor's husband/wife exceeds (ii) the value of the taxable estate of the Grantor's husband/wife (determined by excluding the value of property subject to this general power of appointment) to such one or more persons (including the estate of the Grantor's husband/wife) on such terms as the Grantor's husband/wife may appoint by a Will specifically referring to this power of appointment. (If the lesser of "(a)" and "(b)" is "(b)" and if the trustees hold property that would represent the right to income in respect of a decedent within the meaning of Code Sec. 691 at the death of the Grantor's husband/wife, then the power of appointment hereby granted to the Grantor's husband/wife shall be applied first to property that does not represent the right to income in respect of decedent and shall be exercisable with respect to property that does represent the right to income in respect of a decedent only to the extent necessary to permit the Grantor's husband/wife to be able to exercise the power in full to the extent of the lesser of "(a)" and "(b)".) The "Unused Applicable Exclusion Amount of the Grantor's husband/wife" means the largest taxable estate the Grantor's husband/wife could have at the time of his/her death without incurring any Federal estate tax. To the extent this power of appointment is not effectually exercised by the Grantor's husband/wife, the property subject to the power shall be paid over to the Executor under the Will [*change to "personal representative of the estate" if appropriate*] of the Grantor's husband/wife to become part of his/her estate. If the Grantor's husband/wife (or the Executor of the Will of the Grantor's husband/wife) disclaims the general power of appointment granted under this paragraph, that power shall be expunged as of the date of death of the Grantor's husband/wife and treated as though never granted.

The language for a joint revocable trust (that is, one created by both spouses) might be similar to the following:

> **Grant of General Power of Appointment.** Upon the death of the First Decedent [*many practitioners, in drafting "joint" revocable trusts, refer to the husband and wife as "Trustors" as they both create the trust. Others refer to the "husband and wife," the "Settlors," the "Grantors" or some other term. The term in this provision should be modified in accordance with the "naming" convention for the husband and wife used in the joint revocable trust*], the trustee acting hereunder shall transfer upon the death of the First Decedent, if the First Decedent is then under the age of 115 years, the lesser of (a) all property held hereunder at the time of the death of the First Decedent consisting of the Surviving Spouse's separate property and the Surviving Spouse's one-half interest in community property [*remove the reference to "community*

property" if appropriate] or (b) a {SUM\FRACTIONAL SHARE} of the Surviving Spouse's separate property and the Surviving Spouse's one-half interest in community property then held hereunder equal to the amount, if any, by which (i) the First Decedent's Applicable Exclusion Amount exceeds (ii) the value of the First Decedent's taxable estate (determined by excluding the value of property subject to this power) to such one or more persons (including First Decedent's estate) on such terms as the First Decedent may appoint by a Will specifically referring to this power of appointment. (If the lesser of "(a)" and "(b)" is "(b)" and if the trustees hold property that would represent the right to income in respect of a decedent within the meaning of Code Sec. 691 at the death of the First Decedent, then the power of appointment hereby granted to the First Decedent shall be applied first to property that does not represent the right to income in respect of decedent and shall be exercisable with respect to property that does represent the right to income in respect of a decedent only to the extent necessary to permit the First Decedent to be able to exercise the power in full to the extent of the lesser of "(a)" and "(b)".) The First Decedent's "Unused Applicable Exclusion Amount" means the largest taxable estate the First Decedent could have at the time of the First Decedent's death without incurring any Federal estate tax. To the extent this power of appointment is not effectually exercised by the First Decedent, the property subject to the power shall be paid over to the Executor under the Will of the First Decedent to become part of his or her estate. If the First Decedent (or the Executor of the Will of the First Decedent) disclaims the general power of appointment granted under this paragraph, that power shall be expunged as of the date of death of the First Decedent and treated as though never granted.

As mentioned above, it seems preferable for the spouse dying first to exercise the general power of appointment. Here is a sample of how the exercise might be described in that spouse's will:

> **Exercise of Power of Appointment.** Under [*describe trust agreement*], I may hold a power to appoint certain property held thereunder at the time of my death. I hereby exercise that power and direct that all property subject to that power of appointment be added to my estate to become a part thereof. ■