Drafting Marital Trusts

Prepared by:

Joshua E. Husbands
Holland & Knight LLP
111 SW 5th Ave.
Suite 2300
Portland, OR 97212
503.243.2300

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Funding Marital Trusts

I. Credit Shelter Trust Planning. When representing a married couple, a thorough understanding of the planning opportunities afforded by the marital deduction rules and the applicable exclusion amount is essential.

A. Application Exclusion Amount. The "applicable exclusion amount" is the amount a person may transfer at death without any transfer tax being payable. The applicable exclusion amount is $5,120,000 in 2012 (though it is scheduled to decrease to $1,000,000 in 2013). With a married couple, there are various trust techniques to take advantage of the applicable exclusion amount to essentially double the amount that they can pass to their heirs estate tax free.

1. Disclaimer Trust. One available alternative, if the combined estates of the spouses are potentially less than one applicable exclusion amount, is the disclaimer trust. Under this plan, the deceased spouse gives all of his or her assets to the surviving spouse, with the option to disclaim a portion of the inherited assets. The disclaimed assets will pass automatically to a separate trust that will utilize the deceased spouse's applicable exclusion amount. The surviving spouse can be a beneficiary of the disclaimer trust, but cannot have a testamentary power of appointment over the trust assets. If the disclaimer trust is properly drafted, the trust assets will not be included in the surviving spouse's taxable estate at his or her death. The benefit of this plan is that the surviving spouse can make a decision about funding the trust as late as nine months after the death of his or her spouse.

2. Partial QTIP Election. Another alternative available if the combined estates of the spouses are less than one applicable exclusion amount is the use of a partial QTIP election as discussed in Section 4(c) below.

3. Credit Shelter Trust. If the combined estates of the spouses are greater than the applicable exclusion amount, a common estate planning technique is to allocate a portion of the deceased spouse's trust equal to the applicable exclusion amount to a separate trust often referred to as the Credit Shelter or bypass trust. If the applicable exclusion amount were given directly to the surviving spouse, there will be no estate tax at the first spouse's death, but this merely serves to increase the size of the surviving spouse's estate and his or her potential estate tax liability. By funding a separate bypass (or credit shelter) trust with the applicable exclusion amount, that trust will not be included in the estate of the surviving spouse upon his or her death, thereby saving estate tax on the entire balance of the trust.

4. Marital Gift. After fully utilizing the applicable exclusion amount, the balance of the deceased spouse's estate will often pass to the surviving spouse in a transfer that qualifies for the marital deduction under Code Section 2056. This transfer can be outright or by a trust that qualifies for the marital deduction (a "Marital Trust"). To qualify for the marital deduction, the

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1 I.R.C. §2010
surviving spouse, and no one else, must have the right to all income from the trust for his or her lifetime.²

a. **GPA Trust.** One trust that qualifies for the marital deduction is a general power of appointment (GPA) trust, which allows the surviving spouse to appoint the trust assets to himself or herself or to his or her estate.³

b. **QTIP Trust.** Another Marital Trust concept—which has become by far the most popular—is the qualified terminable interest property (QTIP) trust.⁴ The primary reason for the popularity of the QTIP trust is that the first spouse to die can direct the disposition of the remaining trust estate upon the death of the surviving spouse, and the surviving spouse may not have any power or control over the disposition of the remaining trust estate upon the surviving spouse's death. For that reason, the QTIP trust is used often in situations in which there are multiple marriages and families.

i. **Partial QTIP Election.** Even if a trust meets all of the statutory requirements necessary to qualify as a QTIP trust, it will not qualify for the marital deduction unless the executor so elects on the estate tax return.⁵ Accordingly, to maximize flexibility, a QTIP trust should be structured to allow the personal representative to make a partial QTIP election. As mentioned above, if the combined estates of the spouses appear that they may end up less than one applicable exclusion amount, the trust can provide that at the death of the spouse everything funds a QTIP trust for the benefit of the surviving spouse. If the estate of the first spouse to die turns out to be greater than expected, the executor can make a partial QTIP election to take advantage of the applicable exclusion amount. This technique would give the trustee fifteen months to decide because the QTIP election is made on IRS Form 706, which can be filed on extension 15 months after the death of the grantor.⁶

ii. **Reverse QTIP Election.** A reverse QTIP election is a technique that enables the trustee to take advantage of the full GST exemption ($5,120,000 in 2012, and $1,000,000 in 2013) in the estate of the first spouse to die if that spouse has used a portion of his or her estate tax exemption without reducing his or her GST exemption (such as large gifts to children).⁷ The reverse QTIP election allows the first spouse to die to remain the "transferor" for GST tax purposes of a portion of the trust property; the surviving spouse is the "transferor" for the other (i.e., non-reverse QTIP) portion of the trust property. For example, if the first spouse to die had assets of $5,500,000 in 2012, but had used $1,000,000 of the applicable exclusion amount with non-GST lifetime gifts, the trustee could fund the bypass (or credit shelter) trust with

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² I.R.C. §§ 2056(b)(5), 2056(b)(7).
³ I.R.C. §2056(b)(5).
⁴ I.R.C. §2056(b)(7).
⁵ Treas. Reg. § 20.2056(b)-7(b)(2).
⁷ I.R.C. §2631(a).
$4,000,000 and fund the reverse QTIP Trust with the remaining $1,000,000 [i.e., the
difference between the deceased spouse's GST exemption and remaining applicable
exclusion amount]. The decedent's $5,000,000 GST exemption would be allocated to
those trusts. The decedent's remaining $500,000 of assets would fund a separate
QTIP trust without a reverse QTIP election.

iii. Clayton QTIP. A "Clayton Clause" allows any part of the marital gift not
elected to qualify for the marital deduction to pass to another trust or to other
beneficiaries without jeopardizing the entire marital deduction. This provision stems
from a case in which the IRS argued that if the amount of property passing to a QTIP
Trust was dependent upon the executor's making a QTIP election, then none of the
property would qualify for the marital deduction. In the case, the Fifth Circuit
rejected this argument and allowed the deduction. Other circuits have followed the
Fifth Circuit's ruling. The IRS has also conceded the issue in the regulations.

B. Trust Funding Formulas. Most trusts that employ provisions addressing the use of the
applicable exclusion amount contain a detailed formula for dividing the trust into the credit shelter
trust and the Marital Trust at the death of the grantor. In general, there are two types of formulas,
those that require one of the trusts to be funded with a pecuniary amount, and those that divide the
trust assets on a fractional basis.

1. Pecuniary Formulas. There are two types of pecuniary formulas: "fixed sum" and
"fairly representative." In addition, the estate planning practitioner can choose to fund either the
Marital Trust or the Credit Shelter Trust with the pecuniary amount, with the residue of the trust
passing into the other trust.

a. Preresiduary pecuniary marital share. As noted above, if the trust employs a
pecuniary formula, the grantor has the choice to fund the marital share or the credit
shelter share with the pecuniary amount. The preresiduary pecuniary marital share fixes
the value of the marital share at the date of death, and funds the credit shelter trust with
the residue of the grantor's estate. This approach can be beneficial from a transfer tax
perspective because if the trust assets appreciate between the grantor's date of death and
the funding date, the grantor will achieve some leverage of his or her applicable
exclusion amount, which may result in a bypass (or credit shelter) trust funded with
significantly more than the applicable exclusion amount. However, some practitioners

9 Id.
10 See e.g., Estate of Robertson v. Comm., 15 F3d 779 (CA 8 1994), and Estate of Spencer v. Comm., 43 F3d
226 (CA 6 1995).
(2003).
12 The attached Exhibit contains a chart of pecuniary and fractional funding formulas and their consequences
reproduced with permission from worksheet 21 of Jeffrey N. Pennell, 843 T.M. Estate Tax Marital Deduction
(BNA, Inc.)
do not like to use this approach, particularly in large estates, because if the assets depreciate after death but before funding, the bypass (or credit shelter) trust that bears all of the depreciation could be entirely wiped out.

b. Preresiduary Pecuniary Non-Marital Gift. This approach uses the applicable exclusion amount to fund the bypass (or credit shelter) trust or other non-marital deduction bequest with a pecuniary amount, with the residue passing to the marital share.

c. Fixed sum pecuniary formula. With the "fixed sum" pecuniary formula, the appreciation or depreciation of assets between the date of death and the date of funding shifts to the trust that does not receive the pecuniary amount. If the assets used to fund the pecuniary share increase in value after the deceased spouse's date of death and before funding, the trust will realize a taxable gain on the amount of the increase.\(^{14}\) In addition, the full amount of any IRA account (to the full extent of its value) or other income in respect of decedent (IRD) used to fund the pecuniary amount will be subject to income tax as of the date of funding. Accordingly, it is generally not advisable to use this formula if the trust contains a large percentage of IRD assets.

d. Fairly representative pecuniary formula. With the "fairly representative" pecuniary formula, the pecuniary share need not necessarily be funded with a pro rata portion of each asset. The pecuniary share may instead be funded on a non-pro rata basis provided the funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of all the assets measured from the valuation date to the date of funding.\(^{15}\) If a fairly representative basis is used, and the assets appreciate after the date of valuation, then the funding of the marital and credit shelter shares will include the pro rata share of net appreciation. If the values decline, then this basis of funding will include the pro rata share of net depreciation. One of the benefits of the "fairly representative" pecuniary formula is that there is no gain (and no tax liability) upon funding the marital and credit shelter trust.

2. Fractional Share Formula. If a fractional share formula is selected, the trust property is allocated on a percentage basis between the marital share and the credit shelter trust.

a. The use of a fractional share formula eliminates the need to choose between the preresiduary and residuary marital clauses. The formula allocates an undivided interest in each asset to each trust. All growth will be allocated proportionately under the fractional formula, and no growth shifting will be available. In addition, because no pecuniary amount is to be funded, gain will not be realized upon the funding of the separate trusts.

b. The funding of the fractional share generally is considered to be more difficult than funding a pecuniary amount because of the need to revalue and recalculate the fraction whenever a distribution that is not on a pro rata basis is made to one bene-

\(^{14}\) Treas. Reg. §1.1014-4(a)(3); Kenan v. Comm., 114 F2d 217 (CA 2 1940); Rev Rul 86-105, 1986-2 CB 82.

\(^{15}\) Rev. Proc. 64-19, 1964-1 CB 682.
ficiary.\textsuperscript{16} If no distributions are ever made except on a pro rata basis to all residuary beneficiaries, then no recalculation is necessary, but funding a fractional share can create an additional problem if one adopts the view that there is a need to "fractionalize" each asset. This problem may be avoided by a specific authorization in the trust for non-fractional distributions (often called "pick and choose" funding).\textsuperscript{17} However, if the "pick and choose" method is not authorized by the trust instrument, non-fractional distributions run the risk of being considered taxable exchanges.\textsuperscript{18}

3. Other Options. If the grantor does not want to run the risk of disinheriting his or her spouse by overfunding the bypass (or credit shelter trust), the grantor could provide that the marital share will be no less than the difference between one-half of his or her adjusted gross estate and the aggregate value of all assets that qualify for the marital deduction and that pass under the trust or outside the trust. This option assures that the surviving spouse receives at least one-half of the client's adjusted gross estate and is often used for smaller estates. In effect, it assures there is a marital share rather than having everything fund the bypass (or credit shelter trust). It may not be the best alternative from an estate tax perspective, but the grantor may prefer it anyway.


\textsuperscript{17} Such an authorization for non-fractional distributions should meet the standards announced by the Service in Rev. Proc. 64-19, 1964-1 CB 682.

<table>
<thead>
<tr>
<th>Funding value</th>
<th>True-Worth Pecuniary Funding Formula</th>
<th>Fairly Representative Pecuniary Funding Formula</th>
<th>Minimum-Worth Funding Formula</th>
<th>Fractional Funding Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property distributed to the grantor is valued at its date of distribution value.</td>
<td>Property distributed to the grantor is valued at its federal income tax basis (usually federal estate tax value).</td>
<td>Property distributed under the grantor's estate.</td>
<td>Property distributed under a pro rata funding formula is valued at its federal estate tax value. Property distributed under a pro rata funding formula is generally valued at its date of distribution value.</td>
<td></td>
</tr>
<tr>
<td>Which trust share is frozen in value?</td>
<td>The marital share is frozen in value under an option pecuniary formula. The credit shelter share is frozen in value under a reverse pecuniary formula.</td>
<td>The marital share is frozen in value under an option pecuniary formula.</td>
<td>Neither share is frozen in value. Both shares fluctuate in value during the administration of the grantor's estate.</td>
<td></td>
</tr>
<tr>
<td>Does the grantor's estate receive gain or loss on funding the bequest/trust with noncash property?</td>
<td>Yes.</td>
<td>No.</td>
<td>No gain or loss realized. Loss can be realized but is not recognized due to Code § 767(a)(6).</td>
<td>No.</td>
</tr>
<tr>
<td>Is the Code § 408(b)(3) election available to recognize gain or loss on funding with noncash property?</td>
<td>Yes.</td>
<td>Yes.</td>
<td>Yes.</td>
<td>Yes.</td>
</tr>
<tr>
<td>Does funding with the right to receive a COD accelerate its recognition by the grantor's estate?</td>
<td>Yes.</td>
<td>Yes.</td>
<td>Yes.</td>
<td>No.</td>
</tr>
<tr>
<td>Are the marital and credit shelter trusts separate under Code § 663(c) for income tax and DNI carryout purposes?</td>
<td>Yes.</td>
<td>Yes.</td>
<td>Yes.</td>
<td>Yes.</td>
</tr>
<tr>
<td>How much DNI is carried out from the grantor's estate or funding?</td>
<td>If DNI is carried out (see immediately above), the amount of DNI will be the FMV of the distributed assets.</td>
<td>DNI will be the lesser of the distributed assets' income tax basis at the FMV of the distributed assets.</td>
<td>DNI will be the lesser of the distributed assets' income tax basis or FMV of the distributed assets.</td>
<td>DNI will be the lesser of the distributed assets' income tax basis or FMV of the distributed assets.</td>
</tr>
<tr>
<td>Do assets in the grantor's estate have to be revalued at the time of funding?</td>
<td>Yes.</td>
<td>No.</td>
<td>Yes.</td>
<td>No.</td>
</tr>
<tr>
<td>Does the funding formula work well for GST tax exemption allocation purposes?</td>
<td>Yes.</td>
<td>No.</td>
<td>Yes.</td>
<td>No.</td>
</tr>
<tr>
<td>Does the funding formula work well for Code § 2032A special use valuation property?</td>
<td>Yes.</td>
<td>No.</td>
<td>No.</td>
<td>No.</td>
</tr>
<tr>
<td>Does the formula generally require quick funding?</td>
<td>Yes.</td>
<td>No.</td>
<td>Yes.</td>
<td>No.</td>
</tr>
</tbody>
</table>

**Chart of Pecuniary and Fractional Funding Formulas and Their Consequences**