FUNDING FORMULAS FAIL ON FLEXIBILITY: VARIATIONS ON TRADITIONAL MARITAL/CREDIT SHELTER FUNDING TECHNIQUES

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I. INTRODUCTION.

A. HISTORICAL APPROACH TO MARITAL DEDUCTION/CREDIT SHELTER ESTATE PLANNING. Since 1981, estate planners have used straightforward formulas for determining the amount of the credit shelter and marital portions of an estate. The issues they had to deal with concerned primarily what funding methods to use, the form in which to put the marital share, the structure of the credit shelter trust, and whether to suggest paying gift tax on *inter vivos* transfers or estate tax in the estate of the first spouse to die. For clients with moderately sized estates, planners needed to attend to whether clients had sufficient assets to warrant carving the credit shelter amount out of the marital share and how husbands and wives structured the ownership of assets between them. For high net worth clients, planners frequently developed plans which used all of the clients' applicable exclusion amount during life. Although at the time it may have seemed as though there were many unknown factors in developing estate plans, generally developing a plan for a client was manageable because of the relative certainty regarding the amount of the applicable exclusion and the rates of tax. Occasionally, planners resorted to the use of disclaimers and partial QTIP elections to preserve flexibility at the death of the first spouse, but this was generally the exception, rather than the rule. As most states moved to a "pick-up" or "sop" tax, the impact of the state death tax credit was substantially reduced. Even after the applicable exclusion amount began creeping up from $600,000 to $1 million, for moderately sized and high net worth individuals the choices were fairly simple. Then came EGTRRA.

B. A CONSTANTLY MOVING TARGET. The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (June 7, 2001) ("EGTRRA"), has added more uncertainty to the transfer tax system than may have been believed possible prior to its enactment. Putting aside the difficulty of planning for a single year of estate and GST tax repeal and the subsequent reinstatement of both in the following year at rates equal to those prior to the enactment of EGTRRA, just assisting clients with planning for the changing rates and credits is a daunting task. The usual uncertainties of not knowing the year in which a client will die, which of her family members will survive her, the value and character of her assets at the time of her death and so forth are exacerbated by not knowing the rates of estate tax that will be in effect at the time of her death (or at the time of the death of her survivors, even if they do not survive her by many years), the amount of the applicable exclusion amount at the time of her death, the amount of the generation-skipping transfer ("GST") tax exemption at the time of her death, or even whether there will be an estate tax or GST tax at the time of her death.

C. LEGISLATIVE UNCERTAINTY. Many Congressional elections and two presidential elections will occur during the phase in of the provisions of EGTRRA and its subsequent sunset. Under the Byrd Amendment (the rule which requires a law that will cause a net revenue loss beyond the 10 years typically covered in a budget resolution to be passed by at least 60 Senators), the Senate has failed to obtain the required vote to make the provisions of EGTRRA permanent. However, the likelihood that a law repealing the estate tax and then reinstating it after one year will actually take effect is very low. The unpopularity and impracticality of such a scenario should prevent it from occurring. The question is whether the law will be changed by eliminating the repeal of the estate tax, making the repeal of the estate tax permanent (because the votes necessary to meet the Byrd Amendment requirement can be obtained), extending the years of repeal for a few additional years (*e.g.*, through 2013), freezing the law as it exists at some point during the phase-in of EGTRRA (*e.g.*, in the year 2005 if a new President takes office), or passing some altogether different law to replace EGTRRA.

D. CHANGE IN FOCUS OF ESTATE PLANNING.

1. After the initial flurry of shock following the enactment of EGTRRA, many estate planners decided that the likelihood of repeal of the estate tax followed by its subsequent sunset was so low and the potential repeal so far in the future, that they would adopt a "wait and see" approach with regard to drafting for this eventuality. Estate planners acknowledged that their job had been altered, however, from developing estate plans to clearly implement the client's wishes in the most tax efficient manner to trying to create estate plans that will permit choices to be made

after the client's death. Such choices must be based on the client's wishes, of course, under a variety of different scenarios which could be extant at the time of the client's death. This has meant, among other things, that many decisions which the client would normally make crystal clear in her Will or revocable trust now must be left in the hands of others to make following her death, taking into account the tax considerations at her death, if the flexibility to postpone the decisions can be built into her estate plan. In addition, for healthy clients, it is hard to recommend the making of taxable gifts that require gift tax to be paid since those assets might otherwise pass free of transfer tax if the client dies. Finally, the decision of whether to recommend that some tax be paid in the estate of the first spouse to die is really a shot in the dark and, even if such a payment appears advisable, it may be difficult (and inadvisable) to persuade clients to take the risk.

2. Now, however, time has passed, the law is no more certain than it was, and 2010 and 2011 are ever closer. Perhaps it is time, even for the "wait and see" contingent, not only to take into account the years prior to repeal but also to incorporate a few provisions in the estate plans currently being prepared to at least give a nod to the possibility that repeal under EGTRRA will occur.

II. CHANGES IN ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX RATES, APPLICABLE EXCLUSION AMOUNT, AND GENERATION-SKIPPING TRANSFER TAX EXEMPTION AMOUNT.

A. GIFT, ESTATE AND GST TAX RATES AND APPLICABLE EXCLUSION AMOUNT. Beginning in 2002, the maximum estate, gift and GST tax rates began declining each year for 5 years and the applicable exclusion amount began increasing irregularly and sometimes dramatically through the year 2009.

1. Reduction in Rates of Tax.

a. Maximum estate tax rates. Under EGTRRA, the maximum estate tax rate gradually decreases over six years.

Year	Maximum Rate
2001	55%[1]

[1] For estates in excess of $10 million, an additional 5% tax applied to amounts between $10 million and $17,184,000 to recapture the effect of the graduated

2002	50%
2003	49%
2004	48%
2005	47%
2006	46%
2007	45%
2008	45%
2009	45%

b. Generation-skipping transfer tax rate. Although historically the GST tax was referred to as a flat 55% tax, in fact it is imposed at the maximum estate tax rate in effect at the time of the GST transfer, whether direct skip, taxable distribution or taxable termination. IRC § 2641(b).[2]

c. Gift tax rate. The gift tax rate continues to be the same as the estate tax rate through the year 2009. In 2010, when the estate tax is repealed, the gift tax is NOT repealed and, in effect, becomes a flat tax of 35%. In reality, the gift tax rates continue to be graduated but the applicable credit of $1 million will protect all taxable transfers at rates lower than the maximum rate of 35%.

(1) The legislative history of EGTRRA explains the use of the 35% maximum gift tax rate as equal to the top income tax rate then in effect, but the statutory language does not tie the gift tax rate to the maximum income tax rate.

(2) The relationship between the gift tax and the income tax rate was of some concern during the drafting of EGTRRA due to the possibility that a substantial portion of the tax on income and capital gain on assets could be reduced or eliminated by transferring assets to individuals in lower tax brackets and having those individuals then pay the income or proceeds from sale back to the donor if no gift tax applied to the transfers.

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rates of tax and the unified credit. This tax "bubble" was repealed by EGTRRA.

[2] All references herein to "IRC" sections and to the "Code" are to the Internal Revenue Code of 1986, as amended, unless otherwise provided.

(3) In addition, the imposition of the gift tax on transfers in 2010 will prevent the anticipated tidal wave of transfers in that year to take advantage of what is currently no more than a very narrow window of opportunity.

2. Applicable Exclusion Amount through the Year 2009.

a. The applicable exclusion amount for years 2001 through 2009 is:

Year	Applicable Exclusion Amount
2001	$ 675,000
2002	1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000

b. Note, however, that under section 521(b) of EGTRRA, the applicable exclusion amount for gift tax purposes increased to $1 million in 2002 and remains at that level thereafter, including the year 2010. The amount of gift tax exclusion used during life still reduces the amount of applicable exclusion available at death, but beginning this year, 2004, the amount of the applicable exclusion (other than for gift tax purposes) exceeds $1 million and some portion of it will be available at death because it cannot be used during life. In effect, for 2004 through 2009, the applicable exclusion amount is limited to $1 million during life and an additional applicable exclusion amount (from $500,000 to $2.5 million) is available at death.

3. GST Tax Exemption through the Year 2009.

a. In general. Section 521 of EGTRRA modified the amount of the GST tax exemption to equal that of the applicable exclusion amount for generation-skipping transfers made after December 31, 2003. IRC § 2631(a) and (c). Beginning this year, the amount of the GST tax exemption is $1.5 million.

b. Coordination with exemption for gift tax purposes.

(1) Although GST tax planning could have been simplified because the amount of the GST tax exemption and the applicable exclusion amount are finally coordinated in 2004, this is not the case since the estate and gift taxes are no longer fully unified.

(2) Testamentary GST tax planning may be simplified for decedents who die in the years 2004 through 2009 (if one can say that *any* planning which requires that one identify the year in which a taxpayer will die is simplified) because the applicable exclusion amount is adequate to protect the full amount of the GST tax exemption (subject to reduction for lifetime transfers of up to $1 million). However, gift tax (but not GST tax) will be due on *inter vivos* generation skipping transfers in excess of $1 million (aggregated for all lifetime transfers, whether or not they are generation skipping transfers) made in the years 2004 through 2009. Thus, to avoid payment of transfer taxes on transfers to members of skip generations, transfers of up to $1 million can be made during life, and testamentary generation skipping transfers of the excess of the applicable exclusion amount over $1 million can be made to take advantage of the remaining available GST exemption.

B. STATE DEATH TAX CREDIT.

1. Under EGTRRA, the maximum credit allowed on the federal estate tax return for estate and inheritance taxes paid to the states is reduced over a four-year period to zero and replaced by a deduction.

2. The significance for marital/credit shelter planning of this change in the structure of the state death tax credit is not so much the effect of the reduction in rates, but more the impact of the amount of credit shelter protection afforded under various state laws. As a result of the change in the federal law, many states no longer mirror the amount of the federal protection and this decoupling of the federal and state tax systems may create a situation where the full use of the federal credit will require payment of state estate tax. For states like New York whose sop tax is tied to the federal law in effect in 1998, this is the first year in which the state credit protection will be

limited to $1 million even though the federal applicable exclusion amount will be $1.5 million.[3]

C. CARRYOVER BASIS. Under EGTRRA, during repeal of the estate tax, the basis adjustment to property subject to the estate tax generally available under current law is also repealed and beneficiaries will inherit property with the lesser of the decedent's adjusted basis or the fair market value of the property, subject to a few adjustments. An exhaustive explanation of these carryover basis provisions is beyond the scope of this outline. However, those provisions which estate planners may want to begin to consider in their current drafting are summarized below.

1. Limited Increase in Basis Allocated by Executor. Under new IRC § 1022, $1.3 million of basis increase is available for assets owned by and passing from the decedent and is allocated by the executor to specific assets in the decedent's estate. In addition, $3 million of basis increase is available for assets passing to the surviving spouse. Planning for foreign spouses continues to be treated separately to protect the fisc and thus increases to basis for nonresident foreign spouses is limited to $60,000. All of these amounts are indexed for inflation after 2009.

a. Note that this concept requires an entirely new view of the decedent's assets because it refers not to the value of the property, but to the increase from the decedent's basis to the property's fair market value at the time of the decedent's death. Thus, although the provision specifies the amount of basis increase available, the value of the property to which it applies may be substantially larger and will vary widely from one decedent's estate to another.

b. In effect, the provision provides for $1.3 million shelter from capital gains tax in the hands of the beneficiaries (plus $3 million shelter for spouses). Thus, a married individual who owned $4.3 million of property at death, all of which had a zero basis, could take advantage of the entire available increase, whereas, another individual who owned $10 million of property, all of which had a high basis at her death, might not be able to take full advantage of the entire increase.

[3] *See* NY Tax Law §§ 951(a) and 952.

2. <u>Property to Which Basis Increase Can Be Allocated</u>.

a. Property must be "owned" by the decedent to be eligible for basis increase. This includes property which is jointly-owned, property held in a revocable trust and property over which the decedent retained the right to control the beneficial enjoyment or the power to alter, amend or revoke the trust holding the property. Note that the decedent will not "own" property solely because the decedent held a special or general power of appointment over the property.

b. The special spousal increase in basis adjustment is available for property passing to the spouse outright or passing to a trust for the spouse which is structured similarly to a QTIP trust. Note that this means that property passing *to* a QTIP trust can receive basis increase, but property passing *from* a QTIP trust at the surviving spouse's death will not be eligible to receive increase in basis allocation by the surviving spouse's executor. The spouse must have assets outside of the QTIP to take advantage of the basis increase.

III. <u>WHY PLANNING IS MORE DIFFICULT UNDER EGTRRA</u>.

A. CREDIT SHELTER AMOUNT.

1. Two categories of issues arise in dealing with the credit shelter amount in the current planning environment.

a. <u>Uncertainty as to amount</u>. Under EGTRRA, the uncertainty in the amount of the applicable exclusion amount which will be available to the estate of the first spouse to die and to the estate of the second spouse to die makes determining the structure of the division of the estate between the marital and credit shelter shares extremely difficult. Potentially, these amounts range from $2 million if both spouses die in years after 2010 to $7 million if both spouses die in the year 2009, with a wide variety of permutations in between, depending on the particular years in which each spouse dies. This, of course, does not take into account the possibility that one spouse could die in the year 2010. Many combined estates fall into the range between $2 million and $7 million. In addition, a variety of proposed bills have suggested increasing the credit amount to even larger amounts for each spouse in lieu of repeal.

b. The effect of the increases in the applicable exclusion amount on formulas. Historically, the best way to deal with the fact that the amount of the applicable exclusion amount was unknown was to draft by formula. This accommodated not only the possibility that clients would use a portion of the credit during life, but also changes in the amount of the credit under the law. However, these formulas may have drastically undesirable effects as the amount of the exclusion increases or in the event of repeal. Thus, not only is it difficult to know whether credit shelter planning may be necessary in the estate of the first spouse to die, but also, under the traditional formulas, the property may not end up where expected.

2. These issues are difficult in unified first marriage families. They are even more troubling in the complex multiple marriage families of many clients.

B. GST EXEMPTION AMOUNT. To the extent that GST tax planning is coordinated with the use of the applicable exclusion amount and/or the QTIP trust, similar problems exist in planning for use of the GST exclusion amount.

C. STATE DECOUPLING ISSUES.

1. Applicable Exclusion Amount. To the extent that full use of the federal applicable exclusion amount will require payment of state estate tax, and given that it is impossible to know how much federal applicable exclusion amount will be available to the estate of the surviving spouse, for many estates it is difficult to determine whether full use of the federal credit in the estate of the first spouse to die will be advantageous. Even if flexible planning permits deferral of this decision until the death of the first spouse, the decision may not be any clearer then. Unlike the federal scheme, nonpayment of state estate tax at the death of the first spouse to die may not be deferral of the tax, but actual avoidance: surviving spouses may flock to Florida and other states which impose no state estate tax.

2. GST Tax Exemption and Taxes. As a result of decoupling, it is important to work through what happens under state GST tax regimes when the federal GST tax exemption amounts increase and the rates of GST tax are decreased.

D. REPEAL OF THE ESTATE TAX.

1. Carryover Basis. The planning necessary to take advantage of the permissible increases in basis under the carryover basis regime during repeal is inconsistent with the traditional planning necessary to take advantage of the marital deduction and applicable exclusion amount.

2. Formulas. Some protection to ensure that formulas used to take advantage of the applicable credit and marital deduction do not disrupt the entire estate plan under repeal seems warranted.

3. Use of Trusts. Planners disagree on the best strategy with regard to the use of trusts in the event of repeal: one school favors terminating trusts if the estate tax is repealed and the other favors so-called dynasty trusts to ensure that assets will not be subject to the estate tax if it returns.

4. Cost and Complexity of the Plan. Finally, despite the wisdom of including provisions to address the possibility of repeal in current estate planning documents, clients have only so much tolerance for complexity and are willing to pay only so much to guard against an event which may never occur. The question remains nevertheless to what extent these provisions are necessary to guard against the possibility that the client may be incompetent and unable to revise her estate plan in the event of a major overhaul of the transfer tax system, potentially including permanent repeal.

IV. MARITAL DEDUCTION/CREDIT SHELTER PLANNING.

A. ESTATE PLANNING GOALS. Generally, the goals for estate planning can be broadly stated to include: implementing the client's goals to use her assets to provide for her loved ones and others, anticipating difficulties in the administration of the plan and incorporating techniques to eliminate or minimize them and doing all of this with the lowest possible federal and state death tax consequences. Estate planning generally encompasses two categories of techniques: lifetime giving and testamentary bequests. Although historically, lifetime giving has provided the most powerful method for reducing total transfer taxes imposed on a client's estate, the current deunification of the estate and gift tax regimes (with the attendant disincentive to make taxable lifetime gifts in excess of $1 million) has changed that picture. In addition, many clients do not wish to give their assets away during life or do not have estates of sufficient size to warrant substantial lifetime gifting programs. This section focuses on the backbone of testamentary estate planning to minimize estate tax - the combination of the marital deduction (IRC § 2056) and the applicable credit (formerly known as the unified credit)(IRC § 2010).[4] It should be noted that bequests to a surviving spouse who is not a U.S. Citizen, the unlimited marital deduction is available for bequests to the spouse only if his bequest is held in a "QDOT," a special marital trust designed to preserve the government's ability to collect estate tax on the assets at the death of the surviving spouse. *See* IRC § 2056(d)(2).

B. COMBINING MARITAL DEDUCTION AND APPLICABLE EXCLUSION AMOUNT PROVISIONS. Marital deduction and credit shelter planning takes advantage of two entirely unrelated provisions in the Internal Revenue Code, the marital deduction and the applicable exclusion amount. By combining these two provisions in one of several ways, it is possible to preserve the maximum wealth for both the surviving spouse and, at his death, the client's children or other beneficiaries. Needless to say, this technique is available only to married couples since only married couples can take advantage of the marital deduction. For simplicity in discussing this technique, the outline assumes that planning is being done for a married couple who wish to benefit each other and children (either theirs combined or from prior marriages). However, it can also be used to preserve wealth for beneficiaries other than children.

C. THE SIMPLE MARITAL DEDUCTION/CREDIT SHELTER PLAN.

1. In general. In its simplest form, the marital deduction/credit shelter plan carves out the amount of the client's available applicable exclusion amount and bequeaths it to a trust for the benefit of the surviving spouse and children. The trust can be structured in a variety of ways, the most flexible of which permits discretionary distributions of income and principal among the surviving spouse and children, and, at the death of the surviving spouse, passes to the couple's issue, *per stirpes*. The balance of the estate passes to or for the benefit of the surviving spouse in a manner that qualifies for the marital deduction (*e.g.*, an outright bequest or a bequest to a

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[4] Section 2010 remains titled "Unified Credit Against Estate Tax" even though the credit is no longer "unified" and even though the text of IRC § 2010 no longer refers to the unified credit and instead refers to the "applicable credit amount" and the "applicable exclusion amount." Note that the term "applicable credit amount" refers to the actual amount of the credit against tax (the former unified credit). The "applicable exclusion amount" is the value of property which will be protected from tax by the applicable credit amount. *See* discussion below.

Qualified Terminable Interest Property ("QTIP") trust.[5] At the death of the first spouse to die, no estate tax is due because a portion of the estate is protected by the applicable credit and the balance is protected by the marital deduction. At the death of the surviving spouse, the credit shelter trust is not includible in the surviving spouse's estate (assuming he has no rights in the trust which would make it includible in his estate) and the surviving spouses' available applicable credit amount protects as much as possible of the surviving spouse's assets and, if a marital trust was used, the marital trust. Thus, the children receive the benefit of both spouse's applicable credits.

a. Because it is impossible to know how much applicable credit amount a client will have at the time of her death, both because she may have used some of it making taxable gifts during her life and because, as in the current climate, the amount of the credit may have changed since the plan was designed, it is prudent to express this bequest as a formula, rather than an exact number.

b. Marital deduction/credit shelter planning can be structured in one of three ways:

(1) Preresiduary (pecuniary) credit shelter trust with the residue to the spouse or a marital trust;

(2) Preresiduary (pecuniary) marital bequest (outright or to a marital trust) with the residue to a credit shelter trust; or

(3) Division of the residue into two fractional shares, one of which is the size of the decedent's available applicable exclusion amount which passes to a credit shelter trust and the other of which is the balance which passes to the spouse or a marital trust.

2. Marital Deduction Funding Methods. While the plan appears simple on its face, it actually involves complex issues related to limiting the amount which can pass to the credit shelter trust. Congress and the Internal Revenue Service have long been concerned that when a transfer tax benefit, through a deduction, credit, or exemption, is available, the value of the property protected

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5 *See* IRC § 2056(b)(7).

by the benefit should not exceed the amount Congress intended. Estate planners, on the other hand, want to wring every possible drop of advantage they can from every tax benefit available for their clients. As a result of the delay that occurs during the administration of an estate, assets usually are not worth the same value when the estate plan is funded as they were when the decedent died. If a credit shelter trust is funded with appreciated assets and a marital share is funded with slow-growing or depreciating assets, two benefits occur. The credit shelter trust protects more than its pro rata share of the total increase in the decedent's assets and the amount includible in the surviving spouse's estate is minimized. A number of rules apply to marital deduction funding to limit this leveraging.

a. As a result, in designing a credit shelter/marital deduction plan, several decisions must be made: whether to use a pecuniary formula or a fractional share formula, whether to pay state estate tax[6] and the type of funding to use once that choice is made.

b. Pecuniary formulas.

(1) Preresiduary credit shelter (also known as reverse pecuniary marital): a preresiduary bequest of a non-marital pecuniary amount (*e.g.*, the amount permitted to pass free of federal estate tax by reason of the applicable credit amount (and possibly the state death

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[6] Because many state estate tax laws are "decoupled" from the federal estate tax law, funding a preresiduary bequest with the largest amount that can pass free of federal estate tax may result in a state estate tax liability. If the testatrix wishes that her estate will pay no estate tax, the formula should refer to the amount permitted to pass free of federal and state estate tax. Assuming the testatrix believes it is preferable to pay some state estate tax in order to protect a larger amount from federal estate tax upon her husband's subsequent death, the planner should analyze whether it is appropriate to maximize the amount protected from federal tax by also including in the credit shelter trust the amount of the IRC § 2011 credit for state death taxes. As a general rule of thumb, where the state applicable exclusion amount is less than the federal applicable exclusion amount, it will likely be advisable to take the state death tax credit into account. It bears mentioning, of course, that the analysis of whether to take the state death tax credit into account is relevant only for the estates of decedents who die in 2004 or earlier, because the IRC § 2011 credit is eliminated after 2004. *See*, United States Trust Company of New York, "Planning for State Death Taxes After EGTRRA," Practical Drafting, 7132-7184, 7142 (Jan. 2003).

tax credit)). This type of formula can be funded in two ways:

(a) True worth funding which is satisfied with assets valued at date of distribution. This approach permits the maximum "pick and choose" flexibility and is definitely the simplest to administer. This approach freezes the value of the pecuniary credit shelter amount which moves appreciation to the residuary marital if the estate increases in value and preserves the credit shelter amount if the estate decreases in value. However, one of the most significant disadvantages of this approach is that it requires recognition of gain or loss upon funding. A second disadvantage is that this technique requires revaluation of the assets at the time of distribution.

(b) Fairly representative funding is satisfied with assets valued at their federal estate tax value (or cost if acquired after death), but selected on a basis that fairly represents the net appreciation and depreciation in all of the assets available to fund the bequest from the valuation date to date of funding. This approach permits substantially less flexibility in selecting assets to fund the bequest. The primary advantage of this approach is that no gain is subject to capital gains tax on funding. This approach may overfund or underfund the credit shelter bequest because the assets used to satisfy the bequest are not likely to have the same value as the pecuniary bequest. This approach also requires revaluation of all assets.

(2) Preresiduary pecuniary marital: a preresiduary marital deduction bequest (*e.g.*, the smallest amount necessary to reduce the federal estate tax to zero after taking the applicable credit amount (and possibly the

state death tax credit)[7] into account). Like the preresiduary credit shelter bequest, this bequest can be funded in several ways:

(a) True worth funding which is funded using date of distribution values. This approach has the same advantages and disadvantages that apply to true worth funding of a preresiduary credit shelter trust. The main difference is that any appreciation which has occurred will accrue to the residuary credit shelter trust. Alternatively, if assets decline in value, the value of the marital bequest is preserved.

(b) Fairly representative funding which is satisfied with assets which are fairly representative of appreciation and depreciation in all assets available to fund the bequest using federal estate tax values (or cost if acquired after death). Like preresiduary credit shelter bequests funded using values that are fairly representative of changes in estate tax values, gain is not subject to capital gains tax, but this method risks over- or underfunding of the marital bequest and requires the assets to be revalued when funding.

(c) Minimum worth funding which is funded with assets using the lesser of federal estate tax or date of distribution values. This approach should not be used in conjunction with GST tax exemption allocation because it will require use of date of distribution values as the denominator of the applicable fraction.

c. Fractional share formula.

(1) The concept underlying a fractional share formula is entirely different than that underlying a pecuniary formula bequest. Instead of "carving out" pieces and leaving an undefined residuary amount, it divides the

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7 Id.

estate portions which are defined in terms of fractions of the estate. The numerator of the fraction is similarly worded to a pecuniary bequest and the denominator is the value of the assets available to fund the share.

(2) The common approach to funding a fractional share formula is to divide each and every asset of the estate into the required shares, based on the fraction allocable to each share.

(3) This approach does not require the recognition of gain or loss or the revaluation of assets when funding the bequests.

(4) However, it has several major disadvantages:

(a) No pick and choose flexibility.

(b) It requires a pro rata division of every asset. If a non pro rata distribution is made, a taxable exchange among beneficiaries is likely to result which would generate gain or loss recognition.

(c) It is difficult to administer. For example, each time a distribution is made to one beneficiary and not to others or if an asset is revalued on audit, the fractions will need to be adjusted and the assets will need to be revalued.

d. Generally, the factors involved in choosing which funding method to use are not materially affected by the uncertainties of EGTRRA. However, where the true worth funding method is used, it is usually preferable for the smaller of the credit shelter amount and the marital bequest to be the preresiduary bequest to minimize recognition of any capital gain on funding. Where the applicable exclusion amount increases so substantially under EGTRRA, the relative size of these two shares may reverse over the next few years. For example, in an estate of $5 million, the credit shelter bequest will be smaller than the marital bequest from 2004 through 2008 and will be the larger amount in the year 2009. Since it is not practical to draft a Will to take this change into account, it may be advisable to consider avoiding the use of formulas except in very large estates and instead to use one of the techniques described below.

V. ESTATE PLANNING TECHNIQUES TO PERMIT FLEXIBILITY: PRE-MORTEM PLANNING FOR POST-MORTEM PLANNING

A. CAPPING THE CREDIT.

1. Issues Related to the Size of the Estate.

a. Due to the substantial increases scheduled to occur in the applicable exclusion amount under EGTRRA, using the formulas described above may result in a client's entire estate passing to the credit shelter trust. Such a result may effectively disinherit the spouse requiring him to elect against the Will. Even where the surviving spouse is the sole beneficiary of the credit shelter trust, a client may be uncomfortable leaving no assets outright to the surviving spouse (thus potentially requiring the spouse to rely heavily on the trustee for his support). In a "mixed marriage" situation, if the surviving spouse and children from the decedent's prior marriage are all beneficiaries of a single sprinkle trust, dissension may be unavoidable.

b. Moreover, as the amount of the credit increases, it may outstrip the size of the combined estates of the wife and husband to the point where the surviving spouse's credit could protect most, if not all of their assets. Under these circumstances, the client may want to modify the marital deduction/credit shelter formula to make the bequest to the credit shelter trust equal to the lesser of her available applicable exclusion amount or a particular dollar amount (*e.g.*, $1.5 million).

c. The cap can be expressed as a dollar amount or as a percentage or fraction of the value of the estate, *e.g.*, the amount of the available applicable exclusion amount at the time of the decedent's death, but in no event to exceed $2 million (or in no event to exceed 60% of the value of the estate as finally determined for federal estate tax purposes). These techniques can be used in combination to provide, *e.g.*, that the cap is the lesser (or greater) of $2 million or 60% of the value of the estate.

d. A disadvantage of this plan is that it requires frequent review to ensure that it remains adequate to protect the client's assets from estate tax as the value of the client's and client's spouse's assets fluctuate and changes in the law occur.

e. Note also that in smaller estates which use a preresiduary credit shelter plan, as the value of the applicable exclusion amount increases, an estate may end up with no residuary estate. Since estate expenses are generally paid from the residuary, under these circumstances it is prudent to include a provision in the Will directing where the expenses will be paid from in the event that the residuary is inadequate to cover them.

f. Because the use of a cap does not really enhance post-mortem flexibility, it will not usually be the technique of choice in a first marriage/no conflict of interest family, but it may be a critical factor in the estate plan of a client whose spouse and children do not have a unity of interest.

2. Capping the Credit to Address Decoupling Issues.

a. Regardless of the size of the estate, it may be prudent to make the default credit shelter formula one which caps the amount passing to the credit shelter trust to avoid automatic payment of state estate tax, *e.g.*, that amount which can pass free of *federal and state* estate tax by reason of the applicable exclusion amount, taking into account adjusted taxable gifts, other bequests under the Will, etc.

b. Additional provisions to permit the flexibility to decide whether to increase the amount passing to the credit shelter trust then should be included in the Will or revocable trust to permit a determination of whether to pay state estate tax at the death of the first spouse to die. Alternatively, a few states recognize a state QTIP election for qualifying bequests even when a federal QTIP election has not been made[8] and a bequest to a trust for the surviving spouse which qualifies for the state QTIP election but which is protected from the federal estate tax by the applicable credit amount should be considered. In such an estate, two trusts would qualify as credit shelter trusts (the typical "family trust" and a trust for

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[8] For example, Massachusetts, Ohio, Indiana and Tennessee permit state QTIP elections to be made even when a federal QTIP election has not been made.

the benefit of the surviving spouse). The balance of the estate could then be protected from federal and state estate tax by the marital deduction.

B. DISCLAIMERS. Although disclaimers have long been used to "fix up" an estate plan following a decedent's death and have been used as a planning technique in limited circumstances, the current situation is likely to make the use of disclaimers more important and more frequent than ever before. On the one hand, there is little new in the world of disclaimers: following the issuance of final regulations addressing disclaimers of jointly-held property on December 30, 1997, there have been no new statutory or regulatory developments. On the other hand, because disclaimers are so fact specific, the body of law in private letter rulings and cases continues to grow, indicating that this apparently simple technique may not be so simple to apply.

1. <u>In general</u>. Disclaimers are utilized to permit all or part of a bequest or other disposition to pass as though the designated beneficiary had predeceased the decedent. From a tax perspective, this permits the transfer of the disclaimed assets to someone other than the initial beneficiary without imposition of gift tax on the disclaiming beneficiary. To obtain this benefit for federal tax purposes, a disclaimer must be effective under state law, so state law requirements must always be considered first. Assuming state law requirements are met, federal law also imposes a series of requirements, as outlined below.

2. <u>Federal Requirements for Qualified Disclaimers Vary Depending on When the Interest Being Disclaimed was Created</u>.

a. For interests created before January 1, 1977, the rules are determined under case law, primarily *Jewett v. Comm'r.*, 455 U.S. 305 (1982), and *U.S. v. Irvine*, 114 S. Ct. 1473 (1994). Under *Jewett*, a disclaimer of a pre-1977 interest must be made within a "reasonable" time of knowledge of the transfer which the created interest. Therefore, except for minors who come of age, it is probably too late to disclaim any pre-1977 interests.

b. For interests created thereafter, the rules of Code § 2518 apply to avoid taxable gift treatment of the transfer:

3. Requirements of Code § 2518.[9] There are four requirements which must be met in order for a disclaimer to be a qualified disclaimer for federal transfer tax purposes. Note that a disclaimer may be effective under state law to transfer property away from the disclaimant, but not qualify for the federal tax benefits of a qualified disclaimer. Each test will be discussed separately below.

a. No acceptance of benefits. This is usually the most difficult and troubling of the disclaimer requirements. A disclaimer must precede any acceptance of any benefit from the property.

(1) Acts of acceptance include:

(a) Use of the disclaimed property.

(b) Accepting dividends, interest, rents or other income from the property.

(c) Treating the property as though owned by the disclaimant, *e.g.*, directing others to take certain action with respect to the property, voting the stock, in the case of shares of stock, and withdrawing funds from a joint account.

(d) Receiving any consideration in return for the disclaimer.

(2) Note that when the disclaimant is the executor of the decedent's Will, actions taken as the executor do not constitute acceptance of the property to be disclaimed.

(3) To help prevent the situation in which a surviving spouse will be treated as having accepted the benefits of property which is planned to be disclaimed, it may be prudent to include a preresiduary cash bequest to a surviving spouse to relieve any immediate need for cash. *See*, however, Reg. § 25-2518-3(d), Example 17,

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[9] Be aware of possible additional requirements under state law for a disclaimer is to be effective for state law purposes. *See, e.g.,* New York's requirements in EPTL 2-1.11.

allowing a partial disclaimer after acceptance of a partial distribution.

b. Written refusal. A disclaimer must be in writing. The writing must state that the disclaimer is an irrevocable, unqualified refusal to accept the interest in the property to be disclaimed. The interest to be disclaimed must be adequately described. The documents must be dated and should include an acknowledgment of receipt by the proper party.

c. Nine month requirement. The disclaimer must be delivered to the transferor, legal representative or holder of title of the property to be disclaimed within nine months after the later of creation of the interest -- in most cases death of the testator -- or age 21.

(1) Lack of knowledge of the interest to be disclaimed does not extend the time limit.

(2) In the case of a remainderman under a general power of appointment marital trust, the nine-month period runs from the death of the surviving spouse, but in the case of the remainderman under a QTIP marital trust, the nine-month period runs from the death of the first spouse. Reg. § 25.2518-2(c)(3).

d. No direction requirement. Two separate rules apply under the "no direction" test.

(1) First, the disclaimant must not direct to whom the disclaimed property will pass or hold the power to determine to whom it will pass after the disclaimer is executed. The property must simply pass as it would have if the disclaimant had not been alive at the time of the transfer to the disclaimant or otherwise if so provided by the testator in the Will (or revocable trust) and state law so permits.[10]

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[10] *See, e.g.*, under New York law, EPTL § 2-1.11(c) which provides "*[u]nless the creator of the disposition has otherwise provided*, the filing of a renunciation, as provided in this section, has the same effect with respect to the renounced interest as though the renouncing person had predeceased the creator or the decedent or, if the renounced interest is a future estate, as though the renouncing person had died at the time of filing or just prior to its becoming an estate in possession, whichever is earlier in time, and shall have the effect of accelerating the possession and

(a) Thus, under a Will or revocable trust, unless the testator specifies otherwise, the property must pass to whomever would have taken the property if the disclaimant had predeceased the decedent.

(b) In addition, this means that the disclaimant cannot serve as the trustee of a trust to which the disclaimed property will pass if the trustee holds any discretionary powers to make distributions from the trust. If the disclaimed property will pass to a foundation of which the disclaimant is a trustee or director, a similar issue arises, and the more prudent course may be for the disclaimant to resign from the position in the foundation.

(c) A common mistake made is that the surviving spouse who disclaims property that then passes to a credit shelter trust is given a special power of appointment over the trust property.

(2) In addition, except in the case of the decedent's spouse, the disclaimed interest must pass to someone other than the disclaimant.

(a) Thus, the surviving spouse can disclaim all or a portion of his interest in the marital trust created for his benefit, and if the Will or revocable trust so provides and state law permits direction of the disclaimed property under the Will or revocable trust, the property can thereby be shifted to the credit shelter trust. The spouse can continue to be the income beneficiary of that trust, but cannot retain any power of appointment over the trust. (Note: An otherwise disqualifying power of appointment can be disclaimed.)

(b) This requirement makes it critical to track exactly where property will pass if it is disclaimed to ensure that the property will, in fact, end up

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enjoyment of subsequent interests, but shall have no effect upon the vesting of a future estate which by the terms of the disposition is limited upon a preceding estate other than the renounced interest." (*Emphasis added*).

where it is intended; a disclaimant (other than a spouse) may also need to disclaim her interest in an entity to which the property will then pass (including her intestate share) to effect a qualified disclaimer.

4. Who Can Disclaim.

   a. Generally, any individual may refuse to accept a gift. Some states, however, may limit the power of the beneficiary of a spendthrift trust to disclaim.

   b. Many states, including New York, allow a guardian of an incompetent or executor of the will of a decedent to disclaim, often after obtaining court approval.

5. Partial Disclaimers. Reg. § 25.2518-3 allows disclaimers of partial interests in property. Among the types of partial interests which may be disclaimed:

   a. Severable property,

   b. Powers of appointment,

   c. Undivided fractional interests, and

   d. Pecuniary amounts. Reg. § 25.2518-3(c) creates a trap for the unwary and requires that, following a disclaimer of a pecuniary amount, "the amount disclaimed and any income attributable to such amount must be segregated from the portion of the gift or bequest that was not disclaimed. Such segregation must be made on the basis of the fair market value of the assets on the date of the disclaimer or on a basis that is fairly representative of value changes between the date of transfer and the date of the disclaimer."

6. Successive Disclaimers.

   a. In order to ensure that a disclaimer is qualified and that no part of the disclaimed interest passes to the disclaimant (if the disclaimant is not the spouse), it may be necessary for the disclaimant to disclaim several successive interests under the Will and ultimately under intestacy.

b. Consider whether a plan for successive disclaimers by a surviving spouse may be designed under the Will to provide several alternatives under the instrument for the disposition of the disclaimed property. For example, the Will could provide that the residuary passes to the spouse or, to the extent he disclaims this outright bequest, to a QTIP trust, or, to the extent he disclaims his interest in the QTIP trust, to a credit shelter trust.

7. Difference Between Planned and Remedial Disclaimers.

a. An estate plan that includes disclaimer planning as an intended form of post-mortem flexibility is very different from an estate plan which was not adequately planned to begin with and which must be "fixed up" through the use of disclaimers.

b. Without minimizing the power of disclaimers to make a silk purse out of a sow's ear, often a disclaimer plan not contemplated in the instrument will require cooperation of several generations of beneficiaries and may have unintended results.

8. Rules to Live By.

a. Never disclaim until it is certain to whom the property will pass after the disclaimer. Assume nothing!

b. Estate plans based on post-mortem disclaimers require that the client's family be educated about the requirements for a disclaimer and the "no acceptance of benefits" rule.

C. PARTIAL QTIP ELECTIONS.

1. QTIP Trusts - One Exception to the Terminable Interest Property Rule.[11]

a. The terminable interest property rule. In general, the unlimited marital deduction is available only for property passing from the decedent to her surviving spouse. IRC § 2056(a). The marital deduction acts as a deferral of estate tax until the death of the surviving spouse and is based on the premise that the assets for which the marital deduction was taken in the estate of the first

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[11] A number of exceptions to the terminable interest property rule exist. Trusts which qualify for the marital deduction are: estate trusts in which a trust for the surviving spouse pours into his estate at his death (Reg. § 20.2056(c)-2(b)(1)), general power of appointment trusts (IRC § 2056(b)(5)), and QTIP trusts (IRC § 2056(b)(7)).

spouse to die will be subject to estate tax in the estate of the surviving spouse. No marital deduction is allowed for bequests to a surviving spouse which may terminate or fail upon the passage of time or the occurrence of an event or which may benefit someone other than the surviving spouse. IRC § 2056(b)(1). Such interests, known as terminable interest property interests, generally include bequests to trusts for the surviving spouse.

b. <u>Exceptions to the terminable interest property rule</u>. In recognition of the many legitimate reasons a taxpayer may wish to leave property for her spouse in trust, Congress created exceptions to the terminable interest property rule, all of which ensure that the benefit of the property will accrue solely to the the surviving spouse during his life (Congress did not want an interest to get the benefit of the marital deduction unless it truly was a bequest for the surviving spouse) and will be includible in the surviving spouse's estate at his death. One of these exceptions is the QTIP trust.

2. <u>QTIP Trust - IRC § 2056(b)(7)</u>.

a. QTIP trusts were created specifically to address the problem that married testators, particularly those with children from a prior marriage, should not be faced with the dilemma of providing either for the surviving spouse who might not leave the property to the testator's children or for the children leaving the surviving spouse without maximum financial security.[12] Congress acknowledged that the first spouse to die may have a legitimate concern that the surviving spouse would exercise his power to dispose of the marital trust assets in a manner inconsistent with her estate plan, particularly in the case of second marriages where the surviving spouse has children from a first marriage. However, without a general power of appointment, the trust assets would not be includible in the surviving spouse's estate. Thus, Congress created a special category of trusts as an exception to the terminable interest property rule - qualified terminable interest property trusts. If a trust meets the requirements for a QTIP trust, the bequest to the trust will qualify for the marital deduction and is required to be included in the surviving spouse's estate under IRC § 2044.

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12 *See*, *e.g.*, H. Rep. No. 97-201, 97th Cong., 1st Sess., at 159-60.

(1) Requirements for a QTIP trust.

(a) The property must pass from the decedent.

(b) All of the income must be paid to the surviving spouse at least annually for his life. In addition, the spouse must have the right to make non-income producing property productive. Regs. §§ 20.2056(b)-7(d)(2) and 20.2056(b)-5(f)(4).

(c) No one, with or without the consent of the surviving spouse, can receive a distribution from the trust other than the surviving spouse during the surviving spouse's lifetime. *See* Regs. §§ 20.2056(b)-7(d)(1) and 20.2056(b)-7(d)(6).

(d) An irrevocable election to qualify the trust must be made by the executor on the estate tax return. IRC § 2056(b)(7)(B)(v).[13]

3. Partial Election.

a. QTIP trusts offer an opportunity not available to any other form of marital bequest: an executor may elect to qualify only a portion of the bequest for marital deduction treatment. The elected part must be a fractional or percentile share of the trust. The balance remains in trust for the surviving spouse, but is subject to estate tax in the estate of the first spouse to die and not in the estate of the surviving spouse.

b. The advantage of this flexibility is that it permits an executor to determine how large a marital deduction to take without changing the value of the assets passing from the estate for the surviving spouse's benefit. The executor can make an election which optimizes the marital deduction and takes full advantage of the applicable credit amount to protect the non-elected portion of the marital trust from estate tax. Alternatively, the executor can also

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[13] To reduce the number of returns on which the executor failed to "check the box" on Schedule M of Form 706, the IRS has administratively reversed the presumption of the election, and a trust which qualifies as "QTIP-able" listed on Schedule M for which a marital deduction is taken qualifies as a QTIP trust "unless the executor specifically identifies the trust (all or a fractional portion or percentage). . . to be excluded from the election." *See* Form 706, Schedule M.

decide whether it may be more advantageous to pay a portion of the estate tax that will be due on the combined estates of the wife and husband from each estate and thus take advantage of the lower tax bracket which may be available if all of the assets are not taxed in a single estate. Also, in an estate plan which includes a credit shelter bequest that is designed to avoid automatic payment of state estate tax if the federal credit is larger than that available under state law, the executor can determine whether it may be beneficial to take advantage of the larger federal credit and pay some state estate tax. This is possible because a trust which meets all of the requirements of a QTIP trust does not include any term which would make the trust includible in the surviving spouse's estate unless the election is made. Thus, any portion of a trust designed to be a QTIP trust for which no election is made will not be includible in the surviving spouse's estate. The use of a partial QTIP election to implement credit shelter planning also has substantial disadvantages, as described below.

c. Just as the division between the marital share and the credit shelter share may be defined by formula as described above, it is advantageous to make the partial QTIP election by formula. The formula should be expressed as a fraction of the total value of the trust, *e.g.*, "the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary trust (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate)".[14] In this event, if values of assets in the estate are adjusted on audit, the amount passing to the marital deduction portion of the trust for the benefit of the surviving spouse will self-adjust to obtain the desired tax result. Alternatively, if the QTIP election is not made for a fractional share or is made for a percentage of the trust for the benefit of the surviving spouse, changes in values on audit may result in estate tax being due.

4. The regulations permit the marital trust to be divided into two trusts if authorized by the instrument or governing law: one which qualifies for the estate tax marital deduction and one which does not. Reg. § 20.2056(b)-7(b)(2)(ii)(A). The trusts are identical in every respect except that the trust which is not elected to receive QTIP treatment is not

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[14] Reg. § 20.2056(b)-7(h), Example 7.

includible in the surviving spouse's estate. This division facilitates accounting for the separate shares of the marital trust in the event that distributions from principal are made only from the portion of the trust that is includible in the surviving spouse's estate. Whenever a QTIP trust is included in the estate plan, the Will or revocable trust should include a provision authorizing division of the trust if a partial QTIP election is made.

5. Partial QTIP elections are also useful if it appears likely that the surviving spouse may die within a short time after the first spouse of if he in fact does die shortly after the first spouse to die. Under these circumstances, the executor can elect to qualify a smaller portion of the marital trust for QTIP treatment, pay estate tax in the estate of the first spouse to die and take advantage of the credit for tax paid on prior transfers under IRC § 2013 for the actuarially determined value of the surviving spouse's interest in the nonqualified portion of the marital trust even though the trust is not includible in the surviving spouse's estate. For this reason, it is generally a prudent practice to put the estate tax return on extension when a QTIP trust is utilized so that the executor has 15 months, rather than only nine months, to determine whether this credit will be available in the estate of the surviving spouse. The full amount of the credit is allowed if the surviving spouse dies within two years of the first spouse to die. Thereafter, the credit is reduced by 20% every two years, until it is exhausted at the end of ten years. Note that the value of the surviving spouse's interest is determined under IRC § 7520 which prohibits use of the valuation tables if the surviving spouse was terminally ill at the death of the first spouse.

6. The primary disadvantage of estate plans using partial QTIP elections is that all of the income from the non-elected trust must be distributed to the surviving spouse, thereby increasing his taxable estate and subjecting that income to estate tax before it passes to the children. Also, there can be no discretion to make distributions to children and other family members.

D. CLAYTON (OR CONTINGENT INCOME) TRUSTS.

1. These trusts, in many ways, utilize and combine the advantages of disclaimer credit shelter trusts and partial QTIP trusts.

2. A Clayton trust is a trust which starts life as a qualified trust for which a QTIP election could be made, but to the extent that the executor does not make the QTIP election, the non-elected portion flows to or becomes a

separate trust which is not required to have terms identical to the QTIP trust and is not required to meet the definition of a QTIP trust.[15]

a. Initially, the government was hostile to the concept of a trust designed to make the requirement that all of the income be paid to the surviving spouse contingent on whether the QTIP election was made.[16]

(1) For many years, the Service challenged this type of estate planning and the Tax Court supported the government's position.

(2) In *Estate of Clayton v. Comm'r.*, 976 F.2d 1486 (5th Cir. 1992), the government argued that the marital deduction was not available for the QTIP trust, despite the executor's proper and timely QTIP election on the estate's federal estate tax return, because the executor's power to divert assets from the trust qualifying for the marital deduction constituted an impermissible power to appoint property away from the spouse. Under the facts of this case, the decedent was survived by his second wife and four children from a prior marriage. The decedent's Will created a credit shelter trust and a marital trust. Under the terms of the Will, if the executors failed to make a QTIP election for the marital trust, any portion for which the election was not made would pass to the credit shelter trust. The Will also provided that, to the extent the surviving spouse disclaimed any portion of the marital trust, that portion would pass to a third trust with

15 Conceptually, for drafting purposes, there is no reason why the trust could not start out as family sprinkle trust which, if a QTIP election is made, becomes a marital trust for the spouse which meets all of the QTIP requirements. For ease of discussion, the author will assume the Clayton Trust is drafted as a marital trust which becomes a family trust.

16 In TAM 8631005, the Service ruled that a marital deduction was available where the surviving spouse served as executor for an estate which included a QTIP-able trust which poured over to a nonQTIP-able trust because the election was in the hands of the surviving spouse. However, this position was reversed in subsequent rulings and audits and Reg. § 20.2056(b)-7(d)(3) took the position that such a trust did not qualify for the marital deduction.

terms similar to the credit shelter trust.[17] The spouse elected to qualify an undivided interest in specified bonds, notes and cash as terminable interest property. In a carefully reasoned and thorough opinion, the Fifth Circuit held that from both a statutory analysis and a public policy analysis, such a power did not affect the deductibility of the value of any portion of the trust for which a QTIP election was made because (i) the property to which the statute applies is only the property for which an election is made, not all property for which an election could be made, and (ii) the election relates back to the decedent's death.

(3) After both the Sixth Circuit[18] and the Eighth Circuit[19] also reversed the Tax Court on this issue, the Tax Court, but not the Service, acceded to the decisions of the Courts of Appeal in *Estate of Clack v. Comm'r.*, 106 T.C. 131 (1996).

b. Ultimately, the government abandoned its position and reissued Reg. § 20.2056(b)-7(d)(3) to provide that an income interest which is contingent on the election of the executor will not fail to be a qualifying income interest for purposes of the marital deduction.

c. The non-marital alternative of the Clayton trust does not need to require that all of the income from the trust be distributed to the surviving spouse and can include income beneficiaries other than the surviving spouse. Indeed, the surviving spouse need not be a beneficiary of the non-marital portion of the Clayton trust.

3. Terminology.

a. Clayton trust. Because a Clayton trust is a chameleon of sorts, it is important to clarify the language used to refer to it in order to clarify exactly which aspect of it is being discussed. For

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17 Note that the surviving spouse was appointed co-executor with a bank, which, in an effort to bolster the estate's position, did not take office as executor until after the Form 706 was filed.

18 *Estate of Spencer v. Comm'r.*, 43 F.3d 226 (6th Cir. 1995).

19 *Estate of Robertson v. Comm'r.*, 15 F.3d 779 (8th Cir. 1994).

purposes of this outline, a "Clayton trust" refers to the entire mutable entity of a QTIP-able trust which, to the extent that a QTIP election is not made, becomes a trust which contains provisions that would disqualify it as a QTIP trust. This second feature of a Clayton trust introduces a time element into the nature of the trust during which it has all of the features necessary to qualify as a QTIP trust but also includes latent features which would disqualify it if the QTIP election is not made.

(1) Marital component. In a sense, the "first" component of the trust provides that if the spouse survives the testator, the spouse will have a mandatory income interest and no one other than the surviving spouse will have the right to receive anything from the trust during the surviving spouse's lifetime (including through the exercise of a power of appointment). This QTIP-able component of the Clayton trust may or may not provide that the surviving spouse can receive distributions of principal. Not that the ancient laws of property are crystal clear, but perhaps it is helpful to think of the spouse's interest in the marital component of the Clayton trust as in place, subject to divestment by the failure to make the QTIP election.

(2) Non-marital or family component. Although usually drafted as a "separate" trust under the instrument to which the assets of the Clayton trust will flow to the extent that a QTIP election is not made, in fact this second trust which usually benefits the children and may or may not include the surviving spouse as a beneficiary is conceptually part of the Clayton trust. During the period when a QTIP election could but might not be made, this component of the Clayton trust has as much viability as the marital component, although it appears to be "waiting in the wings."

(3) Either the marital or non-marital component of a Clayton trust may never actually become operational, depending on the election that the executor makes. Alternatively, in the case of a partial QTIP election, they will both be funded.

b. Clayton election. One hears reference to the making of the Clayton election. This is a misnomer since the only formal election involved in a Clayton trust is the QTIP election which, to the extent made, eliminates the non-marital component of the Clayton trust. The "election" which gives life to the non-marital component of a Clayton trust is actually the *absence* of a QTIP election and, in that sense, is not an affirmative act. Nevertheless, in some cases it is helpful to use the term "Clayton election" to refer to the decision not to QTIP and the filing of the return without the QTIP election.

4. Prior to the passage of EGTRRA, few estate planners utilized Clayton trust planning, preferring simply to rely on the traditional credit shelter/marital bequest (outright or in a marital trust) plan.

5. On first blush, the Clayton trust structure may seem identical to that of a bequest to a marital trust which provides that if the surviving spouse disclaims, the disclaimed portion will flow to a credit shelter or other family trust, except that the executor, rather than the spouse, makes the decision. However, in the case of a disclaimer structure, the surviving spouse's interest in the marital trust is fixed or complete. It may be changed by the surviving spouse's act of disclaiming, but no further act is necessary to vest the surviving spouse's interest in the marital trust. In a Clayton trust, the spouse's interest in the marital trust is contingent upon a final act which has not yet occurred, the making of the QTIP election.

6. The interesting challenge presented in drafting a Clayton trust is that it is created upon the *nonoccurrence* of an event. While the making of a QTIP election itself is irrevocable, the nonelection cannot always be said to have occurred with the same definiteness.

    a. The issue raised here is that under Regs. §§ 20.2056(b)-7(b)(4) and (5), a QTIP election may be made or modified on a return until the final due date for the return, including extensions actually granted, or on the first late return.

    b. Presumably, if the drafting language refers to a failure or refusal of the executor to elect the marital deduction for some portion (or all) of the marital trust under IRC § 2056(b)(7)(B)(ii)(V) on the last federal estate tax return filed for the estate on or before the due date of the return, including extensions, or if a timely return is not filed, the first estate tax return filed by the executor after the due date, as the triggering event for an alternate bequest to the credit shelter trust or some other bequest, this should be sufficient.

(1) The question arises, however, as to the status of the "Clayton election" where no timely federal estate return is filed.

(2) Query whether it is advantageous (and permissible) to obtain certainty as to the beneficiaries of the trust by providing in the Will that the trust will remain solely for the benefit of the surviving spouse if the election is or is not made within a specified time limit after the decedent's death. For example, perhaps the provision requiring any non-elected portion of the trust to pourover into a non-qualified trust should expire if not resolved within 15 months after the decedent's death. This would still permit a partial QTIP election to be made on a late filed return but would provide certainty as to the terms of the trust.

c. In this, as in all matters related to division of assets between marital and non-marital shares, consider making the election as a fractional formula to preserve the intended tax consequences in the event of revaluation of or newly discovered assets.

d. One disadvantage of the non-marital portion of the Clayton trust, as compared to the non-marital portion of a traditional partial QTIP trust, is that, if persons other than the surviving spouse are discretionary beneficiaries, the surviving spouse is unlikely to have an interest in the trust capable of actuarial valuation and no credit for tax paid on prior transfers will be available. However, this disadvantage is no greater than that of the traditional marital deduction/credit shelter plan which includes a discretionary credit shelter trust.

e. It is unclear whether a surviving spouse who serves as the sole executor of the estate may have adverse gift tax consequences as a result of his power to direct property away from himself without actually meeting the qualified disclaimer requirements. Arguably he is exercising his power to redirect trust assets as a fiduciary of the estate, but it is also true that he is directing assets away from himself for the benefit of others. Until some guidance has been issued, it may be more prudent not to name the surviving spouse as the sole executor of an estate where a Clayton trust is included and to provide that an independent executor make the decision regarding the QTIP election. In most cases a co-executor could be appointed who would have no responsibility other than making or not making the QTIP election.

f. Use of a Clayton trust may be preferable to a disclaimer trust because (a) the executor has fifteen months instead of only nine months to make his decision and (b) the surviving spouse can have a special power of appointment over the non-elected trust.

E. TAX APPORTIONMENT ISSUES.

1. In a well thought-out marital deduction/credit shelter plan which uses a disclaimer of a portion of the residuary marital trust or residuary Clayton trust to take advantage of the decedent's applicable exclusion amount, the tax apportionment clause should include a provision to apportion any death tax due (*e.g.*, state estate tax) to the credit shelter trust or non-marital portion of the Clayton trust.

2. In the absence of such a provision, it may be necessary to take the payment of such death taxes into account in calculating the amount of the disclaimer or Clayton election to gross up the marital share for any death taxes to be paid from it.

F. OTHER ELECTIONS.

1. <u>GST Tax Planning</u>.

a. Generally, for wealthier clients, full use of the client's GST tax exemption has long been recommended. The biggest benefit from this type of planning for a client who could afford it was best accomplished through lifetime gifts which removed the future appreciation in the gifted assets from the donor's estate. Since the GST tax exemption has been larger than the applicable credit amount, clients often would make gifts of the full amount of the GST tax exemption and pay gift tax on the excess over the applicable exclusion amount.

b. Now that the amount of applicable exclusion available for lifetime giving has been limited to $1 million, it is less attractive to suggest that clients make taxable gifts and pay gift tax.

c. Consider that beginning this year, 2004, most clients will have both applicable credit and GST tax exemption available to use at death, even those clients who had intended to use their full GST exemption making lifetime gifts. For this reason, many of these clients currently have no GST planning in their Wills or revocable trusts. For the foreseeable future, testamentary planning for clients who are motivated to reduce total transfer tax costs should be sure to include testamentary GST planning as a matter of course.

d. Generally, GST planning should be done by formula - "I bequeath the amount of my available GST exemption to . . ." - but this now raises the same concerns as formula bequests to credit shelter trusts. In 2009, the GST exemption will be $3.5 million (if the law is not changed) and may be more than the client wants to pass to grandchildren and may leave the children with very little. Indeed, depending on the size of the estate, the $2 million GST exemption which takes effect in 2006 may be more than a client feels comfortable leaving to grandchildren.

G. TECHNIQUES RELATED TO PLANNING FOR REPEAL.

1. <u>Use of Revocable Trusts to Increase Flexibility.</u>

a. A revocable trust is a trust which the grantor creates during her lifetime and over which the grantor retains the right, exercisable alone or in conjunction with another person, to amend or revoke the trust. The assets can be distributed to the grantor's beneficiaries as the grantor directs in the revocable trust (acting as a Will substitute) and probate is avoided.

b. Sometimes the trust is not funded (or only partially funded) during the grantor's life and, at her death, her Will directs her executor to transfer her assets to the trustee of her revocable trust. The trust acts, in effect, as a Will substitute although probate is not avoided.

c. A revocable trust does not have any income or estate tax consequences during the grantor's lifetime because the grantor is treated as the owner of the trust for both income and estate tax purposes. If the revocable trust is properly drafted, it also should not have any gift tax consequences during the grantor's lifetime.

d. Most importantly in the post-EGTRRA world, use of a revocable trust may safeguard the ability to modify a client's estate plan to take whatever changes may occur in the tax laws into account in the event that the client becomes incapacitated prior to a significant change in the law. Generally, if a client becomes incapacitated, no one can modify her Will, not even her attorney-in-fact. However, under a revocable trust, depending on state law, it is possible for the grantor to give her trustee or another independent person the power to amend her trust, consistent with her testamentary plan, to take advantage of changes in the tax law. This is an extremely broad power and not one to be granted lightly. Nevertheless, assuming a client can identify someone whom she trusts with this power, it is a critical element of preserving a client's ability to respond to changes in the tax laws. Needless to say, the older the client, the more important it may be. Depending on state laws, it may also be possible for such revisions to a revocable trust to be made pursuant to a properly drafted power of attorney.

e. Issues raised by giving a third party the power to amend a revocable trust.

(1) Obviously, the most significant issue in granting the power to amend a revocable trust to someone other than the grantor is an issue of trust. If a client is not comfortable with giving this power to someone, then it should not be done. She may be the rare client who wishes to have her Will or revocable trust drafted to respond to all of the different tax environments currently possible under EGTRRA. However, the client should be made aware that if EGTRRA is replaced, as expected, with a different set of transfer tax laws, her Will or revocable trust may not "work" under the new regime.

(2) Assuming the grantor wants to give the power to amend her revocable trust to someone, several safeguards can be used.

(a) Require two people to agree unanimously on any changes to the trust.

(b) Specifically provide that changes may be made solely for the purpose of maximizing benefit as a result of changes in the tax law within the context of the grantor's existing estate plan and dispositive trust provisions.

(c) Give the power to amend to a person in her individual capacity, not as a trustee, so that if that individual ceases to serve as trustee, the power does not automatically pass to someone else.

(d) Limit the exercise of the power so that the person holding the power cannot benefit herself (mandatory) or her family (if possible).

2. Correction of Formula Bequests. For estate plans using formula bequests of the applicable exclusion amount, after repeal, the results under the formula may be uncertain. For example, a formula using the language, "the maximum amount which can pass free of federal estate tax by reason of the applicable credit amount," may yield nothing passing to the credit shelter trust because there is no applicable credit amount or everything because nothing is subject to the estate tax. Prudence dictates inclusion of a provision which provides that, notwithstanding anything else in the Will (or revocable trust), in the event there is no estate tax applicable to the estate at the decedent's death by reason of its repeal, the balance of the estate after specific bequests will pass to the residuary, either outright or in further trust, depending on the client's preference. *See* discussion of long-term trusts below. Note that a reference to the period "after the estate tax is repealed" would be inadvisable since, under current law, in the year 2011, the estate tax will apply to the estate even though the decedent will have died after repeal.

3. Design Trusts to Permit Use of Basis Adjustments.

   a. Although in some cases, clients may prefer not to give trustees the power to make discretionary distributions of principal to the beneficiaries of the trust for any purpose (particularly the surviving second spouse), it may be time to begin including a provision in trusts which permits the trustee to distribute principal to be sure that beneficiaries can take advantage of the increase in basis available at their deaths during the period of repeal. This is particularly important in the case of a QTIP trust where the surviving spouse does not have substantial assets of his own. Note that the amount the trustee should be permitted to distribute is NOT the $3 million of basis allocation available to the surviving spouse's estate, but property sufficient to permit the surviving spouse to take advantage of $3 million of basis *increase*. The most flexible provision would not specify the amount the trustee can distribute, but rather include this purpose as one of the purposes for which the trustee can make distributions. Even in the case of trusts that permit totally discretionary distributions of principal, some reference to this purpose may be wise, if for no other reason than to flag the issue for the trustee.

b. Inclusion of such a provision may make it inadvisable for the surviving spouse to be the sole trustee of such a trust since the distribution power may not qualify as an ascertainable standard. The power, if held by the spouse, might in fact be construed as a general power, which would prevent the trust from qualifying for QTIP treatment.

4. <u>Consider Use of Long-Term Trusts</u>.

a. Commentators disagree about whether the specter of repeal means that (i) trusts should be designed to terminate (or not be created) if the estate tax is repealed or (ii) all of the decedent's property should be placed in trust so that it will not be subject to estate tax if the tax returns.

b. In either event, planning should take into account the fact that increases in basis are available only for property the decedent "owns" and attempt to ensure that this relief from capital gain tax is adequately addressed, balanced against the fact that the estate tax, if applicable, will probably be imposed at a rate much higher than the capital gain tax. This would suggest a general practice of planning to allocate basis to the lowest basis assets possible to minimize the total amount of property an individual must own to take advantage of the maximum permissible increase.

c. Generally, if the client is not uncomfortable with the selection of trustee and control issues, the ideal plan would maximize the amount passing in trust for the maximum period and give the trustee the powers to terminate trusts if this appears advisable and to make distributions of principal to take advantage of the beneficiary's basis increase, where appropriate. Long-term trusts raise many issues of their own, however, since it is very difficult to foresee the myriad of family, economic, tax and other legal issues which could arise over hundreds (never mind thousands) of years. Such trusts should always be drafted with the maximum possible flexibility. The powers suggested above are generally consistent with the flexibility which is desirable whenever long-term trusts are considered. Even where the client is comfortable with long-term trusts, the instrument should provide for the creation of a QTIP trust in an amount sufficient to permit full use of the decedent's $3 million basis adjustment.

VI. APPLICATION OF TECHNIQUES TO PERMIT FLEXIBLE POST-MORTEM PLANNING.

A. CAPPING THE CREDIT SHELTER BEQUEST. Whenever the client has chosen to limit the maximum amount to be protected by the applicable credit amount, it is generally good practice to provide additional flexibility in the estate plan to permit taking advantage of the applicable exclusion amount in excess of the cap, particularly where the cap is the amount protected from both federal and state estate tax in a decoupled state. This can be done by using a disclaimer provision, a partial QTIP election or a Clayton trust.

B. DISCLAIMERS.

1. Simple Credit Shelter Trust Disclaimer.

a. The following scenario illustrates a typical use of a disclaimer to effectuate a post-EGTRRA estate plan. The client, who has an estate valued at $4,000,000, currently has a standard credit shelter-based Will, that is, the exclusion amount passes to a discretionary trust for husband and issue, with the balance outright to husband, protected from estate tax by the marital deduction. The client is satisfied with how this plan worked and with a $1,000,000 exclusion amount, and perhaps even with a $1,500,000 exclusion amount, but she is concerned that with a larger exclusion amount (or estate tax repeal) the amount of the credit shelter trust might be disproportionate to the marital bequest.

b. Although a ceiling could be placed on the amount of the credit shelter bequest, this approach is inflexible with regard to future changes in financial circumstances. On the other hand, leaving the entire estate to the client's husband, with a provision in the Will or revocable trust that, in the event he disclaims any portion of his bequest, the disclaimed amount passes into the credit shelter trust, is a far more flexible plan. The husband can make a decision about how much should pass to the credit shelter trust based on the tax law and the financial circumstances applicable at the time of the client's death.

c. Note that utilizing a disclaimer trust approach will prohibit the client from giving her surviving husband a power of appointment or other control over the disposition of the trust. Note also that this sort of disclaimer planning is probably inappropriate when the client's surviving spouse and children do not have a unity of interest.

d. The primary weakness of this technique is that a surviving spouse may prefer not to have his assets held in trust and may choose not to disclaim. This distaste for trusts may not have been voiced during the planning process (or the spouse may not have realized he would feel this way). The decision whether to disclaim property for the purpose of saving taxes after the client's death rests entirely in the hands of the surviving spouse. Obviously, this problem is exacerbated if the remainder beneficiaries of the credit shelter trust are not the children of the surviving spouse.

e. Another difficulty with this technique is that clients often do not realize the significance of their actions and do things that constitute the acceptance of the property they plan to disclaim. Thereafter, those assets generally cannot be disclaimed, although a partial disclaimer may, under certain circumstances, still be possible. Even clients who have been educated during the estate planning process about not accepting benefits of the assets still take actions which prevent a qualified disclaimer. For couples who engage in disclaimer credit shelter trust planning, it is imperative that the surviving spouse seek legal assistance in administering the deceased spouse's estate as quickly as possible and not take any action with regard to assets owned by the deceased spouse or jointly with the deceased spouse until he has done so.

f. A third issue (which can get fairly technical but should not be overlooked) is that a pecuniary disclaimer, that is a disclaimer of a specific amount, likely will cause capital gain to be recognized in the assets transferred as a result of the disclaimer.

(1) Use of formula disclaimers is often advisable in order to ensure that the credit shelter amount is not over- or underfunded in the event that assets are revalued on audit. The formulas used in marital deduction/credit shelter disclaimers are the same as those used in drafting marital/credit shelter bequests in the Will. Generally, the disclaimer would be phrased as a preresiduary credit shelter amount, funded on a true worth or fairly representative basis, or as a fractional share of the residuary. The same advantages and disadvantages described above when drafting credit shelter/marital bequests in a Will apply to formula disclaimers.

(2) Since disclaimers to a credit shelter trust may be pecuniary disclaimers even if they are made by formula, it is generally good practice not to delay too long in making the decision to disclaim, particularly in a rising market. And remember to segregate the assets following the disclaimer if the disclaimer is of a pecuniary amount.

C. PARTIAL QTIP ELECTION.

1. To use a partial QTIP election instead of a disclaimer to a credit shelter trust, the Will or revocable trust bequeaths the residuary to a trust for the benefit of the surviving spouse (which meets the requirements for a QTIP election) rather than outright to him. The executor then makes a determination of the amount of the decedent's applicable credit to use, based on the values of the decedent's estate, the surviving spouse's estate and the applicable tax law in effect at the decedent's death. She may also make a determination about whether to pay some federal estate tax or some state estate tax. The executor makes a QTIP election on the decedent's federal estate tax return only for the portion of the estate which she determines to protect from estate tax with the marital deduction.

2. Advantages.

a. Depending on whom the decedent has named as executor, this decision need not be left to the control of the surviving spouse. Thus, in a situation where the decedent's children are not the children of the surviving spouse, the executor can be someone other than the surviving spouse and can make this decision based on a more objective analysis of the economic factors relevant at the decedent's death.

b. Even where the surviving spouse is named as the executor, the spouse is choosing between two alternatives, both of which hold the property in trust for him. Thus, any preference to own the assets outright is not a factor in determining how much should pass to a trust protected by the decedent's applicable credit.

c. There is no danger that the use of the decedent's applicable credit will be barred because the surviving spouse has inadvertently accepted the benefits of the property he planned to disclaim.

d. If the surviving spouse dies within 15 months of the decedent's death, the executor can maximize the benefit of the credit for previously taxed property under IRC § 2013 in the surviving spouse's estate by making a smaller (or no) QTIP election in the decedent's estate.

e. The decedent can be assured that, to the extent principal is not distributed to the surviving spouse, it will pass as she has directed, rather than to whomever the surviving spouse may determine (*e.g.*, his new wife).

f. The trust can be divided into two separate trusts, one includible in the surviving spouse's estate and the other not, to optimize tax-motivated administration of the trust. No gain or loss will be recognized when the two trusts are funded.

3. Disadvantages.

a. The two trusts for the benefit of the surviving spouse will be identical. Both will require distribution of all of the income from the trusts to the surviving spouse, thus unnecessarily subjecting income earned in the credit shelter trust to estate tax in the estate of the surviving spouse. The decedent's children will not be included as income beneficiaries of either trust.

b. When the two trusts are divided, all of the assets used to fund them must be divided on a fractional or percentage basis. Thus, it is not possible to select assets which are expected to appreciate to fund the credit shelter trust and assets which are not expected to appreciate to fund the marital trust.

4. Disclaimer of Outright Bequest to QTIP Trust.

a. Consider combining the disclaimer method with the partial QTIP method to permit the surviving spouse to disclaim an outright bequest to a QTIP trust instead of a credit shelter trust. The Will could provide that, if the surviving spouse disclaims, the disclaimed portion of the bequest will pass to a marital trust designed to qualify for the marital deduction.

(1) This could provide the executor with additional time, up to six months after the original due date of the return, to determine whether taking full or partial advantage of the marital deduction is advisable for the estate. The executor would then make or not make the QTIP election or not, based on an informed analysis regarding how large the marital deduction should be.

(2) In addition, if the decedent did not fully use her GST exemption, and if the trust were properly drafted, a reverse QTIP election could be made.

(3) Finally, If it appears advisable, the executor could make a partial QTIP election, qualifying only a portion of the disclaimed property for QTIP treatment, thus making the credit for previously taxed property available to the estate of the surviving spouse without including the assets of the trust for his benefit in his estate. Obviously, this benefit is not available if assets are owned directly by the surviving spouse.

D. CLAYTON TRUSTS.

1. Advantages.

a. Clayton trust planning has all the advantages of partial QTIP planning:

(1) Control is in the hands of the executor, who should not be the surviving spouse.

(2) There is no danger that the plan will be jeopardized by accidental acceptance of benefits by the surviving spouse of assets which were intended to be disclaimed.

(3) Income need not be distributed to the surviving spouse from the non-marital portion, thus avoiding unnecessarily enlarging his estate.

(4) No gain or loss is recognized on funding the trust.

b. In addition, the Clayton trust can be structured as a sprinkling credit shelter trust, just as with disclaimer credit shelter trusts, and can be held for the benefit of the surviving spouse and the decedent's children, with discretionary income and principal distributions to any of them.

c. The surviving spouse can have a special power of appointment over the trust.

2. Disadvantages.

a. Just as with a partial QTIP election, the assets must be divided between the two trusts on a fractional share basis.

b. If the two spouses die within a short period of time of each other, the estate of the surviving spouse will not qualify for the credit for previously taxed property under IRC § 2013. This is because a Clayton trust which does not require that the income from the non-marital portion be distributed to the surviving spouse (or which permits distributions to other people) does not give the surviving spouse an interest in the trust which is capable of being valued actuarially.

c. Note that the choices between structuring the estate plan to use a partial QTIP election or a Clayton trust are mutually exclusive because they are both triggered by the same event - it is not possible to draft a single marital trust which is QTIP-able and provide that, if an election to qualify the trust for the marital deduction is not made for any portion of the trust, then that portion may either stay as a nonqualified trust for the spouse or be distributed to a Clayton trust (*but see* section G below).

d. Query whether it would be possible to structure the disposition of the non-elected portion by providing in the Will that the first specified dollar amount or formula fraction of the trust for which the election was not made would pass to a sprinkle trust and any portion in excess of that amount for which an election was not made would remain in a non-qualified marital trust. Such a plan would permit taking full advantage of the decedent's available applicable exclusion amount, if desirable, in a discretionary sprinkle trust, and then permit use of the credit for previously taxed property for any amount in excess of that, if desirable. This could provide a compromise when the executor must decide between the attractiveness of the flexibility permitted in the credit shelter trust and the desirability of preserving the availability of the prior transfer credit in the event of both deaths within a short period of time.

E. PARTIAL MARITAL DISCLAIMER AND PARTIAL CLAYTON ALTERNATIVE.

1. Although it is often tempting to design estate plans that maximize tax planning results, a significant portion of the job of the successful estate planner is also to factor in how the parties who survive the decedent will

react to the plan and build in provisions to account for these reactions. Consider how the surviving spouse may feel when the decision about whether he will receive the full benefit of the marital trust or not is placed in someone else's hands.

2. A possible solution to this potential difficulty in larger estates may be to leave a portion of the assets outright to the surviving spouse and a portion in a marital trust. This may make the surviving spouse more comfortable with the concept of the marital trust. The Will would provide that if the surviving spouse disclaims any portion of his outright bequest, it will pass to a credit shelter type trust (but without a special power of appointment) and that if the executor does not elect to qualify the entire marital trust for QTIP treatment, the non-elected portion would pass to the credit shelter trust which could include a special power of appointment. Under these circumstances, the surviving spouse would be included in the analysis of how much federal applicable exclusion amount to use in the estate of the first spouse to die and he can influence the decision about whether he would rather take advantage of the asset protection feature afforded by having assets in the marital trust or rather have assets he owns directly. In addition, if the surviving spouse prefers to hold a special power of appointment over the redirected assets, he can allow the executor to make the Clayton election, rather than disclaiming. Thus the surviving spouse is involved in the decision, but the choice as to whether to take full advantage of the decedent's applicable exclusion amount is not left solely to his discretion.

F. DISCLAIMER IN COMBINATION WITH PARTIAL QTIP ELECTION.

1. In the case of older clients, one way of structuring the estate plan to permit use of a credit shelter-type trust and preserve the possibility of taking advantage of the credit for tax paid on previously taxed property is to bequeath the spousal share to a residuary marital trust that qualifies for QTIP treatment and provide that any portion of the trust disclaimed by the surviving spouse will pass to a credit shelter trust (without a special power of appointment). If the surviving spouse is alive and has a normal life expectancy as of nine months after the decedent's death, he could disclaim an amount adequate to take advantage of all or a portion of the decedent's applicable exclusion amount. If he has died (or is in poor health) at the nine month date (but was healthy enough at the decedent's death to have his interest in the marital trust valued under the tables), no disclaimer to a credit shelter trust will be made, and the executor (who may be the surviving spouse, if still alive) could elect to qualify only a portion of the marital trust for marital deduction treatment when making a QTIP election to take advantage of the credit for the tax paid on the non-elected portion of the marital trust at the death of the surviving

spouse. To increase the value of the surviving spouse's interest in the trust, the spouse should ordinarily be given a "5 & 5" withdrawal power over the trust, whereby the surviving spouse is permitted each year to withdraw $5,000 or five percent of the value of the trust.

2. Note that this plan leaves the possibility of funding the family-oriented credit shelter trust in the hands of the surviving spouse and thus may be inappropriate where the spouse and the remainder beneficiaries do not have a unity of interest.

G. DISCLAIMER IN COMBINATION WITH CLAYTON TRUST AND PARTIAL QTIP ELECTION.

1. Query whether another technique may make it possible to take advantage of either a partial QTIP election or a Clayton election, depending on the circumstances at the decedent's death: structuring the Will so that the property can be directed to different trusts either by disclaimer or by Clayton election. For example, the decedent leaves his estate to a residuary Clayton trust, so that if the executor makes a partial (or no) QTIP election for the property in this trust, the non-elected portion would pass to a credit shelter-type trust. The Will also provides that, if the spouse disclaims his interest in any portion of the Clayton trust, that portion of the trust would pass to a traditional QTIP trust which does not make the spouse's income interest contingent on the QTIP election. A partial QTIP election applied to this traditional QTIP trust would result in the surviving spouse receiving the income from both the marital and non-marital portions of the trust and the credit for tax paid on prior transfers would be available in the estate of the surviving spouse if he has died or dies within a few years. Needless to say, this gives the surviving spouse the power to defeat the Clayton trust and take all of the income for himself - even though he would not be making the election himself. Regardless of the executor's opinion about whether or not to qualify the full value of the Clayton trust for QTIP treatment, the spouse would be in a position to determine whether he would have all of the income interest from the trust or not through his power to disclaim. Note that a disadvantage of this plan would be that the determination of how much of the trust is subject to the Clayton election, and thus eligible to be passed to the credit shelter-type trust, must be made within nine months of the decedent's death, instead of 15 months.

2. On its face, this plan is similar to the preceding one involving a disclaimer from a QTIP trust to a credit shelter trust, but raises some fascinating issues not involved in the former structure.

   a. Can a surviving spouse disclaim from a Clayton trust?

(1) The nature of the surviving spouse's interest in a Clayton trust is similar to, but different from, a surviving spouse's interest in a traditional QTIP trust for which a partial QTIP election can be made. In the case of the partial QTIP, the surviving spouse has the same interest in the trust, whether or not the election is made. In the case of a Clayton trust, the surviving spouse might not even be a beneficiary of the non-marital portion of the trust.

(a) This question raises the issue of the essential nature of the potential beneficiaries' interests in the respective portions of a Clayton trust. On the one hand, the interests of the potential beneficiaries of the non-marital portion cannot be said to have a present interest in the Clayton trust because that would disqualify it for QTIP treatment. On the other hand, the spouse's interest in the Clayton trust, although described as current to qualify for the QTIP election, is not actually possessory and may never materialize. The court in *Clayton* based its analysis that the marital deduction is available for the portion of the trust for which an election is made on the fact that the QTIP rules apply only to the portion for which the election is made. The election itself is one of the requirements necessary to permit the marital deduction to apply. The fact that the balance of the Clayton trust does not meet the requirements for the marital deduction does not "contaminate" the entire trust because the rules apply only to the portion for which the election is made.

(b) Points in favor of permitting a spousal disclaimer from a Clayton trust.

i) The creation of the Clayton trust is predicated on the spouse's survival. If the spouse does not survive the testator, these provisions of the instrument would never become active. The fact that state laws permit the testator to direct the flow of property if the surviving spouse disclaims his interest in the Clayton trust should permit the testator's intention to be effective.

ii) Although the spouse's interest in the marital component of a Clayton trust is contingent on the QTIP election being made, the actual bequest under the instrument is to the marital component of Clayton trust. This must be the case in order for the executor to be in a position to make a QTIP election for the trust that otherwise qualifies for QTIP treatment. Thus, at the time that the spouse disclaims, only the marital component of the Clayton trust is "active." As the court in *Clayton* noted, "the election element of the definition is viewed in the past tense, i.e., that although the *effect* of the election is tested as of the instant of the testator's death, the definitional *eligibility* of the separate terminable interest under examination is tested as though the QTIP election had already been made."[20]

(c) Troubling issues in permitting a surviving spouse to disclaim from a Clayton trust.

i) Unlike a disclaimer from a QTIP trust, a disclaimer from a Clayton trust may disenfranchise other potential current beneficiaries and may not be considered a permissible disclaimer or renunciation under applicable state law.

ii) By analogy, this could be viewed as similar to a disclaimer provision in a credit shelter trust. Suppose the spouse is a discretionary beneficiary with the testator's children and the disclaimer provision provides that if the spouse disclaims, the property would flow to a

[20] *Estate of Clayton v. Comm'r.*, 976 F.2d at 1497.

QTIP trust solely for the benefit of the surviving spouse. Should this work?

(2) Possibility of the disclaimer being recharacterized as a special power of appointment. If the surviving spouse's interest in the marital component of the Clayton trust is considered to be as tenuous as those of the potential current beneficiaries of the non-marital component of the Clayton trust, one must ask what interest it is that the spouse is disclaiming. A disclaimer is a release of an interest. If the spouse does not have a substantial interest in the non-marital component of the Clayton trust, his ability to redirect the trust through a disclaimer could be viewed to be a narrow special power of appointment to appoint the trust property. If this were the case, it is possible that no part of the Clayton trust would qualify as a QTIP trust because the surviving spouse would have a power to appoint property to someone other than himself.[21]

b. Timing issues.

(1) Arguably, if the surviving spouse disclaims all or a portion of the Clayton trust, that disclaimer would take

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[21] Note that it was the government's argument and the Tax Court's holding in *Estate of Clayton v. Comm'r.*, 97 T.C.327 (1991), *rev'd* 976 F.2d 1486 (5th Cir. 1992), *Estate of Robertson v. Comm'r.*, 98 T.C. 678, *rev'd* 15 F.3d 779 (8th Cir. 1994) and *Estate of Spencer v. Comm'r.*, T.C. Memo 1992-579, *rev'd* 43 F.3d 226 (6th Cir. 1995) that, "the surviving spouse did not have a qualifying income interest for life because the passage of an income interest in the property to the surviving spouse was contingent upon the executor's QTIP election as to such property and was therefore subject to the executor's power to appoint the property to someone other than the surviving spouse," *Estate of Clack v. Comm'r.*, 106 T.C. 131, 138 (1996). In reversing the Tax Court in these cases, the appellate courts focused upon the requirement of IRC § 2056(b)(7)(B)(i) that qualified terminable interest property is property, *inter alia*, for which an election *has been made*. *Estate of Clack v. Comm'r.*, 106 T.C. at 140-41. As the court in *Clayton* stated, "No reasonable reading or construction of the Will or the statute can validate the position of the Commissioner, as endorsed by the Tax Court, that the Independent Executrix's QTIP election itself is 'tantamount' to a power of appointment to the testator's children." *Estate of Clayton v. Comm'r.*, 976 F.2d at 1497. This reasoning, however, would not apply to whether a surviving spouse's power to disclaim should be considered "tantamount" to a power to appoint the property.

priority over the subsequent finality of the election by the executor to qualify (or non-election not to qualify) any portion of the Clayton trust for QTIP treatment. The disclaimer must occur within nine months of the decedent's death. Given that the QTIP election (or lack thereof) is revocable until the due date of the federal estate tax return, due nine months after the decedent's death if no requests for extensions are made, the disclaimer will have occurred prior to (or at best simultaneously with) the filing of the federal estate tax return.[22] If the disclaimer effectively directs the assets that would otherwise have flowed to the Clayton trust elsewhere, it is hard to see how the executor could make an election over assets no longer subject to the terms of the Clayton trust.

(2) It may be tempting to provide that the spouse's disclaimer could be contingent on the executor's election of QTIP treatment to ensure that the surviving spouse has a "disclaimable" interest in the Clayton trust (*e.g.,* the spouse disclaims his interest in any portion of the trust for which the executor makes the QTIP election). However, on a practical level, it is difficult to figure out how an estate tax return could be filed which lists the assets of the Clayton trust on Schedule M of the Form 706, makes a QTIP election for those assets qualifying them for the marital deduction and also indicates that the assets are in fact held in a separate trust protected from tax by the applicable credit amount (or subject to tax if the amount exceeds the amount of the available applicable credit amount). Alternatively, if the surviving spouse disclaims his interest without reference to whether the QTIP election is made and the executor believes the assets are no longer subject to the Clayton trust, the executor will not make a QTIP election for assets not in the Clayton trust. No QTIP election for the disclaimed assets would

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[22] Although IRC § 2518(b)(2) provides that, to be qualified, a disclaimer must be made, *inter alia*, "not later than the date which is 9 months after the later of – (A) the date on which the transfer creating the interest in such person is made, or (B) the day on which such person attains age 21," the likelihood of the disclaiming surviving spouse being under the age of 21 is presumably small, making this provision of one of extremely rare applicability.

ever be made and the spouse's interest in the marital portion of Clayton trust would never be complete.

c. Gift Issues. Under the transaction described above, the surviving spouse has a greater interest in the disclaimer QTIP trust than in the Clayton trust, because the spouse has a secure income interest in the disclaimer QTIP as opposed to the Clayton trust. Query whether under a *Dickman*[23] analysis, the surviving spouse's failure to make a disclaimer, particularly if the executor then failed to make QTIP election, could be considered a gift from the surviving spouse to the other beneficiaries of the non-marital portion of the Clayton trust.

3. The bottom line is that it is not entirely clear what the tax result of including a disclaimer in a Clayton trust might be and the inclusion of such a provision in a Clayton trust should probably be reserved for those of your clients who have high risk tolerance, have aggressive tax personalities, and may be prepared to make law, if the numbers involved are large enough to warrant it. Fortunately, a similar benefit to that described through this technique could be obtained in other ways (*e.g.*, reverse the order of the trusts and disclaim from a traditional QTIP to a Clayton trust).

H. GST PLANNING.

1. Capping the Amount of the Exemption. Just as with credit shelter trusts, the amount of the GST bequest can be capped at a particular number if the client prefers, although this is an inflexible solution which will fail to take into account the client's assets and existing law at the time of her death.

2. Use of Disclaimers, Partial QTIPs and Clayton Trusts. Alternatively, it may be possible to structure the funding of the GST bequest through the use of disclaimers, partial QTIP elections and Clayton trusts.

(1) For example, a client's Will or revocable trust could include a bequest to a "reverse QTIP trust" in the full amount of the client's available GST exemption. This is a marital trust which meets the requirements for making the QTIP election, but permits a special election for GST purposes which will treat the decedent as the transferor

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[23] *Dickman v. Comm'r.*, 465 U.S. 330 (1984) (holding that foregone interest on interest-free loans to decedent's children were gifts).

rather than the surviving spouse, even though the trust will be included in the surviving spouse's estate at his death. The remainder of this trust would pass to grandchildren. The decedent's GST exemption would be allocated to the trust to protect it from GST tax. If the surviving spouse disclaims a portion of the reverse QTIP trust, the amount disclaimed can then pass to the "regular" QTIP trust which has the children as beneficiaries. The marital deduction would be available for both trusts. Needless to say, the spouse could not have a special power of appointment over the regular QTIP trust.

(2) A simpler approach, however, assuming any unallocated GST exemption would otherwise not be used, would simply be to give the spouse a special power of appointment over the reverse QTIP trust to permit him to appoint between children and grandchildren. The executor would then allocate the decedent's entire unused GST exemption to the trust. If the spouse determines that a portion of the trust should pass to children, the GST exemption allocated to that portion will be wasted. But if the GST exemption was a larger percentage of the estate than seemed fair to give to grandchildren, there is no harm. The danger with this approach is that the surviving spouse may fail (or be unable) to redo his Will to exercise the special power of appointment prior to his death.

(3) Alternatively, in situations where it is not appropriate to give the surviving spouse the power to determine the size of the GST bequest, it is possible to link the GST bequest with a Clayton election made by the executor. In this case, the Clayton trust would use the decedent's available applicable credit, could be for the benefit of grandchildren and could have GST tax exemption allocated to it. The remaining portion of the marital trust would pass to children at the death of the surviving spouse. The difficulty with this approach is that it requires coordination of the use of the applicable credit with the use of the GST exemption to protect the trust from both estate and GST tax.

(4) A disadvantage of all of these approaches is that they require the existence of a surviving spouse. If there is no surviving spouse, the Will may simply contain a GST

bequest of the maximum amount and no elections or disclaimers will be possible unless the grandchildren themselves wish to disclaim. Under these circumstances, it may be prudent to make the bequest to a sprinkling trust for descendants, allocate the decedent's GST exemption to it, and give the trustee broad discretion to make distributions to children and grandchildren. Keep in mind that a trustee may be reluctant to make distributions to children from such a trust because it will waste GST tax exemption and the trustee may fear accusations to that effect from the grandchildren. Precatory language in the Will making the testator's intentions clear may be helpful here.

VII. CONCLUSION.

The techniques presented in this outline are focused on delaying the ultimate decisions regarding the disposition of a client's estate until after her death. Under normal circumstances, this is not a recommended approach to estate planning. Assuming that the law stabilizes to some extent in the not so distant future, the author recommends reducing the flexibility of the typical estate plan to some extent to ensure that a client can expect her estate plan to be administered as she designed it. In the meantime, it is a disservice to clients not to try to preserve the maximum flexibility possible in her estate plan.

The difficulty in delaying the client's ultimate decisions regarding the disposition of her assets at her death is that someone else must be found to make those decisions for her who will do so in a disinterested manner, attempting to make the decision she believes the client would have made if she were alive; the flip side of this issue is that it may not be so easy to find someone who will accept these responsibilities.