Chapter 24

MARITAL DEDUCTION AND BYPASS – TRUSTS

WHAT IS IT?

The marital/nonmarital trust (also commonly referred to as the "A-B trust" or more currently sometimes the "A-B-Q" trust) is an arrangement designed to give the surviving spouse full use of the family's economic wealth, while at the same time minimizing, to the extent possible, the total federal estate tax payable at the deaths of both spouses.

Married couples can usually eliminate federal estate taxes entirely at the death of the first spouse to die through a carefully considered plan capitalizing on the combination of the unlimited marital deduction coupled with the unified credit. The marital deduction is a deduction for gift or estate tax purposes for property passing to (or in a qualifying trust for) a spouse. The unified credit is a credit provided to each citizen or resident of the United States, which can be applied against either gift taxes or estate taxes. Unified credit used for gift taxes reduces the amount available for estate taxes. The amount of the unified credit is much less for gift taxes than for estate taxes.

The goal typically is to avoid "overqualification" of the estate for the marital deduction because of "underutilization" of the unified credit in the estate of the first spouse to die. The estate tax unified credit (there is no estate tax in 2010) is scheduled to increase as follows:

	Unified Credit	Applicable Credit Amount
2004-2005	555,800	1,500,000
2006-2008	780,800	2,000,000
2009	1,455,800	3,500,000
2010	NA	NA
2011 and after	345,800	1,000,000

Current Planning Techniques

The most common arrangement for a marital/bypass trust is to place into the bypass trust an amount equal to the estate tax unified credit applicable exclusion (the 2006 unified credit of $780,800 equates to exempting $2,000,000 of assets from the estate tax), because the tax on those assets will be eliminated by the unified credit. The assets in the bypass trust will not be taxed at the surviving spouse's death because the trust is specifically designed so the surviving spouse has no rights sufficient to cause inclusion. The balance of the decedent's assets will go to the marital trust tax-free - because of the unlimited marital deduction. But assets in the marital trust will be subject to estate tax at the death of the surviving spouse because of the broad powers the survivor is given in the trust.

Some couples may prefer to have some tax paid at the death of the first spouse to die (since some of the taxed portion will be taxed at the lowest federal estate tax rates instead of being shifted to the surviving spouse's estate and added "on top" of the assets the survivor already owns). However, it will be rare when the payment of an "up front" tax will be advantageous and rarer still when the parties have the willingness and ability to pay any tax before its time. One reason that paying a tax at the first death rarely makes sense is that the surviving spouse often will use up the additional assets received or give them away. The vast majority of "younger" couples may well decide to accept some possible penalty in estate tax rate at the second death in order to avoid tax altogether at the death of the first spouse to die. This is obviously an important decision that the estate planner must review at length with the husband and wife.

An important decision must be made as to how much of the marital deduction property should be subject to the surviving spouse's power to say where it goes at the survivor's death. This is particularly true in second or late life marriages.

In general, the marital deduction can be obtained for property passing outright to a surviving spouse, or in a manner that is tantamount to outright - such as in a qualifying marital trust for the spouse. One type of trust gives the surviving spouse a right to income for life with a power to appoint the property during lifetime or at death to anyone the surviving spouse wishes. This is called a general power of appointment trust. In a second type of trust, an "estate trust," the surviving spouse receives income only, has no right to name the ultimate recipient during her lifetime, but can name the recipient of the remaining property in her will. In a third type of marital trust, a qualifying terminable interest property

(QTIP) trust, the spouse is also given a right to income for life; however, the spouse need not be given a power of appointment over the property. Thus, with a QTIP trust, the first (original property owning) spouse to die can control where the property goes at the surviving spouse's death. This is particularly appealing in second and late-life marriages.

For estates where it is desired that *all* of the marital deduction property or *none* of it should be subject to the survivor's power of disposition at death, it will be satisfactory to have only one marital deduction or "A" Trust, since the same rules will pertain to all of the property.

However, in many estates, it may be desirable to use a QTIP trust for some or all of the estate to ensure that at least some of the marital deduction property passes to the first decedent spouse's chosen beneficiaries at the surviving spouse's death. The balance of the marital deduction property would go to a separate trust (often called "Trust A") that would be controllable by the surviving spouse as to its disposition. Particularly for community property, where the survivor already owns half, it may be very helpful to obtain the marital deduction for all of the estate in excess of the unified credit equivalent (with the exempt portion going to the bypass (or "B") trust to avoid tax at the survivor's death), but to still provide that some of the deducted property will ultimately go to the children (or to the brothers or sisters of the first spouse to die if there are no children).

Thus, a formula will often provide for putting into the "B" or family trust the amount of the estate tax applicable exemption ($2,000,000 in 2006) at the death of the first spouse. This trust can provide for income to the survivor (and if desirable, can even give to the survivor some limited power of disposition to other people and/or the power to take out each year the greater of $5,000 or 5% of the trust principal). Even so, property in this trust will generally escape taxation at the survivor's death. Obviously, the formula used to achieve this is very important. Planners must be careful that the provisions for creating the bypass trust and the marital trust are appropriate in light of the changes made by EGTRRA 2001, including substantial increases in the estate tax unified credit in the years up to 2009 and repeal of the estate tax for one year in 2010.

If it is decided to have a zero estate tax at the first death, and if it is desired that the spouse have disposition powers over all or none of the other assets, all of the other assets can go to the marital or "A" trust.

However, if it is desired that the survivor have a power of disposition over only a portion of the assets, then the portion subject to the power can go into the typical marital or "A" trust, and the balance can go into a QTIP trust. Both trusts will qualify for the marital deduction and be included in the survivor's estate at death. Either or both of these trusts can provide for invasion of principal for the benefit of the survivor, but only the "A" trust will be subject to a power of disposition at the survivor's death.

In some cases, the couple may decide to also restrict the power of the surviving spouse so that some portion may only be appointed among family members. If the surviving spouse cannot appoint such property to herself or her estate, such portion would generally go into either a bypass or a QTIP trust.

Often the revocable A-B or A-B-QTIP trust takes the form of a life insurance trust coupled with a "pourover will." Here a revocable ("I can tear it up and forget about it") insurance trust is created during the grantor's lifetime. The trustee is named as the beneficiary of life insurance policies issued on the grantor's life. The grantor's will contains a provision to the effect that the grantor's residuary estate, what is left after payments of debts, expenses, taxes and specific bequests, is to be "poured over" into the living trust. (Think of a funnel. Life insurance passes outside of the funnel directly to the "pool of assets" at the bottom while noncontractual [probate] assets pass through the grantor's will into the top of the funnel and flow down to join the life insurance.)

The trust instrument provides that upon receiving the insurance proceeds from the insurance company and the residuary estate property from the pourover will provisions, the total principal will then be divided into two (or three) parts: a portion will go to the marital or "A" trust, a portion to the family or "B" trust, and if appropriate, a portion will go to the QTIP trust, which latter will qualify for the marital deduction but be distributed at the survivor's death as provided by the grantor in the trust instrument (e.g., to the children).

The use of the trust can provide flexibility and investment management, while achieving the long term goals of the family and minimizing death taxes.

Whether to use a revocable trust to also hold noninsurance assets is usually a question of whether or not the other assets should be subjected to the costs, delays, and publicity which usually accompany probate. Many practitioners in Northeastern states recommend the will as the instrument to dispose of most of the noninsurance assets. In Florida and on the West Coast, the trust is frequently used to control the disposition of all of the assets, with the goal of both estate tax minimization and also avoidance of probate.

WHEN IS THE USE OF SUCH A DEVICE INDICATED?

1. When it is the desire of the spouses that the survivor have full economic benefit of, and control over, the family's wealth and that the aggregate death taxes payable at the deaths of both spouses be reduced or eliminated. Where an individual leaves all of his property to his spouse, his estate may be "overqualified" for the marital deduction (or more properly, the estate underutilizes his unified credit), as discussed below. Too much property may pass to the surviving spouse and thus be needlessly taxed at the surviving spouse's death. The reason for this result is that the surviving spouse has "ownership" of all of the family wealth and therefore it is taxable for federal estate tax purposes at the surviving spouse's death.

   If the surviving spouse merely had the "benefit" of all of the family wealth (i.e., an A-B or A-B-QTIP trust arrangement), only the portion that qualified for the marital deduction at the death of the first spouse to die (or which was already owned by the surviving spouse) would be subject to federal estate taxes at the survivor's subsequent death. The B trust assets would pass to family members estate tax free at the surviving spouse's death.

   In order to maximize the utility of this technique, the A-B or A-B-QTIP trust device can be designed to pass to the A trust or to the A and QTIP trusts together exactly enough property to reduce the federal estate tax in the estate of the first spouse to die to the lowest desired amount–even to zero. Any additional property subject to tax at the decedent's death and passing to the trust would automatically pass into the B (family or nonmarital) trust (portion) and escape death taxation at the death of the second spouse to die.

2. The overqualification (underutilization of the unified credit) problem referred to above results in passing more to the surviving spouse in property interests qualifying for the marital deduction than is necessary to keep the federal estate tax at the decedent's death to the minimum. Overqualification results in wasting (in whole or in part) the decedent's unified credit. For couples with estates over the amount that can have its tax "paid for" by the unified credit ($2,000,000 in 2006), wasting the unified credit of the first to die could result in a larger-than-necessary estate tax falling on the surviving spouse's estate at the surviving spouse's death. (An example later in the chapter illustrates the point.) A properly designed A-B or A-B-QTIP trust could eliminate or minimize this problem.

3. Where the couple plan to set up "generation-skipping trusts"(see Chapter 18) for the children, the exemption from generation-skipping transfer tax of the first spouse to die can be lost if the property passes outright to the surviving spouse, or in any form of marital deduction trust other than a qualified terminable interest property trust (QTIP trust).

4. Favorable state inheritance tax treatment may be obtained. Rather than giving property outright to a spouse, if property is placed in a "marital trust," even if the spouse has a general power of appointment over the assets in that trust, the laws of some states exclude such property for state death tax purposes from the estate of the holder of the power of appointment. For example, in Pennsylvania, even though a surviving spouse could reduce the property in a marital trust subject to a general power of appointment to his own possession, it will not be subject to state inheritance tax at the death of such spouse. Thus, from a death-tax viewpoint, in some states it is preferable to leave a surviving spouse's assets in trust coupled with a general power of appointment over such assets, rather than leave the same amount outright, all other things being equal.

   However, a majority of states provide for tax-free interspousal transfers but their laws parallel the federal estate tax rules to tax to the surviving spouse's estate the assets in the marital trust which avoided taxation at the first spouse's death.

5. When management of trust property is needed for the benefit of the surviving spouse or other trust beneficiaries.

6. Where it is desired to avoid probate. In addition to the tax reductions and management benefits described above, a person's estate can avoid the expense and delay of probate by transferring the title of the person's assets to a revocable inter vivos trust during the person's lifetime. That trust would also contain the death tax minimization provisions. Since the property is already transferred before the person's death, there is no need for the court to take

charge and transfer the title and therefore no probate proceedings are required.

7. Where one of the spouses is a non-U.S. citizen. (See "Planning for Non-U.S. Persons," Chapter 20.)

8. Where the first spouse to die wants to be certain that his or her assets, while benefiting the survivor spouse, will eventually go to the children (or some other beneficiary) and not the husband, wife, or friend of the surviving spouse.

9. Where it is desirable to defer until the first spouse's death the decision of whether to pay some estate tax at that time in order to lower estate tax payments at the survivor's death.

WHAT ARE THE REQUIREMENTS?

Property that passes outright to the surviving spouse can qualify for the federal estate tax marital deduction. It is also possible to qualify certain types of trusts for the marital deduction. There are three types of trusts that will qualify for the marital deduction–the "power of appointment" trust, the "estate" trust, and the QTIP trust.

1. Power of Appointment Trust–Requirements

   (a) The surviving spouse must be entitled to all of the income produced by the assets of the trust (note that the law states "all of the income" not "all of the net income").

   (b) The income produced by the trust must be payable at least annually.

   (c) The surviving spouse must be given a general power of appointment (during lifetime, at death, or both) exercisable in favor of the spouse or the spouse's estate, or the creditors of the spouse or the spouse's estate.

   (d) The power must be exercisable by the surviving spouse in all events.

   (e) No person may have any power to appoint any part of the trust assets to any person other than the surviving spouse.[1]

   An estate owner can give property in trust subject to a power of appointment but require that–to exercise the power–the donee's will (or a different instrument) must make specific reference to such power. This is important because, in some states, a residuary clause will exercise a general power of appointment automatically unless there is a specific stated intention not to exercise it. In other words, absent the requirement that the donee of a power must specifically refer to it, in certain states the donee is deemed to have exercised the power in favor of his residuary legatee.

   The trust property will qualify for the marital deduction if the spouse is given the power to appoint at death (i.e., a testamentary power of appointment). The spouse does not have to be given the power to withdraw the principal during lifetime (i.e., an inter vivos power of appointment).[2]

   A trust should provide that the spouse has the right to demand that the trust be made income producing.[3]

2. Estate Trust–Requirements

   (a) The trust must provide for income to the surviving spouse for life (payable to, or accumulated for, the surviving spouse's benefit).

   (b) The remainder of the trust (both principal and any accumulated income) must be payable to the surviving spouse's estate at the surviving spouse's death.

   An estate trust falls outside the terminable interest rules because no interest passes to anyone other than the spouse and the spouse's estate.[4] This will enable the trustee to accumulate income or invest in non-income-producing property. However, accumulations will be taxed as part of the surviving spouse's estate at the surviving spouse's death along with the original corpus.

   The estate marital trust is indicated where (a) there is a need or desire to invest in non-income-producing property, (b) the survivor will not need trust assets or income during the survivor's lifetime, and (c) the property placed into the trust is not likely to appreciate substantially in value.

3. Qualified Terminable Interest Property (QTIP) Trust – Requirements

   (a) The same requirements regarding "all income to the surviving spouse and payable at least annually" that apply in the power of appointment trust apply here. Thus, the survivor must receive all of the current beneficial interest in the trust.

(b) However, this trust need not have any power in the surviving spouse to appoint or control the disposition of the property.

(c) There must be no power to shift any of the trust property to anyone other than the spouse during the spouse's lifetime.

(d) The spouse must have the power to require the trustee to make the assets produce income.

(e) The executor must elect to have the trust treated as a QTIP trust on the estate tax return by showing its value on Schedule M of the estate tax return.

With this type of trust, the grantor can be certain that, at the death of the survivor, the property will go to the children or wherever the grantor decides (and not to the survivor's new spouse, which may be the case with the power of appointment trust or the estate trust). The cost of that control is that the property remaining in the QTIP trust at the surviving spouse's death must be included in her estate.

4. Other General Requirements

Assets in the marital trust must pass to or be held for the benefit of the decedent's surviving spouse–the person who is married to the decedent at the decedent's death.[5] Although this requirement appears simple to determine, it has been the cause of extensive litigation because of the increasing frequency of divorce and persons living together without formal marriage that is now prevalent in our society.

Furthermore, the decedent's spouse must survive the decedent. In the event of a common accident (such as a plane or car crash) when it is impossible to ascertain who dies first, the Uniform Simultaneous Death Act (the law in most states) would raise a presumption that neither spouse survived the other and therefore, would defeat the marital deduction. The application of such act can be overcome by inserting into the documents creating the marital trust a survivorship clause that creates a presumption that, for purposes of the marital deduction, the spouse is deemed to survive if it is not possible to establish the order of deaths.[6]

HOW IT IS DONE – AN EXAMPLE

Although there are a number of ways to accomplish the same objective, the life insurance trust/pourover will combination is very popular in many parts of the country. In this arrangement, an individual establishes a trust during lifetime and names the trust as beneficiary of his insurance policies. When the grantor dies, the insurance maintained on his life is paid directly to the trust. The grantor's other assets pass through probate and are "poured over" by will into the trust. The one pourover trust is then split into two (or three) parts and different trusts are created; the "A" or appointment trust, a "B" or family (also called nonmarital or bypass) trust, and, in some cases, the "Q" or QTIP trust. If the insurance is held in a trust that is controlled by the insured grantor, it is included in the insured's estate for estate tax purposes. But if the trust was an irrevocable life insurance trust and the grantor-insured never had any incidents of ownership over the insurance on his life and didn't transfer insurance on his life to the trust within three years of his death, the insurance will not be included in his estate.

A – The Survivor's Property Trust or Power of Appointment Trust

The A trust, or power of appointment trust, is the primary vehicle for receiving the marital deduction assets - unless the very popular QTIP trust is used. Where the QTIP trust is used for the marital deduction instead, Trust A often will hold the surviving spouse's property, particularly in community property states, in order to provide unified management of the assets under the umbrella of the estate planning trust.

Trust A would provide that all income from the trust be paid to the surviving spouse during his lifetime. Where Trust A is used as a marital deduction trust, the pourover trust in many cases would contain a funding formula to ensure that the power of appointment trust, together with any QTIP trust, would receive just enough property to reduce the federal estate tax at the death of the grantor to zero.

In some cases, such as very elderly couples with relatively large estates, the formula for trust division may be drafted so as to pay some estate tax at the first death with the property being taxed in relatively low tax brackets. If the clients wish to permit payment of some estate taxes at the first death, this is generally better arranged by having the marital deduction property pass to a QTIP trust, since a QTIP trust allows the decision as to the amount of tax to pay to be deferred until the death of the first spouse to die. At that time, the planner and the family can better assess whether the surviving spouse's financial security may be impaired by early payment of death taxes. However, with reductions in the estate and gift tax rates and increases in the estate tax unified credit from 2005 to 2009 and a repeal of the estate tax for one year in 2010, early payment of the tax may be an unwise proposition.

The surviving spouse will usually be given the right to designate by will or other written instrument who will receive the corpus of the marital trust and such appointment may be made to anyone the surviving spouse chooses, including the surviving spouse's estate. The surviving spouse may also be given the right to withdraw any part of the corpus of the appointment trust during lifetime. At the surviving spouse's death, if the surviving spouse fails to exercise the power of appointment, the remaining corpus in the appointment trust will pass to the next takers under the trust.

B – The Bypass Trust

The second trust, often called the "B," bypass, nonmarital, or family trust, is designed to receive property that is not allocated to the power of appointment trust, the estate trust, or the QTIP trust. An amount equal to the estate tax applicable exclusion ($2,000,000 in 2006) (assuming no taxable lifetime gifts were made) is placed in this trust. The trustee may be directed to distribute the net income of this trust to the surviving spouse during such spouse's lifetime, or the income may be accumulated or directed to other persons in order to reduce the overall income tax burden on the family. Since the life estate terminates at the death of the surviving spouse, the surviving spouse did not create the life estate, and the surviving spouse has no "general" power of appointment over the trust property, there will be no transfer of property that is includable in the estate of the surviving spouse subject to the federal estate tax at death.[7] Thus, this trust "bypasses" the survivor's taxable estate and is, therefore, often called a credit equivalent bypass trust (CEBT) because it is funded with an amount equal to the exemption equivalent of the unified credit.

To enhance the financial security of the surviving spouse without causing later estate taxation, the surviving spouse can be given a "limited" or "special" power of appointment under this family trust. For example, a surviving spouse might be given the right to appoint, at such spouse's death, all or any part of the assets in the family trust, to a limited class of beneficiaries,[8] such as the children of the grantor. This means that the surviving spouse can distribute the assets in this trust only to the specified children, but can do so in any proportion or amounts the spouse desires. Such a power of appointment will not be classified as a "general" power and will not subject the corpus of the trust to federal estate taxes at the death of the holder, so long as the power cannot be exercised in favor of the holder of the power, his estate, his creditors, or the creditors of his estate.

The bypass trust can also safely provide the surviving spouse a noncumulative limited right of withdrawal. Typically, this provision states that if the A and Q trusts are depleted, the surviving spouse is given the right to make limited withdrawals from the bypass or family trust. Usually, the surviving spouse is provided with a "noncumulative" (use it or lose it) right to withdraw each year the greater of an IRC specified de minimus amount equal to the greater of (a) 5 percent of the corpus of the trust or (b) $5,000.[9] Although this 5 or 5 power will not cause the entire corpus of the family trust to be subject to estate tax, the amount subject to withdrawal in the year of the surviving spouse's death will be included in the surviving spouse's estate).

At the death of the surviving spouse, the family or bypass trust can continue to function for the benefit of the grantor's family, generally his children, or the trust can be terminated and the appropriate amounts paid to trust beneficiaries. The most common dispositive provision requires that the corpus of this trust be divided into separate equal trust funds for the benefit of the grantor's children, who will receive the net income currently and will have the right to demand distributions from principal at stated ages.

Often, rather than having all of the income from the family or bypass trust pass to the surviving spouse for life, a greater degree of flexibility may be obtained by utilizing a "spraying" or "sprinkle" clause. This provision authorizes the trustees (other than a trustee who is a beneficiary), at their discretion, to spray or sprinkle the net income of the bypass trust among the surviving spouse and the grantor's children or other issue (and sometimes spouses of issue) in any way the trustees determine. The trustees can thus apportion the trust's income among the beneficiaries having the greatest need.

Alternatively, since for federal income tax purposes the trust is a separate taxable entity, the trustees could be given the right to apportion the net income of the trust among the trust and the beneficiaries after giving consideration to their relative income tax brackets. Net income generated by the trust is determined substantially in accordance with the same rules applicable to individuals, with certain important differences. Although the taxable income of the trust is subject to the federal income tax, in arriving at taxable income the trust receives a deduction for distributions made or required to be made to beneficiaries during its taxable year to the extent such distributions do not exceed "distributable net income," as that term is defined.[10] By deflecting income to beneficiaries with little or no personal income, the overall income tax for the family can be reduced. However, unearned income of a child under age 18 in excess of $1,700 (in 2006) per year will generally be taxed at the parent's highest marginal rate (the "kiddie tax").

In addition to income tax savings, the estate tax at the survivor's death may be reduced by use of an "accumulation" provision. Instead of the nonmarital income being paid to the surviving spouse, it may be accumulated in the nonmarital trust and pass, free of estate tax, at the survivor's death. Meanwhile, the survivor has been permitted to invade the appointment trust (or the QTIP trust, if one exists) and consume some of the principal of those trusts (instead of using the income which has been accumulated in the nonmarital trust) and, thus, the appointment trust, and any QTIP trust that would be taxed at the survivor's death, would be reduced and the estate tax lowered. The downside of this technique of using up marital trust assets (assets that will be taxed at the surviving spouse's death) and building up nonmarital trust assets that will pass estate tax free at the surviving spouse's death is that allowing large amounts of income to accumulate in the nonmarital trust may result in adverse income taxation. This is because the top federal income tax rate of 35%, which generally does not apply to individuals until income exceeds $336,550, kicks in at the $10,050 income level for trusts (tax rate and amounts for 2006).

The "sprinkle," "spray," or "accumulation" clauses should be avoided where the bypass trust will be a recipient of stock in an S corporation. Only certain types of trusts are permitted to own S corporation stock, and a major requirement of such trusts is that the trust benefit only a single individual, and that such individual receive all the income from the trust on an annual basis.[11]

Another alternative, becoming more common in this era of divorce and remarriage, is to use the B trust as a means of benefiting persons other than the present spouse (e.g., children of a prior marriage). The trust can arrange for continued management of the trust assets for nonspousal beneficiaries, with delayed distribution, or provide for outright distribution.

Where the grantor has planned to take advantage of generation-skipping, the B trust would continue to exist during the lives of children (usually giving them some "nongeneral" powers of appointment as well as income rights) so that the property in the trust can qualify as an "exempt" trust and avoid taxation at the death of the children or grandchildren. If generation-skipping is planned, a federal estate tax return should be filed and an election made to allocate to the B trust some of the grantor's exemption from the generation-skipping transfer tax. See Chapter 18 regarding generation-skipping transfers.

Q – The QTIP Trust

When it is desired that an amount of estate in excess of the estate tax unified credit exemption equivalent (applicable exclusion) amount (i.e., the exempt amount which is allocated to the grantor's "bypass" or family trust) should produce a marital deduction at the death of the first spouse to die, but should not be subject to a surviving spouse's control (e.g. general power of appointment), a QTIP trust may be indicated.

By providing the opportunity for a marital deduction, placing assets in this QTIP trust can result in zero estate tax at the death of the first spouse to die to the extent that the trustee or executor elects to take the marital deduction.

All of the income of this trust must be paid, at least annually, to the surviving spouse. No provision for invasions of the trust can be made for anyone other than the surviving spouse or the marital deduction will be lost. Likewise, it would be lost if there were any condition (e.g., remarriage) or power in anyone else that could prevent the surviving spouse from receiving all the trust income for life. Additionally, the surviving spouse should be given a power to require the trustee to make all of the trust assets income producing.

The principal of this trust may usually be invaded for the benefit of the surviving spouse, but the trust terms may provide for first using up all or part of the marital or appointment trust before invading this trust.

To the extent that the trustee has elected to take a marital deduction at the first spouse's death for assets going into that trust (usually 100%), the assets remaining in the QTIP (Q) trust at the death of the surviving spouse will be included in the estate of the surviving spouse.[12] Thus, the marital deduction has merely deferred the tax on any assets in this trust that are not used up for the benefit of the surviving spouse.

Any assets remaining in this trust at the survivor's death will be distributed as the grantor decided, often subject to a nongeneral power in the surviving spouse as to the method of distribution among the issue of the marriage.

If generation-skipping is planned and if some of the grantor-decedent's exemption from the generation-skipping transfer (GST) tax is still available, provisions are usually made for the QTIP trust to be divided into two trusts: trust Q-E, which will contain property to which will be allocated some of the GST exemption; and trust Q-N, which will not be exempt from the GST tax and which therefore will often have different terms than trust Q-E. Use of this GST split-trust planning to allocate some of the GST exemption to part of the QTIP is accomplished by what is sometimes referred to as a "reverse QTIP election," discussed later in this chapter.

HOW DO THE MECHANICS OF THE A–B OR A–B–Q TRUST PLAN WORK?

First, an inter vivos (living) trust instrument can be drafted creating the different trusts to be used–(the A or power of appointment trust, the B or bypass (family) trust and, when desired, the Q, QTIP trust.) Although the terms of the trust are determined during the grantor's lifetime, it will not become operative until it is funded (until assets are placed into the trust) at the grantor's death (or prior to death if it is desired to use this living trust to avoid probate of the trust assets).

The trust is revocable because the grantor possesses the power to alter, amend, or revoke the trust until his death. Most states allow a grantor to name the trustee as beneficiary of his life insurance proceeds and obviates the need to transfer any other property to the trust during his lifetime.[13] But, if insurance is for some reason unavailable, many states recognize a trust funded with a nominal corpus such as $100, or even less.

Either as a means of shifting assets (through probate) to the trust, or as a backup provision to put into the trust any assets unintentionally not placed in the revocable trust during lifetime, the grantor will provide in his will that his probate property, after payment of settlement costs and any specific bequests or devises, will be added (poured over) to the trust. Where liquid assets may be insufficient to pay death costs and administration expenses, a useful provision in the inter vivos trust is to permit the trustee to make cash available to the estate executor through loans or the purchase of estate assets.

Alternatively, this same marital deduction arrangement can be created in a testamentary trust (i.e., one contained in the decedent's will and which will require the assets to be subject to probate).

The essential provision in the A-B or A-B-Q trust is known as the marital deduction formula. All property included in the decedent's probate estate or made payable to the inter vivos trust will be divided in accordance with the formula clause in the trust agreement. Such a clause might provide that the power of appointment, estate, and/or QTIP trust is to be funded in an amount equal to the amount necessary to reduce the federal estate tax payable to zero, or any other specified portion of the estate. The division of the marital deduction assets between the power of appointment "A" trust and the "Q" trust could be whatever the grantor desires (e.g., half of the separate property going to the "A" trust, and the other half going to the "Q" trust). In any event, the funding clause would also provide that the amount of any such marital portion should be reduced by any property includable in the estate that passes directly to the surviving spouse as a result of the grantor's death (e.g., a specific gift of personal effects, life insurance or jointly owned property).

The net balance of the trust corpus, after allocation of the marital deduction amount and after settlement costs are paid, is then allocated to the family ("B") trust.[14] Thus, the A-B/A-B-Q trust is really two or three trusts in one, administered under one trust agreement by the same trustees.

In some multi-marriage situations, the grantor-decedent may be unwilling to defer benefit (above the bypass trust level) to children of a prior marriage or other persons until after the death of the present spouse and will want them to receive their interests sooner. In that event, the formula may provide for paying some estate tax at the grantor-decedent's death so that assets may pass to these other beneficiaries at that time. Insurance on the life of the grantor is typically the most efficient and effective way to insure that cash is available to pay the required tax when it is due.

Why is the A-B/A-B-Q trust arrangement such an important estate planning tool? To fully appreciate the implications and tax savings potential, it is necessary to examine a typical estate.

A common and often unfortunate arrangement is one where the testator leaves all of his property to his spouse (either by will, by jointly owning all assets with the spouse, or a combination of the two) and therefore overqualifies for the marital deduction and wastes the

Figure 24.1

ESTATE MARITAL PLANNER All To Spouse Plan		
	Estate of First Spouse	Estate of Second Spouse
Adjusted Gross Estate (Year: 2006)	$5,000,000	$0
Year of Death	2006	2009
Adjusted Gross Estate (Growth Rate: 7%)	$5,000,000	$6,125,215
Marital Deduction	- $5,000,000	- $0
Taxable Estate	$0	$6,125,215
Adjusted Taxable Gifts	+ $0	+ $0
Computation Base	$0	$6,125,215
Tentative Federal Estate Tax	$0	$2,637,147
Gift Tax on Adj. Tax. Gifts	- $0	- $0
Unified Credit	- $780,800	- $1,455,800
Federal Estate Tax	$0	$1,181,347
Net Estate at Death	$0	$4,943,868
Value of Net Estate at Second Death	$0	$4,943,868
Net Total $4,943,868		
Total Tax $1,181,347		

Source: Trust Calculator (part of *The Ultimate Trust Resource*, a National Underwriter Company publication).

unified credit available at the death of the first spouse to die. As a result, when the settlement of both estates is considered, federal estate taxes may be higher than if other arrangements were made.

Example: Philip Martin dies in 2006 and leaves his entire estate of $5,000,000 to his wife, Kaye, if living, otherwise to their son, Michael. Philip's primary objectives are to retain control of the estate during his lifetime, to provide an adequate income for his wife after his death, and to minimize his estate settlement costs. Assuming Kaye dies in 2009, and that she does not consume any of the principal of the estate, and further assuming that the value of the estate increases at the average rate of 7 percent a year, Figure 24.1 shows how much is paid in federal estate tax in each estate and how much after tax goes to Michael at Kaye's death.

A Typical Pre-1981 A-B Trust

Prior to 1981, the typical trust to avoid additional taxes over the death of a husband and wife was to pass to the surviving spouse outright or in trust an amount equal to the then marital deduction (the greater of one-half of the separate property or $250,000). This essentially resulted in equalizing the estates taxable at each death (assuming the couple's assets were acquired from the earnings of the first spouse to die), at least for larger estates. The concept of equalizing the estates is often the most economical method of minimizing the taxes over the deaths of both husband and wife where the estates of the husband and wife will be over the available equivalent exemptions. In other cases, however, the tax burden may be greater.

If Philip had a trust designed to equalize the estates (e.g., by giving to Kaye under the marital deduction one-half of his assets), Figure 24.2 shows how much would be paid in federal estate tax in each estate and how much would pass to Michael on Kaye's death (same assumptions as stated in the previous example).

A Typical Post-1981 A-B or A-B-Q Trust to Reduce the Tax at the First Death to Zero

If Philip had wished to be certain that no federal tax were paid at his death, regardless of the size of his estate,

Figure 24.2

ESTATE MARITAL PLANNER Estate Equalizer Plan		
	Estate of First Spouse	Estate of Second Spouse
Adjusted Gross Estate (Year: 2006)	$5,000,000	$0
Year of Death	2006	2009
Adjusted Gross Estate (Growth Rate: 7%)	$5,000,000	$3,062,608
Marital Deduction	- $2,500,000	- $0
Taxable Estate	$2,500,000	$3,062,608
Adjusted Taxable Gifts	+ $0	+ $0
Computation Base	$2,500,000	$3,062,608
Tentative Federal Estate Tax	$1,010,800	$1,258,974
Gift Tax on Adj. Tax. Gifts	- $0	- $0
Unified Credit	- $780,800	- $1,455,800
Federal Estate Tax	$230,000	$0
Net Estate at Death	$2,270,000	$3,062,608
Value of Net Estate at Second Death	$3,780,848	$3,062,608
Net Total $5,843,456		
Total Tax $230,000		

Source: Trust Calculator (part of *The Ultimate Trust Resource,* a National Underwriter Company publication).

he could have provided for an amount of marital deduction to go to Kaye which would exactly equal the amount of deduction needed to reduce his federal estate tax to zero. This is called the "zero tax marital deduction." In that event, Figure 24.3 shows the amount of federal tax that would be paid in each estate and how much would pass to Michael upon Kaye's death.

Comparison of Plans

Savings in federal estate taxes generally occur at the survivor's death. The federal estate tax payable in Philip's estate is the same in his overqualified arrangement (example 1) as it is in the Post-1981 A-B (or A-B-Q) trust arrangement (example 3)–in both cases it is $-0-. Actually, the savings in federal estate taxes occur in Kaye's estate. The trust arrangement accomplishes this because the equivalent exemption amount at Philip's death is never taxed in either estate.

The second arrangement (example 3) is "optimum" for the first spouse's death (zero estate tax then, regardless of the size of the estate), but it can result in more overall tax if the spouse's estate exceeds the unified credit exemption equivalent and the spouse does not use up some of the estate or give some of it away during her lifetime.

Electing to Pay Some Tax

In some cases, there can be some tax saving by paying tax early, where property is increasing in value. For example, if an asset now worth $100,000 is projected to be worth $500,000 at the second death, it is usually much more economical to pay the tax based on the current $100,000 value than on the $500,000 it will be worth later.

The drawback to the "old A-B" arrangement (Figure 24.2) is that the tax is *forced* to be paid at the first death. However, if a QTIP trust is used, the executor will have a right to elect how much of the property over the amount sheltered by the unified credit will be subject to tax–none of it, all of it, or any amount in between! Thus, the QTIP allows the parties to keep their options open, and decide at death how much, if any, tax to pay. If the loss of the funds used to pay the taxes will not impair the surviving spouse's financial security, in some cases, substantial saving could be realized by paying some tax early. Again, the planner will need to weigh the potential

Figure 24.3

ESTATE MARITAL PLANNER
Credit Shelter/Marital Deduction Plan

	Estate of First Spouse	Estate of Second Spouse
Adjusted Gross Estate (Year: 2006)	$5,000,000	$0
Year of Death	2006	2009
Adjusted Gross Estate (Growth Rate: 7%)	$5,000,000	$3,675,129
Marital Deduction	- $3,000,000	- $0
Taxable Estate	$2,000,000	$3,675,129
Adjusted Taxable Gifts	+ $0	+ $0
Computation Base	$2,000,000	$3,675,129
Tentative Federal Estate Tax	$780,800	$1,534,608
Gift Tax on Adj. Tax. Gifts	- $0	- $0
Unified Credit	- $780,800	- $1,455,800
Federal Estate Tax	$0	$78,808
Net Estate at Death	$2,000,000	$3,596,321
Value of Net Estate at Second Death	$2,450,086	$3,596,321

Net Total	$6,046,407
Total Tax	$78,808

Source: Trust Calculator (part of *The Ultimate Trust Resource*, a National Underwriter Company publication).

tax savings against the increasing unified credit and the possibility of repeal of the estate tax.

IMPACT OF THE REVERSE QTIP ELECTION

The generation-skipping transfer (GST) tax, discussed in Chapter 18, is having an increasing impact on the design of the QTIP trust in new estate plans. The plan must be designed in such a way as to obtain the maximum use of the GST exemption that is available to all clients. For 2004 to 2009, the generation-skipping exemption is the same as the unified credit applicable exclusion. This means that in a typical plan, the bypass trust will receive an amount equal to the estate tax unified credit applicable exclusion amount and the same amount of generation-skipping exemption will be allocated to that trust in order to shelter it from generation-skipping taxes. However, after 2010, the unified credit applicable exclusion is scheduled to be $1,000,000, and the generation-skipping exemption to be $1,000,000 indexed for inflation. At that time, the generation-skipping exemption will be more than the unified credit applicable exclusion amount.

Even in 2004 to 2009, it is possible that the GST exemption and estate tax unified credit applicable exclusion will be unequal at death. That could occur if a person made a large lifetime gift that will reduce the value of the bypass trust below the person's available generation-skipping exemption. So the amount that could pass GST tax free is greater than the amount that can pass at death free of federal estate tax.

In such cases, the question arises of how to fully use the decedent's excess generation-skipping exemption. Congress has provided that the exemption can be allocated to a QTIP trust, on the basis of what is called the "reverse QTIP election." Under that election, even though a marital deduction is claimed for estate tax purposes for assets placed into a QTIP trust, the estate can elect to treat the trust, solely for GST purposes, as if it is still part of the decedent's taxable estate. In that case, the GST exemption can be allocated to it and shelter it from any future GST tax, as discussed in Chapter 18.

However, the law provides that the reverse QTIP election can only be made as to a "separate" QTIP trust. This means that if the total amount to be allocated to the QTIP trust for marital deduction purposes exceeds the GST exemption available, it will be necessary to create two QTIP trusts, one to offset the remaining GST exemption, and the other to take advantage of the remaining marital deduction.

Example. Assume the total value of the decedent's taxable estate is $4,000,000 in 2006, and the decedent made a previous taxable gift of $500,000 protected by the unified credit. An amount equal to the remaining $1,500,000 ($2,000,000 - $500,000) of his unified credit applicable exclusion will be placed in a bypass trust; $2,500,000 ($4,000,000 - $1,500,000) to a QTIP trust. If the executor chooses to allocate $1,500,000 of the $2,000,000 GST exemption to the bypass trust, and $500,000 to the QTIP, it will be necessary to split the one QTIP trust into two trusts, a reverse QTIP in the amount of $500,000, and a regular QTIP in the amount of $2,000,000. According to private rulings, these trusts may have identical terms.

To implement this planning, most wills and trusts now contain specific provisions for dividing one QTIP trust into two shares, frequently based on a formula to reflect the amount of GST exemption the executor elects to allocate to the QTIP.

AB TRUST VERSUS ABQ TRUST

In some cases, pre-1982 trusts were amended to take advantage of the new optimum marital deduction (no tax due at first spouse's death) by merely changing the provisions allocating assets between trusts A and B so as to reflect the unlimited marital deduction and the unified credit. The result under this AB trust arrangement is that the estate of the first to die will often pass the unified credit applicable exclusion amount ($2,000,000 in 2006) to trust B and the remainder to trust A, subject to the surviving spouse's right to say where it goes at his or her death.

Figure 24.3 shows the results of this AB trust arrangement for Philip Martin's $5,000,000 estate with only $2,000,000 required to be paid to Michael at Kaye's death and $3,675,129 available for Kaye to shift at her death to Butch, her new husband, a result that Philip may not desire.

By changing the marital deduction to a QTIP marital deduction in Figure 24.3 and employing an (A)BQ trust arrangement, Philip can still provide for zero estate tax at his death, provide for Kaye during her lifetime, and still preserve the remaining estate ($6,046,407) for Michael at Kaye's death.

WHAT ARE THE TAX IMPLICATIONS?

1. For a typical revocable intervivos trust, no gift tax is payable upon creation of the trust since the grantor, at all times, has retained the right to terminate the trust.[15]

2. After death, the assets that qualify for the marital deduction (the assets actually going into the power of appointment, estate, and / or "Q" trust) are includable in the decedent's gross estate for federal estate tax purposes, but since they qualify for the marital deduction, they are not subject to estate tax.[16] In many situations, the assets of these trusts will be minimal since the amount paid to the nonmarital bypass trust will reduce what is paid to the marital trust and property passing outside the will may be sufficient to satisfy any marital deduction remaining. For example, if, in 2006, the decedent's adjusted gross estate is $2,725,000, the optimum marital deduction is $725,000 ($2,725,000 less the effective exemption of $2,000,000 = $725,000). If the decedent left $1,000,000 worth of life insurance proceeds (includable in the adjusted gross estate) to his wife, she would already have received more than the maximum optimum marital deduction. It is important to remember that the marital deduction portion, which is established by formula, can be given outright to the surviving spouse instead of in trust.

3. Assets that are not used to fund the marital deduction trusts (A and Q) are, by formula, placed into the family or bypass trust. The value of these assets is includable in the grantor's estate for federal estate tax purposes, but the available unified credit will actually result in zero tax. Further, since the surviving spouse receives no more than the income (and perhaps certain limited powers of appointment) from the bypass trust and did not transfer the property to the trust, at the surviving spouse's death these assets will not be taxed again.[17]

4. During the grantor's lifetime, income produced by any of the assets transferred to a revocable inter vivos trust will be taxed to the grantor since no irrevocable gift had been made and the grantor remained the owner of trust assets and income for both estate and income tax purposes. At the grantor's death, the income produced by trust assets will be taxable to the trust or to the income beneficiary depending on whether the income is accumulated by the trust or paid out to the income beneficiary.[18]

5. In California and certain other states that have placed limits on real property tax increases, certain transfers

of the real property will cause the loss of such limits. However, transfers to revocable trusts where the owner-grantor still has the beneficial ownership and control of the property will not cause a problem. It is at the owner-grantor's death, when the trust becomes irrevocable, that the property tax laws may cause an increase in property tax, a circumstance that must be anticipated and that sometimes can be avoided.

6. EGTRRA 2001 is increasing the estate tax unified credit exemption equivalent (applicable exclusion) in steps from $1,000,000 in 2002 to $3,500,000 in 2009. Also, the generation-skipping transfer tax exemption equals the estate tax exemption equivalent in 2004 to 2009. Both taxes are repealed for one year in 2010. With all of these changes and uncertainty in tax law, drafting for bypass and marital trusts will need to be much more flexible. QTIP elections and disclaimers may also be used to help balance funding of bypass and marital trusts.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Where the draftsman is dealing with community property, it should be noted that one-half of the property already belongs to the surviving spouse, and will not be subject to the "pour over" provisions of the will of the first spouse to die, unless the first spouse specifically indicates his desire to effect distribution of both halves of the community, *and* the surviving spouse acquiesces freely in that distribution.

To the extent the surviving spouse elects to retain his community half of the property outside the trust, then a problem of split ownership and management arises, with the survivor owning one-half of the assets, and the trustee of the trust owning the other half. If the surviving spouse does allow his half of the community property to pass to the trust, it would typically go into the "A" or power of appointment trust, so the survivor retains control over how the assets are distributed during lifetime or at death.

The marital deduction rules apply to community property as well as separate property states, so community property state couples may also elect to defer the payment of any federal estate tax until the survivor's death.

Where a marital deduction is used, it will reduce the tax at the first spouse's death, but it may increase the tax at the second death if the surviving spouse does not use up the marital deduction portion during his lifetime, and result in somewhat higher overall taxes for both estates. However, most couples would prefer to minimize the tax at the first spouse's death in order to leave more assets available for the survivor's support, and take the risk of having slightly higher overall taxes.

In both community and common law states, holding property in joint tenancy (tenancy by the entirety) with right of survivorship between spouses will result in the property going outright to the surviving spouse, regardless of the provisions of the decedent's will. The marital deduction provisions may be drafted to reduce the marital deduction by the value of the assets passing outside the trust and thus still result in the optimum marital deduction amount passing to the spouse, so long as the assets passing outside the will do not exceed the optimum marital deduction amount. However, holding large amounts of property in joint tenancy can defeat the trust planning to a very significant degree since such holdings can be more than the optimum marital deduction and reduce the first to die spouse's estate to less than the unified credit applicable exclusion amount (thus resulting in a portion of the unified credit being wasted).

In many instances, a couple living in a community property state may have separate property as well as community property, and both kinds of property must be considered in determining the amount that will be optimum for the marital deduction.

The laws in Louisiana are unique and particular care should be taken to obtain counsel knowledgeable in Louisiana law and general tax law if a couple settles in or has community property located in Louisiana.

In any event, it is very important for persons who have an estate plan drafted with only separate property in mind to have the plan reviewed and most probably redrafted upon becoming a resident of a community property state.

QUESTIONS AND ANSWERS

Question – What are the disadvantages of an A-B/A-B-Q trust?

Answer – First, if the trust is an inter vivos trust and is currently "funded" (properties placed in the trust during the lifetime of the grantor), then trustee's fees must be paid. This fee can often be minimized or avoided if the grantor serves as trustee, which is permissible in some jurisdictions, or reserves the right and obligation to administer trust assets during lifetime–unless disabled.

Second, after the death of the grantor, the surviving spouse cannot have unlimited control of, or unlimited access to, the assets that have been placed in the nonmarital trust(s). However, it is permissible and safe to enhance the surviving spouse's financial security and flexibility by giving the surviving spouse the right to invade principal, at such spouse's own discretion, to the extent of a noncumulative right to withdraw up to 5 percent of the corpus or $5,000 annually, whichever is greater.[19] It is also possible to give the surviving spouse a HEMS power, the right to invade principal for health, education, maintenance, and support in addition to the income of the nonmarital trust and the greater of $5,000 or 5 percent of the trust's capital. This use of an ascertainable standard would prevent the surviving spouse from being taxed on the trust property.[20]

Furthermore, the trustee (assuming the trustee was an independent party) may be given a power in its sole and absolute discretion to distribute principal to the surviving spouse for any reason satisfactory to the trustee. However, here the surviving spouse has no right to demand a distribution of principal. A further power that can be given to the surviving spouse is the right to appoint during lifetime or at death to and among a specified class of individuals (but this class must exclude the spouse, his estate, his creditors, and the creditors of his estate).[21] For example, the grantor could state that his spouse has the right to appoint by will to and among the grantor's issue, parents, or siblings. However, if the surviving spouse has a right to income from the trust property for life and a power of appointment over trust property during life, exercise of the power of appointment during life will result in a taxable gift of the spouse's life estate in any property appointed to someone else.

Question – What functions does the trustee have in the A-B/A-B-Q trust?

Answer – The trustee will hold the assets placed in the trust during the lifetime of the grantor(s) and will serve as the recipient of life insurance payable to it, as well as property "poured over" from the decedent's will. The trustee will be the legal owner of the assets of both trusts and manage the trusts in accordance with the provisions of the trust agreement. The trust agreement can be either extremely flexible or severely restrictive, depending on the objectives of the grantor.

The trustee's primary duties are twofold: (1) to manage and invest the trust corpus in such a manner as to generate income for the beneficiaries; and (2) to preserve the corpus. The Uniform Prudent Investor's Act, adopted by many states, contains guidelines (and requirements) for investments by a trustee. The trust instrument may in some cases modify the rules under which the trustee will make investments.

In many instances, a corporate fiduciary may be indicated, either as sole or cotrustee, if the estate is sizable or if conflicts in interest are likely to arise between individual trustees.

Question – What are the different ways to write provisions that qualify for the maximum or optimum marital deduction?

Answer – The first is for the testator to leave a specific dollar amount bequest; however, this technique is not recommended since it is impossible, in most cases, to arrive at a dollar amount that will exactly equal the desired marital deduction at the time of the grantor's death with any degree of accuracy.

The second way is use of a funding formula that is geared to the marital deduction provisions of the Internal Revenue Code. Either a pecuniary formula bequest or a fractional share bequest is the formula clause to use. A pecuniary formula bequest is used where the testator wants the spouse to receive a fixed dollar amount (a general legacy). An example of such a clause follows:

> "If my wife, Deborah, survives me, I give, devise, and bequeath to my trustees (in trust "A" or trust "Q") an amount exactly sufficient–and no larger–to reduce the federal estate tax due at my death to the lowest possible amount, after taking into consideration all other property passing to my wife or which has passed to my wife and which qualifies for the marital deduction and after allowance of all applicable credits."[22]

Under this clause, the property qualifying for the marital deduction is paid to the marital ("A" and/or "Q") trusts. The remainder of the property, after satisfying the marital deduction, is bequeathed to the family trust.

Instead of a fixed amount, the testator may want to give the spouse a fractional share of the estate. Here, the sum that goes to the spouse may fluctuate after the decedent's death and, in essence, the spouse receives a share in the residue. In this case, the clause (the fractional share bequest) should read somewhat as follows:

"If my wife, Deborah, survives me, I give, devise, and bequeath to my trustees (in trust A or trust Q) the following fractional share of my residuary estate (before such estate is diminished by the payment therefrom of estate, inheritance, or death taxes):

(a) The numerator of the fraction shall be exactly sufficient–and no larger–to reduce to the lowest possible amount the federal estate tax due at my death, after taking into consideration all other property passing to my wife or which has passed to my wife and which qualifies for the marital deduction and after allowance of all applicable credits.

(b) The denominator of the fraction shall be the value of my residuary estate, before it is diminished by the payment therefrom of estate, inheritance, or death taxes."

IT IS IMPORTANT TO NOTE THAT MANY OTHER PROVISIONS ARE REQUIRED, IN ADDITION TO THE FUNDING FORMULA, IN ORDER TO OBTAIN THE MARITAL DEDUCTION.

Question – Which type of funding formula is preferable?

Answer – This depends upon the circumstances. The most important thing to look at is the type of assets the grantor owns.

If there is a probability of a substantial increase in value during the period of settlement of the trust or estate, then the pecuniary formula clause may have some benefit if it gives the residual amount (after the marital deduction) to the bypass trust. Under these circumstances, any increase in the size of the estate can be shifted to the bypass trust and thus reduce taxation at the survivor's death.

If there is a possibility that the estate may drop in value, then it may be wise to use a pecuniary formula clause that specifies the exact amount to go to the bypass trust and lets the residue go to the marital deduction trust.

In any use of a pecuniary formula clause, it is possible to recognize an income tax where assets that have increased in value since the date of death are used to satisfy distribution to a trust. In these circumstances, a gain can be recognized and taxed.

A fractional share clause avoids the problem of any recognition of income tax gain upon transfer of assets to a trust to fund a bequest. Additionally, it shifts any increase or decrease proportionately to both the marital deduction trust and the bypass trust.

Question – What are some of the advantages of an estate trust over a power of appointment trust?

Answer – Under the estate trust, it is not necessary that all of the income be paid out to the surviving spouse. Instead, some of the income can be accumulated and kept in the trust. Where there is concern for use of income and a great deal of income available, an estate trust may provide more protection for the survivor.

Additionally, the estate trust may in some cases make it easier to retain assets that are not producing income for the trust.

Question – What are the advantages of having the marital deduction pass to a QTIP trust?

Answer – Many advantages exist. One important one is giving the trustee the power to determine how much of the trust is to be taxed at the death of the first spouse to die. Under the QTIP provisions, it is possible to, if it makes economic sense, to pay an up-front estate tax. This may be appropriate if the parties expect an exceptional future increase in the value of the property.

A second important benefit of a QTIP trust is that the grantor can be certain that, at the death of the survivor, the property will go where the grantor wanted the property to go and not merely to the survivor's new friend, new spouse, or new spouse's children (as is the case under the power of appointment trust where the surviving spouse must be given a power to appoint the property at the survivor's death).

Where it is desirable to give the surviving spouse some control over the disposition of assets, e.g., among the mutual issue of the decedent and survivor, the QTIP trust permits the modification of the disposition by the survivor if the grantor wants that to happen.

Last, the QTIP trust is the only optimum marital arrangement by which the grantor's full exemption from the generation-skipping transfer tax can be preserved for the next generation, with the property still benefiting the surviving spouse during the survivor's lifetime and still have no estate tax due at the grantor's death. For deaths occurring in 2004 to 2009, this will be less important because the generation-skipping transfer tax exemption will be equal to the estate tax unified credit exemption equivalent and a reverse QTIP election may not be required.

Question – Can an A-B/A-B-Q trust be set up in an individual's will?

Answer – Yes. This is called a testamentary trust (as contrasted to an inter vivos trust). Rather than have a separate trust instrument and a separate will, the two are combined into the will document. The provisions of the testamentary trust are generally the same as the inter vivos trust provisions.

Question – Are there any drawbacks to setting up the A-B/A-B-Q trust in the will rather than as an inter vivos document?

Answer – Use of a testamentary trust will *require* a probate at the grantor's death. Often there is a delay in probating a will. If the trust were part of the will, it would not function until the will was probated. Thus, if life insurance were payable to a testamentary trust, there could be a delay in getting funds into that trust.

Some states for inheritance tax purposes will tax insurance payable to a testamentary trust as opposed to proceeds payable to an inter vivos trust. This will unnecessarily cause additional costs to the estate.

Question – In a marital deduction trust, what constitutes income that must be paid to the surviving spouse?

Answer – Traditionally, income is generally monies earned by the trust assets, such as dividends, interest, and rental income from real property, and did not include increases in capital. However, many states have adopted the Revised Uniform Principal and Income Act (UPIA) that allows a trustee to invest for "total return". For example, a trustee might invest in a fund that focuses on growth and yields less income than might otherwise be realized. Under the Revised Uniform Principal and Income Act, the trustee could then allocate some of that appreciation to income to make up for the smaller yield, subject to the trustee's fiduciary duty to treat the income beneficiary and the remainderpersons fairly.

ASRS: Sec. 51, ¶280.

CHAPTER ENDNOTES

1. Treas. Reg. §20.2056(b)-5.
2. Treas. Reg. §20.2056(b)-5(a)(4).
3. Treas. Reg. §20.2056(b)-5(f)(4).
4. *Comm. v. Ellis*, 252 F.2d 109 (3rd Cir. 1958), rev'g in part, 26 TC 694.
5. Treas. Reg. §20.2056(a)-1.
6. For special rules that apply when one spouse is a non-U.S. citizen, see Chapter 24.
7. Rev. Rul. 66-86, 1966-1 CB 216.
8. Treas. Reg. §20.2041-1(c).
9. IRC Sec. 2041(b)(2); Treas. Reg. §20.2041-3(d)(3).
10. IRC Secs. 651, 661.
11. Additional requirements must be met in order for a trust to be a qualified subchapter S trust, as outlined in IRC Section 1361(d).
12. IRC Sec. 2044. The property in the trust includable in the surviving spouse's estate under Section 2044 is considered property acquired from a decedent, and thus in the hands of the one to whom the property passes from the surviving spouse has a basis equal to the fair market value of the property at the date of the surviving spouse's death or alternate valuation date (see the discussion of basis in Chapter 19). IRC Secs. 1014(b)(10), 2044(c).
13. It is extremely important to check the applicable state law to be sure that merely naming a trust as life insurance beneficiary will serve as adequate corpus.
14. See Rev. Proc. 64-19, 1964-1 CB 682.
15. Treas. Regs. §§25.2511-2(b), 25.2511-2(c).
16. IRC Sec. 2056.
17. *Est. of Milner v. Comm.*, 6 TC 874 (1946).
18. IRC Secs. 641, 652, 662.
19. IRC Sec. 2041(b)(2); Treas. Reg. §20.2041-3(d)(3).
20. Treas. Reg. §20.2041-1(c)(2).
21. Treas. Reg. §20.2041-1(c)(1).
22. Certain additional provisions must be added to this "funding" formula in order to guarantee the marital deduction. See, e.g., Rev. Proc. 64-19, 1964-1 CB 682.