TRANSFER TAX PLANNING BETWEEN THE DEATHS

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CHAPTER 1.1

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I. INTRODUCTION

The transfer tax situation undergoes many changes between the deaths, because of the benefits given in the federal estate and gift tax system to married couples.

The gift tax provides the married couple gift splitting and no taxable gifts on outright transfers between husband and wife, benefits that are lost when one spouse dies. The appointment of a personal representative for the deceased spouse places a responsibility on the personal representative to make sure that the decedent has complied with the gift tax laws during life.

The estate tax provides a marital deduction in the estate of the first spouse to die that is unable in the estate of the survivor. The potential lack of tax in the first estate may motivate the tax administration of that estate and the unavailability of a marital deduction for the survivor will effect ongoing tax planning.

II. GIFT TAXES

A. Annual exclusion gifts

1. Timing of gifts.

The deceased spouse cannot make additional annual exclusion gifts. More importantly annual exclusion gifts attempted while living must be complete. In the context of annual exclusion gifts we usually think of completion to determine in what year the transfer will be applied against the annual exclusion. When a person dies, the concern is whether the gift was completed prior to death and can be considered an annual exclusion gift or remains included in the decedent's gross estate for estate tax purposes.

The basic rule, that the effective date will be the date the donor relinquishes dominion and control over the transferred property, Treas. Reg, §25.2511-2(b), will have different applications among different kinds of assets.

a. Gifts of real estate

A gift of real estate probably occurs when the deed is delivered to the grantee. If the deed is not delivered to grantee but rather filed by the grantor or the grantor's agent, then the gift occurs upon filing, because before filing occurs the grantor could have revoked the gift.

PLR 8901004 addressed the year in which gifts of real property were made for federal gift tax purposes. On December 27, 1985 the grantor executed a deed of transfer of Parcel A to an irrevocable trust, and on December 30, 1985, executed a deed of transfer of Parcel B to the same trust. Both deeds were recorded on January 6, 1986, and prior to recording the deeds were in the hands of the grantor's attorney who was acting as the grantor's agent. At no time prior to January 6, 1986, were the deeds under the control of the trustee. Citing Kentucky case law that a donor may revoke his intended gift any time prior to delivery and acceptance, the ruling held that because the deeds were under the grantor's dominion and control until 1986, the transfers were not completed gifts until 1986.

b. Gifts of stock

Where the donor delivers a properly endorsed stock certificate to the donee or the donee's agent, the gift is complete for gift tax purposes on the date of delivery, per Treas. Reg. §25.2511-2(b). On the other hand, if the donor delivers the endorsed stock certificate to the donor's bank or broker as agent for transfer to the donee, or to the issuing corporation or its transfer agent, the gift does not occur until the date that title to the stock is transferred to the donee on the books of the corporation. *Id.*

c. Gifts by check

A gift by delivery of a check without more is insufficient to result in a completed gift, because the donor has the right to stop payment before the check is negotiated. The donee must deposit the check in order to complete the gift.

In Estate of *Metzger v. Comm.*, 100 T.C. 204 (TC 1993), *aff'd* 38 F3d 1181 (4th Cir. 1994), the relation back doctrine was applied when four checks were drawn against the donor's checking account on December 14, 1985, and were deposited in the donees' savings accounts on December 31, 1985, but did not clear until January 2, 1986.

Yet, in *Braun Family Partnership v. Comm.*, 66 TCM 780 (1993), the relation back doctrine was not applied where the father wrote a check dated December 31, 1983, to each of his four children, mailing the checks to two of his children and handling the checks to the other two. The checks cleared on January 11, 1984.

The issue of when a completed gift by check also arises where the donor dies prior to collection on the check.

A gift by check to a charity is complete on delivery if the check subsequently is honored by the bank. *Estate of Belcher v. Comm.,* 83 TC 227 (1984).

A donor of a non-charitable gift may revoke a gift by check (by stopping payment on the check) until it is honored by the bank. Such a gift must be honored by the bank before death to be considered a completed gift and excluded from the decedent's estate. Rev.

Rul. 67- 396, 1967-2 C.B. 351; *Estate of Joseph Gagliardi v. Comm*., 89 TC 1207 (1987). The same conclusion was reached by the Tax Court in *Estate of Newman*, 111 TC 81 (1998), where decedent's son had written $95,000 of checks under a durable power of attorney shortly before her death.

A circuit court has sided with the IRS that the "relation back" doctrine is not applicable in the case of non-charitable gifts and the donor is deceased; *Rosono v. U.S*., 245 F.3d 212 (2d Cir. 2001).

This rule for personal checks would not apply apparently to cashier's checks, certified checks, or money orders, provided there is actual delivery of the instrument prior to year end or death. The ability to revoke the instrument remains while the cashier's check, certified check or money order is in the possession of the payor or maker, but becomes irrevocable upon physical delivery of such check or money order. There are no cases dealing with this, however, the conclusions seem reasonable under the rules applicable to commercial instruments.

d. US Government debt

Government debt is transferred by having the debt reissued in the name of the donee. The date of the gift will be the date the government reissues the debt and not necessarily the date instructions are given by the donor to reissue the debt.

B. Split Gifts

The survivor cannot make additional split gifts after the death of the spouse, but can consent that gifts made while the spouse was living be split under certain circumstances.

1. Split gifts generally

Split gifts by spouses are provided for in IRC §2513:

> (a) In general.
> A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse, but only if at the time of the gift each spouse is a citizen or resident of the United States. This paragraph shall not apply with respect to a gift by a spouse of an interest in property if he creates in his spouse a general power of appointment, as defined in section 2514(c), over such interest. For purposes of this section, an individual shall be considered as the spouse of another individual only if he is married to such individual at the time of the gift and does not remarry during the remainder of the calendar year.

Form 709, Part 1, Item 12, asks whether gifts are split:

> **Gifts by husband or wife to third parties.** Do you consent to have the gifts (including generation-skipping transfer) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.)

The 2006 Form 709 Instructions state:

> If you and your spouse agree, all gifts (including gifts of property held with your spouse as joint tenants or tenants by the entirety) either of you make to third parties during the calendar year will be considered as made one-half by each of you if:
> - You and your spouse were married to one another at the time of the gift;
> - If divorced or widowed after the gift, you did not remarry during the rest of the calendar year;
> - Neither of you was a nonresident alien at the time of the gift; and
> - You did not give your spouse a general power of appointment over the property interest transferred.

The point in the introductory paragraph that gift splitting applies to gifts to third parties comes from IRC 2513(a)(1), which says that gifts made to any person other than the donor's spouse can be split. Gifts to the spouse cannot be split.

a. Spouses married

The first and second bullet point comes from IRC § 2513 (a)(1), which states "an individual shall be considered as the spouse of another individual only if he is married to such individual at the time of the gift and does not remarry during the remainder of the calendar year." To the same effect is Treas. Reg. §25.2513-1, Gifts by husband or wife to third party considered as made one-half by each, which says, "an individual is to be considered as the spouse of another individual only if he was married to such individual at the time the gift and does not remarry during the remainder of the 'calendar period' (as defined in §25.2502-1(c)(1))."

Rev. Rul. 73-207, 1973-1 C.B. 409, did not permit gift splitting on the gift of life insurance proceeds because the couple was not married at the time of the gift. A wife owned all of the incidents of ownership in insurance policies on her husband's life and designated their children as the beneficiaries on the policies. When the husband died, the wife filed a gift tax return for the calendar quarter in which the husband's death occurred on which she reported the transfer of the proceeds to the children. The husband's executor signed the "Consent of Spouse" and filed a gift tax return on behalf of the husband that showed

the transfer of the proceeds as made one-half by each spouse. The Service ruled it was not until the moment of the husband's death that the gift was complete but at that moment the marital relationship ceased to exist.

b. U.S. spouses

The third bullet point IRC § 2513 (a)(1) "A gift made by one spouse to any person other than his spouse shall, for the purposes of this chapter, be considered as made one-half by him and one-half by his spouse, but only if a the time of the gift each spouse is a citizen or resident of the United States." Treas. Reg. §25.2513-1(a) states that gifts can be split "only if at the time of the gift each spouse was a citizen or resident of the United States." "If either spouse was a nonresident not a citizen of the United States during any portion of the calendar period, the consent is not effective with respect to any gift made during that portion of the calendar period." Treas. Reg. §25.2513-1(b)(2).

The fourth bullet point comes from IRC § 2513 (a)(1) and Treas. Reg. §25.2513-1(b)(3), which states, "The consent is not effective with respect to a gift by one spouse of a property interest over which he created in his spouse a general power of appointment (as defined in section 2514(c))."

c. Consent

IRC § 2513(a)(2) provides for written consent of both spouses:

> **Consent of both spouses.** Paragraph (1) shall apply only if both spouses have signified (under the regulations provided for in subsection (b) their consent to the application of paragraph (1) in the case of all such gifts made during the calendar year by either while married to the other.

Form 709, Part 1, Item 12, already quoted in part above, states that the spouses consent must be made.

> **Gifts by husband or wife to third parties.** Do you consent to have the gifts (including generation-skipping transfer) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? (See instructions.) (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below.

The spouse's consent is set forth in Form 709, Part 1, Item 18.

> **Consent of Spouse.** I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.
>
> **Consenting spouse's signature date**

According to the 2006 Form 709 Instructions, p. 2, an individual must file a gift tax return to split gifts with his or her spouse (regardless of their amount). But, a husband and wife can agree to split gifts on one return if only the husband or the wife is required to file. If only one spouse is filing a return, then the consent can be made on that return by both spouses signing that return. We know that both spouses need not file split gifts because the Form 709, Part 1, Item 17, asks "Will a gift tax return for this year be filed by your spouse?" and "No" is an acceptable matter. Treas. Reg. §25.2513-2(a)(1) states that if only one spouse files a gift tax return within the time provided for signifying consent, the consent of both spouses shall be signified on that return.

Form 709-A, United States Short Form Gift Tax Return, previously used by married couples to report nontaxable gifts they consent to split, is obsolete. 2006 Form 709 Instructions, p. 4. This instruction first appeared in the 2003 Instructions.

The 2006 Form 709 Instructions say that if husband and wife agree to split gifts, both individual gift tax returns should be filed in the same envelope to help the IRS process the returns and to avoid correspondence from the IRS. 2006 Form 709 Instructions, p. 4. The request to mail both returns in the same envelope, is also made in Form 709, Part I Item 17.

Treas. Reg. §25.2513-2(a)(1), says

> If both spouses file gift tax returns within the time for signifying consent, it is sufficient if
>
> (i)The consent of the husband is signified on the wife's return, and the consent of the wife is signified on the husband's return;
>
> (ii)The consent of each spouse is signified on his own return; or
>
> (iii)The consent of both spouses is signified on one of the returns.

Subsection (2) of the same regulation, states:

> If one spouse files more than one gift tax return for a calendar period on or before the due date of the return, the last return so filed shall, for the purpose of determining whether a consent has been signified, be considered as the return.

d. Consent to all gifts

Treas. Reg. §25.2513-1 (b) says the signed consent applies to all gifts made during the year, with some exceptions:

> . . . Such consent is not effective with respect to gifts made to third parties during such calendar period except as follows:

(1) If the consenting spouses were not married to each other during a portion of the calendar period, the consent is not effective with respect to any gifts made during such portion of the calendar period. Where the consent is signified by an executor or administrator of a deceased spouse, the consent is not effective with respect to gifts made by the surviving spouse during the portion of the calendar period that his spouse was deceased.

(2) If either spouse was a nonresident not a citizen of the United States during any portion of the calendar period, the consent is not effective with respect to any gift made during that portion of the calendar period.

(3) The consent is not effective with respect to a gift by one spouse of a property interest over which he created in his spouse a general power of appointment (as defined in section 2514(c)).

Jones v. Comm., 327 F.2d 98 (4th Cir. 1964), might be used to save gift-splitting where signed consents were inadvertently not obtained if presented with similar facts. Wife signed consents in 1954 and 1955, but inadvertently failed to sign the consents in 1956 and 1957 returns for similar gifts. In *Jones* no taxes would have been assessable if the gifts listed in the returns had been split between the spouses, so there was no issue of joint and several liability for taxes. Consent to gift-splitting for the two years in question was supported by the express consents for gift splitting in returns for earlier years to the same trust. One would not rely on James to not obtain a consent, but would only use it if the consent was inadvertently not obtained. See the discussion below on Rev. Rul. 78-27, that refused to apply the *Jones* reasoning where the gift exceeded the credits and exclusions if gift-splitting were properly elected and would have created joint and several liability.

2. Spouse unable to make consent

In Treas. Reg. §25.2513-2(c), the executor or administrator of a deceased spouse, or the guardian or committee of a legally incompetent spouse, as the case may be, may signify the consent. The regulations under this code section say nothing about the consent being made under a power of attorney for an incompetent spouse.

Treas. Reg. §25.6019-1, Persons Required to File Returns, states that the return can be made by an agent by reason of illness, absence, or nonresidence, if the person liable for the return is unable to make it. Because the consent can be made on the return of each spouse, this would seem to permit the making of the consent on one spouse's return by the agent.

Rev. Rul. 54-6, 1954-1 C.B. 205, ruled that a husband and wife were entitled to gift split, where the wife as donor of a gift prepared her own gift tax return and indicated her husband's consent to gift splitting. She also signed as agent for the husband on his own return. The husband was absent do to active military duty outside the US. He ratified the return and consent executed by his wife within a reasonable time after he was able to do so.

In Rev. Rul. 78-27, 1978-1 C.B. 387, a spouse made a gift the value of which exceeded the credits and exclusion if gift splitting were elected and the spouse as a minor personal convenience signed the other spouse's signature. Approximately a year later, amended returns were filed by both spouses. The Service ruled that the signature of one spouse on the gift tax return was not sufficient to signify the other spouse's consent to gift splitting and the amended returns did not perfect the prior attempt.

3. Timelines of consent

IRC §2513(b)(2) provides for timeliness of the consent.

Time. Such consent may be so signified at any time after the close of the calendar year in which the gift was made, subject to the following limitations—

(A) The consent may not be signified after the 15th day of April following the close of such year, unless before such 15th day no return has been filed for such year by either spouse, in which case the consent may not be signified after a return for such year is filed by either spouse.

(B) The consent may not be signified after a notice of deficiency with respect to the tax for such year has been sent to either spouse in accordance with section 6212(a).

Because these provisions are in the Code, the IRS cannot give regulatory relief under 9100.

This effectively means that upon the death of the first spouse split gifts cannot be elected on late gift tax returns.

4. Revocation of consent

If the consent was effectively signified on or before the 15th day of April following the close of the calendar year, either spouse may revoke the consent by filing in duplicate a signed state of revocation provided the statement is filed on or before such 15th day of April. Treas. Reg. §25.2513-3(a)(1). That regulation also says the a consent that was not effectively signified until after the 15th day of April following the close of the calendar year to which it applies may not be revoked. A consent filed after

April 15 under an extension could not be revoked even if the revocation was filed on or before October 15.

5. Joint and several liability

If consent to the application of the provisions of IRC §2513 is signified as provided in the regulations and not revoked, the liability with respect to the entire gift tax of each spouse for such "calendar period" is joint and several. Treas. Reg. §25.2513-4.

CCA 200205027 advised that where the taxpayer elected to split gifts with her husband, the husband's fraud in valuing a gift did not provide a sufficient basis for applying IRC §6501(c)(1), which provides an exception to the general three year period of limitations in the case of a fraudulent return with the intent to evade tax. The husband gifted stock to his children and hired a return preparer to prepare the gift tax returns for both himself and the taxpayer. The husband gave the return preparer false information as to the value of the stock. The IRS had no reason to believe the taxpayer or the return preparer had any knowledge of the fraudulent undervaluation.

6. Gift splitting and estate inclusion

The consent by one spouse to the gifts of the other does not make the consenting spouse the owner of the property that can result in estate inclusion. Say a spouse consents to split a gift of a life insurance policy on the life of the consenting spouse and the policy is owned entirely by the non-insured spouse. If consenting insured spouse dies within three years of the transfer, gift splitting should not result in inclusion of the policy in the consenting spouse's estate.

In Rev. Rul. 54-246, 1954-1 C.B. 179, the IRS ruled that treating a gift of property owned by his wife to a third party donee as having been made one-half by each (gift splitting), is not deemed to have created in the husband an interest in the property transferred that upon his death would render any part of such property includible in the husband's gross estate.

C. Gift tax compliance

1. Donor deceased

For the deceased donor, the executor or administrator of the deceased donor's estate shall file the 709 on behalf of the donor for gifts made prior to the donor's death. Treas. Reg. §25.6019-1(g). The 2006 Form 709 Instructions, p. 2, are more direct: "If a donor dies before filing a return, the donor's executor must file the return." The executor may elect to gift-split under IRC § 2513 on behalf of the donor.

There is no definition of executor under the gift tax, while IRC §2203 states that the term "executor" wherever is used in the IRC in connection with the estate tax means the executor or administrator of the decedent, or if there is no executor or administrator appointed, qualified, and acting within the US means any person in actual or constructive possession of any property of the decedent.

During life the donor has the obligation to report taxable gifts, but upon death that obligation passes to the executor. If the executor does not report then the gift tax becomes the obligation of the donee of the gift.

The Instructions to the Form 706, p. 4, state that the executor must make a reasonable inquiry as to any gifts in excess of the annual exclusion made by the decedent, or on or behalf of the decedent under a power of attorney, but for which no Forms 709 were filed. A donor who fails to file gift tax returns passes that obligation on to his or her executor.

2. Unreported gifts

The regulations suggest that this amount on Schedule B, Line 3, should be augmented with the amount of any unreported taxable gifts which should have been properly reported for a prior period. Treas. Reg. §25.2504-1(a) states:

> In order to determine the correct gift tax liability for any calendar period it is necessary to ascertain the correct amount, if any, of the aggregate sum of the taxable gifts for each of the "preceding calendar periods" (as defined in § 25.2502-1(c)(2)). See paragraph (a) of § 25.2502-1. *The term "aggregate sum of the taxable gifts for each of the preceding calendar periods" means the correct aggregate of such gifts, not necessarily that returned for those calendar periods and in respect of which tax was paid.* All transfers that constituted gifts in prior calendar periods under the laws, including the provisions of law relating to exclusions from gifts, in effect at the time the transfers were made are included in determining the amount of taxable gifts for preceding calendar periods. The deductions other than for the specific exemption (see paragraph (b) of this section) allowed by the laws in effect at the time the transfers were made also are taken into account in determining the aggregate sum of the taxable gifts for preceding calendar periods. (The allowable exclusion from a gift is $5,000 for years before 1939, $4,000 for the calendar years 1939 through 1942, $3,000 for the calendar years 1943 through 1981, and $10,000 thereafter.) (emphasis added).

The instructions are not clear whether an unreported gift is reported by (1) filing a gift tax return for the year of the unreported gift if no gift tax return was filed for that period or filing an amended return if a gift tax return was previously filed or (2) by directly listing on Schedule B the previously unreported gifts.

Here is what Richard Covey and Dan Hastings say in *Recent Developments – 2006,* 41st Heckerling Institute on Estate Planning, p. 200:

> Dealing with an omission in reporting is particularly challenging with gift tax returns because they are cumulative. Thus, if a gift was omitted on an earlier return, once it becomes known it must be reported on Schedule B as a part of the total gifts amounts for all prior years. Treas. Reg. §25.2504-1(d) provides:
>
> > If interpretations of the gift tax law in preceding calendar periods resulted in the erroneous inclusion of property for gift tax purposes that should have been excluded, or the erroneous exclusion of property that should have been included, adjustments must be made in order to arrive at the correct aggregate of taxable gifts for the preceding calendar periods (under paragraph (a) of this section). However, see §25.2504-2(b) regarding certain gifts made after August 5, 1997.
>
> The meaning of this regulation is uncertain, but it seems consistent with what is said in the second sentence of this paragraph. :

This Covey and Hastings quote seems to say that the correction is made directly on Schedule B.

Notice that the regulation quoted above authorizes the exclusion of gifts that were improperly included in calculating adjusted taxable gifts.

3. Revaluation of gifts

IRC §2504(c) and its regulations address the determination of gifts in prior periods.

> 2504(c) Valuation Of Gifts. --
> If the time has expired under section 6501 within which a tax may be assessed under this chapter 12 (or under corresponding provisions of prior laws) on--
> (1) the transfer of property by gift made during a preceding calendar period (as defined in section 2502(b)), or
> (2) an increase in taxable gifts required under section 2701(d),
> the value thereof shall, for purposes of computing the tax under this chapter, be the value as finally determined (within the meaning of section 2001(f)(2)) for purposes of this chapter.

For transfers prior to August 6, 1997, the IRS took the position that gifts on which no tax was paid could be readjusted as to value, even if the gift was reported on a timely filed gift tax return and statute of limitations had run on the transfer. This is still the law for transfers prior to August 6, 1997, and is stated in Treas. Reg. §25.2504-2(a).

> Gifts Made Before August 6, 1997.
> If the time has expired within which a tax may be assessed under chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) on the transfer of property by gift made during a preceding calendar period, as defined in Section 25.2502-1(c)(2), the gift was made prior to August 6, 1997, and a tax has been assessed or paid for such prior calendar period, the value of the gift, for purposes of arriving at the correct amount of the taxable gifts for the preceding calendar periods (as defined under Section 25.2504-1(a)), is the value used in computing the tax for the last preceding calendar period for which a tax was assessed or paid under chapter 12 of the Internal Revenue Code or the corresponding provisions of prior laws. However, this rule does not apply where no tax was paid or assessed for the prior calendar period. Furthermore, this rule does not apply to adjustments involving issues other than valuation. See Section 25.2504-1(d).

For transfers after August 5, 1997, they cannot be revalued if they are "finally determined," as stated in Treas. Reg. §25.2504-2(b):

> Gifts Made Or Section 2701(d) Taxable Events Occurring After August 5, 1997.
> If the time has expired under section 6501 within which a gift tax may be assessed under chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) on the transfer of property by gift made during a preceding calendar period, as defined in Section 25.2502-1(c)(2), or with respect to an increase in taxable gifts required under section 2701(d) and Section 25.2701-4, and the gift was made, or the section 2701(d) taxable event occurred, after August 5, 1997, the amount of the taxable gift or the amount of the increase in taxable gifts, for purposes of determining the correct amount of taxable gifts for the preceding calendar periods (as defined in Section 25.2504-1(a)), is the amount that is finally determined for gift tax purposes (within the meaning of Section 20.2001-1(c) of this chapter) and such amount may not be thereafter adjusted. The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift including valuation issues and legal issues involving the interpretation of the gift tax law. For purposes of

> determining if the time has expired within which a gift tax may be assessed, see Section 301.6501(c)-1(e) and (f) of this chapter.

This regulation directs us to the regulations under IRC 2001(f) to find what "finally determined for gift tax purposes" means.

IRC §2001(f) provides for finality of gift tax returns in determination of estate taxes.

> IRC Section 2001(f)
> 2001(f) Valuation Of Gifts. --
> (1) In General--
> If the time has expired under section 6501 within which a tax may be assessed under chapter 12 (or under corresponding provisions of prior laws) on--
> (A) the transfer of property by gift made during a preceding calendar period (as defined in section 2502(b)), or
> (B) an increase in taxable gifts required under section 2701(d),
> the value thereof shall, for purposes of computing the tax under this chapter, be the value as finally determined for purposes of chapter 12.
> (2) Final Determination. --
> For purposes of paragraph (1), a value shall be treated as finally determined for purposes of chapter 12 if--
> (A) the value is shown on a return under such chapter and such value is not contested by the Secretary before the expiration of the time referred to in paragraph (1) with respect to such return,
> (B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the taxpayer, or
> (C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.
> For purposes of subparagraph (A), the value of an item shall be treated as shown on a return if the item is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.

The last sentence raises the issue of what is "adequate disclosure" to avoid revaluation of gifts.

4. <u>Adequate disclosure</u>

Adequate disclosure is addressed in the regulations under IRC §6501.

> 301.6501(c)-1(f) Gifts Made After December 31, 1996, Not Adequately Disclosed On The Return--
> (1) In General.
> If a transfer of property, other than a transfer described in paragraph (e) of this section, is not adequately disclosed on a gift tax return (Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return"), or in a statement attached to the return, filed for the calendar period in which the transfer occurs, then any gift tax imposed by chapter 12 of subtitle B of the Internal Revenue Code on the transfer may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time.
> (2) Adequate Disclosure Of Transfers Of Property Reported As Gifts.
> A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides the following information--
> (i) A description of the transferred property and any consideration received by the transferor;
> (ii) The identity of, and relationship between, the transferor and each transferee;
> (iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

Subparagraph (iv) requires a detailed description of the method used to determine the fair market value of the property transferred. That will be discussed below.

Subparagraph (v) requires "A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer."

The regulation in subparagraph (iv) permits submitting an appraisal, discussed below, or submitting detailed description of the method used to determine the fair market value. The detailed description should include:

> financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest;
> any restrictions on the transferred property that were considered in determining the fair market value of the property:
> a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property.

For publicly traded securities, the requirements are met by

> a statement of the exchange where listed;
> the CUSIP number
> the mean between the highest and lowest quoted selling prices on the application valuation date.

For a transfer of an interest in a not actively traded entity, such as a closely held corporation or a family limited partnership, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by the entity.

If the value of the entity or its underlying assets is properly determined on the net value of the assets held by the entity,

> a statement must be provided regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required in this paragraph (f)(2)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest.

This requires extensive disclosure of pyramiding entities without discounts at each level.

5. Disclosure by appraisal

As stated above, the disclosure required by (iv) can be met by an appraisal that meets the requirements of Treas. Reg. §301.6501(c)-1(f)(3):

> Submission Of Appraisals In Lieu Of The Information Required Under Paragraph (F)(2)(iv) Of This Section.
>
> The requirements of paragraph (f)(2)(iv) of this section will be satisfied if the donor submits an appraisal of the transferred property that meets the following requirements--
>
> (i) The appraisal is prepared by an appraiser who satisfies all of the following requirements:
>
> (A) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.
>
> (B) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued.
>
> (C) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and
>
> (ii) The appraisal contains all of the following:
>
> (A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.
>
> (B) A description of the property.
>
> (C) A description of the appraisal process employed.
>
> (D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.
>
> (E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.
>
> (F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.
>
> (G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.
>
> (H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

6. Intra family transfers

Example 2 under Treas. Reg. §25.2504-2(c) suggests that intra family transfers including sales should be reported on a gift tax return to obtain running of the statute of limitations.

> Example 2.
>
> (i) Facts. In 1996, A transferred closely-held stock to B, A's child. A timely filed a Federal gift tax return reporting the 1996 transfer to B and paid gift tax on the value of the gift reported on the return. On August 1, 1997, A transferred additional closely-held stock to B in exchange for a promissory note signed by B. Also, on September 10, 1997, A transferred closely-held stock to C, A's other child. On April 15, 1998, A timely filed a gift tax return for 1997

reporting the September 10, 1997, transfer to C and, under Section 301.6501(c)-1(f)(2) of this chapter, adequately disclosed that transfer and paid gift tax with respect to the transfer. However, A believed that the transfer to B on August 1, 1997, was for full and adequate consideration and A did not report the transfer to B on the 1997 Federal gift tax return. In 2002, A transfers additional property to B and timely files a Federal gift tax return reporting the gift.

(ii) Application of the rule limiting adjustments to prior gifts. Under section 2504(c), in determining A's 2002 gift tax liability, the value of A's 1996 gift cannot be adjusted for purposes of computing the value of prior taxable gifts, since that gift was made prior to August 6, 1997, and a timely filed Federal gift tax return was filed on which a gift tax was assessed and paid. However, A's prior taxable gifts can be adjusted to reflect the August 1, 1997, transfer because, although a gift tax return for 1997 was timely filed and gift tax was paid, under Section 301.6501(c)-1(f) of this chapter the period for assessing gift tax with respect to the August 1, 1997, transfer did not commence to run since that transfer was not adequately disclosed on the 1997 gift tax return. Accordingly, a gift tax may be assessed with respect to the August 1, 1997, transfer and the amount of the gift would be reflected in prior taxable gifts for purposes of computing A's gift tax liability for 2002. A's September 10, 1997, transfer to C was adequately disclosed on a timely filed gift tax return and, thus, under paragraph (b) of this section, the amount of the September 10, 1997, taxable gift by A may not be adjusted for purposes of computing prior taxable gifts in determining A's 2002 gift tax liability.

The donor should have listed the transaction with adequate disclosure on a gift tax return. The regulations, Treas. Reg. §301.6501(c)-1(f)(4), address this and permit reporting some intra family transactions on an income tax return.

Adequate Disclosure Of Non-Gift Completed Transfers Or Transactions.

Completed transfers to members of the transferor's family, as defined in section 2032A(e)(2), that are made in the ordinary course of operating a business are deemed to be adequately disclosed under paragraph (f)(2) of this section, even if the transfer is not reported on a gift tax return, provided the transfer is properly reported by all parties for income tax purposes. For example, in the case of salary paid to a family member employed in a family owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns. For purposes of this paragraph (f)(4), any other completed transfer that is reported, in its entirety, as not constituting a transfer by gift will be considered adequately disclosed under paragraph (f)(2) of this section only if the following information is provided on, or attached to, the return--

(i) The information required for adequate disclosure under paragraphs (f)(2)(i), (ii), (iii) and (v) of this section; and

(ii) An explanation as to why the transfer is not a transfer by gift under chapter 12 of the Internal Revenue Code.

Reliance on this provision, will permit the parties to have adequate disclosure without the extensive description required by (f)(2)(iv) or meeting the appraisal requirements of (f)(3).

7. Split gifts

If a married couple decides to split gifts, then the consenting spouse meets the requirements of adequate disclosure if the gift tax return filed by the donor spouse (the spouse that actually made the gift) satisfied the adequate disclosure requirements of the regulations with respect to that gift. Treas. Reg. §301.6501(c)-1(f)(6).

III. ESTATE TAXES

A. Disclaimers

An early issue to be addressed when there is a death and a taxable estate is whether a disclaimer should be a part of the administration. With a qualified disclaimer, the property is treated as if it never had been transferred to the disclaimant, and "the disclaimant is not regarded as making a gift to the person who receives the property because of the qualified disclaimer." 2006 Form 709 Instructions, p. 2.

Treas. Reg. §25.2511-1(c)(1) states that the gift tax applies to gifts indirectly made, but does not apply to the donee if, as a result of a qualified disclaimer by the donee, the interest passes to a different donee. That subparagraph also states that the gift tax does not apply to a donor if, as a result of a qualified disclaimer by the donee, a completed transfer of an interest in property is not effected.

1. Disclaimers generally

A disclaimer is a refusal to accept a bequest or gift. When administering an estate and preparing an estate tax return, it can be used to revise the decedent's dispositive plan to accomplish tax or non-

tax results. To accomplish the tax results, the disclaimer must be a "qualified disclaimer" that meets the requirements of IRC § 2518 and Treas. Reg. §25.2518-1 through §25.2518-3. Disclaimers only rarely occur on transfers by gifts.

If a qualified disclaimer is made, the federal estate, gift and generation-skipping transfer tax provisions are to apply with respect to the property interest disclaimed as if the disclaiming person (sometimes called the "disclaimant") had predeceased the donor-decedent or died before the date on the transfer creating the interest was made. With a "qualified disclaimer" the disclaimed property is treated as if it was never transferred to the disclaimant, and the disclaimant is not treated as having made a gift to the person to whom the interest passes by reason of the disclaimer.

2. Qualified disclaimer requirements

The 2006 Form 709 Instructions, p. 2, gives this list of conditions that must be met for a refusal to be a qualified disclaimer.

> 1. The refusal must be in writing.
> 2. The refusal must be received by the donor, the legal representative of the donor, the holder of the legal title to the property to which the interest relates, or the person in possession of the property within 9 months after the later of:
>   a. The day on which the transfer creating the interest is made or
>   b. The disclaimant must not have accepted in interest or any of its benefits.
>   4. As a result of the refusal, the interest must pass without any direction from the disclaimant to either:
>   a. The spouse of the decedent or
>   b. A persons other than the disclaimant, and
>   5. The refusal must be irrevocable and unqualified.

A qualified disclaimer must be the requirements of both IRC §2518(a) and applicable state law.

Requirement 2. presents the most difficulty because under the federal rules, there are no extensions and under state law there may be no holiday or weekend rules. The six month extension to file Form 706 or Form 709 has no counterpart in either Texas disclaimer law, Tex. Prob. Code Section 37A, or Federal disclaimer law.

For qualified disclaimers of property interest from a decedent's estate, Texas law adds the requirement that the disclaimer document be filed with the probate court. Texas disclaimer law has no holiday rule, meaning that if the date nine months after the date of death is on a Monday that is a legal holiday, or on a Saturday or Sunday, then the disclaimer must be filed at the courthouse by the close of business the previous business day.

Further, the requirement that it be received by the personal representative before nine months have run, creates a tremendous problem if the personal representative is out of the county or unavailable when the nine month date is expiring.

The 2006 Form 709 Instructions, p. 2, point out that the nine month period for making the disclaimer generally is determined separately for each taxable transfer. (For a decedent's estate the nine month period runs the same on all transfers.) For gifts the nine month period begins on the date the transfer is a completed transfer for federal gift tax purposes.

3. Non-acceptance of property

To be a qualified disclaimer, the disclaimant must not have accepted the property or any of its benefits. When a beneficiary who disclaims an interest in property is also a fiduciary, actions taken by the disclaimant in the exercise of fiduciary powers to preserve or maintain the disclaimed property are not treated as an acceptance of the property or its benefits, but a disclaimant cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed property.

4. Non-qualified disclaimers

For a disclaimer that is not a qualified disclaimer, the disclaimant will be treated as having received the interest and potentially as having made a gift to the ultimate recipient. Treas. Reg. §25.2518-1(b). A non-qualified disclaimer may be a taxable transfer that must be reported on a gift tax return unless that transfer can qualify the for the annual exclusion.

5. What can be disclaimed by whom

Under Tex. Prob. Code §37A "property" may be disclaimed by any "beneficiary."

> "property"...shall include all legal and equitable interests, powers, and property, whether present or future, whether vested or contingent, and whether beneficial or burdensome, in whole or in part.

In defining "beneficiary," the statute lists some of the types of property within the property definition.

> "[B]eneficiary" includes a person who would have been entitled, if the person had not made a disclaimer, to receive property as a result of the death of another person by inheritance, under a will, by an agreement between spouses for

> community property with a right of survivorship, by a joint tenancy with a right of survivorship, or by any other survivorship agreement, account, or interest in which the interest of the decedent passes to a survivorship beneficiary, by an insurance, annuity, endowment, employment, defined compensation, or other contract or arrangement or under a pension, profit sharing, thrift, stock bonus, life insurance, survivor income, incentive, or other plan or program providing retirement, welfare, or fringe benefits with respect to an employee or a self-employed individual.

This language permits disclaimer of property as that term is commonly understood but also the benefits of an expense or tax allocation clause or provision.

6. Preparing disclaimers

Disclaimers are legal documents that must be prepared with the utmost care to make certain that the disclaimed property passes to the intended person. The disclaimer draftsperson should have the draft disclaimer reviewed by an experienced, knowledgeable practitioner to make sure the disclaimer plan works. The wise preparer drafts disclaimer documents with caution to avoid making taxable gifts.

B. Valuation issues

Because of the availability of the marital deduction for estate taxes in the estate of the first to die, there may be a temptation to place high values on assets in the first estate in anticipation of sale of those assets. High basis resulting from high valuation will result in low or no capital gains. This temptation to over value assets does not occur where estate tax will be paid.

1. Undervaluation penalties in estates

IRC § 6662(a) and (g) provide a 20% penalty for the underpayment of estate tax of $5,000 or more when the underpayment is attributable to valuation understatements. A valuation understatement occurs when the reported value of property is 65% or less of the actual value of the property. (Prior to the Pension Protection Act of 2006 a gross valuation understatement occurred in any property on the return was valued at 50% or less of the value determined to be correct; the percentage adjustments under the Pension Protection Act of 2006 apply to returns filed after August 17, 2006.) The valuation understatement penalty increases to 40% if there is a gross valuation understatement, which occurs if any property on the return is valued at 40% or less of the value determined to be correct. IRC § 6662(h).

2. Understatement of income tax

The IRC § 6662(d)(2) penalty also applies to an understatement of income tax where the understatement is due to overstating an asset's value on an estate tax return of no adverse immediate estate tax consequences, where the marital deduction is relied upon and overstating the basis on the asset. Then when the asset is sold and the income tax is understated, the valuation penalty will be applied.

3. Avoiding the penalty

No penalty is imposed with respect to any portion of an understatement if reasonable cause can be shown for such portion and the taxpayer acted in good faith with respect to such portion. IRC § 6664(c). However, under the Pension Protection Act of 2006, the reasonable cause exception to the accuracy related penalty no longer applies in the case of a gross valuation misstatement. IRC §6664(c)(2).

The regulations under Section 6664 primarily address undervaluation for income tax purposes and at no time specifically addresses understatement for estate tax purposes.

> (b) *Facts and circumstances taken into account*—(1) *In general.* The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances.…Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.
>
> Treas. Reg. §1.6664-4(b)(1)

The regulations address advice from professionals in general.

> (c) Reliance on opinion or advice—(1) Facts and circumstances, minimum requirements. All

> facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.
>
> (i) All facts and circumstances considered. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances.…In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.
>
> (ii) No unreasonable assumptions. The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true…
>
> Treas. Reg. §1.6664-4(c)(1)

Specific mention of reliance on appraisals is brief.

> Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of the property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used.
>
> Treas. Reg. §1.6664-4(b)(1)

In *Estate of Thompson v. Comm.*, 88 TCM 48 (2004), the Tax Court addressed the accuracy-related substantial understatement penalties on an estate tax valuation understatement based upon an appraisal of a closely held business interest. The taxpayer's value was $1.75 million, the Service's expert arrived at the value of $32.4 million, and the court determined the value to be $13.5 million. There were facts regarding the appraiser and the appraisal unfavorable to the estate. The company was located in New York City, yet the estate hired an attorney who lived in Alaska to appraise the interest. The New York State surrogate's court granted the attorney limited estate administrative powers to represent decedent's estate in connection with the anticipated audit of the estate tax return and handling the anticipated negotiations with the Service over the value. The estate acknowledged that it hired the Alaska attorney, whom the family learned about from an attorney for the decedent's family who had met the Alaska attorney on a fishing trip, to have the audit conducted in Alaska where the attorney believed and apparently represented to the estate's representative that he would be able to obtain a more favorable valuation of the stock. The Tax Court noted that the Alaska attorney "impressed us as too inexperience, accommodating, and biased in favor of the estate" while the Service's expert "appears to have selected his comparable companies in a casual manner… made significant errors in his calculations and analysis, and he made questionable and inadequately explained adjustments.…" Although this was an estate tax case, the court referenced the income tax regulations under Section 6664 without comment as to their application to estate taxes. The court concluded it was inappropriate to impose the accuracy-related penalty, because the valuation was particularly difficult and unique; comparable companies were not found; valuation of the interest under the capitalization of income and under the discounted cashflow methods involved a number of difficult judgment calls; the Service's estate made significant errors in his various calculations; the evaluation of intangible risks and opportunities as to the Internet was difficult and imprecise; while the experts for the estate were aggressive in their relatively low valuation of the interest, the Service's expert was aggressive in a relatively high valuation; and the court's valuation was closer to the estate's valuation than to respondent's valuation.

The imposition of accuracy-related negligence penalties were at issue in the notable case of *Estate of Schauerhamer v. Comm.*, TC Memo 1997-242, in which partnerships were disregarded and the underlying assets were included in the gross estate under IRC § 2036(a) because decedent retained enjoyment of the transferred assets; decedent and her family had an implied understanding that she would retain economic benefits post-transfer; and the decedent used partnership income, which she deposited in her personal bank account for her personal benefit. The court held the estate was not

liable for the accuracy-related penalty for negligence because the estate acted reasonably and in good faith in relying on the advice of tax professionals and property appraisers.

In *Sammons v. Comm.*, 838 F.2d 330 (9th Cir. 1988), the court said that reasonable reliance on an appraisal avoids the negligence penalty. The case involved the proper income tax charitable deduction allowed on a donation of American Indian artifacts to a museum. The taxpayers paid $140,000 for a collection of artifacts from a dealer that paid $60,000 for it. The priest who founded the museum advised the taxpayers that the entire collection had a fair market value in excess of $500,000. The collection was appraised at $540,185 and $548,380. The Tax Court found that an appraisal of $422,440 was performed by exceptionally well qualified appraisers. Because negligence within IRC § 6653(a) [now IRC § 6662] is measured by the "reasonable, prudent person" standard, the IRS argued that because the taxpayer was a successful and sophisticated businessman, he should have known that it was unreasonable to claim a deduction in an amount that far exceeded the cost of the donated items, especially when the items had been held for such a brief period, nine months, before the contribution was made, and the taxpayer argued that the claimed deduction was not unreasonable because a reasonable and prudent person is entitled to rely on an expert appraiser's valuation of an art collection. The circuit court found that the taxpayer's reliance on a $548,380 appraisal was at least "reasonably debatable" and the IRC § 6653(a) [now IRC § 6662] negligence penalty was improperly assessed. The court then found that this was in accordance with what the Tax Court has previously held:

> This conclusion accords with cases decided by the Tax Court. In *Biagiotti v. Commissioner*, the Tax Court found that although the taxpayers' expert appraiser's report was not entitled to any probative weight in determining the fair market value of a collection of Pre-Columbian artifacts, imposing a negligence penalty was inappropriate because the taxpayers had no reason to question their expert's ability or reliability. [FN3:In *Biagiotti*, the taxpayers relied on a valuation report prepared by an appraiser whose reputation for credibility and reliability was less than pristine. See, 52 TCM (CCH) at 590. The taxpayers, however, had no reason to suspect that their expert routinely prepared inflated valuation reports. *See id*. at 595.] *Biagiotti v. Commissioner*, 52 TCM (CCH) 588, 595 (1986). Indeed, the Tax Court in *Biagiotti* specifically stated that "the difference between [the taxpayers'] cost and [their expert's] appraised value does not necessarily indicate that [the taxpayers] knew or should have known the appraisals were inflated." *Id*. Similarly, in *Broad v. Commissioner*, 52 TCM (CCH) 12 (1986), and *Lightman v. Commissioner*, 50 TCM (CCH) 266 (1985), the Tax Court reversed the Commissioner's imposition of a negligence penalty when the taxpayers reasonably relied on an expert's valuation of donated property that was subsequently rejected by the Tax Court. "Nothing in the record indicates [the appraisals] were not made in good faith and justifiably relied on by the [taxpayers]." *Lightman*, 50 TCM (CCH) at 271. When a taxpayer exercises due care in obtaining an appraisal of fair market value, *Biagiotti*, 52 TCM (CCH) at 595, and the taxpayer presents "some proof" in support of the asserted fair market value, reasonable reliance on a valuation report does not amount to negligence. See *Broad*, 52 TCM (CCH) at 15.

Reasonable reliance on an appraisal may avoid negligence, but if there is a potential question, then prepare a documented determination as to why reliance is reasonable.

Estate of True v. Comm., TC Memo 2001-167, imposed the undervaluation penalty after finding that the taxpayers did not act in good faith. On gift tax returns subject to review upon the taxpayer's death, the decedent did not engage a professional appraiser to value the transferred interests in partnerships. On the estate tax return the decedent's closely held companies were reported as cash in his living trust because under buy-sell agreements the sales were deemed to have been transacted as of the day before decedent's death. The estate hired an appraiser and instructed him to disregard book values, yet most of his values were approximately book value. Two of the book values were less that 20 percent and 30 percent of the appraiser's value, yet the estate used book value. The reasonable cause exception to the accuracy-related penalties did not apply as the facts of record indicated that the estate did not exercise ordinary business care and prudence in attempting to assess the proper estate and gift tax liabilities. The decedent and his personal representatives had substantial sophistication in legal, valuation, and tax matters; and they were accustomed to working with and using lawyers on both tax and non-tax matters. They did not rely on professional appraisals or obtain professional advice. This case suggests that it may be an open question whether the determination whether the percentage threshold for a substantial or gross valuation understatement had been reached is made on a property-by-property basis.

C. Estate tax marital deduction

1. Qualification for the marital deduction

a. Citizenship

The decedent must be a citizen or resident of the United States. The marital deduction is generally not allowed if the surviving spouse is not a U.S. citizen. The marital deduction is allowed for property passing to a non-citizen spouse in a "qualified domestic trust" (QDOT) or if such property is transferred or irrevocably assigned to such a trust before the estate tax return is filed. Also, if the spouse becomes a U.S. citizen before the return is due, and the spouse was a resident of the U.S. at all times after the date of the death of the decedent and before becoming a citizen of the U.S., the deduction will be allowed. IRC § 2056(d)(4). Good practice suggests that the preparer early on confirm the citizenship of the surviving spouse, so there is adequate time to meet the QDOT requirements.

Tasteful and discreet inquiry can be made by asking the surviving spouse, early in the preparation of the return, these questions set forth at the beginning of Schedule M, which must be answered to complete the return.

2a. In what country was the surviving spouse born? ____

b. What is the surviving spouse's date of birth?

____

c. Is the surviving spouse a U.S. citizen? [Yes or No] ____

d. If the surviving spouse is a naturalized citizen, when did the surviving spouse acquire citizenship? _

e. If the surviving spouse is not a U.S. citizen, of what country is the surviving spouse a citizen?

____

The Instructions to the Form 709 do not elaborate on these questions.

b. Spouse

The decedent must be survived by a *spouse.*

(1) Texas law

The decedent and the significant other (if of the opposite sex) may be married by ceremony, TEX. FAM. CODE § 2.001 *et seq*., by written declaration, TEX. FAM. CODE § 2.401(a)(1), or by common law, TEX. FAM. CODE, §2.401(a)(2). A substantial gift to a spouse is less expensive than the same gift to a mere friend. Texas law does not recognize same sex marriage as valid. TEX. FAM. CODE §1.01 (Vernon's 1993). A ceremonial marriage between a man and a transsexual born as a man, but surgically and chemically altered to have the physical characteristics of a woman, was held not valid in *Littleton v. Prange*, 9 S.W.3d 223, 225-226 (Tex. App.--San Antonio 1999). This Texas case remains the leading case in the United States on this question.

(2) Federal law

In determining the meaning of any Act of Congress, any ruling, regulation, or interpretation of the United States administrative bureaus and agencies, the word "marriage" means only a legal union between one man and one woman as husband and wife, while the word "spouse" refers only to a person of the opposite sex who is a husband or a wife. Defense of Marriage Act, Pub. L. 104-199, 1/0 Stat. 2419 (1996) Sec. 3, 1 U.S.C. §7. Thus, neither a same sex marriage under Massachusetts law nor a civil union under Vermont state law will be recognized by the Internal Revenue Service as creating a spouse for federal estate tax marital deduction purposes.

c. Survival of spouse

The decedent must be *survived* by a spouse. If state law, the will, or an instrument of transfer, provides a survivorship requirement, then the spouse must meet that survivorship requirement. For example, a bequest by will of all of the residuary to the surviving spouse if the spouse survives by 6 months means that the spouse must survive by at least 6 months for the gift to qualify for the marital deduction. It is possible that neither spouse survives the other.

(1) State survivorship law

Section 47 of the TEXAS PROBATE CODE provides that a person who fails to survive the decedent by 120 hours is deemed to have predeceased the decedent unless the decedent's will provides otherwise. TEX. PROB. CODE 47 (Vernon's 1993). The applicable state survival law must be met to the extent not overruled by the testamentary instrument.

(2) Six months maximum

If a period of survival is required, the period cannot exceed six (6) months or for any period that could exceed six (6) months after the decedent's death, or the transfer will not qualify for the marital deduction. IRC § 2056(b)(3)(A). For example, a will requirement that the spouse must survive the period of administration does not qualify for the marital deduction because the period of administration may exceed six (6) months.

(3) Simultaneous death

The regulations contain special requirements where the order of death of the spouses cannot be

determined, and there is no presumption provided by local law or the will.

> If the order of deaths of the decedent and his spouse cannot be established by proof, a presumption (whether supplied by local law, the decedent's will, or otherwise) that the decedent was survived by his spouse will be recognized as satisfying paragraph (b)(1) of Section 20.2056(a)-1, but only to the extent that it has the effect of giving to the spouse an interest in property includable in her gross estate under part III of subchapter A of chapter 11. Under these circumstances, if an estate tax return is required to be filed for the estate of the decedent's spouse, the marital deduction will not be allowed in the final audit of the estate tax return of the decedent's estate with respect to any property interest which has not been finally determined to be includable in the gross estate of his spouse. Treas. Reg. §20.2056(c)-2(e).

d. Receipt of property by spouse

The property must pass *from the decedent* to the surviving spouse in some manner. The property may pass by bequest or devise, by operation of law (survivorship or intestacy), by being the appointee of the decedent's exercise of a power of appointment or in default of a non-exercise of a power of appointment, by being a beneficiary of insurance proceeds, by transfer of property during decedent's lifetime that is includable in decedent's estate, by a survivor interest in an annuity, by disclaimer of an interest by another person resulting in the disclaimed property passing to the surviving spouse, and by the surviving spouse's exercise of any of his or her rights to receive property under the Texas Probate Code. The value of any property that does not pass from the decedent to the surviving spouse may not be deducted on Schedule M. In *U.S. v. Stapf*, 375 U.S. 118 (1963), the Supreme Court held that the marital deduction was limited to the net economic benefit received by the surviving spouse. This is further discussed below in "<u>Property interests not deductible on Schedule M</u>."

2. <u>Terminable interest rule</u>

An interest passing to the surviving spouse will not be deductible if, due to lapse of time, occurrence of an event, or the failure of an event to occur, the interest of the spouse will terminate and pass to another person. IRC § 2056(b); Form 706, p. 28. For example, if the use and benefit of the property terminates upon the remarriage of the spouse, then the interest is terminable and does not qualify for the marital deduction. Below is an important exception for qualified terminal interest property (QTIP) trust.

a. Examples of terminable interests

A testamentary trust that distributes all income to the spouse for 20 years (or until the spouse's earlier death), when the trust terminates and is distributed to her children, is a non-deductible terminable interest. A trust providing for distributions to the spouse, unless the spouse remarries, in which event all future trust distributions are to the children, is a non-deductible terminable interest. A will directing the executor to purchase an annuity making fixed payments for the spouse for life is a non-deductible terminable interest. A patent is also a non-deductible terminal interest.

(1) Texas homestead

The rights of the surviving spouse to the homestead are not deductible on Schedule M because the homestead right is a non-deductible terminable interest. The surviving spouse's rights will terminate upon abandonment.

(2) Allocation of income

If any of the income from a trust can be allocated to anyone other than the surviving spouse, the property interest of the surviving spouse will be considered terminable and the property will not qualify for a marital deduction.

b. Examples of interests not terminable

(1) In terrorem clause

An in terrorem or no contest clause conditioning the bequest on the spouse not bringing an action to contest the will does not create a disqualifying terminable interest. *See*, TAM 8735003; Rev. Rul. 82-184, 1982-2 CB 215; *Estate of Tompkins v. Comm.*, 68 TC 912 (1977), *acq.*, 1982-1 CB 1.

(2) Annuity

If decedent, during life, purchased a joint and survivor annuity calling for payments to himself and to his wife who survived him, the value of the survivor's annuity, to the extent that it is included in the gross estate, qualifies for the marital deduction. Even though the interest will terminate on the wife's death, no one else will possess or enjoy any part of the property. Form, p. 28. (Compare this to where the executor is directed to purchase an annuity.)

(3) Trusts

A trust providing that all income will be paid to the child for ten (10) years and then terminating with distributions to the spouse or the surviving spouse's estate, qualifies for the marital deduction to the extent of the value of the remainder interest; no interest in the remainder passes to another person, and the interest of the spouse does not terminate.

(4) Bonds, notes and contracts

"The ownership of a bond, note or other contractual obligation, which when discharged *would not have the effect of* an annuity for life or for a term, is not considered a terminable interest." (Emphasis added.) Form 706, p. 28.

(5) Family allowance

Family allowance payments to the surviving spouse, TEX. PROB. CODE §286, should qualify for the marital deduction.

(6) Restrictions on sale

LTR 9606008 (11/9/95) held that a gift was not a terminable interest. Wife proposed to transfer corporate stock to her husband and claim the marital deduction. The stock is subject to a right of first refusal under which the corporation can meet any offer of a third person. In addition, both the corporation and the wife have an option to purchase the stock at fair market value if the parties divorce or if the husband dies. The IRS held that the gift qualifies for the marital deduction since the husband will receive fair market value of the stock in any case.

3. Allocating expenses to income

a. Estate of *Hubert*

The *Estate of Hubert v. Comm.*, 63 F.3d 1083 (11th Cir. 1995) involved both marital and charitable deductions. The decedent's will permitted the executor to allocate administration expenses between income and principal. The executors allocated some expenses to principal and the balance were allocated to income and deducted on the estate's income tax returns. The Service contended that the marital and charitable deductions should be reduced by all of the administration expenses, not just those charged to principal. The Tax Court held for the taxpayer in 101 TC 314 (1993). The Eleventh Court of Appeals affirmed the Tax Court for the taxpayer, adopting the opinion of the Tax Court as its own and holding that the marital and charitable deductions are not to be reduced by expenses allocated to income where the will permits allocation of expenses to income. This decision was in conflict with the decisions of two other circuits, *Estate of Street v. Comm.*, 974 F.2d 723 (6th Cir. 1992), and *Estate of Burke v. U.S.*, 994 F.2d 1576 (Fed. Cir.), holding to the contrary that the expenses reduced the deductions, whether allocated to principal or income. The Supreme Court granted certiorari in *Hubert*. In *Comm. v. Hubert*, 520 U.S. 93, 104-105 (1997), four justices with three concurring, held that the estate was not required to reduce its marital and charitable deductions by the amount of administration expenses paid from income generated by assets allocated to marital and charitable bequests, notwithstanding Service's contention that dollar-for-dollar reduction was required, where the Tax Court concluded that the discretion granted under the decedent's will to pay expenses out of income was not a material limitation on the right of the surviving spouse and charitable beneficiary to receive income, and the Service did not challenge the estate's determination of expected future administration expenses as of the date-of-death in calculating deduction amounts.

For a case in which a district court applied the holdings of *Hubert* to permit the deduction of accounting fees and mediation expenses along with interest payments on a gift tax deficiency as charges against marital bequest income and not requiring a reduction in the marital deduction, see *Brown v. U.S.,* 88 AFTR2d Par. 2001-5500. The court also found that certain estate tax deductions would require a reduction in the marital deduction. The decedent died in 1993 before the effective date of the regulations discussed below.

b. IRS regulations

The IRS has adopted amendments to Treas. Reg. § 20.2056(b)-4 relating to the effect of certain administration expenses on the valuation of property that qualified for the estate tax marital deduction. The final regulations are effective for estates of decedents dying on or after December 3, 1999. The regulations do not seek to define a material limitation, but rather bifurcate estate expenses into estate transmission expenses and estate management expenses.

(1) Estate management expenses

Management expenses, which do not reduce the value of property for marital deduction purposes, are expenses that would be incurred in investing, maintaining, and preserving the estate property. The marital deduction is not reduced by estate management expenses attributable to and paid from the marital share unless those expenses are deducted on the estate tax return under IRC § 2053.

(2) Estate transmission expenses

Estate transmission expenses, which are those expenses that would not have been incurred but for the decedent's death, reduce the value of the property for marital deduction purposes and must be deducted on the estate tax return. Estate transmission expenses include any administration expense that is not an estate management expense. Examples include probate fees, expenses incurred in construction

proceedings and defending against will contests and appraisal fees, as well as most executor's commissions and attorney's fees.

(3) Unrelated estate management expenses

The marital deduction is reduced by the amount of any estate management expenses paid from the marital share but attributable to a property interest not included in the marital share. Treas. Reg. §20.2056(b)-4(d)(1)(iii)(4).

(4) Estate management expenses deducted on Form 706

The marital deduction must be reduced by the amount of any estate management expenses deducted under IRC § 2053 on the Form 706. Treas. Reg. §20.2056(b)-4(d)(3). This is based upon the Service's reading of IRC § 2056(b)(9) which provides that nothing in IRC § 2056 or the other estate tax provisions permits deduction for the Form 706 more than once with respect to the same decedent. This is bolstered in the regulations by an example. Treas. Reg. §20.2056(b)-4(d)(5).

> Example 4: The decedent, who dies in 2000, has a gross estate of $3,000,000. Included in the gross estate are proceeds of $150,000 from a policy insuring the decedent's life and payable to the decedent's child as beneficiary. The applicable credit amount against the tax was fully consumed by the decedent's lifetime gifts. Applicable State law requires the child to pay any estate taxes attributable to the life insurance policy. Pursuant to the decedent's will, the rest of the decedent's estate passes outright to the surviving spouse. During the period of administration, the estate incurs estate management expenses of $150,000 in connection with the property passing to the spouse. The value of the property passing to the spouse is $2,850,000 ($3,000,000 less the insurance proceeds of $150,000 passing to the child.) For purposes of determining the marital deduction, if the management expenses are deducted on the estate's income tax return, the marital deduction is $2,850,000 ($3,000,000 less $150,000) and there is a resulting taxable estate of $150,000 ($3,000,000 less a marital deduction of $2,850,000). Suppose, instead, the management expenses of $150,000 are deducted on the estate's estate tax return under section 2053 as expenses of administration. In such a situation, claiming a marital deduction of $2,850,000 would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056 and would shield from the estate taxes the $150,000 in insurance proceeds passing to the decedent's child. Therefore, in accordance with section 2056(b)(9), the marital deduction is limited to $2,700,000, and the resulting taxable estate is $150,000.

4. Reduction for taxes paid

The marital deduction is reduced to the extent that taxes or other non-deductible expenses are paid from the property otherwise qualifying for the marital deduction. IRC § 2056(b)(4), making the marital deduction available only for the net value of qualifying property interests that pass to the surviving spouse. Treas. Reg.§ 20.2056 (b)-4. See *Estate of Robert H. Lurie v. Comm.*, TC Memo 2004-19 for application of this rule to a revocable trust.

The express terms of a tax payment clause may control and reduce a maximum marital deduction. In *Estate of Lewis v. Comm.*, TC Memo 1995-168, the decedent's wills and codicils, after specific devises to her children, left the residue in a marital trust for her husband. The tax clause in the will directed that all taxes be paid from the residue. The value of the non-marital gifts exceeded the unified credit amount. Even though the will clearly evidenced the intent of the testatrix to maximize the marital deduction, the express terms of the tax payment clause controlled.

The marital deduction available with respect to a residuary bequest by a decedent to her surviving spouse was reduced by a proportionate share of the estate taxes owed by the estate because the decedent's will dictated that all estate taxes be paid out of the property in the residuary estate. This directive ran contrary to the Texas apportionment statute, which assigns to each person interested in an estate the portion of estate taxes resulting from his or her interests. *Estate of Miller v. Comm.*, 85 AFTR2d 200-1047 (5th Cir. 2000). The author wonders if this could have been handled by the beneficiaries other than the spouse disclaiming the benefits of the will's tax allocation clause.

5. Unlimited marital deduction

The marital deduction is unlimited, except for wills containing an unlimited marital deduction clause executed before September 12, 1981, in which case the marital deduction is limited to 50 percent of the adjusted gross estate. *Estate of Amiel v. Comm.*, 74 TCM (CCH) 239 (1997), is an example of a case imposing the limits of prior law.

a. "Adjusted gross estate"

Watch for formulas that use the now obsolete term "adjusted gross estate." The term "adjusted gross estate" is now defined in IRC § 6166(b)(6), but the limits of prior marital deduction law may be imposed by the IRS, including the 50% limit as well as

disqualifying for the marital deduction the decedent's share of the community property. Look for any intent expressed in the will to adopt tax law in affect at death. See TAM 9048001.

b. Adjusted taxable gifts

Make sure the formula takes into account adjusted taxable gifts or the marital deduction may not be sufficient to result in zero tax. See PLR 8722010.

6. Property interests not deductible on Schedule M

a. Not passing from decedent

Any property that does not pass from the decedent to the surviving spouse cannot be listed on Schedule M. Form, p. 28. Property passing to the surviving spouse that cannot be related to a will provision or provision of a non-testamentary transfer document does not pass from the decedent.

For example, if the decedent's will left all of his property to his children, requesting them to treat the surviving wife "fairly," and the children ask the executor to transfer $100,000 to the surviving wife, that interest to the wife does not pass from the decedent.

b. Will contest settlements

Obviously what the surviving spouse gives up in a will contest will not be subject to the marital deduction. Treas. Reg. §20.2056(c)-(2)(d)(1). The trick is to qualify for the marital deduction what the surviving spouse receives from a will contest settlement. The IRS will look for a true controversy.

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interests depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse. Treas. Reg. §20.2056(e)-2(d)(2).

The regulation permits a marital deduction for property interests surrendered or assigned to the surviving spouse as a result of controversy, but the controversy requirement does not require the presence of actual litigation between the parties. In *Bel v. U.S.,* 452 F.2d 683 (5th Cir. 1971), the court stated,

> We have held that the parties' adverse interests in the decedent's estate and a resulting settlement achieved at the conclusion of arm's length negotiations are sufficient to evidence the existence of a "controversy" within the meaning of the above regulation. In Citizens & Southern we stated that the "will controversy" regulation does not "encompass only those settlements achieved at the end of an armageddon," but by the same token, we think that for purposes of the regulation, there must be at least a skirmish between the settling parties. 452 F. 2d at 694.

The same conclusion was reached in *Estate v. Barrett v. Comm.*, 22 TC 606 (1954) 22 TC 606 (1954). This apparently represents the position of the National Office, as it was stated in TAM 9347003,

> Accordingly a settlement of a claim asserted by the surviving spouse for a share of the decedent's estate must be based on a legally enforceable claim and paid pursuant to a bona fide compromise agreement. The claim must be asserted in good faith and settled in arm's length negotiations and may be arrived at without court action.

It certainly is in accord with the Service's position as stated in Rev. Rul. 66-139, 1966-1 CB 225, where the Service ruled that a valid claim by the surviving spouse to a share in the decedent's estate, made in good faith and settled as a result of arm's length negotiations without any court contest, will qualify as a bona fide claim within the meaning of the regulations. The ruling says that where such claim is paid by the decedent's estate, the payment will qualify for the marital deduction to the extent that the interest that would have passed to the surviving spouse as a result of the completed exercise of the spouse's right (i.e., in a court contest) would have been a deductible interest. As for the lack of a controversy as the predicate upon which the settlement occurs will disqualify the claimed marital deduction, an example is found in *Estate of Allen v. Comm.,* 60 TAM (CCH) 904 (1990).

Further the regulation requires that the surviving spouse prior to settlement possess "enforceable rights" in the decedent's estate, and determining the existence of enforceable rights will be a question of state law that depends up on the property interests held and transferred by the decedent. *Estate of Brandon v.*

Comm., 828 F.2d 493 (8th Cir. 1987). Yet, as a result of *Comm v. Bosch*, 378 US 456 (1967) the federal courts in tax matters may not be bound by a lower state court's determination of property interests where the lower court fails to apply the law of the highest court of the state. Under *Ahmanson Foundation v. United States*, 674 F. 2d 761 (9th Cir. 1981), the federal courts need not honor the parties characterization of property rights under a settlement agreement.

In *Ahmanson Foundation*, the circuit court held that property distributed to a spouse pursuant to a compromise settlement will be treated as passing from the decedent for marital deduction purposes, only if the distribution represents a good faith settlement of an enforceable claim. "[E]ither a good faith settlement or a judgment of a lower state court must be based on an enforceable right under state law properly interpreted, in order to qualify as 'passing' pursuant to the estate tax marital deduction." *Id.* at 674, citing *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). Hence the federal courts will make an independent determination of the presence of enforceable rights in the surviving spouse. *Estate of Brandon v. Comm.*, 828 F. 2d493 (8th Cir. 1987).

Estate of Huber v. Comm., 101 TC 314 (1993) (state court's findings do not govern federal court's determination regarding validity and enforceability of spouse's claims under state law; settlement distributions qualified for marital deduction because they reflected what the surviving spouse could recover from pursuing rights under state law to challenge decedent's will and codicil; *Estate of Depaoli v. Comm,.* 66 TCM (CCH) 1493 (1993) (no marital deduction for settlement distribution compromising inheritance rights not recognized under applicable state law).

While the enforceable rights surrendered or released need to be the same type of property interest as the property interested received, both the property interest surrendered or released and the property interest received by the surviving spouse must be a property interest that qualified for the marital deduction. In *Estate of Carpenter v. Comm.* 67 TCM (CCM) 2400 (1994), the spouse's rights under the will consisted of terminal interests in a trust that would not qualify for the marital deduction because the settlement agreement could not transform a nondeductible interest into a qualified interest. To the same effect is TAM 8236004. The settlement must be in the form that qualifies for the marital deduction. *United States Trust Co. of NewYork v. Comm.*, 321 F. 2d 908 (2d Cir. 1963) (life estate with general power of appointment converted into life estate) ; *Estate of Tebb v. Comm.*, 27 TC 671 (1957) (fee simple converted into life estate). Several Rulings held that the settlement distribution need not be the same property right as the original property as the original property right released where both qualify under IRC § 2056 *Rev Rul.83-107*, 1983-2 CB 159 (cash payment received, commutable dower interest surrendered); TAM 9251002 (trust interest received, elective statutory share released); TAM 9246002 (cash payment received, commutable life estate in real property released).

c. Settlement through disclaimers

While Texas law favors family settlement agreements, in the author's experience, the marital deduction is more certain where accomplished by disclaimers rather than a settlement agreement alone. Qualified disclaimers are discussed below.

In *Davies v. U.S.,* 124 F. Supp. 2d 717 (D. Maine 2000), the decedent's will created an annuity, not qualified for the marital deduction, for his wife for life with the remainder to his children. The spouse filed for her elective share and eventually settled with the estate for a lump sum payment in lieu of the annuity. The estate amended its estate tax return claiming a marital deduction. The IRS denied the marital deduction as did the district court on summary judgment. The annuity itself would not have been entitled to a marital deduction, and although normally an elective share is entitled to a marital deduction, under applicable state law the elective share was offset by the amount of the annuity. Effectively the court disallowed the transmutation of a nondeductible interest into a deductible one. This case, in the author's view, shows the importance of completing litigation before the return is filed and not relying on obtaining the marital deduction on an amendment. To the author, it would seem that the spouse could have disclaimed the annuity and received the elective share without the limits of the annuity terms.

Disclaimers were effectively used in *Estate of Lassiter v. Comm.*, TC Memo 2000-324, to "reform" a testamentary trust to qualify for the marital deduction. The residuary estate passed to a testamentary trust in which principal and income were for the benefit of the surviving spouse and decedent's descendants. The surviving spouse held inter vivos and testamentary special powers of appointment in favor of the decedent's descendants. The descendants disclaimed any right to receive distributions from the trust during the surviving spouse's life. A guardian ad litem disclaimed on behalf of minor or unborn descendants

to receive distributions during the spouse's life. The spouse disclaimed any right to appoint trust property during her life and any right to require the trustee to accumulate trust income during her lifetime. As trustee, the spouse disclaimed the power to distribute trust property to descendants during her life. The disclaimers, all effective under state law and IRC § 2518 were qualified and the trust qualified for the marital deduction because the spouse was entitled to all income from the property payable annually and no person had a power to appoint trust property to any person other than the surviving spouse. A plan of disclaimers in many instances can make an otherwise unqualified transfer qualify for the marital deduction.

d. Taking against the will

If the surviving spouse elects to take against the will (forced share not available in Texas) the property interests offered by the will are not considered to have passed from the decedent to the surviving spouse, and the marital deduction is to be based on the interests the surviving spouse receives pursuant to the election. Treas. Reg. §20.2056(c)-2(c).

This rule as applied in *Davies v. U.S.,* 87 AFTR 2d ¶2001-417 (D.C. Me. 2001), to reduce the amount of the marital deduction for the settlement by the amount the spouse received for surrender of a non-qualified interest. The decedent left a trust that provided for monthly payments of $3,333.00 per month until his surviving wife reached age 65 and $2,500.00 per month thereafter for life. The wife filed a petition to force her elective share pursuant to Maine law. The augmented estate was found to be $2,121,931 and the value of the elective share was $707,310. The estate claimed a marital deduction of $697,490. In a settlement agreement, the widow received a lump some of $260,000 in lieu of the annuity which she surrendered plus a "settlement inducement amount" of $37,400. The IRS contended that neither the lump sum of $260,000, the present day value of the annuity, nor the inducement of $37,400 were deductible and the estate conceded the $37,400 as not deductible. Under Maine law, the elective share to which the widow was entitled was reduced by the value of the annuity interest. The IRS contended and the court held that the settlement received for relinquishment of the non-deductible annuity was not deductible, because it did not "pass" from the decedent as required by the regulation quoted above. The court's holding is brought into question on policy grounds when it cites *Bosch*, 387 U.S. 464 (1967) as

> "noting Congress' definite concern with the elimination of loopholes and escape hatches that might jeopardize the federal revenue as evidence by limitations on allowance of the marital deduction set forth in Sections 2056(b), (c) and (d)."

Bosch was decided before the unlimited marital deduction became law in 1982 under ERTA.

e. Reformation

Reformation of a trust to qualify for the marital deduction where the trust failed to require payment of all income to the spouse, was unsuccessful in *Ropp v. Comm.*, 140 F.3d 1211 (9th Cir. 1998). The order modifying the trust to give the spouse all of the income was not a construction order and there was no evidence that the decedent intended the trust to qualify for the marital deduction. The appeals court concluded that the order was not binding on the IRS. On the other hand, in *Kraus v. Comm.*, 875 F.2d 597 (7th Cir. 1989), *aff'g in part and rev'g and remanding in part*, TC Memo. 1998-154, the evidence was that the decedent intended the trust to qualify for the marital deduction, but the trust lacked the required general power of appointment. By mistake the draftsperson included a limited power of appointment and the local court reformed the trust instrument to restore the deleted general power. After offering evidence that a mistake had been made, the marital deduction was permitted.

In *Estate of Whiting v. Comm.*, TC Memo 204-68, a surviving spouse's interest in a "marital deduction trust" qualified for the marital deduction and the spouse was held to receive a qualifying income interest for life under IRC § 2056(b)(7), despite a trust provision providing for accumulation of income during disability of the spouse. Under Arkansas law, the conflict between the disability accrual provision and the all income distribution provision was resolved in favor of the decedent's manifest intent in the trust agreement to qualify for the marital deduction. The spouse's income distribution right was framed in mandatory and non-discretionary language and the disability accrual provision was seen in conflict, requiring a construction of the instrument. This case should be reviewed to see what must be proven to "reform" a non-qualifying interest.

f. Property otherwise not deductible

(1) Not included in gross estate

To qualify for a marital deduction, the property must have been included in the decedent's gross estate and be listed on Schedules A through I. Property interests not included in the decedent's gross estate may not be deducted on Schedule M. Form 706, p. 28.

(2) Property otherwise deductible

Property deductible under another provision of the Internal Revenue Code will not qualify for the marital deduction. Form 706, p. 28. For example, compensation paid to the spouse for serving as the personal representative is deductible on Schedule J but not on Schedule M, but compensation paid on Schedule J will be income to the surviving spouse, whereas only IRD deducted on Schedule M will be subject to income tax. Property deductible on Schedule M must be reduced by any deductions claimed on another schedule with respect to the same property. Form 706, p. 28.

(3) Mortgaged property

The full value of a property interest that passes to the surviving spouse subject to a mortgage, other encumbrance, or an obligation of the surviving spouse, may not be deducted on Schedule M. Schedule M should include only the net value of the interest after reducing it by the amount of the mortgage, encumbrance or other obligation. Form, Schedule M, p. 28.

(4) Property disclaimed by spouse

The instructions state that Schedule M cannot include "[a]ny property interest disclaimed by the surviving spouse." Form 706, p.28. That is not an accurate statement of the rules regarding disclaimed property. The spouse could disclaim property and have it pass to the surviving spouse in a form that qualifies for the marital deduction. The disqualification for the marital deduction is not that it was "disclaimed by the surviving spouse," but rather that the property does not pass to the surviving spouse as a result of the disclaimer.

(i.) Disclaimer of the Texas homestead

Because the surviving spouse's homestead rights do not qualify for the marital deduction, when the homestead is community property, consider proposing that the surviving spouse disclaim the decedent's half and retain only the spouse's half of the homestead. As a co-tenant, the survivor can occupy the entire residence. The survivor will be responsible for all upkeep and property taxes.

(ii.) Disclaimer of life insurance on survivor

Say that a couple owns as community property a life insurance policy on the life of Husband. If Wife dies first, her estate will include one-half of the value of the policy valued at its interpolated terminal reserve value, not the face amount of the policy. If the non-insured Wife's interest passes to the insured Husband, then upon the death of the insured Husband, all of the proceeds will be included in the insured Husband's estate. If the insured Husband disclaims the non-insured Wife's interest, then, upon the death of the insured Husband, insured Husband's estate will include only one-half of the proceeds.

(iii.) Preserve a minority interest

If a couple own an interest in property or community property, and the interest of the first to die passes to the survivor, then the surviving spouse's estate will not qualify for a minority discount on that item. By disclaiming the interest of the deceased spouse in that item, the surviving spouse preserves the minority discount.

7. Types of marital deductions

a. Outright transfers

An outright (fee simple) transfer to the surviving spouse will qualify for the marital deduction.

b. Marital deduction power of appointment trust

If the spouse is entitled to all of the income for life, payable at least annually, with the spouse having a testamentary general power of appointment, the trust qualifies for the marital deduction, IRC § 2056(b)(5). The trustee may not have the power to accumulate income, but the regulations provide that the trust will qualify if the spouse has the power to require the distribution of all income annually. Treas. Reg. §20.2056(b)-5(f)(8). Generally, the trustee cannot be authorized to invest in non income producing property, although it can be permitted if the surviving spouse has an unlimited power to require the trustee to make the trust reasonably income producing. Treas. Reg. §20.2056(b)- 5(f)(4) & (5). The trust need not be reasonably income producing to the extent it includes a personal residence or property held for the use of the surviving spouse for life. The power of appointment must include the power to appoint to the power holder (the spouse) or the estate of the power holder (the estate of the spouse). Any power granted to the trustee or any other person to appoint the property during the life of the spouse will disqualify the trust. IRC § 2056(b)(5), Treas. Reg. §20.2056(b)-5(g).

c. The estate trust

An estate trust is for the exclusive benefit of the surviving spouse with distribution at the discretion of the trustee. The estate trust can provide for accumulation of income and the property need not be reasonably income producing. Rev. Rul. 68-554, 1968 - 2 CB 412. At the death of the spouse, the entire trust, including all accumulated income, must be distributed

to the estate of the surviving spouse. Treas. Reg. §20.2056(c)-2(b)(iii).

d. QTIPs

These are discussed in the next section.

e. QDOTs

These are discussed below.

8. Qualified terminable interest property (QTIP) trusts

If the surviving spouse has a qualifying income interest for life and the QTIP election is made, the property qualifies for the marital deduction. IRC § 2056(b)(7).

a. Qualifying income interest

A qualifying income interest is an interest where the spouse is entitled to all the income payable at least annually and no person has any power to appoint any part of the property to any person other than the surviving spouse.

It has been held that where the income interest given by the decedent to his surviving spouse was limited to the amount of income property for her "health, education, or support, maintenance, comfort and welfare" in accordance with her "accustomed manner of living" the income interest does not give the surviving spouse virtual ownership of the trust income that is required to make the trust eligible for the marital deduction as required for qualified terminable interest property, even though the wife also was the trustee, *Davis v. Comm.*, 394 F.3d 1294 (9th Cir. 2005). The same result was reached in *C. Aronson Estate*, TC ¶ 45,189(M) were decedent's will failed to qualify for QTIP treatment when it provided that his wife was to receive only as much income from the trust as she "needed" during her lifetime, and in PLR 200505022 where the trust provided that the third party trustee shall distribute net income to the wife "in such amounts and at such times as my wife, in her sole discretion but in consultation with the Trustee, shall desire for her maintenance, education, health or support commensurate with her station in life."

(1) Underproductive property

A corollary of the requirement that the surviving spouse receive all of the income is the requirement that the terms of the trust and the surrounding circumstances considered as a whole not evidence an intention to deprive the spouse of the requisite degree of enjoyment of the income of the trust or use of the trust property. The regulations state that a trust power to retain trust assets that consist substantially of underproductive property will not disqualify the interest if the applicable rules for the administration of the trust require or permit the spouse to require that the trustee either make the property productive or convert it within a reasonable time. Treas. Reg. § 20.2056 (b) 5 (f) (4). For an example of the application of this requirement, see TAM 200339003.

(2) IRA's paid to trust

In Rev. Rul. 2000-2, 2000-1 CB 305, where an IRA holder designated the trustee of a testamentary trust as its beneficiary, the IRS ruled that the executor may elect QTIP treatment for the IRA and the trust under IRC § 2056(b)(7) because (i) the surviving spouse can compel withdrawal and distribution of the income from the IRA and (ii) no other person has a power to appoint any part of the trust property away from the survivor. Specific language of the ruling should be considered.

> Under the terms of the testamentary trust, [the surviving spouse] is given the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and pay that amount to [the surviving spouse]. If [the surviving spouse] exercises this power, the trustee must withdraw from the IRA the greater of the amount of income earned on the IRA assets during the year or the annual minimum required distribution. Nothing in the IRA instrument prohibits the trustee from withdrawing such amount from the IRA. If [the surviving spouse] does not exercise this power, the trustee must withdraw from the IRA only the annual minimum required distribution.

Preparers taking advantage of this ruling must examine both the testamentary trust instrument and the IRA agreement. Because a QTIP election must be made with respect to both the trust and the IRA itself, both the QTIP and the IRA should be listed separately on Schedule M.

(3) IRAs and defined contribution plans paid to trust

Rev. Rul. 2006-26, 2006-22 I.R.B. 939 (5/30/2006), modified and superseded Rev. Rul. 2000-2 to address situations in which the QTIP trust is in a state with the Uniform Principal and Income Act (UPIA), a trust that is a unitrust, and a trust in a state without UPIA. The ruling clarifies circumstances under which the surviving spouse is considered to have a qualifying income interest for life in an IRA where a marital trust is designated as the IRA beneficiary for purposes of election to have the IRA treated as qualifying terminable interest property under IRC § 2057(b)(7). Only at the end of the ruling does it add that the same principles applicable for

IRAs apply to a qualified retirement plan described in IRC §4974(c) that is a defined contribution plan.

Under the factual situation in the ruling, the decedent dies in 2004, at age 68, survived by a spouse. Prior to death, decedent established an IRA described in IRC § 408(a). Decedent's will creates a testamentary marital trust funded with assets in decedent's probate estate. As of decedent's death, the trust is irrevocable and is valid under applicable local law. Prior to death, decedent named the trust as the beneficiary of all amounts payable from the IRA after decedent's death. The IRA is properly included in decedent's gross estate for federal estate tax purposes. The IRA is currently invested in productive assets and the spouse has the right (directly or through the trustee of the trust) to compel the investment of the IRA in assets productive of a reasonable income. The IRA document does not prohibit the withdrawal from the IRA of amounts in excess of the annual required minimum distribution amount under IRC § 408(a)(6). The executor of decedent's estate elects under IRC § 2056(b)(7) to treat both the IRA and trust as QTIP.

Under the trust's terms, all income is payable annually to the spouse for the spouse's life, and no person has the power to appoint any part of the trust principal to any person other than the spouse during the spouse's lifetime. The spouse has the right to compel the trustee to invest the trust principal in assets productive of a reasonable income.

On the spouse's death, the trust principal is to be distributed to the decedent's children, who are younger than the spouse (not necessarily the spouse's children). Under the trust instrument no person other than the spouse and the children has a beneficial interest in the trust including any contingent beneficial interest.

As in Rev. Rul. 2000-2, 2000-1 C.B. 305, under the trusts terms, the spouse has the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income of the IRA for the year and to distribute that income to spouse. If the spouse exercises this power, the trustee is obligated under the trust's terms to withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount under IRC § 408(a)(6) and distribute currently to the spouse at least the income of the IRA. The trust instrument provides that any excess of the required minimum distribution amount over the income of the IRA for that year is to be added to the trust's principal. If the spouse does not exercise the power to compel a withdrawal from the IRA for a particular year, the trustee must withdraw from the IRA only the required minimum distribution amount under IRC § 408(a)(6) for that year.

The trustee of the trust provides to the IRA trustee a copy of decedent's will (the trust's governing instrument) before October 31, 2005, in accordance with Treas. Reg. §1.401(a)(9)-4A-6(b). Because the regulations are satisfied and there are no beneficiaries or potential beneficiaries that are not individuals, the beneficiaries of the trust may be treated as designated beneficiaries of the IRA. In accordance with IRC § 408(a)(6) and the terms of the IRA instrument, the trustee of the trust elects to receive annual required minimum distributions using the exception to the five year rule in IRC § 401(a)(9)(B)(iii) for distributions over a distribution period equal to a designated beneficiary's life expectancy. Because amounts may be accumulated in trust for the benefit of decedent's children, the spouse is not treated as the sole beneficiary and thus the special rule for a surviving spouse in IRC § 401(a)(9)(B)(iv) is not applicable. A spousal rollover is not permitted, so the trustee of the trust elects to have the annual required minimum distributions from the IRA to the trust begin in 2005 the year immediately following the year of the decedent's death.

The amount of the annual required minimum distribution from the IRA for each year is calculated by dividing the account balance of the IRA as of December 31 of the immediately preceding year by the remaining distribution period. Because the spouse's life expectancy is the shortest of all of the potential beneficiaries of the trust's interest in the IRA (including remainder beneficiaries), the distribution period for purposes of IRC § 401(a)(9)(B)(iii) is the spouse's life expectancy, based on the Single Life Table in A-1 of Treas. Reg. §1.401(a)(9)-9, using the spouse's age as of the spouse's birthday in 2005 reduced by one for each calendar year that elapses after 2005.

On the spouse's death, the required minimum distributions with respect to any undistributed balance of the IRA will continue to be calculated in the same manner and be distributed to the trust over the remaining distribution period.

Situation 1 – Uniform Principal and Income Act state. Next the ruling describes a situation where the trust is governed by the laws of a state that has adopted a version of the Uniform Principal and Income Act (UPIA) including a provision similar to section 104(a) of the UPIA providing that, in certain circumstances, the trustee is authorized to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income

and remainder beneficiaries. More specifically, that state has adopted a provision providing that adjustments between income and principal may be made when trust assets are invested under the state's prudent investor standard, the amount to be distributed to a beneficiary is described by reference to the trust's income, and the trust cannot be administered impartially after applying the state's statutory rules regarding the allocation of receipts and disbursements to income and principal.

The state statute incorporates a provision similar to section 409(c) of the UPIA providing that, when a payment is made from an IRA to a trust: (i) if no part of the payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be distributed currently to the beneficiary, the trustee must allocate 10 percent of the required payment to income and the balance to principal; and (ii) if no part of the payment made is required to be distributed from the trust or if the payment received by the trust is the entire amount to which the trustee is contractually entitled, the trustee must allocate the entire payment to principal. The state's statute further provides that, similar to section 409(d) of the UPIA, if in order to obtain an estate tax martial deduction for a trust a trustee must allocate more of a payment to income, the trustee is required to allocate to income the additional amount necessary to obtain the marital deduction.

For each calendar year, the trustee determines the total return of the assets held directly in trust, exclusive of the IRA, and then determines the respective portion of the total return that is to be allocated to principal and to income under the state's version of section 104(a) of the UPIA in a manner that fulfills the trustee's duty of impartiality between the income and remainder beneficiaries. The amount allocated to income is distributed to the spouse as income beneficiary of the trust, in accordance with the terms of the trust instrument.

The ruling continues that similarly, for each calendar year the trustee of the trust determines the total return of the assets held in the IRA and then determines the respective portion of the total return that would be allocated to principal and to income under the state's version of section 104(a) of the UPIA in a manner that fulfills a fiduciary's duty of impartiality. This allocation is made without regard to, and independent of, the trustee's determination with respect to the trust income and principal. If the spouse exercises the withdrawing power, the trustee withdraws from the IRA the amount allocated to income (or the required minimum distribution amount under IRC § 408(a)(6), if greater), and distributes to the spouse the amount allocated to income of the IRA.

Situation 2 – Unitrust income interest. In the second situation, the state law provides that if the trust instrument specifically provides or the interested parties consent the income of the trust means a unitrust amount of 4 percent of the fair market value of the trust assets valued annually. By state procedures, all interested parties authorize the trustee to administer the trust and to determine withdrawals from the IRA in accordance with this provision. The trustee determines an amount equal to 4 percent of the fair market value of the IRA assets and an amount equal to 4 percent of the fair market value of the trust's assets, exclusive of the IRA, as of the appropriate valuation date. In accordance with the trust terms, the trustee distributes the amount equal to 4 percent of the trust assets, exclusive of the IRA to the spouse annually. If the spouse exercises the withdrawal power, the trustee withdraws from the IRA the greater of the required minimum distribution amount under IRC § 408(a)(6) or the amount equal to 4 percent of the value of the IRA assets and distributes to the spouse at least the amount equal to 4 percent of the value of the IRA assets.

Situation 3 – State without UPIA. In the third situation the trust is governed by the laws of a state that has not enacted the UPIA and hence does not have provisions comparable to sections 104(a) and 409(c) of the UPIA. In determining the amount of IRA income the spouse can compel the trustee to withdraw from the IRA, the trustee applies the state law regarding the allocation of receipts and disbursements to income and principal, with no power to allocate between income and principal. The income of the trust is determined without regard to the IRA, and the income of the IRA is separately determined based on the assets of the IRA.

This ruling then reviewed the conclusions of Rev. Rul. 2000-2 that assuming all other requirements of IRC § 2056(b)(7) are satisfied and provided the executor makes the election for both the IRA and the trust, the IRA and the trust will qualify for the marital deduction under IRC § 2056(b)(7).

As to Situation 1, under section 104(a) of the UPIA as enacted by the state, the trustee of the trust allocates the total return of the assets held directly in the trust other than those held in the IRA between income and principal in a manner that fulfills the trustee's duty of impartiality between the income and remainder beneficiaries. The trustee makes a similar allocation with respect to the IRA. The allocation of the total return of the IRA and the total return of the

trust in this manner constitutes a reasonable apportionment of the total return of the IRA and the trust between the income and remainder beneficiaries under Treas. Regs. §20.2056(b)-5(f)(1) and §1.643(b)-1. Under the terms of the trust, the income of the IRA so determined is subject to the spouse's withdrawal power, and the income of the trust is payable to the spouse annually. The IRS rules that the IRA and the trust meet the requirements of Treas. Reg. §20.2056(b)(7)(B)(ii) and therefore the spouse has a qualifying income interest for life in both the IRA and the trust because the spouse has the right to unilaterally access all of the IRA income, and the income of the trust is payable to the spouse annually.

Depending upon the terms of the trust, the impact of the state's version of sections 409(c) and (d) of the UPIA may have to be considered. Where the state's version of section 409(c) of the UPIA provides in effect that a required minimum distribution from the IRA under IRC §408(a)(6) is to be allocated 10 percent to income and 90 percent to principal, such allocation, standing alone does not satisfy the requirements of Treas. Regs. §20.2056(b)-5(f)(1) and §1.643(b)-1 because the amount of the required minimum distribution is not based on the total return of the IRA and therefore the amount allocated to income does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries. The 10 percent allocation to income also does not represent the income of the IRA under applicable state law without regard to a power to adjust between principal and income.

The ruling notes that the state's version of section 409(d) of the UPIA, requiring an additional allocation to income if necessary to qualify for the marital deduction, may not qualify the arrangement under IRC § 2056. The ruling makes reference to Rev. Rul. 75-440, 1975-2 C.B. 372, using a savings clause to determine testator's intent is a situation where the will is ambiguous, but citing Rev. Rul. 65-144, 1965-1 C.B. 422, for the proposition that savings clauses are ineffective to reform an instrument for federal transfer tax purposes.

In Situation 1, if the spouse exercises the withdrawal power, the trustee is obligated under the trust's terms to withdraw the greater of all of the income of the IRA or the annual required minimum distribution amount under IRC § 408(a)(6) and to distribute at least the income of the IRA to the spouse. In the case of a state with a version of section 409(c)(d) of UPIA that would allocate 10 percent to income and 90 percent to principal would only operate to determine the portion of the required minimum distribution amount that is allocated to the trust income and because the trust income is determined without regard to the IRA or distributions from the IRA would not affect the determination of the amount distributable to the spouse.

The ruling concludes that in Situation 1 the requirements of IRC §2056(b)(7)(B)(ii) are satisfied. Yet, if the terms of a trust do not require the distribution to the spouse of at least the income of the IRA in the event that the spouse exercises the right to direct the withdrawal from the IRA, then the requirements of IRC § 2056(b)(7)(B)(ii) may not be satisfied unless the trust's terms provide that the state's version of section 409(c) of the UPIA is not to apply.

In Situation 2, the trustee determines the income of the trust excluding the IRA and the income of the IRA under a statutory unitrust regime pursuant to which income is defined as a unitrust amount of 4 percent of the fair market value of the assets determined annually. This determination of what constitutes trust income and of the income of the IRA in this manner satisfies the requirements of Treas. Regs. §20.2056(b)-5(f)(1) and §1.643(b)-1. The trustee distributes the income of the trust, determined in this manner, to the spouse annually, and the spouse has the power to compel the trustee annually to withdraw and distribute to the spouse the income of the IRA, determined in this manner.

The ruling concludes that in Situation 2 because the spouse has the power to unilaterally access all income of the IRA and the income of the trust is payable to the spouse annually, the IRA and trust meet the requirements of Treas. Reg. §20.2056(b)(7)(B)(ii). The ruling states that the result would be the same if the state had enacted both the statutory unitrust regime and a version of section 104(a) of the UPIA and the income of the trust is determined under section 104(a) of the UPIA as enacted by the state, and the income of the IRA is determined under the statutory unitrust regime (or vice versa). Trust income and IRA income are each determined under state statutory provisions applicable to the trust that satisfy the requirements of Treas. Regs. §20.2056(b)-5(f)(1) and §1.643(b)-1 and therefore the spouse has a qualifying income interest for life in both the IRA and the trust.

In Situation 3, the spouse has the power to compel the trustee to withdraw the income of the IRA as determined under the law (whether common or statutory) of a jurisdiction that has not enacted section 104(a) of UPIA. Under the terms of the trust, if the spouse exercises this power the trustee must withdraw the greater of the required minimum distribution

amount or the income of the IRA, and at least the income of the IRA must be distributed to the spouse.

The ruling concludes that in Situation 3 the IRA and the trust meet the requirements of IRC §2056(b)(7)B))(ii) and therefore the spouse has a qualifying income interest for life in both the IRA and the trust, because the spouse receives the income of the trust (excluding the IRA) at least annually and the spouse has the power to unilaterally access all of the IRA income determined in accordance with Treas. Reg. §20.2056(b)-5(f). The ruling notes that the result would be the same if the state had enacted section 104(a) of the UPIA, but the trustee decided to make no adjustments pursuant to that provision.

In all three situations, the income of the IRA and the income of the trust (excluding the IRA) are determined separately and without taking into account that the IRA distribution is made to the trust. To avoid any duplication in determining the total income to be paid to the spouse, the portion of the IRA distribution to the trust that is allocated to the trust income is disregarded in determining the amount of trust income that must be distributed to the spouse under IRC §2056(b)(7).

The result in the three situations would be the same if the terms of the trust directed the trustee annually to withdraw all of the income from the IRA and to distribute to the spouse at least the income of the IRA instead of granting the spouse the power, exercisable annually, to compel the trustee to do so.

If instead of the trust being the named beneficiary of a decedent's interest in an IRA, the trust is the named beneficiary of a decedent's interest in some other qualified retirement plan described in IRC § 4974(c) that is a defined contribution plan, the same principles would apply regarding whether the spouse is considered to have a qualifying income interest for life in the qualified retirement plan.

The final ruling is that if a marital trust is the named beneficiary of a decedent's IRA (or other qualified retirement plan described in IRC § 4974(c) that is a defined contribution plan), the surviving spouse, under the circumstances described in the three situation will be considered to have a qualifying income interest for life in the IRA (or qualified retirement plan) and in the trust for purposes of an election to treat both the IRA (or the qualified retirement plan) and the trust as QTIP under IRC §2056(b)(7). If the marital deduction is sought, the QTIP election must be made for both the IRA and the trust.

The ruling cautions, that in situations such as those described in the ruling in which a portion of any distribution from the IRA to the trust may be held in trust for future distribution rather than being distributed to the spouse currently, the spouse is not the sole designated beneficiary of the decedent's IRA. Both the spouse and the remainder beneficiaries must be taken into account as designated beneficiaries in order to determine the shortest life expectancy and whether only individuals are designated beneficiaries.

The limitations illustrated in Situations 1 and 2 will not be applied adversely to taxpayers for taxable years beginning prior to May 30, 2006, in which the trust was administered pursuant to a state statute described in Treas. Regs. §1.643(b)-1, §20.2056(b)-5(f)(1), and §20.2056(b)-7(d)(1) granting the trustee a power to adjust between income and principal or authorizing a unitrust payment in satisfaction of the income interest of the surviving spouse.

(4) Annuity payments

Where the trust provides for an annuity payment to the surviving spouse, the deductible interest is the specific portion of the trust that would produce income equal to the annual annuity amount. Treas. Reg. §20.2056(b)-7(e)(2). Where the annuity amount is to be increased annually to account for inflation, any increases in the amount of the annuity payable to the surviving spouse will not be taken into account in valuing the deductible interest. *Estate of Sansone v. U.S.*, 87 AFTR2d 2001-1361 (D.C. Ca. 2001); *affirmed unpub. opinion R. Sansone Est.*, 2002-2 USTC ¶60,442 (9th Cir. 2002) (limitation in. Treas. Reg. §2-/2-56)b-7(e)(2) with respect to inflation adjustments or other increases a reasonable interpretation of IRC § 2056(b)(7)).

(5) Termination upon incapacity

Provisions for terminating income distributions in the event of incapacity of the spouse may, depending on whether the incapacity provisions or the marital deduction qualification provision predominates, disqualify the trust for failure to provide an income interest for life. In *Estate of Whiting v. Comm.*, TC Memo 2004-68 (2004), the IRS disallowed a marital deduction for a trust passed from the decedent and for which a QTIP election had been made, but for which it believed there was no qualifying income interest for life because of the disability provisions that purported to terminate income upon incapacity. The Tax Court held for the estate that the disability provision needed to give way to the decedent's intent to qualify for the marital deduction, applying trust interpretation rules of the applicable state, Arkansas. The Tax Court distinguished two cases cited by, and favorable to, the IRS, *Estate of Walsh v. Comm.*, 110 TC 393 (1998)

and *Estate of Tingley v. Comm*, 22 TC 402 (1954), *aff'd. sub nom. Starrett v.Comm.*, 223 F.2d 163 (1st Cir. 1955).

b. QTIP election

(1) How made

The QTIP election is made by listing the property on Schedule M and deducting its value. If the property is listed on Schedule M and its value deducted, it is presumed that the QTIP election is made. Form, Schedule M, p. 29. Prior versions of the return required that a proper box be checked; that is no longer a requirement. If the property is elected for the marital deduction then the property must be included in the surviving spouse's federal gross estate.

Estate of Cavenaugh v. Comm., 51 F.3d 597 (5th Cir. 1995), involved the surviving spouse's estate after the estate of the first-to-die took a maximum marital deduction under a QTIP election. The wife's will, who died in 1983, left her residuary estate in trust with income to her husband for life. Husband, as the executor of wife's estate, hired an accountant to prepare the estate tax return and instructed him he wanted to pay no taxes on the estate. A 100% QTIP election was made for the trust and the wife's return utilized none of her unified credit. In the husband's estate, the estate argued that the gross estate does not include the QTIP property since the income payment terms permitted accumulation and the election earlier made was improper. The Tax Court (100 TC 407) had held for the Service and the appeals court affirmed. The terms of the wife's trust gave her husband sufficient income rights. The trust, according to the Court of Appeals, should be construed as giving husband the right to income at least annually for life but with the trustee having some discretion to the timing of the payments.

In the early years of the QTIP provisions, the IRS took the position that a will provision that diverts assets from a martial trust to a bypass trust, to the extent that the executor fails to make a QTIP election, disqualifies the trust. Treas.Reg. §20.2056(b)-7(c)(1). In *Estate of Spencer v. Comm.*, 43 F.3d 226, 231-232 (6th Cir. 1995), the Sixth Circuit has joined the Fifth Circuit in *Estate of Clayton v. Comm.*, 976 F.2d 1486, 1487-1488 (5th Cir. 1992), and the Eighth Circuit in *Estate of Robertson v. Comm.*, 15 F.3d 779, 781-782 (8th Cir. 1994), in holding that a gift to a spouse did not fail to qualify for the marital deduction simply because it was elected by the executor. In *Estate of Willis E. Clack*, 106 TC 131 (1996), the Tax Court reversed its prior decisions and followed the appeals courts. The IRS will no longer litigate the issue, A.O.D. 1996-2 CB 1. A review of these cases suggests broad availability of the marital deduction.

Clayton reversed the Tax Court's denial of the marital deduction where the decedent's will provided that any property for which the QTIP election was not made on marital deduction Trust B was to pass to and be added to the credit shelter, Trust A, of which decedent's children were the beneficiaries. The surviving spouse and a bank were named in the will as independent co-executors and co-trustees, but the bank requested appointment by the court as co-trustee, but that it be permitted to file its oath and be qualified only after the surviving spouse, as sole executor, filed the estate tax return. She checked the appropriate box on Schedule M to elect a marital deduction for QTIP. The IRS disallowed the marital deduction on Trust B as did the Tax Court, 97 TC 327. The executor's power to make partial election didn't invalidate QTIP even though property for which no election was made would pass to nonqualified trust. The surviving spouse's interest was found to be in QTIP property, not the entire residuary estate, so the partial QTIP election wasn't impermissible termination of her qualified interest. The disposition of property for which no election was made, and no deduction taken, was irrelevant in determining whether elected property qualified for QTIP treatment. The QTIP exception should not be interpreted narrowly, because it is an exception to the terminal interest exception to the marital deduction and should enjoy the same favored position and liberal construction as is properly afforded to the marital deduction itself.

If the executor is not the spouse, but a beneficiary of the trust to be funded if the QTIP election is not made, does making the QTIP election cause the executor to make a gift? If the executor is the spouse and not a beneficiary of the trust to be funded if the QTIP election is not made, does not making the QTIP election cause the executor-spouse to make a gift? Probably not. *Clayton and Robertson* both held that the election relates back to the date of death, which would indicate no gift. *Spencer* held that the election relates to the day it is made, opening the possibility of a gift, but *Clack* said it need not decide when it relates, because the result is the same, suggesting no gift. There are fine practitioners who believe a gift is present in these situations.

Estate of Rinaldi v. U.S., 80 AFTR2d 97-5324 (Ct. Cl. 1997), involved whether a transfer in trust for the benefit of the decedent's spouse qualified for QTIP treatment. The decedent bequeathed to a trust for the benefit of the surviving spouse all of the stock in a close corporation. All of the net income was to be

paid annually to the decedent's spouse, while the trust corpus was distributable outright to the decedent's son upon her death. The trust agreement specifically authorized the decedent's son, as trustee, to continue in the daily management of the company, vote all of the stock of the company held by the trust and, if the decedent's son ceased to be involved in daily management of the company, to sell the trust stock to the decedent's son at book value. The court ruled that the bequeathed shares did not qualify for the QTIP election. The son's power if he ceased to be involved in daily management of the company to purchase the shares at book value and effectively to diminish the value of the corpus, the IRS argued, violated the QTIP requirement that no person have a power to appoint any part of the property to any person other than the surviving spouse. Prior to the QTIP election, the shares were redeemed by the company so the son had no right to purchase them at a bargain price. The court held that qualification for the marital deduction must be determined as of the time of the testator's death. Also, nothing prohibited the trust from reacquiring the shares and renewing the son's right to purchase.

The preparer should carefully examine the terms of any trust to make sure it meets the QTIP requirements or through disclaimer can be made to so qualify.

(2) When made

The election is to be made on the last estate tax return filed by the executor 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. Treas. Reg. §20.2056(b)-7(b)(4). If a Form 706 is filed without the election, an amended return to make the election may not be filed unless the amended return is filed on or before the due date for filing the original return. Form, Schedule M, p. 29.

Treas. Reg. §301.9100-1 through 301.9100-3 provide standards under which the Service can determine whether to grant an extension of time to make an election. Under Treas. Reg. §301.9100-1(c) the Service may grant a reasonable extension of time to make a regulatory election, or a statutory election (but no more that 6 months except in the case of a taxpayer who is abroad). Treas. Reg. §301.9100-3 provides relief when the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. Treas. Reg. §301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make the election. PLRs 2004101011, 200411038, and 200526017 under this regulation gave estates extensions of time to make a QTIP election.

(3) Election irrevocable

The QTIP election is irrevocable, IRC § 2056(b)(7)(B)(v), except that an election may be revoked or modified on a subsequent return filed on or before the due date of the return including extensions actually granted. Treas. Reg. §20.2056(b)-7(b)(4)(ii). In PLR 200422050 an estate sought a partial revocation of a QTIP election previously made, and Treas. Reg. §301.9100-3, under which the estate sought relief, did not apply.

(4) Partial election

If less than all of the value of an item listed on Schedule M is deducted, the QTIP election is partial and is made as to a fractional share of the asset, the numerator of the fraction being the amount deducted on Schedule M and the denominator equal to the item's total value as reported on the appropriate asset schedule of the return. A partial QTIP election will expose a portion of the trust to estate taxes in the estate of the first to die. This power is held by the executor. The QTIP election may be made for a part of the trust only if the election relates to a defined fraction or a percentage of the entire trust. IRC §2056(b)(10); Treas. Reg. §20.2056(b)-5. The fraction or percentage may be defined by means of a formula. Form, Schedule M., p. 29. When otherwise nondeductible property for which a QTIP election is to be made is listed on Schedule M, the QTIP election will be considered made for all of the trust or other property unless the fractional portion of the trust not subject to the election is specifically identified. Form, Schedule M, p. 20. It is preferable to make a division of the qualified terminable interest property prior to making the election and make the election as to the whole of the already divided trust.

When a partial QTIP election is made in order to have the maximum amount that can pass free of tax not subject to the marital deduction, the QTIP election should be made by use of a formula rather than a pecuniary (dollar) amount or specific assets. Without a formula, changes in value, in non-marital deductions or in lifetime adjusted taxable gifts may require a change in the amount of the QTIP election to obtain the desired result. Here is an example of a formula:

> A fraction of the Marital Trust equal to the maximum federal estate tax marital deduction available minus the value for federal estate tax purposes of all items in the gross estate which qualify for the marital deduction and which pass or have passed to Decedent's surviving spouse in a form qualifying for the marital deduction otherwise than under this gift, using values as finally determined for federal estate tax purposes, reduced by the amount, if any, needed to increase the taxable estate to the largest amount that will result in no federal estate tax payable by the estate after allowing for the exemption equivalent amount but no other credit.

This fractional formula is based upon Example 7 of Treas. Reg. §20.2056(b)-7(h).

> A fractional share of the residuary estate the numerator of the fraction is the amount of the 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 estate (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate).

The regulation states that the value of the share qualifies for the marital deduction even though the executor's determinations to claim administration expenses as estate or income tax deductions and the final estate tax values will affect the size of the fractional share.

The importance of making a formula election is illustrated in PLR 200450004 where the accountant preparing the return miscalculated the amount of the surviving spouse's one-third statutory share. The surviving spouse elected to receive her one-third statutory share of her husband's estate and the accountant made a QTIP election for "100% of Decedent's property passing to Spouse in accordance with her statutory share." The IRS held that the error may be corrected with a supplemental estate tax return, because the intention to make the QTIP election for the full amount of the spouse's share was disclosed adequately on the return.

(5) QTIP trust division

Where a partial election is made, division of the trust into an elected trust and a non-elected trust facilitates accounting for the separate shares of the trust in the event of principal distributions to be made only from the elected portion of the trust. Treas. Reg. §20.2056(b)-7(b)(2)(ii) permits division of a trust into separate trusts to reflect a partial election that either has been made or will be made provided division is authorized under the trust instrument or under local law. When the trust has not yet been divided at the time of filing the estate tax return, the intent to divide the trust must be unequivocally signified on the estate tax return and such division must be accomplished no later than the end of the period of estate administration. The division of the trust must be done on a fractional or percentage basis to reflect the partial election, but the separate trusts need not be funded with a pro rata portion of each assets held by the undivided trust. Either applicable local law or the express or implied provisions of the trust instrument must require that the division of the trust assets be based on fair market value of the assets at the time of the division.

(6) Defective elections

Litigation guideline memorandum, LGM TL-82, 2000 TNT 121-63, addressed the position to be taken in cases involving defective QTIP elections under IRC § 2056(b)(7). Cases meeting the stated criteria are to be disposed of by a closing agreement under which the marital deduction will be allowed on the condition that the executor of the decedent's estate agrees that the property will subsequently be included in the surviving spouse's gross estate under IRC § 2044. Further, an attempt is to be made for the surviving spouse to sign the closing agreement to strengthen the agreement that the property is includable in the surviving spouse's estate. Under the 1987 version of Form 706 and Schedule M, the closing agreement is to be made available if (i) the property is listed on Part 2 of Schedule M, but the box is not checked, or (ii) the box is checked, but the property is listed on Part 1 of Schedule M. In cases where the box is checked, but no property is listed on Schedule M, the closing agreement procedure is not to be made available.

In Rev.Proc. 2001-38, 2001-28 I.R.B. 1335, the Service announced it will treat a QTIP election as null and void for purposes of IRC § 2056(b)(7) when the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes. The revenue procedure does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero. See PLRs 200318039 and 200443027 for private letter rulings in which the revenue procedure was favorably applied to void an election. In PLR 200219003, the IRS ruled that a QTIP election was required with respect to the marital trust to reduce the decedent's estate tax liability to zero. However, in that case, the taxpayer made the election for more marital trust

property than was necessary in order to reduce the decedent's estate tax liability to zero. Yet that situation was specifically excluded from the purview of Rev.Proc. 2001-38 and, accordingly, the QTIP election with respect to 100% of the marital trust was valid and effective for estate tax purposes. Therefore, 100% of the value of the marital trust on the applicable valuation date was includable in the spouse's gross estate under IRC § 2044. A similar ruling was made in 200422050.

In PLR 200436001 an extension of time to make a QTIP election was granted pursuant to Treas. Reg. §301.9100-1 and Treas. Reg. §301.9100-3.

In PLR 200323010, the IRS ruled that an undervaluation of the value of the property passing to the marital trust and eligible for the QTIP election both did not invalidate the QTIP election for the marital trust and it did not preclude the marital deduction for the full value of the property that would actually fund the marital trust. The estate's personal representative was instructed to file a supplemental estate tax return reporting the full value of the marital property subject to the QTIP election prior to the time prescribed by IRC § 6511 for claiming a refund or credit.

(7) Protective elections

If at the time of filing the estate tax return, it remains uncertain if a property interest will be funded, and if fund, the property interest will in all respects qualify for QTIP treatment (provided its elected), then the property interest may be made subject to a protective election.

First Security Bank of Southern New Mexico v. U.S., 87 AFTR 2d Par. 2001-934 (D.N. Mex. 2001), illustrates the benefits of a protective election. Decedent created an inter vivos trust for her husband and she explicitly provided that the gift was to be elected as QTIP. No timely QTIP election was made on a gift tax return. The instrument creating the inter vivos QTIP revoked a testamentary QTIP trust, conditioned on the inter vivos trust qualifying for QTIP. When decedent died, the IRS assessed gift tax on the inter vivos QTIP because it has not been properly elected. The estate paid the gift tax and sued for refund, claiming that the inter vivos gift was explicitly conditioned on being elected for QTIP and when it failed, the property properly passed to the testamentary trust, which was QTIP and for which a protective election had been made. The district court agreed with the estate's contention that the inter vivos QTIP failed and the protective election in the testamentary QTIP made the marital deduction available.

(8) Reverse QTIP election

In the case of property for which a marital deduction is allowed to the decedent's estate under IRC § 2056(b)(7) (QTIP election), IRC § 2652(a)93) allows the executor to treat such property for purposes of the GST tax as if the election to be treated as QTIP had not been made, the "reverse QTIP election." The IRC § 2652(a)(3) election must include the value of all property in the trust for which a QTIP election was allowed under IRC § 2056(b)(7) and cannot be partial. If a IRC § 2652(a)(3) election is made, then the decedent will for GST tax purposes be treated as the transferor of all the property in the trust for which a marital deduction was allowed to the decedent's estate under IRC § 2056(b)(7). In this case, the executor of the decedent's estate may allocate part or all of the decedent's GST exemption to the property. The significance of this occurs upon the death of the surviving spouse; the trust will be included in the survivor's estate for estate tax purposes, but the exemption allocated in the decedent's estate will not be lost. As a result of EGTRRA 2001, in 2004 the estate tax amount and the GST exclusion will be numerically equivalent, and there will be reduced need to utilize the "reverse QTIP election" under IRC § 2652(a)(3). This election is made on Schedule R and nothing is required for the GST reverse QTIP election on Schedule M.

(9) Severance and assignment of QTIP

In PLR 200223047, the IRS ruled as to a proposed severance of a QTIP trust and assignment of a severed portion of the trust to the beneficiary's daughters. On the estate tax return for the decedent, an election was made to treat a marital trust as a QTIP trust. The surviving spouse and the trustee of the marital trust proposed to petition the court to sever the marital trust into two trusts, a Marital Trust A and a Marital Trust B. The terms of the trust would be similar but not necessarily would they be funded equally. Subsequent to funding, the spouse would renounce her entire interest in Marital Trust B. In an assignment that would incur gift tax on the spouse's part, but pursuant to an agreement that she would pay the gift taxes and she would recover the gift taxes paid from Marital Trust B, the IRS ruled that the proposed severance of the QTIP trust would not affect the QTIP election's validity as to Marital Trust A. The Service further ruled that the property transferred to the beneficiaries would not be included in the spouse's gross estate under IRC § 2044(b)(2).

(10) Basis increase

In planning the QTIP trust uncertainty is created by the scheduled repeal of the federal estate tax in 2010 and the limited basis increase available under new IRC § 1022. Property must be owned by the decedent to be eligible for the basis adjustment, but holding a special or general power of appointment over property does not amount to owning the property for purposes of the basis increase. Property passing from a QTIP trust at the surviving spouse's death will not be eligible to receive any basis increase upon the surviving spouse's death.

c. Charitable remainder trusts

An interest in a charitable remainder annuity trust or a charitable remainder unitrust will not be treated as a nondeductible terminable interest if these conditions are satisfied:

i. The interest in the charitable remainder trust passes from the decedent to the surviving spouse; and

ii. The surviving spouse is the only beneficiary of the charitable remainder trust other than charitable organizations described in IRC § 170(c). Form, Schedule M, p. 29.

d. Reformation

In the Estate of *Bert Rapp v. Comm.*, TCM (CCH) 1709 (1996), *aff'd.* 140 F.3d 1211 (9th Cir. 1998), the Tax Court held that a reformation under California law of a trust to qualify as a QTIP trust was not effective. The trust provided that principal and interest could be distributed for the health, education, and support of the surviving spouse in the discretion of the co-trustees, who were the sons of decedent. The reformation provided that all the income would be distributed annually. The court found that the spouse did not have the right to income annually under the terms of the trust, interpreting California law. The Tax Court held that under California law, extrinsic evidence of a testator's intent could be admitted to show a provision in the will was ambiguous, but the will in this instance was not ambiguous.

In PLR 200106008, a reformation was recognized as providing the widow a qualifying income interest for life in a marital trust that was a qualified deduction. The husband's will established a marital trust in which the trustee had the power to appoint the principal of the trust to persons other than the widow and the widow's income interest did not qualify for the marital deduction. In the widow's reformation petition, she represented that the will contained a scrivener's error by including language in the marital trust that permitted discretionary principal payments to descendants when it was the husband's intent to have that provision included elsewhere. It also was the husband's intent to have the assets passing to the marital trust qualify for the marital deduction under IRC § 2056. The state court reformed the marital trust to correct the scrivener's error and to effectuate the husband's intent. The IRS, following *Comm. v. Bosch*, 387 U.S. 456 (1967), ruled that the court order reforming the will was consistent with the applicable state law as it would be applied to the highest court of the state and the marital trust as reformed gave her an income interest that qualified for the marital deduction.

If the "reformation" can be accomplished by a qualified disclaimer, then the marital deduction will be recognized.

9. Disclaimers and the marital deduction

Much creative planning can be done with disclaimers to increase the amount of the marital deduction, decrease the amount of the marital deduction, to remove an intervening interest that disqualifies the interest for the marital deduction and thus qualify it, and to remove an interest that disqualifies the interest for QTIP treatment.

For example, if a beneficiary other than the spouse has an interest prior to the surviving spouse, a qualified disclaimer by the intervening beneficiary may remove the intervening interest so the bequest to the surviving spouse qualifies. To further illustrate, if the will says $1 million to decedent's son, and if the son does not survive then to decedent's spouse, a qualified disclaimer by son can remove the son's intervening interest, so the $1 million passes directly from the decedent to the surviving spouse and the gift qualifies for the marital deduction.

a. Required disclaimer questions

In the middle of the first page of Schedule M, a disclaimer question is asked:

> "Did any property pass to the surviving spouse as a result of a qualified disclaimer?" If "yes," attach a copy of the written disclaimer required by Section 2518(b).

b. Private letter rulings on disclaimers

Here are some private letter rulings that illustrate how disclaimers can be used in preparing the estate tax return to[1]obtain the desired result. On some of

[1] Most of these examples were taken from Thompson "Disclaimers" When, Why & How to Say No to an Inheritance," ACTEC Summer Meeting, 2001.

these situations your author would not have bothered to obtain a private letter ruling, because the law appears to be sufficiently clear, but remember that a private letter ruling is only good for the taxpayer who requests it, so if there is a potential issue or any doubt, get your own private letter ruling.

(1) Increase the marital deduction

In PLR 8145036, pretermitted children executed formula disclaimers so that property would pass the surviving spouse.

In PLR 8409089, intestate beneficiaries other than the surviving spouse disclaimed so property passed to the surviving spouse.

In PLR 8514095, children disclaimed by formula property other than that sheltered by unified credit. PLR 8439007, the same.

In PLR 8610033, decedent left the residue of his estate in five equal shares to his four sons and his spouse, but disclaimers by the sons left the spouse as the only residuary beneficiary. PLRs 9251019 and 9051007 similar.

In PLR 8625001, children on joint bank accounts and certificates of deposit disclaimed their interests so it passed through probate estate on to surviving spouse.

(2) Remove intervening disqualifying interests

Disclaiming an interest held by persons other than the spouse, may let the property pass by intestacy and qualify for the marital deduction.

In TAM 9301005, the decedent left his residence to his wife for as long as she wished to occupy it, and when all of the remaindermen disclaimed, the residence passed by intestacy to the surviving spouse.

In PLR 8301040, the surviving wife was given the income from property until the earlier of her death or remarriage, and the daughter's disclaimer passed the property by intestacy to the surviving spouse.

In PLR 200006052, decedent's joint will passed all property outright to wife, but upon wife's remarriage, one-half of the property was to immediately pass to child and, upon death, all the remainder was to pass to child, or if child did not survive, to child's issue and, in the absence of issue, to a named charity. Disclaimers by wife, son (of amounts over the unified credit amount) and charity, passed the property to spouse by intestacy.

Practical points. To obtain the disclaimer of a charitable organization or a minor as part of multiple disclaimers, seek their disclaimer first, while the interest is of little or no value.

In the above disclaimer, upon the disclaimer of wife, son took and the remainder to the charity had no value. Seek the charity's disclaimer before seeking the disclaimer of the son.

If son had minor issue, their disclaimer, when son was alive, was a disclaimer of an interest that would not result in the minors taking. Disclaimer before the son disclaims is a disclaimer of an interest without value.

(3) To create QTIP trust

It may be advantageous to have a QTIP marital trust rather than a general power of appointment marital deduction trust, so a partial QTIP election can be made as a reverse QTIP election for marital deduction purposes.

In PLR 9043055, a surviving spouse disclaimed a general power of appointment resulting in the marital trust meeting the requirements for QTIP.

In *Estate of Avery*, 476 N.Y.S2d 1013 (Sur. Ct. 1984), to qualify half a trust for QTIP treatment, the daughter disclaimed half of the right to receive income remaining at wife's death, causing it to pass to the wife as daughter's heir at law, satisfying the requirement that stub income be paid at death to wife's estate. Upon splitting the trust, the trust for the wife qualified for QTIP treatment.

In *Estate of Lassiter v. Comm'r.*, 80 TCM (CCH) 541 (2000), disclaimers by permissible recipients of principal invasions by the trustee eliminated the power in the trustee to invade the trust for someone other than the surviving spouse. Disclaimer by the trustee alone will probably be insufficient for the trust to qualify. There are numerous PLRs:

PLRs	8609014	199949023
8309030	8637044	200030012
9337069	8638016	TAMS
8429085	8725036	8443005
8508009	8815038	8546007
8543009	8906036	8618067
8544019	9119047	9247002
935024	9148021	
9148018	9226059	

(4) Increase QTIP trust

In PLR 200105058 the surviving wife was named as the primary beneficiary of her deceased husband's qualified pension plan and a QTIP trust was named as the contingent beneficiary. She disclaimed her interest in the qualified plan, as well as a special power of appointment in the QTIP trust, and the IRS ruled that these were qualified disclaimers and the pension passed to a QTIP trust that qualified for the marital deduction.

10. <u>Qualified domestic trusts (QDTs)</u>

Where the surviving spouse is not a U.S. citizen, the marital deduction is allowed only if the property passes to the surviving spouse in a qualified domestic trust (QDOT) or if such property is transferred or irrevocably assigned to a QDOT before the decedent's estate tax return is filed. Form, p. 29-30. A trust not meeting all of the requirements of a QDOT may be reformed after decedent's death to meet QDOT requirements. Treas. Reg. § 20.2056A-1(a)(1) and § 20.2056A-4(a).

a. QDOT defined

A QDOT is any trust:

that meets the general requirements of QTIP trusts;

that requires at least one trustee to be either an individual who is a citizen of the United States or a domestic corporation (for decedents dying after August 5, 1997, the Treasury Department was given regulatory authority to permit establishment of a QDOT in countries which prohibit a trust from having a U.S. trustee);

that requires that no distribution of principal from the trust can be made unless such a trustee has the right to withhold from the distribution the tax imposed on the QDOT;

that meets the requirements of any applicable regulations; and

for which the executor has made an election on the estate tax return of the decedent. Form, Schedule M, p. 30.

The above definition and the following explanation can only be described as brief condensation of the extensive QDOT requirements set forth in numerous pages of regulations, Treas. Reg. §20.2056A-1, *et. seq.*

b. How QDOT election is made

The QDOT election is made by listing the qualified domestic trust or the entire value of the trust property on Schedule M and deducting its value. The QDOT election is presumed to have been made if the trust or trust property is listed and its value deducted on Schedule M. When listing a trust for which a QTIP election is made, unless the trust is specifically identified as not subject to the election, the election will be made for the entire trust. Form, Schedule M, p. 27.

c. Required information

The instructions state that the following information should be provided for each QDOT on an attachment to Schedule M:

1. The name and address of every trustee;
2. A description of each transfer passing from the decedent that is the source of the property to be placed in the trust; and
3. The employer identification number (EIN) for the trust.

Form, Schedule M, p. 30.

Interestingly, the instructions do not require proof of the U.S. citizenship of the trustee.

d. Special plan requirements

Treas. Reg. § 20.2056A-4(c)(1) provides that in the case of a plan that is non-assignable, the property passing under the plan from the decedent is treated as passing in the form of a QDOT if the requirements of Treas. Reg. § 20.2056A-4(c)(2) are satisfied. Treas. Reg. §20.2056A-4(c)(2)(i)-(iv) provides that (i) the spouse must agree to annually pay the estate tax imposed under IRC § 2056(b)(1) due on the corpus portion of non-assignable payment received under the plan; (ii) the executor must file with the estate tax return the Information Statement described in Treas. Reg. §20.2056A-4(c)(5) and the Agreement to Pay Section 2056A Estate Tax; and (iii) the executor must make the election under IRC § 2056A(d) with respect to the payment.

PLR 200445010 granted an extension of time under Treas. Reg. §301.9100-3 to file the required documents. The spouse employed an individual she

understood to be an expert in estate tax return preparation and subsequent counsel determined that the documents were not filed with the return. Requests for relief under Treas. Reg. §301.9100-3 will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. Treas. Reg. §301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

e. When determination is made

The determination of whether a trust qualifies as a QDOT will be made as of the date the Form 706 is filed. If before the Form 706 due date, including extensions, judicial proceedings are brought to have the trust revised to meet the QDOT requirements, then the determination will not be made until the court-ordered changes to the trust are made. Form, Schedule M, p. 30.

f. Outright transfers and QDOTs

Outright transfers to a non-citizen spouse, no matter the value, does not qualify for the estate tax marital deduction, but if such property is actually transferred or irrevocably assigned by the surviving spouse to a trust meeting the QDOT requirements, whether created by the decedent, the decedent's executor or by the surviving spouse, it will meet the requirements for the marital deduction in the decedent's estate. IRC §2056(d)(2); Treas. Reg. §20.2056A-2(b)(2).

g. Non transferable assets

A marital deduction can be obtained for annuities, individual retirement accounts, other retirement benefits and other assets that cannot easily be transferred into a QDOT, by special arrangements entered into with the IRS, but require posting a bond and paying an estate tax on all principal distributions. The cumbersome requirements are set forth in the regulations, Treas. Reg. §20.2056A-4(b).

h. Trustee requirements and security arrangements

As stated previously, the QDOT must have at least one U.S. trustee. If the QDOT has more than $2 million in assets, there must be a U.S. corporate trustee, unless a letter of credit or a bond is posted. The regulations set forth in detail the form of the bond or the letter of credit, if those forms of security are utilized. Treas. Reg. §20.2056A-2(d).

i. Tax upon death

An estate tax is imposed upon the value of the property remaining in a QDOT on the date of death of the surviving spouse. IRC § 2056A(b)(1)(B). If the QDOT fails to meet the requirements of a QDOT, then the tax is imposed as if the surviving spouse died on the date of such cessation. IRC § 2056A(b)(4).

j. Tax on distributions

An estate tax is imposed on any distribution before the date of the death of the surviving spouse. IRC § 2056A(b)(1)(A). Certain lifetime distributions are exempt from the tax, IRC § 2056A(b)(3). No tax is imposed on any distribution of income to the surviving spouse and no tax is imposed on any distribution to the surviving spouse on account of hardship.

k. QDOT and repeal

The Federal estate tax is repealed after 2009, except that IRC § 2210(b)(1) preserves the estate tax under IRC § 2056A(b)(1)(A) on distributions prior to the year 2021 to a surviving spouse from a QDOT during the spouse's life if the deceased spouse died before 2010. The trust would not be subject to tax upon the surviving spouse's death. The rationale for preserving the QDOT tax for eleven years on lifetime distributions was due to the budgetary cost of estate tax repeal. Beth S. Kaufman, *Comment,* PHILLIP E. HECKERLING INSTITUTE ON ESTATE PLANNING, January 8, 2002.

l. QDOT when spouse becomes citizen

IRC §2056A provides that an estate tax is no longer imposed if the surviving spouse of the decedent becomes a citizen of the United States, in part, if such spouse was a resident of the United States at all times after the date of death of the decedent and before such spouse becomes a citizen of the United States. The regulations, Treas. Reg. §20.2056A-(10), requires the U.S. trustee of the QDOT to notify the IRS and certify in writing that the surviving spouse has become a U. S. citizen. Notice is to be made by filing a final Form 706-QDT on or before April 15th of the calendar year following the year in which the surviving spouse becomes a U. S. citizen, unless an extension of time for filing is granted under § 6081.

In PLR 200648022 an extension of time, to file notice and certification showing that the surviving spouse has become a U.S. citizen was granted. On decedent's date of death the surviving spouse was not a U.S. citizen. The spouse irrevocably assigned property from decedent's estate to a QDOT with the current trustee a U.S. citizen. Later, the spouse

became a U.S. citizen and the trustee inadvertently failed to file the notice and certification on Form 706-QDT on time. Taxable distributions were made from the QDOT before spouse became a U.S. citizen and the spouse has continuously resided in the US since decedent's death. An extension of time under Treas. Reg. §301.9100-3 was granted to file the notice and certification under Treas. Reg. §20.2056A-10(a).

D. PTP Credit

1. Generally

Where the estate of the first to die contains a QTIP-able trust and the surviving spouse does not have a life expectancy of less than a year, there is a potential planning opportunity with the previously taxed property credit, IRC § 2013. The return in the first estate should be placed on extension for 15 months. If the surviving spouse survives, then the QTIP election should be made and no tax paid in the first estate. But, if the surviving spouse dies within the 15 month period, there may be less estate tax due by the combined estates if the QTIP election is not taken in first estate and the previously tax property credit is taken in the survivor's estate.

2. How calculated.

A previously taxed property credit (PTP credit) IRC § 2013, applies toward payment of federal estate taxes if the decedent inherited property within the last 10 years from an estate and such property generated federal estate tax in the transferor's estate. An actual tracing of assets is not required. (In this discussion the "decedent" is the surviving spouse and the "transferor" is the first spouse to die.) The property need not be included in the decedent's gross estate and the property need not be in existence at the death of the decedent. The full requirements are set forth in the Instructions, pp.18-19. The PTP credit is not permitted for state death taxes so the elimination of the state death tax credit in 2005 makes the PTP credit more valuable.

a. Percentage allowable

The PTP credit is based on a graduated scale, depending on when the transferor predeceased the decedent, as follows:

Time exceeding	Not exceeding	Percentage allowable
	2 years	100%
2 years	4 years	80%
4 years	6 years	60%
6 years	8 years	40%
8 years	10 years	20%
10 years	-	0%

b. How calculated[2]

The PTP credit is calculated as *the lesser of:*

i. an amount determined by multiplying the **federal estate tax** of the transferor's estate by a fraction, the numerator of which is the **net property transferred to the decedent** and the denominator of which is the **adjusted taxable estate** of the transferor; and

ii. the amount of federal estate tax generated by inclusion in the decedent's estate of the **net property transferred to the decedent.**

(1) Federal estate tax

For purposes of the PTP credit calculation, the *federal estate tax* is the federal estate tax paid by the estate of the transferor, excluding inheritance taxes paid to a state, but including any PTP credit allowed the transferor's estate and any credit allowed for gift taxes paid on prior transfers.

(2) Net property transferred to the decedent

This is the value of the *property transferred to the decedent*, as such property is valued in determining the federal estate liability of the first spouse, less any debts, expenses and taxes chargeable to such property.

"Property" here includes any beneficial interest received, so the credit is allowed for annuities, life estates, and interests in a trust that may not be included in the decedent's federal gross estate, in addition to assets in which the decedent becomes the complete owner. A five and five withdrawal right would appear to include outstanding rights of withdrawal held by the decedent on the date of death and the rights that could have been exercised in the future had the decedent not died.

The value of an annuity, income interest, remainder interest, or reversionary interest is computed using tables under IRC § 7520. The tables may not be used if the decedent was "terminally ill" as of the date of death of the transferor. A person is considered "terminally ill" if the person has an incurable illness or other deteriorating physical condition and there is at least a 50% probability that the person will die within one year. Treas. Reg. §20.2013-4(a); Treas. Reg. §20.7520-3(b)(3). If the

[2] Much of this discussion and the examples are taken from Gary V. Post, "The Estate Tax Return: Challenges, Traps and Opportunities," Texas Society of CPA's 2001 Advanced Estate Planning Conference.

decedent has in fact died within one year of the transferor, consider obtaining from the attending physician a statement that tracks the IRC § 7520 language and attach it to the return to avoid questions from the IRS. The value of the decedent's interest depends upon the decedent's age, which is determined as the decedent's nearest birthday on the date of the transferor's death.

The IRC § 7520 tables also cannot be used unless the beneficiary has the right to make the property productive. This is clearly stated in Treas. Reg. §20.7520-3(b)(2)(ii)(A):

(A) Beneficial enjoyment. A standard section 7520 income factor for an ordinary income interest may not be used to determine the present value of an income or similar interest in trust for a term of years, or for the life of one or more individuals, unless the effect of the trust, will, or other governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument and the surrounding circumstances, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. Similarly, in determining the present value of the right to use tangible property (whether or not in trust) for one or more measuring lives or for some other specified period of time, the interest rate component prescribed under section 7520 and §1.7520-1 of this chapter may not be used unless, during the specified period, the effect of the trust, will or other governing instrument is to provide the beneficiary with that degree of use, possession, and enjoyment of the property during the term of interest that applicable state law accords to a person who is unqualifiedly designated as a life tenant or term holder for a similar period of time.

(3) Adjusted taxable estate

This is the taxable estate of the transferor, less any death taxes paid with respect to such estate. *Death taxes* include federal, state, and foreign estate taxes paid.

(4) Limitation

The PTP credit cannot exceed the amount by which (i) the federal estate tax payable on the decedent's estate (after deducting the unified credit, the state death tax credit, the credit for gift taxes on pre-1977 gifts, and the credit for foreign death taxes) without regard to the PTP credit, exceeds (ii) the estate tax computed after excluding the net property transferred to the decedent from the decedent's gross estate (with an extra adjustment if the estate claims a charitable deduction).

3. Examples

We will calculate the PTP credit using an example with these given facts, which involve a husband and wife:

Example 1: Husband dies first in 2000, and his will directs $675,000 to a Family Trust and the remaining assets to a QTIP Trust. All of their property is community property with a value of $5,000,000. Wife dies one year later, but her death was not clearly imminent when H died. The executor of husband's estate files his estate tax return by the nine month due date, and elects QTIP marital deduction treatment for the QTIP trust, resulting in no estate tax in the Husband's estate. Because no estate tax is paid in Husband's estate, Wife's estate cannot claim a PTP credit when the estate taxes are paid by Wife's estate.

Wife's property	$2,500,000
QTIP trust	1,825,000
Total	$4,325,000
Total Tax at Wife's death	1,799,000

Example 2: Basically the same facts as in Example 1, except Husband's executor files an extension to file Husband's estate tax return, and when Wife dies while Husband's return was on extension, the executor chooses not to elect QTIP marital deduction treatment for the QTIP Trust and pays taxes in Husband's estate.

Husband's gross estate	$2,500,000
Marital deduction	- 0
Husband's taxable estate	$2,500,000
Gross estate tax	$1,025,800
Unified credit	(220,550)
State death tax credit	(138,800)
Husband's net federal estate tax	$ 666,450

Assuming that Husband's will charges the estate tax entirely to the QTIP portion, the Family Trust will be funded with $675,000 and the QTIP Trust will be funded as follows:

Husband's gross estate	$2,500,000
Family Trust	(675,000)
Federal estate tax	(666,450)
State death tax	(138,800)

QTIP Trust	$1,019,750

Because Husband's assets pass to a non-elected QTIP Trust that provides for mandatory income payments to Wife, Wife's estate will qualify for a PTP credit. Wife's income interest in the QTIP Trust is calculated under IRC § 7520 as follows:

For purposes of this example, assume that Wife was 76 years old and was not terminally ill when Husband died. Further, assume that the IRC § 7520 rate at Husband's death was 7.8%. Finally, assume that Wife dies one year later at age 77 in September of 2001. Wife's income interest in the QTIP Trust is calculated under IRC § 7520 as follows:

Table S remainder factor for 76 year old	0.50846
Wife's life income interest (1.0-0.50846)	0.49154
Value of QTIP Trust at Husband's Date of Death	$1,019,750
Wife's property value for PTP computations: $1,019,750 x 0.49154 = $501,248	

The calculation of the PTP credit comes from the following formula:

Net Property Transfer to Wife x Federal Estate
Adjusted Taxable Tax of Husband Estate of Husband

= PTP Credit

Assuming that the value of the Net Property Transferred to Wife was $500,000, the calculation of the PTP Credit is as follows:

$\frac{\$500,000}{\$1,694,750} \times \$666,450 = \$196,620$

The PTP credit cannot exceed the amount by which (i) the federal estate tax payable on the Wife's estate (after deducting the unified credit, the state death tax credit, the credit for gift taxes on pre-1977 gifts, and the credit for foreign death taxes) without regard to the PTP credit, exceeds (ii) the estate tax computed after excluding the net property transferred to the Wife from the Wife's gross estate (with an extra adjustment if the estate claims a charitable deduction).

	(i) Estate tax (w/out excluded property)	(ii) Estate tax
Wife's gross estate	$2,500,000	$2,500,000
Excludible property	0	500,000
Taxable estate	$2,500,000	$2,000,000
Wife gross estate tax	$1,025,800	$ 780,800
Unified credit	(220,550)	(220,550)
State death tax credit	(138,800)	(99,600)
Federal estate tax payable	$666,450	$ 460,650
	$666,450	
	(460,650)	
Limitation	$205,800	

The PTP credit is the lesser of $196,620 and $205,800, or $196,620 in this case.

With a full QTIP marital deduction election in Husband's estate, the estate tax paid in Wife's estate was $1,799,000. With no QTIP marital deduction election in Husband's estate, and the PTP credit used in Wife's estate, the total taxes paid is as follows:

Husband's net federal estate tax	$ 666,450
Husband's state death tax credit	138,800
Wife's federal estate tax (before credit)	666,450
Wife's state death tax	138,800
PTP Credit	(196,620)
Total estate tax with PTP credit	$1,413,880
Tax with no PTP credit	$1,799,000
Tax with PTP credit	(1,413,880)
Tax savings	$385,120

Example 3: Decedent is single and he dies with an estate of $5,000,000. Decedent's uncle died seven years prior to decedent and gave decedent a vacation home worth $100,000 in Uncle's estate and now worth $400,000. When Uncle died he had an estate of $2,500,000 and his estate paid estate tax of

$694,200. The credit available to Decedent is as follows:

Uncle's Estate
Assume death occurred in 1994
Current Year 2001
Estate $2,500,000

Total Gross Estate Tax	$1,025,800
Unified Credit	(192,800)
State Death Tax Credit	(138,800)
Net Federal Estate Tax Due	$ 694,200

Decedent's Estate
Year of Death--2001
Estate $5,000,000

Total Gross Estate Tax	$2,390,800
Unified Credit	(220,550)
State Death Tax Credit	(391,600)
PTP Credit on Vacation Home	(16,657)*
Net Federal Estate Tax Due	$1,761,993

(FNI)

Value of Vacation Home*	
$100,000 x $694,200 =	$41,643.67
$1,667,000	40.00%**
Uncle's Adjusted Taxable Estate	$16,657.47

Prior Tax Credit

* This value assumes that no taxes were charged to the Vacation Home

** Credit percentage established under IRC § 2013(a) for a prior transferor dying within the seventh or eight years preceding the decedent's death

4. Simultaneous death

The tax court has ruled that the estates of a couple that boarded their private plane and disappeared are not entitled to tax on prior transfers credits and the value of the spouses' interests in each other's estates was valued at zero. *Estate of Harrison v. Comm.*, 115 TC 161 (2000). Simultaneous death cases will provide no situation for claiming the credit.

5. Disclaimers

A disclaimer, which creates a presumed simultaneous death, has nevertheless been used to obtain a PTP credit. In TAM 8512004 the maximum marital deduction amount went to the decedent's surviving spouse. The residue was to pass to a trust that required that the income be paid quarterly to the surviving spouse. The surviving spouse died three months after the decedent and her estate renounced the marital bequest. The IRS permitted a PTP credit.

6. Planning

The planning for obtaining the PTP credit is made when preparing the transferor's Form 706, not the Form 706 in which the credit is actually taken. If there is a question as to whether the surviving spouse will qualify for the credit, because of death within one year of the transferor, consider making the QTIP election under a formula that takes into consideration the anticipated credit.

Before filing the return, run the numbers both taking the PTP credit and not taking the credit to determine the savings that are available. With the scheduled repeal of the estate tax, deferral of the estate tax may be the wiser choice if the deaths do not occur within 15 months of each other.