Marital Deduction Formula Planning

Pecuniary Amount and Fractional Share Formula

Prepared by:
T. James Lee, Esq.
Fennemore Craig, P.C.

LORMAN EDUCATION SERVICES
January 2017

A. ***Pecuniary Amount Formula***

1. Date-of-Distribution Funding

a. Marital (true worth marital).

(i) Sample formula language:

"Trustee shall transfer to the Marital Trust the smallest pecuniary amount (if any) necessary as a marital deduction to eliminate (or reduce to the extent possible) any federal estate tax payable with respect to Settlor's estate. All the rest of the trust property shall be transferred to the Credit Shelter Trust."

(ii) Satisfaction of pecuniary amount:

"In the determination of the amount of the allocation to the Marital Trust by pecuniary formula, the final determination of values in the federal estate tax proceeding in Settlor's estate shall control, but for purposes of allocation of property to satisfy such amount, values at the time of transfer shall control, and only cash or other assets qualifying for the federal estate tax marital deduction shall be used."

(iii) Assumptions relating to determination:

(a) A federal estate tax marital deduction is allowed for property allocated to any trust intended to qualify for such marital deduction. A marital deduction is not allowed for any property allocated to any trust not intended to qualify for such marital deduction.

(b) No disclaimer will be made; or if made it will be disregarded for purposes of this determination.

(c) The exercise of any tax elections are to be taken into account.

(iv) Advantages:

(a) Pick-and-choose (non-pro rata) funding flexibility.

(b) Marital Trust protected against depreciation.

(c) Appreciation benefits Credit Shelter Trust (estate tax sheltered).

(d) Ease of administration.

(v) Disadvantages:

(a) Gain or loss realized on funding of Marital Trust with in-kind assets (pecuniary satisfaction).

(b) Revaluation of assets used to satisfy pecuniary amount. (Can be particularly problematic for large estates with many assets that are difficult and costly to value.)

(c) Allocation to Marital Trust may carry out DNI.

(1) Subchapter J of the Internal Revenue Code generally requires carry out of DNI on the funding of a pecuniary trust and a residuary trust. IRC §§ 661(a); 662(a); Treas. Regs. §§ 1.662(a)-3(b)(4) and 1.663(a)-1(b)(2).

(2) The section 663(a)(1) non-carry out exception does *not* apply with respect to a pecuniary allocation to a trust, because this type of a distribution "is neither a bequest of a specific sum of money or of specific property." Treas. Regs. § 1.663(a)-1.

(3) Treas. Regs. § 1.663(c)-4(b) provides, in effect, that the amount of DNI for the pecuniary funding of a trust is zero, if such trust is not entitled to interim income or a share of the interim appreciation or depreciation. *See also* Treas. Regs. § 1.663(c)-5, Example 4. (For these purposes, payment of statutory interest is not a substitute for income allocation. Treas. Reg. § 1.663(c)-5, Example 7.)

(4) If the governing instrument or state law (see section 5(b) of the Revised Uniform Principal and Income Act, and sections 201 and 202 of the Uniform Principal and Income Act (1997)) requires that a proportionate share of the interim income be allocated to the pecuniary trust, then DNI will be carried out to such trust to the extent of such income <u>and</u> the FMV of the non-cash assets allocated thereto. Treas. Reg. § 661(a).

(d) Allocation of a right to receive IRD to the Marital Trust may accelerate income represented by the item of IRD. (Consider dealing with right-to-IRD items by employing a specific bequest mechanism (*see* IRC § 691(a)(2)) or by a fractional formula, to avoid acceleration of income.)

(e) No carry over of unused losses to the Marital Trust, because a pecuniary (or other non-residuary) beneficiary is *not* treated as a "beneficiar[y] succeeding to the property of the estate or trust" under IRC § 642(h). Treas. Reg. § 1.642(h)-3.

(f) Pressure on Trustee for quick funding.

b. <u>Credit Shelter</u> (true worth credit shelter, or reverse pecuniary)

(i) Sample formula language:

"Trustee shall transfer to the Credit Shelter Trust the largest amount (if any) that produces no (or the least possible amount of) estate tax (including any federal estate tax and, if applicable, any state death taxes) payable with respect to Settlor's estate. All the rest of the trust property shall be transferred to the Marital Trust."

(ii) Satisfaction of pecuniary amount:

"In the determination of the amount of the allocation to the Credit Shelter Trust by pecuniary formula, the final determination of values in the federal estate tax proceeding in Settlor's estate shall control, but for purposes of allocation of property to satisfy such amount, values at the time of transfer shall control; and with respect to the corresponding residuary allocation to the Marital Trust, only cash or other assets qualifying for federal estate tax marital deduction shall be used. Additionally, prior to making the pecuniary calculation required, Trustee shall distribute to the Credit Shelter Trust any assets that do not qualify for the federal estate tax marital deduction, and any assets that are excluded from Settlor's gross estate for federal estate tax purposes or exempt from federal estate tax."

(iii) Assumptions relating to determination:

(a) A federal estate tax marital deduction is allowed for property allocated to any trust intended to qualify for such marital deduction. A marital deduction is not allowed for any property allocated to any trust not intended to qualify for such marital deduction.

(b) No disclaimer will be made; or if made it will be disregarded for purposes of this determination.

(c) The exercise of any tax elections are to be taken into account.

(iv) Advantages:

(a) Pick-and-choose (non-pro rata) funding flexibility.

(b) Credit Shelter Trust protected against depreciation (but no benefit to the Credit Shelter Trust with respect to any interim appreciation).

(c) If no income is allocable to the Credit Shelter Trust, then no DNI is carried out to that trust. (See below for further explanation.)

(d) Ease of administration.

(v) Disadvantages:

(a) Appreciation benefits the Marital Trust.

(b) Gain or loss realized on funding of Credit Shelter Trust with in-kind assets (pecuniary satisfaction).

(c) Revaluation of assets used to satisfy pecuniary amount.

(d) Allocation to Credit Shelter Trust may carry out DNI. (See analysis for Pecuniary Amount Formula, Marital). (Consider having the governing instrument deny allocation of income to the Credit Shelter Trust, to avoid DNI carry out to that trust based on FMV of non-cash assets; but bear in mind the income tax (non-deduction) consequences of in-lieu payment of statutory interest to the Credit Shelter Trust, if required under state law.)

(e) Allocation of a right to receive IRD to the Credit Shelter Trust may accelerate income represented by the item of IRD. (Consider dealing with right-to-IRD items by employing a specific bequest mechanism (*see* IRC § 691(a)(2)) or by a fractional formula, to avoid acceleration of income.)

(f) No carry over of unused losses to the Credit Shelter Trust, because a pecuniary (or other non-residuary) beneficiary is <u>not</u> treated as a "beneficiar[y] succeeding to the property of the estate or trust" under IRC § 642(h). Treas. Reg. § 1.642(h)-3.

(g) Pressure on Trustee for quick funding.

2. Fairly Representative Funding

a. <u>Satisfaction of pecuniary amount, taking into account net appreciation and depreciation:</u> "In satisfying that pecuniary amount to be allocated to the **[**Marital / Credit Shelter**]** Trust, Trustee shall select the cash, securities and other assets based on the adjusted basis of each asset for federal income tax purposes; provided that the assets so allocated to such trust shall be selected in such a manner that they have an aggregate fair market value fairly representative of the appreciation or depreciation in the value to the date(s) of distribution of all assets then available for distribution or allocation."

b. Advantages:

(i) No recognition of gain or loss.

(ii) Possibly less DNI carry out. As to a distribution of property, the portion of DNI carried out in connection with the pecuniary allocation is limited to the lesser of basis and FMV (as opposed to being based solely on FMV, as with true worth pecuniary formula).

c. Disadvantages:

(i) Probable overfunding or underfunding. May result in overfunding or underfunding of the pecuniary allocation, since the FMV of the property used to satisfy the pecuniary amount (on the trust funding date) and the basis of that property are not likely to be the same.

(ii) Revaluation of all assets.

(iii) Limits pick-and-choose flexibility. Assets that represent a ratable sharing of the overall appreciation and depreciation of the funds available for distribution must be selected to fund the fairly representative bequest. Thus, the fiduciary's flexibility to select which assets will be used to fund the bequest may be restricted, and it may be necessary to fractionalize assets to allocate a pro rata portion of each appreciated asset and each depreciated asset.

(iv) Allocation of a right to receive IRD to the pecuniary trust may accelerate income represented by the item of IRD. (Consider dealing with right-to-IRD items by employing a specific bequest mechanism (*see* IRC § 691(a)(2)) or by a fractional formula, to avoid acceleration of income.)

(v) Not ideal for IRC §§ 2032A and 2057 property.

3. Minimum Worth Funding

a. <u>Satisfaction of pecuniary amount, using the lesser of asset basis or FMV for valuation purposes:</u> "In satisfying that pecuniary amount to be allocated to the **[**Marital / Credit Shelter**]** Trust, Trustee shall select the cash, securities and other assets based on the lesser of the adjusted basis of the asset for federal income tax purposes or the fair market value of the assets on the date(s) of distribution."

b. Asset selection for pecuniary bequest can be based on individual assets (the lesser of date-of-distribution value or basis, as described above) or collective assets (basis only).

c. Advantages - Generally the same as with a fairly representative formula, as to DNI, IRD and IRC § 642(h) matters. However—

(a) If the basis of the assets distributed to the pecuniary trust is greater than the FMV of those assets on the funding date, the lesser value will be used for valuation purposes; in which case, a loss will be realized (but not recognized, due to §267(b)(6)).

(b) No underfunding of a pecuniary bequest.

(c) Only depreciated assets used to satisfy the pecuniary amount need to be revalued for date-of-distribution appraisal purposes.

(ii) Disadvantages:

(a) Generally the same as with a fairly representative formula, as to DNI, IRD, IRC §§ 2032A and 2057 property, and IRC § 642(h) matters. However, there is the potential for overfunding of pecuniary bequest, since the trust assets are distributed based on the lesser of their basis or FMV on the date(s) of distribution. As a result, the Settlor's spouse's taxable estate may be increased. There is also a risk of depleting the Credit Shelter portion if sufficient depreciated assets are distributed to a pecuniary Marital Trust. Additionally, DNI may be zero if no interim income is allocated to the pecuniary trust.

(b) Problems associated with allocation of GST Tax exemption.

(c) Not ideal for IRC §§ 2032A and 2057 property.

B. ***Fractional Share Formula***

1. Pro Rata Funding

a. Advantages:

(i) No gain or loss.

(ii) No Issues with Rev. Proc. 64-19.

(iii) IRD not accelerated.

(iv) DNI limited to lesser of FMV and basis.

(v) Losses and excess deductions carry over (pro rata) under IRC § 642(h).

(vi) No revaluation.

(vii) Risk of disputes mitigated.

b. Disadvantages:

(i) No pick-and-choose flexibility.

(ii) Difficult to administer.

(iii) Recognition of gains/losses on any non-pro rata distributions.

(iv) Not ideal for IRC §§ 2032A and 2057 property.

2. Pick-and-Choose Funding

a. Advantages:

(i) Maximum flexibility.

(ii) No gain or loss recognition.

(iii) No Issues under Rev. Proc. 64-19.

(iv) Apparently, treated like a pro rata fractional distribution for income tax purposes (as to DNI, IRD and § 642(h) distributions).

b. Disadvantages:

(i) Must revalue all assets.

(ii) Tax results not well established – uncertainty. (*But see* Priv. Ltr. Rul. 844703).

(iii) Marital bequest not protected or frozen (may be underfunded or overfunded).

(iv) Not ideal for IRC §§ 2032A and 2057 property.