Marital Deduction Formula Planning

Pecuniary vs. Fractional Dispositions, and Income Tax Matters

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A. ***Pecuniary vs. Fractional Dispositions – Factors to Consider***

1. Flexibility — pro rata vs. non-pro rata

2. Effect of Interim Appreciation/Depreciation

   a. Underlying strategy — maximize or protect credit shelter allocation or marital allocation.

   b. Risk of bankrupting marital or credit shelter portion.

3. Realization of Gain or Loss

   a. Satisfaction of pecuniary amount. Treas. Regs. § 1.1014-4(a)(3); *Kenan v. Comr.*, 114 F2d 217 (2d Cir. 1940).

   b. Disallowed losses. IRC § 267(a) and (b); § 645.

   c. Unused losses. Treas. Regs. § 1.642(h)-3.

   d. Non-pro rata fractional distribution. Treas. Regs. § 1.661(a)-2(f)(1); Priv. Ltr. Rul. 844703.

   e. Election to recognize gain/loss. IRC § 643(e)(3).

4. Revaluation

   a. Subsequent valuation based on date of distribution.

   b. IRC § 6662(e) penalty. *See, e.g.*, Rev. Rul. 85-75; Rev. Rul. 84-105.

   c. Recomputation of fraction on audit, due to revaluation.

5. Income Tax Issues

   a. Distributable Net Income ("DNI"). Treas. Reg. § 1.663(a)(1).

      (i) Allocations that carry out DNI.

      (ii) Method of determining DNI carry out.

         (a) Based on fair market value at time of funding.

         (b) Based on lesser of basis or fair market value at time of funding. IRC § 643(e)(2).

(iii) Amount of DNI carry out anticipated.

b. Income in respect of a decedent (“IRD”). IRC § 691(a)(2).

(i) Acceleration.

(ii) Effect on DNI.

(iii) Tax efficient allocation.

c. Excess deductions. Treas. Regs. § 1.642(h)-3(c)(1).

6. Proportionate Share of Interim Income vs. Statutory Interest

a. Governing instrument.

b. State law.

7. Ease/Difficulty of Administration

a. Pick-and-choose.

b. Non-simultaneous distributions.

c. Change of value on audit.

8. Potential Overfunding or Underfunding

a. Fairly representative. Rev. Proc.64-19.

b. Freeze value of marital bequest/allocation. TAM 8746003.

9. Generation-Skipping Transfer Tax (“GST Tax”) Allocations

B. ***Income Tax Matters***

1. Fiduciary Accounting Income (“FAI”)

a. Based on provisions of the governing document and applicable local laws.

b. Determines the economic interests of the income and remainder beneficiaries.

c. Receipts and disbursements are classified as current income, additions to principal, deductions from current income or principal.

d. Income is the return in money or property derived from the use of principal.

e. Principal is the property set aside by the owner for eventual delivery to a remainderman.

f. If a trust requires all or a portion of the income to be distributed currently, the income referred to in the instrument is fiduciary accounting income.

g. An estate or trust is allowed an income tax deduction for distributions to beneficiaries in the same amount subject to DNI limitation.

2. Distributable Net Income

a. DNI is used to determine—

(i) The amount of the deduction allowed to any estate or trust for distributions to its beneficiaries.

(ii) How much of the amount distributed to a beneficiary is to be included in the taxable income of the beneficiary.

(iii) What type of income the beneficiary received. (Under the conduit theory, if the estate or trust is entitled to a deduction for amounts distributed to beneficiaries, then the amount distributed to the beneficiary has the same tax character as the amount had in the hands of the estate or trust.)

b. Under IRC § 643(a) DNI is Tentative Taxable Income with the following adjustments:

- No deduction for distributions to the beneficiary
- No deduction for personal exemption
- Capital gains and losses are excluded (if normally allocated to principal)
- Extraordinary and taxable stock dividends are excluded (if normally allocated to principal)
- Tax exempt income is included
- Foreign trust income is included

c. Capital gains and losses are included in DNI only in a final tax year of the estate or trust.

d. Tangible personal property is usually distributed to the beneficiary soon after death. Unless the tangible personal property bequest is made separately from the bequest of the residuary estate, the distribution of that property will result in shifting from the trust or estate to the beneficiary the income tax liability on the amount of the trust/estate's DNI, which is equal to the value of the distributed tangible personal property.

3. Allocation of Income in Respect of a Decedent[1]

a. Some examples of IRD assets:

- Qualified Retirement Plans
- Annuities
- Deferred or unpaid compensation
- Installment sales (where the installment sale method is elected)
- Other receivables (such as those involving pass-through entities)

b. Tax treatment of IRD.

(i) Items of IRD generally represent *principal* or corpus for trusts and estates, whereas they are *income* for income tax purposes.

(ii) Property that constitutes either IRD or a right to receive IRD does not get a new basis at death; rather the person receiving the IRD gets a carryover basis.

(iii) IRC § 691 distinguishes between (a) IRD and (b) the right to receive IRD. Under IRC § 691(a)(1), IRD is includible in the gross income of the recipient upon receipt. The transfer of a right to receive IRD triggers an income tax, *unless* the recipient is entitled to receive the IRD by reason of the owner's/participant's death or as a result of a bequest. For example, an installment sale payment (where the installment method was properly elected) would be taxed, upon receipt, to the recipient. However, the promissory

[1] For a detailed discussion on IRD, see the CCH publication, *Estate Planners' Guide to Income in Respect of a Decedent*, by Alan S. Acker, 2006 edition; and for retirement benefit planning, an excellent resource is Natalie B. Choate's published handbook, *Life and Death Planning for Retirement Benefits*, sixth edition revised, 2006. See also Sebastian V. Grassi, Jr., *A Practical Guide to Drafting Marital Deduction Trusts*, ALI-ABA, 2004 (2006 and 2008 supplements).

note evidencing the installment obligation itself is a right to receive IRD. Thus the recipient of the note would *not* necessarily be taxed immediately on the remaining value of the note.

(iv) IRD paid to a trust does not necessarily constitute trust income for FAI purposes. For example, unless the trust instrument provides otherwise, only 10% (under the Uniform Principal and Income Act) of an IRA distribution would typically constitute income for FAI purposes. Therefore, even if all trust income were required to be distributed to the beneficiaries at least annually, the portion of the IRA distribution that constitutes trust principal (the remaining 90%) will generally be subject to the trust/estate income tax rates, since *for income tax purposes* all of the IRA distribution is income. This tax consequence can of course be mitigated by requiring that all IRA distributions be immediately distributed from the trust to the trust beneficiaries, which as a distribution of principal will potentially carry out distributable net income in the year of distribution.

c. Effect of funding pecuniary bequests with IRD assets; available deduction.

(i) Although not expressly stated, the regulations under IRC § 691(a)(2) seem to imply that transferring a right to receive IRD *to satisfy* a pecuniary bequest would have tax consequences similar to those resulting from fulfilling a specific bequest with appreciated property. There are private letter rulings supporting this position generally. See PLR 9123036 (involving an installment sale obligation), and also 9315016 and 9507008 (dealing with Series E and H bonds).[2]

[2] The text of the private letter rulings cited above refer to the "sale" principle set forth in a regulation promulgated under § 661; IRD is taxed under IRC § 691 and not §§ 661-663. Thus some practitioners may feel that it is not unreasonable to take the position that funding a pecuniary bequest with a right-to-receive IRD could carry the income tax burden to the beneficiary, whereas funding the same bequest with appreciated property would make the income taxable at the trust/estate level. (Arguably, from a tax policy standpoint, IRD is different. After all, an IRA (for example) may depreciate in value between the date of death and the date of funding a pecuniary bequest. So why should it be treated in the same manner as appreciated property?) In other contexts (not precisely on point), the Tax Court has stated that § 691 overrides the §§ 661-662 scheme;

(ii) When IRD is recognized, a deduction is allowed for income tax purposes for the federal estate tax attributable to the inclusion of the IRD value on the decedent's estate tax return. IRC § 691(c). Note that no deduction is allowed for any state death tax attributable to the IRD. The taxpayer who recognizes the income is entitled to the deduction even if the tax allocation provisions of the document impose the related estate tax on someone other than the payee.

(iii) The deduction is reported as a Miscellaneous Itemized Deduction <u>not</u> subject to the 2% of AGI limitation.

(iv) IRD is reduced by DRD (deductions in respect of a decedent) and a calculation is performed to determine the estate tax after all credits "with and without" the amount of net IRD included in the gross estate.[3]

(v) The effect of the treatment of IRD on DNI can lead to unexpected results. "Under the separate share rule of IRC section 663(c), accelerated IRD that is not treated as income under fiduciary accounting rules (*i.e.*, accelerated IRD that is treated as corpus under fiduciary accounting rules) is deemed to be allocated pro rata to bequests that can be potentially funded with the IRD, even if the bequests are not entitled to receive any income under the terms of the governing instrument or applicable local law. Treas. Reg. §1.663(c)-2(b)(3). In such instance, the [trust] receives a deduction under IRC section 661 for the DNI distribution pertaining to the accelerated IRD, and the recipients of the deemed allocation of the

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that is, IRD is taxed only when § 691 says so. Nevertheless, it appears that most commentators assume that transferring IRD in satisfaction of a pecuniary bequest results in a taxable event.

[3] Calculation:

- Determine the total amount of IRD includible on the income tax returns of the estate and beneficiaries.
- Reduce this amount by the total DRD reported on the income tax returns of the estate and beneficiaries to arrive at the net IRD.
- Recalculate the estate tax by reducing the total taxable estate by the net IRD (the "without" calculation).
- Subtract the "as if" estate tax calculated above from the actual estate tax per the Form 706.
- Allocate the deduction between the estate and the beneficiaries based on the amount of net IRD reportable by each.

accelerated IRD include their pro rata share of the accelerated IRD in their income for the tax year in question. Therefore, in the absence of a specific allocation of the IRD assets in the governing instrument, the separate share rule may result in (phantom) DNI (attributable to the accelerated recognition of the IRD) being carried out to more than just the beneficiary whose pecuniary bequest is satisfied with the IRD. Treas. Reg. §1.663(c)-5, Examples 6 and 10. However, a specific direction in the governing instrument concerning the allocation of IRD assets will override the Regulation's requirement of pro rata allocation among the potential recipients. Treas. Reg. §1.663(c)-5, Example 9." Grassi, Sebastian V., Jr., A Practical Guide to Drafting Marital Deduction Trusts, ALI-ABA, §15.3(c), n.11 (Cum. Supp. 2008). See also, John W. Randolph, Jr. and Jennifer Gurevitz, "Opportunities and Pitfalls with Non-Pro Rata Distributions to Residuary Beneficiaries," 19 Probate & Property 60 (July/August 2005).

d. Sample "IRD exception" language for pecuniary formula:

"Except with respect to qualified retirement plans or accounts, and corresponding interests therein, and except as may be otherwise designated in the applicable beneficiary form, before Trustee's division of the trust estate pursuant to the pecuniary funding formula, Settlor hereby directs that each item of Settlor's property constituting income in respect of a decedent or the right to receive income in respect of a decedent under IRC section 691(a) shall be allocated to the Marital Trust in kind."

e. Fractional share approach for IRD.

(i) If the IRD is too large to be bequeathed specifically, an estate or trust may establish marital and non-marital shares as fraction of the residue vs. a pecuniary amount and a residuary balance.

(ii) Satisfaction of fractional shares with a right to IRD will not accelerate the taxation of the deferred income.

4. Income in Lieu of Statutory Interest

   a. The statutory interest paid by a deceased Settlor's administrative trust to the trust receiving a pecuniary amount under a pecuniary formula is a nondeductible personal expense, and the deceased Settlor's trust (or estate, if applicable) is denied an interest expense deduction. IRC § 163(h); Treas. Reg. § 1.663(c)-5, Example 3; *Estate of Marvin M. Schwan v. United States*, 264 F. Supp.2d 887 (D.S.D. 2003).

   b. If income is not allocated to a pecuniary trust under state law, and if a governing instrument is permitted to require that income be so allocated in lieu of statutory interest under state law, the governing instrument could include a provision such as "In funding the Marital Trust (by pecuniary formula), the Trustee must also allocate to that trust a proportionate share of the income earned by the trust estate during the period beginning as of the date of Settlor's death and ending upon the funding date of the Marital Trust, and such proportionate share will be deemed (among other things) to be paid in lieu of paying interest otherwise required by law."

5. Interim Capital Gains and Losses

   a. The distribution of the in-kind property from a deceased Settlor's administrative trust (or estate, if applicable) in satisfaction of the pecuniary amount is treated as a sale or exchange of assets between the administrative trust and the pecuniary trust.

   b. Under a traditional date-of-distribution funding formula, any difference between the income tax basis of non-cash property and its fair market value on the date of its distribution by the administrative trust (the distributing entity) to the pecuniary trust (the distributee) will result in the realization of gain or loss to the administrative trust. Treas. Reg. §§1.661(a)-2(f), 1.661(a)-2(f), and 1.1014-4(a)(3); *see also* Treas. Regs. § 1.663(c)-5, Example 4.

6. Disallowed Losses

   a. IRC § 267(a) provides in part that "[n]o deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b)." Subsections (b)(5) and (b)(6) list the following: "A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;" and "A fiduciary of a trust and a beneficiary of such trust".

b. Note, however, that IRC § 267(b)(13) allows loss recognition in the context of a probate estate, on funding a pecuniary bequest (except in the case of a sale or exchange in satisfaction of such bequest). (Consider an IRC section 645 election[4] to treat the deceased Settlor's revocable trust as a part of the probate estate for income tax purposes.)

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[4] Reasons to make a § 645 election (to treat a qualified revocable trust as a part of the decedent's estate) include the following:

1. Making the election eliminates the need for separate income tax returns for the trust and estate.
2. Estates can select a fiscal year, whereas a trust is required to adopt a calendar year; note that he first taxable year of an estate must be adopted on or prior to the time for filing the income tax return for the year (Treas. Regs. § 1.441-1(c));
3. Making the election avoids disallowance of losses under section 267 between related taxpayers (such as between a revocable trust and a marital trust to be funded with a pecuniary amount using revocable trust assets) and the resulting dual basis for loss assets that are used to satisfy a pecuniary allocation;
4. Estates are not required to make estimated tax payments for their first two tax years, whereas a trust must make estimated tax payments in its first year;
5. Estates are allowed a charitable deduction for amounts permanently set a side for charitable purposes, whereas trusts are allowed a charitable deduction only for amounts paid to charities;
6. No need to file Form 1041-A (charitable distributions from trust);
7. The active participation requirement under the passive loss rules is waived in the case of estates (but not trusts) for tax years ending less than two years after the owner's death;
8. Estates (but not trusts) can take advantage of the $25,000 rental real estate passive loss exemption;
9. An estate is a permitted S Corporation shareholder, whereas generally a trust is only an eligible S Corp shareholder for a 2 year period beginning on the date the stock is transferred to the trust (unless the trust is a QSST or ESBT); note that if an estate, or an administrative trust with a valid § 645 election, distributes to a new trust, then the two-year period for the new trust generally begins immediately after such transfer; and
10. Estates can qualify for amortization of reforestation expenditures under § 194.