Preserving the GST Tax Exemption Marital Deduction Trust Funding

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A. ***A Calculation Refresher***

1. The portion of a trust or trust distribution that is "exempt" from GST Tax is determined by multiplying the value of the trust/distribution by the *inclusion ratio*. The inclusion ratio is calculated by subtracting the *applicable fraction* from the integer one. In general, the numerator of the applicable fraction is the amount of GST Tax exemption allocated to the trust, and the denominator is the value of the assets transferred to the trust (reduced by any federal estate tax or state death tax actually recovered from the trust attributable to such assets, and any gift or estate tax charitable deductions with respect to such assets).

$$\text{Portion of Trust/Distribution Subject to GST Tax} = \underbrace{\left(1 - \frac{\text{Numerator of the Applicable Fraction}}{\text{Denominator of the Applicable Fraction}} \right)}_{\textit{Inclusion Ratio}} \times \text{Value}$$

2. The so-called "separate share rules" and the "valuation rules" set forth in IRC section 2654 and 2642, respectively, and the Treasury Regulations promulgated thereunder, must be met to successfully exempt a trust or trust distribution fully from GST Tax. (See Exhibits A and B.)

3. Any distribution from a trust with an inclusion ratio of zero will be fully exempt from GST Tax. To achieve an inclusion ratio of zero, the denominator of the applicable fraction must generally reflect assets at their date-of-death values. Whether or not date-of-death values can be used for the denominator depends on application of the valuation rules.

B. ***Drafting Strategies: Severances and Formula Selection (Downstream Allocation of Exemption)***

1. Mandatory Severances – Trustee directed in governing instrument to divide trust into two or more trusts or shares.

a. *Pecuniary allocation.*

(i) **Marital Pecuniary Formula** - funding at date-of-distribution values (sometimes referred to as upfront true worth funding).

(a) Compliance with separate share rules.

(1) Trust funding – severance of a trust is recognized for GST Tax purposes (i.e.,

resulting trusts are treated as separate shares) if:

i) Trust is included in transferor's gross estate,

ii) Trust is severed into two or more trusts, and

iii) Severance is pursuant to a direction (mandatory) in the governing instrument

(2) Outright distribution – treated as a separate share only if:

i) "Appropriate interest" paid for any cash distributions

a) If there is a statutory rate of interest ("SRI"), pay amount at least equal to the SRI, but not greater than 120% of the 7520 rate effective at date of death; or

b) If there is no SRI, pay amount at least equal to 80%, but not greater than 120%, of the 7520 rate at date of death; or

c) Allocate proportionate share of income (if permitted in governing instrument or under state law) earned by the undivided share; or

d) Fully fund pecuniary payment within 15 months of death.

ii) Fairly reflects net appreciation or depreciation – for non-cash payment where any method other than date-of-distribution values is used.

(b) Compliance with valuation rules – *What value can we use for the denominator in calculating the applicable fraction?*

(1) Always want to be able to use the date-of-death value of the residuary assets for the denominator of the applicable fraction.

i) Using the date-of-distribution value for the denominator (if so required) results in an inclusion ratio greater than zero (and less than one), if the property used to fund the GST trust appreciates in value between the date of death and date of funding.

ii) If the residuary assets are transferred as result of death, value is as finally determined for federal estate tax purposes (i.e., date-of-death value -- use that value in the denominator), unless non-compliance with allocation of post-death changes in value.

(2) If cannot use date-of-death value for residuary assets, must use date-of-distribution value for the denominator.

(3) Pecuniary payment of cash – must carry “appropriate interest”; otherwise, the applicable fraction is calculated by subtracting the present value of the pecuniary payment from the estate tax value of the assets available to satisfy the pecuniary payment, rather than the actual pecuniary payment made.

(4) For pecuniary bequests made in kind, a pecuniary funding (true worth) formula

meets the GST Tax regulations' requirement that a residual transfer after a pecuniary payment must be satisfied at date-of-distribution values. Treas. Regs. § 26.2642-2(b)(3)(ii)(A).

(ii) **Marital Fairly Representative Formula** - funding at date-of-death values, using fairly representative allocation.

(a) Compliance with separate share rules – same as with marital pecuniary (upfront true worth) formula.

(b) Compliance with valuation rules – same with marital pecuniary formula. (For pecuniary bequests made in kind, a "pecuniary funding, fairly representative formula" meets the GST Tax regulations' requirement that a residual transfer after a pecuniary payment must be satisfied at date-of-distribution values. Treas. Regs. § 26.2642-2(b)(3)(ii)(B).)

(iii) **Minimum Worth Formula** – funding at lesser of date-of-distribution or date-of-death values.

(a) The required use of date-of-distribution values for the denominator of the applicable fraction effectively prevents the trustee from using this formula for GST Tax exemption allocation purposes.

(b) May be used for non-GST Tax sheltering purposes.

(iv) **Reverse Pecuniary Formula** (where the pecuniary amount is allocated to the Credit Shelter Trust).

(a) Compliance with separate share rules – same as with marital pecuniary (upfront true worth) formula.

(b) Compliance with valuation rules.

(1) If the pecuniary payment is satisfied with cash, the denominator is the pecuniary amount.

(2) If the pecuniary payment is satisfied with non-cash property, the property must be valued as of the date of distribution OR on a basis that fairly reflects net appreciation and depreciation. (These are the same requirements as Rev. Proc. 64-19.)

b. *Fractional allocation.*

(i) Compliance with separate share rules – same as with marital pecuniary (upfront true worth) formula.

(ii) If assets transferred as result of death, value is as finally determined for federal estate tax purposes (i.e., use that value in the denominator).

2. Discretionary Severances – Trustee has discretion whether or not to sever the trust.

a. *Pecuniary allocation.*

(i) Compliance with separate share rules.

(a) Discretionary *pecuniary* severance <u>must</u> be provided for in the governing instrument.

(b) New trusts must provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust.

(c) Severance must occur, or the reformation proceeding must commence, prior to the date prescribed for filing the federal estate tax return (including extensions).

(d) Pecuniary payment must be satisfied in a manner that would meet the requirements addressed above regarding the outright payment of a pecuniary amount. Treas. Regs. § 26.2654-1(b)(1)(ii).

(ii) Compliance with valuation rules – same as with marital pecuniary formula.

b. *Fractional allocation.*

(i) Compliance with separate share rules.

(a) New trusts must provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust.

(b) Severance must occur, or the reformation proceeding must commence, prior to the date prescribed for filing the federal estate tax return (including extensions).

(c) New trusts must be severed on a fractional basis. The severance may be made on a pro rata or non-pro rata basis. Treas. Regs. § 26.2654-1(b)(1)(ii). If non-pro rata, the property must be valued as of the date of funding or on a basis that fairly reflects net appreciation and depreciation.

(ii) Compliance with valuation rules – same as with marital pecuniary formula.

C. ***Planning with Powers of Appointment, and with Trustee and Third-Party Powers***

1. Mandatory severance – draft non-exempt trust to include a GPOA

2. Discretionary severance

a. Include carve-out provision, granting GPOA for non-exempt property. (Careful with potential application of section 2036.)

b. Require grant of GPOA for non-exempt trust upon discretionary severance.

c. Give independent trustee, trust protector power or third-party power to create GPOA as to non-exempt trust property.

d. Allow qualified disclaimer of existing GPOA by beneficiary of trust (if have sufficient GST Tax exemption to allocate to that trust, to make it exempt from GST Tax).

Exhibit A
Separate Share Requirements

Regs. § 26.2654-1. Certain trusts treated as separate trusts.

(b) Division of a trust included in the gross estate.

(1) In general. The severance of a trust that is included in the transferor's gross estate (or created under the transferor's will) into two or more trusts is recognized for purposes of chapter 13 if—

	Mandatory Severance	Discretionary Severance
Fractional	(i) The trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or	(ii) The governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and (A) The terms of each of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust; (B) The severance occurs (or a reformation proceeding, if required, is commenced) prior to the date prescribed for filing the Federal estate tax return (including extensions actually granted) for the estate of the transferor; and (C) (1) The new trusts are severed on a fractional basis. If severed on a fractional basis, the separate trusts need not be funded with a pro rata portion of each asset held by the undivided trust. The trusts may be funded on a nonpro rata basis provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding; or
Pecuniary	(i) The trust is severed pursuant to a direction in the governing instrument providing that the trust is to be divided upon the death of the transferor; or	(ii) The governing instrument does not require or otherwise direct severance but the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law; and (A) The terms of each of the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust; (B) The severance occurs (or a reformation proceeding, if required, is commenced) prior to the date prescribed for filing the Federal estate tax return (including extensions actually granted) for the estate of the transferor; and (C) (2) If the severance is required (by the terms of the governing instrument) to be made on the basis of a pecuniary amount, the pecuniary payment is satisfied in a manner that would meet the requirements of paragraph (a)(1)(ii) of this section if it were paid to an individual.

Please note the special rule that applies to separate share treatment of a pecuniary *payment* (see Treas. Reg. § 26.2654-1(a)(ii), as opposed to a trust severance and allocation under (a)(i)):

Treasury Regulation § 26.2654-1. Certain trusts treated as separate trusts.

- (a) Single trust treated as separate trusts.
  - (1) Substantially separate and independent shares.
    - (i) If a single trust consists solely of substantially separate and independent shares for different beneficiaries, the share attributable to each beneficiary (or group of beneficiaries) is treated as a separate trust for purposes of Chapter 13….
    - (ii) Certain pecuniary amounts. For purposes of this section, if a person holds the current right to receive a mandatory (i.e., nondiscretionary and noncontingent) payment of a pecuniary amount at the death of the transferor from an inter vivos trust that is includible in the transferor's gross estate, or a testamentary trust, the pecuniary amount is a separate and independent share if—
      - (A) The trustee is required to pay appropriate interest (as defined in §26.2642-2(b)(4)(i) and (ii)) to the person; and
      - (B) If the pecuniary amount is payable in kind on the basis of value other than the date of distribution value of the assets, the trustee is required to allocate assets to the pecuniary payment in a manner that fairly reflects net appreciation or depreciation in the value of the assets in the fund available to pay the pecuniary amount measured from the valuation date to the date of payment.

Special thanks to Debra Polly, associate attorney with the law firm of Fennemore Craig, P.C. in its Phoenix office, for preparing this exhibit.

Exhibit B

Valuation Requirements

IRC § 2642 Inclusion ratio

(b) Valuation rules, etc.

(2) Transfers and allocations at or after death.

(A) Transfers at death. If property is transferred as a result of the death of the transferor, the value of such property for purposes of subsection (a) shall be its value as finally determined for purposes of chapter 11; except that, if the requirements prescribed by the Secretary respecting allocation of post-death changes in value are not met, the value of such property shall be determined as of the time of the distribution concerned.

(B) Allocations to property transferred at death of transferor. Any allocation to property transferred as a result of the death of the transferor shall be effective on and after the date of the death of the transferor.

Treasury Regulation § 26.2642-2. Valuation.

(b) Transfers at death.

Fractional Formula	(1) In general. Except as provided in paragraphs (b)(2) and (3) of this section, in determining the denominator of the applicable fraction, the value of property included in the decedent's gross estate is its value for purposes of chapter 11.

Pecuniary Formula	**Allocation of the GSTT Exemption to the Residual Transfer After Satisfaction of a Pecuniary Allocation or Payment** (*e.g.*, to the Credit Shelter Trust under an True Worth Marital (Pecuniary) Funding Formula)	**Allocation of the GSTT Exemption to the Pecuniary Allocation or Payment** (*e.g.*, to the Credit Shelter Trust under a True Worth Credit Shelter (Reverse Pecuniary) Funding Formula)
Date of Distribution Value used to fund the pecuniary payment	(3) Special rule for residual transfers after payment of a pecuniary payment. (i) In general. Except as otherwise provided in this paragraph (b)(3), the denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment is the estate tax value of the assets available to satisfy the pecuniary payment reduced, if the pecuniary payment carries appropriate interest (as defined in paragraph (b)(4) of this section), by the pecuniary amount. The denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment that does not carry appropriate interest is the estate tax value of the assets available to satisfy the pecuniary payment reduced by the present value of the pecuniary payment. For purposes of this paragraph (b)(3)(i), the present	(2) Special rule for pecuniary payments. (i) In general. If a pecuniary payment is satisfied with cash, the denominator of the applicable fraction is the pecuniary amount. If property other than cash is used to satisfy a pecuniary payment, the denominator of the applicable fraction is the pecuniary amount only if payment must be made with property on the basis of the value of the property on— (A) The date of distribution…. (ii) Other pecuniary amounts payable in kind. The denominator of the applicable fraction with respect to any property used to satisfy any other pecuniary payment payable in kind is the date

	value of the pecuniary payment is determined by using— (A) The interest rate applicable under section 7520 at the death of the transferor; and (B) The period between the date of the transferor's death and the date the pecuniary amount is paid. (ii) Special rule for residual transfers after pecuniary payments payable in kind. The denominator of the applicable fraction with respect to any residual transfer after satisfaction of a pecuniary payment payable in kind is the date of distribution value of the property distributed in satisfaction of the residual transfer, unless the pecuniary payment must be satisfied on the basis of the value of the property on— (A) The date of distribution….	of distribution value of the property.

	Allocation of the GSTT Exemption to the Residual Transfer After Satisfaction of a Pecuniary Allocation or Payment (*e.g.*, to the Credit Shelter Trust under a True Worth Marital (Pecuniary) Funding Formula)	**Allocation of the GSTT Exemption to the Pecuniary Allocation or Payment** (*e.g.*, to the Credit Shelter Trust under a True Worth Credit Shelter (Reverse Pecuniary) Funding Formula)
Date of Death Value used to fund the pecuniary payment, with fairly representative allocation of appreciation or depreciation	(3) Special rule for residual transfers after payment of a pecuniary payment. (i) In general. Except as otherwise provided in this paragraph (b)(3), the denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment is the estate tax value of the assets available to satisfy the pecuniary payment reduced, if the pecuniary payment carries appropriate interest (as defined in paragraph (b)(4) of this section), by the pecuniary amount. The denominator of the applicable fraction with respect to a residual transfer of property after the satisfaction of a pecuniary payment that does not carry appropriate interest is the estate tax value of the assets available to satisfy the pecuniary payment reduced by the present value of the pecuniary payment. For purposes of this paragraph (b)(3)(i), the present value of the pecuniary payment is determined by using—	(2) Special rule for pecuniary payments. (i) In general. If a pecuniary payment is satisfied with cash, the denominator of the applicable fraction is the pecuniary amount. If property other than cash is used to satisfy a pecuniary payment, the denominator of the applicable fraction is the pecuniary amount only if payment must be made with property on the basis of the value of the property on— … (B) A date other than the date of distribution, but only if the pecuniary payment must be satisfied on a basis that fairly reflects net appreciation and depreciation (occurring between the valuation date and the date of distribution) in all of the assets from which the distribution could have been made.