



Marital Deductions *GST, Estate and Income Tax Implications*

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EXAMPLES AND CONCLUSIONS — GST, ESTATE, AND INCOME TAX IMPLICATIONS

A. *Pecuniary Formula Dispositions*

1. **Marital Pecuniary** – John, a married person, created a revocable living trust to be divided upon his the death into a Marital (QTIP) Trust and a Credit Shelter Trust. The Marital and Credit Shelter Trusts are to be funded based on a marital pecuniary formula (sometimes referred to as a true worth pecuniary formula). The generation-skipping transfer tax formula provides that, upon the Settlor's demise, any available GST Tax exemption of the Settlor will be applied first to the Credit Shelter Trust. Any remaining GST Tax exemption will be applied to the Marital Trust. (The Marital and Credit Shelter Trusts may each be further divided, if necessary, into exempt and non-exempt trusts for inclusion ratio purposes, and for a reverse QTIP election). At the time of John's death in year 2016, his available applicable exclusion amount and exemption amount are each \$5.45 Million. Assuming that the total value of the trust assets exceeds John's available applicable exclusion amount, that all of the trust assets are available for trust funding and would qualify for the federal estate tax marital deduction, and that all advisable tax elections/allocations are made, the assets used to satisfy the pecuniary allocation:

- Can be selected on a pick-and-choose basis
- Will be subject to a taxable event
- If a *right to IRD*, will be subject to acceleration of income
- Must be appraised based on date-of-death values, and re-appraised based on date-of-distribution values
- Must receive "appropriate interest" for GST Tax purposes, as to a cash (principal) allocation
- Will NOT carry out DNI to the Marital Trust *unless* income is allocated to the Marital Trust; if DNI is carried out, it will be based on the FMV of assets allocated

(The value of this trust is frozen through the date of funding.)

The assets passing to the residuary allocation:

- Can be selected on a pick-and-choose basis
- Will NOT be subject to a taxable event

- Will only need to be appraised based on date-of-death values
- Will be used, in effect, to meet GST Tax regulations requiring “appropriate interest” to be paid to the Marital Trust for any cash (principal) allocation to that trust
- Will carry out DNI to the Credit Shelter Trust, based on the FMV of assets allocated

If income is (or is required to be) allocated to the pecuniary Marital Trust, non-deductible personal expense treatment and federal income tax on any statutory interest will be avoided. The allocation of income can also serve to preserve the marital deduction (all income of John’s trust estate allocable to the Marital Trust is required to be distributed to the John’s surviving spouse, from date of John’s death). Note: This will carry out DNI to the Marital Trust.

With the marital pecuniary formula, appreciation and depreciation inures to the benefit of the Credit Shelter Trust. If the value of the John’s trust on date of death were about \$7 Million (after subtracting all taxes and expenses payable during the administration period), and increased or appreciated during the administration period to \$7.5 Million, then the Marital Trust would receive approximately \$1.55 Million, and the Credit Shelter Trust would receive about \$5.95 Million (ignoring expense allocations, income taxes associated with DNI carry outs, IRD, etc.). Fortunately, because this type of formula complies with the GST Tax severance and valuation rules (relating to date-of-distribution funding), the Credit Shelter Trust will have an inclusion ratio of zero, and thus be fully exempt from GST Tax, even though it receives \$0.5 Million more of asset value than John has of GST exemption.

Consider, however, that if the value of the John’s trust on date of death were about \$12 Million (after subtracting all taxes and expenses payable during the administration period), and decreased or depreciated during the administration period to \$6 Million, then the Marital Trust would receive approximately \$6 Million, and the Credit Shelter Trust would not be funded.

Now substitute a \$100 Million value for the \$12 Million value assumed above, and \$94 Million for the \$6 Million distribution value. With all other premises remaining the same, the Credit Shelter Trust would again have a value of zero, but perhaps more relevant would be the cost of revaluations (as of date of distribution) on all of the assets, particularly if those assets are difficult to value.

2. **Credit Shelter Pecuniary** – Same facts as above, except the Marital Trust and Credit Shelter Trust are to be funded based on a credit shelter pecuniary formula (sometimes referred to as a true worth reverse pecuniary formula). Assets used to satisfy the pecuniary allocation:

- Can be selected on a pick-and-choose basis
- Will be subject to a taxable event
- If a *right to IRD*, will be subject to acceleration of income
- Must be appraised based on date-of-death values, and re-appraised based on date-of-distribution values
- Will NOT carry out DNI to the Credit Shelter Trust (except to the extent that income is allocated to that trust)

The assets passing to the residuary allocation:

- Can be selected on a pick-and-choose basis
- Will NOT be subject to a taxable event
- Appraised based on date-of-death values only
- Will carry out DNI to the Marital Trust

(The value of this trust is frozen through the date of funding.)

If income is (or is required to be) allocated to the Credit Shelter (pecuniary) Trust, non-deductible personal expense treatment and federal income tax on any statutory interest will be avoided. Note: This will carry out DNI to the Credit Shelter Trust, based on the income and the FMV of the assets allocated to that trust. The governing instrument could be drafted so that no DNI is carried out to the Credit Shelter Trust.

With the credit shelter (or reverse) pecuniary formula, appreciation and depreciation inures to the benefit of the Marital Trust. If the value of the John's trust on date of death were about \$7 Million (after subtracting all taxes and expenses payable during the administration period), and increased or appreciated during the administration period to \$7.5 Million, then the Marital Trust would receive approximately \$2.05 Million, and the Credit Shelter Trust would receive about \$5.45 Million (ignoring expense allocations, income taxes associated with DNI carry outs, IRD, etc.). Observe that if FAI for John's trust (during the administration period) were substantial, and if trust income were allocable to the Credit Shelter Trust, it could have a significant DNI burden (since the DNI carry out would be based, in part, on the FMV of non-cash principal allocated to the Credit Shelter Trust). This type of formula complies with the GST Tax severance and valuation rules (relating to date-of-distribution funding).

If the value of the John's trust on date of death were about \$12 Million (after subtracting all taxes and expenses payable during the administration period), and decreased (depreciated) during the administration period to \$6 Million, then the Marital Trust would receive approximately \$0.55 Million, and the Credit Shelter Trust would receive its locked-in amount of about \$5.45 Million (which would be fully exempt from GST Tax upon proper allocation of available exemption).

If the \$12 Million value assumed in the above paragraph were instead \$100 Million, and the \$7 Million distribution value were in fact \$94 Million, then with all other premises remaining the same, the Credit Shelter Trust would again have its locked-in value of about \$5.45 Million (fully GST Tax exempt), but perhaps more important the revaluation requirement would apply only to the assets funding the Credit Shelter Trust.

3. **Marital Pecuniary, Fairly Representative** – Same facts as above, except the Marital Trust (pecuniary) and Credit Shelter Trust (residuary) are to be funded such that the aggregate fair market value of the assets allocated to the Marital Trust is fairly representative of the appreciation or depreciation in the value to the date(s) of distribution. Assets used to satisfy these trusts:

- Can be selected on a pick-and-choose basis, but subject to the inherent limitations of the “fair representative” requirement. It may be necessary to fractionalize assets to allocate a pro rata portion of each appreciated asset and each depreciated asset.
- Will NOT be subject to a taxable event
- If a *right to IRD*, will be subject to acceleration of income if allocated to the pecuniary trust
- Must be appraised based on date-of-death values, and re-appraised based on date-of-distribution values
- Must receive “appropriate interest” (Marital Trust only) for GST Tax purposes, as to a cash (principal) allocation
- Will carry out DNI to the two trusts, but the amount may be less than with a traditional pecuniary formula, since the DNI here is limited to the lesser of basis and FMV (IRC §

643(e)(2)); alternatively, can elect to recognize gain under IRC § 643(e)(3)

- 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.

4. **Marital Pecuniary, Minimum Worth** – Not discussed, because using this formula will likely result in trusts having an inclusion ratio between zero and one, and thus NOT fully exempt or fully non-exempt from GST Tax.

B. ***Fractional Formula Dispositions***

1. **Pro Rata.** Same facts as above, except the Marital Trust and Credit Shelter Trust are to be funded based on a pro rata (traditional) fractional formula. Results:

- No taxable event.
- No acceleration of income with respect to any *right to IRD*
- CanNOT pick and choose assets for funding
- Will carry out DNI on a fractional basis (but based on the lesser of FMV or basis)
- Appraised based on date-of-death values only

2. **Pick-and-Choose Formula.** Same facts as above, except the Marital Trust and Credit Shelter Trust are to be funded based on a pick-and-choose fractional formula. Results:

- No taxable event.
- No acceleration of income with respect to any *right to IRD*
- Can pick and choose assets for funding
- Will carry out DNI on a fractional basis (but based on the lesser of FMV or basis)
- Must be appraised based on date-of-death values, and re-appraised based on date-of-

distribution values *if intended to qualify as a
GST severance*

C. ***Optimal Formula Selection***

1. Some rules of thumb
2. Predominant issues – client based

