

# CHAPTER TEN

## Transfers to/for a Spouse

**Objective:** Property transfers to the spouse to enable him/her to have financial support during survivorship period from the entire marital estate. Avoid dilution for federal estate tax).

**If** the federal estate tax applies (\$5.490 mil.+) to the estate of first spouse to die, then issues are:

- (1) how to transfer to spouse to possibly avoid estate tax at death of first spouse to die; and**
- (2) treatment at subsequent death (or gift) of surviving spouse? Only tax postponement?**

# Who is a Surviving Spouse?

p.3

Does a surviving spouse include a “common law” spouse? How define a “common law” spouse? Remember the Bosch case re state law relevance? State law as determinative?

Rev. Rul. 76-155, p.4, where 3/40ths of potential dower interest amount was received by person arguing spousal status – not treated as having spousal status for federal estate tax purposes.

What about heterosexual (1) common law marriage and (2) a “palimony” situation?

# Same-Sex Relationships

## p.6

Consider (1) same-sex marriages and (2) “civil unions,” in the context of DOMA, §3, & the marital deduction.

Windsor case, 2013, involving the estate tax marital deduction, p. 6; marital deduction OK.

Note Rev Rul. 2013-17, p. 6, applying a “place of celebration” rule for recognizing same-sex marriages (but not domestic partnerships, etc.).

What relevance of these rules in Texas? See Obergefell case, p. 6.

# Determining the Net Marital Deduction Amount

Code §2056(b)(4)(A) concerns the reduction of marital deduction by any burden of estate tax.

Estate of McCoy, p. 7, “equitable apportionment”, i.e., is tax contribution requirement applicable only to those assets producing an estate tax liability? But, what if contrary tax allocation instructions in the trust agreement? Note: here assets were both in (1) the probate estate and (2) the trust estate.

Held: no apportionment to the MD portion.

See Texas Estates Code, §124.005 (see Ch. 3).

# Determining MD Amount – Administration Expenses

Code §2056(b)(4)(B) re reduction of marital deduction by burden of debts/admin expense.

Estate of Hubert (US Sup. Ct., 4 vote plurality), p. 15: no reduction for administration expenses paid from estate income. Only “material limitations” on the income right are noted in determining (reducing) the value of interest passing to surviving spouse. Notice 97-63, p. 16.

Note the subsequent regulations (p.18) – estate transmission expenses reduce the MD transfer.

Cf., estate management expenses (not reducing the MD amount); e.g., investment advisor costs.

# Subsequent inclusion in surviving spouse's estate

Premise that marital deduction only permits deferral until surviving spouse's death – unless the surviving spouse spends or gives away the property during her survival period.

How much estate tax exclusion for the surviving spouse? Start with the statutory exclusion - \$5.490 million for 2017.

What if the first spouse did not use all of his exclusion? Portability of the unused portion to the surviving spouse. See Code §2010(c)(2)(B) re “deceased spousal unused exclusion amount.”

# DSUEA described; See 2010 Tax Act, §303(a)

Code §2010(c)(4) identifies DSUEA as lesser of:

- 1) Basic exclusion amount, or
- 2) Deceased spouse's exclusion amount less the exclusion used by the estate of deceased spouse.

Example: Husband dies in 2017 & makes taxable transfers of \$3 million & no taxable estate. At wife's subsequent death: her \$5.49 million exclusion (or larger) and his unused exclusion of \$2.49 million equals \$7.98 million exclusion available.

# Conditions for using the DSUEA

**Deceased spouse's estate files federal estate tax return & makes an election for the deceased spouse's unused exclusion amount to be claimed by surviving spouse.**

**How prove this amount when the surviving spouse subsequently dies? File non-taxable estate tax return when the first spouse dies.**

**See Rev. Proc. 2014-18, p.20 (fn15), providing relief (during 2014) when first estate tax return not timely filed. Is subsequent relief possible?**



# Conditions for using the DSUEA, continued

**Options:** (1) If using DSUEA - tax basis step-up will be available to the estate of surviving spouse; (2) Cf., credit shelter trust previously used - no basis step-up, but protection from post-death appreciation of his assets being subsequently included in estate of spouse.

**Note:** DSUEA from 1<sup>st</sup> spouse disappears if remarriage by surviving spouse & 2<sup>nd</sup> spouse dies. What planning options for this situation?

# Options for Transfers to Surviving Spouse, p.20-21.

See Code §2056(c) concerning property transfer mechanics:

- 1) Bequest or devise to spouse
- 2) Inheritance (intestacy)
- 3) Joint tenancy with the surviving spouse
- 4) General power of appointment to spouse
- 5) Life insurance proceeds paid to beneficiary spouse.
- 6) P/A trust and QTIP trust – §2056(b)(5)&(7).

# The “Terminable Interest” Limitation Rule p.21

Code §2056(b)(1)(A) disallows marital deduction for a “nondeductible” terminable interest, e.g., to “wife for life, remainder to children.”

**Exceptions:** Code §2056(b) -- (5) life estate & general P/A; (6) life insurance; (7) QTIP; and (8) CRT.

Also, the “estate trust” option (where assets flow into the probate estate of surviving spouse, then governed by the last will of spouse).

# The “Six Months Survival Condition” P.22

Code §2056(b)(3) – exception to the terminable interest rule: where (1) the interest is conditioned on spouse survival for six months, and (2) the event of non-survival does not occur.

What purpose of this rule (under state law)?

Heim, p. 23 – California statute restricting “survival until estate distribution.”

No “savings clause” availability here (Cal Prob. Code § 1036) – since no MD gift intent (p.29).

Correct? How present evidence of intent here?

# Life Estate – Power of Appointment Trust p.31

Code §2056(b)(5) requirements – see p.31

- 1) All income for life, payable at least annually (& not limited by a standard);
- 2) Payable to the surviving spouse only;
- 3) General power of appointment to (a) the surviving spouse or (b) that spouse's estate - causes inclusion when she later dies.
- 4) No other person has any powers over the disposition of the trust property.

**Structure enables MD at first spouse's death.**

# Code §2056(b)(5)

## “Right to Income” p.32

Is an income payment delay permissible during a reasonable probate administration period?

What if unproductive property (e.g., raw land or non-dividend stock) is held by the trust for the surviving spouse? Texas Prop. Code?

What if the property held by this trust for the spouse is a personal residence?

See Rev. Rul. 69-56, p. 33 – re fiduciary powers over allocating receipts and disbursements - although “net income” paid annually to spouse.

# The “Specific Portion” Limitation p.36

Code §2056(b)(5) provides for distribution of income from all “or a specific portion.”

Northeastern Pennsylvania Bank, p.36

Can the fair market value of a gift of a \$300/\$350 per month payment be quantified?

How much is includible in the surviving spouse’s subsequent gross estate?

See Est. of Alexander, p. 41.

See (p.42) Code §2056(b)(10) – only fractional or percentage basis gifts are MD eligible. Why?

# The §2056(b)(5) Power of Appointment Requirement

**P. 42. For marital deduction eligibility the surviving spouse must have a general P/A (intervivos or testamentary).**

**Why pick a power only exercisable at the death of the powerholder? What income tax effect if holding an intervivos P/A? – See Code §678.**

**Provide a special P/A during life and a general P/A exercisable at death? What structure for exercising the power at the time of death?**

**Include a “default clause” when non-exercise?**



# The §2056(b)(6) Life Insurance Payments

**P. 43.**

**Arrangements for installments from life insurance company – sourced from life insurance policy death proceeds.**

**Also, power to appoint by spouse (general testamentary power?).**

# QTIP Arrangements

Code §2056(b)(7)

p.43

**Requirements for MD eligibility under this alternative:**

- 1) Property passes from the decedent.**
- 2) The surviving spouse has a qualifying income interest for life.**
- 3) A “QTIP” election is made. This election causes the subsequent inclusion of the MD trust assets in the surviving spouse’s gross estate at her subsequent death - Code §2044.**

# QTIP Income Distribution Requirements p.44

**Required current income distributions - no power to accumulate income in the trust.**

**No power to another to appoint the property away from the surviving spouse.**

**P. 44. No discretion permitted concerning income distributions, e.g., “accustomed manner of living.” No “ascertainable standard” can be applicable to income distributions.**

# QTIP Trust as an IRA Beneficiary

p.44

**Purpose of an IRA: income deferral; subject to the “minimum distribution” (MRD) rules.**

**Purpose of the marital deduction: current income distribution required for the QTIP.**

**What happens if the entire IRA is distributed to the MD trust? Liquidate the IRA (into trust)?**

**Rev. Rul. 2006-26, p. 45, query re status of the “qualifying income interest.” *next slide***

# Rev. Rul. 2006-26, p.45

**Does the distribution provision satisfy the QTIP spousal income requirement?**

- 1) Adjustments are permitted re income and principal under Uniform P&I Act for determining the income amount.**
  - 2) Unitrust income determination possible.**
  - 3) State law “traditional” definition of income**
- Spouse needs authority to access all the IRA income.**

# The “Stub Period” Income Problem

p.51

**Example:** All income was distributed for the prior year on Jan 2. Spouse dies on Jan. 10. QTIP trust provision states that all Jan. 2-10 income is to go to remainder beneficiary. Why?

Estate of Rose Howard, p.52 – did the spouse have a “qualifying income interest” for life?

How solve this issue in the planning context?

Does a “duty of consistency” apply? What is a “duty of consistency”? Is the problem solved by the Treasury regulations?

# Marital Deduction for a Texas Homestead? p.56

Kyle case, p. 56 - MD eligibility for 25% of the residual share of estate received in an exchange when she surrendered Texas homestead rights?

Is the “homestead right” less than a “life estate”? See Texas Constitution (p. 60) re the status of the homestead right – must continue to use as the homestead; cannot abandon; the homestead right is “personal.” P.61.

However, is the will “rewritten” in the will contest settlement process? p.62. No. p. 63.

Was a QTIP election essential here? P. 63.

# Post-death QTIP Election Flexibility

p.64

Clayton case, p. 64 – MD & “by-pass” trusts.

What is the effect of an executor’s authority to make a QTIP election as to distribution of some or all of the property in an estate settlement?

Was this authority a “power of appointment” which negates QTIP eligibility? No, p. 69.

See Code §2056(b)(7)(B)(ii)(II).

Held: MD was available for the elected portion - .563731 of the securities as funded into the “B” (QTIP) trust (with remainder to “A” trust).



# Response to the Clayton case for Taxpayer

Reg. §20.2056(b)-7(h), Example 6 (p. 70) – provides that, where executor can elect portion of a trust as QTIP, the executor is not considered to have a power to appoint property to another person.

Therefore, QTIP eligibility does exist for the property transferred into the marital deduction trust (“B” trust) for the spouse.

# Protecting Against Drafting Errors

p.71

- 1) Include a “savings clause”? What effect of a “generic statement of intent” that desiring QTIP treatment (after specifying QTIP trust terms)?
- 2) What if merely providing in the will (or the revocable trust agreement) that a trust is to be established consistent with the statutory requirements of the QTIP provisions (as existing as of the time of death)?

# Tax Effects at Death of Surviving Spouse p.71

- 1) Inclusion of the QTIP trust assets in the gross estate of the surviving spouse – Code §2044.
- 2) Where is the estate tax payment to be sourced from? P. 71. How is the estate tax amount attributable to the included QTIP assets determined? See Code §2207A. Note that a “stacking,” not a proportional, approach applies to making determination. Waive this reimbursement right? QTIP trust reduced? No.

# Make a protective QTIP election? p.73

Should the QTIP election be made?

The election is irrevocable.

Consider: Risk of the surviving spouse dying shortly after the QTIP election (Howard case)?

Is a “protective election” available? Only if a bona fide issue exists; and, the protective election is irrevocable.

Limited protection: delay filing estate tax return for 1<sup>st</sup> spouse’s estate until time limit.

# Disposition of Qualifying Income Interest p.73

Code §2519 specifies that the disposition of any part of the income interest is treated as a gift transfer of all interests in the QTIP property – except the qualifying income interest transfer.

But, Code §2511 applies to the income interest transfer. See Reg. § 25.2519-1.

What is the purpose of this gift tax rule?

How collect the gift tax owing in this situation (i.e., gift of the income interest)? See §2207A(b) (a gift tax provision included in an estate tax statute).

# Spouse Buys Remainder Interest

p.73

Possible option to subvert IRC §2519?

What if the remainder interest is terminated?

See Rev. Rul. 98-8 (p.73) concerning a transaction for consideration? Is §2519 still applicable? Yes, in substance a “commutation” has occurred here, and treated as a sale/disposition for §2519 purposes.

What is a “commutation”? What if all the parties agree to terminate a trust and receive their percentage interests?

**Holding:** A gift is made of the value of the remainder interest & §2519 applies.

# Determining the Amount of Gift On Transfer p.77

**The gift amount (by spouse) is reduced by the recoverable gift tax (§2207A(b)). See Reg. §25.2519-1(c)(4).**

**An interrelated computation is necessary.**

**What if the spouse pays the gift tax (rather than seeking reimbursement from trust)? A further gift is made (in amount of foregone gift tax)?**

**See Morgens case (p.88) re inclusion under §2035(b) for the gift tax paid by the recipients of the QTIP remainder.**

# Disclaimer Trusts

p.77

Assume the assets will be included in a QTIP trust unless the surviving spouse elects to reject (i.e., disclaim) the QTIP benefits. The assets would (if a disclaimer is made) then go to a non-qualifying trust, e.g., a transfer exposed to estate tax at the 1st death (but subject to unified credit availability?). Cf., Clayton case.

However: Consider what is the probability of the widow's actual disclaimer (i.e., rejection of property ownership)?



# Charitable Remainder Trusts

p.78

Code §2056(b)(8) provides for a qualified charitable remainder trust (CRAT or CRUT).

Technique useful where (1) a surviving spouse and (2) no surviving children/grandchildren.

See §664 re CRAT or CRUT details.

What if (1) a QTIP trust and (2) “remainder to charity” (i.e., not satisfying the §2056(b)(8) requirements, but §2056(b)(7)) & a QTIP election is made. Result: inclusion in the surviving spouse’s estate (§2044), but then a charitable deduction to the spouse’s estate?

# The “Estate Trust” p.79

Reg. §20.2056(c)-2(b)(1)(iii)

No QTIP qualification – because no required income distribution. Why structure a trust with no mandated income distribution? Why limit the spouse’s current income?

Note - the income tax rate for the trust is higher.

What if the assets are then distributable to the spouse’s probate estate at her death?

Additional probate costs when she dies. And what happens to these assets under her will?

Note Rev. Rul. 75-128, p. 79, only an undefined part is includible in the probate estate and, thus, no “estate trust” eligibility here (since a P/A).

# Marital Deduction Formula Clauses

p.81

**What is the objective of the MD formula clause?**

**Assume unified credit = \$5.49 million (2017).**

- 1) Assume the total value of the combined marital estates is less than \$5.49 million.**
- 2) Assume the total value of the combined marital estates is \$5.49-10.98 million.**
- 3) Assume the total value of the combined marital estates is in excess of \$10.98 million.**

**What happens if community property is held?**

**What if the unified credit amount changes?**

# Using an “Equalization Formula” p.83

## Alternative considerations:

- 1) Balance the two estates for two “runs up the bracket ladder” for estate tax – but how much progressivity exists at the top bracket (after the unified credit)?
- 2) Cf., “time value of money” for the deferred estate tax – but what if a low interest rate/investment return during the estate tax deferral period (particularly if appreciating assets are held by surviving spouse)?

**Note Smith case (p. 84) and Howard (earlier).**

# Allocation to the Residuary Estate

p.84

**Who should be the beneficiary of the  
“residuary estate”?**

**Choices for this distribution:**

- 1) “Credit shelter” trust (or other) assets, or,**
- 2) Marital deduction trust assets**

**What are the considerations for making this  
choice concerning the recipient of the residuary  
estate? Allocate the larger portion to the  
residuary?**

# Using a Formula Approach to Allocate

p.84

Objective in using a formula approach?

- (1) Provide for a zero tax at the death of first spouse, but (2) fully utilize the unified credit.
- Must account for other transfers outside the primary marital deduction gift transfer (e.g., prior gifts and specific bequests reducing the remaining unified credit amount).
- How implement this approach when unified credit is a varying amount (or uncertain)?

# Correcting An Erroneous Formula Approach p.85

Rev. Proc. 2016-49 - An unnecessary (irrevocable) QTIP election – when the estate tax liability is not reduced. E.g., (1) taxable estate (before the MD) is less than the exclusion amount (i.e., no estate tax would be imposed). Or, (2) an unnecessary QTIP election made for credit shelter trust. Election is “null and void.”

Election is not “null & void” where a partial QTIP election is necessary for tax protection.

Effect of treatment as invalid: no subsequent §2044 or §2519 inclusion (relevant for the surviving spouse’s subsequent estate).

# Funding Marital and Non-Marital Gifts p.90

*Which* assets should be picked to fund:

(1) the MD (“B”) trust, and

(2) the credit shelter/family (“A”) trust?

Wasting assets, e.g., depreciating property?

High-income, low appreciation property?

Fixed dollar obligations?

High appreciation potential assets?

What is the ultimate objective here?



# Funding the Pecuniary Formula Gift p.91

**Estate tax qualification considerations:**

**Rev. Proc. 64-19, p. 92; Objective:** gift must be funded at date of distribution values – either (1) “no less than” amount of pecuniary bequest or (2) “fairly representative” of appreciation or depreciation of the estate assets.

**Not relevant (p.93) to:** (1) fractional share, (2) specific bequest; (3) cash bequest; or, (4) no discretion re distribution of assets in kind.

**What is the objective of this Rev. Procedure?**

**See Texas Estates Code rescue provision, p.93.**

# Revenue Procedure 90-3

## p.94

Pecuniary bequest to child and payment on basis of FMV at the time of the distribution.

The residuary bequest to surviving spouse (after fulfilling the pecuniary bequest) may be significantly diminished by an asset value decline for the entire estate (or could be significantly increased).

Held: the residuary bequest is not a nondeductible “terminable interest.”

# Funding the Fractional Share Bequest

p.95

**How distribute fractional (or percentage) interests in each property? Remember the % interest in the Clayton case.**

**What if a fractional share interest in a property is distributed/funded to one party but not to another at the same time?**

**Will values change in interim (during probate)?**

**How adjust the fractional share formula for future distributions to the beneficiaries?**

# Income Tax Issues When Funding Bequests p.96

E.g., transfer of an appreciated asset to satisfy an obligation on executor to distribute a “pecuniary amount” from the estate.

Is the accrued gain in the distributed asset to be recognized for FIT purposes? Loss treatment?

Cf., any FIT gain recognition treatment when the distribution of appreciated property is made to satisfy a factional share bequest?

What if the shares in each distributed asset are not proportionate?

What treatment of any “DNI” distribution? If a DNI distribution, what is the income tax basis for the distributed asset? See §643(e).

# Issues When Closing Estate Administration

**E.g., issues concerning:**

- 1) Allocation of values.**
- 2) Income tax basis for assets received.**
- 3) Income tax attributable to estate distributions, i.e.,
  - (a) DNI carryout, and**
  - (b) gains triggered on funding of pecuniary bequests with appreciated assets.****

**Use a “Closing Agreement” among all the beneficiaries?**

# Transfer to Non-Citizen Spouse? P.97

**No marital deduction for an estate transfer to a non-citizen spouse (whether on not U.S. resident). Why? Can assets disappear from the U.S. tax base?**

**Solve with a QDT (qualified domestic trust, §2056(d)) - enabling a marital deduction; but, later estate tax inclusion is required at the death of the surviving spouse.**

**How assure the tax payment at the later time?**