

Marital Trust Funding Issues

Marital Trust Types

Property that passes from a decedent into a specially drafted marital trust qualifies for the unlimited federal estate tax marital deduction. Such trusts may take essentially three forms.

1. A general power of appointment (GPA) marital trust may be created for the sole benefit of the surviving spouse during his or her lifetime with terms that provide the surviving spouse with an income interest for life, coupled with either an inter vivos or testamentary general power of appointment in favor of the spouse or the spouse's estate.
2. A qualified terminable interest property (QTIP) trust may be used for the sole benefit of the surviving spouse during his or her lifetime, but its terms require that the surviving spouse have a qualifying income interest for life only.
3. An estate trust may be used to provide discretionary distributions to the surviving spouse during his or her lifetime, but it requires that the remainder of the trust pass to the surviving spouse's estate at death.

All of the marital trusts described above share the following characteristic: the value of the assets held by each trust will be included in the gross estate of the surviving spouse. In other words, bequests to these trusts do not eliminate federal estate tax, but instead, merely defer it.

Formula Clauses

Various clauses in the decedent's will dictate both the amount and manner in which the marital and other testamentary trusts are to be funded. These clauses take one of two general forms - pecuniary formula clauses or fractional formula clauses. Both types of formula clauses can generally be subdivided on the basis of funding methodologies. Seemingly innocuous on their face, these clauses may seriously affect the value and the nature of the assets passing into the marital trust.

The drafter of a will exercises complete discretion in choosing a funding mechanism, assuming the testator agrees with the choice. However, once a funding mechanism is chosen, that choice binds an executor administering a decedent's estate.

Funding a pecuniary marital trust usually involves one of three methods: (1) a true worth pecuniary approach; (2) a fairly representative pecuniary approach; or (3) a minimum worth pecuniary approach. The Sum-Certain approach will not be discussed here. When properly drafted:

1. A true worth pecuniary approach involves funding the marital trust with assets valued at the date of distribution.
2. A fairly representative pecuniary (64-19 formula) approach involves funding the marital trust with assets that are fairly representative of all appreciation and depreciation in the assets available for funding, using the value of such assets as finally determined for Federal Estate Tax purposes.
3. A minimum worth pecuniary approach involves funding the marital trust with assets at the lesser of the assets' date of distribution value or basis for federal income tax purposes (i.e., the value as determined for federal estate tax purposes or cost basis, if acquired after the decedent's death).

In contrast, funding a fractional marital trust usually involves either:

1. A proration of each asset involving dividing each asset between the marital and the balance of the estate.
2. A selection among the assets of an estate. This method allows the executor to choose the assets which are to be used to fund the marital trust.

True Worth Pecuniary/Optimum/Exact formula Marital

The operative wording distinguishing this type of Pecuniary Formula is: "My Personal Representative shall select assets to constitute the marital share, using for this purpose values current at the date or dates of distribution."

1. This formula guarantees a specific sum to the marital share.
2. Allows the P/R to select assets with which to fund the marital share and therefore permits a high degree of post-mortem tax planning.

3. Requires revaluation of assets and can be costly or difficult depending upon the type of estate assets.
4. Distributions will carry out distributable net income.
5. Capital gains are recognized to the extent distribution values exceed estate tax values.
6. Capital losses may be limited.
7. Overall appreciation or depreciation of estate after death and before distribution is passed to the non-marital share.

Fairly Representative Pecuniary (64-19)

Typical language for this type of Pecuniary Formula is: "My Personal Representative shall select the assets to constitute the marital share, and shall value each asset so selected at the value of such assets as finally determined for federal estate tax purposes in my estate; provided, however, that assets so allocated to the marital share shall be selected in such manner that such property shall have an aggregate fair market value fairly representative of the appreciation and depreciation in value to the date or dates of such allocation of all estate property then available for allocation to the marital share."

1. This is the type of funding Revenue Procedure 64-19 targeted.
2. Requires revaluation of assets and can be costly or difficult depending upon the type of estate assets. Partial distributions are problematic.
3. Distributions will carry out distributable net income.
4. No gains or losses are recognized upon funding.
5. Assets purchased post-death utilize cost to substitute for estate tax value.

Minimum Worth Pecuniary

Typical language for this type of Pecuniary Formula is: "My Personal Representative shall select the assets to constitute the marital share, each asset so selected shall be valued for purposes of satisfying the pecuniary amount: (a) at the values of such asset as finally determined for federal estate tax purposes in my estate; or (b) at the value of such asset current at the date or dates of distribution whichever of (a) or (b) is lower."

1. May result in overfunding the marital.
2. Over funding issue can be resolved by selling assets and distributing cash.
3. Distributions will carry out distributable net income.
4. No gains or losses are recognized upon funding.

Funding Issues

Timing Gains and Losses

Generally speaking, distribution of an asset in satisfaction of a pecuniary amount is considered a disposition of that asset. In the first attached funding scenario, True Worth Pecuniary Marital, there are 1,900 shares of Procter & Gamble Co that are funding the pecuniary marital amount. Those shares are valued at \$133,000 on the estate tax return and have a value of \$144,400 on the distribution date. The gain of \$11,400 is recognized and reported by the estate. If the estate has terminated, the gain will be passed down to the residual beneficiary. The marital trust can never report the gain and pay the tax. This would result in an underfunded marital bequest.

Related taxpayers include: (1) trustee and grantor, (2) trustee and beneficiary, (3) trustees of trusts created by the same grantor, (4) trustee and beneficiary of different trusts created by the same grantor, and (5) estate and beneficiary unless the transaction satisfies a pecuniary bequest. Beneficiaries are related unless they have only a remote contingent interest. [IRC §1239] **A loss from the sale or exchange of property between related taxpayers is not deductible.** Gain from the sale or exchange of depreciable property between related taxpayers is treated as ordinary income [IRC §267 and IRC §1239]. This means the \$100,000 loss on the Fannie Mae stock used to fund the True Worth Pecuniary Marital would not be recognized if the asset were being distributed from a trust, but is recognized if being distributed from an estate. When losses cannot be recognized the beneficiary's basis is that of the decedent. In this example the basis of the Fannie Mae shares transferred from a trust to the marital trust will be \$300,000.

Similar rules apply when distribution of passive activities occur. IRC §469(j)(12) requires the suspended losses to be added to the basis of the activity where the related party rules apply.

So, using the True Worth Pecuniary Marital example, and assuming the parties are related, a total long term capital gain of \$130,700 would be recognized by the distributing trust and the losses of \$246,000 would be deferred. A way around this result might be to sell the assets with losses before the distribution date to match losses with gains. Then use cash to fund the pecuniary amount.

Also, keep in mind all assets acquired from a decedent are considered long-term for purposes of computing capital gains or losses, irrespective of the decedent's holding period or the length of time since death.

Valuation Discounts

An often overlooked consideration is the impact on asset valuation when an asset is divided between beneficiaries. The IRS expects the fiduciary to consistently apply discounted valuation methods whether the asset value is used for computing the taxable amount for estate tax purposes or for the amount used to satisfy the marital deduction amount.

643(e)(3) Election

Under IRC §643(e)(3) an election by a Personal Representative or Trustee may be made to treat property distributed in kind as if sold before transfer by the estate or trust and then distributed in kind to the beneficiary. One limiting aspect is the election must be made for all assets distributed in kind during the tax year. Also, the related party loss recognition limitations apply.

The most common use of this election is a situation where an assets is specifically bequeathed and will be the only in kind distribution for that tax year. The fiduciary may choose to make this election to capture the gain or loss to date at the estate or trust level and transfer the asset to the beneficiary with a new cost basis. This is generally not a viable strategy in a year in which an estate or trust funds the marital bequest.

Personal Residence

Taxpayers can, under certain circumstances, exclude gains from the sale of their personal residence §121. This can have implications when one spouse has passed and the surviving spouse wishes to sell the residence. In the year in which a spouse dies, the survivor spouse can file a joint return. This allows the survivor to utilize the full \$500,000 exclusion of a married couple, on the final joint return, instead of the \$250,000 exclusion available to the survivor in subsequent years.

There is a school of thought that it is best to place the decedent's share of the personal residence into the credit shelter trust, as recent history has been that residences appreciate fairly rapidly. The downside is the share of the residence held by the credit shelter trust and not considered owned by the survivor is not eligible for the §121 exclusion of gain. Distributing the residence outright to the survivor or placing it into a grantor trust for the survivor preserves the exclusion (\$250,000) for the share distributed outright or in a grantor trust considered owned by the survivor.

Savings Bonds

The unrecognized income from United States Series E and EE savings bonds may be reported on the decedent's final income tax return, at the election of the executor.

If a cash basis decedent elected under IRC §454(a) to report the income from either Series E or EE United States Savings Bonds annually, no part of the interest is income in respect of a decedent.

If the §454(a) election was not made during life, the executor may make the election on the decedent's final individual income tax return, and the interest will not be income in respect of a decedent. If the election on the final income tax return isn't made, the interest earned to date of death will be income in respect of a decedent, and is therefore not reported on the final income tax return of the decedent. In this case, the taxpayer, whether it be the estate or the beneficiary, can elect to report all of the income earned both before and after death on the earlier of the maturity or surrender date. The portion of the interest earned prior to death is income in respect of a decedent and therefore the recipient can deduct the estate tax attributable to it.

Alternatively, if the §454(a) election was not made during life or on the decedent's final income tax return, the cash basis recipient (the estate or beneficiary) may make the IRC §454(a) election to have the interest taxed annually. In this case the accrued but unrecognized income earned in previous years will be recognized and reported in the year of the election. This income is income in respect of a decedent and the IRC §691(c) deduction is available with respect to it.

If Series EE or E bonds are used to satisfy a pecuniary legacy, the transfer will be treated as a sale and any previously unrecognized income will be recognized by the estate. **The income to date of death would be income in respect of a decedent.**

In the attached examples, the US HH Savings Bonds were purchased with the surrender of EE bonds that had \$25,000 of deferred interest. Therefore, these HH bonds need to be treated in a manner similar to how you would treat EE bonds with deferred interest. Using these bonds to satisfy the pecuniary amount will trigger recognition of the deferred interest. Is that the desired result?

Distributions of IRD Assets in Satisfaction of a Pecuniary Bequest

Distribution of a right to receive IRD in satisfaction of a fixed sum of money will cause acceleration of the IRD, IRC §691. Treasury Reg. §1.691(a)-4(b)(2) seems to make it clear the distributing estate or trust recognizes the income.

Consider the complications this causes an estate made up of almost entirely installment obligations. If those installment obligations are distributed to satisfy a pecuniary marital amount, income is accelerated. If the notes are passed to a bypass trust, the notes are considered to have passed from the obligor to the bypass trust and the income continues to be deferred as if the decedent still held them, IRC §453B(c). The trouble then comes when the bypass trust terminates. If the notes remain, the transfer is not considered from the obligor under IRC §453 and the income is accelerated. This can be problematic if there is insufficient liquidity to pay the income tax.

A possible partial solution is to use a non pecuniary fractional formula which may place the bulk of the notes into a marital trust that will receive the benefit of IRC §453 when the spouse passes on.

The following IRA discussion is reproduced from a presentation by Stephen R. Akers of Bessemer Trust Company, N.A.

"A different result may apply in the situation of satisfying a pecuniary bequest with an IRA. For example, the IRS has issued several letter rulings that address the availability of a spousal rollover when a pecuniary marital deduction bequest was funded with an IRA without also addressing whether funding the pecuniary bequest with the IRA triggered immediate income recognition. Ltr. Ruls. 9808043, 9623056, 9608036, & 9524020. Some commentators believe that the taxation of distributions from qualified plans and IRA's is governed exclusively by sections 672, 402(a), and 408(d)(1), and that no income recognition occurs until there is an actual distribution or some other transaction expressly made taxable under those sections. See Ice, Hot Topics and Recent Developments in the IRA/Qualified Plan Distribution Arena From the Sublime to the Ridiculous, Texas Tax Lawyer 37 (Oct. 2000) (describing positions of Marjorie Hoffman and Merv Wilf). The issue whether section 402(a) and 408(d)(1) are exclusive and, in effect, override section 691. An argument can also be made under §691 itself that satisfying a pecuniary bequest with an IRA would not trigger acceleration. See Choate, Life and Death Planning for Retirement Benefits 103-08 (5th ed. 2003).

In CCM 2006-44020, a trust made a pecuniary bequest of \$100,000 to charities. The trustee directed the IRA provider to put \$100,000 of the IRA into the names of the charities (hoping to get the \$100,000 IRA to the charity without anyone having to pay income tax on the \$100,000 because of the charities tax exempt status.) The IRS said the distribution would trigger ordinary income to the trust, reasoning that a transfer of an IRA to a pecuniary fixed dollar legatee accelerates income recognition under §691(a)(2). There is a split among planners as to whether this is correct. For example, Professor Christopher Hoyt believes that the qualified plan rules should trump §691, and that there should not be gain recognition when an IRA is used to fund a pecuniary bequest. Leimberg Information Services Charitable Planning Newsletter #110 (Nov. 7, 2006). Natalie Choate thinks the IRS may have been right. Leimberg Information Services Employee Benefits and Retirement Planning Newsletters #395 & 396 (Dec. 26 & 28, 2006). Natalie reasons that the trustee had a choice of assets to use to fund the bequest, and because the trustee chose to use the IRA, that could be assignment of income under §691(a)(2). Section 691(a)(2) says that after death of an owner of an "income in respect of a decedent" asset, a transfer of IRD to someone else triggers immediate realization of income UNLESS the person is entitled to the asset under the decedent's will or trust. The ruling reasoned that the charity was not entitled to that particular asset. (The CCM went too far, though in citing a 60 year old case that does not even mention §691(a)(2) as support for its conclusion.)

Planning Pointer: Natalie Choate points out this ruling should not apply if the trust document says the trustee MUST satisfy the bequest with the IRA – even if it is a pecuniary bequest. Also, the ruling does not apply if the beneficiary designation itself contains the pecuniary gift. Id."

Fiscal Years

A decedent's Estate, but not a trust, may elect any month as a year end as long as the first year does not exceed 12 months and the year end is the last day of the month selected. Considerations include:

1. Deferring income tax reporting by beneficiaries of the estate
2. Splitting income between years
3. Matching deductions (or time to generate them) with income
4. Minimize return filings
5. Defer payment of income taxes by the estate

IRC Section 645 Election

The 645 Election allows the executor of an estate and a trustee of a Qualified Revocable Trust to treat the trust as part of the estate for income tax purposes for taxable years of the estate ending after the decedent's date of death. This irrevocable election is allowed in an effort to treat estates and trusts in a similar manner.

Form 8855 is used to make the election. Whether a 645 Election is made or not, a trustee must obtain a new TIN for the QRT after the death of the deceased owner and this TIN must be provided to payers to the trust after death of the owner.

Caution: There is no requirement a short year tax return be filed for the trust after death provided the QRT income and expenses are included on the Estate Income tax return. If it is decided later to not make the election and it is too late to file a timely trust return, penalties and interest may apply to the trust. If there is uncertainty about making the election, file a timely trust return.

What are the effects?

1. Trust can use a fiscal year end
2. Trust can delay estimated tax payments for two years
3. Allowing losses in funding pecuniary bequests under 267(b)(13)
4. Reduces number of returns to file
5. Availability of permanent charitable set-aside deduction allowed only to estate
6. Waiver of special trust rules for holding S Corporation stock for the reasonable period of estate administration and for the section 6166 deferral period.
7. Makes available estate's allowance to deduct up to \$25,000 in losses from rental real estate activities over the estate's passive income
8. Estate's \$600 personal exemption applies – lose additional trust exemption (\$300 or \$100) and use of lower trust tax brackets

663(b) Election

In order to allow a complex trust or estate time to finish its year-end accounting and make appropriate distributions, a trust or estate may elect to treat amounts distributed in the first 65 days of the next tax year as though they were distributed in the current tax year [IRC §663(b)]. To make the 65-day election, check Box 6 in "Other Information" on Page 2 of Form 1041. The 65-day rule never applies to simple trusts because simple trusts, by definition, cannot make discretionary distributions.

Tier Distribution Rules

Distributable Net Income is the tax concept used to allocate taxable income between the trust or estate and the beneficiaries. Distributable Net Income is an approximation of the actual economic benefit available to the income beneficiaries. Distributable Net Income is the maximum amount that can be taxed to the beneficiaries. Distributions in excess of Distributable Net Income are generally treated as tax-free distributions of principal.

To Calculate Distributable Net Income:

Start With: Adjusted total income (Line 17, Page 1 of Form 1041).

+ Plus net tax-exempt interest (total tax-exempt interest less charitable contributions and expenses allocated to tax-exempt interest).

+ Plus capital gains allocated to accounting income or used to determine the amount distributed or required to be distributed. Capital gains are generally not included in Distributable Net Income even if a trustee makes a discretionary distribution of principal. Capital gains are included in Distributable Net Income in the year of termination. [Reg. §1.643(a)-3]

+ Plus charitable deduction for charitable contributions made from capital gains.

+ Plus capital loss (Line 4).

– Less capital gain (Line 4).

Required Income Distributions (Tier 1): Income required to be distributed to beneficiaries in the current year is entered on Line 9 of Schedule B. For a simple trust, this amount is the net accounting income. For a complex trust, this amount is generally a percentage (0–100%) of net accounting income required to be distributed under the trust instrument. For most estates, no income is required to be distributed in the current year unless a support allowance gift of income is made by will or under state law. Income is included on Line 9 if the trustee is legally required to distribute it even if the income has not been distributed when the return is filed. [Reg. §1.651(a)-2 and §1.661(a)-2]

Other Distributions (Tier 2): Other amounts actually paid to beneficiaries (including discretionary distributions) are entered on Line 10. Gifts or bequests of specific sums of money or of specific property that are paid all at once or in not more than 3 installments are not included on Line 10. [IRC §663]

Apportionment of Distributable Net Income to Beneficiaries: If the estate or trust made distributions to beneficiaries during the tax year, Distributable Net Income passes to the estate or trust beneficiaries. The apportionment of Distributable Net Income among the beneficiaries depends on the amount and type of distribution made to each. The actual source of payment for each distribution (whether income or principal) is irrelevant. Tracing is not allowed; trustees cannot designate which beneficiaries receive taxable income and which receive nontaxable distributions of principal.

Apportionment:

- If Distributable Net Income is less than the income required to be distributed currently, Distributable Net Income is distributed proportionately to the beneficiaries receiving first-tier distributions.
- In a complex trust or estate, Distributable Net Income may exceed the income required to be distributed currently. Distributable Net Income is first apportioned dollar for dollar to the first-tier beneficiaries. Remaining Distributable Net Income is divided proportionately among beneficiaries receiving second-tier distributions.

Separate Share Rule: If beneficiaries have substantially separate and independent shares in a trust or estate, they are treated as having separate trusts for purposes of determining Distributable Net Income. This rule prevents income accumulated for one beneficiary from being taxed to another beneficiary who receives a distribution of principal. Application of the rule is mandatory, not elective. [Reg. §1.663(c)-1]

Examples of tier rules applied:

Beneficiary A is required to receive all net income of trust. Trust has DNI of \$10,000. Beneficiary received all accounting net income and \$5,000 of discretionary principal. Beneficiary reports \$10,000.

Beneficiary A is to receive all net income and may receive discretionary principal. Beneficiary B may receive discretionary principal. Beneficiary A receives \$10,000 during the year and B receives \$50,000. Beneficiary A will report all the trust DNI and beneficiary B will report nothing.

Capital Gains and DNI

Typically, capital gains are not part of Distributable Net Income §643(a)(3) except in the final tax year §1.643(a-3)(e)(ex. 7).

. Gains from the sale or exchange of capital assets are excluded from DNI to the extent that these gains are allocated to corpus and they are not either paid, credited, or required to be distributed to a beneficiary during the year, or to corpus and they are not either paid, credited, or required to be distributed to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. Final regulation issued January 2004 provide the trustee more flexibility to allocate capital gains to DNI if the fiduciary uses discretion in a consistent manner from year to year §1.643(a-3)(e)(ex. 2, 12, 13, 14).

General Considerations

Some of the more common elections to consider are:

1. Alternative Valuation §2032
2. QTIP Election §2056(B)(7)
3. Stock Redemption under §303 – converts dividend income from §301 redemption to possible capital gain treatment.
4. Basis adjustment to partnership assets §732(d) and §754
5. Special Use Valuation §2032A
6. GSTT issues
7. Disclaimer strategy?

Tax returns – Very early on in the administration process the Personal Representative and Trustee need to identify all the entities and the assets they hold or control, understand the possible elections to be made and anticipate the timing of income and its character. Are there relationships to other entities that impact the estate or trust? What expenses are to be incurred and when should they be paid.

Noel C. Ice has a checklist that may not be current on all issues, but it can be helpful to remind administrators of the more common issues that need consideration. The checklist can be accessed at:

<http://www.trustsandestates.net/Nutshell-Public/PostMortemChklist/PostMor.htm>

Biography

Douglas Dixon is an Investment and Trust Consultant with Key Private Bank of Colorado. Doug's current role includes working with Key Bank's high net worth clients to develop personal wealth and estate planning strategies. Doug has 25 years of specialized trust/estate experience including managing a fiduciary administration department for a large bank, a national brokerage firm and management of a bank trust tax department. Doug also owned a CPA practice dedicated exclusively to fiduciary tax matters and administration. Doug is a former instructor for the Arizona CPA society lecturing on AICPA courses concerning fiduciary tax preparation, tax planning and estate tax preparation. Doug holds CPA licenses in Arizona and Colorado.