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ESTATE PLANNING FOR THE MARRIED COUPLE

DON W. LLEWELLYN†

I. INTRODUCTION

CHANGES in the estate and gift tax provisions of the Internal Revenue Code (Code) made by the Economic Recovery Tax Act of 1981 (ERTA) have had a major impact on estate planning for the married couple, especially with respect to planning for the optimum marital deduction and unified tax credit and for the ramifications of holding property as joint tenants. These ERTA provisions were clarified by the Technical Corrections Act of 1982 and, with one significant exception, have survived the sweeping tax reform provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). We have now reached the point where these provisions have been suffi-

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2. For a discussion of planning for the optimum marital deduction, see notes 11-47 and accompanying text infra.
3. For a discussion of the unified tax credit, see notes 42-60 and accompanying text infra.
4. For a discussion of the impact of ERTA on jointly held property, see notes 226-36 and accompanying text infra. Of course, the tax rate reductions alone, including the fixing of a 50% tax rate ceiling, have had a major impact on estate planning. See I.R.C. §§ 1, 2001(c) (Supp. V 1981).
ciently analyzed, thereby allowing certain estate planning maxims to be formulated.

Estate planning for a married couple is principally concerned with the formulation of a dispositive plan for the passage of the couple’s wealth between the spouses and ultimately to the objects of their bounty. Tax planning for such dispositions can be divided rather neatly into three categories:

1. Dispositive schemes for the disposition of probate property in a manner that will maximize tax savings.
2. Dispositive schemes involving property which is held in a form of joint ownership which includes a survivorship feature.
3. Dispositive schemes involving the use of will substitutes which can, in many instances, be structured in a manner that will totally avoid federal transfer tax on the passage of such interests between the spouses and ultimately to their successors.

The major portion of this article is devoted to dispositive schemes for probate property and is principally concerned with the optimum use of the marital deduction and the unified transfer tax credit. The transfer tax treatment of jointly held property has been simplified considerably by ERTA\(^7\) but the survivorship feature of such property continues to reduce the flexibility necessary to obtain maximum transfer tax savings. The circumstances where this lack of flexibility creates acute problems are identified and the estate tax treatment’s impact on the basis of such property is fully discussed. Will substitutes,\(^8\) especially the irrevocable insurance trust, form an integral part of the estate plan for the married couple and some mention of the major tax saving opportunities is made. There are also occasions where availability of the marital deduction will result in a variation of the standard utilization of these tax saving techniques. Coverage of this category is brief and is limited to an explanation of how the transfer tax savings result and the identification of those occasions where the marital relationship requires some unique modification of the standard scheme.

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7. Prior to ERTA, there were two tests for inclusion of jointly held property in the gross estate of the first spouse to die. See I.R.C. §§ 2040(a), 2040(b) (1976) (amended 1982). For a further discussion, see notes 226-31 and accompanying text infra.

8. The will substitutes referred to in category three include insurance trusts, beneficiary designation of death benefits paid by employers, and survivorship benefits under qualified deferred compensation plans.
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Complete coverage of estate planning for a married couple needs at least limited reference to the consequences of state transfer taxes. Rather than continually raise a caveat concerning their possible effect under one or more of the myriad of state provisions, the transfer tax consequences of the Pennsylvania statutes are noted throughout. In this way, issues dealing with the juxtaposition of state and federal provisions can be raised and resolved. Because Pennsylvania does not impose a tax on inter vivos gifts, references will be limited to its inheritance tax. Pennsylvania also imposes an estate tax which is merely a "pick-up" tax which is imposed when the inheritance tax is less than the federal credit allowed for state death taxes.

II. THE MARITAL DEDUCTION

The most complex feature of a married couple's estate plan is the dispositive scheme for the passage of probate property between the spouses. The dominant influence in structuring such a scheme is the marital deduction.

A. ERTA Amendments to the Marital Deduction

ERTA removed the dollar and percentage ceiling on the marital deduction. ERTA also expanded the exceptions to the terminable interest limitation, so that it is now possible to obtain a marital deduction for the entire value of property in which the donee or surviv-

12. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(d), 95 Stat. 172 (codified at I.R.C. § 2056(b) (Supp. V 1981)). Where the interest passing to the surviving spouse will fail or terminate either with the passing of time or the happening of a certain event, such interest is deemed to be a terminable interest and as a general rule will not qualify for the marital deduction. I.R.C. § 2056(b)(1) (1976). There are several exceptions to the terminable interest limitation including 1) interests passing to the surviving spouse conditional on survival for a limited period, not exceeding six months so long as the spouse does in fact survive; 2) life estates with a general power of appointment in the surviving spouse; and 3) certain life insurance or annuity payments with a general power of appointment in the surviving spouse. Id. §§ 2056(b)(3), 2056(b)(5), 2056(b)(6). ERTA has added an additional exception for qualified terminable interest property. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(d)(1), 95 Stat. 172, 302-03 (codified at I.R.C. § 2056(b)(7) (Supp. V 1981)). For a discussion of this new qualified terminable interest and its effect on estate planning, see notes 105-16 and accompanying text infra.
ing spouse receives nothing more than a gift or bequest of an income interest. Such property is designated by the statutory provisions as "qualified terminable interest property." These provisions are the statutory underpinning for a new type of marital deduction trust which in the land of acronyms is referred to as the "QTIP Trust." The policy for permitting a marital deduction for property in which the spouse receives such a limited interest will be addressed later in this article in connection with the discussion of the specific statutory requirements. For now, it is sufficient to note that the unlimited marital deduction and the QTIP trust have resulted in a substantial alteration of the spousal dispositive schemes used prior to the passage of ERTA.

The ERTA amendments to the marital deduction apply to transfers made after December 31, 1981. A transitional rule, however, excludes from qualification for the unlimited marital deduction, estates of decedents dying after that date which pass property by will executed or trust created before September 12, 1981, if such will or trust contains a formula by which the surviving spouse receives the maximum amount of property qualifying for the marital deduction. A disposition is removed from the coverage of the transitional rule if an amendment, specifically referring to an unlimited marital deduction, is made to such a will or trust subsequent to September 12, 1981 or if the application of the transitional rule is preempted by state statute. To date, Pennsylvania has not adopted such a statute. To avoid imposition of this transitional rule, a prudent planner should have his client revoke any previous will or trust indenture and execute a new will or indenture.

It should be noted at the outset that although there is no express statutory limitation on the amount of the marital deduction, many nonstatutory factors may impede qualification of the entire taxable estate for the deduction even where the estate plan calls for all property to pass to the surviving spouse. For example, section 2056(b)(4) of the Code provides that in valuing the interests passing to the sur-

14. Id.
15. See notes 105-16 and accompanying text infra.
17. Id.
18. Id.
19. Id.
20. New Jersey, New York, and Delaware, like Pennsylvania, have not as of this writing adopted such a statute.
viving spouse, the effect of any death tax liability and any encum-
brance on the property shall be taken into account. Thus, where
the estate assets are used to pay expenses which are not deductible for
estate tax purposes, the marital deduction will not be sufficient to
reduce the taxable estate to zero. Obviously, if the nondeductible
expenses exceed the exemption equivalent of the various credits, the
marital deduction will not be sufficient to avoid imposition of estate
tax. In this respect, it is quite common for administration expenses to
be deducted for income tax purposes, thereby rendering them nonde-
ductible for estate tax purposes. The problems created by the impact
of state death taxes on the value of the property passing under
the marital deduction bequest are most acute when the QTIP trust is
used and these problems will be discussed in connection with the use
of the QTIP trust.

B. The Prototype Plan Before ERTA: The Optimum
Marital Deduction Bequest

Even before ERTA removed all limitations on the amount of the
marital deduction, the maximum marital deduction was frequently
not the optimum marital deduction for tax planning purposes. A full
understanding of the factors involved in determining the optimum
marital deduction requires a brief exposition of the planning objec-
tives desired when formulating a dispositive plan for a married

Valuation of Interest Passing to Surviving Spouse—In determine
ig for purposes of subsection (a) [allowance of marital deduction] the value
of any interest in property passing to the surviving spouse for which a de-
duction is allowed by this section—
(A) there shall be taken into account the effect which the tax imposed
by section 2001, or any estate, succession, legacy, or inheritance tax, has on
the net value to the surviving spouse of such interest; and
(B) where such interest or property is encumbered in any manner, or
where the surviving spouse incurs any obligation imposed by the decedent
with respect to the passing of such interest, such encumbrance or obligation
shall be taken into account in the same manner as if the amount of the gift
to such spouse of such interest were being determined.

22. For further discussion of this problem, see notes 134-43 and accompanying
text infra. Consider a spouse who dies in 1982, leaving a gross estate of $1,000,000.
If the estate incurs $300,000 of administrative expenses which the executor elects to
take as an income tax deduction, the maximum possible marital deduction would be
$700,000. This would result in $300,000 of the estate being subject to tax ($300,000
and the unified credit for 1982 will shield only $225,000).

23. See I.R.C. § 642(g) (1976). This section requires an election to be made be-
tween deducting administration expenses on the estate tax return or on the estate's
income tax return.

24. For a discussion of these problems, see notes 144-50 and accompanying text
infra.
couple. The planning objectives for a spousal dispositive scheme include both deferral of federal transfer tax and reduction of the aggregate federal transfer tax imposed on the ultimate disposition of the couple's wealth. Deferral of the transfer tax until the death of the surviving spouse can be accomplished with respect to that qualified property which passes to the surviving spouse and which results in a marital deduction.

Before ERTA, the marital deduction was limited in amount. Thus, not all transfers which qualified as deductible interests were eligible for the marital deduction. Furthermore, a transfer which qualified as a deductible interest had the concomitant effect of the potential inclusion of such property in the gross estate of the recipient spouse even though a marital deduction with respect to such transfer was precluded by the maximum limitation. It was possible, therefore, for the estates of both spouses to be subjected to a transfer tax on the same property. Consequently, the achievement of maximum transfer tax savings mandated that transfers qualifying as deductible interests be limited by the amount of the maximum available marital deduction. This mandate was expressed in an estate planning maxim which cautioned against overqualifying the marital bequest. This maxim was routinely implemented by the creation of two testamentary trusts, the so-called “A” and “B” trusts. The “A” trust, which was limited by the maximum marital deduction, was structured to qualify for the marital deduction by giving the surviving spouse interests which qualified as deductible interests. The “B,” or by-pass trust, did not qualify for the marital deduction, but was structured so as to provide the surviving spouse with benefits which were limited in such a way that the termination of those benefits escaped the imposition of a transfer tax on the surviving spouse or his estate.

27. See note 11 supra.
28. The possibility of double taxation in rapid order is diminished by § 2013 which allows a credit for taxes paid on prior transfers. Under this section, a 100% credit is allowed for all transfers by a transferor who died within two years before or within two years after the death of the decedent. A less than 100% credit, on a decreasing scale, is allowed for transfers by a transferor whose death was within 10 years before the decedent’s death. Id. § 2013 (1976).
31. After ERTA, the by-pass trust share is frequently referred to as the “credit shelter share.” The title is appropriate because when a no-tax marital deduction is
scheme not only satisfied the tax planning objectives but also was totally compatible with the goal of having all of the couple’s property accessible to the surviving spouse.

It was (and still is) possible to create for the surviving spouse interests in the nonmarital deduction or by-pass trust property that were substantially equivalent to full ownership but which did not result in the imposition of a transfer tax on the surviving spouse or his estate. To accomplish this, the interests granted to the surviving spouse were limited to nondescendible beneficial interests, such as income interests for life and special, as opposed to general, powers of appointment over the ultimate disposition of the property.32 The bequest of such limited property interests together with the marital deduction bequest formed the prototype estate plan for married persons.

The marital deduction bequest portion of the prototype dispositive scheme was not necessarily pegged to the maximum marital deduction. In many cases, particularly where the estate was of moderate size, a bequest of something less than the maximum marital deduction would be sufficient to reduce the taxable estate of the non-surviving spouse so that after application of applicable credits, there would be no tax liability. In that situation, the aggregate transfer taxes for the married couple were reduced by limiting the marital deduction bequest to the minimum amount necessary to reduce tax liability to zero. Under the typical dispositive scheme, the by-pass trust, in which the surviving spouse had a nondescendible property interest with or without a nongeneral power of appointment, was increased to the extent that the limitation on the amount of the marital bequest precluded property from passing as part of that bequest. Therefore, an increased portion of the couple’s wealth by-passed the estate of the surviving spouse and the imposition of an estate tax upon the death of the surviving spouse.

Under some circumstances, tax deferral could only be accomplished at the expense of increasing the aggregate federal transfer tax imposed on the married couple. Since the transfer tax rate was graduated,33 the starting assumption was that the greatest aggregate tax reduction could be accomplished by equalizing the tax rate applicable to each spouse. This required that the tax be spread between the spouses or their estates and thus had the effect of foregoing the oppor-

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33. Id. § 2001(c) (Supp. V 1981).
tunity, through full utilization of the marital deduction, to defer some or all transfer tax until the death of the surviving spouse. Although the dilemma created by these competing objectives was in many cases resolved in favor of deferral, in some cases it was desirable to equalize the rates by reducing the qualified marital bequests and thus the marital deduction to some amount lower than the maximum allowed. The equalization route was chosen in those cases where it was determined that the present value of the earnings from the deferred taxes, over the expected life of the surviving spouse, was less than the aggregate tax increase to the couple.

C. Post-ERTA Dispositive Schemes for Married Couples: New Prototype Plans

The unlimited marital deduction created by ERTA now affords a married couple the opportunity to defer all transfer tax on the disposition of the couple's wealth until the death of the surviving spouse. This deferral may be accomplished so long as transfers are structured so that the marital deduction, operating in tandem with the available transfer tax credits, will result in no transfer tax being imposed on the first spouse to die or on his estate.

In determining the optimum amount of a qualified marital deduction transfer, one should initially consider pegging it to the amount necessary to obtain a marital deduction which will reduce transfer taxes to zero after application of the available transfer tax credits. Use of the so-called "A" and "B" testamentary trusts as repositories for the bequeathed property may still be advisable, but the amount passing to the trusts will differ from that under pre-ERTA planning. The "B," or by-pass trust, will be pegged to the amount that will in effect be exempt from taxation because of the available transfer tax credits. All other property would pass to the "A," or marital deduction trust.

As was the case prior to the passage of ERTA, there may be a few occasions where the planner would choose to forego complete deferral in order to accomplish, through the equalization of the spouses' tax rates, the greatest possible aggregate transfer tax savings for the couple. This would mean that the qualified marital transfer, and thus the marital deduction, would be reduced so that a transfer tax would be imposed on the transferor or the transferor's estate. Only in rare situations will the equalization of tax rates be beneficial,

34. See note 11 and accompanying text supra.
35. For a discussion of the available credits, see note 48 infra.
36. For a discussion of these trusts, see notes 30-31 and accompanying text supra.
primarily where the couple possesses very substantial wealth and there is little likelihood that the surviving spouse will survive the other by more than a few years. In that instance, the credit shelter trust should be increased to the amount necessary to utilize all estate tax brackets lower than the maximum bracket. After 1984, that amount would be $2,500,000. In addition, the credit shelter trust should provide for an income interest for the surviving spouse so that the prior transferred property tax credit will be available to the estate of the surviving spouse. Under this scheme, the maximum amount of the couple's wealth would be subjected to the lowest rates.

Assume, for example, each spouse is seventy years old and the husband owns all of the couple's $8,000,000 estate. Also assume that the wife's health makes it unlikely that she would survive her husband by more than a few years. In that situation, serious thought should be given to establishing a testamentary credit shelter (by-pass) trust in the amount of $2,500,000. In this situation, if the husband predeceased the wife, the maximum possible amount of the couple's wealth, or $5,000,000, would be taxed at a rate under fifty percent. In addition, if the surviving spouse's limited interest in the credit shelter trust is capable of valuation, the prior transfer credit will also be available to further reduce the estate tax.

In all other situations, any decision to equalize tax rates at the expense of tax deferral should probably be delayed until the post-mortem period. A disclaimer of a portion of the marital bequest or a partial election, in the case of a QTIP trust, may be effective to equalize tax rates where appropriate.

1. "Overqualifying" The Marital Deduction After ERTA

As was the case prior to ERTA, it is still possible to overqualify the marital deduction. This occurs when the marital deduction is in excess of the amount necessary to eliminate estate tax liability after

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37. This amount will be as much as $1,000,000 higher if the husband dies before 1985, because of the phase-in of the rate reductions. I.R.C. § 2001(c) (Supp. 1981).

38. If the entire $2,500,000 were taxed in the husband's estate upon his death in 1987, the tax would be $833,000. If it is assumed that the wife's limited income interest was valued at 40% of $2,500,000, a § 2013 credit as high as $333,200 may be available. The exact amount of the credit could not be predicted at the husband's death because the credit is limited by the tax savings in the wife's estate resulting from removal of the value of the transferred property from her taxable estate. In addition, the amount of the credit is phased out over a survival period of 10 years. See note 28 supra.

39. For a discussion of the opportunity to change the dispositive scheme by post-mortem decisions, see notes 61-84 and accompanying text infra.

40. See notes 29-31 and accompanying text supra.
application of all available tax credits. A marital legacy in excess of that amount has the effect of causing a portion of the deceased spouse’s credits to be unused or wasted. The most significant credit, of course, is the unified transfer tax credit.

When complete deferral of estate tax on the death of the first spouse is accomplished by using the marital deduction and the transfer tax credits in tandem, considerable estate tax savings can result on the death of the surviving spouse. These savings result because the exemption equivalent of such credits by-passes the gross estate of the surviving spouse and consequently passes free of federal estate tax in either spouse’s estate.

Various alternatives for describing a testamentary dispositive scheme have been developed to achieve the dual goals of maximum deferral and tax reduction. One simply provides for a marital deduction pecuniary legacy which is limited by a zero-estate-tax formula. This legacy can be expressed by a pre-residuary zero-tax formula provision such as:

In addition to any other property which passes or has passed to my wife under other provisions of my Will or outside my Will and which qualifies for the marital deduction, I bequeath to my wife, if she survives me, such further amount as shall reduce the federal estate tax upon my estate to the minimum amount payable, after taking into account all credits available against such tax in my estate (provided use of the state death tax credit does not result in an increase in state death taxes).

<table>
<thead>
<tr>
<th>Year</th>
<th>Exemption Equivalent</th>
<th>Unified Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>$225,000</td>
<td>$62,800</td>
</tr>
<tr>
<td>1983</td>
<td>$275,000</td>
<td>$79,300</td>
</tr>
<tr>
<td>1984</td>
<td>$325,000</td>
<td>$96,300</td>
</tr>
<tr>
<td>1985</td>
<td>$400,000</td>
<td>$121,800</td>
</tr>
<tr>
<td>1986</td>
<td>$500,000</td>
<td>$155,800</td>
</tr>
<tr>
<td>1987 &amp; thereafter</td>
<td>$600,000</td>
<td>$192,800</td>
</tr>
</tbody>
</table>

41. A credit is not considered wasted if it can only be obtained at the expense of incurring additional state death taxes. See notes 49-51 and accompanying text infra.


The residue of the estate, which equals the exemption equivalent of the unified credit and other credits reduced by other bequests or transfers of gross estate property not qualifying for the marital deduction and the amount of nondeductible principal expenses, is then passed to a by-pass trust. 44

The other method provides for a pecuniary legacy in the amount of the exemption equivalent of all available credits reduced by other gross estate property not qualifying for the marital deduction and nondeductible principal expenses. This legacy can be described by a formula provision such as:

If my wife survives me, I bequeath to my trustee the maximum amount which can pass free of federal estate tax in my estate by reason of all credits available against such tax in my estate (provided use of the state death tax credit does not result in an increase in state death taxes) and after taking into account (i) any other dispositions under my Will; (ii) [gross estate] property passing outside my Will; and (iii) all charges to principal, which are not deducted for purposes of computing the federal estate tax in my estate. 45

The residue of the estate is then passed to the surviving spouse as the marital deduction bequest. 46

44. Consider a decedent with a gross estate of $1,000,000 who dies in 1982 with the following credits: 1) the unified credit of $62,800; 2) a credit for foreign death taxes of $10,000; and 3) a credit for taxes from prior transfers (e.g. from his recently deceased father) of $12,000. This leaves the decedent with total credits of $84,800. By using the applicable estate tax table of § 2001(c), we can calculate the amount of the gross estate necessary to cover the available credits. First, we note that the tax on $250,000 to $500,000 is $70,800 plus 34% of the excess over $250,000. Since the tax on $500,000 (70,800 + (34 x 250,000) = $155,800) is well over our available credits, we know that the amount we seek lies in the $250,000 to $500,000 range. The following formula can be used to compute the exact exemption equivalent of the available credits:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total credits</td>
<td>$84,800</td>
</tr>
<tr>
<td>Less: tax on lowest amount in tax range</td>
<td>$70,800</td>
</tr>
<tr>
<td>Credits in marginal tax range</td>
<td>$14,000</td>
</tr>
<tr>
<td>Divide by the marginal tax rate</td>
<td>+ .34</td>
</tr>
<tr>
<td>Exemption equivalent for marginal tax</td>
<td>$41,176</td>
</tr>
<tr>
<td>Plus exemption equivalent for lowest amount in tax range</td>
<td>$250,000</td>
</tr>
<tr>
<td>Exemption equivalent necessary to utilize all available credits</td>
<td>$291,176</td>
</tr>
</tbody>
</table>

This amount subtracted from the gross taxable estate gives the zero tax marital deduction ($1,000,000 - $291,176 = $708,824). In this example, the wife would be given a pecuniary bequest of $708,824 ($1,000,000 gross estate less the $291,176 exemption equivalent available) with the residue left to a by-pass trust.


46. The actual calculations, whether the residuary or pecuniary formula is used,
The considerations involved in selecting either scheme, or some adaptation thereof, are essentially the same as those which were previously involved in selecting between a fractional formula marital bequest and a pecuniary formula marital bequest.47

2. The Role of Credits in Describing the No-Tax Marital Deduction Share

There are six credits available for application against the federal estate tax.48 It is the draftsman’s choice, of course, whether to take all credits into account in describing the marital deduction bequest or the exemption equivalent share or to limit consideration to the unified transfer credit under section 2010 of the Code.

In the formula provisions set forth above,49 the consideration of the state death tax credit is expressly forborne where such credit, if utilized, would cause additional state death tax to be due. This provision is necessary to avoid an interaction between the federal estate tax and the state death tax credit that ultimately results in increased tax liability. This situation occurs where a state imposes death taxes in an amount equal to the maximum state death credit.

would be essentially the same. See note 44 supra. However, different income tax considerations and the future effect of the increase in the exemption equivalent of the unified credit must be taken into account when deciding which formula to use. For a discussion of these factors, see notes 171-205 and accompanying text infra.

47. For a discussion of the considerations in selecting between these dispositive schemes, see notes 171-205 and accompanying text infra. For an explanation of fractional formula marital bequests and pecuniary formula marital bequests, see Llewellyn, supra note 25, at 334.

48. These credits include the following:
   2) Credit for state death taxes. Id. § 2011 (1976 & Supp. V 1981). The credit for state death taxes is allowed to the extent such taxes are actually paid so long as the payment does not exceed the limits of § 2011(b).
   3) Credit for gift taxes. Id. § 2012. A credit is given for gift taxes paid, with respect to gifts which are includible in the gross estate of the decedent and which were made prior to 1976. Id. For gifts made after 1976, there is a gift tax offset in the computation of the estate tax payable. Id. § 2001(b)(2) (Supp. V 1981).
   4) Credit for taxes on prior transfers. Id. § 2013 (1976). A credit is allowed for taxes paid on property passing to the decedent from a transferor who died within ten years before or two years after the decedent. The amount of the credit is dependent upon the proximity of the transferor’s death to the decedent’s. Id. See note 28 supra.
   5) Credit for foreign death taxes. I.R.C. § 2014 (1976). In general, a credit is given for foreign death taxes with various limitations as to amount. Id.
   6) Credit for death taxes on remainders. Id. § 2015. The credit for death taxes on remainders allows a credit, in the case of § 6163(a) election to postpone payment of federal estate taxes, for state or foreign death taxes attributable to the remainder interest and which would have been allowable as a credit under § 2011 or § 2014, if paid before the expiration of the extended time for payment of the federal estate tax. Id.

49. See text accompanying notes 43-47 supra.
The maximum credit is dependent upon the size of the taxable estate, which in turn is dependent upon the size of the marital deduction.\textsuperscript{50} Use of the maximum possible state death tax credit results in a downward adjustment of the marital bequest and an increase in the state death tax. This increase is unnecessary since application of the additional credit does not affect federal estate tax liability, which is already zero because of the unlimited marital deduction.\textsuperscript{51}

3. Estates With a Lower Value Than the Exemption Equivalent of the Unified Credit

Where it can be predicted with reasonable certainty that the value of property owned by the married couple will not exceed the exemption equivalent of the unified credit at the time of the surviving spouse’s death, it is not necessary for tax saving purposes to limit the marital deduction bequest. Making such a prediction, however, is difficult, especially during the phase-in period of the unified credit, because not only is it necessary to foresee the size of the surviving spouse’s taxable estate but it is also necessary to predict his life expectancy.\textsuperscript{52}

\textsuperscript{50} I.R.C. § 2011 (1976).

\textsuperscript{51} This could occur in a state like Florida which has no death tax, except the amount necessary to shift tax from the federal government to the state government by use of the state death tax credit under § 2011. For example, a decedent dies in Florida having established a marital trust and a by-pass trust in a will stating that the by-pass trust is to receive an amount equal to all available credits. The will does not have a clause excluding a state death tax credit from consideration if its use would increase state death taxes. Therefore, a state death tax would be paid to Florida in an amount necessary to qualify for the maximum state death tax credit. Property, equal to the exemption equivalent of this credit, would then be transferred to the by-pass trust. The net result would be payment of tax to Florida and no federal estate tax liability. The zero federal tax liability, however, could also be achieved without the payment of a state death tax (and corresponding loss of the available state death tax credit) by taking advantage of the unlimited marital deduction and transferring the property to the marital trust as opposed to the by-pass trust.

This result could also occur in Pennsylvania in situations where the state inheritance tax is not applicable (perhaps because the whole estate consisted of insurance) but federal estate inclusion did result. In that case, Pennsylvania would impose an estate tax equal in amount to the maximum credit allowed under § 2012. See Inheritance and Estate Tax Act, No. 255, 1982 Pa. Legis. Serv. 1398 (Purdon) (to be codified at PA. STAT. ANN. tit. 72, § 1717). See generally Blattmachr & Lustgarten, Selected Considerations in Structuring Wills (or Will Substitutes) for Married Persons After ERTA ’81, Planning and Drafting for the Marital Deduction, Prac. L. Inst. Handbook No. 134, Planning and Drafting For the Marital Deduction 41, 81-82, n.30 (1982).

\textsuperscript{52} For a schedule of the phase-in of the unified credit and corresponding exemption equivalents, see note 42 supra.
4. Estates Between $275,000 & $600,000: The Phase-In Period of Unified Credit

Structuring the proper dispositive scheme is a very complex task in any case where the couple's wealth exceeds the exemption equivalent of the unified credit as it presently exists, but will not exceed that exemption equivalent after completion of the phase-in period. It involves a consideration of the optimum marital deduction and the interaction of that deduction with the phase-in period increases in the exemption equivalent of the unified credit. The tax savings created by limiting the marital deduction to its optimum amount are quite significant even with estates of moderate size. For example, where the couple's wealth of approximately $600,000 is held entirely by a husband who dies in 1984 and is survived by a wife who dies in 1985, use of the optimum marital deduction ($275,000), rather than the unlimited marital deduction, would save the couple $71,000 in estate taxes. This saving, of course, occurs upon the death of the surviving spouse in 1985 because, under the optimum plan, $325,000 of the couple's wealth would be passed on the death of the husband to the by-pass trust leaving approximately $275,000 (rather than $600,000) in the surviving spouse's gross estate, all of

53. The optimum marital deduction would be the excess of the gross estate over available credits. In this situation that would be $600,000 (the value of the gross estate) less $325,000 (the exemption equivalent of the 1984 unified credit) which equals $275,000.

54. A comparative calculation of total estate taxes is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Use of Optimum Marital Deduction</th>
<th>Use of Unlimited Marital Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Death of Husband</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Estate</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Marital Deduction</td>
<td>275,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Net Taxable Estate</td>
<td>325,000</td>
<td>0</td>
</tr>
<tr>
<td>Tentative Tax</td>
<td>96,300</td>
<td>0</td>
</tr>
<tr>
<td>Unified Credit</td>
<td>96,300</td>
<td>96,300</td>
</tr>
<tr>
<td>Net Tax</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Death of Wife</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Taxable Estate</td>
<td>$275,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Tentative Tax</td>
<td>79,300</td>
<td>192,800</td>
</tr>
<tr>
<td>Unified Credit</td>
<td>121,800</td>
<td>121,800</td>
</tr>
<tr>
<td>Net Tax</td>
<td>0</td>
<td>71,000</td>
</tr>
<tr>
<td>Total Tax to Both</td>
<td>0</td>
<td>$ 71,000</td>
</tr>
<tr>
<td>Estates</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note that where tax computations are made in this article, the unstated assumption is that no credits are available other than the unified credit.
which subsequently passes free of transfer tax after application of the unified credit.

The standard method for obtaining the optimum marital deduction for the estate of the first spouse to die is to use a zero-tax formula which pegs the marital deduction to an amount equaling the difference between the taxable estate (before the application of the marital deduction) and the exemption equivalent of the available credits. Thus, as the exemption equivalent of the unified credit increases during the phase-in period, there will be a corresponding decrease in the marital deduction bequest required to result in zero federal estate tax liability. This necessarily means that where the first spouse dies during the phase-in period with a will having such a dispositive scheme, some portion of the surviving spouse’s unified credit will be unused. This unused portion will increase for each year of survival during the phase-in period.

To illustrate, if the husband in the above example died in 1984 but the wife did not die until 1986, the marital deduction bequest which has the concomitant effect of inclusion in her estate would have been $275,000; therefore, $225,000 of her available exemption equivalent of $500,000 would have been unused. Consequently, it may be desirable to adjust the standard dispositive scheme so that the surviving spouse will have greater utilization of the family wealth without causing a federal estate tax to be incurred on her death. This can be accomplished by adding to the by-pass trust a series of springing general invasion powers that are phased in under a schedule that causes the surviving spouse’s gross estate to approximate, but not exceed, the exemption equivalent for the year in which the invasion power becomes effective.

If the husband in the example above died in 1985 with a stan-

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55. I.R.C. § 2044 (Supp. V 1981). Under § 2044, an election to qualify terminable interest property for the marital deduction results in the value of such property being included in the estate of the surviving spouse. Id. This section was added by ERTA. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(d)(3)(A)(1), 95 Stat. 172, 304 (codified at I.R.C. § 2044 (Supp. V 1981)). The rationale for this addition is obvious. Prior to ERTA such property would not have qualified for the marital deduction and would have been taxed, absent the availability of any credits, in the estate of the first spouse to die. I.R.C. § 2033 (1976) (amended 1981). Now, since this property can escape (actually defer) taxation in the estate of the first spouse to die by application of the marital deduction, it is necessary to tax it in the estate of the surviving spouse so as not to allow it to escape taxation completely. See id. §§ 2044, 2056(b)(7) (Supp. V 1981).

56. See note 42 supra.

57. Since the value of property subject to a general power of appointment is includible in the gross estate whether the power is exercised or not, the effect of such a provision would be to increase automatically the surviving spouse’s estate so as to fully utilize the unified credit. I.R.C. § 2041 (1976 & Supp. V 1981). Note that if the...
dard no-tax marital deduction formula, the marital bequest and the
concomitant inclusion in the wife’s estate would be $200,000. The
unified credit exemption equivalent on the wife’s death in 1986 would
be $500,00058 of which $300,000 would be unused. In this situation,
no federal transfer tax would be incurred even if the surviving spouse
was given greater access to the couple’s wealth so long as such addi-
tional access resulted from a springing general power of invasion (ef-
fective in 1986) to the extent of $300,000 with respect to the
 testamentary by-pass trust created on the husband’s death.

5. Protecting the Surviving Spouse in the Event of Estate Shrinkage

The standard dispositive provision for obtaining the optimum
marital deduction should contain a provision which would result in
an increase to the marital deduction bequest in the event of a
shrinkage of the couple’s assets to $600,000 or below (or to the
amount of the exemption equivalent available during the relevant
year during the phase-in period).

Suppose, for example, that at time the husband’s will was exe-
cuted, the couple’s wealth was held entirely by the husband and had
a value of $1,200,000. By the time of his death, however, the couple’s
wealth had shrunk to $600,000. The standard provision for obtaining
an optimum marital deduction—a zero-tax marital deduction
formula—would cause all $600,000 to pass to the by-pass trust, and
thus there would be no marital deduction bequest.

In all situations where the couple’s wealth is held by one spouse,
and such a shrinkage is possible, the will should contain a provision
providing for a minimum marital bequest equal to the exemption
equivalent of the surviving spouse’s available unified credit before
any funds would pass to the by-pass trust. In this way, the surviving
spouse would have access to the couple’s wealth to the greatest extent
possible, without the imposition of any transfer tax cost upon the ter-
mination of the surviving spouse’s interests in the property. It is more
difficult, however, to formulate a minimum marital deduction be-
quest where ownership of the couple’s wealth is divided between the
spouses or where the assets are held jointly. In these situations, fixing
the precise amount of a minimum marital deduction bequest is quite
complex and would require the insertion of a formula that would peg
the minimum bequest at the exemption equivalent less the other
property that would be included in the gross estate of the surviving

marital bequest assets are likely to appreciate substantially, this type of provision
may not be necessary.

spouse if she died at that time. In lieu of such an elaborate formula provision, some designated minimum figure could be substituted and if that figure proved to be excessive, it could be cured by a disclaimer by the surviving spouse. 59 Although a provision for minimum funding of the marital bequest can be used with either of the standard structures for the dispositive scheme set forth above, its insertion seems more consistent with a pecuniary marital bequest than with a residuary marital bequest. 60

D. Formulating the Spousal Dispositive Scheme by Post-Mortem Decisions

It is often difficult to formulate the optimum dispositive scheme until the circumstances existing at the death of the first spouse to die become known. Frequently, it may be desirable to make post-mortem adjustments to the dispositions set forth in the will in order to effectuate the maximum aggregate tax savings or deferral. A legatee is treated as though the property which he disclaims has never been transferred to him, so long as the disclaimer is permitted under state law 61 and meets the requirements of section 2518. 62 Thus, the legatee is not subject to transfer tax on the disclaimed property and the property is considered as passing directly to the person entitled to receive

59. For a discussion of such post-mortem estate planning, see notes 61-84 and accompanying text infra.

60. If used with a residuary marital bequest, the provision to establish the minimum residuary marital deduction bequest would have to be placed in a preresiduary provision. In effect, it would provide for the by-pass bequest being reduced to the point where the residue is sufficient to satisfy the minimum marital bequest.


62. Prop. Reg. §§25.2518-1, 25.2518-2, 45 Fed. Reg. 48,925, 48,926-48,928 (1980). Under §2518(b) a disclaimer is qualified if that the disclaimer is an irrevocable and unqualified refusal by a person to accept an interest in property but only if:

1. such refusal is in writing,
2. such writing is received by the transferor of the interest, his legal representative, or the holder of the legal title to the property to which the interest relates not later than the date which is 9 months after the later of—
   (A) the day on which the transfer creating the interest in such person is made, or
   (B) the day on which such person attains age 21,
3. such person has not accepted the interest or any of its benefits, and
4. as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either—
   (A) to the spouse of the decedent, or
   (B) to a person other than the person making the disclaimer.


In virtually all instances where a disclaimer would be used for post-mortem estate planning, it would be a partial disclaimer rather than a disclaimer of a complete interest. Therefore, §2518(c) dealing with disclaimers of complete interests is not covered in this article.
the property as a result of the disclaimer.63 In 1978, section 2518 was amended64 to permit a spouse to reobtain certain interests in disclaimed property.65 The Senate Finance Committee Report clearly indicates that Congress intended the amendment to cover disclaimed marital bequests which drop into the typical by-pass trust.66 A spouse can accordingly disclaim property which would have resulted in a marital deduction for the decedent and subsequent inclusion in the spouse’s estate, yet retain certain interests in the disclaimed property. The 1980 Proposed Regulations under section 2518, however, indicate that a disclaimer will not be treated as a qualified disclaimer for transfer tax purposes if the surviving spouse retains the right to direct the beneficial enjoyment of the disclaimed property by a transfer that is not subject to federal transfer tax.67 A disclaimer will be qualified even if in addition to being an income interest beneficiary, the surviving spouse is a permissible appointee of a trustee’s power of appointment over the corpus of the by-pass trust, or has a power limited by an ascertainable standard to invade the corpus for his own needs.68 But if the spouse has a special power of appointment over disclaimed property, the disclaimer will not meet the requirements of section 2518.69

Some commentators70 have made a tongue-in-cheek suggestion that the disclaimer provisions now permit the adoption of a totally ambulatory estate plan which will not be finalized until a post-

unclear as to whether a disclaimer is valid for transfer tax purposes where a surviving spouse refuses to accept all or a portion of an interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest . . . .

Id. In resolving this vagueness the report states:
The committee believes that, where the decedent spouse refuses to accept all or a portion of his or her interest in property passing from the decedent and, as a result of that refusal, the property passes to a trust in which the spouse has an income interest, such disclaimer should be recognized as a qualified disclaimer.

Id.
70. Address by Paul N. Frimmer, New York University Institute on Federal Taxation (June 2, 1981).
mortem decision can be made with respect to the amount of the optimum marital deduction. Such an ambulatory plan would provide for either a maximum marital deduction or a zero-tax marital deduction. Additionally, in anticipation of a disclaimer, the will would provide for the disclaimed property to pass to the by-pass trust. The surviving spouse would be given that maximum constellation of interests that could be held in the by-pass trust without disqualifying the partial disclaimer of the marital bequest. A disclaimer would thereby result in the spouse reacquiring a substantial interest in the disclaimed property.

It is essential to emphasize that unless there is an express provision in the will which provides that the disclaimed property will pass to the by-pass trust, to be disposed of in accordance with all of the terms of that trust (including those terms which bestow benefits on the surviving spouse), the Pennsylvania disclaimer provisions would preclude the spouse from reacquiring any beneficial interests in the disclaimed property.71

Where the expectation is that, in addition to the disclaimed property, other nonmarital bequest probate property will be in the estate, it would be advisable to establish two by-pass trusts; one to serve as a repository for the disclaimed property and one to serve as a repository for the other nonmarital bequest property. Separating the disclaimed property from other nonmarital bequest property will prevent both from being treated as one interest under the disclaimer regulations.72 In this way, the surviving spouse could retain maximum control over and access to the by-pass trust containing the nondisclaimed property, consistent with exclusion from his or her gross estate, without affecting the qualification of the disclaimer. Although the maintenance of two by-pass trusts may create some administrative inconvenience, it appears to be the only way that one can couple a qualified partial disclaimer of the marital bequest with the retention by the surviving spouse of maximum access to and control over

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unless a testator or donor has provided for another disposition, the disclaimer shall, for purposes of determining the rights of other parties, be equivalent to the disclaimant's having died before the decedent in the case of a devolution by will or intestacy or before the effective date of an inter vivos transfer.

Id.

72. Under the proposed disclaimer regulations, all assets in the same trust are treated as one interest unless the assets are transferred by different transferors or by the same transferor at different times. Prop. Reg. § 25.2518-3, 45 Fed. Reg. 48,925, 48,929-48,930 (1980).
the nonmarital probate property.\textsuperscript{73}

One may consider that as an alternative to creating a separate trust as a repository for the disclaimed property, the disclaimed property could pass to the standard by-pass trust which provides the surviving spouse with special powers of appointment and other interests that are designed to give maximum control and enjoyment yet avoid inclusion of the interests in the surviving spouse’s gross estate. Then, simultaneously with any disclaimer of the marital bequest property which drops into the by-pass trust, the surviving spouse would file a partial disclaimer with respect to the by-pass trust. This disclaimer would be designed to prevent the surviving spouse from using powers given him in the by-pass trust to direct the beneficial enjoyment of the disclaimed marital property.\textsuperscript{74} Furthermore, the disclaimer would be designed so as not to affect the surviving spouse’s control over the other by-pass trust property. A close reading of the proposed regulations, however, indicates that this suggestion does not present a viable alternative to creating a separate by-pass trust for the disclaimed property. The single interest rule for all trust assets established by the proposed regulations,\textsuperscript{75} when parlayed with a proposed regulation position that all interests in corpus be considered a single interest,\textsuperscript{76} requires the surviving spouse to disclaim fully all corpus interests in all property contained in a single trust.\textsuperscript{77} Such a position would prevent a partial disclaimer, which was limited to property...

\textsuperscript{73} The establishment of two separate by-pass trusts, especially where the beneficial interests are different, should not be treated as one interest under the Proposed Regulations provision which states that “if the property is divided in a manner that would permit the disclaimant to avoid the limitations of section 2518, the separate interests created by the grantor are treated as one indivisible interest.” \textit{Id.} at § 25.2518-3(a)(1)(i), 45 Fed. Reg. at 48,929 (1980).

\textsuperscript{74} The power of invasion for the surviving spouse’s benefit, when limited by an ascertainable standard, is technically a special power. This power would not have to be disclaimed since it does not adversely affect the qualification of the disclaimer of the marital bequest. Prop. Reg. § 25.2518-2(e)(2), 45 Fed. Reg. 48,925, 48,928 (1980).


\textsuperscript{76} \textit{See note} 72 \textit{supra}.

\textsuperscript{77} Powers of appointment are not interests which are separate from their principal interests. Prop. Reg. § 25.2518-3(a)(2), 45 Fed. Reg. 48,925, 48,929 (1980). For the disclaimed property to fall into a residuary trust for the benefit of the surviving spouse, the surviving spouse may have to disclaim a limited power and all other powers of appointment over the property which passes to the residuary trust, including any interest in principal as a discretionary appointee of corpus. This will prevent retention by the disclaiming spouse of the “right to direct the beneficial enjoyment of the disclaimed property in a transfer that is not subject to federal estate and gift tax . . . .” which would disqualified the disclaimer. Prop. Reg. § 25.2518-2(e)(2), 45 Fed. Reg. 48,925, 48,928 (1980).
augmenting the by-pass trust as a result of a disclaimer of the marital bequest, from meeting the requirements of section 2518.

Another alternative to the establishment of a separate trust as the repository for the disclaimed property that has been suggested is the insertion of a provision in the typical by-pass trust that limits the special power of appointment to trust property other than property in the trust as a result of a disclaimer. This provision satisfactorily deals with the technical requirements of a disclaimer\(^{78}\) but would require the trustee to segregate the disclaimed property to permit continuous tracing during the life of the surviving spouse.

It is clear that some of the inherent features of a disclaimer, as well as the Treasury’s restrictive position on the disclaimer of trust interests, render the implementation of an ambulatory estate plan by use of disclaimer quite inappropriate except in a few isolated situations.\(^{79}\) The first problem is that the surviving spouse may be unwilling to disclaim valuable property interests simply to save estate taxes. Secondly, although the Pennsylvania disclaimer provisions\(^{80}\) create no additional problems because they are drawn quite liberally,\(^{81}\) unlike those of some other states,\(^{82}\) a planner cannot always be certain

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78. See text accompanying notes 61-68 supra.
79. See note 84 and accompanying text infra.
82. State disclaimer statutes may vary as to the prescribed procedures for effectuation. See, e.g., Del. Code Ann. tit. 12, § 602 (Supp. 1982) (delivery of a written disclaimer to legal representative of transferor or holder of legal title); N.J. Stat. Ann. §§ 3B:9-6, 9-7 (West 1982) (written disclaimer filed in the office of surrogate or Superior Court in which administration of decedent’s estate is commenced, as well as with register of deeds and mortgages of the county in which any real property disclaimed is located, with a copy delivered to decedent’s personal representative, fiduciary or holder of legal title to which the interest relates); N.Y. Est. Powers & Trusts Law § 2-1.11 (McKinney 1981) (written, signed and acknowledged renunciation filed with clerk of court having jurisdiction over the trust agreement governing renounced property, accompanied by disclaimant’s affidavit, with notice served upon the fiduciary directed to make the disposition and upon all persons whose interest is increased or created by reason of the renunciation). State statutes may also vary as to the timing of a disclaimer. See, e.g., Del. Code Ann. tit. 12, § 602 (Supp. 1982) (not later than nine months after death of transferor); N.J. Stat. Ann. § 3B:9-5 (West 1982) (not later than nine months after decedent’s death if disclaiming a present interest and not later than nine months after happening of the event which determines disclaimant’s rights to a future interest unless court extends time); N.Y. Est. Powers & Trusts Law § 2-1.11 (McKinney 1981) (within nine months after the effective date of disposition; time may be extended for reasonable cause and on notice to such persons as court may direct). States also vary as to the types of interests that may be disclaimed. See, e.g., Del. Code Ann. tit. 12, § 601
that Pennsylvania law will be applied.\textsuperscript{83}

While these considerations advise against building an estate plan around the disclaimer provisions, the post-mortem opportunities for adjusting the dispositive scheme by a disclaimer must be given serious consideration. Post-mortem events such as the death of the surviving spouse during the probate period may very well affect the amount of the optimum marital deduction for the estate of the first spouse to die. Under such conditions Pennsylvania law would permit the personal representative of the deceased beneficiary to disclaim all or a portion of the marital bequest thereby maximizing estate tax savings.\textsuperscript{84} Even where the spouse continues to survive, some post-mortem circumstances, such as imminent death or short life expectancy, may make it clear that the surviving spouse's estate would be augmented by the marital bequest to a point where the additional estate tax payable by the surviving spouse's estate would exceed the savings of estate tax on the death of the first spouse plus the investment income from such savings during the period of survival. Under these conditions, a disclaimer of all or a portion of the marital bequest may be appropriate.

E. The Surviving Spouse's Interest in the Marital Bequest

Certain terminable interests that pass to the surviving spouse will

\textsuperscript{83} Obviously, the disclaimer of any interest in an asset such as foreign real property would be controlled by the disclaimer law of the jurisdiction which is the situs of the real property.

\textsuperscript{84} 20 Pa. Cons. Stat. Ann. § 6202 (Purdon Supp. 1982). This section permits such a disclaimer where it is determined that it will not materially prejudice the rights of creditors, heirs or beneficiaries of the decedent. Likewise, § 2518(a) which states the general rule concerning disclaimers, refers to "a person" making a disclaimer, rather than a disclaimer made by the deceased surviving spouse. Furthermore, the proposed regulations state that "the value of a decedent's gross estate, for purposes of the federal estate tax, does not include the value of property with respect to which the decedent or the decedent's executor or administrator on behalf of the decedent, has made a qualified disclaimer." Prop. Reg. § 25.2518-1(b), 45 Fed. Reg. 48,925 (1980).
not qualify for the marital deduction. This statutory limitation is intended to provide assurance that the property interests qualifying for the marital deduction will be subjected to estate tax if retained by the surviving spouse until death or to a gift tax if gratuitously transferred prior to death.

The terminable interest provisions do not require the surviving spouse to receive some minimum use or possessory interest in the property. For example, a vested remainder interest will qualify for the marital deduction even where it is unlikely that the interest will become possessory during the life of the surviving spouse. Moreover, a specific exception to the terminable interest limitation, added by ERTA, permits property to qualify for the marital deduction even when a surviving spouse receives only an income interest for life and thus has no interest in or control over the descent of the property. Consequently, the surviving spouse's interest in the marital deduction bequest can be more limited than was previously possible.

At this point it should be noted that while qualifying property for the marital deduction requires the spouse to receive at least an income interest for life in the transferred property, this requirement does not create a substantial restriction on the estate planner, in view of the prohibitions against disinheritance contained in the forced share provisions available to a surviving spouse under state law.

Section 2056(b)(7) of the Code sets forth the special requirements for obtaining a marital deduction for property in which the interest of the surviving spouse is limited to an income interest for life.

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86. See notes 12 & 55 supra.
90. The addition by ERTA of § 2056(b)(7) eliminated the need to give the surviving or donee spouse control over the ultimate disposition of the property in order for a trust bequest to qualify for the marital deduction.
91. See, e.g., 20 PA. CONS. STAT. ANN. § 2203 (Purdon Supp. 1982). This statutory provision guarantees the surviving spouse one-third of all probate property plus one-third of certain other property transferred by a testamentary-type disposition. It should be noted, however, that two nonprobate assets, pension benefits and insurance, cannot be reached by the surviving spouse and the surviving spouse must also forfeit her interest in these assets when the elective share is exercised. The treatment of these assets permits restricting the spouse's share to these assets as well as the other assets.
92. I.R.C. § 2056(b)(7) (Supp. V 1981). For a discussion of this section, see notes 105-16 and accompanying text infra. For a discussion of the requirements of § 2056(b)(8) which also permits a marital deduction for property in which the surviv-
ing from the amount of interest the tax bar has shown in section 2056(b)(7), it can be anticipated that use of the so-called QTIP trust will extend well beyond the second marriage situation, the principal purpose for which it was apparently intended.

As should now be evident, the selection of an interest for the surviving spouse in the marital bequest may be made within a very extensive range that includes considerable variations in enjoyment and control. If a determination is made that the spouse is to receive a property interest that is less than a fee, a trust bequest is the appropriate form in virtually all cases. Certain guidelines can be suggested for selecting the appropriate type of trust interests from the myriad of possibilities that are available for qualifying the bequest for the marital deduction.

1. Power of Appointment Trusts

Where the surviving spouse is perceived as not having sufficient competence in the area of property management, a power of appointment trust in accordance with section 2056(b)(5) is indicated. Under this provision, the surviving spouse must have an income interest for life and a general power of appointment over the property. The general power can be exercisable during the surviving spouse’s lifetime or can be restricted to testamentary exercise. The decision whether to subject the property to an inter vivos power of appointment or a testamentary power or both will depend on non-tax considerations, especially the degree to which the surviving spouse can be trusted to competently manage and dispose of the property in accordance with the desires of the grantor.

Although the Pennsylvania inheritance tax law does not contain a marital deduction, there is no state transfer tax imposed on property subject to a general power of appointment. The net effect for Pennsylvania tax purposes is that the marital bequest property will not be subject to inheritance tax on the death of the surviving spouse where the power of appointment trust is selected for the marital bequest. In fact, any marital bequest which is designed to meet the terminable interests exceptions under sections 2056(b)(5)(6) or (7) will

93. A qualified interest may range from a fee simple to a life estate or a remainder that may never become possessory. See I.R.C. § 2056(b) (1976 & Supp. V 1981).
96. Inheritance and Estate Tax Act, No. 255, 1982 Pa. Legis. Serv. 1398 (Purdon) (to be codified at PA. STAT. ANN. tit. 72, § 1711(K)).
escape Pennsylvania inheritance tax on the death of the surviving spouse.97 This provides an additional motive for using any of such trust marital bequests.

2. The Estate Trust

If income tax planning necessitates diverting from the surviving spouse the tax burden on the income from the marital bequest property, the so-called “estate trust” may be appropriate.98 The “estate trust” which is not considered to be a terminable interest,99 provides for an income interest in the surviving spouse for life and a remainder interest to pass in fee to the estate of the surviving spouse. During the surviving spouse’s life, income payments may be left to the discretion of the trustee with all accumulated income passing to the estate of the surviving spouse. The income tax provisions applicable to trusts and trust beneficiaries will prevent the trust income from being included in the income of the surviving spouse except where there is an actual distribution of such income to him.100 Payment of the accumulated income to the surviving spouse’s estate will trigger the so-called “throwback rules”101 but these rules should not result in any additional tax.102 The chief disadvantage of the estate trust is that the inclusion in the gross estate of the surviving spouse is likely to be considerably greater than the marital deduction for the estate of the first spouse because of the undistributed trust income and the earnings from such income.

State law should be checked carefully before attempting to create the estate trust because some states do not permit a remainder interest to be created in the estate of a living person.103 Under Pennsylvania law there appears to be absolutely no impediment to the cre-

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97. Id.
98. The estate trust is the only arrangement which qualifies for the marital deduction where the surviving spouse does not have an absolute right to receive income from the property. See 4 J. RABKIN & M. JOHNSON, FEDERAL INCOME GIFT AND ESTATE TAXATION § 53.06(2) (1982) and authorities cited therein. For an example of an estate trust, see Treas. Reg. § 20.2056(e)-2(b)(2)(ii) (1958).
99. Treas. Reg. § 20.2056(b)-5(f) (1958). An interest in trust property is not considered a terminable interest when the surviving spouse and his estate are the sole beneficiaries of the trust property. Id.
100. See notes 158-68 and accompanying text infra.
101. For a discussion of the “throwback rules,” see notes 169-70 and accompanying text infra.
102. Treas. Reg. § 1.668(b)-2A(a) (1972). This result is obtained because the distribution of the accumulated income is to the surviving spouse’s estate, which was not in existence in the years the income was earned.
103. See Fox, Estate: A Word To Be Used Cautiously, If At All, 81 HARV. L. REV. 992 (1968); Huston, Transfers to the “Estate” of a Named Person, 15 SYRACUSE L. REV. 463 (1964).
3. **The QTIP Trust**

The section 2056(b)(7) QTIP trust provides for an income interest for life in the surviving spouse but severely limits the spouse's interest or control over the corpus. Use of the QTIP trust and its concomitant limitation on the surviving spouse's control over the ultimate disposition of the marital bequest property is quite appropriate where the surviving spouse is incompetent or for some reason, such as a second marriage, cannot be relied upon to dispose of the property in accordance with the desires of the testator spouse. It seems likely, however, that in most cases use of the QTIP trust is motivated by a perceived need to protect the marital bequest property from being squandered on the ephemeral paramours of the surviving spouse.

The Treasury, of course, is not deprived of revenue by a marital bequest in the form of a QTIP trust. The entire value of the property will be subjected to a transfer tax either on the death of the surviving spouse under section 2044 or earlier under section 2519 if he gratuitously transfers the income interest. The real loser where the QTIP trust severely limits the surviving spouse's access to the corpus may very well be the surviving spouse—a result which the testator spouse probably never intended.

While section 2056(b)(7) permits a trustee to have discretion to invade corpus for the surviving spouse, no one, including the surviving spouse, can have the power to appoint the corpus during the life of the surviving spouse to anyone other than the surviving spouse. A power of appointment which does not become effective until the death of the surviving spouse can be created in anyone, but a testamentary power in the surviving spouse must be limited to a special power in order to stay within the context of section 2056(b)(7).

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106. *Id.* § 2044.
107. *Id.* § 2519.
108. *Id.* § 2056(b)(7)(B)(ii). This section states that
[t]he surviving spouse has a qualifying income interest for life if—
(I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and
(II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

Subclause (II) shall not apply to a power exercisable only at or after the death of the surviving spouse.

*Id.*

109. *Id.* If the surviving spouse is given a general power of appointment, the provisions of § 2056(b)(5) would control, rather than § 2056(b)(7).
The unique feature of the QTIP trust is that the marital deduction for the estate of the first spouse to die and the concomitant inclusion in the gross estate of the surviving spouse under section 2044 will occur only where such treatment is elected by the personal representative of the estate of the first spouse. Thus, a very appealing feature of the QTIP trust is the opportunity it apparently offers for implementing post-mortem determinations with respect to the optimum marital deduction.

Although nothing in the statute clearly indicates that a partial election of qualified terminable interest property can be effected, a recent temporary regulation provides that a partial election can be made by the executor. Any such election must be expressed as a percentile or fractional share of the trust property, thereby insuring that any inclusion under sections 2044 or 2519 will reflect the proportionate share of appreciation or depreciation in value. The fractional election may be defined by means of a formula.

One problem with placing substantially all of the estate property in a QTIP trust, and permitting the executor to make a post-mortem implementation of the optimum marital deduction, relates to the desired interaction of the marital and non-marital bequests. Some of the provisions typically found in the marital and the by-pass trusts are designed so that the trusts operate in tandem to effect the maximum aggregate tax savings. For example, the trustee may be required to make corpus invasions, for the benefit of the surviving spouse, from the marital trust before making such invasions from the by-pass trust. This provision cannot be employed if all the property is placed in a single trust, and as a result, the estate of the surviving

110. Id. § 2056(b)(7)(B)(v). This section states that "[a]n election under this paragraph with respect to any property shall be made by the executor on the return of tax imposed by section 2001. Such an election, once made, shall be irrevocable." Id.

111. The election must be made on the estate tax return. Id. This return must be filed within nine months of the decedent's death unless an extension is granted. Id. §§ 6075, 6081(a) (1976). The disclaimer election must also be made within nine months but there is no opportunity for an extension. Id. § 2518 (1976 & Supp. V 1981).


113. Id. The temporary regulation provides as follows:

If the interest of the surviving spouse in a trust (or other property in which the spouse has a life estate) meets the requirements of section 2056(b)(7)(B)(f) and (II), the executor may make an election . . . with respect to a part of that trust (or other property) only if the election relates to a defined fraction or percentage of the entire trust (or other property). The fraction or percentage may be defined by means of a formula.

Id.

114. Id.
spouse may be larger than necessary. The surviving spouse is also frequently designated as only a permissible income beneficiary of the by-pass trust rather than a required beneficiary of all income so that the income tax burden with respect to such income can be split between two taxpayers.\footnote{115} This income tax savings could not be accomplished where substantially all the estate property is placed in a QTIP trust, unless there is included in the will a trust provision permitting the surviving spouse's income interest to become discretionary for that portion of the QTIP property not elected for marital deduction qualification. This writer, and other commentators, believe that such a provision for downgrading the income interest would certainly create an unacceptable risk that the entire marital deduction would be lost for all QTIP property subject to such a provision.\footnote{116}

4. The Marital Deduction and Charitable Remainder Trust

ERTA contains provisions, codified at sections 2056(b)(8) and 2523(g) of the Code which permit a marital deduction for the value of an income interest passing to a spouse where the spouse is the only noncharitable beneficiary of a qualified charitable remainder trust.\footnote{117} The surviving spouse's income interest in the qualified charitable remainder trust must be expressed in the form of a unitrust\footnote{118} or an

\footnote{115. Section 661 of the Code only requires inclusion by a beneficiary of undistributed income when the income is required to be distributed currently under local law. I.R.C. § 661 (1976).}

\footnote{116. \textit{See, e.g.}, Blattmachr & Lustgarten, supra note 51, at 52. These commentators observe that there is a chance that if the will directs that the portion of the trust as to which no QTIP election is made is to be placed into a fund in which the spouse's rights are such that it could not qualify as a QTIP [spouse not entitled to all income payable at least annually], the entire amount which originally could have been "Q.Tipped" cannot qualify for the marital deduction because it is a terminable interest.}


\footnote{118. A charitable remainder unitrust is defined in § 664(d) as a trust:
  (A) from which a fixed percentage (which is not less than 5 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals.
  (B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c), and
  (C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for
annuity trust\textsuperscript{119} as described in section 664(d).\textsuperscript{120} Thus, where the transfer is inter vivos, all such charitable remainder trusts should be structured in accordance with section 2523(g) in order to permit the transferor spouse a charitable income tax deduction as well as gift tax charitable and marital deductions.\textsuperscript{121}

Where a testamentary charitable remainder gift is desired, the planner must decide whether to provide for it through a QTIP trust under section 2056(b)(7) or a charitable remainder trust under section 2056(b)(8). Where the dominant motive is to maximize the charitable bequest, section 2056(b)(8) is the better vehicle, because a trust under that section is subject to the provisions of section 664, which removes any incentive for the trust to acquire high income, low growth (or wasting) assets.\textsuperscript{122} If the QTIP trust is selected, and the testator wishes to primarily benefit the charity, the trustee's power to invade corpus for the benefit of the surviving spouse should be limited, thereby preserving the corpus for the charity. Under either method the property is not included in the taxable estate of either spouse and thus the estate tax result is the same, although the method of achieving the result differs. Where a section 2056(b)(8) trust is used, the testator will receive an estate tax deduction for the entire value of the property, which consists of a marital deduction for the

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\textsuperscript{119} The use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

\textsuperscript{120} Id. §664(d)(2)-(3) (1976).

\textsuperscript{121} A charitable remainder annuity trust is defined in §664(d)(1) as a trust:

(A) from which a sum certain (which is not less than 5 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) may be paid to or for the use of any person other than an organization described in section 170(c), and

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use.

\textsuperscript{122} Id. §664(d)(1).

\textsuperscript{120} Id. §2056(b)(8)(B)(ii) (Supp. V 1981).

\textsuperscript{121} In order for the trust to qualify for a charitable income tax deduction, §170(f)(2) requires it to be a charitable remainder unitrust or an annuity trust. Id. §170(f)(2) (1976). Likewise §2522(c)(2)(A) imposes the same restrictions in order to qualify a trust for the gift tax deduction. Id. §2522(c)(2)(A).

\textsuperscript{122} Section 664 requires that distributions be made to beneficiaries on a fixed basis. Id. §664(d). Consequently, a trustee cannot increase the income distributable to the trust beneficiary by investing in high yield, low growth investments, as he could by use of a QTIP trust. See notes 126-27 and accompanying text infra.
value of the surviving spouse’s interest and a charitable deduction for
the remainder.123 Where the QTIP trust is used, the estate of the first
spouse gets a marital deduction for the value of the entire property.124
While the entire value is then included in the gross estate of the
surviving spouse under section 2044, this inclusion is offset by a charita-
table deduction under section 2055.125

Since the surviving spouse’s income interest in the qualified chari-
table remainder trust is expressed in the form of a unitrust or annuity
trust, there is no opportunity for the trustee to control the income
flow to the spouse through his selection of trust investments.126 In a
section 2056(b)(7) trust, however, the trustee does have some flex-
ibility to control income flow. The trustee of the QTIP trust may
have the power to increase the income of the spouse by holding high
income yielding assets or, on the other hand, the trustee can decrease
income by holding nonincome producing assets, without jeopardizing
the marital deduction, so long as the surviving spouse has the power
to cause a conversion to income producing assets.127

The tax consequences of a distribution to the surviving spouse
from a qualified charitable remainder trust are governed by section
664(b). Unlike the regular conduit rules which govern the taxation of
distributions from a QTIP trust,128 section 664(b) does not limit in-

125. Id. §§ 2044, 2052, 2055 (1976 & Supp. V 1981). Until recently, it was un-
clear whether the surviving spouse’s estate would be able to obtain a charitable
deduction for the passage of QTIP property to a charity, due to the requirement of
§ 2055(a) that the distribution of the QTIP property on the death of the surviving
spouse constitute a “bequest, legacy, devise or transfer.” Id. § 2055. This uncertainty
was clarified by the addition of a new subsection to § 2044 which provides that “[f]or
the purposes of this chapter and chapter 13, property includible in the gross estate of
the decedent under § 2044(a) shall be treated as property passing from the de-
cendent.” The Ways and Means Committee report further states that “QTIP
property included in a deceased donee spouse’s estate is treated as passing from that
spouse, for purposes of the estate tax, including the charitable or marital deduction.”
126. In the case of an annuity trust, the surviving spouse will receive, no less
frequently than annually, a fixed percentage of the value of the corpus with the
corpus being valued at the time of the creation of the trust. In the case of a unitrust,
the surviving spouse will receive, no less frequently than annually, a fixed percentage
of the value of the corpus, which value is determined annually. I.R.C.
on the trust assets has no effect on the distributions to the surviving spouse. See note
122 supra.
of administrative powers to the trustee will not disqualify an interest passing in trust
unless the grant is determined to be intended to deprive the surviving spouse of the
required income interest. Id.
128. See notes 158-70 and accompanying text infra.
come inclusion of distributions to the amount of the current and accumulated ordinary income. The beneficiary may also be taxed on the trust's current and accumulated capital gains. Not until all current and accumulated ordinary income and all current and accumulated capital gains are deemed distributed is any distribution from a qualified charitable remainder trust deemed to be a distribution of tax-exempt income or corpus. It should be noted, however, that the qualified charitable remainder trust is a nontaxable entity and affords an opportunity through constant tax-free trading to increase the amount of the corpus, thereby maximizing the return to a surviving spouse under a unitrust. In spite of the opportunities for maximizing the yield under a unitrust, the needs of the surviving spouse seem better served by a QTIP trust with a charitable remainder rather than a qualified charitable remainder trust.

F. Tax Apportionment and Abatement: The Optimum Marital Deduction

As was previously noted, it is not possible to obtain an unlimited marital deduction if any portion of the marital deduction share is used to pay expenses, such as state death taxes, that are not deductible for federal estate tax purposes. Under section 2056(b)(4), the marital deduction will be reduced by such expenses and to the extent that such a reduction results in the imposition of additional federal estate tax which would also be borne by the marital deduction, the

129. I.R.C. § 664(b) (1976). Section 664 characterizes distributions as follows:
   (1) First, as amount of income (other than gains, and amounts treated as gains, from the sale or other distribution of capital assets) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years;
   (2) Second, as a capital gain to the extent of the capital gain of the trust for the year and the undistributed capital gain of the trust for prior years;
   (3) Third, as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and
   (4) Fourth, as a distribution of trust corpus.

Id.

130. Id.

131. Id. § 664(c).

132. See D. Westfall, Estate Planning 336 (2d Ed. 1982).

133. The QTIP trust permits invasion of corpus for the spouse's benefit and this alone certainly tips the balance toward the QTIP trust as being more capable of fulfilling both the anticipated and unanticipated needs of the surviving spouse. See I.R.C. § 2056(b)(7)(B)(ii)(II) (Supp. V 1981).

134. See notes 21-23 and accompanying text supra. Pennsylvania inheritance and estate tax is first charged to the residuary share, unless the will contains an instruction to the contrary. After the residue is exhausted, the Pennsylvania inheritance and estate tax is charged on a pro rata basis. Pa. Stat. Ann. tit. 72, § 1744(a) (Purdon Supp. 1982).
marital deduction will be further reduced. In many states, including Pennsylvania, the additional reduction of the marital share, and thus the marital deduction, will not occur if other sources are available to pay the federal estate tax. For example, the Pennsylvania apportionment statute provides:

*Inheritance or death tax effect.* To the extent that property passing to or in trust for a surviving spouse does not constitute an allowable deduction solely by reason of an inheritance tax or other death tax imposed upon and deductible from such property, it shall not be included in the computation [of basis or apportionment] . . . and to that extent no apportionment shall be made against such property. 135

Where the probate estate consists only of a marital deduction share and an exemption equivalent share created by either of the formula provisions previously set forth, any principal expenses that are nondeductible for federal estate tax purposes will be borne by the exemption equivalent share to the extent thereof. 136 Where the will contains a no-tax marital share, expressed as either a pecuniary or a residuary bequest, all principal expenses that are deductible for federal estate tax purposes will be borne by the marital deduction share. This occurs because the formula provisions suggested above contain provisions that have the effect of causing the shares to self-adjust for deductible and nondeductible expenses. Where the exemption

135. 20 PA. CONS. STAT. ANN. § 3704(b)(4) (Purdon 1975). Pennsylvania's provisions regarding apportionment of federal estate tax excuse from contribution any share which qualifies for the marital deduction, even when that share is part of the residue. In Pennsylvania, a marital deduction fractional formula that appears to be a true residuary formula is, as a result of the apportionment, a pre-estate tax fractional residuary formula. See R. Covey, The Marital Deduction and the Use of Formula Provisions 10 (2d ed. 1978). The general order of abatement for testamentary dispositions is first the residue and when it is exhausted, the shares of those persons receiving assets in accordance with the ratio of the value of the assets to the value of the net estate. See, e.g., 20 PA. CONS. STAT. ANN. § 3541 (Purdon 1975).

136. See text accompanying notes 43-47 supra. The description of the funds in the provisions set forth in the text accompanying notes 43 & 45 makes clear that nondeductible principal expenses are to be borne by the exemption equivalent share and deductible principal expenses are to be borne by the marital share. In Pennsylvania, any expenses attributed to income as well as income expenses on assets not specifically devised are borne by the residuary share. 20 PA. CONS. STAT. ANN. § 3543 (Purdon 1975). Basically, the residue receives income; therefore, it bears the expenses attributable to the income.

Except for situations where there is no available credit or the available unified credit is exhausted by nondeductible expenses, no federal estate tax will be payable under the spousal dispositive scheme described in text accompanying notes 43-47. This eliminates the serious problem of making certain that the marital share does not bear any of the federal estate tax. The only abatement preference for a surviving spouse is when property is specifically bequeathed to the surviving spouse.
equivalent share as described in the above paragraph is exhausted and the will contains a pre-residuary (pecuniary) marital share as well as other pre-residuary legacies, the nondeductible principal expenses other than taxes will be borne in accordance with the state abatement provision. In that situation, the specific reference to a zero-tax marital deduction bequest may or may not be interpreted as an expression by the testator of an intended abatement priority which would require the other legacies to abate before the marital deduction bequest was reduced. For example, assume the will consisted of a pecuniary zero-tax marital deduction bequest, a pecuniary bequest to a child of $500,000, and a residuary bequest to a by-pass trust. Assume also that the probate and gross estates both totaled $1,200,000, and that all of the principal expenses in the amount of $150,000 were nondeductible. (Assume that these principal expenses were administration expenses which were deducted on the estate's federal income tax return.) In this situation, the initial calculation of the total amount of bequests would be $500,000 as a pecuniary bequest to the child and $600,000 as a marital bequest, leaving nothing for the residuary bequest. Although these bequests total $1,100,000, the net assets available to satisfy the bequests would total only $1,050,000. Under Pennsylvania law, it is clear that in this example the residue would abate (or perhaps the more accurate term might be self-adjust) first. However, if the will contained no specifically expressed abatement priority, it is unclear what the abatement order would be with respect to the additional $50,000 needed for expenses. If the marital share and the other pecuniary bequest abate proportionately then an additional federal estate tax would result.

137. In Pennsylvania, the marital share is relieved from any apportionment for federal estate tax. 20 PA. CONS. STAT. ANN. § 3704 (Purdon 1975).

138. Some states provide marital deduction bequests a preference in the order of abatement. N.Y. EST. POWERS & TRUSTS LAW § 2-1.8 (McKinney 1981). Note that Pennsylvania, which does not specifically provide for such a preference, allowing it only where property is specifically bequeathed to the surviving spouse, may infer such a preference from the impact of the estate tax in this situation.

139. The combination of the $500,000 bequest to the child and the $150,000 of nondeductible expenses would completely exhaust the unified credit exemption equivalent of $600,000; therefore, nothing would pass through the residuary bequest. (Technically, the residue in this case is not abating but rather is decreased to zero by the terms of the bequest itself.) There would, however, still be an additional $50,000 of expenses which would be borne by the pecuniary bequest, the marital deduction bequest, or proportionately by each.

140. Pennsylvania permits the will to establish an order of abatement. 20 PA. CONS. STAT. ANN. § 3541 (Purdon 1975).

tion to such additional federal estate tax,\textsuperscript{142} thereby preventing a further reduction of the marital deduction. Of course, uncertainty can be obviated by inserting an express provision providing that the pecu- niary marital share shall abate last under these conditions.

If the exemption equivalent share and the zero-tax marital deduction share are both described as fractional shares of the residue, the will should contain a provision that all taxes, debts and expenses are to be paid off the top of the residue without apportionment within the residue.\textsuperscript{143} Under these circumstances, the self-adjusting provisions inherent in the description of each share will accomplish the correct result: the marital share will bear the deductible expenses and the exemption equivalent share will bear the nondeductible expenses.

G. QTIP Trust: Pennsylvania Death Tax

The consequences of section 2056(b)(4) are more difficult to ascertain when the marital bequest is in the form of a QTIP trust and there is a possibility that the Pennsylvania death tax will be apportioned to the marital share. When a QTIP trust is used to obtain the marital deduction, the remainder interest of the trust may remain contingent until the death of the surviving spouse. In such a situation, it may be impossible to determine with certainty whether the ultimate taker of the remainder interest will be classified under the Pennsylvania Inheritance Tax Act as a Class A beneficiary (6% tax)\textsuperscript{144} or a Class B beneficiary (15% tax).\textsuperscript{145}

1. Decedents Dying After December 31, 1981 and Before December 13, 1982

Recently the Pennsylvania inheritance tax was amended substantially by the Inheritance and Estate Tax Act No. 255, which had

\textsuperscript{143} This provision is in accordance with the Pennsylvania statute which treats the payment of Pennsylvania inheritance and estate tax as other payments, and charges them to the residue. Inheritance and Estate Tax Act, No. 255, § 1, 1982 Pa. Legis. Serv. 1398 (to be codified at Pa. Stat. Ann. tit. 72, § 1744(a). Pennsylvania does not specifically apportion federal estate tax to the nonmarital share of the residue; however, under the formula provisions discussed above, no federal estate tax is contemplated.

\textsuperscript{144} Under Pennsylvania law, Class A beneficiaries are "(1) grandfather, grandmother, father, mother, husband, wife and lineal descendants; (2) wife or widow, and husband or widower of a child." Inheritance and Estate Tax Act, No. 255, § 1, 1982 Pa. Legis. Serv. 1398 (Purdon) (to be codified at Pa. Stat. Ann. tit. 72, § 1716(a)(1)).

\textsuperscript{145} Class B beneficiaries are "all persons other than those designated in Section 1716(a)(1)." \textit{Id.} (to be codified at Pa. Stat. Ann. tit. 72, § 1716(a)(2)).
an effective date of December 13, 1982. Before the amendment, the tax rate determination for a contingent remainder was postponed until the remainder vested and an absolute determination could be made as to whether the beneficiary belonged to Class A or Class B. With respect to a QTIP trust, that time is the death of the surviving spouse. The old law also permitted payment at the lowest possible rate and deferral of payment at the higher rate, without penalty, until the death of the surviving spouse. Under this arrangement, which will apparently continue for estates of decedents who died before December 13, 1982, the spouse's life interest in the income is not diminished even when the higher rate is ultimately imposed. However, the effect of this potential tax liability on the marital deduction for a QTIP bequest is unclear. On the one hand, an argument could be made that since any apportionment of the increased state tax to the QTIP trust will in no way diminish the surviving spouse's interest in the marital bequest, the marital deduction should not be affected. On the other hand, it appears from reading sections 2056(b)(7), 2044, and 2519 of the Code, in pari materia, that a downward adjustment of the marital bequest under section 2056(b)(4) may be appropriate, even when a tax will not be paid until the death of the surviving spouse. Whether such a reduction should be made on the basis of the highest possible tax rate payable or whether such a reduction should be discounted based on the remoteness of the contingency must also await future clarification. This entire problem can be obviated by the insertion of a will provision imposing all tax payments on shares other than the marital share.

2. Decedents Dying After December 12, 1982

The dilemma set forth above will not arise for Pennsylvania decedents dying after December 12, 1982, even if the marital share bears some of the inheritance tax. The recent amendment to the Pennsylvania inheritance tax provides that the tax rate on contingent remainders shall be fixed at the decedent's death by agreement between the taxpayer and the Department of Revenue. Where a compromise cannot be reached, the Orphan's Court division of the Court of Common Pleas shall determine what portion of the transfer

148. Id. §§ 2485-713(b), 2485-714(b) (Purdon 1964) (amended 1982).
is to be taxed at each of the applicable rates.\textsuperscript{150}

H. Executor Elections That Affect the Bequest to the Surviving Spouse

Administration expenses and casualty losses may be deducted in computing either the estate tax or the estate’s income tax, but not both.\textsuperscript{151} Even before ERTA, decisions by the executor concerning the best tax return on which to take the deductions were made with relative ease when a maximum marital deduction formula bequest was applicable. Under these circumstances if the adjusted gross estate exceeded $500,000, deducting administrative expenses and casualty losses on the estate’s income tax return had the consequence of increasing the marital deduction. This increase had the effect of offsetting one-half of the estate tax deductions lost for estate tax purposes. In the post-ERTA period, a loss of the estate tax deduction for administration expenses and casualty losses will be meaningless for estate tax purposes in virtually all instances, because a marital deduction zero-tax formula will automatically increase the marital deduction bequest in the exact amount of the waived estate tax deductions.\textsuperscript{152}

It must be noted that the use of such deductions for estate income tax purposes results in a direct benefit to the surviving spouse. If a zero-tax marital deduction formula is used, this benefit is an increase in the marital bequest. If an equalization marital formula is used, such a use of the deductions probably would not affect the marital bequest. The surviving spouse would possibly benefit, however, in that such use could result in a reduction in the tax borne by the income beneficiary, the surviving spouse, and an increase in the estate tax borne by the beneficiary of the principal. In any event, the will should grant the executor complete discretion in making such a choice. Furthermore, the will should relieve the executor of any duty to make adjustments between beneficiaries when an increase in tax for one results in a tax saving for another.\textsuperscript{153}

\textsuperscript{150} Id. (to be codified at Pa. Stat. Ann. tit. 72, § 1788(b)).
\textsuperscript{151} I.R.C. § 624(g) (1976).
\textsuperscript{152} The two instances where there would not be an equivalent increase in the marital deduction are 1) when the exemption equivalent of the unified credit is less than the amount of the unclaimed expenses and 2) when the marital deduction formula is not pegged to an amount necessary to eliminate estate tax such as when an equalization of rates formula is used.
\textsuperscript{153} State law might provide for adjustments that would require the beneficiary experiencing the tax reduction to indemnify, in the amount of the tax saving, the beneficiary whose tax liability was increased. See, e.g., Estate of Warms, 140 N.Y.S.2d 169 (1955).
I. Property Used to Satisfy the Marital Bequest

Section 2056(b)(2) of the Code dictates a reduction in the marital deduction to the extent that the marital bequest may be satisfied with nonqualified assets. Therefore, as in the pre-ERTA period, the will should provide that the marital bequest should be satisfied exclusively with property that qualifies for the marital deduction.

Where an estate planning motive, such as equalization of the estate tax rate of the spouses, leads to a dispositive plan which will result in the payment of some estate tax on the death of the first spouse, a clause should be inserted in the marital bequest directing that, where possible, satisfaction of the marital bequest be made with qualified property with respect to which there is available neither a credit against federal estate tax nor a deduction for income tax purposes. This prevents a "waste" of the credit, because when the marital deduction share receives property with respect to which a credit is available, no tax against which the credit can be claimed is incurred. For the same reason, it would make no sense to give any item constituting income in respect of a decedent to the marital portion.

In many instances where there is a marital deduction bequest it would be created by a zero estate tax formula provision and no estate tax will be incurred. In such instances, it may be advisable to use items of income in respect of a decedent to fund the marital bequest because it will diminish, to the extent of income tax due, the property which is potentially subject to estate tax when the surviving spouse dies.\footnote{154}

J. Simultaneous Death Provision

The marital deduction is available only for property passing to a surviving spouse. When it is not possible to ascertain the order of death, however, the Regulations permit a will provision which establishes a survival presumption.\footnote{155} Prior to ERTA, it was common to establish a presumption that the poorer spouse survived a common death.

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\footnote{154}{A distribution of IRD at estate tax value to a pecuniary bequest will constitute a sale or exchange triggering income recognition by the estate. This will not result where the distribution is made to a residuary bequest. See Treas. Reg. §1.691(a)-4 (1957). The Tax Court has held that a basis adjustment under Treas. Reg. §1.661(a)-(2)(f)(3) is not permitted with respect to a distribution of IRD. Rolfert Residuary Trust, 80 T.C. 619 (1983). The income tax liability with respect to the IRD does not make such property "encumbered property" under §2056(b)(4) because the decedent did not cause the liability to be imposed on the item of IRD.}

\footnote{155}{Treas. Reg. §20.2056(e)-2(e). This regulation provides in pertinent part that "if the order of deaths of the decedent and his spouse cannot be established by proof, a presumption (whether supplied by local law, the decedent's will, or otherwise) that the decedent was survived by his spouse will be recognized . . . ." Id.}
disaster and thereby received the marital deduction bequest. Under the pre-ERTA limited marital deduction, this presumption often had the effect of equalizing the size of the spouses' estates and thus minimizing progressive estate tax rates. The unlimited marital deduction introduced by ERTA reduces the probability that the presumption of survivorship will result in equalization of estate tax rates. Additionally, preventing the lapse of a no-tax marital bequest, by expressly providing for a presumption of survival, frequently will not result in the optimum marital deduction because the surviving spouse's survival period is too short to obtain any benefits from deferral. Nevertheless, where both spouses have wills naming the same ultimate beneficiaries, a provision establishing a presumption that the other spouse survived should be placed in the will of the wealthier spouse. The executor of the presumed surviving spouse would then be in a position to disclaim that portion of the marital bequest necessary to effect equalization of the tax rates for each spouse's estate.

III. FUNDING A MARITAL BEQUEST: INCOME TAX CONSEQUENCES

Consideration must be given to several major income tax consequences that can result from funding either a marital bequest or by-pass or credit shelter trust.

Perhaps the most significant tax consequence of a distribution in satisfaction of a bequest is the possibility of a shift of income from the estate to the beneficiary. This income shift will only result from a distribution in satisfaction of either a bequest created by certain pecuniary formulas (a formula such as a marital deduction formula or a by-pass or credit shelter formula which will not permit the amount to be computed at the testator's death) or a bequest of the residue or some fractional portion thereof. All other bequests will be specific property bequests or specific sum bequests and are expressly exempted under section 663(a)(1) from the normal income-shifting distribution rules except where the bequest is confined to income or is to be paid in more than three installments. Thus, even where the spouse is the sole beneficiary under the will it may be advisable to

156. See Keydel, Estate and Gift Tax Changes Made by The Economic Recovery Tax Act of 1981, 17 Real Prop. Prob. & Tr. J. 18 (1982). This commentator suggests that "in view of the tendency of the new unlimited marital deduction to bunch nearly everything in the surviving spouse's estate, equalization will now be a more significant consideration than it was when the marital deduction could not be more than half of the first spouse's estate." Id. at 39.

make a specific bequest of those assets which are likely to be distributed early in the estate administration period, thereby eliminating any possibility that the distribution of those assets will carry income to the spouse. The recipient of a bequest which results in a shifting of income is frequently a trust and, therefore, a clear presentation of the mechanics of such an income shift necessitates a short review of the fundamental income tax principles relating to estates and trusts.

A. The Income Taxation of Estates and Trusts

All estates and all irrevocable trusts not treated as owned or controlled by the grantor or another person are taxed for income tax purposes as separate entities. Estates and trusts are taxed much like an individual except that they receive a deduction for certain distributions to their beneficiaries. To the extent that an estate or trust receives such a distribution deduction, the beneficiary has an inclusion in gross income. Thus, the taxable income of estates and trusts is taxed only once: to the estate or trust, to the beneficiary, or partly to each. Additionally, the character of income distributed to a beneficiary remains the same as those items used to compute the net trust income for trust accounting purposes.

In order to ensure that the deduction to the estate or trust and the inclusion to the beneficiary are equal, a ceiling on both the inclusion and deduction is fixed by the Code. This ceiling amount is termed "distributable net income" (DNI). DNI is calculated by making the following adjustments to the estate or trust taxable income as

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231 appeared in a slightly different form in an article which the author wrote prior to the enactment of ERTA. See Llewellyn, supra note 25.


159. Id. § 641(b). This section provides in pertinent part that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part." Id. Section 651(a) and § 661(a) provide for a distribution deduction. The other differences between the computation of taxable income for an estate or trust and the computation for individuals are set forth in § 642. See id. § 642 (1976).

160. Id. §§ 652(a), 662(a) (1976).

161. Id. §§ 652(b), 662(b). These sections, which closely parallel each other, provide in part:

The amounts [specified in] subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the [estate or trust]. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income [of the estate or trust] as the total of each class bears to the total distributable net income of the [estate or trust], unless the terms of the [governing instrument] specifically allocate different classes of income to different beneficiaries.

Id.

162. Id. §§ 661(a), 662(a)(2).
computed prior to the distribution deduction: 1) disallowance of the personal exemption for trusts or estates; 2) exclusion of capital gains (except where gains are paid, credited, or required to be distributed to a beneficiary) and disallowance of any section 1202 deduction for capital gains; 3) exclusion of capital losses (except to the extent of capital gains includible in DNI); 4) addition of tax-exempt income less any deductions which were denied because of section 265 or because a portion of the charitable contribution was allocated to tax-exempt income; and 5) disallowance of any dividend exclusion.163

The result obtained from these adjustments closely resembles net trust or estate accounting income. In fact, except when tax deductible expenses are charged to corpus or income expenses are nondeductible, DNI and net trust or estate income should be identical in amount in all years other than the entity's years of funding or termination.164

The amount deductible by a trust or estate and includible in the gross income of the beneficiary is determined by the amount actually distributed or required to be distributed from the trust or estate to the extent of DNI.165 It must be noted, however, that neither a deduction nor an inclusion results to the extent that a distribution is deemed to consist of items not included in the gross income of the estate or trust, such as tax exempt income.166

The actual source of a distribution, be it income or corpus, is not controlling for tax purposes. All distributions, whether from income or corpus, are deemed to consist of the items used to compute DNI. In fact, the only time the actual source of a distribution is significant to the beneficiary is when in the same year there is both a required distribution of trust or estate income and either a discretionary distribution of income or a distribution of corpus.167 In that situation, a concept called the tier system, which is beyond the scope of this explanation, is operative.168

It is readily apparent that distributions of trust or estate corpus must be treated under some circumstances as distributions of taxable income if there is to be any limit on the ability of the trustee or executor, through the use of accounting entries, to spread the income tax impact among the trust or estate and the beneficiaries. For example,

164. In the year of termination, capital gains and losses are included in computing DNI. Treas. Reg. § 1.643(a)-3(a)(2) (1975).
166. Id. §§ 651(b), 661(c).
167. Id. § 662(a)(2). Where there is no requirement to distribute current income, a pro-rata share of the entire DNI will be allocated to each distribution.
168. Id. § 662(a).
when the trustee or executor has the power to distribute corpus or income, he could reduce the tax impact on the beneficiary merely by charging the distribution to corpus rather than to income.

Even under a system in which some distributions of corpus are considered distributions of income, opportunities for abuse and distortion exist because of the concept of strict annual accounting. Since actual distributions are potentially taxable in any given year only to extent of DNI for that year, strict application of the annual accounting concept allows distributions in excess of DNI for the taxable year to escape taxation, even though in prior years there were considerable amounts of DNI that were not distributed and therefore not included in the gross income of the beneficiary. As for trusts, this effect is precluded by the application of the "throwback rules" which cause distributions in any given year, to the extent they are in excess of that year's DNI, to be taxed as if distributed in prior years when available DNI went undistributed. 169 Although the "throwback rules" apply to trust distributions, they do not apply to distributions by an estate. 170 Therefore, the ability of the executor to control the tax consequences to the estate and beneficiaries by the timing of distributions, remains unfettered.

B. Income Tax Consequences of Property Distributions to Satisfy A Pecuniary Formula Bequest

When an estate makes a distribution of property to satisfy a marital deduction or credit shelter bequest established by a pecuniary formula clause, income may be shifted to the beneficiary, gain or loss may be recognized by the estate, and the basis of the property to the beneficiary will be its cost, which is equivalent to the fair market value. 171 At first blush, one might equate a distribution from a pecuniary formula marital deduction or credit shelter bequest, with a distribution of a specific sum of money, which is not subject to the

169. Id. § 666 (1976 & Supp. V 1981). Section 667(b)(1), in effect, credits the beneficiary with the tax paid by the trust. This is done by treating the tax paid by the trust as if it were distributed to the beneficiary in the year of the accumulation distribution and then giving the beneficiary a credit in that amount. Note, however, that if the trust paid a larger amount of tax than the tax imposed upon the beneficiary as a result of the distribution, neither the beneficiary nor the trust receives a refund. See id. § 666(e) (1976); id. § 667(b)(1) (1976 & Supp. V 1981).

170. Id. § 666 (1976).

171. A distribution of property is treated as an exchange for tax purposes. Estate of Stouffer v. Commissioner, 30 T.C. 1244 (1958). Any gain realized on the distribution must be fully recognized. Any loss realized would be recognized to the extent of § 1211 since the loss recognition limitations of § 267 do not apply to estates. The basis of distributed property is its cost which is fair market value at the date of distribution.
regular estate income distribution rules. Section 1.663(a)-1(b) of the Treasury Regulations, however, specifically adopts a contrary position for marital bequests and states that Code section 663(a)(1) is applicable only when the bequest is of a specific amount ascerturable at death.\(^{172}\) Because the amount of the marital or credit shelter bequests, under the post-ERTA formula clauses, will continue to be dependent upon variables in computing the taxable estate,\(^{173}\) the amount of the bequest cannot be ascertained with the requisite certainty at the testator's death. Thus, satisfaction of the marital pecuniary formula bequest or the credit shelter formula bequest during a year in which the estate has DNI will cause income inclusion for the beneficiary while providing a deduction for the estate. The amount of a bequest under a pecuniary formula is uncertain at the testator's death. The amount is, however, certain at the time of distribution and distribution of property in satisfaction of a pecuniary bequest is treated as an exchange for income tax purposes. Furthermore, if an asset other than money is distributed, the estate may realize a gain or loss, either of which must be recognized.\(^{174}\) The right of the beneficiary under such a pecuniary formula clearly is a right to receive a specific sum of money and not a right to receive specific property. Receipt by the spouse of specific property in satisfaction of such an estate obligation is treated for income tax purposes as if the spouse received a specific sum of money and then purchased the property distributed in satisfaction of the money claim.\(^{175}\)

C. Pecuniary Formula Marital Deduction Bequests to a Trust

If a pecuniary formula bequest is made to a trust rather than outright to a beneficiary, there is an additional taxable entity with which to contend. The tax planner must determine how any DNI carried out from the estate as a result of a funding distribution will be shared by the beneficiary and the trust. First, with respect to a pecu-

\(^{172}\) See Treas. Reg. § 1.663(a)-1(b) (1956). This requirement certainly eliminates a credit shelter formula from the ambit of § 663(a)(1). For one thing, the amount varies with the executor's choice of whether to take deductions for income or estate tax purposes.

\(^{173}\) Such variables include the amount of administration expenses and the executor's election whether to take administration expenses as an income tax or an estate tax deduction. See notes 151-52 and accompanying text supra.

\(^ {174}\) See note 171 supra.

niary formula marital bequest, qualification of the trust for the marital deduction under sections 2056(b)(5) or 2056(b)(7) requires that trust income be distributed currently to the spouse. What is required to be distributed currently is determined by the trust accounting income under local law and not by income for federal tax purposes. Income required to be distributed currently is treated as a distribution to the beneficiary in the beneficiary's tax year with which or within which the trust's tax year ends, regardless of the time it is actually distributed to the beneficiary. A distribution by an estate in satisfaction of the marital trust bequest, however, will be treated by local trust law as a distribution of corpus. As such, this funding distribution is not income required to be distributed and the surviving spouse's taxable income will be unaffected unless the surviving spouse receives an actual distribution, or an income distribution is required by the terms of the trust instrument. In many states, the funding distribution to the trust is accompanied by a comparatively smaller distribution that will be treated under local law as trust income. For example, Pennsylvania provides that a pecuniary legacy to a trust shall bear interest at a rate of five percent per annum from the date of the testator's death until the payment of the legacy. This income portion of the distribution is required to be distributed currently by the trust to the surviving spouse. This has the effect of increasing the spouse's taxable income in the year the trust is funded regardless of whether this portion is actually distributed to the spouse in that year.

The ultimate result appears to be that the receipt of a funding distribution by the trust may immediately increase its gross income for the year of funding. The amount of the increase will depend on

178. This is sometimes referred to as a "trapping" distribution. In effect, DNI carried out by the distribution of corpus in funding a trust is "trapped" in the trust and not passed through to the beneficiary. This "trapped" DNI, therefore, is taxed to the trust as a separate entity and not to the beneficiary. See United States v. Bank of America Nat'l Trust & Savings Ass'n, 326 F.2d 53, 54 (9th Cir. 1963). The trapping distribution results only where the trust is recognized as a separate taxable entity. The trust will not be a separate taxable entity if the surviving spouse has an unlimited power of invasion during life. See I.R.C. § 678 (1976).
179. For a listing of those states which require distribution to the trust of the income earned on the trust corpus prior to funding, see R. COVEY, supra note 135, at appendix B.
180. 20 PA. CONS. STAT. ANN. § 3543(a) (Purdon Supp. 1982).
1) the amount of the estate's DNI in the year of funding, and 2) distributions, if any, by the estate to other beneficiaries in the year the trust is funded. The distribution deduction for the trust and the income inclusion by the surviving spouse are determined by the amount of actual distributions from the trust to the spouse for that taxable year and the amount of required distributions not actually distributed. Both the deduction and the inclusion are limited by the DNI of the trust. It is clear, however, that the timing of the funding determines how much of the estate's income, if any, is shifted to the trust and the amount of such shifted income that remains trapped in the trust or is further shifted to the surviving spouse. For example, if, on December 31, a calendar year estate with DNI and taxable income of $40,000 makes a funding distribution of $38,000 and a $2,000 distribution of interest on the legacy to a calendar year marital trust, and the marital trust made no distributions for the year, the trust would have $40,000 of income inclusion and receive a $2,000 deduction for the income required to be distributed currently. The surviving spouse would have a $2,000 income inclusion in that calendar year even though no actual distributions were made to the surviving spouse.

It should be noted that the tax consequences of interest payments on a legacy are not entirely clear. The Third Circuit has ruled that the interest is true interest (rather than a share of the estate's income) deductible by the estate but taxable in full to the beneficiary in the year in which paid. This reduces the flexibility of the executor and many draftsmen now provide for a share of income in lieu of interest.

D. Income Tax Consequences of a Distribution of the Residue of the Estate

Distribution in kind, of the residuary assets, in satisfaction of a residuary marital deduction bequest, is subject to the regular distribution rules and, therefore, may allow the estate a distribution deduction and may cause income inclusion to the recipient beneficiary.

182. See note 178 supra. See also Treas. Reg. 1.643(a)-0 (1960).
184. Id. §§ 661(a), 662(a).
185. Id.
186. Wolf v. Commissioner, 84 F.2d 390 (3d Cir. 1936). In contrast, the Court of Claims treats interest on a legacy, not as true interest, but rather as a distribution of income by the estate and taxes the recipient on his proportionate share. Davidson v. United States, 149 F. Supp. 208 (Cl. Cl. 1957).
187. Section 663, which contains special rules applicable to § 661 and § 662, contains no exception from the regular distribution rules of those sections.
In contrast to distributions in kind in satisfaction of pecuniary formula bequests, the estate realizes no gain or loss and the basis of the property in the hands of the beneficiary is the same as the basis to the estate with an adjustment in accordance with Treasury Regulation 1.661(a)-2(f)(3). This Regulation provides that the basis of an asset distributed to a beneficiary is its fair market value at the time of distribution to the extent that such value was included in the gross income of the beneficiary under the general estate distribution rules. To the extent the value of property distributed is not included in the gross income of the beneficiary, the basis is governed by section 1014. For example, when a distribution of property with a section 1014 basis of ten dollars and a fair market value of twenty dollars results in an income inclusion for the beneficiary of fifteen dollars, the basis to the beneficiary is seventeen dollars and fifty cents (¼ x $10 plus ¾ x $20 = $17.50). On the other hand, if property with a section 1014 basis of ten dollars and a fair market value of only eight dollars is distributed, and which carries two dollars of income to the beneficiary, the basis to the beneficiary would be nine dollars and fifty cents (¾ x $10 plus ¼ x $8 = $9.50). This upward or downward basis adjustment on a section 661 distribution makes selection of the proper asset for distribution an important tax planning function and where possible appreciated assets should be distributed in years where there is DNI. Note the interesting phenomenon that occurs when the DNI of the estate is carried to the recipient to the full extent of the fair market value of appreciated property. Since the property has appreciated, it has a fair market value higher than its basis, but, because of the basis adjustment of Treasury Regulation section 1.661(a)-2(f)(3), neither the estate nor the residuary beneficiary ever realize a taxable gain from the predistribution appreciation.

188. Treas. Reg. § 1.661(a)-2(f)(3) (1973). For a discussion of the determination of the amount of the beneficiary's gross income inclusion, and the basis of the property to the beneficiary as a result of an estate distribution in kind, see M. Ferguson, J. Freeland & R. Stephens, supra note 175, at 525-34.


190. Moreover, the timing of the distribution is an important planning function because DNI is first allocated to distributions of cash. Treas. Reg. § 1.661(a)-2(f)(3) (1973). Thus, distributions of appreciated property should generally be made in a year with minimal cash distributions if possible.

191. TEFRA may have mitigated this favorable result by amending § 643(d) of the Code. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 502(b)(1), 96 Stat. 324, 586-87 (to be codified in scattered sections of 26 U.S.C.). This section deals with the credit for interest and dividend withholdings. As always, these withholdings are treated as a distribution by means of a gross-up. This new section, however, indicates that their distribution may be treated as a cash rather than a property distribution. Id. Since DNI is attributed to cash distributions before property distributions this could reduce the amount of DNI assigned to the property.
The estate planner’s selection of a residuary versus a pecuniary marital bequest is influenced by the income tax consequences set forth above. Many planners, although reluctant to have the marital bequest increased by predistribution appreciation, have nonetheless adopted a residuary marital bequest in order to avoid the taxable gain which results from satisfaction of a pecuniary bequest with a distribution in kind. There were, however, efforts to get the best of both worlds by attempting to prevent the marital bequest from being increased by predistribution appreciation and also preventing the recognition of any gain as a result of the appreciation. This end was sought by inserting a will provision permitting the personal representative to reduce the amount of a pecuniary bequest by valuing property distributed in satisfaction of the bequest at its estate tax value. The primary purpose for inserting such valuation instructions was not to permit reduction of the marital bequest, but rather to avoid imposition on the estate of a taxable gain from satisfaction of the pecuniary bequest with appreciated property. In addition, such instructions permitted the funding of the marital bequest with depreciated property which, if allowed, ultimately resulted in the value of the property included in the surviving spouse’s estate being much less than the marital deduction allowed the first spouse to die. In response to these attempts, the Service promulgated Revenue Procedure 64-19, which disallows the marital deduction when the personal representative is given such valuation power unless certain requirements are met.\footnote{192}

Disqualification of a pecuniary marital bequest for noncompliance with Revenue Procedure 64-19 is a continuing threat. As such, provisions providing for valuation at distribution date value or some other distribution instruction permitted by Revenue Procedure 64-19, should be inserted in the will. The acceptable variances set forth in Revenue Procedure 64-19 led to widespread adoption of two variations of distribution instructions designed to avoid gain without disqualifying the bequest for the marital deduction.\footnote{193} One variation involves use of a minimum-worth clause and provides that assets used to satisfy the bequest be valued at the lower of estate tax values or distribution values.\footnote{194} The other variation provides for distribution

\footnote{192} Rev. Proc. 64-19, 1964-1 C.B. 682. For a full discussion of Revenue Procedure 64-19, see R. Covey, supra note 135, at 109.

\footnote{193} See R. Covey, supra note 135, at 116-38.

\footnote{194} Id. at 116. More precisely drawn will clauses would refer to valuing the property at its adjusted basis. This is often the same as the estate tax value. However, it can be different. Simply put, in avoiding gain, the goal is to equate the
at estate tax values, but requires that assets selected to satisfy the bequest be, in the aggregate, fairly representative of all the appreciation or depreciation in assets available for distribution.\textsuperscript{195}

These distribution instructions actually create a hybrid bequest with characteristics of both residuary and pecuniary bequests. They resemble residuary bequests in that they increase in amount with the appreciation of assets used to satisfy the bequest. On the other hand, if a bequest subject to a minimum worth clause is satisfied solely with cash or assets that have depreciated, the amount of the bequest does not change and thus resembles a pecuniary bequest. Moreover, these hybrid pecuniary bequests should be treated as pecuniary bequests for purposes of determining the right to income and interest accruing prior to funding the bequest. But for income tax purposes, including the determination of the distributee's basis, these hybrids should be treated as residuary bequests whenever the assets used to satisfy the bequest are valued other than at distribution date value.

E. \textit{Pecuniary Bequest of Marital or Exemption Equivalent Share v. Residuary Bequest of Marital or Exemption Equivalent Share}

The unlimited marital deduction, and the substantial increase in the exemption equivalent of the unified credit necessitate a re-evaluation of the advantages and disadvantages of pecuniary versus residuary bequests.

The unlimited marital deduction and the substantial increase in the exemption equivalent have a profound effect on the relative size of the two major shares under typical dispositive plans. This factor must also be considered in deciding which, if either, share should be satisfied by a pecuniary or residuary bequest. Note that as the size of each share increases, the potential for an increase in the gain required to be recognized on satisfaction of a pecuniary bequest is substantial. Of course, one way that such gain can be minimized is by funding the pecuniary bequest as quickly as possible, thereby reducing the potential for appreciation of the assets. Furthermore, if the funding is accomplished within six months of the decedent's death, the alternate valuation election affords an opportunity to avoid the realization of gain.\textsuperscript{196} The opportunity for early funding, however, decreases, to

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\textsuperscript{195} \textit{Id.} at 117.

\textsuperscript{196} I.R.C. § 2032 (1976). Section 2032 allows an executor to value the gross estate at a date other than the date of death choosing either the value six months
some extent, as the size of the bequest increases.

Prior to ERTA, the limitation on the marital deduction was the greater of $250,000 or fifty percent of the value of the adjusted gross estate. Where a residuary marital bequest was used, this limitation made it necessary to carve out a share of the residue to obtain the precise marital bequest desired. Since the surviving spouse usually received an undivided fractional interest in all the assets of the residuary estate, the administrative problems connected with carving out such an interest were formidable. This was a real impediment to the use of the residuary bequest.

With the introduction of the unlimited marital deduction and the substantial increase in the unified credit, it is now quite practical to satisfy all dispositive goals, other than the marital deduction bequest, with preresiduary bequests. Consequently, the entire undivided residue can be used in satisfaction of the marital bequest. Thus, the administrative problems formerly experienced by creating fractions of the residue are eliminated, and this should encourage the use of residuary marital bequests.

The determination of whether to use a residuary or pecuniary legacy requires a consideration of both the tax consequences discussed above and the different treatment afforded the legacies under state law. These principal differences can be summarized as follows:

<table>
<thead>
<tr>
<th>Pecuniary Bequest</th>
<th>Residuary Bequest</th>
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<tr>
<td>1. Amount remains unaffected by</td>
<td>1. Amount changes with appreciation</td>
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<td>appreciation and depreciation of assets.</td>
<td>and depreciation of residuary assets.</td>
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<tr>
<td>2. Limited right to an interest payment</td>
<td>2. Right to all income earned on the</td>
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<td>on assets used to satisfy the</td>
<td>estate except for income from assets</td>
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<td>bequest.</td>
<td>specifically bequeathed or devised.</td>
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198. See, e.g., notes 179-81 and accompanying text supra.
199. See, e.g., 20 Pa. Cons. Stat. Ann. § 3543(d) (Purdon 1975). This section provides that "[a]ll income from real and personal estate earned during the period of administration and not payable to others shall be distributed pro rata among the income beneficiaries of any trust created out of the residuary estate and the other persons entitled to the residuary estate." Id.
3. Taxable gain or loss to the estate on satisfaction of bequest with appreciated or depreciated assets.\textsuperscript{200}

4. Basis to beneficiary is cost which is fair market value at distribution.\textsuperscript{202}

5. Not subject to estate income distribution rules unless a formula is used under which the precise amount of the bequest cannot be determined at the decedent’s death.\textsuperscript{204}

3. No gain or loss to the estate on satisfaction of bequest with appreciated or depreciated assets.\textsuperscript{201}

4. Section 1014 basis is carried over to beneficiaries with an adjustment for any estate income shifted to the beneficiary at the funding of the bequest.\textsuperscript{203}

5. Subject to estate income distribution rules.\textsuperscript{205}

The estate planner must determine which of the above factors are most desirable for a particular couple’s dispositive scheme. Of course, by the use of hybrid formula bequests, some combination of the best characteristics of both residuary and pecuniary bequests may be achieved. For example, the use of a pecuniary formula with a minimum-worth clause will avoid the recognition of gain by the estate and at the same time gives the executor discretion to determine whether and to what extent the surviving spouse shares in the benefits of asset appreciation.

It has been suggested that a minimum worth provision could go so far as to give the executor authority to distribute appreciated assets at any value between adjusted basis and distribution value. In this way the executor could, with respect to such assets either pass on appreciation (by distributing at adjusted basis) or recognize gain (by


\textsuperscript{201} Treas. Reg. § 1.661(a)-2(f)(3) (1973).


\textsuperscript{203} Id. See also Treas. Reg. § 1.661(a)-2(f)(3) (1973). See notes 188-89 and accompanying text supra.

\textsuperscript{204} I.R.C. § 663(a)(1) (1976).

\textsuperscript{205} See text accompanying notes 187-91 supra.
distributing at a value higher than adjusted basis) without incurring any brokerage expenses for selling the asset. One caveat must be noted. A minimum worth provision should not be used in connection with a pecuniary formula for creating a credit shelter bequest where the marital bequest is created by a residuary bequest. The effect of such a provision in this situation is to give the executor discretion to direct appreciation to the credit shelter trust while all depreciation is charged to the marital bequest. The executor's discretion to reduce the marital bequest creates serious obstacles to qualify the marital bequest under Revenue Procedure 64-19.

F. Carving Both the Exemption Equivalent and the Marital Bequest From the Residue

Consideration should be given to satisfying both the marital bequest and the exemption equivalent bequest from the residue. A typical formula provision which would create an optimum marital deduction fractional share from the residue provides as follows:

(A) If my wife survives me, there shall be distributed to her that fraction of my residuary estate equal to the excess of (i) that portion of my adjusted gross estate, as finally determined in the federal estate tax proceeding relating to my estate, which will reduce the federal estate tax upon my estate to the minimum amount payable, after taking into account all credits available against such tax in my estate (provided use of the state death tax credit does not result in an increase in state death taxes) over (ii) the value of all property which qualifies for the marital deduction in my estate and which passes or has passed to my wife under other provisions of my Will or outside my Will. This bequest shall be satisfied with property which qualifies for the federal estate tax marital deduction, and, to the extent possible, exclusively with cash or with property with respect to which there is neither a credit against federal estate tax nor a deduction for federal income tax purposes.206

The other fractional share of the residue (the by-pass or credit shelter share) would be composed of the assets remaining in the estate after payment of other preresiduary legacies, and expenses not deductible for estate tax purposes.

It must be recognized that use of a formula provision which sati-
fies both the marital and exemption equivalent bequest from the residue, will require confrontation and resolution of the complex administrative tasks experienced when residual type marital bequests were used prior to ERTA.\(^{207}\) This administrative burden can be reduced, however, by giving the executor the power to satisfy the residuary bequests by distributing complete interests in some of the residuary assets rather than undivided interests in all of the residuary assets. Where the will does not specifically authorize such a non-pro-rata distribution, Pennsylvania law permits the executor to seek court approval for it.\(^{208}\)

A non-pro-rata distribution of assets which is authorized by the will should not be treated for federal income tax purposes as a pro-rata distribution to the beneficiaries followed by a taxable exchange.\(^{209}\) Where the will does not authorize such a non-pro-rate distribution, but it is effectuated through court approval or consent of all residuary beneficiaries, it should be treated as a division of co-owned property and not a taxable exchange.\(^{210}\) Revenue Ruling 69-486, however, reaches the opposite result for a non-pro-rata distribution agreed to by trust beneficiaries.\(^{211}\)

IV. THE GIFT TAX MARITAL DEDUCTION: A METHOD FOR ACHIEVING FULL UTILIZATION OF EACH SPOUSE'S UNIFIED CREDIT AND EQUALIZING TRANSFER TAX RATES

Maximum tax savings from use of the estate tax marital deduction usually can be achieved only where the wealthier spouse dies first and thus has the opportunity to utilize the optimum marital deduction. The optimum marital deduction may be the amount necessary to equalize the transfer tax rate applicable to each spouse on the ultimate disposition of the couple's wealth. It is more likely, however, that it will be the minimum amount necessary to defer all estate tax on the death of the first to die. When the wealthier spouse dies first, maximum tax savings result because both spouses have the opportu-

\(^{207}\) See text following note 197 supra. See also R. Covey, supra note 135, at 122.

\(^{208}\) See, e.g., 20 Pa. Cons. Stat. Ann. § 3534 (Purdon 1975). In Pennsylvania, a court, for cause shown, may order the estate assets distributed in kind to the parties in interest. In addition, a distributee may request a partition or sale of the property. Id.


\(^{210}\) This result is suggested by the cases dealing with property settlements on divorce. See, e.g., Carriers v. Commissioner, 64 T.C. 959 (1975). See also Rev. Rul. 81-292, 1981-50 I.R.B. 11.

nity to utilize fully their available unified credits. In addition, equalization of transfer tax rates can be achieved, if desired, through post-mortem decisions.

For example, consider a couple whose total wealth of $2,000,000 is held entirely by the husband. If he dies first, utilizing a zero-tax marital deduction bequest, the total federal transfer tax liability on the ultimate disposition of the couple's wealth (assuming he survived until 1987 and there was no appreciation, depreciation or consumption of the estate's assets) would be $320,000.212 If the wife predeceases the husband, the total federal transfer tax liability would be $588,000.213

Inter vivos gifts from the wealthier to the poorer spouse can accomplish the same federal transfer tax savings that occur when the poorer spouse survives the wealthier. This was not possible prior to the enactment of the unlimited marital deduction.214 This new opportunity for transfer tax savings through inter vivos gifts cannot be overemphasized, especially in a state like Pennsylvania where there is a death tax, but not a transfer tax on lifetime transfers.215

The fashioning of inter vivos transfers can now be made in a manner much more palatable to the donor, as a result of ERTA's additions to the types of terminable interests which qualify for the marital deduction.216 The donor spouse no longer need surrender control over the ultimate disposition of the transferred property. As previously noted, the creation of a mere life estate in the transferee spouse will permit qualification of the entire property for the marital deduction.217 Also, it appears that the transferor spouse can retain certain beneficial interests in the transferred property without subjecting that property to inclusion in his gross estate. This is the logi-

212. Of the husband's $2,000,000 estate, $600,000 would be sheltered from tax by the exemption equivalent of the unified credit and would go to the credit shelter trust. Taxation of the remaining $1,400,000 would then be deferred by the marital deduction. Consequently, the husband's estate would have no estate tax liability. On the death of the wife, the $1,400,000 which she received as a marital bequest would be taxed. The estate tax on this sum after application of the unified credit equals $320,000. I.R.C. § 2001(c) (1976 & Supp. V 1981). Note that if the marital deduction bequest was pegged to equalization of tax rates, the total federal transfer tax would be $306,000.

213. Since all the couple's wealth was held by the husband, the wife would have no estate against which her $192,800 unified credit could be applied. This credit, therefore, would be lost. The entire $2,000,000 would then be taxed to the husband's estate.


216. See notes 105-16 and accompanying text supra.

217. See notes 89 & 105-16 and accompanying text supra.
cal result if the transferred property is strictly regarded for estate tax purposes as if it were owned outright by the donee spouse.218 Furthermore, if this treatment is honored for all estate tax purposes, the retention by the transferor spouse of an income interest which follows the income interest of the transferee spouse should not result in inclusion of the remainder in the estate of the transferor spouse. In fact, the Technical Corrections Act of 1982 provides that there will be no such inclusion when the donor spouse predeceases the donee spouse.219 The Act, however, also provides that this rule does not apply after the property is included in the gross estate of the donee spouse under section 2044 or after the donee spouse is treated as transferring such property under section 2519.220 The theoretical underpinning for the statutory exclusion is that the surviving spouse is deemed under both of these sections to have received a fee simple in the property. Although the timing of the transferor’s death should not be a critical factor, the specificity of the technical amendment may cause it to be controlling.

Even where there is a possibility that the couple’s marriage may terminate, the inter vivos gift should not be summarily dismissed. In the event of a divorce, a good argument could be made that the court should consider the inter vivos gift in determining whether the wealthier spouse has a continuing obligation to the poorer spouse.221

The proverbial bottom line is that in the previous example, a $600,000 inter vivos gift of property, in which the spouse has only an income interest for life, will accomplish the same aggregate federal transfer tax savings as the utilization of a zero-tax marital deduction bequest from the wealthier spouse to the poorer one. Better yet, the federal transfer tax savings resulting from the inter vivos gift, unlike the savings resulting from a testamentary bequest, will be accomplished regardless of which spouse survives. In addition, in a state like Pennsylvania, use of the inter vivos gift as an alternative to testamentary disposition of all the husband’s assets will result in a savings of at least $36,000 in state inheritance tax.222 It should be obvious that a tax planner should consider inter vivos transfers either outright or in a form that complies with section 2523(f), in all situations where the

220. Id.
221. See, e.g., 23 PA. CONS. STAT. ANN. §§ 401(d), 501(b) (Purdon Supp. 1982) (equitable distribution and alimony provisions).
222. See notes 144 & 215 and accompanying text supra.
couple's property is not divided between them so as to permit full utilization of the available unified credits regardless of the order of death. It should be equally obvious that inter vivos gifts can also be used to accomplish the equalization of the tax rate applicable to each spouse's estate.

When considering inter vivos gifts as part of the estate plan, not only must gifts by one spouse to the other be considered, but it is also necessary to consider gifts made by a spouse to a third person. ERTA increased the annual gift exclusion from $3,000 to $10,000.\textsuperscript{223} Therefore, when a married couple exercises their right under section 2513 to treat a gift made by one spouse as if one-half of the gift was made by each spouse,\textsuperscript{224} a substantial amount of the couple's wealth can be transferred free of any transfer tax, with no diminution of either spouse's unified credit. For example, transfers of $60,000 per year could be made to a trust for three children without any adverse transfer tax consequences so long as each child had an equal power to invade one-third of the trust corpus. This invasion power qualifies the entire gift for an annual per-donee exclusion because it converts any future interests in the trust into present interests.\textsuperscript{225}

V. Joint Interests With right of Survivorship as a Form of Ownership for a Married Couple

ERTA repealed the elaborate set of rules previously applicable to the creation or termination of a joint property interests held by a husband and wife, and retained only the fractional interest treatment (one-half for each spouse) which is now applicable in all cases.\textsuperscript{226} Furthermore, a consequence of the unlimited marital deduction is that no federal transfer tax will be imposed on the creation or termi-


\textsuperscript{225} See notes 240-41 and accompanying text infra.

\textsuperscript{226} Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(c), 95 Stat. 172, 301-02 (codified at I.R.C. § 2040(b) (Supp. V 1981)). For a detailed discussion of the pre-ERTA treatment, see Llewellyn, infra note 25, at 352-56. Prior to ERTA, the "contribution test" of § 2040(a) was applicable except where the fractional interest (one-half for each spouse) provisions of § 2040(b) applied. The application of § 2040(b) was quite limited because it only applied where the tenancy was created by one of the spouses after 1976 and then only where the creation resulted in a taxable gift. I.R.C. § 2040(b)(2) (1976) (amended 1982).

Under ERTA, one-half of the value of jointly held property is includable in the gross estate of the first to die regardless of which spouse furnished the consideration for such property. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(b), 95 Stat. 172, 301 (codified at I.R.C. § 2040(b) (Supp. V 1981)). The § 2040(a) contribution text continues to be applicable to joint tenants who are not husband and wife. I.R.C. § 2040(a) (Supp. V 1981).
nation of such joint interests.\textsuperscript{227} This characterization of the creation or termination as a non-taxable gratuitous transfer is significant in determining the income tax basis for such property.\textsuperscript{228} The basis of a joint interest received by a donee spouse in a gratuitous inter vivos transfer by the other spouse is a carryover basis under section 1015.\textsuperscript{229} The one-half interest obtained under the survivorship feature of such property receives an estate tax value basis under section 1014. It is also significant to note that Pennsylvania will impose no state tax on the creation or termination by either spouse of a joint interest with right of survivorship.\textsuperscript{230}

\textbf{A. Joint Interests: Planning Prior to ERTA}

Prior to ERTA, the principal estate planning disadvantage of joint ownership by a husband and wife was the potential for overqualifying the estate tax marital deduction. When the sole contributor to the acquisition of the jointly held property died first and estate tax inclusion was determined under the contribution test of section 2040(a), overqualification could only be avoided when the aggregate value of all such jointly held property did not exceed the maximum estate tax marital deduction. When overqualification of the estate tax marital deduction did occur, the excess of the joint property's value over the maximum marital deduction was included in the estate of both spouses. If jointly held property did not exceed the available estate tax marital deduction such multiple estate tax could be avoided provided the other property in the gross estate was probate property which could be directed to a by-pass or credit shelter trust.

Before ERTA the transfer tax treatment of such joint interests was almost punitive, not only when the contribution test of section 2040(a) was applied, but also under the fractional interest rule of section 2040(b). The ultimate result in all cases was that multiple inclusion of the same property for transfer tax purposes occurred as that property passed between the couple and finally to their successors.\textsuperscript{231}

\textsuperscript{227} Joint interests are not treated as terminable interests and as such qualify for the marital deduction. I.R.C. § 2523(d) (1976).

\textsuperscript{228} Id. § 2523(d).

\textsuperscript{229} Id. § 1015.


\textsuperscript{231} This pre-ERTA effect can be clearly illustrated by the charts below.

\textbf{The Section 2040(a) Contribution Test}

\textbf{Chart One}

Value subject to transfer tax where the only marital asset is jointly held
B. *Joint Interests After ERTA*

ERTA has simplified the tax treatment of jointly-held property. The unlimited marital deduction will prevent multiple transfer taxes from being imposed on the passage of jointly held property between the spouses and to their successors. In addition, the new fractional interest treatment (one-half for each spouse) obviates the evidentiary personal property acquired before 1977 with the sole contribution of one spouse, and value remaining constant at $1,000\,\text{K}.

<table>
<thead>
<tr>
<th>Value Subject To Tax</th>
<th>Marital Deduction</th>
<th>§ 2012 Credit</th>
<th>Total Taxed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creation</td>
<td>$500,\text{K}</td>
<td>$250,\text{K}</td>
<td>$250,\text{K}</td>
</tr>
<tr>
<td>Death of Contributor</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>§ 2040(a)</td>
<td>1,000,\text{K}</td>
<td>500,\text{K}</td>
<td>250,\text{K}</td>
</tr>
<tr>
<td>Death of Non-contributor</td>
<td>1,000,\text{K}</td>
<td></td>
<td>1,000,\text{K}</td>
</tr>
</tbody>
</table>

Other Assumptions:
1. Parties had the same life expectancy.
2. Gift and estate tax marital deduction was 50%.
3. The surviving spouse did not remarry and survived the contributor by ten years.
4. The $3,000 annual gift exclusion was not available.
5. No § 2040(d) election was made.

The Section 2040(b) Fractional Interest Test

Chart Two

Same assumptions as Chart one except that the tenancy was created after 1976 but before 1981.

<table>
<thead>
<tr>
<th>Value Subject To Tax</th>
<th>Marital Deduction</th>
<th>Total Taxed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creation</td>
<td>$500,\text{K}</td>
<td>$250,\text{K}</td>
</tr>
<tr>
<td>Death of Contributor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>§ 2040(b)</td>
<td>500,\text{K}</td>
<td>250,\text{K}</td>
</tr>
<tr>
<td>Death of Non-contributor</td>
<td>1,000,\text{K}</td>
<td></td>
</tr>
</tbody>
</table>

Comparison of the Section 2040(a) test with the Section 2040(b) test when the noncontributor dies first.

The charts reproduced below make the same assumptions as the first two charts except that charts three and four indicate the aggregate tax effect when the noncontributing spouse dies first.
problems posed under the pre-ERTA contribution test.\textsuperscript{232}

At first blush, this fractional interest treatment may appear to be a benefit to a married couple, but in view of the unlimited marital deduction it is, in fact, a detriment. The fractional interest rule limits the section 1014 step-up in basis to one-half of the jointly held property. In many instances this consequence alone may dictate a severance of the joint tenancy.

Consider the situation where one spouse is likely to die first. In that instance, serious consideration should be given to transferring the jointly held property to that spouse outright. On his death the property can be passed by will to the surviving spouse and the estate will receive a marital deduction for the entire amount of the transfer. More importantly, the surviving spouse will receive a stepped-up basis for the entire property, provided that the donee spouse survives for one year after the severance.\textsuperscript{233} When the property is conveyed to the spouse likely to die first, the other spouse could retain an income interest or the right to use the property for life. This would ensure inclusion in the transferor spouse’s estate and a step-up in basis for one-half of the property in the unlikely event that spouse predeceases the

\begin{align*}
\text{The Section 2040(a) Contribution Test} \\
\text{Chart Three} \\
\text{\begin{tabular}{lll}
\hline
Value Subject & Marital & Total Taxed \\
To Tax & Deduction & \\
\hline
Creation & $500K & $250K & $250K \\
Death of Non- & -0- & -0- & \\
Contributor \S 2040(a) & & & \\
Death of Contributor & 1,000K & 1,000K & $1,250K \\
\S 2033 & & & \\
\hline
\end{tabular}}
\end{align*}

\begin{align*}
\text{The Section 2040(b) Fractional Interest Test} \\
\text{Chart Four} \\
\text{\begin{tabular}{lll}
\hline
Value Subject & Marital & Total Taxed \\
To Tax & Deduction & \\
\hline
Creation & $500K & $250K & $250K \\
Death of non-contributor & 500K & 250K & 250K \\
\S 2040(b) & & & \\
Death of Contributor & 1,000K & 1,000K & $1,500K \\
\S 2033 & & & \\
\hline
\end{tabular}}
\end{align*}

232. For a discussion of the problems which were previously associated with the accurate identification of the property to be included in the taxable estates, see Lowndes & Stephens, \textit{Identification of Property Subject to the Federal Estate Tax}, 65 MICH. L. REV. 105 (1966).

spouse predicted to die first. However, if the expected order of death occurred, the entire value of the property less the value of the retained life estate would be included in the transferee's estate and receive the basis step-up.

In addition to the unfavorable basis treatment of jointly held property, its survivorship feature greatly reduces the flexibility in providing an appropriate testamentary dispositive scheme. Excess amounts of jointly held property may even prevent the couple from achieving maximum transfer tax savings. Only when a sufficient amount of other gross estate property is available for disposition by the first spouse will there be an opportunity to fully utilize the available unified credit. If, for example, a couple possesses a moderate amount of wealth (over $1,200,000), maximum tax savings can only be obtained by passing to a by-pass or credit shelter trust, on the death of the first spouse, an amount equal to the exemption equivalent of all available estate tax credits. This would avoid inclusion of that property in the estate of the surviving spouse. Thus, in instances where such a dispositive scheme cannot be implemented because substantially all property is jointly held, serious consideration must be given to severance of a portion of the joint interests. Fortunately, severance may be accomplished without the imposition of a gift tax due to the unlimited marital deduction.

One should also consider the state tax effect of a severance of jointly-held property. For example, Pennsylvania inheritance tax exempts from taxation property held jointly by a husband and wife with right of survivorship. It should be noted, however, that if the property is retained by the survivor until death, the entire property is subject to Pennsylvania inheritance tax. In this instance the exemption merely serves as a deferral. The advantage of this deferral must be weighed against the federal estate tax disadvantages of holding property jointly.

VI. OTHER WILL SUBSTITUTE: MAJOR TAX PLANNING GOALS

A. Irrevocable Insurance Trusts

Utilization of the irrevocable insurance trust can save a considerable amount of federal transfer tax. Estate tax inclusion of life insur-

234. Id. § 2036 (1976).
235. Id. § 2033.
236. Inheritance and Estate Tax Act, No. 255, § 1, 1982 Pa. Legis. Serv. 1398 (Purdon) (to be codified at Pa. Stat. Ann. § 1711 (m)). The general rule stated in the text does not apply if the joint interest was created in contemplation of death. Id.
ance proceeds is determined by an incidents of ownership test.\textsuperscript{237} When the irrevocable insurance trust is utilized, all incidents of ownership are transferred by the insured to the trustee. The insurance proceeds are, therefore, removed from the gross estate of the insured so long as he survives the transfer by three years.\textsuperscript{238}

The surviving spouse's interests in an insurance trusts are typically limited to nondescendible interests and special powers of appointment. This allows the proceeds to escape inclusion in the surviving spouse's gross estate.\textsuperscript{239} Therefore, the proceeds of insurance trusts in which the surviving spouse's interest is so limited pass from the couple to their successors without the imposition of any estate tax.

While a gift tax may be incurred upon creation of the irrevocable trust, it should be quite modest for several reasons. When the insurance transferred is a whole life policy it is quite likely that it will have, at the time of transfer, a very modest value relative to its face value. Although an insurance trust does not ordinarily create a present interest in any beneficiary, provisions can be inserted into the trust instrument to create such an interest. These provisions should give the beneficiaries the power to withdraw property from the trust, but should restrict withdrawal to the amount of property transferred for the calendar year.\textsuperscript{240} Even though a donee does not receive possession of the transferred property, if he has an unrestricted right to enjoyment or possession (i.e., the right to withdraw), he is considered as having a present interest in the property and as such the annual per donee exclusion for present interest gifts may be utilized.\textsuperscript{241} Note that to the extent the withdrawal provisions exceed the limits of section 2514(e)—the so-called "5 and 5" provisions—unintended gift tax consequences can result from a lapse of the withdrawal power.\textsuperscript{242}

\textsuperscript{237} I.R.C. § 2042 (1976).
\textsuperscript{238} Id. § 2035(d)(2) (Supp. V 1981); Treas. Reg. § 20.2042-1(c)(4) (1958).
\textsuperscript{239} I.R.C. § 2041 (1976).
\textsuperscript{240} See, e.g., Crumley v. Commissioner, 397 F.2d 82 (9th Cir. 1968); Treas. Reg. § 25.2514-3(c)(4) (1958). For an example of a withdrawal provision, see D. Kahn & L. Waggoner, Federal Taxation of Gifts, Trusts & Estates 547 (2d ed. 1982).
\textsuperscript{241} Treas. Reg. § 25.2503-3(b) (1958).
\textsuperscript{242} Section 2514(e) provides:

The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power . . . during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:

(1) $5,000 or

(2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.
there are several trust beneficiaries, however, which is frequently the case when the couple has children, the withdrawal provisions can be designed to stay within the limits of section 2514(e).

An insurance trust with these kinds of provisions is called a withdrawal or “Crummey” trust.\(^{243}\) Although the creation of such a trust can create a complex income tax pattern,\(^{244}\) any tax liability should be minimal since the income potential of such trusts, during the insured’s life, is modest. This complex income tax pattern and the ramifications of the invasion provisions are discussed at length in the legal literature, and a detailed discussion is beyond the scope of this article.

In determining precisely what interests the surviving spouse should have in the irrevocable insurance trust, the income tax consequences as well as the estate tax consequences must be considered. It is not uncommon for the surviving spouse to receive an ample amount of income from other estate assets, especially those assets which were used to qualify for the marital deduction. In such situations, sound income tax planning dictates that the surviving spouse’s income interest in the insurance trust be no greater than that of a permissible income beneficiary of a sprinkling income power held by the trustee. This permits the trustee to consider both the income needs of the surviving spouse and the tax impact of an income distribution.\(^{245}\)

On the other hand, it must be emphasized that although ERTA repealed a major portion of section 2035, insurance transfers or transactions having the effect of an insurance transfer, within three years of death, continue to result in inclusion of the insurance proceeds in the gross estate of the insured.\(^{246}\) If the surviving spouse’s interest in the insurance trust is an exclusive income interest for life which requires current distributions of income, such interest could qualify for a marital deduction, thereby serving as a hedge to any increase in

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I.R.C. § 2514(c) (1976).

Covey suggests that to the extent the invasion power exceeds $5,000 or 5%, the power simply be left to “hang” (not lapse) thereby eliminating gift tax problems for the power-holder. This, of course, will result in estate tax inclusion but such estate tax inclusion can be dealt with on a one-time basis. See R. COVEY, supra note 135.

243. Crummey v. Commissioner, 387 F.2d 82 (9th Cir. 1968).

244. See I.R.C. § 678 (1976).

245. The trust instrument may provide the trustee with discretion to “sprinkle” trust income among the permissible beneficiaries in whatever proportions or amounts he considers necessary. If the surviving spouse can be provided for adequately through other assets, especially those assets qualifying for the marital deduction, there is no need to increase his income tax burden by requiring certain distributions as opposed to permitting the trustee to make distributions.

estate tax resulting from the death of the insured within three years of the transfer (or some act equivalent to a transfer). An alternative to granting the surviving spouse an unqualified income interest is a provision which would cause such an interest to emerge only in the event that the insurance proceeds were includible in the gross estate of the insured. While this makes the exclusive income interest contingent on gross estate inclusion, it seems clear that such an interest would be a qualified terminable interest since the time of vesting would be no later than the death of the insured. The executor, therefore, could elect to have the interest qualify for the marital deduction.\textsuperscript{247}

For some time now Pennsylvania inheritance tax has excluded the proceeds of life insurance from taxation so long as the proceeds were made payable to a designated beneficiary other than the estate of the insured.\textsuperscript{248} This exclusion operated even when the designated beneficiary was an insurance trust created by the will of the insured.\textsuperscript{249} A recent amendment to the Pennsylvania inheritance tax provides for more favorable treatment and excludes insurance proceeds even when the proceeds are paid to the estate of the insured.\textsuperscript{250}

\textbf{B. TEFRA Ceiling on Estate Tax Exclusion for Qualified Plans}

Another will substitute designed to allow assets to escape estate taxation is an appropriately structured death benefit plan. Sections 2039(c) and (e) of the Code exclude from estate taxation certain benefits received by the beneficiaries (other than the estate) of a deceased participant in a qualified pension plan or an individual retirement account. TEFRA, however, has imposed a $100,000 limit on this exclusion.\textsuperscript{251} The form of the beneficiary designation for such benefits is often designed to allow the benefits to escape taxation in the estate of each spouse. The surviving spouse's benefits under the beneficiary designation are limited in the same way that the surviving spouse's beneficial interests are limited in the by-pass trust or the irrevocable insurance trust. Specifically, the benefits are limited to non-descendible interests and non-general powers of appointment.

The estate tax exclusion of survivorship benefits under a qualified plan is available only on the condition that the beneficiary waive

\textsuperscript{247} Id. § 2056(b)(7) (Supp. V 1981).
\textsuperscript{248} PA. STAT. ANN. tit. 72, § 2485-303 (Purdon 1964) (amended 1982).
\textsuperscript{249} Id.
\textsuperscript{250} Inheritance and Estate Tax Act, No. 255, § 1, 1982 Pa. Legisl. Serv. 1398 (Purdon) (to be codified at PA. STAT. ANN. § 1711 (d)).
certain preferential income tax treatment for such benefits.\textsuperscript{252} TEFRA has not altered that requirement; however, imposition of the $100,000 ceiling has changed the stakes in such a choice considerably. It is not yet clear whether this choice can be bifurcated so that the waiver of preferential income tax treatment covers only that portion of the benefits necessary to take full advantage of the $100,000 exclusion. Note that IRA lump-sum benefits are not entitled to preferential income tax treatment.\textsuperscript{253} That is, only IRA benefits paid in the form of an annuity qualify for the exclusion.\textsuperscript{254} It may very well be that as more people acquire IRAs, it will be the IRA payment which is structured to qualify for the full $100,000 estate tax exclusion, and other qualified plan benefits will be structured to obtain the maximum income tax benefits.

In any event, imposition of the $100,000 ceiling will result in estate tax inclusion of at least some of these benefits in the estates of a great many plan participants. This means that serious consideration must be given to structuring the benefits in such a way as to qualify them for the marital deduction.

C. Pennsylvania Inheritance Tax on Qualified Benefits

The 1982 Pennsylvania Inheritance and Estates Tax Act contains a dual exemption for employment benefits. First, the benefits are excluded to the extent such benefits are excluded under the federal provisions.\textsuperscript{255} The Act also excludes employment benefits to the extent that the decedent before his death did not otherwise have the right to enjoy, assign or anticipate the payments so made.\textsuperscript{256} This provision provides an exclusion for nonqualified (under subchapter D of the Internal Revenue Code) retirement plans as well. The Act also seems to permit the inference that where the plan did not give the decedent at any time before his death a right to a lump sum payment, the $100,000 federal ceiling should not be applicable for Pennsylvania inheritance tax purposes.\textsuperscript{257} Of course, the employee contri-

\textsuperscript{252} Section 2039(f)(2) provides for an estate tax exclusion for a lump sum distribution if the recipient makes an irrevocable election not to use ten-year averaging. In other words, the beneficiary of a lump sum payment must make a choice between favorable income tax treatment (10 year forward averaging or capital gain treatment for lump sum payments) or estate tax exclusion. I.R.C. § 2039(f)(2) (1976).

\textsuperscript{253} \textit{Id.} § 402(e)(4)(A) (1974).


\textsuperscript{255} Inheritance and Estate Tax Act, No. 255, § 1, 1982 Pa. Legis. Serv. 1398 (to be codified at PA. STAT. ANN. tit. 72, § 1711(r).

\textsuperscript{256} \textit{Id.}.

\textsuperscript{257} \textit{Id.} In addition, the federal requirement that IRA benefits be payable in
butions to the plan are subject to both federal and Pennsylvania death taxes.

VII. CONCLUSION

All indications are that the Treasury and the Congress are satisfied with the present law in the estate and gift area, with the possible exception of the generation skipping provisions. Estate and gift tax reform, which received so much congressional attention from 1976 through 1980, appears to have been completed.258

Some may think that upon completion of the unified credit phase-in period in 1986, estate planning will be limited to the very wealthy. If past experience can serve as a forecast of the future, however, a very substantial portion of the population will outgrow even the increased exemption equivalent of the unified credit.259 The $100,000 ceiling on estate tax exclusion of certain qualified survivorship benefits and the future of escalating housing values will have a significant impact on the size of the group which outgrows the exemption equivalent. These factors will also influence how quickly this occurs. It is also important to note that once taxable transfers do exceed the $600,000 exemption equivalent the transfer tax rates begin at a hefty thirty-seven percent.260 As shown in this article, rather sophisticated estate planning continues to be necessary to utilize fully the exemption equivalent for each spouse.

Enactment of the unlimited marital deduction was a sound tax measure and it has contributed to the simplification of estate planning. But so long as the optimum marital deduction continues to be something less than a maximum marital deduction, the role of the estate planner remains vital. Even though the QTIP provisions have added flexibility and tax savings opportunities, these provisions have also increased the complexity involved in estate planning. Estate planning, especially for the married couple, will continued to be a valued service in this society.

258. Indeed, the only substantial estate tax provision addressed by TEFRA was the § 2039(c) and (e) exclusion for certain survivorship benefits from qualified deferred compensation plans. See note 251 and accompanying text supra.

259. If inflation were to continue at the rate it has in the past, the $600,000 credit available in 1987, though seeming very generous now, could well be worth only half that amount in 1982 dollars. Of further interest is the fact that the 1976 Act exemption equivalent of $175,625 suffered a reduction in value of close to 50% over its five year phase in period. S. KESS & B. WESTLIN, ESTATE PLANNING GUIDE 344 (4th ed. 1982).