

Tax Management Portfolios
Estates, Gifts and Trusts Series
843-1st : Estate Tax Marital Deduction

TITLE PAGE

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This portfolio is derived in part from Johanson & Pennell, Family Wealth Transfers: Taxation and Estate Planning (West 1992). Professor Johanson's contribution is gratefully acknowledged.

PORTFOLIO DESCRIPTION SHEET

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Tax Management Portfolio, Estate Tax Marital Deduction, No. 843, presents a detailed study of the marital deduction under the federal wealth transfer tax laws. It analyzes practical and tax advantages of using the marital deduction (as well as its potential pitfalls), including issues raised in planning, qualification, funding, and administering a marital bequest.

Section 2056 grants an unlimited federal estate tax marital deduction for qualifying dispositions of property to or for the benefit of a decedent's surviving spouse. The estate tax marital deduction, together with the Section 2523 unlimited federal gift tax marital deduction for qualifying lifetime transfers, provides the most powerful estate planning tool available for married individuals. Through optimum use of the marital deduction, all federal wealth transfer taxes can be deferred until the surviving spouse's death, regardless of the size of the estate of the first spouse to die.

The Portfolio explores the following questions that the estate planner must answer in formulating and funding a marital bequest: How much marital deduction is appropriate? Which of the many forms of qualifying disposition is preferable? How should a clause be drafted to qualify the preferred disposition for the marital deduction? Which of the eight available alternatives for funding the marital bequest should be used to segregate the marital bequest from the rest of the decedent's property and transfer it to the dispositive vehicle chosen? How should the generation-skipping transfer tax reverse QTIP election exemption allocation be factored into effective marital deduction planning? And the special requirements for bequests to spouses who are not U.S. citizens also are examined.

This Portfolio may be cited as Pennell, 843 T.M., Estate Tax Marital Deduction.

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One negative attribute of the estate trust is illustrated by Rev. Rul. 75-128, [FN242] in which the government ruled that an estate trust may not grant a general testamentary power of appointment to the surviving spouse. According to the government, permissible appointees under the power of appointment are persons other than the surviving spouse to whom the property passes from the settlor after the spouse's enjoyment terminates, making the trust a nondeductible terminable interest. Because the surviving spouse is not entitled to all income annually, the trust also is not a qualified exception to the nondeductible terminable interest rule under Section 2056(b)(5) or Section 2056(b)(7).

Comment: The ruling is unfounded because a general power of appointment is the equivalent of paying the remainder to the surviving spouse's estate [FN243] and then disposing of it under the surviving spouse's testamentary directive. Nevertheless, prudence dictates that the flexibility sought by the planning in Rev. Rul. 75-128 not be granted in an estate trust unless this issue is litigated favorably to taxpayers. That being the case, the estate trust also suffers from inflexibility, which is a malady of no small proportions in today's estate planning environment.

F. Qualified Terminable Interest Property

Before 1982, the following disposition would not have qualified for the estate tax marital deduction:

The trustee shall pay the trust income to S in convenient installments, at least annually, for life. On the death of S the trustee shall distribute the trust estate, including any accrued but undistributed income, to such of my descendants as S may appoint by will. To the extent this power is not validly exercised, on the death of S the trustee shall distribute the balance of the trust estate per stirpes to my then living descendants.

This disposition creates a terminable interest because the spouse is granted only a naked life estate that terminates at death, and because an interest in the property (the remainder interest) passes to someone other than S or S's estate after S's death. Although S is granted a power of appointment, it is a nongeneral power that cannot be exercised in favor of S or S's estate; therefore, this trust does not qualify as an exception to the nondeductible terminable interest rule under Section 2056(b)(5).

Before enactment of the unlimited marital deduction rule in 1981, the existing dispositive vehicles to secure the marital deduction (i.e., outright gifts, Section 2056(b)(5) power of appointment arrangements, Section 2056(b)(6) insurance settlements, and estate trusts) required that the surviving spouse be given control that could alter devolution of the property

after the spouse's death. Considering in particular the situation of a subsequent marriage and children of the decedent by a former spouse (who the surviving spouse might not favor), [FN244] Congress enacted the Section 2056(b)(7) exception to the nondeductible terminable interest rule, to permit marital deduction qualification without granting the surviving spouse testamentary control over the deductible property. This exception causes the illustrated trust to qualify for the marital deduction unless the decedent's personal representative elects to opt out of automatic qualified terminable interest in property (QTIP) treatment. Otherwise, property settled in an otherwise qualifying trust and scheduled on the decedent's estate tax return as marital deduction property will generate a marital deduction in the decedent's estate under Section 2056(b)(7) and, by virtue of §§ 2044 and 2519, will be wealth transfer taxed to the surviving spouse upon release or assignment of the income interest during life or its termination at death, all notwithstanding that the spouse has been given only a naked life estate. [FN245]

Some controversy has surfaced surrounding Section 2044. The government's position is that Section 2056(b)(7) qualification for the marital deduction requires Section 2044 inclusion of the QTIP trust corpus in the estate of the surviving spouse, even if the government was wrong to permit the marital deduction. But taxpayers, seeking to whipsaw the government, argue that QTIP qualification and Section 2044 inclusion should be considered independently so that, if the QTIP requirements are not met, estate tax inclusion to the surviving spouse is avoidable. Thus, the estate of the surviving spouse made numerous arguments in *Cavanaugh Est. v. Comr.* [FN246] that the government should not have granted the marital deduction in the estate of the first spouse to die and that the QTIP trust corpus therefore was not includible in the surviving spouse's gross estate at death. The court nevertheless held that property for which a QTIP deduction was allowed is includible in the surviving spouse's estate, notwithstanding the dual requirement in Section 2044 that a deduction was allowed with respect to the property and that the surviving spouse "had a qualifying income interest for life" in the trust. That element was spotlighted in *Shelfer Est. v. Comr.*, [FN247] in which the Tax Court, over three dissenting opinions, held that failure to pay stub income to the estate of the surviving spouse or make it subject to a general power of appointment in the spouse means that the marital trust fails to meet the qualified terminable interest property requirements. In this case the issue arose at the death of the surviving spouse, the government already having granted the marital deduction to the estate of the first spouse to die, and the result of the court's holding was that Section 2044 inclusion was precluded. In essence, the government was whipsawed because the property escaped tax in both spouses' estates. First raised in *Howard Est. v. Comr.*, [FN248] which is discussed in VI, F, 1, b, below, this stub income issue is addressed in the regulations [FN249] and the last word has not been heard; legislation likely will be enacted to eliminate this issue prospectively. [FN250]

Although *Cavanaugh* makes the flat statement that allowance of the marital

deduction under Section 2056(b)(7) or Section 2523(f) is all that is required to cause subsequent Section 2044 or Section 2519 inclusion to the donee spouse, it may be possible to preclude inclusion by proving that the spouse did not receive a qualifying income interest for life, notwithstanding that the government improperly allowed the deduction. That would produce the wrong result (a deduction without the payback inclusion to the spouse) and certainly would produce litigation if the government was aware that the deduction was granted but inclusion was contested, but it may be supportable based on a technical reading of §§ 2044 and 2519.

In essence this is what the taxpayers hoped to accomplish in TAMs 9548002 and 9537004 and what the court precluded in *Talman v. U.S.*, 97-1 USTC ¶60,270 (Fed. Cl. 1997), in which the Shelfer effort to whipsaw the government was rejected notwithstanding that the case predated Regs. Section 20.2044-1(d)(2). The government's response to the Shelfer issue in TAM 9537004 was to state that the decedent's estate "affirmatively made the QTIP election [which]... effectively adopt[ed] the Service's published position that the failure to pay the stub income to the spouse's estate did not preclude QTIP treatment." (Emphasis in original). As such, the government appears to be articulating an equitable estoppel or duty of consistency argument to preclude the whipsaw and, although the notion of a tacit confirmation of the government's position was novel, it is appropriate that the government not be whipsawed in granting a marital deduction without corresponding inclusion in the estate of the surviving spouse.

This was essentially the reasoning adopted in *Letts v. Comr.*, [109 T.C. 290](#) (1997), in which the trust was not defective as QTIP property but the QTIP election for the marital deduction (which was required at the time) never was made. The marital deduction was claimed on the estate tax return of the first spouse to die and allowed by the government, which did not audit that return. Schedule M of that decedent's estate tax return referred to the trust as a "qualified marital trust" but placed an "X" in the "No" box on page two in answer to the question whether the QTIP election was being made. When the surviving spouse died, before the marital trust was even funded, the position was taken (and fully disclosed) on the survivor's estate tax return that the trust was not includible because it did not qualify as a QTIP trust due to the absence of the election. In that context, and having raised the issue only by an amendment to its answer and therefore assuming the burden of proof, the government asserted and the court agreed that the trust property was includible in the estate of the surviving spouse.

Stating that "[t]he duty of consistency prevents a taxpayer who has benefited from a past representation from adopting a position inconsistent with that taken in a year barred by the statute of limitation," the Tax Court cited authority for the proposition that spouses "can have interests so closely aligned that one may be estopped under the duty of consistency by a prior representation of the other" and that the duty of consistency can be applied "to

bind one person to a representation made by another where the two are deemed to be in privity." Further logic for its conclusion was that the estates of these spouses "were a single economic unit" and had a "sufficient identity of interests" that the duty should apply. And the court buttressed its holding by noting that, in addition to the surviving spouse being a beneficiary of the estate of the first to die and therefore of the tax saving attributable to the marital deduction that was claimed in that decedent's estate, the surviving spouse and a child were executors of the estate of the first spouse to die and that child also was an executor of the surviving spouse's estate. According to the court, "[t]he duty of consistency can bind a beneficiary of an estate to a representation made on an estate tax return if the beneficiary was a fiduciary of the estate." Most interestingly, the court concluded that the estate of the first spouse to die, by not making the QTIP election but claiming the marital deduction, effectively made a representation that the marital trust itself was not a terminable interest -- otherwise it could not have qualified for the deduction -- and, having made that representation, the surviving spouse must live with an inclusion result that is consistent with it. Letts clearly is the "right" result even if it is a technically challenged decision.

1. Requirements

The Section 2056(b)(7) exception to the nondeductible terminable interest rules applies if four requisites are met:

(1) the property must "pass" from the decedent;

(2) the surviving spouse must be entitled to a Section 2056(b)(5) income interest for life;

(3) no other beneficiary may have any rights in the trust during the surviving spouse's overlife; and

(4) an irrevocable QTIP election must be made.

a. Passing

The passing requirement is the same as for all other marital deduction purposes. See V, B, 3, above, for a detailed discussion of this requisite.

b. Qualifying Income Interest for Life

The QTIP exception requires that the surviving spouse be granted an income

interest that would qualify under the Section 2056(b)(5) requirements. By regulation, all of the well-established Section 2056(b)(5) rules with respect to guaranteeing the income interest are adopted by reference (e.g., unproductive property should not be held for more than a reasonable time without the surviving spouse's consent, income should be paid at least annually, and an income interest that terminates on remarriage does not qualify): "The principles of Section 20.2056(b)-5(f)... apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust." [FN251] Thus, for example, the trust involved in TAM 8508002 provided for payment of income to the surviving spouse for life but provided for payment of an annuity to the decedent's sister if the sister was widowed, and gave the trustee discretion to pay taxes and administration expenses out of trust corpus. And TAM 9409005 involved a trust paying an annuity to the surviving spouse and provided that income in excess of that annuity amount could be paid to third parties during the surviving spouse's overlife. Both TAMs properly concluded that the marital deduction was not available because the surviving spouse was not the exclusive beneficiary of the trust nor was the surviving spouse entitled to receive all the trust income for life.

Although the trend is to the contrary, several astonishing decisions illustrate that qualification for the all-income-annually requirement in a QTIP trust may be found based merely on statements of the decedent's intent. Thus, for example, in *Ellingson Est. v. Comr.*, [FN252] income payable to S from a QTIP trust could be accumulated to the extent it exceeded what the trustee deemed necessary for S's "needs, best interests, and welfare." Although S was a cotrustee of the trust, S's control in that capacity over trust income was terminable with S's incapacity or resignation. The court nevertheless allowed the marital deduction over the government's argument that the trust violated the Section 2056(b)(7)(B)(ii)(I) all income requirement, because "[t]he Commissioner's reading of the Trust Agreement causes the agreement to self-destruct in defiance of the settlor's obvious intent." Loss of the marital deduction would generate taxes that would necessitate liquidation of the principal trust asset (a family farm), which would not be in the "best interests" of S, as that standard was used in the accumulation provision itself. Thus, the accumulation provision was deemed not to apply in a manner that would disqualify the trust for the marital deduction. [FN253]

Comment: The court stated that "it would make bad law to read a trust agreement as... qualif[ying] for a QTIP deduction solely because the settlor expressly declared" that to be the desired result, and it even stated that it was not doing so in *Ellingson*, which seems questionable. Nevertheless, the result gives hope that a seemingly defective trust income interest can be made to qualify if tax deferral is desirable and, as the discussion next below indicates, may even be available by way of a closing agreement with the government by which the deduction is allowed in exchange for an agreed inclusion when the surviving spouse disposes of the trust income interest or it

terminates when the spouse dies.

There is one notable difference between the Section 2056(b)(5) and QTIP income requirements and it has spawned some controversy notwithstanding governmental efforts to be QTIP accommodating. Unlike a Section 2056(b)(5) qualifying trust, in which the surviving spouse must be given a general power to appoint any accrued but undistributed income at death ("stub" income earned before S's death but not yet distributed under the fiduciary's periodic distribution procedure), the QTIP regulations provide that stub income of a QTIP trust at the surviving spouse's death need not be subject to such a power, nor must it be paid to the surviving spouse's estate. [FN254] Instead, although the stub income will be subject to Section 2044 inclusion in the estate of the surviving spouse at death, [FN255] along with the rest of the QTIP trust property, it may be distributed in the same manner as the QTIP trust corpus. [FN256] As a result, the spouse need not be given control of its devolution, nor must an estate administration be opened for the spouse to dispose of this item, and trusts that fail to address this issue should not fail to qualify for the QTIP marital deduction.

Unfortunately, notwithstanding that it is favorable to most taxpayers, the validity of this stub income regulation is subject to doubt. While still in its proposed form, [FN257] the government's position was declared invalid in *Howard Est. v. Comr.*, [FN258] the Tax Court stating that there is no statutory support for the government's treatment and, absent payment of the accrued income to the estate of the surviving spouse or it being made subject to the control of the surviving spouse through a general testamentary power of appointment, the entire marital deduction will be disallowed under Section 2056(b)(7). [FN259] Based on legislative history to the effect that the Section 2056(b)(7)(B)(ii)(I) all-income-annually requirement was meant to mirror the same requirement under Section 2056(b)(5), the Tax Court simply held that the proposed regulation was inconsistent with established Section 2056(b)(5) rules. Finding no indication in the legislative history of a congressional intent to deviate from the Section 2056(b)(5) income requirements, the court declared the regulation invalid and the marital deduction improper. Since the regulation became final the court had occasion to state the same result in the even more egregious *Shelfer* case, discussed below. Thus, this issue has not been resolved, making the appellate court review of *Howard* all the more significant.

In reversing the Tax Court, the Court of Appeals for the Ninth Circuit upheld the government's regulatory position as a valid interpretation of the Code, consistent with the legislative history behind Section 2056(b)(7), stating: [FN260]

As long as the income is payable at least annually and the spouse is entitled to all regular distributions as long as she lives, the statutory test is met....

The statute did not impose... the requirement that the spouse hold a power of appointment over the stub income. All that was required was that the spouse be entitled to all the income at the time of its annual or more frequent distribution....

The whole purpose of the QTIP provision was to dispense with the requirement of a power of appointment as a condition of entitlement to the marital deduction. Since the power of appointment is not required, there is no need to require a power of disposal of the undistributed income.

Notwithstanding the logic of this holding, the Tax Court again held in *Shelfer Est. v. Comr.* [FN261] that failure to pay the stub income to the surviving spouse's estate or make it subject to a general power of appointment in the spouse meant that the marital trust failed to meet the QTIP requirements and, as a consequence, Section 2044 inclusion would not occur. The irony in *Shelfer* is that the government went out of its way to allow the marital deduction notwithstanding that Howard had not yet been reversed on appeal, the government having responded to taxpayer concerns about the effect of Howard by promulgating Notice 89-4, [FN262] which contained an "interim settlement procedure" by which the government and taxpayers could settle estates in which the stub income issue arose. It was pursuant to this Notice that the government allowed the *Shelfer* marital deduction by adhering to its position that the stub income is includible in the spouse's gross estate under Section 2044 but need not be paid to the spouse's estate or be subject to a general testamentary power of appointment to qualify the QTIP trust for the marital deduction. Because the government's position in the regulations is binding on it, taxpayers who want the marital deduction need not worry about disallowance even if the stub income is not payable or subject to a general power of appointment in the spouse, and it remains for the court on appeal in *Shelfer* or for Congress to restore sanity to this issue by making certain that the government is not whipsawed.

The Tax Court was reversed in *Shelfer*, the appellate court holding that the QTIP marital deduction was properly allowed in the predeceased spouse's estate and the property includible in the surviving spouse's estate. [86 F.3d 1045](#), 96-2 USTC Para.60,238 (11th Cir. 1996). Note: If the QTIP trust is silent about the stub income issue, the state Principal and Income Act may cover the issue and mandate distribution of the stub income to the surviving spouse's estate, meaning this issue may exist only in documents that alter state law by specifically addressing the issue.

c. No General Power of Appointment is Required

Unlike the Section 2056(b)(5) trust, the decedent need not give the surviving spouse a general power to appoint QTIP trust corpus. Thus, the QTIP

trust is attractive to many clients who want to "handcuff" the surviving spouse while at the same time qualifying for the marital deduction. This does not preclude a decedent from granting the surviving spouse a power to appoint the property at death (but not during life) [FN263] to or among a class of permissible appointees specified by the decedent, nor does it preclude giving the spouse a power to withdraw QTIP trust corpus during life, so long as there is no restriction on withdrawal that the spouse must make a gift and that therefore constitutes a constructive power of appointment in violation of the statute. Because of concerns whether a general power of appointment in the form of a withdrawal right during life or a testamentary power might make the trust a Section 2056(b)(5) marital trust (which automatically qualifies for the deduction and as to which the Section 2652(a)(3) reverse QTIP election for generation-skipping transfer tax purposes may not be available), it would be wise to be certain that the power of appointment would fail to qualify for Section 2056(b)(5) purposes, such as by imposing a delay before it becomes available or by requiring a third party's consent to exercise.

In addition, TAM 8943005 (discussed in detail at VI, F, 1, d, below) states that it is permissible to give the surviving spouse an inter vivos general power of appointment in a QTIP trust notwithstanding the Section 2056(b)(7)(B)(ii)(II) prohibition. Presumably any general power would be permissible, again including one exercisable only with the consent of a nonadverse party (e.g., the trustee), which may give the surviving spouse enough flexibility to, for example, make annual exclusion transfers from the marital trust, without bestowing greater control than the decedent prefers or converting the QTIP trust into a Section 2056(b)(5) trust. Note: Although a general power of appointment in a QTIP trust might cause the trust to be regarded as a Section 2056(b)(5) trust, with a concomitant loss of the QTIP advantages, TAM 8943005 did not even mention this possibility.

In any event, a client who is willing to grant the surviving spouse some control may create as broad or as narrow a nongeneral testamentary power as the client wants the surviving spouse to possess, without any of these fears.

d. No Other Beneficiaries During Spouse's Overlife

The second primary requisite to qualify as a QTIP trust is that, although the trustee may invade principal for the benefit of the surviving spouse, no one (according to the legislative history, not even the spouse) [FN264] may have a power to divest the surviving spouse of any interest in the trust. The limits of this restriction are quite uncertain. For example, Rev. Rul. 85-35 [FN265] provides that a standard facility of payment provision does not disqualify a Section 2056(b)(5) marital deduction trust, and TAM 8706008 draws the same conclusion for QTIP trusts. Thus, if the surviving spouse is unable to manage normal affairs, the trustee properly may pay income for the benefit of

the surviving spouse (rather than directly to the spouse) and even may distribute income to a next friend or guardian for use on the spouse's behalf. Caution must be exercised in drafting such a provision, however, as illustrated by the provision involved in TAM 9318002, which read:

Regardless of any other provision of this instrument... as often as the Trustee deems it appropriate so to do, in order to carry out the spirit and purpose of this provision, payment to any beneficiary herein may be discontinued, and in lieu thereof, the Trustee may expend for the account of such beneficiary and for his or her support, comfort, happiness and welfare, such amounts as would otherwise be paid over directly to such beneficiary. (Emphasis added.)

Used in a trust with a beneficiary as trustee, this provision was deemed to give the trustee a general power of appointment because the terms "comfort, happiness, and welfare" are not ascertainable standards. [FN266] This type of provision is not meant to authorize distributions at all; usually such "facility of payment" provisions are intended only to permit a trustee to avoid making distributions directly to a beneficiary and instead to expend amounts required or authorized under other provisions directly for the beneficiary or to reimburse others for amounts they expended for the beneficiary. For example, the trustee might choose to pay the beneficiary's rent, utility, and grocery bills rather than give the beneficiary amounts needed for those living expenses. Thus, a more carefully drafted provision might specify:

If income or discretionary amounts of principal become payable to a minor or to a person under legal disability or to a person not adjudicated disabled but who, by reason of illness or mental or physical disability, is in the opinion of the trustee unable properly to manage his or her affairs, then that income or principal shall be paid or expended only in such of the following ways as the trustee deems best: (a) directly to the beneficiary or his or her attorney in fact; (b) to the legally appointed guardian of the beneficiary; (c) to a custodian for the beneficiary under a Uniform Transfers or Gifts to Minors Act; (d) by the trustee directly for the benefit of the beneficiary; (e) to an adult relative or friend in reimbursement for amounts properly advanced for the benefit of the beneficiary.

Particularly useful about this provision are the statements in (d) that the trustee may pay items directly for the beneficiary and in (e) that amounts paid to others are in reimbursement for amounts already expended for the beneficiary, along with the absence of any language that might imply that this provision itself is a principal distribution authority that is inappropriate for tax purposes. [FN267]

Closely related is TAM 8526009, which determined that a power granted to the trustee to distribute principal to the surviving spouse "for her comfortable support, maintenance, health and/or [sic] education and that of the

settlor's issue under her care and supervision " (emphasis added) would not disqualify an otherwise valid QTIP trust. The government noted that distributions could be made only to the spouse (notwithstanding the determination of needs used to measure the amount to be distributed) and the surviving spouse could choose to retain the funds or disburse them in his or her sole discretion. Unfortunately, TAM 8701004retracted TAM 8526009because, under state law, the government determined that the surviving spouse was deemed to be under a fiduciary obligation with respect to distributions made for the needs of the settlor's issue and therefore could be compelled to use funds received from the trust for the exclusive benefit of those individuals. Accordingly, because those indirect beneficiaries were not persons to whom the surviving spouse necessarily owed an obligation of support, the government determined that "[t]he terms of the... Trust authorized the trustee to appoint trust property to persons other than the spouse" in violation of Section 2056(b)(7)(B)(ii)(II). [FN268]

Comment: The marital deduction should be allowed if the distribution power is limited to distributions measured by the needs of persons the spouse is obliged to support, or if the trust negates any fiduciary obligation otherwise imposed on the surviving spouse to pass any distributions received along to the descendants whose needs were the measure of those distributions. [FN269] If there is no obligation on the spouse to pass along distributed funds, TAM 8526009would authorize an attractive planning opportunity because it expands the flexibility of QTIP trusts and could, for example, permit the surviving spouse to dissipate trust corpus through annual giving without running afoul of the prohibition against the surviving spouse or the trustee having a prohibited power of appointment or disposition. [FN270]

Clearly impermissible in a QTIP trust is the power addressed in PLR 8527009to distribute income or principal "for the support and maintenance of my wife, except that such portions of the income and principal may be used as may be necessary to furnish my children with a college or university education." [FN271] *Manscill Est. v. Comr.* [FN272] involved a similar power to distribute corpus to a child, but it was exercisable only with the surviving spouse's consent. Still the court held that this constituted a prohibited power to divert corpus to someone other than the surviving spouse, not limited to the amount of the spouse's legal obligation to support the child, that could not be purified by requiring the spouse's consent (which, at best, converts it to a prohibited power of appointment in the spouse). And in TAM 8843004the government correctly ruled that a provision authorizing the decedent's child to purchase QTIP trust property for less than its fair market value and to borrow from the trust at below-market rates to finance the purchase also would prevent marital deduction qualification. The first power was deemed an improper power to divert trust assets to someone other than the surviving spouse and the latter was deemed to make the child an improper beneficiary of the QTIP trust income. [FN273]

In a case that almost certainly is the same as that involved in TAM 9139001, the court in *Rinaldi Est. v. U.S.*, 97-2 USTC Para.60,281 (Fed. Cl. 1997), cert. denied, upheld the government and concluded that the provision in a QTIP marital deduction trust granting the decedent's son the right to purchase stock from the trust at less than its fair market value constituted a prohibited power to benefit the child that disqualified the trust under Section 2056(b)(7)(B)(ii)(II). Involved was stock in a family corporation that actually was redeemed from the trust before the QTIP election was made, causing the estate to argue that disqualification was thereby precluded. The court nevertheless rejected the taxpayer's suggestion, based on *Spencer Est. v. Comr.*, 64 T.C.M. 937(1992), rev'd, [43 F.3d 226](#) (6th Cir. 1995), that QTIP qualification should be judged at the time the QTIP election is made. The court distinguished cases involving QTIP eligibility that judged the trust at the time of the QTIP election, because the trusts in those cases always were qualified and it was only the amount of the marital deduction or the fact of the election itself being made properly that was in question, whereas *Rinaldi* involved a trust that did not qualify from its inception. Moreover, notwithstanding the lack of the stock that was subject to the sweetheart purchase right at the time of the QTIP election, the court properly noted that the element of disqualification still would exist if the trust could reacquire stock at any time during the surviving spouse's overlife that would be subject to the child's prohibited power in the form of the purchase right. The child should have made a qualified disclaimer of the purchase right, rather than having the corporation redeem the stock subject to the power.

Some flexibility is, however, available in a QTIP trust. For example, the surviving spouse may be given a withdrawal right during life and anyone may have a power of appointment exercisable at or after the surviving spouse's death, [FN274] all without violating the sole beneficiary restriction. In addition, in a surprising technical advice, the government advised that the surviving spouse may be given a general power of appointment without losing QTIP status. In TAM 8943005 the decedent granted the surviving spouse an annually exercisable, inter vivos, general power to appoint to third parties the greater of \$5,000 or 5% of the value of a QTIP trust. Without even suggesting that the power of appointment converted the trust into a Section 2056(b)(5) all income, general power of appointment trust -- even with respect to a portion of the trust -- with concomitant loss of the postmortem flexibility and advantages of a QTIP trust, the TAM concluded that the power is proper in a QTIP trust. The government noted that the logic underlying the Section 2056(b)(7)(B)(ii)(II) prohibition against powers of appointment in favor of anyone other than the surviving spouse is to "insure that the value of the property not consumed by the spouse is subject to tax upon the spouse's death (or earlier disposition)..." and stated that this logic is not violated by a general power because wealth transfer tax is not avoided. It concluded that denying this power:

would be unnecessarily restrictive.... [W]e believe the better reading of

the legislative history would preclude a spousal power of appointment only where the exercise of the power would not be subject to transfer taxation; i.e., where the power is not a general power of appointment as defined in Section 2514 of the Code. An interpretation requiring that a spouse must first take physical possession of the property prior to a transfer to a third party would focus too much attention on the form of transaction. It is sufficient that the exercise of the power by the spouse in favor of a third party would be subject to transfer taxation.

The same result also might apply if the surviving spouse, as trustee of the marital trust, has powers not limited by a Section 2041(b)(1) restriction (joint power with an adverse party) or an ascertainable standard. Possible application of Section 2519 should not be a problem, however, notwithstanding that appointment of corpus would carry income away from the surviving spouse, because an outright distribution to the spouse followed by an outright gift would not involve Section 2519 (which is the analogy the TAM used). Moreover, the abuse to which Section 2519 is aimed is an assignment of income permitting avoidance of wealth transfer tax on corpus, which is not presented under the general inter vivos power of appointment scenario.

Caution: Until it is clear whether the general power of appointment is deemed to create a Section 2056(b)(5) general power of appointment trust, [FN275] in which case the consequence might be to lose the ability to do postmortem planning through exercise or withholding of the QTIP election, and loss of other advantages of QTIP trusts discussed below, caution is appropriate. It may be that the government is not concerned with the Section 2056(b)(5) versus Section 2056(b)(7) issue, but practitioners should be cautious because qualification for the marital deduction under Section 2056(b)(5) is automatic whereas qualification under Section 2056(b)(7) is subject to the requisite QTIP election. Moreover, a Section 2056(b)(5) marital deduction trust cannot engage in Section 2652(a)(3) reverse QTIP planning for generation-skipping transfer tax purposes and the other postmortem planning available to a QTIP trust. Because a general power of appointment in a QTIP trust can provide useful planning flexibility, this is an issue that should be watched carefully.

e. The QTIP Election

The final requirement to qualify as a QTIP disposition is made necessary because, unlike the Section 2056(b)(5) trust, qualification for the Section 2056(b)(7) QTIP marital deduction is not by statute meant to be automatic. For the transfer to be treated as qualified terminable interest property, an election is contemplated under Section 2523(f)(4) by the donor spouse on a gift tax return if the transfer is made during life, and under Section 2056(b)(7)(B)(v) by the decedent's personal representative on the estate tax

return if the transfer is made at death. Because there have been so many problems with QTIP elections, however, the current position is the reverse of the statutory expectation and QTIP treatment is automatic unless the donor or the personal representative elects out of that treatment. Because the election is irrevocable once made, and because of the importance of this election, it is discussed separately and in detail at VI, F, 3, below.

2. Legal Life Estates Can Qualify for QTIP Treatment

A QTIP disposition need not be in trust. A devise of Blackacre "to S for life, and on S's death per stirpes to my descendants" would be in qualifying form [FN276] and would constitute QTIP marital deduction property if listed on Schedule M of Form 706 or line 8 of Schedule A of Form 709. Thus, although legal life estates rarely are used in estate planning because of their inflexibility, in PLR 8351141 the government ruled that QTIP treatment was available for real property that the surviving spouse could "use for any purpose, demolish or modify existing buildings or construct new buildings." TAM 9040001 advised that a surviving spouse's right to occupy a residence for life, coupled with a right to receive 50% of the sale proceeds upon vacating the residence before death, qualifies 50% of the residence for QTIP treatment. PLR 8352062 granted QTIP treatment for a testamentary gift of all the income for life from a ranching operation and grain farming corporation because the surviving spouse was given "absolute and unrestricted control over the payment of income." PLR 8351098 granted QTIP treatment for the surviving spouse's right "to have, hold, possess and enjoy the rents, interests, dividends, and profits thereof for and during the full time of her natural life." And PLR 9046031 held that a personal residence passing in trust to a spouse for lifetime use qualified under Section 2056(b)(7) because obligations imposed on the spouse were consistent with obligations ordinarily imposed on a life tenant. Similarly, in *Novotny Est. v. Comr.*, [FN277] the Tax Court allowed QTIP treatment for a life estate in real property that would terminate if the surviving spouse failed to pay various property expenses, including taxes, payments under a deed of trust note (which the surviving spouse had co-signed), maintenance expenses, and repairs. The court held that the spouse had a qualifying interest for life because the conditions on the life estate imposed by the decedent's will were substantially the same as conditions that existed independently in the deed of trust note and under local law (e.g., payment of taxes).

Disposition of a marital residence to residuary heirs with a reserved right of a surviving spouse "to occupy said property for as long as he desires" qualifies for the QTIP marital deduction if the surviving spouse's right to occupy the property includes the right to all income from the property if he does not reside in the property. [FN278] Thus, PLR 9126020 ruled that a bequest of a vacation home to a trust as to which the decedent's surviving spouse was

not the sole beneficiary nevertheless qualifies for the QTIP marital deduction because the spouse was entitled to the full use and enjoyment of the property and, when not using the property, the spouse could rent it and receive the income therefrom. In addition, the rights of all other permissible users were subject to the spouse's "superior right of usage," which the government determined to mean that, under state law, these other users could use the property only as the spouse permitted in the exercise of an absolute and unrestricted discretion.

Drafters effectuating similar plans are wise to spell out the aspects of full and superior use needed to qualify for the marital deduction, rather than relying on state law to satisfy those requirements. For example, TAM 9033004 advised that the surviving spouse's right to occupy a condominium (which she had owned as tenants in common with her husband) was not a Section 2056(b)(7)(B) qualifying income interest for life because, under local (Missouri) law, the devise of a right to occupy a property does not convey the right to sell or lease it. And in TAM 9229004 the surviving spouse was granted a right to occupy the decedent's personal residence that resembled the nonqualifying homestead interest in *Kyle Est. v. Comr.*: [FN279] it would terminate upon failure to occupy the property, there was no right to convey the lifetime right to occupy the residence, and the spouse could not obtain rental income from the property when not personally in possession. The QTIP marital deduction was denied notwithstanding an agreement by the remainder beneficiaries that purported to upgrade the spouse's entitlement to an unrestricted life estate, which was regarded as ineffective to qualify for the marital deduction because the agreement was not a qualified disclaimer, it was not in settlement of a bona fide controversy involving the decedent's estate plan, nor was it a product of the spouse asserting an enforceable entitlement under the state law spousal right of election. [FN280]

Moreover, for the first time, in states that still recognize the common law dower estate or provide a comparable statutory substitute (i.e., a life estate in an undivided one-third of the decedent's lands), the dower estate may qualify for the marital deduction if a QTIP election is made, without having to commute the value and pay that amount as a lump-sum settlement. See V, C, 3, b, above. And, by virtue of the last clause of Section 2056(b)(7)(B)(ii)(I), even the Louisiana form of usufruct in consumable or nonconsumable property qualifies for QTIP treatment if it is for the life of the surviving spouse. [FN281]

3. The QTIP Election

Notwithstanding the statutory presumption in Sections 2056(b)(7)(B)(v) and 2523(f)(4) that transfers to QTIP trusts will not automatically qualify for the marital deduction but require an affirmative election, the government has

encountered so much trouble with returns that compute the deduction but fail to make the election [FN282] that it has adopted an administrative position exactly opposite the statutory presumption. If property is scheduled on the return as deductible and the tax is computed with the deduction, the forms presume that the election is made unless an affirmative election out of QTIP treatment is made. [FN283] Naturally this only applies with respect to transfers that otherwise are "QTIPable" because they would qualify if the election were made, but as to those interests the government has gone so far as to presume at the surviving spouse's death that any interest that was QTIPable was allowed in the decedent's estate and therefore is Section 2044 includible in the spouse's gross estate unless proven to the contrary. [FN284] As discussed in VI, F, 4, below, because the government will deny the marital deduction entirely if the QTIP election affects who takes an interest in the property, it is imperative that the surviving spouse receive an income interest in the property in all events, which means that the only consequence of the election is to fix the tax consequences to the donor or the decedent's estate and, later, to the surviving spouse. Viewed in this light, the government's administrative position favoring the deduction is not unreasonable notwithstanding the statutory discordance.

For estate tax marital deduction purposes, any executor appointed, qualified, and acting in the United States is responsible for the Section 2056(b)(7)(B)(v) election with respect to all property includible in the decedent's gross estate, including property not in the executor's possession (i.e., property passing outside of probate). [FN285] Only if there is no such U.S. executor is the person in possession of electable property responsible for the election. In PLR 9444026, for example, the decedent's gross estate included only assets of an inter vivos revocable trust and property passing to the surviving spouse by operation of law; there was no probate estate and therefore there was no personal representative. Pursuant to Regs. Section 20.2056(b)-7(b)(3), the government ruled that the trustees and the spouse, as all the persons in actual or constructive possession of property includible in the decedent's estate, were the proper parties to make the QTIP election.

Because there is no box to check on the estate tax return to indicate that the election is being made, it is the fact of listing the property on Schedule M and claiming the deduction that constitutes the election. Therefore, it makes sense that the person who is responsible for filing that return is deemed to be the person who is responsible for the election. [FN286] Similarly sensible is that the time for making the estate tax election is the last estate tax return that is timely filed, including extensions; if no return is timely filed, the deadline is the first estate tax return filed after the due date. [FN287] Curiously and somewhat confusingly, however, an election made on a timely filed return may be revoked or modified by a subsequent return that also is timely filed, but "no subsequent election may be made with respect to other properties included in the gross estate after the return" is filed (emphasis added); [FN288] perhaps the intent is that only the last timely filed return counts.

TAM 8501005 illustrates the government's position that neither reasonable cause to amend, mistake of law or fact, change of mind, nor other factors are cause to deviate from the rule that, once made (or deemed made because the property is scheduled and the deduction claimed) the election is irrevocable. Thus, in the situation presented, only two pages of the decedent's will were found and admitted to probate, but two additional pages containing a marital deduction provision were later discovered. The government denied the personal representative's request to file an amended return electing qualified terminable interest treatment for the newly discovered marital deduction provision. In denying that request, the government placed a heavy premium on making the election properly, the first time, and only after all relevant facts have been ascertained.

The government allows some flexibility in describing the QTIP assets on Schedule M, as illustrated by TAM 9116003, which advised that an estate need not specify the particular assets used to fund a marital deduction bequest of a preresiduary optimum marital deduction amount. Rather than describing the assets on Part 2 of then-applicable Schedule M, the estate was permitted to state that the election was being made for a specific portion of the estate "represented by a fractional share that is required to reduce the federal estate tax on the decedent's estate to zero...." [FN289] And TAM 9217005 stated the government's recognition and acceptance of the fact that:

As a practical matter, the pecuniary amount of the property passing to the marital trust, the value of the property subject to the election, and the assets the executor selects to fund the marital trust will not be known until the value of the gross estate for estate tax purposes is finally determined and administration of the estate is complete. Further, any increase in the valuation of estate assets pursuant to an audit would, under the terms of the trust and formula election, increase the pecuniary amount passing to the trust, the value of the property subject to the election, the quantity of estate assets needed to fund the trust, and the election portion.

Thus, a QTIP formula election of "that percentage interest up to 100 percent of the below described [QTIP trust]" was proper to qualify for the marital deduction, and the regulations now also permit formula elections. [FN290]

PLR 199902014 accepted as valid a QTIP election made on a timely filed return for 100% of the trust even though the trustee incorrectly calculated the amount passing to it, noting that the incorrect calculation did not affect the amount properly passing to the marital trust under the terms of the governing instrument.

a. Remedying Defective Elections

By a little publicized 1985 National Office Memorandum, [FN291] field offices were instructed to allow a closing agreement to cure defective elections for the marital deduction, if the personal representative, the trustee of any involved marital deduction trust, the surviving spouse, and all affected remainder beneficiaries consented to the agreement. [FN292] That sort of agreement provides one avenue for relief to taxpayers and their advisors in cases in which administrative glitches, such as an inadvertent failure to elect the marital deduction properly, preclude qualification.

Also available to remedy a defective effort to qualify for the QTIP marital deduction are the procedures under Regs. Section 301.9100-1T through - 3T, which allow taxpayers an extension of time in certain circumstances to cure administrative defects such as defective QTIP elections or reverse QTIP elections by filing an amended return after expiration of the time for filing the original estate tax return. [FN293] An automatic six month extension of time to make these elections is available under Regs. Section 301.9100-2T(b) if corrective action (i.e., filing a replacement original or an amended return listing the property and claiming the deduction) is taken within the six month period. [FN294]

If a request for an extension of time does not meet the requirements of Regs. Section 301.9100-2 for an automatic extension, Regs. Sections 301.9100- 1(a) and 301.9100-3 permit the Commissioner discretion to grant an extension if the taxpayer acted reasonably and in good faith and granting relief will not prejudice the interests of the government. The regulations adopt the standards for reasonableness and good faith that applied under Rev. Proc. 92-85. Reasonable action is presumed [FN295] if the request is made before the government discovers the failure to timely elect [FN296] and prejudice is deemed to exist only if granting the requested relief gives the taxpayer a lower tax liability than if the election had been timely made. [FN297]

In a long series of TAMs and PLRs [FN298] the government frequently agreed to requests for relief under Regs. Section 301.9100-1, most often with respect to defective QTIP elections, stating in the earlier cases that the federal estate tax return identified the trust corpus and deducted the value thereof on Schedule M but failed to "unequivocally manifest an affirmative intent to make the QTIP election with respect to the return" - - which meant the QTIP election box on the return was not checked -- and further stating that "[t]he taxpayer has satisfactorily demonstrated to us that, at the time the return was filed, the taxpayer had the requisite intent to make the election." This later element was a required showing under Rev. Proc. 79-63, [FN299] which established the "evidence standard" then applicable to Regs. Section 301.9100-1. Rev. Proc. 92- 85 (in turn

superseded by Regs. Sections 301.9100-1T through -3T) superseded Rev. Proc. 79-63 in establishing the proper procedure and elaborating on the entitlement to request an extension of time under Regs. Section 301.9100-1 to make certain elections required under the Code or regulations. The later Procedure, an improvement over Rev. Proc. 79-63, was improved further by the temporary regulations, because Regs. Section 301.9100-1 relief no longer is strictly limited to deadlines prescribed only by regulation, ruling, procedure, notice, or announcement (administrative pronouncements); relief now is available with respect to elections that are required by statute and regulation to "be made by the due date of the tax-payer's return... including extensions" and certain statutory and regulatory extensions are automatic.

In addition to curing defective QTIP elections, the government also has allowed Section 2652(a)(3) reverse QTIP election relief in situations in which Schedule R showed allocation of the decedent's \$1 million generation-skipping transfer tax exemption to a QTIP marital deduction trust but the box on Schedule R indicating the reverse QTIP election was not checked, [FN300] or in which Schedule R was not filed at all, [FN301] although more recent grants of relief deny the opportunity to make a late allocation of the \$1 million generation-skipping transfer tax exemption. [FN302] And the government has granted an extension of time to make the qualified domestic trust (QDOT) election or to allow a non-U.S. citizen surviving spouse to irrevocably assign property to a QDOT. [FN303]

Not all cases will qualify for discretionary relief to cure a defect, however. For example, the government denied Regs. Section 301.9100-1 relief in PLRs 9218018 and 9218041 because the personal representative in each situation thought the surviving spouse received a fee simple interest in property and did not intend to make a QTIP election for property in which it only later was determined that the surviving spouse received only a life estate. The request for an extension of time to make an election in the first instance -- rather than to correct a defective election -- was denied. PLR 9226019 denied relief because the personal representative claimed the marital deduction under Section 2056(b)(5) and only later determined that the surviving spouse was not granted the requisite general power of appointment; relief to amend the return to make the QTIP election was denied because the personal representative did not intend to elect QTIP treatment on the original return. PLRs 9222037 and 9219028 denied relief because the personal representative did not claim the marital deduction in computing the tax, in addition to failing to make the QTIP election itself. Note, however, that Regs. Section 301.9100-3 no longer requires a showing that the estate intended to make the election on the original return. And TAM 9224003 denied Regs. Section 301.9100-1 relief because the estate properly made the QTIP election and wanted an extension to reduce the amount of marital deduction it claimed, to shelter more of the decedent's unified credit. In PLR 9848041 that request was denied in

the context of the personal representative's inappropriate election of both the marital and bypass trusts. Similarly, PLR 9526015 denied an extension of time to change the amount of a properly made QTIP election; the estate sought the extension after the surviving spouse died because a partial QTIP election would save taxes in the surviving spouse's estate. Without citing Regs. Section 20.2056(b)- 7(b)(4)(ii), the government nevertheless held consistent with it that relief under Regs. Section 301.9100-1 "is not available because a proper election was already made and no extension of time is needed. As provided for by Section 2056(b)(7)(B)(v), an election under Section 2056(b)(7), once made, shall be irrevocable." If the automatic six month extension under Regs. Section 301.9100-2(b) had been available at the time of the surviving spouse's death in PLR 9526015 and the amended return was filed within the six month period, the revised election might have been allowable because Regs. Section 20.2056(b)- 7(b)(4)(ii) allows an election to be "revoked or modified on a subsequent return filed on or before the due date of the return, including extensions actually granted." In any event, the availability of the six month extension would have given the decedent's estate additional time to assess the surviving spouse's health before making the QTIP election decision.

b. Protective QTIP Elections

The regulations [FN304] authorize the personal representative to make a protective QTIP election if, but only if, at the time the federal estate tax return is filed, there is a bona fide issue that concerns whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is to receive. The protective election, which is irrevocable, must identify either the specific asset, group of assets, or trust to which it applies and the specific basis for the protective election. For example, the government granted Regs. Section 301.9100-1 relief for making a protective QTIP election in PLR 9520038. The estate claimed a marital deduction on its original return for property passing outright to the surviving spouse. After disinherited heirs initiated litigation, the personal representative filed a protective election under Section 2056(b)(7) and Regs. Section 20.2056(b)-7(c) and the government granted an extension of time to make the election.

c. Authorizing the Election

It is not wise in most cases for a decedent to direct the personal representative regarding the QTIP election, dictating whether and to what extent it should be made. Rather, to the extent any statement is thought to be appropriate, the governing document could contain precatory language suggesting

factors the personal representative may consider in deciding whether to make a total or partial election, or no election at all. For example, it would be particularly unfortunate to direct an election if the spouses die in quick succession and equalization would be the best tax-oriented result. A fine-tuned partial election could be used instead to minimize the estates' taxes, especially to under-utilize the marital deduction in the estate of the first spouse to die and thereby produce estate taxes that would permit a Section 2013 previously taxed property credit in the surviving spouse's estate. See III, F, above.

TAM 8512004 illustrates the value of fine-tuning using the postmortem QTIP election. The decedent died three months before the surviving spouse, to whom the decedent bequeathed an amount equal to the maximum marital deduction allowable to the decedent's estate. A nonmarital trust of the residue guaranteed to the surviving spouse a right to receive all income for life, sufficient to qualify for a Section 2013 credit [FN305] (notwithstanding that no part of the corpus of that trust was includible in the surviving spouse's estate at death). The personal representative of the surviving spouse's estate determined that aggregate estate taxes over both estates would be minimized if the outright marital bequest was disclaimed, thereby generating some tax in the decedent's estate that could be claimed as a Section 2013 credit in the surviving spouse's estate. Under the actuarial tables, the value of the nonmarital trust life estate income interest (and the Section 2013 credit based thereon) was far in excess of the income actually received by the surviving spouse during the three month overlife. Nevertheless, because Rev. Rul. 80-80 [FN306] required use of the actuarial tables because the surviving spouse's death was not clearly imminent due to an incurable physical condition that was known at the decedent's death, the surviving spouse's estate was able to maximize the credit at a nominal cost. [FN307] Note: Similar results are available if the marital bequest is held in trust and can be generated by partial disclaimer or by a partial QTIP election, but a partial election would not be available under these circumstances if the will directed the personal representative to make the QTIP election, unless one of the factors to be considered in fulfilling that obligation was the Section 2013 credit. Unfortunately, in drafting documents today for operation potentially many years in the future, it is difficult (if not impossible) to know all the elements that may affect such an election. Thus, the election ought to be left to the personal representative's judgment in most cases.

Complicating this issue, however, is the notion that a fiduciary's duty to maximize the decedent's estate by minimizing its taxes may make it imprudent for a personal representative ever to make a partial election if the effect is to cause the decedent's estate to pay tax. Because the personal representative's duties run only to the single estate represented, it is necessary to view the decedent's estate alone, making an election that results in payment of tax an act that arguably is against the estate's interest (even though it may be prudent when viewing both spouses' estates together). [FN308]

The point is that, although partial elections are contemplated by the Code and regulations, [FN309] they might not be permissible under state fiduciary law principles unless the decedent's document grants this authority. [FN310]

Given the uncertainties surrounding marital deduction planning and the extent to which it is best to make a QTIP election, usually it is best to leave the election in the personal representative's discretion. Thus, many well drafted documents authorize the personal representative to exercise the election in its discretion and hold the personal representative harmless for the effects of this decision on any beneficiary. [FN311] By way of example:

Qualification for Marital Deduction: To the extent my personal representative so elects, it is my intent that, the marital deduction bequest and the property comprising this trust estate shall qualify for the federal estate tax marital deduction applicable to my estate. No power or discretion with respect to allocations of property to this trust or administration of the trust shall be exercised or exercisable inconsistent with this intent. I expect that my personal representative will make an election to treat some part or all of this trust as qualified terminable interest property, although I recognize that circumstances could arise in which such an election would not be in the best interests of the beneficiaries of my estate. The decision whether and to what extent to make that election shall be in the sole discretion of my personal representative, whose decision shall be conclusive on all concerned and who shall have no personal liability for any consequences of that election. The election, even if not made, shall be deemed to have been made with respect to the entire trust for purposes of determining the amount of the bequest to this trust.

Drafting Note: It probably is advisable to put this language in the QTIP trust provisions, rather than in a clause appearing elsewhere in the document dealing with tax elections generally. This is an important matter relating to the marital deduction and, if all QTIP related provisions are in one place, there is less likelihood of using the wrong clause in the wrong form or, worse, of overlooking something because it does not appear where the personal representative might be looking. The general "savings clause" language regarding the decedent's intent with respect to the marital deduction bequest makes sense, merely to resolve any doubts in favor of deductibility. [FN312]

The last sentence of the sample clause specifies that, regardless of the extent to which the personal representative makes the QTIP election, the amount of the marital deduction bequest nevertheless will be determined pursuant to the formula clause, as if the election were made with respect to the entire trust. The corresponding balance of the estate passing into the nonmarital trust will be computed accordingly. Without this provision, the personal representative would not know the relative size of these trusts because it would be unclear whether the formula direction to reduce taxes to the lowest possible amount had been met.

Sophisticated postmortem estate planning presents the personal representative with a bewildering array of elections, including whether to elect Section 2032 alternate valuation or Section 2032A special use valuation, whether to make the Section 642(g) swing item election, choosing the appropriate income tax year for the estate, determining the best size of any partial QTIP election, and whether to allocate any part of the decedent's \$

Tax Elections: In determining the wealth transfer and income tax liabilities related to my estate, my personal representative's decision as to all available tax elections shall be conclusive on all concerned and my personal representative shall have no personal liability for any consequences of any election. The marital deduction bequest shall not be construed as requiring that the personal representative exercise any tax election [, other than the election to have the marital deduction gift treated as qualified terminable interest property,] [FN313] only in such manner as will result in a larger allowable estate tax marital deduction than would be obtained if a contrary election had been made. No adjustment shall be made between principal and income or in the relative interests of the beneficiaries to compensate for the effect of any elections or allocations made by my personal representative. If my personal representative joins with S in filing income tax returns, or consents for gift tax purposes to having gifts made by either of us during my life considered as made half by each of us, any resulting liability shall be borne by my estate and S in such proportions as they may agree.

4. Partial QTIP Elections

Because partial QTIP elections are anticipated by the Code and regulations, they should be authorized by the estate plan and postmortem planning in most situations should evaluate the size of the appropriate election. The issues addressed below are practical aspects of this planning: (1) how the election should be described to identify the portion as to which the election is made; and (2) the ancillary consequences of a partial election. Partial elections may be made by formula, [FN314] which is advisable to protect against the consequences of using a specific fraction or percentage if values or other factors change on audit, in which case the desired tax results might not be achieved. This is significant because, once made, the election is irrevocable. [FN315]

Practice Note: Self-adjusting formula fractional elections should be used, of which the numerator is that amount needed to reduce taxes to the lowest possible amount and the denominator is the value of the fund against which the fraction is applied. TAM 9327005 illustrates this principle for partial QTIP election planning. As required by Section 2056(b)(10), [FN316] the estate stated its desire to qualify a specified dollar amount of a trust for the

marital deduction by converting the numerical amount into a percentage of the total. That dollar amount was based on the value of property subject to a buy-sell agreement, which the government successfully challenged. Because that value changed, the amount of marital deduction needed to produce the desired tax result also changed, which the estate argued would occur automatically under its partial QTIP election. The government rejected that allegation, however, because the percentage election was not made by a formula clearly stated on the estate tax return.

A self-adjusting fraction or percentage election would specify the result sought (such as to reduce the estate tax incurred in the estate to the lowest amount possible without increasing state death taxes) rather than specifying the dollar amount or the fixed percentage of an estate based on the return as filed. [FN317] To illustrate, consider TAM 8722010, which involved a nonmarital trust as to which the personal representative made a formula election of that:

fractional share of up to 100 percent... that is required to reduce the federal estate tax on the decedent's estate to zero based upon finally determined federal estate tax values, after taking into consideration all other items deducted on the federal estate tax return, the allowable state death tax credit (to the extent it does not increase the amount of death taxes payable to any state), and the unified credit.

The problem was that the estate tax return showed that this produced an election of 69.34%. When a previously unreported adjusted taxable gift was discovered during audit of the estate tax return, the personal representative proposed to increase the percentage elected to offset the tax generated by this gift. The government denied the increase, stating that the formula failed to consider items such as administration expenses and prior gifts and that "[t]he terms of the formula chosen by the executor are clear and unequivocal in defining the part of the by-pass trust to which the election applies." Translation: irrevocable means irrevocable and specific means "you're stuck" with the percentage you stated. Moreover, as advised by the government in TAM 8728005, a miscalculation, oversight, or misunderstanding of the law is not sufficient to mitigate the irrevocable nature of the QTIP election.

TAM 9017001 illustrates another danger of an improper irrevocable QTIP election. When the decedent's surviving spouse died within six months after the decedent's estate tax return was filed it was discovered that the decedent's estate was overvalued; a supplemental estate tax return was filed and accepted for the reduced value. The question considered was the proper amount includible in the surviving spouse's estate under Section 2044. One option was a fraction of the proper value of the decedent's estate of which the numerator was the original marital deduction election amount and the denominator was the original federal estate tax value of the decedent's estate.

Example: D's estate originally was valued at \$1.5 million. A fractional

partial QTIP election qualified 9/15ths of the entire estate for the marital deduction to produce an optimum marital deduction result. Later it was determined that the proper value of D's estate was \$1.3 million and a proper fraction (to produce the same result) would be 7/13ths of that amount.

If the government selected this option the original 9/15ths election would dictate the amount includible in the surviving spouse's gross estate, making \$

The regulations [FN318] provide models for provisions making partial elections:

D's executor elects to deduct a fractional share of the residuary estate under section 2056(b)(7). The election specifies that the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary trust (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate).

The facts are the same... except that, rather than defining a fraction, the executor's formula states: "I elect to treat as qualified terminable interest property that portion of the residuary trust, up to 100 percent, necessary to reduce the Federal estate tax to zero, after taking into account the available unified credit, final estate tax values and any liabilities and specific bequests paid from the residuary estate." The formula election is of a fractional share... equivalent to the fractional share determined in [the prior example].

Similarly, PLR 9043015 approved the use of a fractional share formula election of which the numerator was the smallest Section 2056(b)(7) deduction that would result in zero federal estate tax, after using the maximum unified credit available, and the denominator was the federal estate tax value of all trust assets. The government noted that the proposed formula satisfied the purpose of the partial share requirements because the elected part will reflect its proportionate share of the increment or decline in the property for §§ 2044 and 2519 purposes. Note: There are several planning defects in these examples that might need correction in some circumstances. For example, as discussed at IV, E, above, because of the Section 4980A(d) supplemental estate tax in estates of decedents dying before 1997, it usually is wiser to target the smallest portion needed to reduce taxes to the smallest possible amount, which is not necessarily zero. As discussed at VIII, G, 1, below, it may not be appropriate to utilize the net residue denominator employed by the government's fraction rather than a gross residue approach (it is good, however, that the denominator is defined by the government's approach). And none of these examples would be useful in an estate that seeks to pay some taxes in the decedent's estate to secure a Section 2013 previously

taxed property credit in the estate of the surviving spouse or to equalize the estates and thereby minimize taxes paid over both spouses' estates. Drafting formula partial election clauses that adjust to changed values on audit and produce the optimum amount of tax on the death of the surviving spouse is a distinctive (and challenging) undertaking. Nevertheless, the government will approve elections pursuant to formula clauses, [FN319] the regulations permit elections that qualify the portion of a fund necessary to produce a specified dollar amount of income annually, [FN320] and it should be acceptable to make a formula partial election that produces a specified dollar amount of tax payable rather than a reduce taxes to zero approach.

a. Separate Shares Permitted

In addition to drafting a formula partial election properly, it is necessary to consider the effect of the partial election on other portions of the document. For example, what will be the effect of a partial election on the "Taxes, Debts, and Expenses" clause? Is it clear that the tax imposed on the surviving spouse's death under Section 2044 will be payable only out of the elected portion of the trust, and that taxes caused on the decedent's death by virtue of making only a partial election will be paid out of the nonelected portion of the trust? To ease the determination of these issues the regulations [FN321] permit separate trusts to be created by a partial election:

Division of trusts -- (A) In general. A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law. Any such division must be accomplished no later than the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.

(B) Manner of dividing and funding trust. The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust. [FN322]

If separate trusts are not created but a partial election is made, the regulations [FN323] make it clear that principal invasions can be made from the portion as to which the QTIP election was made, before invasions are made from the nonelected share. Thus, the property included in the surviving spouse's estate is reduced by invasions from the QTIP trust as though no invasions were made from the nonelected portion and no distributions were made from the nonmarital trust. [FN324]

To accomplish this form of planning, the following format is thought to qualify on the basis of the present state of the law:

A portion of the Marital Trust, herein referred to as the "qualified terminable interest portion," shall qualify for the federal estate tax marital deduction. The value of the qualified terminable interest portion at any time may be determined by multiplying the value of the trust estate at that time by the fraction then in effect. Commencing with my death, and until the first distribution of principal pursuant to the provisions of section [*], the numerator of the fraction shall be equal to [the amount or formula determined deduction desired], and the denominator shall be the value as finally determined for federal estate tax purposes of all interests in property included in the Marital Trust. At the time of each payment of principal pursuant to the provisions of section [*], the fraction shall be adjusted, first by restating it so that the numerator and denominator are the values of the qualified terminable interest portion and of the trust estate, respectively, immediately prior to the payment, and then by subtracting the amount of the payment from each of the numerator and the denominator, except that the numerator shall not be reduced below zero.

As authorized by the regulations, [FN325] the last sentence of this provision creates a "rolling fraction," which has the effect of treating any invasions of principal for the benefit of the surviving spouse (pursuant to section [*], permitting discretionary distributions by the trustee or withdrawals by the surviving spouse), as coming from the elected qualified terminable interest portion. The effect is to reduce the amount of property includible under § § 2044 and 2519 on termination or disposition of the surviving spouse's income interest.

Example: The initial fund consisted of \$1,000,000 and the initial fraction was 4/10 (which produced an optimum marital deduction). A distribution of assets worth \$100,000 is made to S when the trust is valued at \$1,500,000. The fraction immediately before the distribution, restated to reflect current values, is 600,000 / 1,500,000 (4/10ths of \$1.5 million) and, immediately after the distribution, the fraction is 500,000 / 1,400,000 (5/14). The amount that would be includible in S's estate if S dies when the balance of the trust is valued at \$2,100,000 would be \$750,000 (5/14ths of \$2.1 million). Had the fraction not been adjusted, the inclusion amount would have been \$840,000 (4/10ths of \$2.1 million). Thus, the effect of the rolling fraction adjustment is to take all of the distribution to S, rather than just 40% of it, from the marital portion.

The practical problem in the administration of a trust with a rolling fraction is that, before the fraction can be adjusted, it first must be restated to reflect current values. Thus, every asset in the fund must be revalued, which may create a difficult, time-consuming, and potentially

expensive administrative chore. [FN326] Consequently, most planners direct division of the original fund into two separate funds following a partial election, which accomplishes the same result as the rolling fraction, without the need to engage in the administrative chore of adjusting the fraction.

Comment: The rolling fraction may be wise planning because division into separate trusts has the disadvantage of requiring administration of multiple separate entities, including: (1) the nonmarital trust, (2) any nonelected portion of the QTIP trust, (3) any \$1 million generation-skipping transfer tax exempted portion of the estate tax elected portion of the QTIP trust, as required by the "all or nothing" rule in Section 2652(a)(3)(B), and (4) the balance of the estate tax elected portion of the QTIP trust. The rolling fraction also may be useful if the trust owns difficult to sever assets, such as the right to receive distributions from an IRA or qualified employee benefit plan. On the other hand, it may be preferable to sever and pursue different investment strategies (e.g., "high yield" for the elected portion and "growth" for the nonelected portion) that would not be possible in a single trust using the rolling fraction. If the rolling fraction approach is used, it makes sense to direct that distributions of principal to the surviving spouse be made first from that portion of the estate tax elected portion of the QTIP trust (trust #4, above) that is not also the reverse QTIP elected portion meant to shelter the decedent's \$1 million generation-skipping tax exemption, as authorized in PLR 9002014.

b. Paying Taxes from Nonelected Portion

If a partial qualified terminable interest election is made, the equitable result may be for the taxes generated by that decision to be paid out of the nonelected portion of the QTIP trust. By proper accounting, this decision will not affect the amount includible at the subsequent death of the surviving spouse because, in estate plans that embrace the concept of equitable apportionment, taxes in the decedent's estate are not paid from the qualified portion of the QTIP in any event. See V, B, 3, c, above. Instead, the issue here is whether to pay these taxes from the nonmarital portion of the decedent's estate or from the nonelected portion of the QTIP trust.

Each choice has advantages, so some gambling is required. Because the government's position is that both the elected and nonelected portions of the QTIP trust must direct the payment of all income to the surviving spouse, [FN327] while a nonmarital trust may permit accumulations of income, payment of taxes from the nonelected portion of the QTIP trust effectively will reduce the income subsequently generated and payable to the surviving spouse, thereby potentially reducing income taxes during the surviving spouse's overlife (if

that income is distributable to lower income taxable beneficiaries) and the amount subject to inclusion in the surviving spouse's gross estate at death. On the other hand, because the nonelected portion of the QTIP trust must direct the payment of all income annually, generally it will produce a larger Section 2013 credit than a discretionary income nonmarital trust, which is relevant if the surviving spouse may die within 10 years after the decedent.

Perhaps more importantly, payment of the tax from the nonelected portion of the QTIP trust, rather than from the nonmarital trust, guarantees that the ultimate beneficiaries of the QTIP trust, who would have paid the tax when the surviving spouse dies if a QTIP election had been made for the entire property, will pay the tax under a partial election as well. The only effect of the partial election is whether a portion of those taxes will be incurred at the decedent's death instead of all tax being paid at the death of the surviving spouse. This consequence can be important if the QTIP and nonmarital trusts pass to different remainder beneficiaries and reflects the fact that, under Section 2207A, any tax on the QTIP trust incurred at the surviving spouse's death (or earlier, under Section 2519) is payable from the QTIP trust. In most cases this tax apportionment should not change just because a particular QTIP election causes a portion of the tax to be incurred when the decedent dies. Furthermore, preventing payment from the nonmarital trust avoids the use of potentially generation-skipping exempt property to pay estate taxes if the nonmarital trust was the first fund to which the \$1 million generation-skipping transfer tax exemption was allocated.

Although it should not be necessary to physically segregate the elected and nonelected portions of the QTIP trust following a partial election, a division might make it easier for the fiduciary to account for each portion and identify the taxes apportioned to the nonelected portion without jeopardizing the marital deduction for the elected portion. Thus, the drafter probably should decide whether taxes should be paid from the nonelected portion and, if so, whether to direct that the QTIP be severed into two portions. [FN328]

In addition, it is conceivable that the government's position on contingent income, discussed below, could have an effect on this issue, because use of corpus to pay taxes from the nonelected portion would necessarily reduce the income generated thereby, which the government argues must be payable to the spouse in all events, even if the election is not made. That position is ill founded and has been rejected by the courts that have considered it, and its extrapolation would be improper even if it were correct (because it would create an exclusive beneficiary requirement for nonelected property that is not justified by the Code or regulations). But caution dictates that the tax payment issue be considered until the contingent income issue has been resolved finally in the taxpayer's favor.

c. Contingent Income

Most estate plans direct that property not passing pursuant to a marital deduction bequest be held in a nonmarital trust and many nonmarital trusts contain discretionary income distribution provisions. Some plans also provide that any nonelected portion of a QTIP trust pours over to the nonmarital trust, which until 1998 the government regarded as a violation of the all income requirement if the nonmarital trust income is not guaranteed to the surviving spouse. [FN329] Previously, the government's position was that a nonelected QTIP pour-over provision to a discretionary income trust would disqualify the entire QTIP trust for marital deduction purposes under Section 2056(b)(1), even if the personal representative made a 100% QTIP election, asserting that, on the happening of an event or contingency (the executor's partial QTIP election), the surviving spouse's mandatory income interest terminated or failed and an interest in the QTIP trust passed under the decedent's estate plan to someone other than the surviving spouse or his or her estate. Put another way, failure to preserve the same dispositive provisions without regard to whether the QTIP election is made violated the government's interpretation that the surviving spouse's right to receive income cannot be contingent on the election being made. This issue created quite a saga, [FN330] which finally ended with promulgation of final regulations in 1998. An abbreviated summary of the progression is provided here for perspective, along with a description of the final result.

In TAM 8631005 the surviving spouse was the personal representative and, notwithstanding the partial QTIP election pour-over provision and its corresponding contingent income problem, the government allowed the marital deduction because the QTIP election, which would turn on or off the income entitlement, was in the hands of the surviving spouse. In *Clayton Est. v. Comr.*, [FN331] the surviving spouse was one of two co-executors of the decedent's estate, which provided for nonelected QTIP property to pour-over to a nonmarital trust that did not guarantee payment to the spouse of all income annually. The probate court granted an order appointing the spouse as sole executor until the federal estate tax return was filed, presumably seeking to bolster the estate's effort to argue that the surviving spouse alone controlled the QTIP election. The Tax Court nevertheless rejected the sole executor theory for qualification of the QTIP marital deduction because the taxpayer did not "articulate grounds for reaching a contrary result merely because the control over the assets was possessed by [the surviving spouse] in her capacity as executrix" and because the spouse might fail to become or cease to act as executor -- in which case the other co-executor would immediately take over administration of the estate and file the return. [FN332] The court also rejected the argument that, by making the QTIP election, the property qualified for the marital deduction and did not pour-over to the nonqualifying trust, stating that the Code requires that the income interest must qualify for the marital deduction independent of the QTIP election being made.

PLR 9224028 then expansively interpreted Clayton with potentially far-reaching consequences. The government ruled that the marital deduction was not available for an otherwise QTIPable trust because any nonelected property was distributable to a nonmarital trust. According to the government, if the personal representative did not make the QTIP election, the surviving spouse would be divested of any interest in the QTIP trust, making the personal representative's power not to elect QTIP treatment tantamount to an impermissible power in the personal representative to appoint the QTIP property in violation of Section 2056(b)(7)(B)(ii)(II) (no person may have a power to appoint QTIP property to anyone other than the surviving spouse). Without mentioning whether the nonmarital trust allowed distributions of corpus to anyone other than the spouse, or whether it provided for the payment of all income to the spouse annually, the government simply held that this power to control the QTIP trust corpus alone was sufficient to preclude a QTIP marital deduction. With that conclusion, the issue regarding contingent income became far more significant because even a mandatory income nonmarital trust with the ability to distribute corpus to a third party (or even to pay taxes) could constitute an impermissible power of appointment. As stated by the Tax Court, the election gave the executor "control over the trust assets [that] is tantamount to a power to appoint property that was subject to the qualifying income interest" in violation of Section 2056(b)(7)(B)(ii)(II). [FN333] This gratuitous statement then provided the government with a theory that any QTIP trust that pours nonelected property over is flawed, even if the nonmarital trust is QTIPable in its own right.

Comment: That was not a proper result because no abuse was involved, and its extrapolation from Clayton (in which the nonmarital trust could not be qualified as a QTIP trust because it did not guarantee all income to the surviving spouse and it gave the surviving spouse an impermissible nongeneral inter vivos power of appointment) was unwarranted. Nevertheless, PLR 9224028 illustrated that the Tax Court decision in Clayton was a far more significant decision than it appeared originally.

A factually similar case, *Robertson Est. v. Comr.*, [FN334] decided within two weeks after release of PLR 9224028, reached the same result for the same reason. And in *Spencer Est. v. Comr.*, [FN335] the marital deduction similarly was disallowed. But the most outrageous application of the Clayton power of appointment theory was PLR 9226059, which held that a power expressly granted to a surviving spouse to "at any time and from time to time renounce or disclaim the whole or any part of an interest in" a QTIP marital deduction trust, upon which the interest would pass to a designated charity, was an impermissible power of appointment that would disqualify the trust under Section 2056(b)(7)(B)(ii)(II). The marital deduction was saved in that case only because the surviving spouse disclaimed this power to disclaim. Observation: If the power to disclaim granted by the document in PLR 9226059 is improper, then it should follow that no QTIP trust could qualify for the marital deduction unless the

trust denies the right of a surviving spouse to disclaim benefits from the trust, which is patently unreasonable and inconsistent with the government's own regulations, [FN336] which deal with disclaimers in all forms of marital bequests. The position taken also is unnecessary if the spouse's disclaimer in this case were not timely under Section 2518 the result would be gift taxation under §§ 2511 and 2519 if a QTIP marital deduction previously had been allowed, and if the disclaimer were timely under Section 2518 the result would be that no marital deduction would be allowed. [FN337] Either way the government is not harmed and there is no need for the result stated in the PLR, making the government's prohibited power of appointment theory both unwarranted and illogical. Fortunately, and properly, the final regulations abandon it. [FN338]

The Court of Appeals for the Fifth Circuit ultimately reversed Clayton, [FN339] the Court of Appeals for the Eighth Circuit followed suit in Robertson, [FN340] and the Court of Appeals for the Sixth Circuit reached the same result in Spencer. [FN341] In a lengthy decision that detailed the policy underlying the QTIP exception to the nondeductible terminable interest rule, the Clayton court on appeal essentially held that the QTIP election relates back to the date of the decedent's death so that, once the election is made and elected property is identified as remaining in the QTIP trust, nothing in the document diminishes the all income entitlement of the surviving spouse. As stated by the Robertson court on appeal, "it is irrelevant to inquire what would have happened had the election not been made." Rejecting the government's argument that the full property available for election is the property as to which the surviving spouse must have the requisite income interest and as to which no one may have a prohibited power of appointment, both courts essentially held that it is only the portion as to which the deduction is granted that must comply with those requirements. Under that vision, the trusts in Clayton, Robertson, Spencer, and the various PLRs and TAMs comply with the QTIP marital deduction requirements. As stated by the Clayton court on appeal, "the property being tested for eligibility is the same property to which the election made... applies." [FN342] The court went further to deflate the government's power of appointment argument, stating: [FN343]

No reasonable reading or construction of the Will or the statute can validate the position of the Commissioner, as endorsed by the Tax Court, that the... QTIP election itself is "tantamount" to a power of appointment to the testator's children.... To embrace the Commissioner's flawed logic and deliberate disregard of the plain wording of the pertinent part of Code Section 2056 would be to engage in pure sophistry....

From whence it came we know not, but the Tax Court here made the pronouncement that the QTIP election gave the executor "control over trust assets [that] is tantamount to a power to appoint property that was subject to the qualifying income interest." That unsubstantiated,

conclusionary statement can only be the product of a circular argument -- one that we reject. First, the QTIP election cannot vest the executor with control over "trust assets" before they become trust assets! The undivided interests in the securities for which the election is made are estate assets but they do not become trust assets until the trust is funded, even though the economic effect of funding is retroactive to the instant of death. Assets used to fund each testamentary trust get there by virtue of the provisions of the Will and the administration of the estate. The same analysis is applicable to that portion of the quotation from the Tax Court's opinion that refers to property that was subject to the qualifying income interest. No income interest is qualifying until it meets the full definition for QTIP, including the election prong. As we have just noted, one of the three essential elements in the definition of such property interest is that it be property for which -- in the Tax Court's own words -- "an election has been made." <<backslash>>49/

[49] Robertson, 98 T.C. No. 47, at 4976 (emphasis added). [Court's note -- Ed.]

Additionally, the Commissioner appears to have seized on a gratuitous statement from the Tax Court opinion in the instant case to bootstrap an even more adventuresome government position, i.e., that "any QTIP trust that pours nonelected property over is flawed, apparently even if the bypass trust is QTIPable in its own right." <<backslash>>50/ Such an arbitrary and unsupported misconstruction of the statute cannot be justified by any reasonable reading. It can only be explained as overzealousness in revenue collection, deliberate disregard for the clear purpose, intent and policy behind the statute, and a historic aversion to the Marital Deduction which is well documented in the Tax Court Reports, the Federal Reporter System, Treasury Regulations, Revenue Rulings, Technical Advice Memoranda, Private Letter Rulings, and the like.

[50] Pennell, above 11, at C & A 5 (Supp. 8/10/92). "This is not a proper result, because no abuse is involved, and its extrapolation from Clayton... is unwarranted.... Nothing in the government's proposed QTIP regulations anticipates or warns taxpayers about this unwarranted result." Id. [Court's note, citing this portfolio -- Ed.]

"Loophole" is a term frequently used as a pejorative in the context of taxation. Although it is usually reserved for taxpayers and their professional advisors, in truth the Commissioner and the Service are no less active in probing tax statutes for loopholes. Historically, that has been part of the game, leaving to Congress the damage control of plugging loopholes through technical amendments. The position taken by the IRS and advocated by the Commissioner in the instant case, however, goes beyond mere probing for loopholes overlooked by Congress. Rather, it reflects an effort to batter such a hole in the statutory wall where none exists. We

will not approbate such overreaching.

In addition to these forceful positions regarding the power of appointment flier taken by the government, the Clayton court on appeal also produced the following analogy dealing with the relation back principle of the QTIP election that should speak to, and negate, the government's disclaimer position in PLR 9226059: [FN344]

The question is not when those determinations are made or when those acts are performed but whether their effects relate back, ab initio, to the moment of death. For example, a qualified disclaimer by the Surviving Spouse has precisely the effect of the QTIP election here: Both are volitional acts; both can be made only after the death of the testator; both relate back, ab initio, to the date of death of the testator; and both have the effect of causing estate property which would otherwise pass to the Surviving Spouse to pass instead directly to or for the benefit of other parties.

According to the court, neither should negate the marital deduction to the extent the QTIP election is made and no interest required for qualification is disclaimed.

The issue came to the Tax Court again in *Clack Est. v. Comr.*, [FN345] a reviewed opinion in which 16 judges essentially joined in or concurred in the court's decision to reverse itself in light of its track record on appeal, stating that it "will no longer disallow the marital deduction for interests that are contingent upon the executor's election under Section 2056(b)(7)(B)(v), where the election is actually made under facts similar to those in the instant case." [FN345.1]

Comment: Notwithstanding the government's unwritten rule that, if it loses the same argument in three different circuits, it will cease pressing the issue, [FN345.2] the government initially acquiesced only in the particular result in *Clack* and for a while left open the possibility that it might continue to argue that the then final regulation was controlling and valid. Presumably its recognition that the regulation was no different from the argument that the courts had been rejecting and therefore would regard as invalid ultimately led the government to promulgate a new regulation throwing in the towel on this issue. [FN345.3] New Regs. Section 20.2056(b)-7(d)(3)(i) restates the former regulation as follows (with the new language highlighted and the deleted language placed in brackets):

[A] qualifying income interest... that is contingent upon the executor's election under Section 2056(b)(7)(B)(v) [deleting "is not"] will not fail to be a qualifying income interest for life because of such contingency or because the portion of the property for which the election

is not made passes to or for the benefit of persons other than the surviving spouse [deleting ", regardless of whether the election is actually made"].

Additionally, Regs. Section 20.2056(b)-7(h) Example 6 is amended to provide:

D's will established a trust providing that S is entitled to receive the income from that portion of the trust the executor elects to treat as qualified terminable interest property. [deleting "S does not have a qualifying income interest for life in any portion of the trust because the income interest is contingent upon the executor's election."] The portion of the trust which the executor does not elect to treat as qualified terminable interest property passes as of D's date of death to a trust for the benefit of C, D's child. Under these facts the executor is not considered to have a power to appoint any part of the trust property to any person other than S during S's life.

This regulation also grants an extension of time to make a QTIP election for decedents whose estate tax returns were due on or before the temporary regulation was released on February 18, 1997.

On a related matter, the result in *Spencer* may raise more questions than it resolved, because the opinion on appeal in *Clayton* regarded the QTIP election as relating back to the date of death so that, if the right to income was guaranteed with respect to the elected portion, it was deemed to be guaranteed at all times after the decedent's death. *Spencer* regarded that holding as an unnecessary legal fiction. Instead, *Spencer* stated that qualification for the marital deduction is to be determined "upon the date of the QTIP election," rather than at the date of the decedent's death, which is sufficiently beyond prior authority that it raises the spectre of a further challenge by the government. Indeed, some attorneys will read *Spencer* as standing for the proposition that, if a trust did not qualify for the marital deduction at the decedent's death but it can be reformed before the QTIP election is required to be made, that trust will qualify for the deduction. Although a marital deduction reformation procedure would be a sensible addition to the Code, it took legislative action to provide its counterpart in Section 2055(e) and it is unlikely that it will be deemed to exist by judicial fiat following *Spencer*. As a result, *Spencer* probably has a bull's eye painted on it, not any longer for the *Clayton* issue aspect but for the postmortem reformation implications that it creates. *Rapp Est. v. Comr.*, [FN345.4] sidestepped the issue whether *Spencer* is tantamount to a postmortem judicial reformation authority, the court holding that a postmortem state court reformation of a defective QTIP trust (it only paid income in the trustee's discretion) was not adequate to qualify the trust for the marital deduction because the state court proceeding was not binding on

the federal government and, therefore, the trust failed to qualify regardless of when the all income annually test was applied: at death or when the QTIP election was made.

5. Inter Vivos QTIPs

Estate planning for spouses with disparate wealth often leads to the suggestion that the more wealthy spouse make a gift to the less wealthy spouse to cover the contingency of "deaths out of order." Often a planning concern in noncommunity property states, the tax-sheltering benefit of one unified credit (and, in larger estates, a full use of the estate tax brackets or that spouse's \$1 million generation-skipping transfer tax exemption) may be lost if the nonpropertied spouse dies first and no inter vivos intraspousal gifts were made. Until the advent of the inter vivos QTIP trust, the only way to address this concern was by outright lifetime gift to the less wealthy spouse or an inter vivos general power of appointment marital deduction trust (which gave the donee spouse unfettered power to dispose of the transferred property), or by a Section 2513 inter vivos split gift to a third party (which took the property out of the marital coffers entirely). Since its enactment in 1982, however, Section 2523(f) allows the propertied spouse to create an irrevocable inter vivos QTIP trust to pay income to the donee spouse for life with the remainder passing as the donor spouse originally designated in the trust, or as the donee may appoint pursuant to a nongeneral testamentary power of appointment, if granted by the trust. [FN346] The donor spouse may make an inter vivos QTIP election under Section 2523(f)(4), making the initial transfer gift-tax free and, on the donee spouse's death, corpus will be includible in the donee spouse's gross estate, thus sheltering that spouse's unified credit, taking advantage of the donee spouse's \$1 million GST tax exemption, or taking advantage of a full bracket run in the donee spouse's estate -- all without giving the donee spouse more control over the trust property than the donor chooses.

A frequent inquiry in this arena is whether the donor spouse may retain enjoyment of the trust property after the donee spouse dies, if the donor survives. In such a plan the question is whether the retained secondary life estate in the donor will cause Section 2036(a)(1) to apply when the donor subsequently dies. The government's private letter ruling position is that trust property includible in the donee's gross estate at death under Section 2041 is regarded as if the donee spouse were the transferor and any secondary life estate in the donor is deemed created by the donee spouse, rather than having been retained by the donor. [FN347] Under this vision, Section 2036(a)(1) would not apply at the donor's subsequent death.

An inter vivos transfer into a QTIP trust that reserves a secondary life estate to the donor spouse is the subject of Section 2523(f)(5)(A). If the

never subjected to comment as a proposed regulation, is ripe for challenge.

6. Estate Tax Attributable to QTIP Trust

Absent a contrary provision in the surviving spouse's will, Section 2207A provides that any tax attributable to inclusion of QTIP trust corpus in the surviving spouse's gross estate under Section 2044 (and any interest and penalties attributable thereto) is recoverable from the corpus of the QTIP trust. The amount of tax attributable to the QTIP trust, computed under Section 2207A(a)(1), is the difference between the amount of the actual estate tax in the surviving spouse's estate and the amount of estate tax that would be due if the corpus of the QTIP trust was not includible. Thus, Section 2207A allows a recovery of the amount the surviving spouse's estate tax is increased by inclusion of the QTIP, sometimes referred to as the "incremental" tax attributable to the QTIP. [FN364] However, no recovery is granted for any amount of the surviving spouse's unified credit exhausted by the inclusion (because Section 2207A is for tax paid, not for tax payable), [FN365] nor for any state estate or inheritance taxes attributable to the QTIP trust.

If the surviving spouse's estate seeks recovery of the tax after the trust property has been distributed to the remainder beneficiaries, the estate is entitled to recover the tax from the distributees. [FN366] And, if there is more than one QTIP disposition includible in the surviving spouse's estate (e.g., because the surviving spouse was beneficiary of both a QTIP trust and a QTIP-elected legal life estate), the right to recover with respect to each disposition is a pro rata share of the total tax attributable to inclusion of all the QTIP assets. [FN367]

Failure of the surviving spouse's estate to exercise the right to recover the tax under Section 2207A is a taxable gift "from the persons who would benefit from the recovery" (usually the surviving spouse's residuary beneficiaries) "to the persons from whom the recovery could have been obtained" (the QTIP remainder beneficiaries), [FN368] although this gift may be negated to the extent the spouse's beneficiaries cannot compel recovery because the spouse waived the right or, presumably, because the QTIP remainder beneficiaries are judgment proof. [FN369] This transfer is considered as made when the right of recovery no longer is enforceable under local law, and any "delay" in exercising the recovery right "may be treated as an interest-free loan with appropriate gift tax consequences under section 7872 depending on the facts of the particular case." [FN370] No guidance exists with respect to the meaning of a "delay."

Typical boilerplate tax payment provisions in the surviving spouse's will waiving all rights of reimbursement for taxes paid should not be used in drafting the surviving spouse's estate plan if recovery of these taxes is

desired. Instead, a provision like the following should be employed:

My personal representative shall pay from the residue of my estate all estate and inheritance taxes assessed by reason of my death, except that the amount, if any, by which the estate and inheritance taxes shall be increased as a result of the inclusion of property in which I may have a qualifying income interest for life shall be paid by the person holding or receiving that property. I waive for my estate all rights of reimbursement for any payments made pursuant to this article.

The intended effect of this provision is to preserve the tax apportionment anticipated by Section 2207A while causing the recipients of the QTIP trust to pay tax initially -- rather than imposing on the spouse's estate the cash flow problem of payment followed by reimbursement from the QTIP beneficiaries.

Alternatively, if waiver of the Section 2207A right of reimbursement is desirable, the requisite degree of specificity required also should be considered in light of Section 2207A(a)(2) [FN370.1] and *In re Will of Gordon*, [FN371] in which the decedent's tax clause read "I direct that all... taxes... imposed... by reason of my death with respect to any property includable in my estate... whether such property passes under or outside my will be paid out of my Residuary Estate... without apportionment." If the court in *Gordon* had found that the Section 2207A reimbursement right had been waived by this provision, a charitable residuary bequest would have abated completely, which clearly was not the decedent's intent. Therefore, the court found that this provision was not adequate to work that result. [FN372] Although waiver might avoid nasty gift tax problems, it also may be inappropriate if the surviving spouse's estate otherwise is unable to pay its estate taxes. [FN373] Comment: As illustrated in the sample provision, above, a better approach to the problem of being able to pay the tax, without running the risk of an inadvertent gift tax liability caused by a failure to assert the right of reimbursement, is to waive the Section 2207A right of reimbursement by a provision in the surviving spouse's will while also preserving a state law right of outside apportionment of taxes against nonprobate property includible in the surviving spouse's gross estate. [FN374]

A surviving spouse who assigns all or any part of a QTIP income interest triggers a gift of the full value of the remainder interest in the QTIP trust under Section 2519, in addition to the Section 2511 gift of the value of the assigned income interest. The surviving spouse is liable for the gift tax on both transfers, but is entitled under Section 2207A to recover the gift tax attributable to the gift of the remainder interest from "the person receiving the property," which is the trustee if the property is held in trust. [FN375] Failure of the surviving spouse to exercise this right of recovery may result in a taxable gift to the persons who are benefitted thereby, although the final regulations that address this issue were "reserved" pending comment on the effect of a waiver of that right. [FN376]

Without full explanation, TAM 9736001 agreed with Prop. Regs. Section 25.2519-1(c) that the value of a Section 2519(a) gift is calculated as a net gift. Involved in a QTIP trust was the surviving spouse's nonqualified disclaimer that triggered Section 2519 gift taxation, subject apparently to an agreement between the spouse and the trust remainder beneficiaries: "Under the terms of the transfer, the donees agreed to pay all gift taxes generated by the transfer." As a consequence, the surviving spouse treated the Section 2519 transfer of the remainder interest as a net gift, which the TAM concluded was proper, because Section 2207A "shifts the burden, but not the liability, for paying the gift tax." Which is to say that the liability remains the spouse's and the burden being shifted by the agreement consistent with Section 2207A is tantamount to a net gift. The National Office recognized that it is not necessary that the surviving spouse affirmatively impose this obligation on the beneficiaries, as the spouse did in TAM 9736001, because "net gift treatment of a transfer under Section 2519 is implicit under Section 2207A(b)." It never is clear whether a TAM signals the government's position and they are not written by those who craft the regulations, so it is impossible to know whether this result telegraphs the result to expect when (if ever) the Treasury responds to any comments received on this issue.

Given these rights of reimbursement, the beneficiaries of a QTIP trust are intimately affected by tax computations and payment by the surviving spouse's estate. Yet they may have no protection if the surviving spouse's personal representative files a return with generous values for non-QTIP assets to obtain a high basis for those assets, while causing a higher incremental tax attributable to the QTIP beneficiaries.

To illustrate the possible conflicts that may arise in a similar context, consider *Dixon Est. v. Comr.*, [FN377] in which the decedent's estate disputed a deficiency assessed for the undervaluation of its major asset, corporate stock. The surviving spouse moved to intervene, asserting an interest in the proceeding adverse to the estate because it was in the surviving spouse's interest to have the adjusted gross estate valued as high as possible because the higher the estate tax value, the more the surviving spouse would receive under a pre-1982 maximum allowable marital deduction bequest. The bequest was to be satisfied out of assets other than the corporate stock and the surviving spouse's share was to be free of any estate taxes, so an inflated value of that stock also would not work to the spouse's ultimate detriment. Affirming the Tax Court's refusal to grant intervention on the ground that doing so would "open Pandora's box," the Court of Appeals for the Ninth Circuit held that the Tax Court had discretion to grant or deny intervention and that the Tax Court's decision could be reversed on appeal only if an abuse of discretion was shown. The court was most persuaded by the government's arguments that allowing intervention might cause a "flood" of motions for intervention by beneficiaries adversely affected by Tax Court valuations, and that the surviving spouse's underlying concern was the proper division of the trust corpus, which is a

matter of state law. Thus, the beneficiaries' only remedy in a case in which an alleged overvaluation occurs, especially one involving valuation of a QTIP trust for Section 2207A reimbursement purposes, appears to be a state court proceeding asserting a violation of fiduciary duties.

7. Annuities, Employee Benefit Payments, and Individual Retirement Accounts

An annuity generally will qualify for the marital deduction if there is no refund or survivor benefit payable, other than to the surviving spouse's estate, that would cause the annuity to be a nondeductible terminable interest. [FN378] If the annuity is a terminable interest because there is an interest in a beneficiary other than the surviving spouse, automatic QTIP qualification will salvage the marital deduction if the annuity was includible in the decedent's gross estate under Section 2039 and the surviving spouse is the sole beneficiary during the spouse's overlife. [FN379]

These two forms of qualification cover many annuity situations, leaving as a major category only individual retirement accounts (IRAs) in which a QTIP trust is the sole designated beneficiary during the surviving spouse's overlife but a remainder benefit is payable to a third party after the spouse's death. With respect to these IRAs, the regulations and at least one published ruling [FN380] complicate the issue of annuity qualification because they presume uncommon annuity installment payments during the spouse's overlife of the IRA corpus plus annual payment of an amount equal to all income earned by the entire undistributed IRA balance. Because this added income distribution is not customary, planners worry about qualifying other forms of annuity payouts for the marital deduction. The government has made clear, however, that the illustrated payout is not the exclusive method of qualifying IRAs or other terminable interest annuities for the marital deduction and planners therefore need not agonize over duplicating the unusual payout illustrated in those authorities.

PLR 9317025 provides a veritable road map of how to draft an IRA with a QTIP trust as beneficiary and qualify for the marital deduction: (1) the IRA itself required annual distribution of an amount no less than all income generated in the IRA for the year; (2) the QTIP trustee was directed to exercise its authority to demand distributions from the IRA of no less than this amount if that mandate was not met; (3) the surviving spouse was given a power to compel the QTIP trustee to make that demand; and (4) the QTIP trustee was directed to allocate to trust income distributions received from the IRA equal to the income earned in the IRA. In addition, the surviving spouse was given a power to compel the QTIP trustee to: (5) convert underproductive property to property producing a reasonable amount of income annually, or (6) distribute QTIP trust amounts at least equal to the income that would be earned by assets producing reasonable income. [FN381] Subsequently, PLR 9320015 ruled