

Excerpt,

**“Mastering the Fundamentals
of Estate Planning”**

HARVEY & MORTENSEN

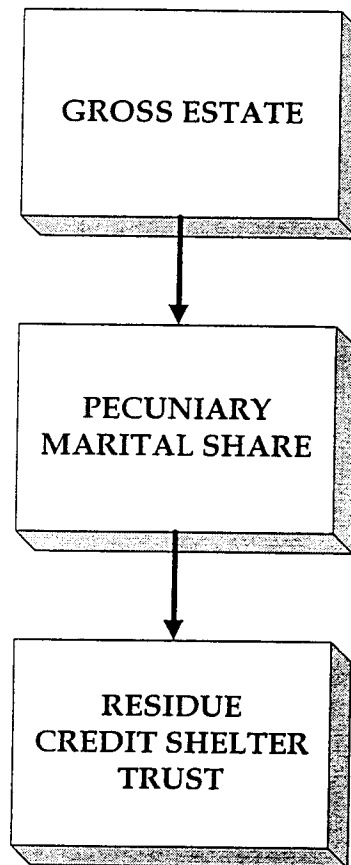
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- a. Specific dollar amount -- Many marital deduction gifts are expressed as a specific dollar amount or a bequest of specific property.
 - (i) Specific dollar amount -- I give to X, my wife, the sum of \$250,000.
 - (ii) Bequest of specific property -- I give to Y, my husband, my 5,000 shares of IBM stock.
- b. Specific percentage of estate -- The first spouse may want to divide the estate between his surviving spouse and children.
 - (i) Example: I give my wife, X, 40 percent of my entire estate and the remaining 60 percent shall pass in trust for the benefit of my children from a prior marriage.
- c. Marital formula clause -- There are two basic forms of marital formula clauses. Although both clauses arrive at the same marital share, they do so in a different manner.
 - (i) Pecuniary marital clause -- In a pecuniary marital clause, the surviving spouse receives a specific dollar amount of the estate determined by reference to a formula. Some sample language:

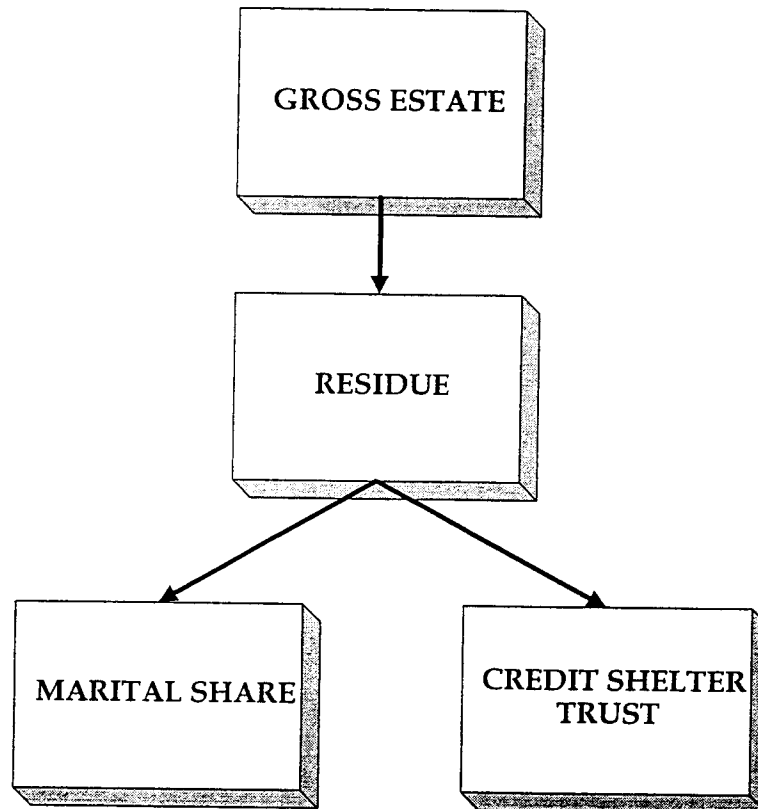
Maximum marital deduction -- Pecuniary formula bequest -- Maximize applicable credit amount -- Payable to wife. If my wife shall survive me, I give, devise, and bequeath to my wife, cash, securities, or other property of my estate (undiminished by any estate, inheritance, succession, death, or similar taxes) having a value equal to the *maximum marital deduction as finally determined in my federal estate-tax proceedings, less the aggregate amount of marital deductions (if any) allowed for such tax purposes by reason of property or interests in property passing or that have passed to my wife otherwise than pursuant to the provisions of this Item; provided, however, the amount of this bequest shall be reduced by the amount, if any, needed to increase my taxable estate (for federal estate-tax purposes) to the largest amount that, after allowing for the applicable credit amount against the federal estate tax, and the state death-tax credit against such tax (but only to the extent that the use of such state death-tax credit does not increase the death tax payable to any state), will result in the smallest, if any, federal estate tax being imposed on my estate* -- The term "maximum marital deduction" shall not be construed as a direction by me to exercise any election respecting the deduction of estate administration expenses, the determination of the estate-tax valuation date, or any other tax election that may be available under any tax laws, only in such manner as will result in a larger allowable estate-tax marital deduction than if the contrary election had been made. My Executor shall have the sole discretion to select the assets that shall constitute this bequest. In no event, however, shall there be included in this bequest any asset or the proceeds of any asset that will not qualify for the federal estate-tax marital deduction, and this bequest shall be reduced to the extent that it cannot be created with such qualifying assets. My Executor shall value any asset selected by my Executor for distribution in kind as a part of this bequest at the value of such asset at the date of distribution of such asset.



- (ii) Formula fractional share clause -- A fractional share of the decedent's residuary estate is bequeathed to the surviving spouse. The numerator of the fraction is the maximum allowable marital deduction (reduced by other qualifying nonprobate or probate transfers) and the denominator is the residuary estate. Thus, the surviving spouse receives a fraction of every asset in the residuary estate. Some sample language:

Maximum marital deduction -- Fractional share formula bequest -- Maximize applicable credit amount -- Payable to wife. If my wife shall survive me, my Executor shall divide my residuary estate into Two (2) separate shares, hereinafter designated as "the Marital Share" and "the Family Trust." The Marital Share shall be composed of that *fraction of my residuary estate (undiminished by any estate, inheritance, succession, death, or similar taxes) determined as follows: the numerator of the fraction shall be the maximum marital deduction as finally determined in my federal estate-tax proceedings, less the aggregate amount of marital deductions (if any) allowed for such tax purposes by reason of property or interests in property passing or that have passed to my wife otherwise than pursuant to the provisions of this Item; provided, however, the numerator for the Marital Share shall be reduced by the amount, if any, needed to increase my taxable estate (for federal estate-tax purposes) to the largest amount that, after allowing for the applicable credit amount against the federal estate tax, and the state death-tax credit against such tax (but only to the extent that the use of such state death-tax credit does not increase the death tax payable to any state), will result in the smallest, if any, federal estate tax being imposed on my estate. The denominator of the fraction shall be the value of my residuary estate as finally determined in my estate-tax proceedings* -- The term "maximum marital deduction" shall not be

construed as a direction by me to exercise any election respecting the deduction of estate administration expenses, the determination of the estate-tax valuation date, or any other tax election that may be available under any tax laws, only in such manner as will result in a larger allowable estate-tax marital deduction than if the contrary election had been made. In no event, however, shall there be included in the marital fraction any asset or the proceeds of any asset that will not qualify for the federal estate-tax marital deduction and the marital fraction shall be reduced to the extent that it cannot be created with such qualifying assets. Such nonqualifying asset shall be allocated to the Family Trust and the marital fraction shall be created from my residuary estate less the nonqualifying asset. The Marital Share shall be paid over and distributed to my wife and the Family Trust shall be the balance of my residuary estate.



4. Basis considerations

Under carryover basis, the allocation of the basis increase to the property passing to different beneficiaries can have significant tax impact. The \$3 million step-up is worth \$600,000 of saved capital gains tax. The issue of the amounts passing to the bypass trust and the marital share is complicated by the possibility of carryover basis in the future. Assets passing to the spouse outright or by QTIP will qualify for the \$3 million step-up in basis. However, such assets do not qualify for a basis step-up in the estate of the surviving spouse because they are not owned by the surviving spouse.

Note:

Remember that the step-up is framed in terms of appreciation, not value, and consequently the value of the property that may be required to fully qualify for the step-up may be way out of bounds from what a client may want. However, given the \$4.3 million of appreciation available in the estate of the first spouse, this is a problem that will generally only affect very large estates.

Planning point:

There is nothing to preclude the inclusion in the credit shelter (bypass) trust of a provision authorizing the trustee of that trust to make distributions of principal to a spouse in order to qualify for the basis step-up.

5. Marital and nonmarital share example

Example: Suppose H and W have a combined estate of \$2,000,000. H owns a \$1,100,000 residence and W owns \$900,000 of securities. H and W have identical wills providing for the use of the applicable credit amount. H and W live in a state with no death taxes. Assuming H predeceases W, how would the calculations differ between a pecuniary marital formula and a fractional share marital formula. Assume there are no administration expenses and H predeceases W.

- a. Pecuniary marital formula -- **Translation of above legalese** (assuming no state death-tax credit): the largest marital share to result in the lowest estate tax after considering the applicable credit amount. Thus, the largest marital share would be \$1,100,000, but after considering the applicable credit amount \$1,000,000 (2002), the largest marital would be \$100,000. The calculation would work as follows:

Gross Estate	\$1,100,000
Marital Deduction	-\$100,000
Taxable Estate	\$1,000,000
Federal Tax	\$345,800
Applicable Credit Amount (2002)	-\$345,800
Net Federal Tax	\$ 0

- b. Fractional share marital formula -- **Translation of above legalese** (assuming no state death credit): assets going to marital share equal my residuary estate times a fraction, the numerator of which is the largest marital share to result in the lowest estate tax after considering the applicable credit amount and the denominator is my residuary estate. Thus, the largest marital share would be \$1,100,000, but after considering the applicable exclusion amount (2002) (\$1,000,000), the largest marital would be \$100,000. The calculation would work as follows:

$$\begin{aligned}
 &= \text{Residuary estate} \quad \times \quad \frac{\text{Marital Deduction less other transfers to spouse}}{\text{Residuary Estate}} \\
 &= \$1,100,000 \quad \times \quad \frac{\$100,000 - 0}{\$1,100,000} \\
 &= \$100,000
 \end{aligned}$$

Gross estate	\$1,100,000
Marital deduction	-\$100,000
Taxable estate	\$1,000,000
Federal tax	\$345,800
Applicable credit amount (2002)	-\$345,800
Net federal tax	\$ 0

5. Calculating the credit-shelter trust

In calculating the credit-shelter trust, the tax professional must be extremely cognizant of the wording used in the formula clause.

- a. Formula with language considering state death-tax credit in all events -- A traditional formula clause will have language requiring the use of all credits, including the state death-tax credit, in calculating the credit shelter amount. Under this formula, the credit will be as large as possible while minimizing estate taxes. Some sample language:

[I give to the marital trust an amount] equal to the maximum marital deduction as finally determined in my federal estate-tax proceedings, less the aggregate amount of marital deductions (if any) allowed for such tax purposes by reason of property or interests in property passing or that have passed to my wife otherwise than pursuant to the provisions of this Item; provided, however, the amount of this bequest shall be reduced by the amount, if any, needed to increase my taxable estate (for federal estate-tax purposes) to the largest amount that, after allowing for the applicable credit amount against the federal estate tax and the state death-tax credit against such tax, will result in the smallest, if any, federal estate tax being imposed on my estate.

Calculation	A	B
Gross estate	\$2,000,000	\$2,000,000
Marital deduction	\$1,000,000	-\$932,337
Taxable estate	\$1,000,000	\$1,067,663
Estate tax	\$345,800	\$373,542
Applicable credit amount (2002)	-\$345,800	-\$345,800
State death-tax credit	-\$17,000	-\$27,742
Net estate taxes	\$ 0	\$ 0

Under this formula, \$1,067,663 in Column B would be the correct credit shelter amount as long as the state had death or inheritance taxes of \$27,742. Some practitioners believe they can under fund by choosing Column A, but that is incorrect. In order to have Column A apply, the practitioner must alter the language of the formula clause as outlined below.

- b. Formula with language preventing increase in state death taxes -- Certain formula clauses have language allowing for the use of the state death-tax credit. However, the credit will only be considered in determining the credit shelter amount if it does not result in an increase in state death taxes. Some sample language:

[I give to the marital trust an amount] equal to the maximum marital deduction as finally determined in my federal estate-tax proceedings, less the aggregate amount of marital deductions (if any) allowed for such tax purposes by reason of property or interests in property passing or that have passed to my wife otherwise than pursuant to the provisions of this Item; provided, however, the amount of this bequest shall be reduced by the amount, if any, needed to increase my taxable estate (for federal estate-tax purposes) to the largest amount that, after allowing for the applicable credit amount against the federal estate tax and the state death-tax credit against such tax (but only to the extent that the use of such state death-tax credit does not increase the death tax payable to any state), will result in the smallest, if any, federal estate tax being imposed on my estate.

In this case, \$1,000,000 in Column A would be the credit shelter amount because the increase in Column B would cause an increase in state death taxes.