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## Chapter 6

### Use of the Marital Deduction in Estate Planning

#### Overview

The marital deduction, considered by many the most important estate tax saving device available, provides a deduction from the adjusted gross estate for all property passing to the surviving spouse. The deduction originated in 1948 when tax-saving provisions related to property passing to a surviving spouse that had been available only in community property States were extended to individuals in all States. The provisions were expanded several additional times, until the Economic Recovery Tax Act of 1981 (ERTA, Public Law 97-34) provided an unlimited deduction for both lifetime and testamentary gifts to spouses. The marital deduction today recognizes both spouses' contribution to the family's assets. Wills written before 1982 that contain a marital deduction clause based on pre-ERTA law should be reviewed and amended if the clause will produce an unsatisfactory result based on current law.

#### Qualifying for the Marital Deduction

The decedent's estate can claim a deduction—the marital deduction—for qualifying lifetime and testamentary (by will at death) transfers of property to a surviving spouse. As noted above, the deduction for both lifetime gifts and testamentary transfers is unlimited. The property actually must pass from the decedent to his (her) spouse; thus, the marital deduction is not available to estates of widows, widowers, or unmarried persons.

Neither is the marital deduction available for gifts or bequests made to spouses who are not United States citizens, unless they are made using a qualified domestic trust. In order to qualify the trust instrument must provide that at least one trustee be a United States citizen or domestic corporation, and that any distribution from the trust principal be subject to the United States trustee's right to withhold the estate tax due on the distribution.

#### Status as Surviving Spouse

The person receiving the decedent's property for which a marital deduction is claimed must qualify as a "surviving spouse" on the date of the decedent's death. A legal separation that has not terminated the marriage at the time of death does not change the status of the surviving spouse. If, however, an interest in property passes from the decedent

to a person who once was the decedent's spouse but was not married to the decedent at the time of death, the interest is not considered as passing to a surviving spouse. If a decedent's divorce from a prior spouse is declared invalid by a State court having jurisdiction, the Internal Revenue Service (IRS) will not allow a marital deduction for the decedent's bequest of property to a subsequent spouse (Revenue Ruling 67-442 CB 65).

A transfer by the decedent during the decedent's lifetime to an individual to whom he (she) was not married at the time of the transfer but to whom he (she) was married at the time of his (her) death and who survives the decedent is a transfer by the decedent to his (her) surviving spouse with respect to gifts includible in a decedent's gross estate under section 2035 of the Internal Revenue Code (IRC).

#### Transfer of Property Interests

To be eligible for the marital deduction the decedent must have been a citizen or resident of the United States at his (her) death. The estate tax marital deduction allows a deduction equal to the value of the property included in the decedent's gross estate that actually passes to the surviving spouse, and which is not a non-qualified terminal interest (IRC section 2056). Not only must the value of the property interest be included in the decedent's gross estate, but it must also be of a type that will be included in the surviving spouse's gross estate to the extent that it is not consumed or given away during the spouse's lifetime.

Property left with no strings attached—an absolute interest—qualifies for the marital deduction. The terminal interest rule [IRC section 2056(b)] generally does not permit a marital deduction for property interests that are terminal interests. A terminal interest is an interest in property that will terminate or fail on the lapse of time or on the occurrence, or failure to occur, of some event or contingency. Examples include life estates, annuities, and property given to a surviving spouse that would revert to the children if the surviving spouse remarries. The purpose of this rule is to require that if property is transferred to the surviving spouse it will be included in the surviving spouse's estate unless disposed of during the surviving spouse's lifetime. Whether or not an interest is a terminal interest is determined by State law at the death of the decedent. Whenever trust between spouses is lacking and conditions are attached to gifts or bequests, the use of the marital

deduction is on shaky ground. As discussed below, there are certain exceptions to the terminal interest rule.

Examples of eligible property transfers to the surviving spouse include: an outright bequest by will; a power of appointment; life insurance proceeds; joint tenancy survivorship; transfers by annuity, insurance, or other contract; and intestate transfers under State law. In summary, any property left with no strings attached is an absolute interest and qualifies for the marital deduction.

Property interests passing to a surviving spouse that are not included in the decedent's gross estate do not qualify for the marital deduction. Expenses, indebtedness, taxes, and losses chargeable against property passing to the surviving spouse will reduce the marital deduction.

## Exceptions to the Terminal Interest Rule

Each spouse must trust the other implicitly for the marital deduction to work effectively. There are five exceptions to the terminal interest rule: (1) qualified terminal interest property (QTIP), (2) general power of appointment, (3) survivorship condition, (4) right to payment, and (5) income interest. These exceptions generally stipulate that the property interests in question will qualify for the marital deduction if certain requirements are met. They also will be taxable in the surviving spouse's estate if not consumed or given away before his (her) death. The most important of these exceptions is the QTIP election.

### QTIP Election

Property under a QTIP election is eligible for the Federal estate tax marital deduction. Under this election, the value of the property is included in the surviving spouse's estate at his (her) death. A more detailed discussion follows.

### The General Power of Appointment

The general power of appointment is the right to determine the ultimate disposition of certain designated property. When a decedent gives his (her) spouse an interest for life, together with a general power of appointment, the possibility of exclusion from the surviving spouse's gross estate is substantially removed. The survivor must have a life interest that entitles him (her) to all the income (payable at least annually), and he (she) has the power to appoint the property to himself (herself) or his (her) estate. Such transfers are permitted to qualify for the marital deduction as exceptions to the terminable interest rule as long as certain conditions are met [IRC section 2056(b)(5)].

### Survivorship Condition

A bequest to a spouse may be conditioned on his (her) survival for a specified period, not to exceed 6 months, after the death of the decedent. It also may apply to a common disaster, providing the spouse does in fact survive the decedent.

### Right to the Payment

The surviving spouse must have a right to the payment of life insurance, endowment, or annuity proceeds, coupled with a power of appointment for the survivor or the survivor's estate. Annuities payable from a trust and commercial annuities qualify.

### An Income Interest

The survivor must have an income interest in a charitable remainder unitrust or annuity trust (see chapter 9) where he (she) is the only non-charitable beneficiary. These conditions apply automatically; however, the executor can elect for these provisions not to apply.

## QTIP and the Marital Deduction

A QTIP is a special form of life estate interest given to a surviving spouse that qualifies for the marital deduction. With a QTIP, the estate owner (first spouse to die) can control the disposition of the remainder interest after the surviving spouse's death (i.e., the property will pass to the children or other beneficiaries the estate owner designates). For example, forest property may be put into a QTIP, with the value qualifying for the marital deduction. The surviving spouse receives the income from the property for life, with the remainder interest passing to the children or other designated beneficiaries at his (her) death.

The amount of the marital deduction resulting from the QTIP election is the net value of the property involved, after reduction of indebtedness charged against it. The debt to be reduced from the property value includes any estate taxes charged against the property.

### Qualification for the QTIP

The QTIP interest must specifically be elected by the executor of the estate on the estate tax return. Once made, it is irrevocable. Failure to make the election also is irrevocable. In certain limited circumstances, a protective election can be made [Treasury Regulation 20.2056(b)-7(c)]. To qualify, the following conditions must be met: (1) the surviving spouse must be entitled to all of the income from the designated property payable at least annually for

his (her) life (this income interest is known as a “qualifying income interest”); (2) a QTIP interest in property not placed in trust must provide the survivor with rights to income that are sufficient to satisfy the rules applicable to marital deduction trusts; and (3) there must be no power of appointment in anyone, including the spouse, to appoint any part of the property subject to the qualified income interest to any person other than the spouse during the spouse’s life. Use of a marital deduction formula, as discussed below, to determine the amount of property passing to a QTIP does not jeopardize the QTIP election (Private Letter Ruling 8814002, October 29, 1987).

The marital deduction is available when the spouse is entitled to all the income from the entire interest in the property, or to the income from only a specific portion of the property. Under IRC section 2207A, the surviving spouse’s estate is entitled to recover from the person receiving the QTIP property the portion of the estate tax attributable to the inclusion of the property in the surviving spouse’s estate, unless the surviving spouse directs otherwise by will. Previously, a general provision in the will that all taxes be paid by the estate was sufficient for this purpose. Under the Taxpayer Relief Act of 1997 (Public Law 105-34), however, such a general provision is no longer sufficient to waive the right of recovery. To waive the right of recovery, the decedent must indicate in the will (or revocable trust) a specific intent to waive such right.

### Contingent Income Interests

Generally, an income interest will not qualify for QTIP treatment if it is contingent on the occurrence of some event. One exception to this rule is making the interest contingent on the executor making a QTIP election [Treasury Regulation 20.2056(b)-7(d)(3)(i)].

### To What Extent Should the Marital Deduction Be Used?

The marital deduction is a powerful planning tool which must be used carefully in order to meet both the forest landowner’s objectives and legal constraints on the transfer of property. The survivor’s estate, his (her) general state of health, and his (her) ability to manage additional resources efficiently also are factors to be considered.

### Legal Rights

Legal rights of the surviving spouse—called dower and curtesy (surviving spouse’s marital right)—to take a share of the real property and sometimes personal property in the estate, must be taken into account in deciding how much and in what form property should pass to the surviving spouse.

The rights of dower and curtesy, under various names, are governed by State law. These decisions will be affected by the presence of children from the current and perhaps former marriages of either or both spouses.

### Nontax Factors

Nontax factors that may affect use of the marital deduction include the nature of the couple’s personal relationship, each spouse’s confidence in the other’s ability, and the likelihood that the surviving spouse will remarry. Spousal trust permits equalization of the estate’s resources (necessary for the marital formulas to work regardless of which spouse is the first to die) and freedom to use all the planning tools that are available to save taxes. On the other hand, lack of trust or fear of a divorce or that the surviving spouse will remarry may force the owner to maintain maximum control, which complicates the planning process.

The surviving spouse’s resources and possible inheritances from other sources should be taken into account in projecting tax outcomes. When young children are present, their needs must be taken into account as well. The value of both spouses’ estates and the effects on each other’s estate tax return should be considered. Other factors include the disposition of a personal residence, which often has a high sentimental value to the surviving spouse.

### Marital Deduction Deferral

The marital deduction defers the estate tax until the surviving spouse’s death; therefore, the estate taxes of both spouses must be considered. If, however, the goal simply is to save the maximum estate tax at the death of the first to die, the marital deduction should be used to the fullest extent possible. A will that states, “I leave everything to my spouse,” results in the deferral of all estate taxes on the death of the first to die. This may, however, create a huge tax problem for the estate of the surviving spouse, especially if that person already has a substantial estate of his (her) own. When the survivor’s health is good and life expectancy is relatively long, the deferral gives time for him (her) to do further estate planning. A number of tax factors, as follows, should be considered.

**Maximize credit**—Maximizing use of the applicable exclusion amount in each spouse’s estate is the key to effective use of the marital deduction. The \$780,800 applicable credit amount (2006 through 2008 under the law in effect at this writing) permits each spouse to transfer \$2 million in net taxable estate value to persons other than the other spouse—for example the children—without incurring an estate tax. Together, two spouses can pass \$4 million in net taxable value to other persons without estate tax cost.

**Example 6.1.** Assume a husband, a forest landowner, owns 1,200 homogeneous acres of pine timber with a net value of \$3 million after payment of estate debts and administrative costs. His wife is without assets (the analysis works the same with husband and wife's roles reversed). If he wills her the entire estate with a marital deduction bequest, his estate will pay no tax. When the wife dies, with income earned used to pay interim living expenses, funeral expenses and administrative costs, her estate will face a Federal estate tax of \$450,000 on the \$3 million value of the inherited forest land (through 2008), reducing by 15 percent the amount of the estate that passes to the children. The tax may have to be paid by selling part of the property, or using IRC section 6166 (see chapter 13) to pay the tax in installments, from timber sale income.

Having assets concentrated in one spouse's estate, as in this example, presents considerable risk, since the spouse without assets may be the first to die and the opportunity to use the marital deduction wasted. This situation can be remedied easily by the husband making a large lifetime gift (see chapter 8) to the wife. Balancing the spouses' estates in this way ensures that the marital deduction can be used and also permits use of the applicable credit amount at both deaths. Spousal trust is essential for this strategy to work.

**Balancing the marital deduction**—The goal is to balance the expected values in each estate with adjustment for life expectancy, earning power, and the ability to manage forest land or other assets.

**Example 6.2.** Assume the same facts as in example 6.1, except now the husband makes a lifetime gift of \$1 million in forest land value (400 acres) to the wife, removing it from his estate. At his death, he makes an outright bequest of \$1 million in forest land value (400 acres) to the children. The bequest is protected from estate tax by the applicable credit amount, which could shield \$2 million in net taxable estate value from estate tax, if needed. He wills the remaining forest land value (400 acres valued at \$1 million) to his wife using a marital deduction bequest, and his estate pays no estate tax on it. When the wife dies, her estate also has an applicable credit amount of \$780,800, which shields the entire amount of her \$2 million net taxable estate from estate tax and prevents any reduction in the amount that passes to the children.

While it addresses the shortcomings of example 6.1, this example has the disadvantage that the wife loses the control and use of one-third of the forest land estate that she helped to accumulate. This may mean a diminished lifestyle for her, a problem that could be remedied by using a trust (see chapter 9) instead of an outright bequest to the children.

**Example 6.3.** Assume the same facts as in example 6.2, but now the \$1 million bequest to the children is put into a non-marital or credit by-pass trust from which the wife has income for life. Now, she has access to the same level of income as in example 6.1. If desired, a clause can be included in the trust that permits invasion of the trust principal subject to an ascertainable standard of living (see chapter 9).

This example provides for use of the marital deduction regardless of which spouse is the first to die and use of the applicable credit amount at the death of both the husband and wife, while providing the surviving spouse access to the income generated by the full estate during his (her) lifetime.

**Survivor's ability**—The surviving spouse's ability and willingness to reduce the size of his (her) estate must be considered. As well, the spouses' goals with respect to the welfare of the children must be compatible.

To summarize the optimum marital deduction strategy: (1) it must be used in conjunction with the applicable credit amount; (2) it must be used with regard to the survivor's estate; and (3) consideration must be given to the survivor's ability, health, and willingness to reduce the remaining estate to minimize estate tax liability. Generally, the marital deduction is used to defer the tax at the first spouse's death so that additional planning can be done by the surviving spouse.

## How to Make a Marital Deduction Bequest

### Basic Patterns

A bequest that qualifies for the marital deduction may be made as an outright gift (see chapter 8), a direct bequest to the surviving spouse, or by trust for his (her) benefit (see chapter 9). In any case, the transfer usually will fall into one of the following patterns.

**Property**—An outright bequest of specific property may be made in these terms: "I give my wife the 600 acres of forest land that I own (legal description) in Laidback County, Forested State."

**Example 6.4.** Assuming the same facts as in example 6.2, but specifying that the timber is organized into three 400-acre management units of different age classes: (1) a premerchantable plantation, (2) small sawtimber, and (3) mature sawtimber. It might be advantageous if the husband's lifetime gift and bequest to the wife were made specifically from the small sawtimber and mature sawtimber management units,

for two reasons. First, it would provide liquidity to meet her immediate income needs. Second, it would permit his bequest to the children to be made from the premerchtable plantation management unit—either outright or by using a non-marital or credit by-pass trust—preventing that rapidly-appreciating asset from entering the wife’s estate.

**Example 6.5.** Assuming the same facts as in example 6.4, but specifying further that the premerchtable trees in the plantation management unit are valued at \$600 per acre; the timber in the small sawtimber unit is valued at \$1,500 per acre, primarily as chip-n-saw; the timber in the mature sawtimber unit is valued at \$3,750 per acre; and the land on which the timber stands has a bare land value of \$1,500 per acre. This reflects the potential value of a managed forest property. The total value of the timber is \$2,340,000 [(\$600 per acre x 400 acres) + (\$1,500 per acre x 400 acres) + (\$3,750 per acre x 400 acres)] and the value of the land is \$1,800,000 (\$1,500 per acre x 1,200 acres), for a combined total of \$4,140,000 (\$2,350,000 + \$1,800,000). In this case, both the husband’s lifetime gift and bequest to the wife can be made primarily from the mature sawtimber management unit, which could be sold immediately, if necessary, to generate cash. Note: In many instances only 75 to 80 percent of forested property is operable due to roads, streamside management zones, etc., which are ignored here for simplicity.

**Money**—A bequest of money is known as a “pecuniary bequest.” It can be phrased as “I give my husband \$1 million.” This statement alone does not necessarily make it so, however; the resources to generate the cash must be available in the estate.

**Fractional share**—The owner can give a straight fractional share, that is, “I give one-half of my residuary estate, outright, to my wife.” The residuary estate is what remains from the gross estate after payment of debts, administrative expenses, other charges, and specific bequests.

### Formula Marital Deduction Bequests

Other things being equal, the preferred approach would be to use a formula marital deduction bequest that sets aside the largest amount that can pass free of Federal estate tax by way of the applicable credit amount. This circumvents the problems generated when the bequest amounts have appreciated (or depreciated in some cases, but rarely for timber). There are three basic formula clauses that normally are used: (1) pecuniary marital deduction; (2) pecuniary unified credit; and (3) fractional residuary marital reduction. Numerous variations and refinements can be applied to each.

**Pecuniary marital deduction**—The pecuniary marital deduction formula is easy to express, and may offer the greatest opportunity for postmortem planning. The bequest can be made outright or in a marital deduction trust (see chapter 9). It directs that the amount of the marital share for the surviving spouse be the sum that minimizes the Federal estate tax payable. The residual share corresponds to the applicable exclusion amount, plus the Federal deduction for State death taxes.

**Example 6.6.** Assume the same facts as in example 6.4. The pecuniary marital deduction share can include the premerchtable management unit. This places growth and value appreciation in that portion of the first spouse’s estate that will not be taxed again at the second spouse’s death. Amounts in excess of \$2 million in the marital share (2006 through 2008) can be consumed or gifted to reduce the second spouse’s estate tax value.

**Pecuniary unified credit**—The pecuniary unified credit formula (usually in trust form; see chapter 9) is similar to the pecuniary marital deduction formula. It directs that an amount equal to the applicable exclusion amount, plus the Federal deduction for State death taxes, if appropriate, be given outright or in trust. The residual estate in this case will constitute the marital deduction amount that also can be outright or in trust. The results are similar to example 6.6 with respect to appreciation and liquidity.

**Fractional residuary marital deduction**—The fractional residuary marital deduction formula directs to the survivor the smallest fraction that minimizes the Federal estate tax payable. Although it is harder to calculate than the pecuniary formula—shares can be determined only after a final accounting by the executor—appreciation of estate assets is shared by the spouse and other beneficiaries. This may be a desirable outcome in terms of family relationships even if it costs some additional tax.

### The Choice of Marital Deduction Formula

Which marital deduction formula to use depends on the gain (or loss) potential of estate assets, preferences about whether the surviving spouse or children or both should benefit from the appreciation (or bear the burden of depreciation) in the estate’s timber assets, estate taxes that may be due at the surviving spouse’s death, and family relationships. The choice should be made only after an analysis of financial and tax considerations, with emphasis on the personal preferences of the individuals involved.

**Timber assets**—Treatment of timber assets should be dictated by the landowner’s goals as expressed in the forest management plan. These include continuity of management,

keeping the forest property intact as a management unit, financial targets, and nonmonetary considerations of the family. Integrating the forest management plan into the overall estate plan can be facilitated if the forest management plan has an estimate of current value by stand or management unit, a projection of net cash flows over the immediate planning horizon (operational plans usually are for 5 years, but sometimes up to 10 years), and a projection of the timber value at the end of the planning period.

Timber assets are dynamic, appreciating (or occasionally depreciating) in response to weather and markets. Their current value depends on the distribution of timber stands as affected by volume of merchantable timber and product classes (see chapter 4). Timber assets usually appreciate but present particular challenges due to their unitary nature, the fact that income usually is available only periodically, and illiquidity. Appreciation, moreover, will vary with market fluctuation and the stage of the growth cycle that stands are in at a particular time.

**Life insurance**—Life insurance proceeds may qualify for the marital deduction in numerous ways, but a life insurance specialist should be consulted to ensure both the marital deduction qualification and the best financial choice for the heirs. It is imperative that the policies be carefully coordinated with the overall estate plan with respect to

policy ownership, beneficiaries, and settlement options. Otherwise, the financial advantages of insurance may be dissipated, and the needs of the beneficiaries left unmet or only partially served (see chapter 10).

**Personal effects**—Special attention should be given to the treatment of personal effects when using a marital deduction formula. Many family heirlooms are difficult to value or equitably divide. The decedent and heirs often have specific attachments that should not be ignored, but should be handled separately.

**Disclaimer**—In making a marital deduction bequest, it may be desirable to provide in the will that the surviving spouse can refuse to accept any part of the marital bequest, creating the opportunity for a second look at the outcomes (see chapter 7).

**State death taxes**—The applicable State death taxes, if any, should be reviewed and included in drafting the marital deduction formulas and other analyses. State death taxes often do not conform to the Federal estate tax model and can upset plans if not incorporated. This is especially the case now that the State death tax credit for Federal estate tax purposes has been replaced with a deduction, in effect cutting the State taxes adrift from the Federal tax (see chapter 18).