Skills Training for Estate Planners

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Funding Marital (and Other) Bequests

Nancy C. Hughes
Attorney at Law
Hughes & Scalise, P.C.
600 Luckie Drive, Suite 310
Birmingham, Alabama 35223
nhughes@hughesscalise.com
(205) 871-0300

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I. Marital Deduction Formulas frequently used by practitioners which are designed to reduce the estate tax to zero.

A. Pecuniary Marital. This type of formula defines the Marital Share and generally is written as an amount equal to the smallest amount which qualifies for the marital deduction, which will pass to or for the benefit of the surviving spouse after taking into account the applicable exclusion amount, and which will result in the least amount of estate tax due. The remaining assets will pass to the by-pass or Family Share. Frequently, the Will requires that the amount due the Marital Share must be funded at date of distribution fair market values. To the extent the Marital Share is funded with appreciated or depreciated assets, the estate will recognize capital gain or capital loss, as the case may be, Treas. Reg. §1.1014-4(a)(4); Rev. Rul. 60-87, 1960-1 C.B. 86; Kenan v. Comm’r, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D.Conn.1935).

Example: A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Pecuniary Marital Formula requiring funding at date of distribution fair market value. On the estate tax return, the executor will allocate $550,000 to the Marital Share and $5,450,000 to the Family Share, resulting in no estate tax. If, at the time of funding, the estate's assets have appreciated and have a fair market value of $6,600,000, the executor will allocate $550,000 to the Marital Share and $6,050,000 to the Family Share. To the extent the Marital Share is funded with appreciated assets, the estate will recognize capital gain. No capital gain will be recognized on funding the Family Share.

1 The allocation of the Generation Skipping Exemption and funding issues which arise in that context are beyond the scope of these materials and thus have not been addressed in this outline.

2 Even though an executor of an estate and a beneficiary of that estate are included in the list of related parties in §267(b) (which would disallow the recognition of capital loss), §267(b)(13) provides an exception to the disallowance of losses between related taxpayers for losses incurred in the satisfaction of a pecuniary bequest.
Example: A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Pecuniary Marital Formula requiring funding at date of distribution fair market value. On the estate tax return, the executor will allocate $550,000 to the Marital Share and $5,450,000 to the Family Share, resulting in no estate tax. If, at the time of funding, the estate's assets have depreciated and have a fair market value of $5,500,000, the executor will allocate $550,000 to the Marital Share and $4,950,000 to the Family Share. To the extent the Marital Share is funded with depreciated assets, the estate will recognize capital loss. No capital loss will be recognized on funding the Family Share.

As demonstrated in the above examples, with a Pecuniary Marital Formula, all potential for appreciation and all risk of depreciation during the estate administration fall on the Family Share.

B. Pecuniary Family. This type of formula defines the Family Share and generally is written as an amount equal to the largest amount which can pass estate tax free, after taking into account the applicable exclusion amount, and which will result in the least amount of estate tax due. The remaining assets will pass to the Marital Share. Frequently, the Will requires that the amount due the Family Share must be funded at date of distribution fair market values. To the extent the Family Share is funded with appreciated or depreciated assets, the estate will recognize capital gain or capital loss, as the case may be, Treas. Reg. §1.1014-4(a)(4); Rev. Rul. 60-87, 1960-1 C.B. 86; Kenan v. Comm'r, 114 F.2d 217 (2d Cir. 1940); Suisman v. Eaton, 15 F. Supp. 113 (D.Conn.1935).

Example: A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Pecuniary Family Formula requiring funding at date of distribution fair market value. On the estate tax return, the executor will allocate $5,450,000 to the Family Share and $550,000 to the Marital Share, resulting in no estate tax. If, at the time of funding, the estate's assets have appreciated and have a fair market value of $6,600,000, the executor will allocate $5,450,000 to the Family Share and $1,150,000 to the Marital Share. To the extent the Family Share is funded with appreciated assets, the estate will recognize capital gain. No capital gain will be recognized on funding the Marital Share.

Example: A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Pecuniary Family Formula requiring funding at date of distribution fair market value. On the estate tax return, the executor will allocate $5,450,000 to the Family Share and $550,000 to the Marital Share, resulting in no estate tax. If, at the time of funding, the estate's assets have depreciated and have a fair market value of $5,500,000, the executor will allocate $5,450,000 to the Family Share and $50,000 to the Marital Share. To the extent the Family Share is funded with depreciated assets, the estate will recognize capital loss. No capital gain will be recognized on funding the Marital Share.
As demonstrated in the above examples, with a Pecuniary Family Formula, all potential for appreciation and all risk of depreciation during the estate administration fall on the Marital Share.

C. Fractional. This type of formula can define either share, but if defining the Marital Share, it generally is written as a fraction, the numerator of which is an amount equal to the smallest amount which qualifies for the marital deduction, which will pass to or for the benefit of the surviving spouse after taking into account the applicable exclusion amount, and which will result in the least amount of estate tax due, and the denominator of which is an amount equal to the residuary estate. The remaining assets will pass to the by-pass or Family Share. If the executor distributes to the Marital Share its fraction of each estate asset, no capital gain or capital loss is recognized on funding. Additionally, if the Will or local law permits non-prorata distributions, no capital gain or capital loss will be recognized on funding even if a "pick and choose" approach to funding is adopted. However, if the Will or local law does not permit non-prorata distributions, then capital gain or capital loss will be recognized on funding, Rev. Rul. 69-486, 1969-2 CB 159; Ltr. Rul. 7929054.

\[
\frac{\text{Smallest Amount Which Will Result in No Tax}}{\text{Entire Value of Residuary}} = \text{Marital Share}
\]

Example: A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Fractional Formula permitting non-prorata distributions. On the estate tax return, the executor will allocate 90.83% or $5,450,000 to the Family Share and 9.17% or $550,000 to the Marital Share, resulting in no estate tax. If, at the time of funding, the estate's assets have appreciated and have a fair market value of $6,600,000, the executor will allocate 90.83% or $5,994,780 to the Family Share and 9.17% or $605,220 to the Marital Share. The estate will recognize no capital gain on funding either share.

Example: A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Fractional Formula permitting non-prorata distributions. On the estate tax return, the executor will allocate 90.83% or $5,450,000 to the Family Share and 9.17% or $550,000 to the Marital Share, resulting in no estate tax. If, at the time of funding, the estate's assets have depreciated and have a fair market value of $5,500,000, the executor will allocate 90.83% or $4,995,650 to the Family Share and 9.17% or $504,350 to the Marital Share. The estate will recognize no capital loss on funding either share.

As demonstrated in the above examples, with a Fractional Formula, the Marital Share and the Family Share bear proportionately all potential for appreciation and all risk of depreciation during the estate administration.
D. Which Formula Should You Use?

1. A Fractional formula provides economic fairness between shares, does not trigger gain on funding, and does not accelerate recognition of IRD. However, a fractional formula may be difficult for the client to understand and administer.

2. If using a pecuniary formula, should you use Pecuniary Marital or Pecuniary Family?
   
   (a) Very large estates (valued at more than $11M): Use Pecuniary Family because gain is recognized on funding Family (the smaller share).
   
   (b) More moderate estates (valued at less than $11M): Use Pecuniary Marital because gain on funding is limited to the smaller share and appreciation during administration shifts to Family.

II. General Rules.

A. §2056 allows a marital deduction for qualifying property passing to a surviving spouse.

B. §2055 allows a charitable deduction for qualifying property passing to charity.

C. §2036 provides that if a donor makes a transfer (without full and adequate consideration) and retains for his or her life the income from the property, the property is included in the donor’s estate.

D. §2702 provides that if a donor makes a transfer and retains an income interest (which is NOT a UNITRUST or ANNUITY payment), then the value of the remainder interest is deemed to be zero. As a result, the donor has made a gift valued at 100% of the property transferred.

E. §2519 provides that if a surviving spouse disposes of an interest in a QTIP Trust, he or she is deemed to have made a taxable gift of the entire value of the Trust.

III. Complications when funding is delayed or distributions are made at different times.

A. Market Fluctuations. As demonstrated in the Examples set out in Part I of this outline, with either Pecuniary Formula, market fluctuation changes dramatically what the beneficiaries of the respective Shares ultimately receive. Obviously, the risk for market fluctuation increases with the passage of time. With a Pecuniary Marital Formula, the amount due the Marital Share is frozen at the first spouse's death. If the executor unduly prolongs the administration of the estate, or the IRS believes the administration has been unduly prolonged, the IRS could argue that the surviving spouse made a gift to the beneficiaries of the Family Share if the surviving spouse consents, or does not object, to the estate settlement, Rev. Rul. 84-105, 1984-2 C.B. 197. Alternatively, the Service could argue that the funding should have occurred sooner, in which case the Marital Share would have received its share of appreciation after a REASONABLE period for administration, TAM 8746003. In such a case, presumably more would be included in the estate of the surviving spouse upon his or her death. On the other hand, in Estate of de St. Aubin v. Comm’r, 138 T.C. No. 14 (2012) the court refused to allocate a portion of the appreciation to the Marital Share even if the lower court on remand found the
period of administration to be unreasonable. Rather, under the applicable state law in that case, (New York), a higher rate of interest on the bequest would be due if the lower court found the period to be unreasonable.

**Example:** A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Pecuniary Marital Formula requiring funding at date of distribution fair market value. On the estate tax return, the executor will allocate $550,000 to the Marital Share and $5,450,000 to the Family Share, resulting in no estate tax. If the executor funds the two Shares in 2020, and, at the time of funding, the estate's assets have appreciated and have a fair market value of $8,650,000, the executor will allocate $550,000 to the Marital Share and $8,100,000 to the Family Share.

Was five years a reasonable or unreasonable period in which to administer the estate?

If the period of administration was unreasonable, and the spouse consents to the estate settlement, has she made a gift to the beneficiaries of the Family Share? How do you measure the gift?

If the spouse served as executor of the estate, and if she is an income beneficiary of the Family Share, has she made a transfer to the Family Share which may cause it, or a portion of it, to be included in her estate under §2036 of the Code (did she make a transfer and retain the beneficial enjoyment from the transferred property?)? If the spouse did not serve as the executor, but consented to the estate settlement, and if she is an income beneficiary of the Family Share, has she made a transfer to the Family Share that may cause it to be included in her estate under §2036 of the Code?

If a transfer has occurred, would §2702 apply whereby the spouse made a transfer and retained an interest transferred in trust which is not a qualified annuity or unitrust interest, resulting in a gift of 100% of the value?

If the Marital Trust is a QTIP, has she made a disposition under §2519 triggering an immediate gift tax? See PLR 199926019. (The severance of a QTIP Trust into a disclaimed part (which was the result of a nonqualified disclaimer) and a retained part will not cause §2519 to apply). Here, there would be a severance too. The alleged appreciation due the Marital Trust would be split off and sent to the Family Trust.

At the surviving spouse’s death, the Service could argue that instead of including only the assets of the Marital Share (funded at $550,000) in her estate, that a more appropriate result would be to treat the bequest from the first estate as a fractional share rather than a pecuniary share, resulting in a prorata share of the appreciation (which was all allocated to the Family Share) being included in the surviving spouse’s estate, Connecticut National Bank v. United States, 937 F. 2d 90 (2d Cir. 1991). See also, Estate of de St. Aubin v. Comm’r, 76 T.C.M. (CCH) 409 (1998) (the court remanded the case for a determination of the reasonableness of the delay in funding, which occurred some sixteen years after the decedent’s death).
B. **Changing Ownership of Estate Income or Changing Fraction.**

1. **Pecuniary Formulae.** The Principal and Income Act in effect in many states provide that a Pecuniary Share is entitled to its prorata share of estate income before funding. On the other hand, the Principal and Income Act in effect in some states provide that a Pecuniary Share is entitled to interest only before funding. In the states in which the Pecuniary Share is entitled to a prorata share of income, the income portion due the Pecuniary Share is generally computed as a fraction of the estate income, *Bogert, Trusts and Trustees*, §817 at 385 (2d ed. 1981). As a result, any distributions to one Share without a corresponding distribution to the other Share will cause the fractions of income due each Share to change.

   **Example:** A decedent dies in 2016 leaving an estate valued at $6,000,000. All of the decedent’s applicable exclusion amount is available at his death. The Will contains a Pecuniary Marital Formula requiring funding at date of distribution fair market value. State law provides that a Pecuniary Share is entitled to its prorata share of the estate's income prior to funding. On the estate tax return, the executor will allocate $550,000 to the Marital Share and $5,450,000 to the Family Share, resulting in no estate tax. The Marital Share will be entitled to 9.17% of the estate's income and the Family Share will be entitled to 90.83% of the estate's income. If the executor makes a partial distribution of $500,000 to the Marital Share and none to the Family Share, the Marital Share will be entitled to 9.17% of the income through the date of the partial distribution. At that time, the Marital Share's fraction of income will change to $500,000/$5,500,000 (assuming there has been no change in the market value of the estate’s assets) or 1% and the Family Share will be entitled to 99% of the income from that date forward. Unless other partial distributions are made, these percentages will remain constant for the remainder of the administration.

   Since partial distributions made on a non-prorata basis create the changing fraction problems mentioned above, and since the Separate Share Rules (to be discussed below) apply to estates, executors should strive to make prorata distributions for ease of administration.

2. **Fractional Formulae.** Fractional Shares are entitled to a fractional share of the appreciation and the income. As with the income shares in Pecuniary Formulas, partial non-prorata distributions will cause the fractions to change and will create difficult administrative issues. Additionally, in those cases in which there is a Fractional Formula and estate tax is due, the calculation of the respective fractions can become quite complex.

   For example, in *Iandoli v. Iandoli*, 547 So. 2d 664, 665 (Fla. App. 4 Dist. 1989), the court stated that there are,

   at least seven methods of dealing with computation of the relative shares of a residuary estate . . . :

   1. Gross Share Fixed Fraction;
   2. Pre-Tax Fixed Share;
   4. Pre-Tax Changing Fraction Fair Market Value;
5. Gross Share Changing Fraction Inventory Value;
6. Pre-Tax Share Changing Fraction Inventory; and
7. True Residue Method.

The Iandoli court concluded that there is no one correct answer and that a number of factors must enter into the funding method. Id. at 666. These factors include: the testator's intent; the nature and extent of the assets; the relationship of the parties to one another; the equitableness of the final result; and any other factors which the executor in good faith deems important. Id. The court affirmatively stated, "Unless the end result is *patently wrong or unfair* it should not be disturbed by the courts," (emphasis added). Id.

For other cases which address the changing fraction issue, see Estate of Greenfield, 398 A.2d 983 (Pa. 1979) (an executor must use the changing fraction method where the estate administration period is prolonged); and In Re Estate of White, 230 N.E. 2d 735 (Ct. App. N.Y. 1967) (an executor must use the changing fraction method to account for principal advancements).

Executors should strive to make prorata distributions so that the fractions remain constant.

IV. Marital/Charitable Deduction or Gift Tax Issues which may arise as a result of funding.

A. Deductibility Issues. The logical corollary to the decisions in Bonner Estate v. Comm'r, 84 F.3d 196 (5th Cir. 1996), Mellinger Estate v. Comm'r, 112 T.C. No. 4 (1999), Nowell Estate v. Comm'r, T.C. Memo 1999-15, and Estate of Lopes v. Comm'r, T.C. Memo 1999-225, is that the marital deduction or the charitable deduction could be reduced depending on the assets used to fund the Marital Share or Charitable Share, Estate of Victoria E. Dieringer et al. v. Comm'r, 146 T.C. No. 8 (2016); The Ahmanson Foundation v. U.S., 48 AFTR 2d 81-6317; TAM 9403005; But see Estate of Turner v. Comm'r, 138 T.C. No. 14 (2012) (the Service allowed the marital deduction for the FLP interests passing to the surviving spouse (no discount on inclusion and no discount on deduction so the court did not need to address the mismatch). See also, Estate of Black v. Comm'r, 133 T.C. 340 (2009) and Estate of Shurtz v. Comm'r, T.C. Memo 2010-21 (2010) (in both Black and Shurtz, the court would have applied the “mismatch” theory – assets included without discount but deduction limited to discounted value – if 2036 had applied. In both cases, the court found that the transfers fell within the bona fide sale for full and adequate consideration exception so there was no inclusion under §2036.)

In Bonner, Mellinger, Nowell and Lopes, the courts considered whether property included in the gross estate under different Code Sections should be aggregated for valuation purposes. For example, in Bonner, a fractional interest in property was included under §2033 and the remaining fractional interest was included under §2044. The issue was whether the estate should value 100% ownership of an asset, rather than two fractional interests. The court concluded that two fractional interests, with appropriate discounts, should be included. However, no discounts were allowed in Estate of Fontana v. Comm'r, 118 T.C. 318 (2002 U.S.
Tax Ct.). In that case, the decedent owned a portion of the property, outright, and held a power of appointment over the rest of the property. As a result, the Court merged the two interests for purposes of valuation. See also FSA 200119013.

The concern with regard to funding is with the reverse factual situation. If the estate owns 100% of the asset and the executor funds the Marital Share with a fractional interest in the asset, does the marital deduction get reduced by virtue of the fractional interest discount? In AOD 99-116, 1999-35 I.R.B. 314, the Service acquiesced to Mellinger, in result only, and stated that "the Tax Court's decision in this case is consistent with the Service's position regarding the valuation of minority interests passing to QTIP trusts. The proper funding of the QTIP trust should reflect, for example, the value of minority interests in closely-held entities or fractional interests in real estate that are used in satisfying the marital bequest."

See also, Chenoweth v. Comm’r, 88 T.C. 1577 (1987) (Decedent left 51% of the stock of a closely held company to his spouse. A larger marital deduction was allowed because the court found that a control premium should be added to the value of the bequeathed stock); The Ahmanson Foundation v. U.S., 48 AFTR 2d 81-6317 (9th Cir. 1981) (Decedent owned all the outstanding shares of stock of a closely held company: 1 share of voting stock and 99 shares of nonvoting stock. For purposes of valuing the 100 shares included in the gross estate, no discount was allowed for the nonvoting because the decedent could have liquidated the company and thus the nonvoting stock would receive the same price as the voting. The decedent’s Will left the 99 shares of nonvoting to charity and the 1 share of voting to a different beneficiary. The charitable deduction was discounted because the stock was nonvoting and thus had no ability to liquidate or declare dividends. Since there was a mismatch in the value of the nonvoting stock included and the value of the nonvoting stock passing to charity, estate tax was due); Estate of Victoria E. Dieringer et al. v. Comm’r, 146 T.C. No. 8 (2016). (Decedent’s Will left some voting stock and some non-voting stock to her family foundation. No discounts for lack of marketability and minority interest were applied. As a result, the voting stock was included at $1,824 per share, the non-voting stock was included at $1,733 per share, and the estate claimed a charitable deduction for $1,824 and $1,733, respectively. Seven months later, the Co. (which the decedent’s family controlled) redeemed the stock paying $916 and $870, respectively. The reduction in value was attributed to discounts for lack of control and lack of marketability. The court applied a mismatch theory whereby the value of the stock included was different from the value of the charitable deduction.) Estate of Turner v. Comm’r, Estate of Black v. Comm’r, and Estate of Shurtz v. Comm’r.

In Estate of Frank M. DiSanto v. Comm’r, T.C. Memo 1999-421 (Decedent owned 53.5% of stock of company and left it all to wife. Wife disclaimed part of stock so that she received a minority block of stock. On decedent’s 706, the Executor included the 53.5% at a value which recognized its control, but took a marital deduction for the stock (a minority interest after the disclaimer) passing to the spouse without any discount for the minority interest. The wife died within 7 months after the decedent. On her 706, the Executor included the minority stock at a discounted value. The court held that the Decedent’s marital deduction should have been reduced to recognize the minority discount resulting in estate tax in the husband’s estate because the amount deductible was less than the amount includable); Estate of Foy Proctor, T.C. Memo 1994-208 (Decedent left a ranch to charity. However, Decedent’s Will gave an employee
the option to lease the ranch upon favorable terms. The court held that the charitable deduction must be reduced to recognize the encumbrance on the property passing to charity. As a result, estate tax was due because the amount deductible was less than the amount includable).

**Example:** A decedent dies in 2016 and owns 100% of a ranch valued at $6,000,000. The decedent had very few other assets. The Will contains a Fractional Formula, with the Marital Share receiving 9.17% and the Family Share receiving 90.83%. The Marital Share is to be distributed to a QTIP Trust. Upon funding, the Marital Share will receive 9.17% of the ranch. The IRS might take the position that the marital deduction is something less than $550,000 because of a fractional interest discount. In such a case, estate tax would be due on the amount of the fractional interest discount. Additionally, the IRS could take the position that unless the surviving spouse insists on receiving a greater percentage of the ranch to make her whole for the $550,000 Marital Share to which she was entitled, she has disposed of a portion of the QTIP causing an immediate gift tax on the QTIP. Alternatively, the IRS could take the position that the surviving spouse had made a gift of the foregone share of the ranch.

Executors should avoid funding the Marital Share with fractional interests in real estate, unless that was all that was included in the estate. Additionally, if the estate holds a majority interest in stock of a company, the executor should avoid funding the Marital Share with stock representing a minority interest in the company.

Alternatively, the Executor could fund with a fractional share having a market value equal to the marital deduction the estate seeks. In the above example, that would mean funding with more than 9.17% to avoid the inclusion/deduction mismatch.

**V. Separate Share Regulations.**

The Separate Share Regulations are contained in Regulations §1.663(c). In a nutshell, Pecuniary Shares entitled (under local law) to a share of the estate's income and Fractional Shares will be treated as Separate Shares for income tax purposes. There are some complexities in calculating the respective shares of DNI; however, if the earlier admonitions regarding prorata distributions are taken to heart, the income tax treatment should be fairly straightforward.