The Marital Deduction:
Selected Traps and Opportunities
(Never Having to Say You're Sorry)

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Hubert Proposed Regulations.

a. Summary. As stated in the preamble to the regulations:

The proposed regulations define estate transmission expenses and estate management expenses and provide that estate transmission expenses, but not estate management expenses, reduce the value of property for marital and charitable deduction purposes.

A copy of the proposed regulations is attached as Exhibit "A.

b. "Estate Transmission Expenses" and "Estate Management Expenses."

(1) The terms "estate transmission expenses" (which expenses reduce the value of the property for marital deduction purposes) and "estate management expenses" (which expenses do not reduce the value of the property for marital deduction purposes) are defined as follows:

Estate transmission expenses include expenses incurred in the collection of the decedent’s assets, the payment of the decedent’s debts and death taxes, and the distribution of the decedent’s property to those who are entitled to receive it. Examples of these expenses include executor commissions and attorney fees (except to the extent specifically related to investment, preservation and maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.

... the term estate management expenses means expenses incurred in connection with the investment of the estate assets and with their preservation and maintenance during the period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees, and interest.
(2) Despite the general rule that estate management expenses do not reduce the value of the property for marital deduction purposes, the value is reduced for such expenses "incurred in connection with property that passed to a beneficiary other than the surviving spouse if a beneficiary other than the surviving spouse is entitled to the income from the property and the expenses are charged to the deductible property interest which passed to the surviving spouse."

(3) In general, a shorthand way to think about the distinction between estate transmission and estate management expenses is that, under traditional accounting rules, the former would generally be charges to principal, while the latter would generally be charges to income. Note that, under the regulations, the outcome is in no way affected by whether a particular expense is, in fact, charged to principal or income.

(4) In current practice, counsel fees and executor commissions are not allocated between "transmission expenses" and "management expenses." Consideration must be given as to how an allocation should be made. It may be advisable to code time entries between the two categories.


(1) Examples. The regulations include three examples, which illustrate the application of the new rules in a taxable estate. The facts for the examples are as follows:

(a) The decedent dies after 2006

(b) There is a bequest of shares of ABC Corporation stock to the decedent’s child. The shares are worth $3,000,000 on the date of the decedent’s death. The decedent’s child is entitled to the income from the shares from the date of death.

(c) The residue passes to a QTIP trust. The value of the residue is $6,000,000 on the date of the decedent’s death, before expenses and death taxes.

(d) Local law allows the executor to pay administration expenses from the income or principal of the residuary estate.

(e) All estate taxes are paid from the residuary estate.

(2) Transmission Expenses. Example 1 in the regulations illustrates the impact of estate transmission expenses, (i) if the expenses are taken as deductions on the federal estate tax return and (ii) if the expenses are taken as
deductions on the federal income tax return. The conclusions in example 1 are straightforward and can be duplicated by applying general estate-tax concepts, as shown in the computations in Exhibit "B."

(3) **Management Expenses.**

(a) Example 2 in the regulations illustrates the impact of estate management expenses, (i) if the expenses are taken as deductions on the federal estate tax return and (ii) if the expenses are taken as deductions on the federal income tax return.

(b) When management expenses are taken as deductions on the federal income-tax return, the conclusion in example 2 is straightforward and the underlying computations are shown in case 2 on Exhibit "C."

(c) When management expenses are taken as deductions on the federal estate-tax return, the position in the regulations is questionable.

(i) **Marital Deduction Not Reduced By Form 706 Expenses; Decrease in Estate Tax Does Not Increase Marital Deduction.** The regulations take the approach illustrated in case 1 on Exhibit "C." Under that approach, the amount of the marital deduction is calculated as if no management expenses were taken on the Form 706. If no management expenses were taken on the Form 706, the amount of the marital deduction would be $3,900,000 (as in case 2 on Exhibit "C," in which all management expenses were taken on the Form 1041). By taking the management expenses on the Form 706 (rather than on the Form 1041), the estate taxes are reduced from $2,100,000 to $1,880,000.

(ii) **Marital Deduction Not Reduced By Form 706 Expenses; Decrease in Estate Tax Increases Marital Deduction.** As a general rule, when death taxes are charged to the marital share and the death taxes are reduced, the amount of the marital deduction increases (because the burden on the marital share is reduced). That increase in the amount of the marital deduction in turn decreases the estate tax, and so on. The result of this interrelated calculation is illustrated in case 3 on Exhibit "C." The interrelated calculation reduces the estate from $1,880,000 (case 1 on Exhibit "C") to $1,611,111 (case 3 on Exhibit "C").

(d) Why don't the regulations use the interrelated calculation? There is nothing in the regulations that provides an answer to this question. The Service has informally stated the position that post-death management expenses are not to affect the amount of the marital deduction in any way. The amount of the marital deduction is calculated as if
there were no management expenses. Once that calculation is made, the amount of the marital deduction is "frozen." The marital deduction is neither reduced by management expenses nor increased because of a decrease in death taxes.

(e) There is, however, a real distinction between a possible decrease in the marital deduction because of the payment of expenses and a possible increase in the marital deduction because death taxes are reduced. This can be understood most easily by thinking about management expenses as payments out of income (which is the traditional source of the kinds of expenses that are characterized as "management expenses") and death taxes as payments out of principal in the following manner:

(i) Expenses that are paid out of the income of the marital share should not reduce the amount of the marital deduction because the marital deduction is allowed for the principal passing to the marital share, which is not reduced because of payments properly charged to income.

(ii) On the other hand, the payment of death taxes is charged to principal. The amount of the death taxes must reduce the amount of the marital deduction. The higher the death taxes, the lower the marital deduction, and vice versa.

d. Applying the new rules: nontaxable estate. How will the regulations apply in the case of a formula marital deduction bequest that eliminates federal estate tax?

(1) How Will the Marital Deduction Be Calculated?
When a zero-tax formula is used, the calculation of the marital deduction will be the same, whether an item is characterized as a transmission expense or as a management expense.

Example: Assume an estate in the amount of $9,000,000, expenses in the amount of $400,000 and death occurring after 2005. If the expenses are taken on the Form 706, the minimum marital deduction that will create zero tax is $7,600,000, whether the expenses are transmission or management expenses. If the expenses are taken on the Form 1041, the minimum marital deduction that will create zero tax is $8,000,000. See computations in Exhibit "D."

(2) How Will the Distribution to the Surviving Spouse Be Calculated?

(a) To the extent that transmission expenses are charged to principal and management expenses are charged to
income, the funding of the marital deduction gift is fairly simple:

(i) The amount of principal distributable to the surviving spouse will be equal to the amount of the marital deduction (assuming no appreciation or depreciation in the case of a fractional marital deduction formula). That amount is $7,600,000 if transmission expenses are taken on the Form 706 and $8,000,000 if transmission expenses are taken on the Form 1041. (These figures are "net" of any transmission expenses charged to the marital share.)

(ii) The surviving spouse will receive the net income (that is, gross income reduced by the management expenses). The reduction from gross income to net income has no impact on the amount of the marital deduction because management expenses do not reduce the amount of the marital deduction.

(iii) Is there an advantage to characterizing an item as a management expense, rather than as a transmission expense? The answer is yes, whether expenses are taken on the Form 706 or the Form 1041. The following paragraphs describe the mechanics of determining the amount distributable to the surviving spouse. (For simplicity, it is still assumed that transmission expenses are charged to principal and management expenses are charged to income.)

i) Assume that $400,000 of expenses are taken on the Form 706, all of which are transmission expenses, and that the gross (and net) income allocable to the marital share is $500,000. In that case, the surviving spouse will receive principal in the amount of $7,600,000, and net income in the amount of $500,000, for a total of $8,100,000.

ii) The facts are the same as in the last example, except that counsel fees and executors commissions are allocated between transmission expenses ($300,000) and management expenses ($100,000), and the management expenses are allocable to the marital share.1 In this case, the surviving spouse will receive principal in the amount of $7,600,000, and net income in the amount of $400,000, for a total of $8,000,000.

iii) The facts are the same, except that all expenses are taken as deductions on the Form 1041. If all of the expenses are transmission expenses, the surviving spouse will receive principal in the amount of $8,000,000, and net income in the amount of $500,000, for a total of $8,500,000.

1It is assumed that the management expenses are incurred in connection with the marital share.
If $100,000 can be allocated to management expenses, the surviving spouse will receive principal in the amount of $8,000,000, and net income in the amount of $400,000, for a total of $8,400,000. (This assumes the $100,000 in management expenses are allocable to the marital share.)

(b) What happens if transmission expenses are charged to the income of the marital share? To the extent the marital share is burdened with transmission expenses, the amount of the marital deduction must be reduced. As illustrated below, the total amount passing to the surviving spouse will not change, but the trust accounting will be more complicated than when transmission expenses are charged to principal.

(i) Assume that $400,000 in transmission expenses are taken on the Form 706, all of which are allocable to the income of the marital share. If the marital share were funded with principal in the amount of $7,600,000, which was burdened with transmission expenses in the amount of $400,000, the estate would be entitled to a marital deduction in the amount of $7,200,000, which would result in the imposition of federal estate tax.

(ii) Assuming the formula in the Will is drafted to produce the minimum marital share necessary to reduce federal estate taxes to zero, the following will result:

i) The amount of the marital deduction will be $7,600,000, and there will be no estate tax.

ii) The amount of principal distributable to the marital share will be "grossed up" from $7,600,000 to $8,000,000.

iii) The surviving spouse will receive $8,000,000 in principal and $100,000 in income, for a total of $8,100,000. Thus, the surviving spouse receives the same amount whether transmission expenses are charged to income or principal. (See paragraph i) above.)

(3) Does the Kind of Marital Formula Make a Difference? The regulations are relevant only to the extent the marital share is charged with administration expenses.

(a) In the case of an upfront pecuniary marital gift, this entire discussion can be ignored because the pecuniary marital gift is not burdened with administration expenses. An exception would apply if, in a particular case, a pecuniary marital gift were charged with expenses.
(b) In the case of an upfront credit shelter gift, the marital share is the residue and would generally be charged with all administration expenses. Accordingly, allocation between transmission and management expenses is most significant in this case.

(c) In the case of a fractional marital deduction gift, administration expenses are borne pro rata by the marital and credit shelter shares. Accordingly, the significance of the allocation between transmission and management expenses will depend upon the relative sizes of the marital and credit shelter shares.

e. Tentative Conclusions.

(1) If the marital share does not bear any expenses (for example, in the case of an upfront pecuniary marital deduction), the Hubert regulations are irrelevant.

(2) If the marital share does bear expenses, the decision as to whether an expense is a transmission expense or a management expense will have significance in both taxable and nontaxable estates. Executors commissions and counsel fees should be allocated between the two categories.

(3) The allocation of transmission expenses to principal and management expenses to income may simplify estate accounting issues.

(4) When management expenses are allocated to income, the double-deduction argument under section 2057(b)(9) (applicable in the case of a taxable estate) is undermined.

(5) In a nontaxable estate, the decision as to whether to take expenses on the Form 706 or on the Form 1041 is unaffected by the Hubert regulations. As before, the income-tax advantage of the Form 1041 deduction must be weighed against the estate-tax reduction in the surviving spouse’s estate when expenses are taken on the Form 706.

(6) The illustrations above show zero estate tax in the first estate, without regard to whether an expense is characterized as a transmission expense or a management expense. The assumption is that the marital deduction formula will be self-adjusting to create zero tax. If a formula is not drafted in terms of a zero-tax result, the impact of the categorization on the amount of the marital deduction should be considered.

(7) In a taxable estate, expenses should always be taken on the Form 706 because the estate-tax bracket is always higher than the income-tax bracket. (The estate-tax bracket at $1,000,000 is 41%.) In example 1 in the regulations, there is an
increase in estate tax in the amount of $488,888 if $400,000 in transmission expenses are taken on the Form 1041, rather than on the Form 706 (Exhibit "B"). In example 2 in the regulations, there is an increase in estate tax in the amount of $220,000 if $400,000 in management expenses are taken on the Form 1041, rather than on the Form 706 (Exhibit "C").

2. Pecuniary Marital Deduction Gift and Interest Payments.

a. Problem. Under the law of most states, a pecuniary gift that is outright is entitled to statutory interest. In the case of a pecuniary gift in trust, a significant number of states provide for statutory interest and a significant number of states provide for the payment of income on the pecuniary gift. In the case of statutory interest, is the interest payment "real interest" or is it, in substance, a share of the income of the estate?

(1) In the former case, the payment will be interest income to the beneficiary. In all likelihood, the payment will be characterized as "personal interest," so that there is no interest deduction to the estate.

(2) In the latter case, the payment would be governed by the rules of sections 661 and 662, which provide, in general, for a deduction in the estate for the amount distributed to a beneficiary and a corresponding inclusion of the amount in the taxable income of the beneficiary.

b. Background.

(1) For income-tax purposes, the Service has taken the position that interest on a pecuniary bequest is real interest. The Service has been successful in several cases, and unsuccessful in at least one.

(2) In the estate-tax context, the Service has viewed the interest payment through different lenses. In TAM 9604002, the Service rejected the taxpayer’s position that an
interest payment on a pecuniary legacy was an administration expense for which the estate was entitled to a deduction.

(a) The Service had two interconnected bases for rejecting the deduction:

(i) First, the Service looked to the nature of the payment of interest on a pecuniary bequest:

We believe the analysis of the court in Stevenson Estate confirms that the statutory interest is merely a mechanism to allocate estate income among the estate beneficiaries to compensate the pecuniary legatees for a delay during administration in funding their bequests. Thus, payment of statutory interest should no more be viewed as an administration expense deductible under section 2053 than should the payment of estate income to estate beneficiaries.

(ii) Second, the Service concluded that the expense was not necessary to the administration of the expense:

In the present case, there was no liquidity problem or any other evident need for the executors to borrow money in administering the estate. Consequently, we cannot conclude that the interest payments made in this case are properly characterized as interest payments. However, in view of the purpose of the payments, ensuring allocation of trust income among the beneficiaries in an equitable manner, the payments cannot properly be viewed as a deductible expense of administering the estate under section 2053.

It is unclear from the paragraph last quoted whether the result would have been different if there had been a liquidity need.

(b) Recognizing an inconsistency between its positions in the income-tax and estate-tax arenas, the Service repeated the often-heard statement that "the income tax and estate tax are not in pari materia."

C. Proposed Regulations for Separate Shares.

(1) Background.

(a) Prior to the Taxpayer Relief Act of 1997 (the "1997 Act"), section 663(c) provided that, for purposes of determining the amount of distributable net income for a trust, "substantially separate and independent shares of different
beneficiaries in the trust shall be treated as separate shares." The 1997 Act extended the separate share rule to estates.

(b) On January 6, 1999, proposed regulations were issued regarding the separate share rule (the "Separate Share Regulations"). The Separate Share Regulations specifically provide that the elective share of a surviving spouse is a separate share for purposes of section 663(c). A copy of the Separate Share Regulations is attached as Exhibit "E."

(2) Impact of Regulations on Marital Deduction Planning.

(a) The Separate Share Regulations give three examples of the application of the separate share rule -- two in the context of an elective share of a surviving spouse and one in the context of a formula fractional marital deduction. In the first elective-share example, relevant state law provides that a surviving spouse is entitled to share in the income and in the appreciation (or depreciation) in the value of the estate. In the second elective-share example, relevant state law provides that the surviving spouse is entitled to interest on the elective share, and is not entitled to participate in the income or in the appreciation in the value of the estate.

(b) In the second elective-share example (as in the first), the elective share is considered a "separate share" for purposes of section 663(c). In the second example, it would appear that income will never be allocated to the spouse's separate share (for purposes of section 663(c):

Because the surviving spouse was not entitled to any estate income under state law, no income is allocated to the spouse’s separate share.

The Separate Share Regulations describe the impact of the payment to the surviving spouse of $1,000,000 in interest on the elective share as follows:

The distribution in satisfaction of the spouse’s elective share does not consist of any distributable net income and is not included in the spouse’s gross income under section 662. The $1,000,000 of interest payment to the surviving spouse must be included in gross income of the spouse under section 61. . . . The $1,000,000 interest payment is a nondeductible personal interest expense described in section 163(h).

(c) What impact does the separate-share rule have on a pecuniary marital deduction formula? Assuming the gift
is not entitled to a portion of the income of the estate, the results will be as follows:

(i) The funding of a pecuniary marital deduction will not carry out any estate income to the surviving spouse because no portion of the estate's income will ever be allocated to that separate share.  

(ii) Interest payments on the gift will result in taxable income to the surviving spouse, with no corresponding deduction for the estate. As noted above, the Service has argued for these results for some time. The incorporation of the position in a regulation, however, will make it extremely difficult to prepare a return that takes a contrary position.

d. Planning Possibilities.

(1) Providing for Payment of Income in Lieu of Interest. If applicable state law provides for the payment of statutory interest, is the nondeductibility problem solved if the testator's Will provides that the pecuniary formula marital deduction gift is entitled to a share of income in lieu of interest?

(a) Income-Tax Consequences. If the gift is entitled to a share of income, a proportionate share of the income of the estate is allocable to this separate share. A distribution of income or principal to the surviving spouse will carry out estate income, and the surviving spouse will be taxed on a share of the income of the estate and the estate will receive a corresponding deduction.

(b) Estate-Tax Consequences. Does the provision create a potential marital deduction problem? Can the Service take the position that the Will is depriving the surviving spouse of assets to which she is entitled?

Example: Assume that Tom Testator lives in a jurisdiction in which a pecuniary gift is entitled to interest at the rate of 5% per annum from the date of death until the date of funding. Assume that the bulk of the assets of the estate are equities that produce a return of 1 1/2%. The income-

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6In the past, the funding of a pecuniary marital deduction formula gift has carried out income from the estate to the beneficiary. Treas. Regs. §1.663(a)-1 specifically provides that this kind of gift is not considered a gift of a "specific sum of money or of specific property." (Under section 663(a), the funding of a gift of a "specific sum of money or of specific property" will not carry out estate income to the beneficiary.)
instead-of-interest provision will reduce the spouse's "return" from 5% to 1 1/2% until the gift is funded.

The answer should certainly be that there is no marital deduction problem. It is hard to imagine that a provision requiring the payment of income to the surviving spouse during the period of administration could jeopardize the marital deduction. In addition, to do so would create a dichotomy based on state law. In states in which income on a pecuniary gift is provided by state law, there would be no marital deduction issue, while in states in which the same provision is set forth in the Will, there would be a marital deduction problem.7

(2) Providing for Payment of Greater of Income or Interest. What if the Will provides that the surviving spouse will receive the greater of (i) statutory interest or (ii) a proportionate share of income?

(a) Estate-Tax Consequences. Obviously, this provision would not create any marital deduction issue.

(b) Income-Tax Consequences.

(i) To the extent of the excess of statutory interest over income, the basic problem (income to spouse with no corresponding deduction) remains. To the extent of the excess of income over statutory income, the problem should be solved.

(ii) The treatment of the portion of the payment that could be either income or interest (for example, the first 1 1/2% return in the last example) is uncertain. Does it matter whether the income or the interest is greater?

(c) Economic Consequences. This provision will probably "work" for income-tax purposes only when income exceeds interest. In that situation, there is a "bad" economic result (that is, increasing the amount payable to the surviving spouse), which may well outweigh the potential income-tax benefit.

(3) Providing for Payment of Income in the Amount of Interest. What if the Will provides that the surviving spouse will receive a portion of the income equal to the amount of interest? This provision could be interpreted in one of two ways.

7 See Treas Reg §20.2067(b)-5(f)(9)

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(a) First, the provision might mean that the surviving spouse will, in all events, receive the amount that he or she would have received without the special provision. In that case, the only change is the label ("income" instead of "interest") and it is likely the income-tax result would not change.

(b) Second, the provision might mean that the payment to the surviving spouse is subject to a cap equal to the amount of income of the estate (meaning, in essence, that the surviving spouse will receive the lesser of the income or the interest). Query whether this creates a marital deduction issue.

e. Conclusion. If the Separate Share Regulations are finalized, this will highlight the potential income-tax disadvantage of a pecuniary marital deduction gift that carries statutory interest.

3. OTIP, Bonner and Premiums/Discounts.

a. In allocating shares of closely held stock between the marital trust and the unified credit trust, attention should be paid to the Service's position in distinguishing the value such shares have in the estate of the decedent and the value given to the shares of stock allocated to the marital share.

b. The Service has ruled that when a minority interest passes to a marital share, a marital deduction may be taken only for the discounted value of the minority interest, even though the value of the stock in the gross estate may have been valued as part of a controlling interest in the closely held corporation. In PLR 9403005, the decedent owned a controlling interest in a corporation, consisting of 400 shares of preferred stock and 27,728 shares of common stock. He bequeathed the common stock to a unified credit trust and the preferred stock to his wife. The common stock and preferred stock were worth more as part of a combined block than when considered as separate holdings. Because the preferred stock going to the surviving spouse represented a minority interest, its value was discounted for marital deduction purposes. See also PLR 905004.

c. Similarly, the Tax Court has held that if the controlling interest in a corporation passes to the surviving spouse, the stock must be valued to reflect a control premium. Therefore, where the decedent left 51% of the stock in his closely held corporation to his wife, the estate argued that the valuation of the stock at 51% of the total value of the corporation would not reflect the control premium represented by the stock passing to the wife. The estate was successful in obtaining a 38% control premium in the stock allocated to the surviving spouse. Estate of Chenoweth v. Commissioner, 88 T.C. 1577 (1987). Similarly, a minority interest in property passing
to a charity was held to have a lower value for charitable
deduction purposes than for purposes of inclusion in the gross
estate. *Ahmanson Foundation v. U.S.*, 674 F.2d 761 (9th Cir.

d. Obviously, care must be taken in dividing stock of
a closely held corporation between the marital share and other
testamentary gifts when a majority interest is included in the
estate and less than control may be allocable to the marital
share. Otherwise, the value remaining in the estate with which
to fund the marital share may be less than the amount desired for
the marital deduction. Does the Chenoweth principle apply in
funding the QTIP trust where another marital trust is being
funded?

e. In TAM 9550002, the Service stated its position
that QTIP assets must be aggregated with assets owned by the
surviving spouse in determining whether the estate of the
surviving spouse is entitled to a minority discount when the QTIP
trust and the estate of the surviving spouse include interests in the
same property or entity.

f. The Fifth Circuit rejected the Service’s
"aggregation" position in *Estate of Bonner v. U.S.*, 84 F.3d 196
(5th Cir. 1996), in which the court held that the assets in the
QTIP trust could not be aggregated with the estate’s assets
because the surviving spouse had no control over the QTIP trust.

At the time of Bonner’s death, his estate did not have
control over Mrs. Bonner’s interests in the assets [of
the QTIP trust] such that it could act as a
hypothetical seller negotiating with willing buyers
free of the handicaps associated with fractional
undivided interests. The valuation of the assets
should reflect that reality.

The court allowed a fractional interest discount with respect to
partial interests in real estate and a boat held in the QTIP
trust and the decedent’s estate even though 100% of the property
was held between the two.

g. What are the planning implications of Bonner?
What are the results in the following scenarios in which W owns
all of the stock in Widget, Inc.?8

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8The discussion focuses on interests in a closely held business, which would
generally create a larger discount than interests in real estate. The same
principles should apply to interests in real estate.

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(1) W leaves all of the stock to her husband. What if H makes no gifts of the stock during his lifetime? What if H makes gifts of stock during his lifetime?

(2) W leaves all of the stock to a QTIP trust. What if the trustee makes distributions of some of the stock to H? What provisions should the trust contain to allow such distributions? What if the trustee sells some of the stock to H or to another trust? What are the fiduciary duties of the trustee?

(3) W leaves all of the stock to be divided between a QTIP Trust and a Credit Shelter Trust.

(4) W leaves all of the stock to be divided between a QTIP Trust and an outright gift to H.

(5) W gives some of the stock to H during lifetime.

h. In each case:

(1) What are the results in W’s estate if she dies first? If she dies second?

(2) What are the results in H’s estate if he dies first? If he dies second?

(3) What are the implications for sections 6166 and 2057?

4. QTIP Trust and Credit for Tax on Prior Transfers ("TPT").

a. General Rule. Section 2013 provides a credit in the estate of the decedent for federal estate-tax paid with respect to the transfer of property to the decedent from a person (the "transferor") who died within ten years before, or within two years after, the decedent’s death.

b. Phase-out of TPT Credit. If the transferor predeceased the decedent by more than two years, the credit is the following percentage of what the credit would otherwise have been:

   (1) Eighty percent, if the transferor died within the third or fourth years before the decedent.
   
   (2) Sixty percent, if the transferor died within the fifth or sixth years before the decedent.

A-18-BRB
(3) Forty percent, if the transferor died within the seventh or eighth years before the decedent.

(4) Twenty percent, if the transferor died within the ninth or tenth years before the decedent.

c. **First Limitation: Tax in Transferor’s Estate.** The first part of the computation of the TPT credit is the determination of the portion of the federal estate tax paid on the transferred property in the transferor’s estate. The computation is based on the average (rather than the incremental) estate tax. This can be seen in the following formula:

\[
X = \frac{\text{estate tax paid in transferor's estate}}{\text{value of property transferred}} \times \frac{\text{taxable estate of transferor decreased by death taxes in transferor’s estate}}{9}
\]

d. **Second Limitation: Tax in Decedent’s Estate.** The TPT credit cannot exceed the federal estate-tax imposed in the decedent’s estate on the transferred property. Unlike the computation of the federal estate tax in the transferor’s estate, the federal estate tax is computed on an incremental (rather than an average) basis for this purpose.\(^{10}\)

e. **Valuation of "Transferred Property."**\(^{11}\)

(1) The value of the "transferred property," for both the first and second limitations, is the value of the property in the transferor’s estate.

(2) It is not necessary that the decedent own the transferred property at the time of his or her death.

**Example:** A’s estate included Blackacre at a value of $100,000. Blackacre was devised to B. B sold Blackacre for $150,000, and died after the sale (and within ten years of A’s death). The credit is available in B’s estate with respect to Blackacre, and, for purposes of computing the TPT credit, the value

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9Increased by any credits under Section 2012 (credit for gift tax) and under Section 2013 (credit for tax on prior transfers).

10Where the decedent’s estate received a charitable deduction, an adjustment is made to the charitable deduction in making this computation.

11Treas Reg. §20.2013-4
of the transferred property is $100,000.\footnote{12}

(3) It is not necessary that the decedent receive a fee-simple interest in the transferred property. The term "transferred property" includes "annuities, life estates, estates for terms of years, vested or contingent remainders and other future interests,"\footnote{13} as well as general powers of appointment. The term does not include a power of appointment that is not a general power of appointment.

Example: A's estate included Blackacre, at a value of $100,000. Blackacre was devised to B for life, remainder to C. Based on the actuarial tables in effect at the time of A's death, the value of B's life estate was $44,000 and the value of C's remainder interest was $56,000. B died two years after A's death, and C died three years after A's death. The credit is available in B's and C's estates. For purposes of computing the TPT credit in B's and C's estates, the values of the transferred property are $44,000 and $56,000, respectively.\footnote{14}

(4) The value of the transferred property is reduced by any death taxes payable out of the transferred property, or any encumbrance on the transferred property or any death taxes or obligation imposed on the decedent with respect to the property transferred to him or her.

(5) The value of the transferred property is reduced by the amount of any marital deduction allowed in the transferor's estate with respect to the transferred property.

(6) The value of an annuity, life estate, estate for a term of years or a future interest is determined under section 7520.

(a) As a general rule, the computation will use the section 7520 rate in effect on the date of the transferor's death.

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\footnote{12}{See Treas. Reg. §20.2013-4(a) Example (1).}

\footnote{13}{Treas. Reg. §20.2013-5(a)}

\footnote{14}{See Treas. Reg. §20.2013-4(a) Example (2)}
(b) The "terminal illness" exception provides that the mortality component in section 7520 cannot be used to determine the present value of an annuity, income interest and so on "if an individual who is a measuring life is terminally ill at the time of the decedent's death." Under Treas. Reg. §20.7520-3(b)(3)(i), an individual is terminally ill "if there is at least a 50 percent probability that the individual will die within 1 year." Nevertheless, if the individual survives for at least 18 months, he or she will pass the terminal illness test, regardless of the prognosis at the earlier date.

f. Implications for Marital-Deduction Planning.

(1) General Impact of Marital Deduction on TPT Credit. If the marital deduction is allowed for all of the property transferred to the surviving spouse, no TPT credit will be allowed in the estate of the surviving spouse (because no estate tax was paid in the transferor's estate with respect to the property passing to the surviving spouse). If the marital deduction is not allowed for property transferred to the surviving spouse, a TPT credit may be allowed in the estate of the surviving spouse. Where the TPT credit is available, there will generally be a significant reduction in the overall estate taxes.

(2) Fact Patterns: Assume that H and W each have assets in his or her individual name in the amount of $5,000,000. H dies on January 1, 2006, and W dies on January 1, 2008. At the time of H's death, he is 80 years old and W is 78 years old. Consider the different tax results under the following sets of facts:

(a) Example 1: Outright Marital Gift. H's Will provides for a Credit Shelter Trust and the balance of estate outright to W.

(b) Example 2: QTIP Trust; No "Five-and-Five"; QTIP Election. H's Will provides for a Credit Shelter Trust and the balance of the estate to be held in a QTIP trust. The executor of H's estate makes a QTIP election for the entire QTIP trust.

(c) Example 3: QTIP Trust; "Five-and-Five"; QTIP Election. H's Will provides for a Credit Shelter Trust and the balance of the estate to be held in a QTIP trust. W has a "five-and-five" withdrawal power in the QTIP trust. The executor of H's estate makes a QTIP election for the entire QTIP trust.

(d) Example 4: QTIP Trust; No "Five-and-Five"; No QTIP Election. H's Will provides for a Credit Shelter Trust and the balance of the estate to be held in a QTIP trust.
The executor of H's estate does not make a QTIP election for the QTIP trust.

(e) Example 5: QTIP Trust; "Five-and-Five"; No QTIP Election. H's Will provides for a Credit Shelter Trust and the balance of the estate to be held in a QTIP trust. W has a "five-and-five" withdrawal power in the QTIP trust. The executor of H's estate does not make a QTIP election for the QTIP trust.

(3) Value of the Transferred Property. In Examples 4 and 5, there is no QTIP election. To compute the credit, it is necessary to value the "transferred property."

(a) In Example 4, the transferred property is the life estate. The actuarial factor for an income interest for the life of an individual age 78, using a section 7520 rate of 5.4% (the rate in effect for December 1998), is .34607.

(b) In Example 5, the transferred property consists of (i) the life estate and (ii) the five-and-five withdrawal right.\(^\text{15}\)

(i) As set forth above, the actuarial factor for the income interest is .34607.

(ii) The actuarial factor for the five-and-five withdrawal right for the life of an individual age 78, using a section 7520 rate of 5.4%, is .213586.\(^\text{16}\)

(iii) The factor for the combined income interest and five-and-five withdrawal right is .559656 (.34607 plus .213586).


(a) The death taxes under the facts described in the foregoing examples are as follows:\(^\text{17}\)

\(^{15}\)Rev. Rul 79-211, 1979-2 C.B. 319 holds that "a noncumulative annual right to withdraw the greater of $5,000 or five percent of the value of trust corpus is a general power of appointment that qualifies as property for purposes of the credit for tax on prior transfers under section 2013(a) of the Code."

\(^{16}\)This factor was determined on the Factors program by multiplying .65393 (the factor for a remainder interest following the life of an individual age 78, using a Section 7520 rate of 5.4%) by .32662 (the factor for a unitrust interest with a 5% payout, income at 5.4% and a delay for the first payment of 12 months).

\(^{17}\)The computations are attached as Exhibit "A." The computations assume that H and W are residents of a state that imposes a death tax equal to the federal estate-tax credit for state death taxes.
<table>
<thead>
<tr>
<th></th>
<th>Tax in H's Estate</th>
<th>Tax in W's Estate</th>
<th>Total Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examples 1, 2 and 3</td>
<td>0</td>
<td>$4,245,000</td>
<td>$4,245,000</td>
</tr>
<tr>
<td>Example 4</td>
<td>$2,045,000</td>
<td>$1,435,000</td>
<td>$3,470,000</td>
</tr>
<tr>
<td>Example 5</td>
<td>$2,045,000</td>
<td>$1,049,000</td>
<td>$3,094,000</td>
</tr>
</tbody>
</table>

(b) In the above computations, Example 4 results in savings in the amount of $775,000 ($4,245,000 less $3,470,000) and Example 5, savings in the amount of $1,151,000 ($4,245,000 less $3,094,000). There are two components to the savings. One is the TPT credit, and the other is a greater equalization of the estates. As can be seen in Exhibit "F," the amounts of the TPT credit in Examples 4 and 5 are $610,000 and $996,000, respectively, the bulk of the savings. The balance of the savings is attributable to the equalization.

(5) Death-Tax Computations: Part 2. Some ruminations relating to the TPT credit are:

(a) The older the decedent, the more likely the TPT credit will be available (because the credit is available only if the decedent dies within ten years following the death of the transferor). On the other hand, the older the surviving spouse, the smaller the value of the "transferred property" (that is, the life estate and, where relevant, the five and five withdrawal power). Consider the following life expectancies:

<table>
<thead>
<tr>
<th>Age</th>
<th>Life Expectancy</th>
</tr>
</thead>
<tbody>
<tr>
<td>60</td>
<td>20.02</td>
</tr>
<tr>
<td>65</td>
<td>16.51</td>
</tr>
<tr>
<td>70</td>
<td>13.32</td>
</tr>
<tr>
<td>75</td>
<td>10.48</td>
</tr>
<tr>
<td>80</td>
<td>7.98</td>
</tr>
<tr>
<td>85</td>
<td>5.95</td>
</tr>
<tr>
<td>90</td>
<td>4.42</td>
</tr>
</tbody>
</table>

(b) For estates under $3,000,000, the larger the estates of both spouses, the higher the potential average and incremental estate-tax brackets of the decedent spouse and the surviving spouse and, therefore, the greater the potential TPT credit. At $3,000,000, the 55% bracket kicks in. For estates over $3,000,000, except when the 60% rate applies, the larger the estate, the higher the credit for state death taxes and,

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*Life expectancies from Tiger Tables, TSP Software*
therefore, the lower the federal estate tax and the smaller the potential TPT credit.

(c) Intuitively, one might think that, all other things being equal, the first limitation would generally be lower than the second limitation (because the first limitation is computed on an average basis, while the second limitation is computed on an incremental basis). The opposite is frequently the case. The first limitation tends to be high because the denominator of the fraction is the transferor’s taxable estate reduced by all death taxes. (See formula shown above.)

Drafting Implications. The basis issue is whether a QTIP trust should include a five-and-five withdrawal power. In answering this question, the following issues should be considered:

(1) Income-Tax Implications.19 If the surviving spouse has a five-and-five power, he or she will be treated, for federal income-tax purposes, as the "grantor," of a portion of the principal under section 678, making him of her taxable on a portion of the capital gains of the trust.

(a) Statutory Background. Section 678(a) provides as follows:

(a) GENERAL RULE.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof. [Emphasis supplied.]

(b) What Portion of the Trust Will Be Treated as a Grantor Trust?

(i) One view is that the holder of a five-and-five power will always be treated as the owner of 5% of

the trust principal. The rationale is that during each year the power-holder had, at some point, the right to withdraw 5%, and at no time during any year did the power-holder have the right to withdraw more than 5%.

(ii) The second view is that the power-holder is treated as the owner of 5% of the trust for the first year in which he or she had the withdrawal right and, assuming the withdrawal right is not exercised (but, instead, lapses), an increasing percentage in each subsequent year.

(iii) The issue presented is whether a power that has lapsed should be treated in the same manner as one that has been "partially released or otherwise modified." If so, the person who allowed the power to lapse will be treated as the subpart E owner under section 678(a)(2) of the portion of the trust over which the power has lapsed, if he or she retains the kind of control that would make an actual grantor the owner under Subpart E.²⁰

(iv) The argument that the person who allowed a power to lapse does not fall within the scope of section 678(a)(2) is that a "lapse" is different from a "release." Sections 2041(b)(2) and 2514(e) make this distinction for estate-tax and gift-tax purposes, respectively. Under section 2041(a)(2), property subject to a general power of appointment created after October 21, 1942, is includible in the decedent's gross estate, as is property "with respect to which the decedent has at any time exercised or released such a power of appointment" and retained certain rights or powers. Section 2041(a)(2) provides as follows:

LAPSE OF POWER—The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power . . . [subject to the "five and five" exception]

If the term "release" includes a "lapse," what is the purpose of section 2041(a)(2) (and the similar language in section 2514(e), dealing with the gift-tax aspects of the exercise or release of a general power of appointment)?

(v) The Service takes the position that section 678(a)(2) does apply to the person whose power has lapsed. Thus, in the Service's view, if the person who allowed

²⁰ For an excellent discussion of this issue, see Westfall, "Lapsed Powers of Withdrawal and the Income Tax," 39 Tax Law Review 63. Professor Westfall agrees with the Service's position, described below.
the power to lapse has the kind of interest or power in the trust that would make a grantor the owner under Subpart E, the person who allowed the power to lapse will continue to be the Subpart E owner following the lapse.\textsuperscript{21} (Adopting the terminology of the Westfall article, the position that a lapse is not a release is referred to as the "noncumulativist view," while the Service's position (that a lapse is a release) is referred to as the "cumulativist view.")

(vi) How would the Service’s view be applied to the surviving spouse who allows a five-and-five power to lapse each year? The portion of the trust that is a grantor trust will increase each year.

i) Clearly, the surviving spouse is the "owner" of 5% of the trust under section 678(a)(1) in the first year.

ii) In the second year, the spouse is the "owner" of 5% of the trust under section 678(a)(2) (since he or she had allowed his or her 5% power to lapse at the end of the first year). The spouse holds a current power to withdraw 5% of the total principal of the trust. It would appear that the additional grantor-trust portion in the second year should be 4.75% (determined by multiplying 5% by 95%, the portion of the trust not already considered "owned" by the spouse under section 678(a)(2)). Thus, the grantor-trust portion for year two would be 9.75%.

iii) Following the same approach for year three, the spouse would be considered the "owner" of 14.26% (9.75% under section 678(a)(2)) and an additional 4.51% (5% of the remaining 90.25%).

(c) Does Grantor-Trust Status Have Estate-Tax Implications for the Surviving Spouse?

(i) If the QTIP election is made, grantor-trust status has no impact for estate-tax purposes in the estate of the surviving spouse. Whether the tax on the trust’s capital gains is paid out of the QTIP trust or the separate assets of the surviving spouse will have the same result on the surviving spouse’s estate.

(ii) If the QTIP election is not made, grantor-trust status and the resulting payment of capital-gains tax by the surviving spouse will reduce the assets subject to estate tax in the surviving spouse’s estate.

\textsuperscript{21} PLRs 8521060, 8805032 and 8827023.
(d) **Cash-Flow Implications.** Will the surviving spouse have adequate assets to pay the capital-gains tax? This problem can be dealt with if the QTIP trust either directs payment to the surviving spouse for the tax he or she incurs or allows discretionary distributions of principal to the surviving spouse. The latter approach offers greater flexibility and, as noted above, can provide flexibility for estate-tax savings in the estate of the surviving spouse if the QTIP election is not made.

(2) **Generation-Skipping Transfer Tax ("GSTT") Implications**

(a) Section 2652(a) provides the definition of the term "transferor" for purposes of the GSTT. The general definition is as follows:

(1) IN GENERAL.—Except as provided in this subsection or section 2653(a), the term "transferor" means—

(A) in the case of any property subject to the tax imposed by chapter 11, the decedent, and

(B) in the case of any property subject to the tax imposed by chapter 12, the donor.

An individual shall be treated as transferring any property with respect to which such individual is the transferor.

(b) The special rule for QTIP trusts (the so-called "reverse QTIP election") provides as follows:

(3) SPECIAL ELECTION FOR QUALIFIED TERMINABLE INTEREST PROPERTY.—In the case of—

(A) any trust with respect to which a deduction is allowed to the decedent under section 2056 by reason of subsection (b)(7) thereof, and

(B) any trust with respect to which a deduction to the donor spouse is allowed under section 2523 by reason of subsection (f) thereof,

the estate of the decedent or the donor spouse, as the case may be, may elect to treat all of the property in such trust for
purposes of this chapter as if the election to be treated as qualified terminable interest property had not been made.

Thus, under section 2652(a)(3) the estate of the first spouse to die may elect to treat the QTIP election as not having been made for purposes of the GSTT to prevent the "transferor" from changing to the surviving spouse upon the death of the surviving spouse (which change would "wipe out" any of the first decedent’s GSTT exemption that had been allocated to the trust).

(c) To the extent that a trust is includible in the estate of the surviving spouse under section 2041 (general power of appointment), however, it would appear that the "transferor" will change to the surviving spouse for purposes of the GSTT. Even ignoring the QTIP election for the trust (as a result of the reverse QTIP election), the portion of the QTIP trust subject to a general power of appointment is "property subject to the tax imposed by Chapter 11." If (i) this interpretation is correct, (ii) the surviving spouse dies while the withdrawal power is effective and (iii) the trust had been exempt from the GSTT because of an allocation of GSTT exemption in the estate of the first spouse to die, a portion of the QTIP trust may lose its insulation from GSTT. (The executor of the surviving spouse’s estate could, of course, allocate a portion of his or her GSTT exemption to the trust.)

3) Drafting the Five-and-Five Power.

(a) Consider the following language for a five-and-five power:

If my wife, WWW, is living on the last day of a calendar year, my Trustees shall distribute to her such portions of the principal of this trust as she may have requested during such year, provided that the aggregate of such distributions shall not exceed, with respect to any such year, the greater of Five Thousand Dollars ($5,000) or five percent (5%) of the principal remaining in this trust on the last day of such year. My wife shall exercise this right by written instrument or instruments delivered to my Trustees prior to December 31 of such year, and her right to request these distributions shall not be cumulative and shall lapse to the extent not so exercised in any calendar year. My Trustees shall make any distributions required under the provisions of this paragraph within forty-five days after the
end of the calendar year with respect to which the distributions are to be made.

(b) Under the foregoing language, over what portion, if any, of the QTIP trust will WWW hold a general power of appointment at the time of her death? As will be seen below, WWW will hold a general power of appointment over 5% of the trust if, and only if, she dies on December 31 of a particular year and has not exercised her withdrawal right in the year of her death.

(i) If WWW dies on December 31, 5% of the trust would be includible in her gross estate. If she had made a request for a distribution during the year of her death, her estate would be entitled to the distribution, and the 5% portion would be includible in her gross estate under section 2033 ("property in which the decedent had an interest"). If WWW had not made a request for a distribution, she would hold a general power of appointment on the date of her death, and the 5% portion would be includible in her estate under section 2041. In the latter case, if the QTIP trust had had an inclusion ratio of zero prior to WWW's death, the inclusion ratio of the QTIP trust would change to .05, unless WWW's executors made an allocation of WWW's GSTT exemption to the QTIP trust.

(ii) If WWW does not die on December 31 and has not requested a distribution, nothing would be includible in her gross estate.

(iii) If WWW does not die on December 31 and has requested a distribution which was not made to her, there would be includibility in her gross estate if, and only if, she was alive on the December 31 that entitled her to the distribution. For example, assume WWW requested a distribution in 1999 and she dies either (i) on December 30, 1999, or (ii) on January 1, 2000. If WWW dies on December 30, 1999, her estate would have no right to the distribution, and nothing would be includible in her estate. On the other hand, if WWW dies on January 1, 2000, her estate would be entitled to the distribution. In that case, the distributable share would be includible in WWW's gross estate under section 2033.

(c) Is it better to use a date other than December 31 for the withdrawal right to "vest"?

(i) The actuarial value of the withdrawal right increases as the delay to the first payment decreases. For example, in the above example, where there is a twelve month delay until the first payment, the actuarial factor of the five-and-five withdrawal right is .213586. If the delay
is shortened to one month, the actuarial factor is .221492,22 an increase of .0079. If the value of the trust were $1,000,000, the increase in the value of the transferred property would be $7,900, a minor difference. Accordingly, there can be a relatively small advantage in tying the vesting date to the date of death.

(ii) If in a particular case, there was a desire to shorten the delay, the following variation on the above language might be considered:

If my wife, WWW, is living on the thirtieth day following my death or on any anniversary of that thirtieth day (the thirtieth day and each such anniversary hereinafter referred to as the "Vesting Date"), my Trustees shall distribute to her such portions of the principal of this trust as she may have requested following my death and during the twelve month period prior to a Vesting Date, provided that the aggregate of such distributions shall not exceed the greater of Five Thousand Dollars ($5,000) or five percent (5%) of the principal remaining in this trust on the Vesting Date. My wife shall exercise this right by written instrument or instruments delivered to my Trustees within the twelve month period prior to the Vesting Date of such year, and her right to request these distributions shall not be cumulative and shall lapse to the extent not so exercised. My Trustees shall make any distributions required under the provisions of this paragraph within forty-five days after the Vesting Date with respect to which the distributions are to be made.

(4) Estate Tax Implications for the Surviving Spouse

(a) If there is a QTIP election for the entire trust, the five-and-five power will have no impact on the estate taxes in the estate of the surviving spouse (because the entire trust would be included in his or her gross estate under

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22 This factor was determined on the Factors program by multiplying .65393 (the factor for a remainder interest following the life of an individual age 78, using a Section 7520 rate of 5.4%) by .33871 (the factor for a unitrust interest with a 5% payout, income at 5.4% and a delay for the first payment of one month)
section 2044 ("certain property for which marital deduction was previously allowed") in any event).

(b) If there is no QTIP election for the trust and the five-and-five power is drafted as quoted above, the power will result in five percent of the trust being included in the gross estate of the surviving spouse under section 2041 if, and only if, he or she dies on December 31 (as described above).

5. Planning Elements of Contingent QTIP Trusts.

a. What Is a Contingent QTIP Trust. In final regulations issued on August 19, 1998, the Service approved the so-called "contingent QTIP trust." A contingent QTIP trust is a trust in which the spouse's "qualifying income interest" is contingent upon the executor of the decedent's estate making a QTIP election with respect to the trust. The example from the regulations is as follows:

Example 6. Spouse's qualifying income interest for life contingent on executor's election. D's will established a trust providing that S is entitled to receive the income, payable at least annually, from that portion of the trust that the executor elects to treat as qualified terminable interest property. 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.23

b. Why Use a Contingent QTIP Trust?

(1) When a Contingent QTIP Trust is Not Needed. The executor of the decedent's estate may determine whether, and what portion of, a QTIP trust should be subject to tax in the estate (by virtue of the QTIP election or non-election). Thus, a contingent QTIP trust is not needed for this purpose.

(2) Flexibility Added by Contingent QTIP Trust. In the case of a noncontingent QTIP trust, the surviving spouse will be entitled to all of the income of the trust, whether or not the QTIP election is made. If a QTIP election is not made, this may result in an unnecessary increase in the estate of the surviving spouse.

23Example 6 in Treas Reg §20.2056(b)-(7)(h)

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(3) **Case Study.**

(a) W's Will provides a formula which creates a credit shelter trust (equal to the exemption amount) and a noncontingent QTIP trust (for the balance of the estate). The credit shelter trust allows the trustee to make distributions of income and principal to H and issue on a discretionary basis. W dies in 2006. At the time of her death, W has a $15,000,000 estate and H's assets are negligible. Neither W nor H has used any portion of the exemption amount during lifetime.

(b) The attorney for W's estate, Able Sage, advised the family and the executor that if the executor of W's estate made a QTIP election with respect to the entire QTIP trust, no death taxes would be paid in W's estate, and the tax in H's estate would be $7,195,000 (assuming no change in the value of the assets). Able told his clients that the overall taxes in both estates would be reduced if some tax were paid in W's estate. The first dollar taxed in W's estate is at the 41% bracket, while the last dollar taxed in H's estate will be at the 60% bracket. Able showed his clients the computations attached as Exhibit "G," which calculate the tax that is created if the executor does not make a QTIP election with respect to $1,000,000 (plus the amount necessary to pay the estate tax in W's estate).

(c) The clients were skeptical about the savings because of the time value of money that would be lost in paying tax in W's estate. In response to that concern, Able produced the computations attached as Exhibit "H," which assume a total return of 8% annually.

(d) The clients pointed out to Able that his computer-generated figures made the assumption that none of the income on the $1,000,000 "non-elected" QTIP trust would be subject to estate tax in H's estate. But H would, in fact, receive the income on the $1,000,000 non-elected QTIP trust, and that amount should be added to H's gross estate in the computations. Able quickly made the handwritten calculations on Exhibit "H."

(c) **Some Rules of Thumb Regarding Use of Noncontingent and Contingent QTIP Trusts.**

(1) A partial QTIP election for a noncontingent QTIP trust will be less favorable than a full QTIP election the longer the surviving spouse lives. This is for two reasons:

(a) The possible TPT credit decreases with time and is eliminated after ten years.

(b) The income from the non-elected QTIP trust is, in effect, taxed twice. Estate tax was paid on the
entire non-elected QTIP trust in the first estate. Each year following the first death, the survivor receives the income, which will be taxed in his or her estate. This is true even if the surviving spouse actually consumes the income from the non-elected QTIP trust because dollars are fungible (and other dollars could have been consumed).

(2) For tax purposes, the only circumstance under which a noncontingent QTIP trust will be better than a contingent QTIP trust is if the surviving spouse is likely to have a short life expectancy at the death of the first spouse. In that case, a noncontingent QTIP trust will maximize the TPT credit because the surviving spouse will have both an income interest and a five-and-five power.

(3) For a contingent QTIP trust, the computation of the TPT credit will depend on the terms of the "default trust" (that is, the trust that will receive the assets if there is no QTIP election).

(a) There is no authority for the method of calculating the value of a five-and-five power when the holder of the power is not also entitled to the income.

(b) Presumably, if the default trust allowed the trustee to spray income among the power-holder and others, the value of the power would be calculated in the same way it is calculated when the power-holder is entitled to all of the income (that is, the calculation is based on the value of the remainder interest).

(c) What if the only potential distributee of income of the default trust were the power-holder? In that case, the value of the power should be based on the entire value of the trust (not just the remainder interest). If a distribution of income were made (thereby reducing the base against which the power is calculated), the income would be added to the estate of the power-holder.

Example. Using the facts described in the above examples that calculate the TPT credit, assume that there was a contingent QTIP trust. If the default trust provided for a spray of income among the surviving spouse and issue, the factor for determining the value of the transferred property would be .213586. If the surviving spouse were the only permissible distributee of income, the factor for determining the value of the transferred property should be .32662. (See paragraph (b)(ii) on page 22 above.)

(d) If the trust allowed the trustee to make distributions of income and principal among the power-holder and
others, it would appear that the value of the power could not be
determined and no TPT credit would be allowed.

**d. How Should the Contingent Beneficiary in a Contingent QTIP Trust Be Structured?** The following should be considered in the structuring of a contingent QTIP trust:

1. The surviving spouse should not be entitled to all of the income of the trust because this will result in an increase in estate tax in the estate of the surviving spouse and eliminate the major advantage of a contingent QTIP trust over a noncontingent QTIP trust.

2. If there is a spray of income among the surviving spouse and issue,\(^{24}\) the following will result:

   a. Subject to the exception in the next paragraph, a spray may create an opportunity to minimize income tax. Because of the compressed income-tax brackets and the "kiddie tax," this opportunity may be extremely limited.

   b. If there is a spray of income and the surviving spouse holds a five-and-five power, the surviving spouse will be treated as the subpart E owner, for grantor income-tax purposes, of a portion of the ordinary income, as well as the capital gains, of the trust.\(^{25}\) From an estate-tax point of view, this is desirable because the surviving spouse will pay income tax on income that may be distributed to members of younger generations.

3. If there is a spray of income and principal among the surviving spouse and issue, the income-tax consequences will be the same as if there were a spray of income (as discussed above). A spray of income and principal will maximize the flexibility for nontax purposes.

4. To the extent the objective is to maximize the possible TPT credit, the contingent QTIP trust should provide for discretionary distributions of income to the surviving spouse only, grant the surviving spouse a five-and-five withdrawal power and preclude discretionary distributions of income or principal to anyone other than the surviving spouse.

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\(^{24}\)As with any trust, if there is no independent trustee, the standard for distributions would be "health, maintenance, support and education," to prevent adverse gift or estate-tax consequences to the beneficiary/trustee.

\(^{25}\)Treas. Reg. §1.271-3(b)(3)
(5) Taking into consideration (i) the potential estate-tax advantage of permitting a spray of income (surviving spouse paying income tax on income that may be distributed to other family members) and (ii) the potential availability of the TPT credit, a suggested approach is to provide for a spray of income among the spouse and issue, grant the surviving spouse a five-and-five power, and permit distributions of principal to the spouse only.

e. Compare Partial QTIP Election with Disclaimer. A disclaimer can sometimes accomplish the same result as a partial QTIP election, that is, it can result in payment of federal estate tax in the first estate. If the surviving spouse disclaims his or her interest in all or a part of the QTIP trust, the disclaimed assets would pass to alternate beneficiaries named in the Will. The alternate beneficiaries might be family members other than the surviving spouse or a trust not meeting the QTIP requirements (the same "default trust" as in the case of a contingent QTIP trust). If the Will had no specific alternate provisions in the case of a disclaimer, state law would govern, which would generally provide for the disclaimed assets to pass from the QTIP trust as if the surviving spouse were deceased.

(1) Comparison of Contingent QTIP Trust with Disclaimer. The following considerations distinguish the two techniques:

(a) **Time Limitation.** A disclaimer must be made within nine months of the date of the decedent’s death. The decision with respect to a QTIP election is made on the decedent’s estate tax return. The executor of an estate can almost certainly obtain a six-month extension for the filing of the federal estate-tax return, giving the executor fifteen months from the date of death to make a decision regarding the QTIP election.

(b) **Difficulty in Carrying Out Plan.** While neither a QTIP election nor a disclaimer of property passing under the Will of a decedent will ordinarily create a problem, a disclaimer may present certain practical problems if the surviving spouse is not competent. To deal with this possibility, the surviving spouse may have given someone a Power of Attorney that includes a specific power to disclaim property. Notwithstanding the inclusion of specific disclaimer language in a Power of Attorney, at least one state (Pennsylvania) will require court approval for the attorney-in-fact to make the disclaimer.

(c) **Decision-Maker.** In the case of a disclaimer, the decision would, of course, be made by the surviving spouse. In the case of the contingent QTIP trust, the decision would be made by whomever is named as executor.
(d) Spouse’s Limited Power of Appointment. If it is desired that the contingent recipient of the assets be a trust over which the surviving spouse would have a limited testamentary power of appointment, the disclaimer route will not work. Under section 2518(b)(4), in the case of a disclaimer, the disclaimed interest must pass "without any direction on the part of the person making the disclaimer..." 

(e) Estate and Gift-tax Issue. If the executor of the decedent’s estate is also a beneficiary under the Will, will there be estate or gift-tax ramifications for the executor in the case of a contingent QTIP trust?

Example: W leaves her estate to a QTIP trust for H, but if the QTIP election is not made, the assets will pass to C.

Assume, first, that H is the executor. If H does not make the QTIP election (so that the assets pass to C), will H be considered to have made a gift to C?

Assume, second, that C is the executor. If C makes the QTIP election will she be considered to have made a gift to H? If C is the remainderman of the QTIP trust, will a portion of the QTIP trust be included in her estate under section 2037 if she dies before H?

(2) Conclusions. While there is no "one-size-fits-all" conclusion, the following factors will weigh in favor of a contingent QTIP trust (rather than relying on a disclaimer):

(a) The existence of an independent executor, which will eliminate any estate or gift-tax concern

(b) The desire by the surviving spouse to have a limited testamentary power over the contingent trust.

(c) The surviving spouse’s access to sufficient assets for his or her financial security if he or she in not to control the QTIP election.

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"Example 6 of Treas. Reg. §20.2056(b)-(7) provides that "Under these facts [the existence of a contingency provision], 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 rule is, or course, essential for qualification of the QTIP trust for the marital deduction. It says nothing about potential estate or gift-tax consequences to the executor."
(d) In all cases, the fifteen-month timeframe for the contingent QTIP trust compares favorably to the nine-month limitation for the disclaimer.

f. Compare Partial QTIP Election with Lifetime Gift By Surviving Spouse. If the surviving spouse is willing to accelerate a fixed number of tax dollars, a lifetime gift by the surviving spouse might be considered as an alternative to a partial QTIP election. A comparison between the two approaches is difficult because, to some extent, it is an "apples-oranges" comparison. In any event, the following are some of the factors to be considered in this context:

1. The surviving spouse must give up all access to the assets in the case of a lifetime gift.

2. The TPT credit has no relevance to a lifetime gift by the surviving spouse.

3. The surviving spouse must live for at least three years following a lifetime gift to avoid inclusion of the gift tax in his or her gross estate under section 2035(c).

4. In order to pay gift tax, the surviving spouse must have used his or her entire exemption amount or must be willing to make a gift sufficient to use the exemption amount and incur the gift tax.

5. The savings in the case of a lifetime gift results from removing the gift tax itself from any gift or estate tax, while the savings from a partial QTIP election or disclaimer results from moving taxable assets from the highest bracket of the surviving spouse to the bracket of the deceased spouse.

(a) The savings resulting from the bracket differential decreases as the amount subject to tax in the first estate increases. Except where the estate of the surviving spouse will be in the 60% bracket, there is no further savings from a bracket differential once the first estate reaches the 55% bracket at $3,000,000.

(b) There is no "ceiling" on the amount of lifetime gifts that will produce a savings.

6. Assuming the surviving spouse is willing to accelerate a fixed number of tax dollars and ignoring the factors noted above, a lifetime gift will produce greater potential savings than a partial QTIP election or disclaimer.

Example: Assume the surviving spouse has used her entire exemption amount, that she is in a 50%
bracket and that, at her death, her estate will be in a 55% bracket.

(a) In the case of a gift by the surviving spouse, she can give away $666,666 and pay gift tax in the amount of $333,333. At her death, the savings will be approximately $183,000 ($333,333 x 55%).

(b) If there is a partial QTIP election creating an estate tax in the amount of $333,333 in the first estate, and assuming there is a 12% bracket differential between the two estates (first estate in a 43% bracket and second estate in a 55% bracket), the partial QTIP election will result in savings in the amount of approximately $93,000 (the differential between taxing $775,000 at 43%, rather than 55%).

(c) The figures above do not take into account the impact of future appreciation. In the case of the lifetime gift, the amount appreciating outside the spouse’s estate is $666,666, while in the case of the partial QTIP election, the amount accumulating outside the spouse’s estate is $775,000. (This assumes a contingent QTIP trust so that the surviving spouse’s estate is not being increased by the income from the trust.)

6. Qualification of IRAs for the Marital Deduction\(^{28}\)

a. Statement of the Problem. For a number of nontax reasons (such as a spouse’s inability to manage assets or the desire to control distribution at the spouse’s death), it is sometimes important to name a marital trust (rather than the spouse) as the beneficiary of an IRA (or other retirement plan).\(^{29}\)

\(^{27}\)The $775,000 figure is the amount that can be taxed at a 43% bracket and create a federal estate tax of approximately $333,000 ($775,000 x 43% = $333,000).

\(^{28}\)The discussion of this topic is based on a paper submitted to the Internal Revenue Service by the Estate and Gifts Taxes Committee of the Section of Taxation of the American Bar Association, which was drafted by Beverly R. Budin.

\(^{29}\)For income-tax purposes, a spouse (rather than a trust) is the preferred beneficiary of an IRA or other qualified retirement plan. The spouse/beneficiary has opportunities for significant income-tax deferral that are not available to any other beneficiary. First, if the spouse is the beneficiary, he or she can roll over the distribution into his or her own IRA, in which case he or she can (i) defer the commencement of distributions until he or she has attained the age of 70\(\frac{1}{2}\) years and (ii) name a beneficiary of the roll-over IRA, whose life
b. Rev. Rul. 89-89. The only authority for qualification of an IRA for the marital deduction when the IRA is payable to a trust is Rev. Rul. 89-89 (the "1989 Ruling"). The 1989 Ruling has the following two requirements for allowance of the marital deduction:

1. **The IRA Distribution Requirement.** The decedent must have elected a distribution option under which (a) the principal balance of the IRA is to be distributed to the trust in annual installments over the lifetime of the surviving spouse and (b) the income earned on the undistributed balance is to be paid annually to the trust.

2. **The Trust Requirement.** The trust must require "that both the income earned on the undistributed portion of the IRA which it receives from the IRA and the income earned by the trust on the distributed portion of the IRA be paid currently to the decedent's spouse for life."

c. **Practical Problem.** The major planning problem with the approach in the 1989 Ruling is that many IRA sponsors do not have a distribution option that requires distributions of "income," making compliance with the 1989 Ruling difficult and, in certain cases, impossible.

d. **Recommended Solution.** The suggestion made to the Service is the modification of the 1989 Ruling to provide that qualification for the marital deduction is allowed if the following criteria are met:

1. The trust instrument includes one or more of the following provisions:

   a. A provision giving the surviving spouse the power to demand that any nonincome-producing property be converted to income-producing property within a reasonable time.

   b. A provision requiring the trustee to convert any nonincome-producing property to income-producing property within a reasonable time.

   c. A provision requiring the trustee to (i) withdraw from the IRA, annually or more frequently, an amount equal to the income earned by the IRA during the year and (ii) distribute such amount (in addition, to the income earned expectancy can be taken into account in determining the spouse's "minimum distribution." Second, if the spouse does not "roll over," he or she can defer the commencement of distributions until the year in which the decedent spouse would have attained the age of 70½ years.

   "Several letter rulings have dealt with the issue.
inside the trust) to the surviving spouse, annually or more frequently.

(d) A provision giving the spouse the power to compel the trustee to (i) withdraw from the IRA, annually or more frequently, an amount equal to the income earned on the IRA during the year and (ii) distribute such amount (in addition, to the income earned "inside" the trust) to the surviving spouse, annually or more frequently.

(2) If the marital deduction is based on the provisions in paragraphs (1)(a) or (1)(b) above, the IRA may not contain any substantive prohibition on the withdrawal of all amounts from the IRA; and if the marital deduction is based on the provisions in paragraphs (1)(c) or (1)(d) above, the IRA may not contain any substantive prohibition on the withdrawal of the income earned by the IRA.

(3) Unless the balance remaining in the IRA at the death of the surviving spouse is payable to the estate of the surviving spouse or the surviving spouse holds an inter vivos or testamentary general power of appointment over the said balance, the executor of the estate of the deceased spouse must make a QTIP election with respect to the IRA (as well as with respect to the trust that is the recipient of the IRA).

e. Discussion of Proposal. The proposal is based on the belief that the Service's concern in allowing a marital deduction in the case of an IRA payable to a "qualified terminable interest property" ("QTIP") trust is the income requirement for such a trust. The following discusses that issue:

(1) Statutory Provisions. To qualify as QTIP, the surviving spouse must have a "qualifying income interest for life" in the property. One of the requirements for a "qualifying income interest for life" is that "the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property ..." This income requirement for a QTIP trust is virtually identical to the income requirement under section 2056(b)(5) for a "general-power-of-appointment" trust.

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31 Section 2056(b)(7)(B)(i)

32 Section 2056(b)(7)(B)(ii).
(2) Regulations.

(a) The principles of section 20.2056(b)-5(f) (relating to general-power-of-appointment trusts) apply in determining the income requirement for a QTIP trust.33

(b) The following provisions of the regulations dealing with the income requirement for general-power-of-appointment trusts are relevant to this discussion:

(i) The income requirement is met "if the effect of the trust is to give her [the surviving spouse] substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust."34

(ii) The regulations deal with the question of unproductive property in section 20.2056(b)-5(f)(4) as follows:

... For example, a power to retain trust assets which consist substantially of unproductive property will not disqualify the interest if the applicable rules for the administration of the trust require, or permit the spouse to require, that the trustee either make the property productive or convert it within a reasonable time. Nor will such a power disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets ... .

(iii) A marital deduction is disallowed "... to the extent that the income is required to be accumulated in whole or in part or may be accumulated in the discretion of any person other than the surviving spouse; to the extent that the consent of any person other than the surviving spouse is required as a condition precedent to distribution of the income; or to the extent that any person other than the

Treas Regs Section 20.2056(b)-7(d)(2)
Treas Regs Section 20.2056(b)-5(f)(1)

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surviving spouse has the power to alter the terms of the trust so as to deprive her right to the income.\textsuperscript{35} [Emphasis added.]

(c) Interpretation of the Regulations. It is clear from the regulations that a "qualifying income interest for life" does not require actual distribution of income to the spouse. The spouse can allow income to be accumulated. Any one of the provisions listed in paragraphs (1)(a) through (1)(d) above is sufficient to meet the income requirement for QTIP. Thus, unless the terms of the IRA contract or beneficiary designation override the rights of the spouse or the duties of the trustee listed in paragraphs (1)(a) through (1)(d), as the case may be, the IRA should qualify as QTIP if the appropriate election is made.


(1) The ideal approach is to meet both the "IRA Distribution Requirement" and the "Trust Requirement" of the 1989 Ruling (as described above).

(2) When it is not possible to meet the IRA Distribution Requirement (because of lack of flexibility on the part of the IRA sponsor), it is suggested that (i) the Trust Requirement be met and that (ii) the spouse be given the power to demand that any nonincome-producing property be converted to income-producing property within a reasonable time.

g. Sample Trust Provisions. Trust provisions that should qualify the IRA distributions for the marital deduction would provide as follows:

The Trustees shall pay the net income to or for the benefit of the surviving Trustor in monthly or other convenient installments but in any event at least annually during his or her lifetime. If the Trustees have been designated as the beneficiaries of any individual retirement account, pension plan, profit sharing plan or other employee benefit plan of the Trustor, then:

(a) if the account balance is paid to the Trustees in installments, whether or not required under applicable law, and if the income earned by the account in any year is more than the installment payments for that year, the Trustees shall withdraw an amount from the account equal to the difference between the income earned and the installment payment and all such amounts paid or withdrawn shall constitute income of the trust;

\textsuperscript{35} Treas Regs. Section 20.2056(b)-5(f)(7)

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(b) during any period in which applicable law does not require any payment to be made to the Trustees from such account, the Trustees shall withdraw an amount equal to all of the income earned by the account in that year less amounts actually distributed to the Trustees, and all such amounts paid or withdrawn shall constitute income of the trust;

(c) the Trustees shall have the power to change any instrument’s payment schedule to one that is more rapid than required by applicable law and shall have the power to withdraw all or any portion of the account balance at any time in order to insure the qualification of this trust for the marital deduction;

(d) if the account consists substantially of unproductive property, the surviving Trustor shall have the power to require the Trustees to make the property productive or to convert it within a reasonable time or to provide out of the other assets of the account the amount such property would produce if it were productive;

(e) the surviving Trustor shall have the power to compel the Trustees to exercise the powers set forth in subparagraphs (a) through (d) of this subparagraph with respect to any such accounts.

OTIP and Options: Rinaldi v. U.S.

a. Description of the Case.

(1) In Rinaldi v. U.S.,36 Clyde Rinaldi left the stock in his closely held business (the "Stock") to a trust for the benefit of his wife (the "Trust"). Rinaldi died on November 25, 1988. On December 31, 1988, the fair market value of the stock was approximately $1,520,000 and the book value, approximately $1,390,000.

(2) Under the terms of the Trust, if Rinaldi’s son ceased managing the business, the trustee was to offer the Stock to the son at book value.

(3) After Rinaldi’s death and before the filing of the federal estate-tax return, the company and the trustee of the Trust agreed that the Stock would be redeemed for its fair market value (approximately $1,520,000). The purpose of the redemption was to prevent the lose of the company’s S election.

(because, under the law at that time, the Trust would not have qualified as an eligible S corporation shareholder).

(4) The Service disallowed the QTIP election for the Trust, arguing that the Trust flunked the QTIP requirement in section 2056(b)(7) (B)(ii)(II) that "no person has a power to appoint any part of the property to any person other than the surviving spouse."

(5) The court agreed with the Service that the potential sale to the son at a bargain price disqualified the Trust from QTIP treatment:

. . . the trust established by the terms of Rinaldi’s will was clearly ineligible for QTIP treatment -- the will explicitly subjected the trust’s value to diminution through the potential sale of its assets at a bargain price to someone other than the surviving spouse.

(6) The taxpayer’s argument, that the redemption cured any defect in the Trust, was rejected by the court. The court pointed out that the Trust could reacquire the Stock, which would then be subject to the disqualifying buyout provision.

b. Thoughts on Rinaldi.

(1) Possible Cure. A post-mortem cure would have been the son’s disclaimer of his right to buy the Stock.

(2) Outright Marital Gift. If Rinaldi had made an outright give to his wife, would the result have been different?

(3) Analysis as Valuation Issue. Should Rinaldi have been analyzed as a valuation case? Under this theory the stock would be included in the gross estate at its unencumbered value but, in valuing the stock for purposes of the marital deduction, the stock would be valued under the willing buyer-willing seller test, taking the option into account.

(4) Distinction from Restrictions in Shareholders Agreements. What would the result have been if there had been no provision in Rinaldi’s will for a buyout, but the Stock had been subject to a shareholders agreement that provided for a right of first refusal at book value? This situation differs from Rinaldi in two significant respects.

(a) First, in the case of a shareholders agreement, the stock included in the gross estate is subject to the restriction; the restriction is not imposed by the decedent’s Will.
(b) Second, in Rinaldi, the son could trigger the buyout, while, in the case of a shareholders agreement, the holder of the stock could never be forced to sell

(5) Caveat. Rinaldi is a reminder that unusual provisions that may affect the marital deduction should be reviewed with great care.

8. Avoiding Inadvertent Gifts in a QTIP Trust.

a. If a QTIP trust holds nonincome-producing assets and the surviving spouse fails to demand that the assets be converted to income-producing assets, at some point the Service may argue that the surviving spouse has made a gift of the income to the QTIP trust. Under section 2702, the amount of the gift would be the full amount of the foregone income, without any reduction for the actuarial value of the spouse's income interest.\(^{37}\)

b. If the surviving spouse holds a special power of appointment over the QTIP trust, his or her gift to the trust will be incomplete.\(^{38}\) Thus, inclusion of a special power will eliminate any gift tax consequences of holding nonincome-producing assets in a marital trust, as well as provide overall flexibility.

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\(^{37}\) Even without section 2702, the result might be the same under the section 7520 regulations.

\(^{38}\) Treas. Reg. §25.2511-2(c)
IRS Proposed Rules and Notice of Public Hearing (REG-114663-97)
On Treatment of Estate Administration Expenses


DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 20
[REG-114663-97]
RIN 1545-AV45

Marital Deduction; Valuation of Interest Passing to Surviving Spouse

AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the effect of certain administration expenses on the valuation of property which qualifies for the estate tax marital or charitable deduction. The proposed regulations define estate transmission expenses and estate management expenses and provide that estate transmission expenses, but not estate management expenses, reduce the value of property for marital and charitable deduction purposes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by Feb. 16, 1999. Outlines of topics to be discussed at the public hearing scheduled for April 21, 1999, at 10 a.m., must be received by March 31, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG-114663-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-114663-97), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. FOR FURTHER INFORMATION CONTACT: concerning the proposed regulations, Deborah Ryan (202) 622-3090; Concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background


Section 2056(b)-4 provides that, in determining the value of an interest in property which passes from the decedent to the surviving spouse for purposes of the marital deduction, account must be taken of any encumbrance on the property or any obligation imposed on the surviving spouse by the decedent with respect to the property. Section 20.2056(b)-4(a) of the Estate Tax Regulations amplifies this rule by providing that account must be taken of the effect of any material limitations on the surviving spouse’s right to the income from the property. The regulation provides, for example, that there may be a material limitation on the surviving spouse’s right to the income from marital trust property where the income is used to pay administration expenses during the period between the date of the decedent’s death and the date of distribution of the assets to the trustee.

The facts in Estate of Hubert are similar, to a common fact pattern herein the decedent’s will provides for a residuary bequest to a marital trust which qualifies for the marital deduction and also provides that estate administration expenses are to be paid from the residuary estate. Further, the will (or state law) permits the executor to use the income generated by the residuary estate (otherwise payable to the marital trust) to pay administration expenses, and the executor does so. The issue before the Supreme Court in Estate of Hubert was whether the executor’s use of the income to pay estate administration expenses was a material limitation on the surviving spouse’s right to the income which would reduce the marital deduction under §20.2056(b)-4(a).

The issue in Estate of Hubert also involved the estate tax charitable deduction, and the proposed regulations relate to the valuation of property for both marital and charitable deduction purposes. However, for simplicity and clarity, this discussion focuses on the provisions of the estate tax marital deduction.

In Estate of Hubert, the Commissioner argued that the payment of administration expenses from income is, per se, a material limitation on the surviving spouse’s right to income for purposes of §20.2056(b)-4(a), and, therefore, the value of the marital bequest should be reduced dollar for dollar by the amount of income used to pay administration expenses. The Court agreed that the value of the marital bequest should be reduced if the use of income to pay administration expenses is a material limitation on the spouse’s right to income. The Court found, however, that the regulation does not de-
In Notice 97-63 (November 24, 1997), the IRS requested comments on possible approaches for proposed regulations in light of the Estate of Hubert decision. Notice 97-63 suggested three alternative approaches for determining when the use of income to pay administration expenses constitutes a material limitation on the surviving spouse’s right to income. One approach distinguished between administration expenses that are properly charged to principal and those that are properly charged to income and provided that there is a material limitation on the surviving spouse’s right to income if income is used to pay an estate administration expense that is properly charged to principal. A second approach provided a de minimis safe harbor amount of income that may be used to pay administration expenses without constituting a material limitation on the surviving spouse’s right to income. A third approach provided that any charge to income for the payment of administration expenses constitutes a material limitation on the spouse’s right to income.

Notice 97-63 also asked for comments on whether the test for materiality should be based on a comparison of the relative amounts of the income and the expenses charged to the income; whether materiality should be based on projections as of the date of death rather than on the facts that develop afterwards; and whether present value principles should be applied.

In response to Notice 97-63, several commentators suggested that local law should be determinative of whether an expense is a proper charge to income or principal. If the testamentary document directs the executor to charge expenses to income, and the charge is allowed under applicable local law, then the charge to income should not be treated as a material limitation on the spouse’s right to income.

This approach was not adopted because statutory provisions relating to income and principal may vary from state to state, and this would result in disparate treatment of estates that are similarly situated but governed by different state law. Moreover, in states that have adopted some form of the Uniform Principal and Income Act, the definitions of principal and income, and the allocation of expenses thereto, can be specified in the will or trust instrument and given the effect of state law. Thus, simply following state law was thought to be too malleable to protect the policies underlying the marital and charitable deductions.

Several commentators agreed with the de minimis safe harbor approach whereby a certain amount of income could be used to pay administration expenses without materially limiting the surviving spouse’s right to the income. Under this approach, the safe harbor amount is determined in two steps: first, the present value of the surviving spouse’s income interest for life is determined using actuarial principles and, second, the resulting amount is multiplied by a percentage, for example, 5 percent.

The proposed regulations do not adopt this approach. Although a de minimis safe harbor approach would provide a bright line test for determining materiality in the context of the marital deduction, it is unclear how this approach would apply for charitable deduction purposes because there is no measuring life for valuing the income interest.

One commentator suggested that, consistent with the plurality opinion in Estate of Hubert, the test for materiality should be quantitative, based upon a comparison between the amount of income charged with administration expenses and the total income earned during administration. The commentator, however, considered the requirement that projected income and expenses be presently valued to be impractical, complex, and uncertain. Another commentator considered a quantitative test to be impractical. A third commentator suggested that a quantitative test would require a factual determination in each case and, as a result, the period of estate administration would be greatly prolonged.

Because these tests for materiality appear to be complex and difficult to administer, the proposed regulations adopt neither a quantitative test nor a test based on present values of projected income and expenses.

Many commentators opposed an approach in which every charge to income is a material limitation on the surviving spouse’s right to income. Two commentators contended that adoption of this approach would effectively overrule the result in Estate of Hubert.

One commentator suggested the approach adopted in the proposed regulations, a description of which follows, and two commentators suggested similar approaches.

Explanation of Provisions

Under the proposed regulations, a reduction is made to the date of death value of the property interest which passes from the decedent to the surviving spouse (or to a charitable organization described in section 2055) for the dollar amount of any estate transmission expenses incurred during the administration of the decedent’s estate and charged to the property interest. Such a reduction is proper because these expenses would not have been incurred but for the decedent’s death. No reduction is made for estate management expenses incurred with respect to the property and charged to the property because these expenses would have been incurred even if the death had not occurred. However, a reduction is made for estate management expenses charged to the marital property interest passing to the surviving spouse if the expenses were incurred in connection with property passing to someone other than the surviving spouse and a person other than the surviving spouse is entitled to the income from that property. Estate transmission expenses are all estate administration expenses that are not estate management expenses and include expenses incurred in collecting estate assets, paying debts, estate and inheritance taxes, and distributing the decedent’s property. Estate management expenses are expenses incurred in connection with the in-
vestment of the estate assets and with their preservation and maintenance during the period of administration.

**Proposed Effective Date**

These regulations are proposed to be effective for estates of decedents dying on or after the date the regulations are published in the Federal Register as final regulations.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7905(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

**Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 21, 1999, beginning at 10 a.m. in Room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 31, 1999. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

**Drafting Information**

The principal author of these proposed regulations is Deborah Ryan, Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

**List of Subjects in 26 CFR Part 20**

Estate taxes, Reporting and recordkeeping requirements.

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 20 is proposed to be amended as follows:

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**PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954**

**Paragraph 1.** The authority citation for part 20 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

**Par. 2.** In § 20.2055-1, paragraph (d) (6) is added to read as follows:

§ 20.2055-1 Deduction for transfers for public, charitable, and religious uses; in general.

(c) * * *

(6) For the effect of certain administration expenses on the valuation of transfers for charitable deduction purposes, see § 20.2056(b)-4(e). The rules provided in that section apply for purposes of both the marital and charitable deductions. This paragraph (d)(6) is effective for estates of decedents dying on or after the date these regulations are published in the Federal Register as final regulations.

**Par. 3.** Section 20.2056(b)-4 is amended by:

1. Removing the last two sentences of paragraph (a).
2. Adding paragraph (e).

The addition reads as follows:

§ 20.2056(b)-4 Marital deduction; valuation of interest passing to surviving spouse.

(e) Effect of certain administration expenses—(1) Estate transmission expenses. For purposes of determining the marital deduction, the value of any deductible property interest which passed from the decedent to the surviving spouse shall be reduced by the amount of estate transmission expenses incurred during the administration of the decedent’s estate and paid from the principal of the property interest or the income produced by the property interest. For purposes of this subsection, the term estate transmission expenses means all estate administration expenses that are not estate management expenses (as defined in paragraph (e)(2) of this section). Estate transmission expenses include expenses incurred in the collection of the decedent’s assets, the payment of the decedent’s debts and death taxes, and the distribution of the decedent’s property to those who are entitled to receive it. Examples of these expenses include executor commissions and attorney fees (except to the extent specifically related to investment, preservation, and maintenance of the assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees.

(2) Estate management expenses—(i) In general. For purposes of determining the marital deduction, the value of any deductible property interest which passed from the decedent to the surviving spouse shall not be reduced by the amount of estate management expenses incurred in connection with the property interest during the administration of the decedent’s estate and paid from the principal of the property interest or the income produced by the property interest. For marital deduction purposes, the value of any deductible property interest which passed from the decedent to the surviving spouse shall be reduced by the amount of any estate management expenses incurred in connection with property that passed to a beneficiary other than the surviving spouse if a beneficiary other than the surviving spouse is entitled to the income from the property and the expenses are charged to the deductible property interest which passed to the surviving spouse. For pur-
poses of this subsection, the term estate management expenses means expenses incurred in connection with the investment of the estate assets and with their preservation and maintenance during the period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees, and interest.

(ii) Special rule where estate management expenses are deducted on the federal estate tax return. For purposes of determining the marital deduction, the value of the deductible property interest which passed from the decedent to the surviving spouse is not increased as a result of the decrease in the federal estate tax liability attributable to any estate management expenses that are deducted as expenses of administration under section 2053 on the federal estate tax return.

(3) Examples. The following examples illustrate the application of this paragraph (e). In each example, the decedent, who dies after 2006, makes a bequest of shares of ABC Corporation stock to the decedent’s child. The bequest provides that the child is to receive the income from the shares from the date of the decedent’s death. The value of the bequeathed shares, on the decedent’s date of death, is $3,000,000. The residue of the estate is bequeathed to a trust which satisfies the requirements of section 2056(b)(7) as qualified terminable interest property. The value of the residue, on the decedent’s date of death, before the payment of administration expenses, interest and estate taxes, is $6,000,000. Under applicable local law, the executor has the discretion to pay administration expenses from the income or principal of the residuary estate. All estate taxes are to be paid from the residue. The state estate tax equals the state tax credit available under section 2011. Examples of these expenses include investment and maintenance during the period of administration. If the management expenses are deducted on the estate’s income tax return rather than on the estate’s income tax return, the marital deduction is $3,900,000 (§6,000,000 minus $2,100,000 federal and state estate taxes). If the management expenses are deducted on the estate tax return rather than on the estate’s income tax return, the marital deduction remains $3,900,000, even though the federal and state estate taxes now total only $1,880,000. The marital deduction is not increased by the reduction in estate taxes attributable to deducting the management expenses on the federal estate tax return.

Example 1. During the period of administration, the estate incurs estate management expenses of $400,000 in connection with the bequest of ABC Corporation stock to the decedent’s child. The executor charges these management expenses to the residue. For purposes of determining the marital deduction, the value of the residue is reduced by the federal and state estate taxes and by the management expenses. The management expenses reduce the value of the residue because they are charged to the property passing to the spouse even though they were incurred with respect to stock passing to the child and the spouse is not entitled to the income from the stock during the period of estate administration. If the management expenses are deducted on the estate’s income tax return, the marital deduction is $3,011,111 ($6,000,000 minus $400,000 management expenses and minus $2,588,899 federal and state estate taxes). If the management expenses are deducted on the estate’s income tax return, rather than on the estate’s income tax return, the marital deduction remains $3,011,111, even though the federal and state estate taxes now total only $2,368,889. The marital deduction is not increased by the reduction in estate taxes attributable to deducting the management expenses on the federal estate tax return.

(4) Effective date. This paragraph (e) applies to estates of decedents dying on or after the date these regulations are published as final regulations in the Federal Register.

/s/ Robert E. Wenzel
Deputy Commissioner of Internal Revenue
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A-50-BRB

Exhibit B
Case 1: ded on 706  
Case 2: ded on 1041  
Case 3: ded on 706; marital increases when tax decreases  

hubert regs - example 2

Main Worksheet

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A-51-BRB  

Exhibit C
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**Exhibit D**
IRS Proposed Rules and Notice of Hearing (REG-114841-98)
On Separate Share Rules Applicable to Estates


DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
[REG-114841-98]
RIN 1545-AW57
Separate Share Rules Applicable to Estates

AGENCY: Internal Revenue Service (IRS), Treasury.
ACTION: Notice of proposed rulemaking and notice of public hearing.
SUMMARY: This document contains proposed regulations that provide that substantially separate and independent shares of different beneficiaries are to be treated as separate estates for purposes of computing the distributable net income. These proposed regulations also provide that a surviving spouse's statutory elective share of a decedent's estate is a separate share. Further, a revocable trust that elects to be treated as part of a decedent's estate is a separate share.

DATES: Written and electronic comments must be received by April 6, 1999. Outlines of topics to be discussed at the public hearing scheduled for April 22, 1999, at 10 a.m. must be received by April 1, 1999.

ADDRESSES: Send submissions to: CC:DOM-CORP:R (REG-114841-98), room 5226, Internal Revenue Service, 6101 Constitution Avenue, NW., Washington, DC 20224. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM-CORP:R (REG-114841-98), Courier's Desk, Internal Revenue Service, 611 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/taxregs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 611 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Laura Howell, (202) 622-3060; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Michael L. Slaughter, Jr., (202) 622-7130 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:
Background
Prior to amendment by Section 1307 of the Taxpayer Relief Act of 1997, Public Law 105-34, August 5, 1997, (TRA 1997), section 663(c) of the Internal Revenue Code (Code) provided that, for the purpose of determining the amount of distributable net income in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries (or classes of beneficiaries) of the trust shall be treated as separate trusts. The application of the separate share rule is mandatory where separate shares exist. Section 1.663(c)-1(d) and H.R. Conf. Rep. No. 2014, 105th Cong. 1st Sess. 712-13 and fn. 18.

Section 1307 of TRA 1997 amended section 663(c) of the Code by extending the separate share rule to estates. Prior to this amendment, a distribution to an estate beneficiary in the ordinary course of administration often resulted in the beneficiary being taxed on a disproportionate share of the estate's income. The extension of the separate share rule to estates promotes fairness by more rationally allocating the income of the estate among the estate and its beneficiaries thereby reducing the distortion that may occur when a disproportionate distribution of estate assets is made to one or more estate beneficiaries in a year when an estate has distributable net income. Under the separate share rule, a beneficiary is taxed only on the amount of income that belongs to that beneficiary's separate share.

In addition, section 1305 of TRA 1997 added section 649 to the Code (originally enacted as section 646 and redesignated as section 645 by the Internal Revenue Service Restructuring and Reform Act of 1998). Under section 645, both the executor (if any) of an estate and the trustee of a qualified revocable trust may elect to treat the revocable trust as part of the decedent's probate estate for income tax purposes. The legislative history for section 1305 provides that the separate share rule applicable to estates will apply when a qualified revocable trust elects to be treated as part of the decedent's estate.

Explanation of Provisions
The proposed regulations conform the current regulations to the statutory changes. In addition, the proposed regulations address two specific matters involving separate share treatment of interests in estates: the treatment of the spousal elective share and the treatment of an electing revocable trust under section 645 of the Code.

General Separate Share Rule
If an estate has multiple beneficiaries, substantially separate and independent shares of different beneficiaries (or classes of beneficiaries) are to be treated as separate estates only for purposes of computing distributable net income. There are separate shares in an estate when the governing instrument of the estate and applicable local law create separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by the economic interests accruing to another separate beneficiary or class of beneficiaries. Thus, there are separate shares in an estate when a beneficiary or class of beneficiaries has an interest in a decedent's estate (whether corpus or income, or both) that no other beneficiary or class of beneficiaries has in the decedent's estate. The application of the separate share rule to estates is mandatory where separate shares exist. The separate share rule requires that the estate's income and deductions be allocated among the separate shares as if they were separate estates. The section 661
The gross income of the beneficiary are limited by the deduction to the estate and the section 662 inclusion involving specific gifts and bequests described in section 663(a).

Surviving Spouse's Elective Share

Most non-community property states have some form of elective share statute which replaces common law dower and curtesy (the common law protection for surviving spouses). Generally, an elective share statute gives the surviving spouse the right to claim a share of the deceased spouse's estate if the surviving spouse is disinherited or dissatisfied with what the spouse would have received under the will or otherwise. In most states the elective share consists of a fraction, ranging from one-fourth to one-half of the decedent's estate. Elective share statutes vary as to when the share vests and whether the share includes a portion of the estate income, as well as whether the share participates in the appreciation or depreciation of the estate's assets.

Rev. Rul. 64-101 (1964-1 C.B. 77) addresses the Florida statutory dower interest which, at the time of the revenue ruling, entitled the widow to the dower interest in the gross estate. The ruling holds that the value of assets transferred to the widow as dower is not a distribution to a beneficiary subject to sections 661(a) and 662(a) of the Code. Instead, the transfer of assets is governed by section 102.

Rev. Rul. 71-167 (1971-1 C.B. 163) modifies Rev. Rul. 64-101 by holding that the amount distributed to the widow representing mesne profits is subject to sections 661(a) and 662(a) of the Code. Therefore, an amount corresponding to the allowable deduction to the estate under section 661(a) is includable in the gross income of the widow under section 662(a).

Recently, two cases, Deutsch v. Commissioner, TCM 1997-470, and Brigham v. United States, 983 F.Supp. 46, (D. Mass. 1997), have addressed how to treat payments to the surviving spouse in satisfaction of the spouse's elective share amount. In Deutsch, the surviving spouse elected to take against the decedent's will as provided by the Florida elective share statute. Under the statute, the surviving spouse was entitled to 30 percent of the net estate based upon date of death values, but not entitled to any income of the estate, and did not participate in appreciation or depreciation of the estate assets. The Tax Court, noting Rev. Rul. 64-101, held that payments to the surviving spouse in satisfaction of her elective share amount were not subject to sections 661(a) and 662(a). Rather, the payments were governed by section 102.

In Brigham, the surviving spouse elected to take against the decedent's will as provided by the New Hampshire elective share statute. Under the statute, the surviving spouse was entitled to one-third of the personalty and one-third of the real estate. The court held that the payments made to the surviving spouse in satisfaction of her elective share amount were subject to sections 661(a) and 662(a). Thus, the court held that all of the estate's distributable net income was taxable to the surviving spouse because she was the only beneficiary to receive a distribution for the year in question and her distribution exceeded the amount of the estate's distributable net income.

In light of the uncertainty concerning the proper treatment of payments in satisfaction of a surviving spouse's elective share, and also given that Rev. Ruls. 64-101 and 71-167 are outdated because dower has been replaced by elective share statutes in most states, the Internal Revenue Service and Treasury have concluded that regulatory guidance is needed to provide uniform treatment.

These proposed regulations do not change the rules involving specific gifts and bequests described in section 663(a).

Proposed Effective Date

These regulations apply to estates of decedents dying after the date that the Treasury decision adopting these rules as final regulations is published in the Federal Register.

Effect on Other Documents

When these regulations are finalized, Rev. Rul. 64-101 (1964-1 C.B. 77) and Rev. Rul. 71-167 (1971-1 C.B. 163) will be obsolete.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulation and how it may be made easier to understand. All comments will be available for public inspection and copying. We especially request comments concerning the treatment of pecuni-
A public hearing has been scheduled for April 22, 1999, beginning at 10 a.m. The hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by April 6, 1999, and submit an outline of topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by April 1, 1999. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Laura Howell of the Office of Assistant Chief Counsel (Pass-throughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 ** *
Section 1.663(c)-1 also issued under 26 U.S.C. 663(c).
Section 1.663(c)-2 also issued under 26 U.S.C. 663(c).
Section 1.663(c)-3 also issued under 26 U.S.C. 663(c).
Section 1.663(c)-4 also issued under 26 U.S.C. 663(c).
Section 1.663(c)-5 also issued under 26 U.S.C. 663(c).
Section 1.663(c)-6 also issued under 26 U.S.C. 663(c).

Par. 2. Section 1.663(c)-1 is amended as follows:
1. The section heading is revised.
2. The first sentence of paragraph (a) is amended by removing the language “trust” and adding the language “trust (or estate)” in its place and removing the the language “trusts” and adding the language “trusts (or estates)” in its place. The second sentence of paragraph (a) is amended by removing the language “trusts” and adding the language “trusts (or estates)” in its place.
3. Paragraph (b)(2) is removed.
4. Paragraphs (b)(3) and (b)(4) are redesignated as paragraph (b)(2) and (b)(3).
5. Paragraph (b) introductory text, is amended by removing the language “trusts” and adding the language “trusts (or estates)” each place it appears.
6. Paragraph (c) and the last sentence of paragraph (d) are amended by removing the language “trust (or estate)” in its place.

The revision reads as follows:

§ 1.663(c)-1 Separate shares treated as separate trusts or as separate estates; in general.

Par. 3. Section 1.663(c)-2 is revised as follows:

§ 1.663(c)-2 Computation of distributable net income.
The amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust or estate. Accordingly, any deduction or any loss which is applicable solely to open separate share of the trust or estate is not available to any other share of the same trust or estate.

Par. 4. Section 1.663(c)-3 is amended by revising the section heading and removing paragraph (f) to read as follows:

§ 1.663(c)-3 Applicability of separate share rule to trusts.

§ 1.663(c)-4 [Redesignated as § 1.663(c)-5]

Par. 5. Section 1.663(c)-4 is redesignated as § 1.663(c)-5 and a new § 1.663(c)-4 is added to read as follows:

§ 1.663(c)-4 Applicability of separate share rule to estates.

(a) General rule. The applicability of the separate share rule to estates provided by section 663(c) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of the decedent’s estate such that the economic interests of the beneficiary or class of beneficiaries are not affected by economic interests accruing to another beneficiary or class of beneficiaries. A separate share should be allocated only the share of the estate’s income and deductions that the beneficiary (or beneficiaries) of such separate share is (or are) entitled to (if any) under the terms of the governing instrument or local law. The separate share rule does not affect rules under section 663(a) concerning specific gifts and bequests.

(b) Examples of separate shares. Separate shares include—

(1) A surviving spouse’s elective share;
(2) A revocable trust that elects to be part of the decedent’s estate under section 645;
(3) The residuary estate, or some portion of the residuary estate, if the requirements of paragraph (a) of this section are met; and
(4) A gift or bequest of a specific sum of money or of specific property that is paid or credited in more than three installments, if the requirements of paragraph (a) of this section are met.

(c) Shares with multiple beneficiaries and beneficiaries of multiple shares. A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is economically separate and independent from another share in which one or more beneficiaries have an interest. Moreover, the same person may be a beneficiary of more than one separate share.
Par. 6. Newly designated § 1.663(c)-5 is amended by:
1. Revising the section heading and introductory text.
2. Redesignating the "Example" as "Example 1", and redesignating paragraphs (a), (b), (c), (d), and (e) in newly designed Example 1 as paragraphs (i), (ii), (iii), (iv), and (v).
3. Adding Example 2, Example 3, and Example 4.

The revisions and addition read as follows:

§ 1.663(c)-5 Examples.

Section 663(c) may be illustrated by the following examples:

Example 1. **
Example 2. (i) Facts. (A) Testator died domiciled in State X on January 30, 1999, leaving an estate of $40,000,000 after debts, expenses, and estate taxes, and survived by a spouse and three adult children from a previous marriage. Testator's will directed the executrix to pay the surviving spouse $1,000,000 in cash and divide the residue, after payment of debts, expenses, and estate taxes, equally among Testator's three children.

(B) The surviving spouse filed an election under State X's elective share statute. The court determined that the surviving spouse's election was valid and ordered the executrix to pay the elective share. Under State X's elective share statute, a surviving spouse is entitled to one-fourth of a decedent's estate after debts, expenses, and estate taxes if the decedent had children. Further, the surviving spouse is entitled to a proportional amount of the estate net income and participates proportionally in appreciation or depreciation of the estate's assets.

(C) The executrix elected the calendar year for the estate. On June 30, 1999, the executrix distributed $5,000,000 to the surviving spouse in partial satisfaction of the elective share. During the 1999 taxable year, the estate received dividend income of $2,000,000 and paid expenses of $50,000. For the 1999 taxable year, the value of the estate neither appreciated nor depreciated. The executrix made no other distributions during the 1999 taxable year.

(ii) Holding. Separate share treatment applies to each of the three residuary bequests, and to the surviving spouse's elective share.

(iii) Application. (A) After determining the income and expenses for the estate, the executrix allocated a portion of the income and expenses to each separate share based upon each share's percentage of the estate. Thus, while the surviving spouse's elective share initially constituted 25% of the estate, after the partial distribution of $5,000,000 made on June 30, 1999, the elective share constituted a smaller percentage of the estate. Accordingly, the percentage of the estate's income and expenses allocated to the elective share after June 30, 1999, was correspondingly reduced in accordance with the executrix's determination of the proper allocation of income and expenses to the elective share.

(B) For the 1999 taxable year, the estate is treated as having distributed to the surviving spouse the distributable net income that was allocated to the elective share. In accordance with section 662, the surviving spouse must include in gross income for the 1999 taxable year an amount equal to the distributable net income allocated to the surviving spouse's separate share and distributed to the surviving spouse for the 1999 taxable year. The estate will, accordingly, be allowed a deduction under section 661 for the amount of distributable net income allocated to the elective share and distributed to the surviving spouse.

Example 3. (i) Facts. (A) Assume the same facts as in Example 2 except that Testator died domiciled in State Y leaving an estate of $60,000,000 after debts, expenses, and estate taxes. Under State Y's elective share statute, the surviving spouse is entitled to the date of death value of one-third of the decedent's estate after debts, expenses, and taxes. The statute also provides that the surviving spouse is not entitled to any of the estate's income and does not participate in appreciation or depreciation of the estate's assets. Further, under the statute, the surviving spouse is entitled to interest on the elective share from the date of the court order directing the executrix to make payments.

(B) The executrix elected the calendar year for the estate. During the 1999 taxable year, the estate received dividend income of $3,000,000, and paid administration expenses of $60,000 and paid the surviving spouse $1,000,000 of interest payments on the elective share. Also, during the 1999 taxable year, the executrix distributed $5,000,000 to the surviving spouse in partial satisfaction of the elective share. The executrix made no other distributions during the 1999 taxable year.

(ii) Holding. Separate share treatment applies to each of the three residuary bequests and to the surviving spouse's elective share.

(iii) Application. The distributable net income of each child's residuary bequest is $980,000 (a 33.33% share of estate income less a 33.33% share of estate expenses). Because the surviving spouse was not entitled to any estate income under state law, no income is allocated to the spouse's separate share. The distribution in satisfaction of the spouse's elective share does not consist of any distributable net income and is not included in the spouse's gross income under section 662. The $1,000,000 of interest payment to the surviving spouse must be included in gross income of the spouse under section 61. Therefore, the estate is treated as having distributed to the surviving spouse $5,000,000 of amounts other than 1999 estate income. Accordingly, the estate is not allowed a deduction under section 661 for the distribution made to the surviving spouse. The taxable income of the estate for the 1999 taxable year is $2,939,400 ($3,000,000 (dividend income) minus $60,000 (expenses) and $600 (personal exemption)). The $1,000,000 interest payment is a nondeductible personal interest expense described in section 163(h).

Example 4. (i) Facts. (A) Testator died domiciled in State Z on February 14, 1999, survived by a spouse and two children. Testator's will contains a nonproportional funding fractional formula marital bequest for the surviving spouse with a residuary credit shelter trust for the lifetime benefit of the surviving spouse, and remainder to the two children on the surviving spouse's death. The date of death value of the estate is $1,650,000.

(B) The executrix elected the calendar year for the estate. Under the fractional formula, the marital bequest constitutes 60% of the estate and the credit shelter trust constitutes 40% of the estate. Accordingly, the executrix claims a marital deduction of $990,000 on the estate tax return for the amount passing to the spouse under the fractional formula. On December 31, 1999, the executrix made a partial proportionate distribution of $1,000,000, $600,000 to the surviving spouse outright and $400,000 to the credit shelter trust. As of December 31, 1999, the remaining estate income includes interest payments of $1,000,000. On December 31, 1999, the executrix made a partial proportionate distribution of $1,000,000, $600,000 to the surviving spouse outright and $400,000 to the credit shelter trust.
31, 1999, prior to the distribution, the value of Testator's estate had appreciated to $2,000,000.

(C) During the 1999 taxable year, the estate made no other distributions, received dividend income of $20,000, and paid expenses of $8,000.

(ii) Holding. Separate share treatment applies to the fractional formula marital bequest and the credit shelter trust.

(iii) Application. (A) Because Testator provided for a fractional formula marital bequest in the will, the income and any appreciation in the value of the estate assets is proportionately allocated between the marital bequest share and the credit shelter trust share. Therefore, the distributable net income must be allocated 60% for the marital separate share and 40% for the credit shelter separate share.

(B) The distributable net income allocable to the marital share is $7,200 (60% of estate income less 60% of estate expenses). Correspondingly, the distributable net income allocable to the credit shelter share is $4,800 (40% of estate income less 40% of estate expenses). Because the $600,000 amount distributed in partial satisfaction of the marital bequest exceeds the distributable net income of $7,200 allocated to the marital share, the estate is treated as having distributed to the surviving spouse $7,200 of 1999 distributable net income and $592,800 of other amounts. Similarly, because the $400,000 distributed in partial satisfaction of the amount payable to the credit shelter trust exceeds the distributable net income of $4,800 allocated to the credit shelter share, the estate is treated as having distributed to the credit shelter trust $4,800 of 1999 distributable net income and $395,200 of other amounts. Accordingly, the estate is allowed a deduction of $12,000 under section 661 for the 1999 taxable year.

The taxable income of the estate is $0, computed as follows:

<table>
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<tr>
<th>Description</th>
<th>Amount</th>
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</thead>
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<tr>
<td>Dividends</td>
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<td>Deductions:</td>
<td></td>
</tr>
<tr>
<td>Distribution to surviving spouse</td>
<td>$7,200</td>
</tr>
<tr>
<td>Distribution to credit shelter</td>
<td>$4,800</td>
</tr>
<tr>
<td>Expenses</td>
<td>$8,000</td>
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<tr>
<td>Personal exemption</td>
<td>$600</td>
</tr>
<tr>
<td></td>
<td>$20,600</td>
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</table>

(C) In accordance with section 662, the surviving spouse must include in gross income for the 1999 taxable year an amount equal to the distributable net income of the marital bequest share ($7,200) that was distributed to the surviving spouse. The credit shelter trust must include in gross income for the 1999 taxable year an amount equal to the distributable net income of the credit shelter trust share ($4,800) that was distributed to the credit shelter trust.

Par. 7. Section 1.663(c)-6 is added to read as follows:

§ 1.663(c)-6 Effective date.

Sections 1.663(c)-1 through 1.663(c)-5 concerning the application of the separate share rules to estates apply to estates of decedents dying after the final regulations are published in the Federal Register.

/s/ Robert E. Wenzel
Deputy Commissioner of Internal Revenue

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**IRS Proposed Rules (REG-106388-98) on Hope Scholarship Credit and Lifetime Learning Credit of I.R.C. Section 25A**


**DEPARTMENT OF THE TREASURY**

Internal Revenue Service

26 CFR Part 1

[REG-106388-98]

RIN 1545-AW65

Education Tax Credits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and requests to hold a videoconference public hearing.

SUMMARY: This document contains proposed regulations relating to the Hope Scholarship Credit and the Lifetime Learning Credit in section 25A of the Internal Revenue Code. These proposed regulations provide guidance to individuals who may claim the Hope Scholarship Credit or the Lifetime Learning Credit for certain postsecondary educational expenses. This document also announces that a public hearing will be held on the proposed regulations upon request and that persons outside the Washington, DC, area who wish to testify at the hearing may request that the IRS videoconference the hearing to their sites.

DATES: Written or electronically generated comments must be received by April 6, 1999. Requests to videoconference the hearing to other sites must be received by March 8, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP.R (REG-106388-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP.R (REG-106388-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/taxRegs/comments.html. The IRS will publish the time and date of the public hearing and the locations of any videoconferencing sites in the Federal Register.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622-4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend...
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<th>Case 3</th>
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<td>Wife</td>
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### actec-contingent marital

#### Main Worksheet

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<th>Husband</th>
<th>Wife</th>
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Exhibit G
### Main Worksheet

**Actec - Contingent Marital - Increase in Assets at 8% Between Deaths**

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<th>Date of Death</th>
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<tr>
<td>1-1-2016</td>
<td>16,105,952</td>
<td>4,317,850</td>
</tr>
</tbody>
</table>

---

**Adjusted in Accordance to Income from $1,000,000**

Trust - Assume Trust Income = 4%

This 1/2 the total increase in Income

$1,000,000 will increase to $2,158,925

Income @ 8% = $1,158,925

1/2 Income (4%) = $579,462

Tap on SS's estate

Top 55 (3)

Family Share per computation

Net Tap on Income from $1,000,000

$143,553

16,435,534

3,18,704

$1,16,830

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A-60-BRB

Exhibit H