

## **ACTEC Comments on Extension of Marital Deduction Reforms to U.S. Citizens**

**Karen M. Moore**

Bricker & Eckler LLP  
100 S. Third Street  
Columbus, OR 43215  
(614) 227-2363  
kmoore@bricker.com

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Honorable Sander Levin, Chairman  
Honorable Dave Camp, Ranking Member  
Committee on Ways and Means  
U.S. House of Representatives  
1102 Longworth House Office Building  
Washington, D.C. 20515

Honorable Max Baucus, Chairman  
Honorable Charles E. Grassley, Ranking Member  
Committee on Finance  
U.S. Senate  
209 Dirksen Senate Office Building  
Washington, D.C. 20510

### **Re: Extension of Marital Deduction Reforms to U.S. Citizens**

Dear Congressmen and Senators:

I write on behalf of the American College of Trust and Estate Counsel ("ACTEC") concerning an anomaly in the estate and gift tax marital deduction which grants non-U.S. citizen surviving spouses the opportunity to reform trusts to qualify for the marital deduction but does not extend the same post-mortem opportunity to U.S. citizens.

ACTEC is a non-profit professional association of approximately 2,600 lawyers selected on the basis of professional reputation and ability in the field of trusts and estates. ACTEC does not take positions on matters of tax policy and politics. From time to time, based on the extensive experience that ACTEC members have with estate, gift and generation-skipping transfer taxes, we comment on existing tax laws and offer recommendations to improve the implementation of existing tax laws.

Attached hereto is a Report from one of the subcommittees of our organization which outlines the marital deduction anomaly. We believe that U.S. citizen spouses should have the same opportunity to reform trusts so that they can qualify for the marital deduction as that currently granted to non-citizen surviving spouses. We recommend the adoption of the proposed statutory changes attached to the Report.

Should you have any question concerning this letter and the attachments, please contact me or the contact individual listed below.

Thank you for your consideration of these comments and recommendations.

Very truly yours,

Karen M. Moore,  
President

KMM  
attachments

Cc: Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation  
Mr. John Buckley, Chief Tax Counsel, House Ways and Means Committee  
Mr. Jeffrey Van Hove, Department of the Treasury, Office of Tax Policy  
Ms. Tiffany P. Smith, Senate Finance Committee  
Ms. Catherine V. Hughes, Department of the Treasury, Office of Tax Policy

Contact Individual:

Ronald D. Aucutt, Esq.  
McGuire Woods LLP  
Suite 1800  
1750 Tysons Blvd.  
McLean, VA 22102-4215  
Telephone Number: (703) 712-5497

**American College of Trust and Estate Counsel**

**Report of Transfer Tax Study Committee Concerning Marital Trusts**

The Transfer Tax Study Committee recommends that the Internal Revenue Code be amended to permit post-mortem reformations of marital trusts to qualify for the marital deduction.

Discussion. The Committee believes there are certain trusts which are intended to, but do not, qualify for the Federal estate (or gift) tax marital deduction. The Committee believes these trusts should be able to qualify for the appropriate marital deduction after a reformation.

Reformations to Qualify for Charitable Deduction. Currently, the Internal Revenue Code, at [§2055\(e\)\(3\)](#), authorizes a charitable deduction for certain trusts which are reformed in compliance with the statutory requirements. The ability to reform a trust for which a charitable deduction is otherwise not available into a trust for which a charitable deduction is allowed often eliminates adverse consequences for taxpayers. The fisc is in the same position it would have been in, had the trust been drafted at the outset in a manner to qualify for the intended deduction. Therefore, it appears that the fisc would not be adversely impacted by the allowance of a charitable deduction after the reformation. Similar considerations should apply to the marital deduction.

Reformations to Qualify for Marital Deduction for Non-Citizen Surviving Spouse. Currently, the Internal Revenue Code, at [§2056\(d\)\(5\)](#), allows for reforming property interests to qualify for the marital deduction as a qualified domestic trust. (This form of trust is utilized to obtain the marital deduction when the surviving spouse is not a U.S. citizen.) Therefore, the Federal tax law already includes the ability to obtain a marital deduction by a reformation. The proposed change would place surviving spouses who are U.S. citizens on equal footing with those who are not U.S. citizens. It appears that from a public policy standpoint, this parity would be appropriate.

Good for the Surviving Spouse. The ability to obtain a marital deduction for a trust which has been reformed in a manner for which a marital deduction would have been allowed will benefit

taxpayers. Surviving spouses can be expected to have access to an increased level of property interests as a result of reformations. A reformation will typically remove, or reduce, interests in property held by persons other than a surviving spouse in order to qualify for the marital deduction. The surviving spouse's increased rights in the property should increase benefits to the surviving spouse. This result is consistent with the now long established tax policy dating back to the Economic Recovery Tax Act of 1981 of an unlimited marital deduction.[1]

Good for the Federal Government. The ability to reform interests to qualify for the marital deduction will also have a positive impact on the Federal government because fewer Federal resources will be required to address issues of qualification. The burden on the Federal courts and on the U.S. Treasury Department will be reduced as a result of allowing reformed property interests to qualify for the marital deduction. The administration of the technical rules relating to qualification for the marital deduction and the interpretation of those complicated rules consume significant Federal resources. This burden could be eliminated if property interests could be reformed to qualify for the marital deduction.<sup>2</sup>

#### Proposed Statutory Provision.

Estate Tax. The proposed new [§2056\(e\)](#) consists of four paragraphs. The first paragraph sets forth a general rule. The second paragraph describes interests which may be reformed. A statute of limitations is included in the third paragraph. The final paragraph broadly defines reformation for purposes of this statute.

In order to allow for reformation after the decedent's death, the general rule set forth in paragraph (1) allows a trust to be tested for qualification under [§2056\(b\)](#) at a date subsequent to the date of death. This date is the later of (A) the date when the estate return is filed or (B) if a judicial proceeding has been timely commenced, the date provided for in the proceeding. A judicial proceeding is timely commenced for this purpose if commenced on or before the due date (determined with regard to extensions) for filing the estate tax return.

The interests which may be reformed, as described in paragraph 2, are broadly defined to be any interest that a surviving spouse has in property. Therefore, as long as the surviving spouse has some interest in property, that interest can be altered in a way that will qualify for the marital deduction.

Paragraph (3) provides for a statute of limitations of one year after being notified of a reformation in a judicial proceeding. This statute of limitations is appropriate in the event that a judicial proceeding in which a reformation is sought lasts longer than the statute of limitations otherwise applicable to the government.

The fourth paragraph defines the term "reformation" to mean essentially any type of change to a governing instrument. The change may be a reformation, an amendment, a change or any other modification made by a court having jurisdiction to do so.

The interests which may be reformed are not limited to interests created by trust instruments. For instance, a surviving spouse's interest in property created by a will or a deed would be reformable to qualify for the marital deduction.

Gift Tax. A new subsection (j) would be added to [Internal Revenue Code §2523](#). This subsection would include three paragraphs, the first of which incorporates the new [§2056\(e\)](#), the second of which would extend the statute of limitations, and the last of which broadly defines actions which are to be treated as reformations.

A second gift tax provision is also proposed. This provision, a new subsection (h) to [Internal Revenue Code §2503](#), would prevent a taxable gift from occurring when an interest in property is terminated by a reformation in [§2056\(e\)](#) or [§2523\(j\)](#).

Examples. In these examples, the property interest described has been created by the estate plan of the deceased spouse to be effective as of the death of the deceased spouse.

1. Discretionary Income. The trustee may pay to my surviving spouse so much or all of the income and principal from this trust as the trustee deems necessary from time to time for her health and maintenance in reasonable comfort, considering her income from all sources known to the trustee. Because trust income is discretionary rather than mandatory, this trust does not qualify for the marital deduction.
2. Children as Current Beneficiaries. The trustee may pay to my surviving spouse and to my children, in equal or unequal shares, so much or all of the income and principal from this trust as the trustee deems necessary from time to time for the health and maintenance in reasonable comfort of each of them, considering their income from all sources known to the trustee. Because distributions may be made to the grantor's children during the surviving spouse's lifetime, this trust does not qualify for the marital deduction.
3. Remarriage. The trustee shall pay to my surviving spouse the income from the trust in the installments as my surviving spouse may prefer, but not less frequently than annually. The trustee also may pay to my surviving spouse any amount of principal of the trust as the trustee deems necessary from time to time for the surviving spouse's health and maintenance in reasonable comfort, considering the surviving spouse's income from all sources known to the trustee. Notwithstanding any other provision herein, (i) underproductive property shall not be held as an asset of this trust for more than a reasonable time during my wife's life without her written consent and (ii) in the event my surviving spouse remarries or cohabits with a person of the opposite gender, then these interests shall terminate and this trust shall be administered as if my surviving spouse then died. Because distribution of net income to the surviving spouse is conditional, the trust does not qualify for the marital deduction.
4. Power to Appoint During Lifetime. My surviving spouse may appoint upon her death principal from the trust to one or more of my descendants, with the powers and in the manner and proportions as my surviving spouse may specify by her will or revocable trust making specific reference to this power of appointment. In addition, my surviving spouse may appoint during her lifetime principal from the trust to one or more of my descendants, with the powers and in the manner and proportions as my surviving spouse may specify by an instrument delivered to the trustee making specific reference to this power of appointment. Because the spouse may terminate her income interest by exercise of the granted power of appointment, the trust does not qualify for the marital deduction.

In each of these examples, the interest should be reformable to result in a marital deduction.

Conclusion. The ability to change a property interest into a form that qualifies for the estate (or gift) tax marital deduction would be beneficial to taxpayers. The flexibility created by these proposed statutory changes would facilitate post-mortem planning with more certainty and at less expense to taxpayers. A reformation may be remedial in nature or may address changed circumstances not anticipated by the decedent. The policies underlying the unlimited marital deduction and the treatment of non-citizen spouses support the enactment of these changes.

#### **2056(e) Certain Reformations Permitted**

- (1) In general. In the case of any property with respect to which a deduction would be allowable under subsection (a) but for subsection (b), the determination of whether an interest in property of the decedent's spouse qualifies for the deduction under subsection (a) shall be made-

- (A) as of the date on which the return of the tax imposed by this chapter is filed, or
  - (B) if a judicial proceeding is commenced on or before the due date (determined with regard to extensions) for filing such return to change such an interest into one that qualifies for the deduction under subsection (a), as of the time when the changes pursuant to such proceeding are made effective.
- (2) Interests that may be reformed. Any property in which the decedent's surviving spouse has an interest may be reformed pursuant to a judicial proceeding described in paragraph (1).
  - (3) Statute of limitations. If a judicial proceeding described in paragraph (1)(B) is commenced with respect to any interest, the period for assessing any deficiency of tax attributable to any failure of such interest to be reformed so that it qualifies for the deduction under subsection (a) shall not expire before the date 1 year after the date on which the Secretary is notified that the trust has been changed pursuant to such judicial proceeding or that such proceeding has been terminated.
  - (4) Forms of Reformation. For purposes of this section, reformation shall mean a reformation, amendment, change or other modification to a governing instrument made by a court having jurisdiction to do so.

#### **2523(j) Certain Reformations Permitted**

- (1) In general. A deduction shall be allowed under subsection (a) with respect to any reformation pursuant to [section 2056\(e\)](#). For purposes of this subsection, rules similar to the rules of [section 2056\(e\)](#) shall apply.
- (2) Statute of limitations. If a judicial proceeding with respect to a reformation described in paragraph (1) is commenced with respect to any interest, the period for assessing any deficiency of tax attributable to any failure of such interest to be reformed so that it qualifies for the deduction under subsection (a) shall not expire before the date 1 year after the date on which the Secretary is notified that the trust has been changed pursuant to such judicial proceeding or that such proceeding has been terminated.
- (3) Forms of Reformation. For purposes of this section, reformation shall mean a reformation, amendment, change or other modification to a governing instrument made by a court having jurisdiction to do so.

#### **2503(h) Elimination of Interest in Marital Deduction Property**

The termination of any interest in property of an individual by reason of a reformation pursuant to [section 2056\(e\)](#) or [section 2523\(j\)](#) shall not be treated as a transfer of property by gift for purposes of this chapter.

[1] See Joint Committee on Taxation, "[General Explanation of the Economic Recovery Tax Act of 1981](#) (H.R. 4242, 97th Congress: Public Law 97-34)," at 233: "Although the Congress recognized that this additional tax [the "widow's tax" caused by the limited marital deduction under the law prior to the enactment of ERTA] could be minimized through proper estate planning, it believed that an individual generally should be free to pass his or her entire estate to a surviving spouse without the imposition of any estate tax."

[2] The reformation proceedings will occur in state courts. Therefore, some additional governmental resources will be consumed, but at a state level, not Federal.