



Davis Wright  
Tremaine LLP

DEFINING SUCCESS TOGETHER

# Administering the Marital Funding Formula

Advising the Taxable Estate

Oregon State Bar

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# Question: Who Gets What and When?

## Difficult challenges:

- “Rich widows never die!”
- “I am the surviving spouse; why didn’t I get what I thought I would?”
- “What do you mean I got disinherited by my spouse’s marital formula?”

# Take Aways

- Formulas
- Funding
- Reality
  - Things change during administration
  - Who bears burden of expenses?
  - Who benefits/loses from gains or losses in asset values?
  - What about:
    - DNI?
    - IRD?
    - Oregon Uniform Principals & Income Act?
    - Basis in assets?
    - GST?

# Types of Marital Funding

- Non-formula
- Outright with a Disclaimer
- Fractional
- Pecuniary
- Reverse
- Single Fund

# Non-formula Marital

- Pecuniary – “I give my spouse \$1,000,000.”
- Specific Property – “I give my Lake Tahoe residence to my spouse.”
- Fraction of a Fund or Asset – “I give my spouse 50% of the Merrill Lynch account or the family farm.”
- Single Fund
  - Divisible QTIP
  - Clayton QTIP
  - Reverse QTIP

# Non-formula Marital – Deceptively Simple!

- I give my spouse \$1,000,000 – Satisfied with appreciated/depreciated assets. (Gain/loss? Recognized?)
- Does spouse report income on distribution? (DNI)
- I give my spouse \$1,000,000 – Satisfied with a receivable. (Income accelerated? – IRD)
- What is spouse's basis?
- Can spouse report a loss on distribution of depreciated asset satisfying a pecuniary request?

# Outright Marital with Disclaimer

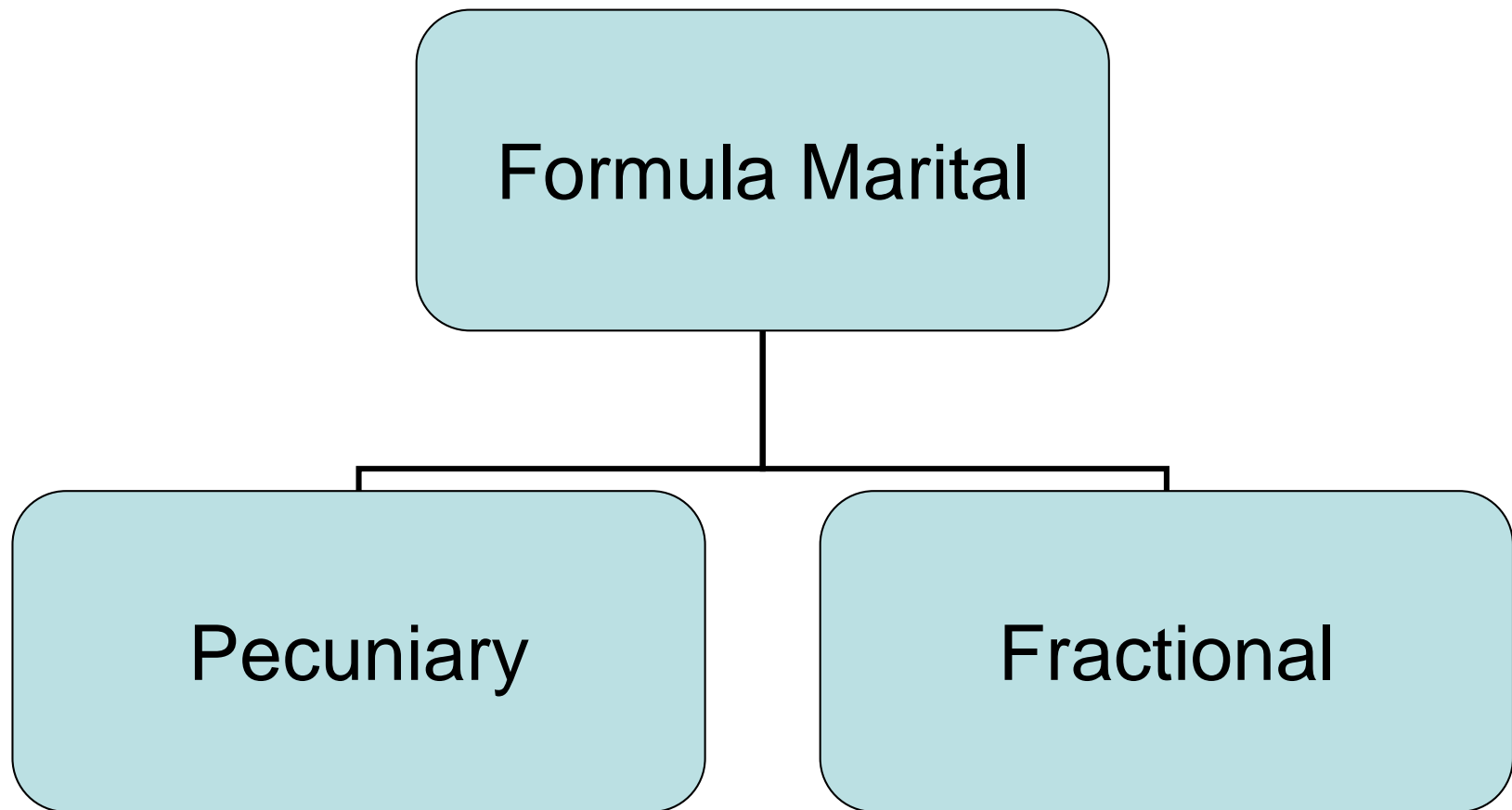
- Uncertainty of size of estate
- Uncertainty of tax law at time of death
- Allow flexibility
- Administrative issues
- Must have “qualified disclaimer”

# Qualified Disclaimers

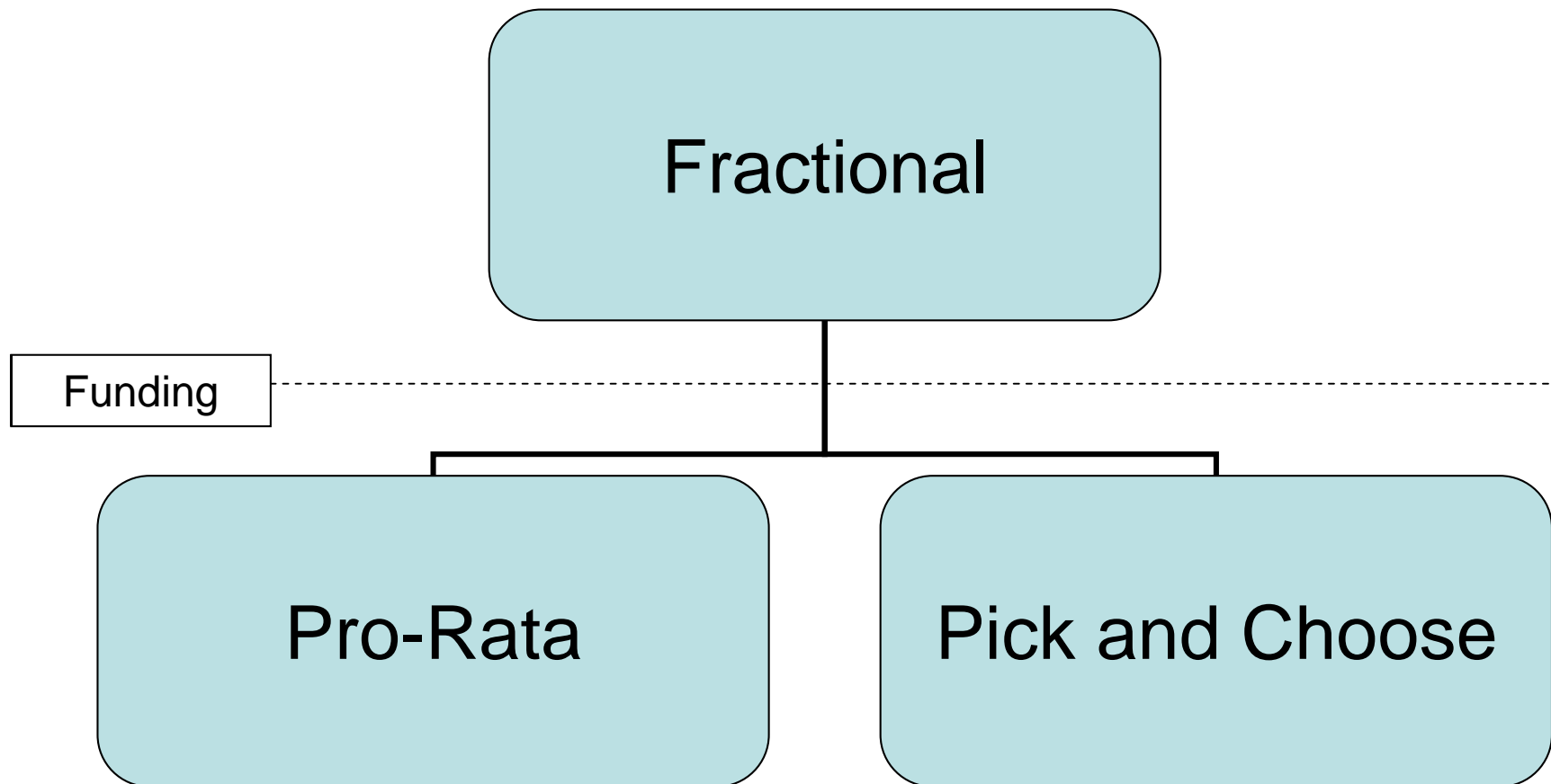
- Written
- Received by the legal representative of transferor
- Nine months after creation
- No interest or benefit accepted
- Pass without direction
  - To spouse
  - Or another
- No retained power
- Disclaimer trust or exemption trust (disclaimer powers?)



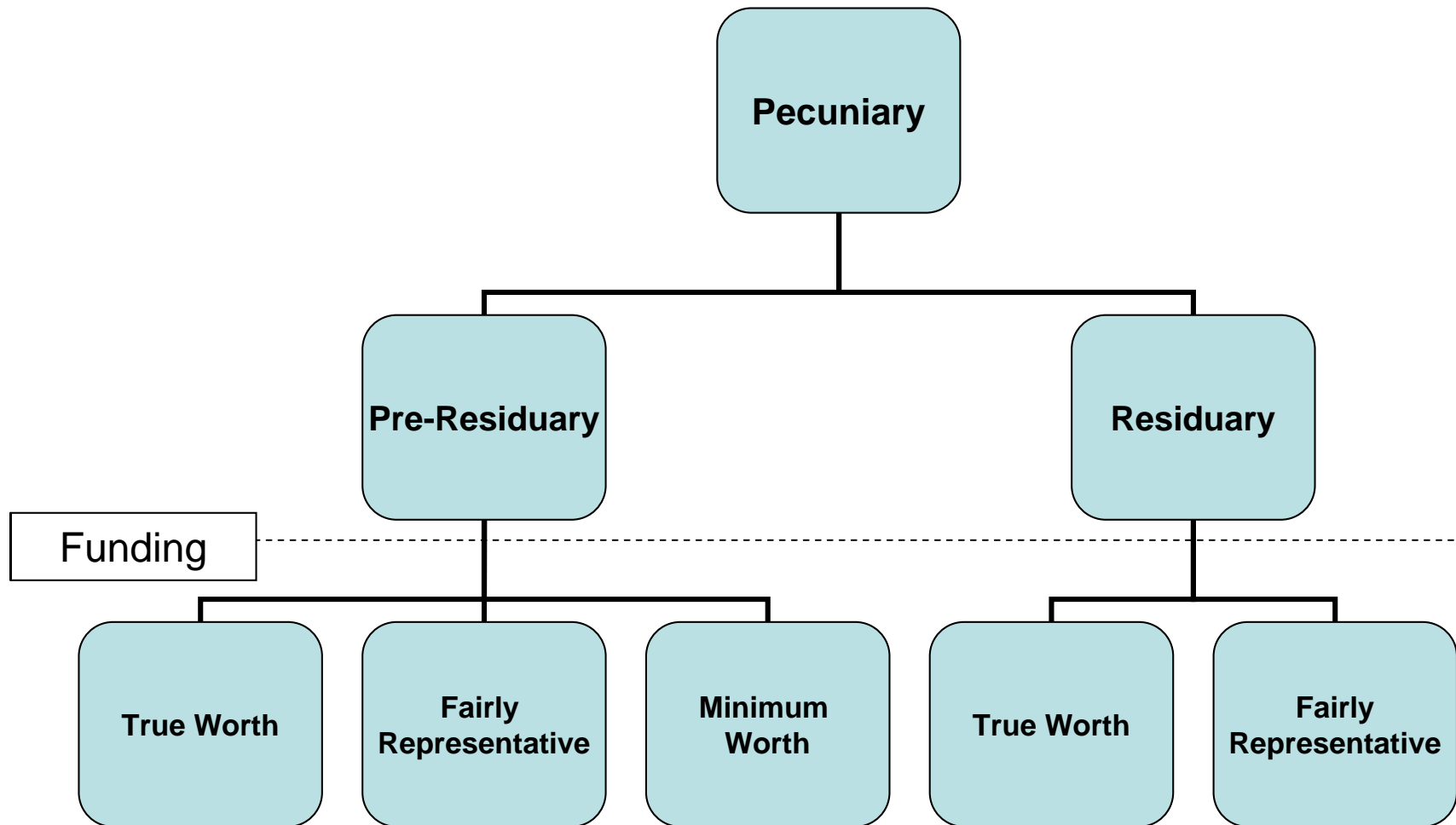
# Formula Marital – Two Types



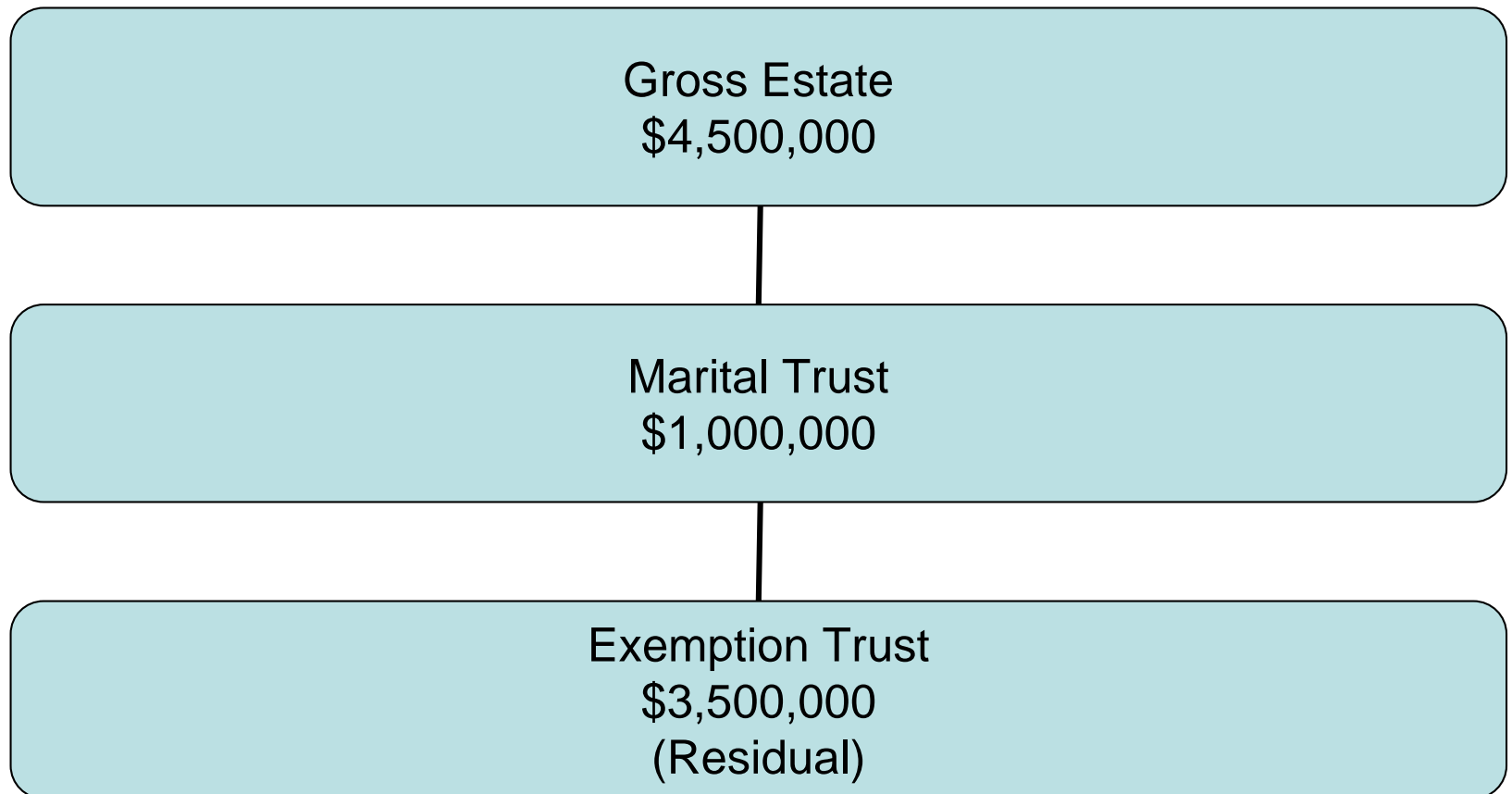
# Fractional Marital – Two Types



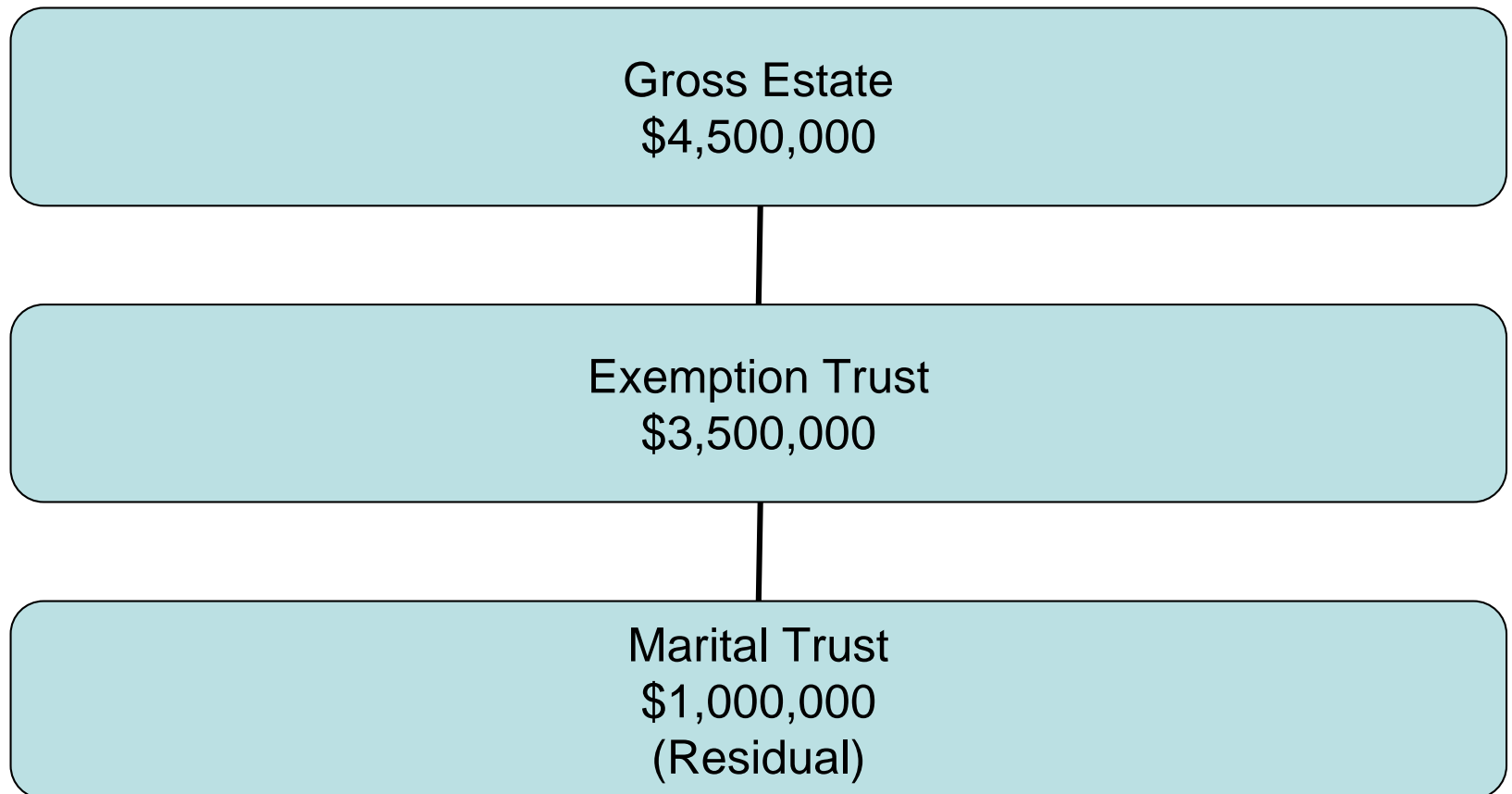
# Pecuniary Marital – Five Types



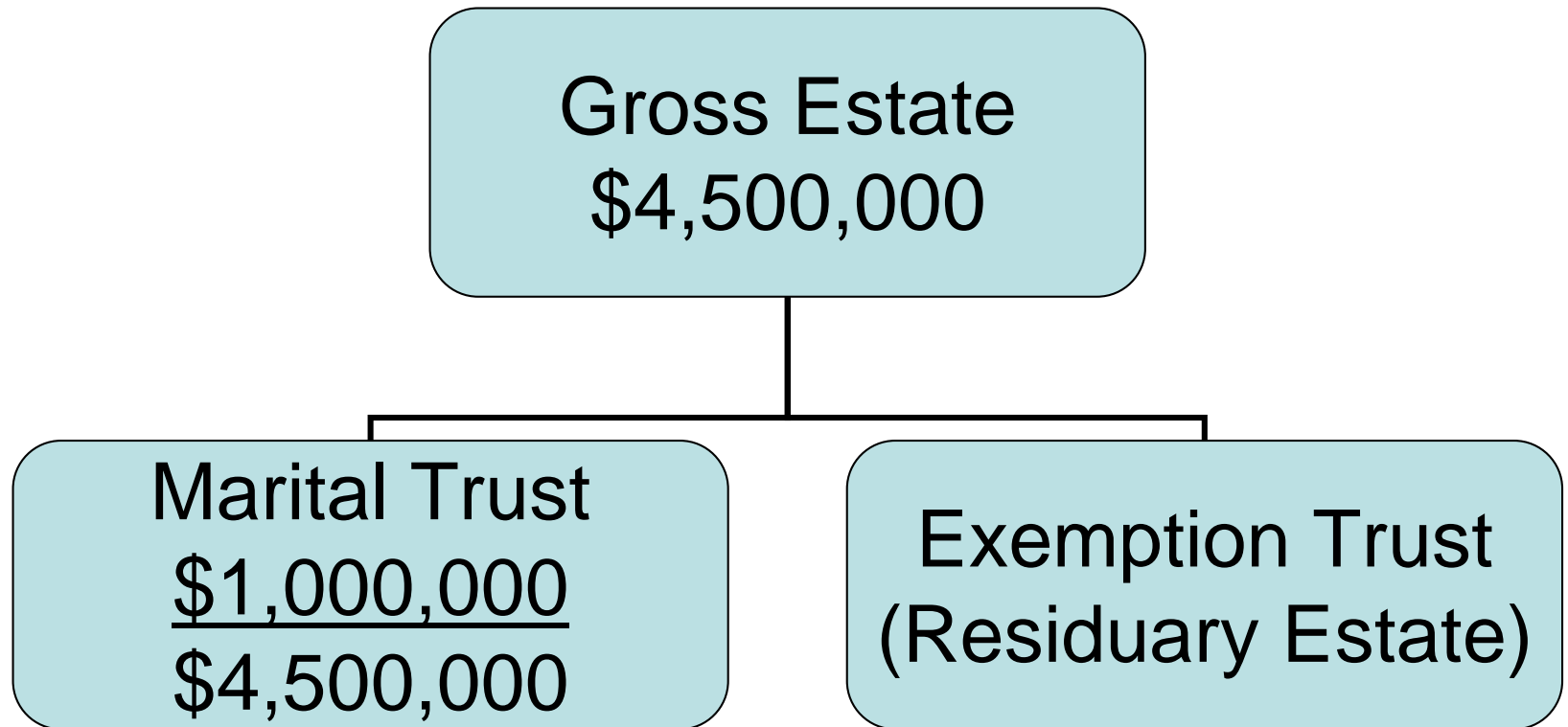
# Pecuniary Marital – Pre-Residual



# Residual Marital



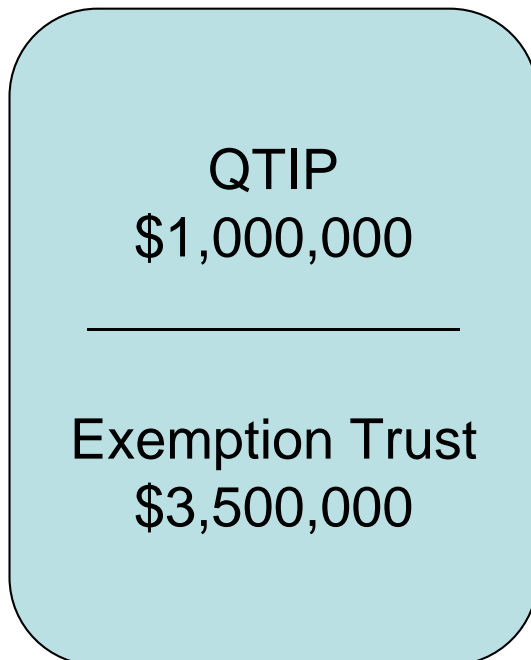
# Fractional Marital



# Single Fund Marital

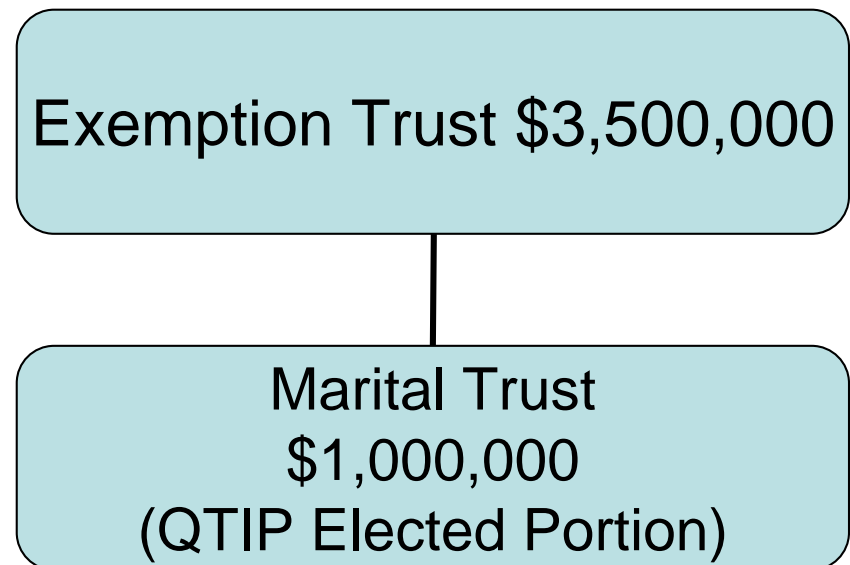
## Divisible QTIP

Gross Estate \$4,500,000



## Clayton QTIP

Gross Estate \$4,500,000



# Pecuniary Marital – Rev. Proc. 64-19 True Worth Funding

- **Gross Estate**

Date of Death	\$4,500,000	
Date of Funding	\$4,600,000	
Assets at Funding		
Stocks		
FMV	\$1,000,000 →	Marital Trust \$1,000,000
Basis	<u>900,000</u>	
Potential Gain	\$100,000	
Other	\$3,600,000 →	Exemption Trust \$3,600,000
Estate recognizes	\$100,000	

Exemption Trust benefits from growth



# Pecuniary Marital Rev. Proc. 64-19 Fairly Representative Funding

- **Gross Estate**

Date of Death                      \$4,500,000

Date of Funding                    \$4,550,000

Stock (apply fraction to each asset – avoid gain)

FMV                                  \$250,000

Basis                                \$200,000

Potential Gain    \$50,000

Avoid Gain by:

$1/4.5 \times \$250,000 = \$55,556$  →

$(\$250,000 - 55,556) = 194,444$  →

Marital Trust

Exemption Trust

# Pecuniary Marital Rev. Proc. 64-19 Fairly Representative Funding (cont'd)

Pro Rata

Asset into Trust

Marital Trust  
\$55,556

$$\leftarrow \$250,000 \times \frac{\$1,000,000}{\$4,500,000}$$

Exemption Trust  
\$194,444

$$\leftarrow \$250,000 \times \frac{\$1,000,000}{\$4,500,000}$$

No Gain

# Pecuniary Marital Rev. Proc 64-19 Aggregation of Basis & FMV – Fairly Representative Alternate

- **Gross Estate**

Date of Death \$4,500,000  
Date of Funding \$4,550,000  
Potential Gain \$50,000

- **Marital to Equal:**

- Aggregate Basis = \$1,000,000
- FMV equals pro-rata share of equity at funding
- Assets available = \$4,550,000
- Pro rata share of assets –  
 $1/4.5 \times \$4,550,000 = \$1,011,111$

Marital Trust  
FMV - \$1,011,111  
Basis - \$1,000,000

- Remainder – \$3,538,889

Exemption Trust  
FMV - \$3,538,889

# Pecuniary Marital – Rev. Proc. 64-19 Minimum Worth Funding

- Funding: value asset at the lesser of:
  - Income tax basis (usually estate tax value), or
  - Date of distribution value
- Example: \$200,000 needed to fund pecuniary marital

## Stock A

Basis	\$100,000
FMV @ Distribution	150,000

## Stock B

Basis	200,000
FMV @ Distribution	100,000
Total Basis	\$300,000
Total FMV	\$250,000

Marital Trust
A @ basis
<u>B @ FMV</u>
Total \$200,000
(even though FMV = \$250k)

# Residual Marital Funding

- Fund Exemption Trust on a pecuniary basis
- Opposite of pecuniary marital
- Residuary is marital
- Best where marital share is large compared to exemption share
- Acceptable funding methods:
  - True worth
  - Fairly representative
  - NOT minimum worth

# Fractional Marital Funding

- Where numerator is usually the smallest amount necessary to fund the marital to reduce the estate and inheritance tax to zero
- Where denominator is the residuary estate

# Fractional Formula – Gross Residue or Net Residue – Difference in Outcome?

- Gross Estate - \$4,500,000
- Debts, expenses and taxes (DET) = \$100,000  
(charged against non-marital if division before payment)
- Gross Residue Formula (prepayment):

	<b><u>Marital</u></b>
▪ $1M/4.5M \times \$4.5M =$	\$1,000,000
- Net Residue Formula (post payment):

▪ $1M/4.4M \times \$4.4M =$	\$1,000,000
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- No apparent difference! BUT-----

# Fractional Formula – Gross Residue or Net Residue – Difference in Funding

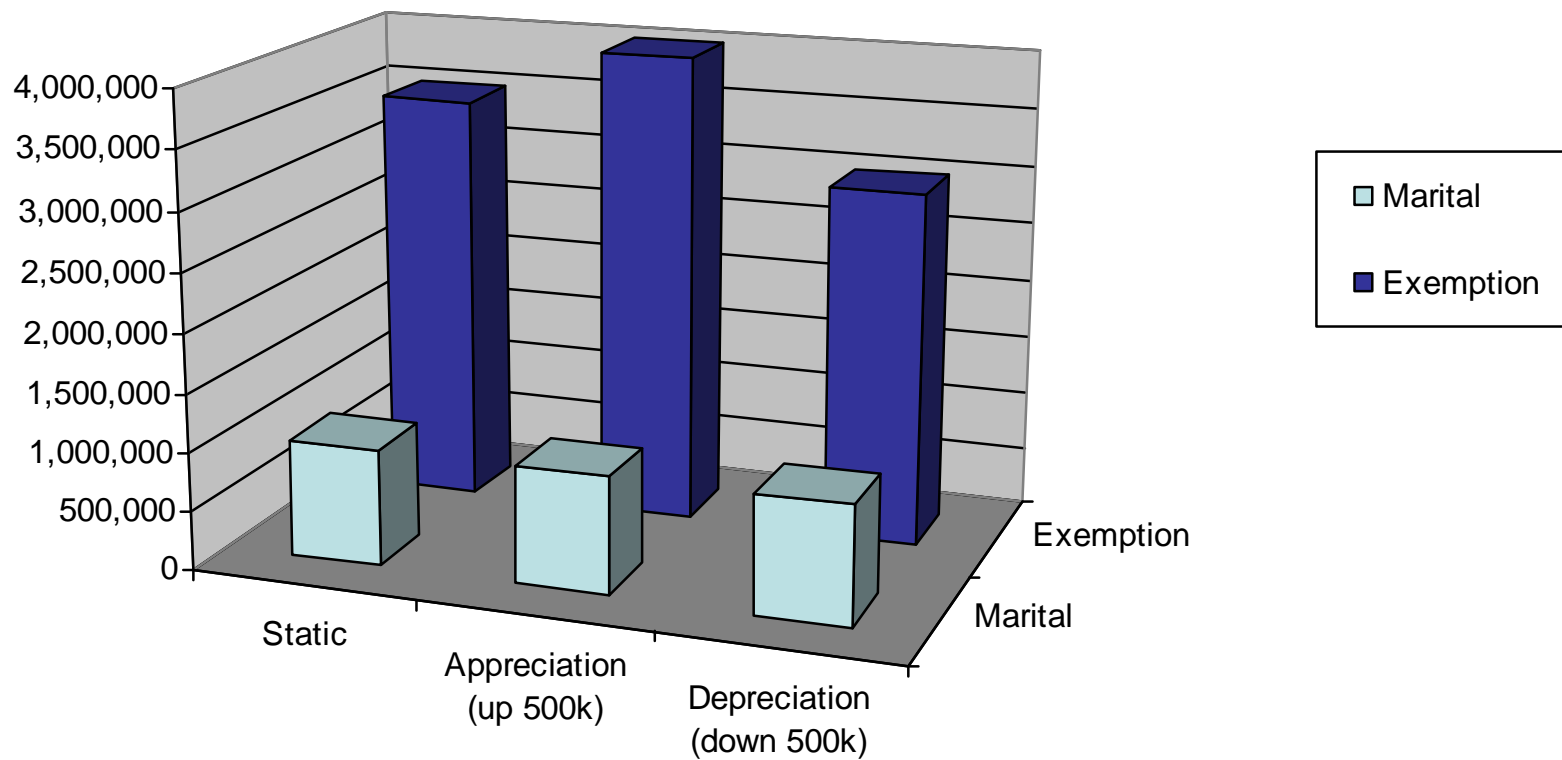
- Value of estate after payment of DET at funding - \$4.5M grows to \$6M
- Which fraction to apply to Marital Share?
  - Gross Residue (pre-payment):  $1/4.5 = 22.2\%$   
OR
  - Net Residue (post-payment):  $1/4.4 = 22.7\%$
- Result
  - Gross Residue Marital:  $22.2\% \times \$6M = \$1,332,000$   
OR
  - Net Residue Marital:  $22.7\% \times \$6M = \$1,362,000$
  - Difference = \$30,000 in Marital Share!!!



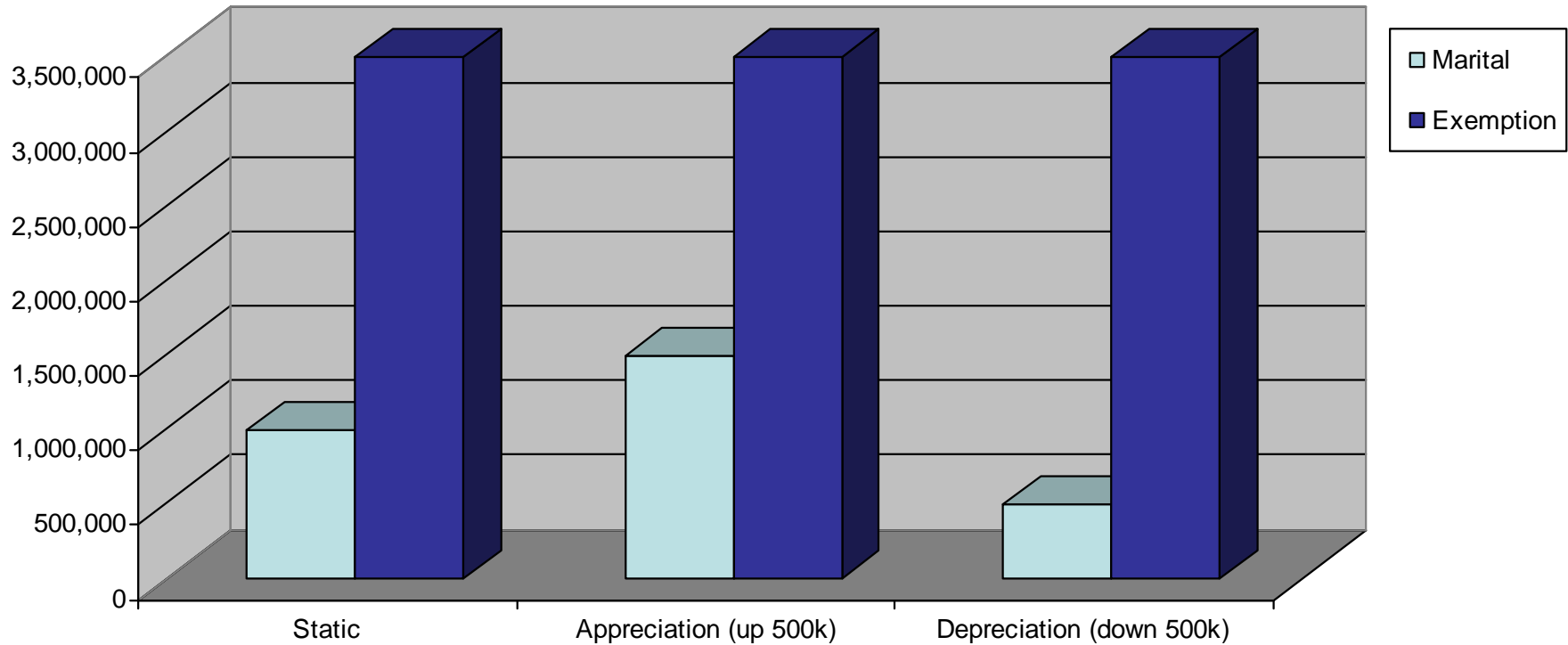
# Changing Asset Values During Administration of Estate or Trust

	<b>Marital</b>	<b>Exemption</b>
<b>Pecuniary Marital (True Worth Funding)</b>		
Static	1,000,000	3,500,000
Appreciation (up 500k)	1,000,000	4,000,000
Depreciation (down 500k)	1,000,000	3,000,000
<b>Residuary Marital (True Worth Funding)</b>		
Static	1,000,000	3,500,000
Appreciation (up 500k)	1,500,000	3,500,000
Depreciation (down 500k)	500,000	3,500,000
<b>Fractional</b>		
Static	1,000,000	3,500,000
Appreciation (up 500k)	1,111,111	3,888,889
Depreciation (down 500k)	888,889	3,111,111

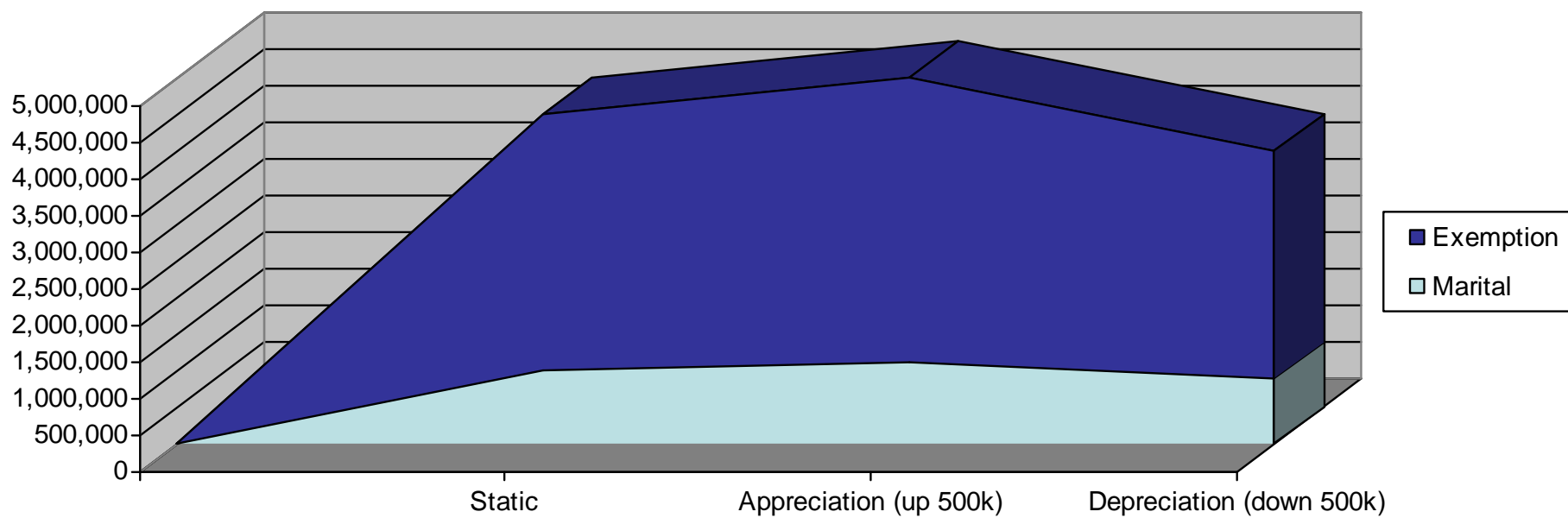
# True Worth Marital



# True Worth Reverse Marital



# Fractional



# Source of Tax Payment

- Apportionment – Oregon default
- Residue – Without apportionment
  - May impact marital deduction
  - Example: Residuary estate - \$10,000,000
    - Surviving spouse: 50% = \$5,000,000
    - Children (previous marriage): 50% = \$5,000,000
    - But, taxes will reduce residue
    - So, marital deduction will be less than \$5,000,000
    - Result: Interrelated calculation (smaller marital and larger tax)

# Source of Tax Payment - Illustration

- Example: Residuary estate - \$10,000,000
  - Surviving spouse: 50% = \$5,000,000
  - Children (previous marriage):  
50% = \$5,000,000
  - But, taxes will reduce residue
  - So, marital deduction will be less than \$5,000,000 – Actually \$3,772,727
  - Result: Interrelated calculation (smaller marital and larger taxes = \$1,227,272)

# Interrelated Calculation

IRS Publication 904  
Out of Print!!

Software Solutions  
Or  
Call IRS

# Oregon Principal and Income Act

## ORS 129.200-129.450

- Payment of administrative expenses from income on interests passing to a marital trust
  - Permitted
  - Only if marital deduction not reduced or lost
- Reimbursement of amount of estate tax paid when an amount paid from principal but deducted for income tax which resulted in increase in estate taxes paid and decrease in income taxes by benefitted beneficiary



# IRC §2053 Administrative Expenses Estate Tax or Income Tax Deduction

- Assume \$3.5M applicable exemption fully consumed by distribution to non-spouse
- Spouse = residuary beneficiary
- Taxes paid from residue

# Administration Expenses

## Regs § 20.2056(b) – 4(d)

- Management – Expenses incurred in connection with:
  - Investments (advisory, stock broker, custodial interest)
  - Preservation of assets
  - Maintenance
  - During a reasonable period of administration

# Administration Expenses

## Regs § 20.2056(b) – 4(d) (cont'd)

- Transmission – Expenses incurred:
  - Expenses – “but for” decedent’s death
  - Collecting assets
  - Paying debts
  - Paying death taxes
  - Distributions
  - (e.g. RR and attorney fees, probate fees, fees for will contests and appraisal fees)

# Administrative Expenses and the Marital Share (Residual Marital)

- **Transmission Expenses**

- Reduce marital share

- **Management Expenses**

- Do NOT reduce marital share when taken on fiduciary income tax return even if charged to Marital Share
- Unless deducted under IRC2053 on FET return

# Administrative Expenses and the Marital Share (Residual Marital) (cont'd)

Gross Estate: \$9,000,000  
 Less specific bequest: <3,000,000>  
 Residue (marital): \$6,000,000  
 Expenses: <400,000>  
 FET and OIT: <will vary>  
 Marital Deduction = will vary

## Transmission Expenses

Charged to residue and deducted on FET or 1041?

**How does this decision impact the marital share and the estate tax?**

	<b><u>FET</u></b>	<b><u>1041</u></b>
Expenses	<\$400,000>	<\$400,000>
FET and OIT	<u>&lt;\$2,100,000&gt;</u>	<u>&lt;\$2,588,889&gt;</u>
Marital Deduction =	\$3,500,000	\$3,011,111

# Administrative Expenses and the Marital Share (Residual Marital) (cont'd)

Gross Estate: \$9,000,000  
Less specific bequest: <3,000,000>  
Residue (marital): \$6,000,000  
Expenses: <400,000>  
FET and OIT: <2,100,000>  
Marital Deduction = \$3,900,000

## Management Expenses

Charged to residue but  
taken as deduction on FIT  
1041 return

Expenses	<\$0>
FET and OIT	<u>&lt;\$2,100,000&gt;</u>
Marital Deduction =	\$3,900,000
Taxable Estimate =	\$5,100,000 (\$9M-\$3.9M)

# Recognition of Gain

- Gross Estate = \$4,500,000
- Pecuniary Marital = \$1,000,000
- Estate Assets Funding Marital
  - FMV \$1,000,000
  - Basis 800,000
  - Gain on Funding \$200,000

# Recognition of Loss

- Gross Estate = \$4,500,000
- Pecuniary Marital = \$1,000,000
- Estate Assets Funding Marital
  - FMV \$1,000,000
  - Basis <1,200,000>
  - Loss \$200,000
- Recognize?
  - From Estate to Trust – Yes
  - From Trust to Trust – No IRC 267(b) - (unless IRC 645 Election)



# IRD – Income in Respect of a Decedent

- Gross Estate = \$4,500,000
- Pecuniary Marital = \$1,000,000
- Estate Assets Funding Marital  
Installment Contract

FMV	\$1,000,000
Basis	<u>&lt;500,000&gt;</u>
Gain recognized on funding	<u>\$500,000</u>
- Alternatives
  - Delay administration?
  - Drafting in contemplation
    - Specific or residuary bequest
    - Fractional formula

# DNI – Distributable Net Income

- Estate or Administrative Trust
- Income Distribution
  - Cash – Include DNI in income (if entitled to income)
  - Property: Include DNI in income 643(e)(2): Lesser of:
    - 1) Tax basis to distributee, or
    - 2) FMV of property
- Election 643(e)(3): Include DNI in income =  
Basis + gain recognized or – loss recognized

# Basis

- To distributee of property in kind
  - Adjusted basis to estate or trust before distribution
  - + gain recognized to estate or trust on distribution, or
  - loss recognized to estate or trust on distribution
- Limitation = lesser of:
  - Basis in hands of distributee (see above), or
  - Fair market value of property
- Election 643(e) – Elect to carry out gain on distribution of property and to include amount of gain in basis of distributee

# Unused Losses or Excess Deductions

- On termination of estate or trust administrations
    - Election to deduct administration expenses on 1041 and where loss occurs
    - Often more expenses than income – excess Deductions
  - Can the income beneficiary deduct?
    - Pecuniary – no (whether marital or exemption because they do no bare risk of loss)
    - Residual – yes
    - Fractional – yes (prorata)
  - Authority 642(h) and regulations
-

# GST Exemptions

- A part of estate administration with exemption share
- Goal – assign full GST exemption to the exemption Share to create an “exempt trust/share” with the Remainder to the “non-exempt trust/share”
- How? – achieve a “zero inclusion ratio”
- Example:  $1 - \text{applicable fraction} = 0$
- i.e.,  $1 - 3.5/3.5 = 0$
- What if exemption funded with  $> \$3.5\text{M}$ ?
  - Valuation rules and funding
  - Separate share rules
  - Fractional share



Thank You!