Drafting the Marital Deduction
Disclaimer Trust After
the 2001 Tax Act
(with Sample Clauses and Trust Form)
(Part 1)

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In drafting the marital deduction disclaimer trust, make sure you sufficiently circumscribe the trustee’s powers.

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BEFORE THE SCHEDULED REPEAL OF THE FEDERAL ESTATE TAX and the generation skipping transfer ("GST") tax in 2010, the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, 115 Stat. 38 ("2001 Tax Act") provides for a phased-in increase in the federal estate tax applicable exclusion amount and the GST exemption. The federal gift tax applicable exclusion is increased in 2002 to $1 million permanently, subject to the sunset (repeal) provision of the 2001 Tax Act. As the applicable exclusion amount for federal estate taxes increases to $3.5 million in 2009, care needs to be taken in the use of traditional reduce-to-zero marital deduction formula clauses, which in modest estates may result in the marital deduction trust being "underfunded" or receiving no funding.

One way to deal with this issue in a modest estate is to consider, in appropriate circumstances, the use of a marital deduction disclaimer trust. The marital deduction disclaimer trust concept envisages the residue of the decedent’s estate being left outright to the surviving spouse, who then determines the appropriateness of disclaiming part of the bequest. The disclaimed bequest generally devolves to a credit shelter trust for the benefit of the surviving spouse and the decedent’s children. (All section references are to the Internal Revenue Code unless otherwise indicated.)

REQUIREMENTS FOR THE ESTATE TAX MARITAL DEDUCTION • Six requirements must be met for an interest to qualify for the federal estate tax marital deduction:
• The decedent must be legally married at the time of his or her death;
• The person to whom the decedent is legally married at the time of his or her death must survive the decedent;
• The surviving spouse must be a U.S. citizen;
• The interest passing to the surviving spouse must be includable in the decedent’s U.S. gross estate;
• The interest must “pass” to the surviving spouse; and
• The interest received by the surviving spouse cannot be a nondeductible terminable interest.

Legally Married Requirement
The validity and the existence of marriage is a question of local law, such as common law marriages. Marriage continues until a final divorce or dissolution decree is entered by the court. Eccles v. Commissioner, 19 T.C. 1049 (1953), aff’d per curiam on other grounds, 208 F.2d 796 (4th Cir. 1953). See, also, Defense of Marriage Act, 28 U.S.C. §1739C.

Survivorship Requirement for Spouse
Local law will govern survivorship determinations in the case of simultaneous death and in the absence of a contrary provision in the governing document. The Uniform Simultaneous Death Act presumes that each spouse survived the other, which results in each estate receiving one half the joint property. Presumption-of-survivorship clauses should be drafted to avoid under-utilization of the estate tax applicable exclusion amount. The spouse who otherwise would have insufficient separate assets to fully fund a credit shelter trust should be presumed to have survived. A survivorship clause should not be based upon death as the result of a common disaster (e.g., “If my spouse and I die as the result of a common disaster”) unless it is qualified “such that it cannot be determined which of us died first.”

The marital deduction is allowed when the spouse is required by the governing instrument to survive the decedent by as much as six months. But if the bequest is contingent upon a condition that may not be determined within that six-month period, the marital deduction will fail.

Surviving Spouse Must Be U.S. Citizen
The surviving spouse must be or become a U.S. citizen by the time the federal estate tax return is filed. A noncitizen spouse who is in the process of obtaining citizenship must also be a U.S. resident at all times after the decedent’s death and before citizenship is granted. If the surviving spouse decides to become a U.S. citizen, the lawyer for the decedent’s estate should request an extension of time to file the federal estate tax return because the citizenship process will take more than nine months in most instances. In the absence of citizenship, the marital deduction is allowed only for property placed in a qualified domestic trust before the estate tax return is filed and for property governed by an applicable tax treaty.

Decedent Need Not Be
Before 1988, the citizenship or residence status of the decedent, not of the surviving spouse, was controlling for purposes of the federal estate tax marital deduction. If the decedent was a citizen or resident of the United States, taxable on his or her worldwide assets, the marital deduction was allowed without regard to the surviving spouse’s citizenship. Conversely, there was no provision for a marital deduction if the decedent was a nonresident alien, taxable only on assets situated within the United States. Adoption of Code sections 2056(d), 2106(a)(3), and 2523(i) in 1988 changed both rules. Now §2106(a)(3) allows a marital deduction for property situated in the United States that is owned by a nonresident who is not a U.S. citizen but that is included in that decedent’s U.S. gross estate, provided the other section 2056 requirements to qualify for the marital deduction are met. But no marital deduction is allowable if the surviving spouse is not a U.S. citizen unless the qualified domestic trust exception to section 2056(d) found in section 2056A applies, as discussed below. In addition, the rules for qualified joint interests between spouses do not apply in such a situation, so that joint property is includable in the estate of the spouse who supplied the consideration. §2056(d)(1)(B). See, Pvt. Letter Rul. 9551014 for a ruling applying the joint ownership rules to property acquired both before and after July 14, 1988, the effective date of the revised marital deduction rules for noncitizen spouses.

Includable in Decedent’s Gross Estate Requirement

An interest is nondeductible to the extent that it is not includable in the decedent’s gross estate. Treas. Reg. §20.2056(a)-2(b)(1).

A marital deduction will not be allowed for property that is otherwise deductible as an expense, claim, or loss. No double deduction is permitted. Thus, an interest cannot qualify for the marital deduction if it otherwise is deducted under either sections 2053 or 2054. §2056(b)(9).

Passing Requirement

Section 2056(c) defines “passing” to include interests acquired by the spouse by will, intestate succession, dower or elective share, right of survivorship, qualified disclaimer, premarital agreement, estate, will, or trust settlements in bona fide recognition of the surviving spouse’s enforceable rights in the decedent’s estate, the exercise or default of exercise of a power of appointment, or pursuant to a life insurance beneficiary designation. The requirement generally is not satisfied if the spouse’s interest is created by the action of third parties. Estate of Allen v. Commissioner, 60 T.C.M. (CCH) 904 (1990). The passing requirement also can be satisfied by designating the surviving spouse as the beneficiary of employee death benefits or any other
An annuity includable in the decedent’s gross estate under section 2039. Treas. Reg. §§20.2056(c)-1, 2, 3.

**Not a Nondeductible**

**Terminable Interest Requirement**

As part of the terminable interest rule, an interest passing to the surviving spouse must be subject to inclusion in the surviving spouse’s gross estate to the extent not consumed or disposed of during the surviving spouse’s lifetime. This reflects the fact that the marital deduction only permits deferral of the federal estate tax.

**Terminable Interest Defined**

A “terminable interest” is any interest in property that will terminate or fail either on the mere lapse of time (e.g., a term of years, a patent, copyright, or royalty interest), or on the occurrence or nonoccurrence of some event or contingency (e.g., incapacity, death or remarriage of the surviving spouse, death or survivorship of a third party, or failure to perform certain acts). The determination whether an interest is terminable is made as of the decedent’s death, even if section 2032 alternate valuation is selected and even though subsequent facts reveal that the interest will not in fact terminate. Treas. Reg. §20.2056(b)-1(e)(3).

**Nondeductible Terminable Interest Defined**

Not all terminable interests are nondeductible. In fact, terminable interests are deductible unless: (1) the interest was acquired by the decedent’s fiduciary at the decedent’s direction (§2056(b)(1)(C)); or (2) upon termination of the spouse’s interest (a) another interest in the same property will pass (b) for less than full and adequate consideration (c) from the decedent (d) to a third person whose enjoyment or possession commences upon termination of the spouse’s interest. §2056(b)(1)(A), (B). Deductibility is determined as of the decedent’s date of death. See, Rev. Rul. 85-100, 1985-2 C.B. 200.

**Exceptions to Nondeductibility**

The following are exceptions to the general rule concerning nondeductible terminable interests:

- An interest that is dependent on survival by the surviving spouse of up to six months. §2056(b)(3);
- A life income interest coupled with a general power of appointment. §2056(b)(5);
- Life insurance proceeds or annuity payments coupled with a general power of appointment. §2056(b)(6);
- Qualified terminable interest property. §2056(b)(7);
- An income interest in a charitable remainder trust where the surviving spouse is the sole non-charitable beneficiary. §2056(b)(8);