Drafting Flexibility Into Marital Deduction Trusts
And Credit Shelter Trusts

§11.1 DESIGNING FLEXIBLE ESTATE PLANS UNDER THE 2001 TAX ACT
As a result of the uncertainty of the permanency of estate tax repeal, the scheduled reinstatement of the pre-2001 Tax Act federal transfer tax regime in 2011, and the possibility that future legislation may freeze the phased-in applicable exclusion amount in lieu of estate tax repeal, estate planners need to consider drafting flexibility into estate planning documents, especially trusts. Such flexibility may include: (1) use of a single QTIP trust subject to a partial QTIP election; (2) use of a Clayton contingent QTIP trust election; (3) disclaimer-based marital deduction planning; (4) use of a joint marital deduction trust; (5) use of trust termination provisions; (6) appointment of a special powerholder with the power to appoint the trust assets to the current trust beneficiaries; (7) giving the spouse and children testamentary limited powers of appointment; (8) use of a state death tax marital deduction trust; and (9) use of a joint trust for nontaxable estates.

§11.2 ALL TO SURVIVING SPOUSE IN A DIVISIBLE QTIP MARITAL DEDUCTION TRUST WITH A PARTIAL QTIP ELECTION
An alternative to the traditional reduce-to-zero marital deduction formula is the use of a single marital deduction QTIP trust subject to a partial QTIP election. In such instance, the residue of the decedent’s estate (to the extent the assets qualify for the marital deduction) is left to a single (albeit, divisible) QTIP marital deduction trust for the benefit of the surviving spouse. Through the use of a partial QTIP election, the decedent’s fiduciary can then determine how much of the QTIP trust property should be qualified for the marital deduction. With a six-month extension to file the decedent’s federal estate tax return, the decedent’s fiduciary may have as long as 15 months to determine the appropriate partial QTIP election amount. This 15-month window period affords tremendous post mortem flexibility, as discussed in section 3.6, above. A single QTIP trust subject to a partial QTIP election is useful where the decedent wants the entire estate to benefit the surviving spouse during his or her lifetime, but desires more post-mortem flexibility than is available under an outright bequest to the surviving spouse who has only nine months to disclaim some or all of the marital bequest. In addition, the surviving spouse’s income interest in a partial QTIP trust, when the surviving spouse receives a mandatory income interest in the nonelected (divided) QTIP trust, may provide the surviving spouse’s estate with an IRC section 2013 previously taxed property (PTP) credit opportunity. See, section 3.6, above, concerning sample drafting language for a partial QTIP election. A partial QTIP election that leaves less than the full applicable exclusion amount to the nonmarital trust may also be advantageous when the surviving spouse is expected to live past a point in time where his or her gross estate will be less than the then available applicable exclusion amount. In such instance, the surviving spouse would receive a larger marital deduction amount but the assets included in his or her estate would escape estate taxation and would receive a basis adjustment subject to any limitations imposed by IRC section 1014 and the implementation of a modified carryover basis regime under the 2001 Tax Act.

§11.3 ALL TO SURVIVING SPOUSE IN A QTIP MARITAL DEDUCTION TRUST WITH CLAYTON CONTINGENT QTIP ELECTION

The Clayton contingent QTIP election is a more flexible variation of the partial QTIP election. As previously discussed in section 3.7, above, a Clayton contingent QTIP election permits a surviving spouse’s income interest in a QTIP marital deduction trust to be contingent on the fiduciary’s election to treat the marital trust property as QTIP property under IRC section 2056(b)(7). The property elected for QTIP treatment remains in the QTIP marital deduction trust while the nonelected portion of the QTIP trust property is generally distributed to a credit shelter trust or a descendants’ trust. Additional flexibility can be achieved by having the credit shelter trust provide for discretionary distributions of income and principal to the surviving spouse and the grantor’s descendants. Alternatively, the surviving spouse could be given a mandatory income interest in the credit shelter trust, which should have the effect of making the Clayton contingent QTIP election more palatable to the surviving spouse. A complete sample form of Clayton contingent QTIP trust is contained in the Sample MD Trust (by selecting alternative 1 to paragraphs 3.5, 3.6 and 3.7) contained in Appendix 1.

§11.3(a) Time For Election

Treasury Regulation §20.2056(b)-7(b)(4)(i) states that the QTIP election must be made on “the last estate tax return filed by the executor on or before the due date of the return [nine months], including extensions [six months] or, if a timely return is not filed, the first estate tax return filed by the executor after the due date.”

Practice Point: Because of the 15-month post death window period available to the executor to determine how much trust property should be elected for the QTIP marital deduction, there is no need for a six-month spousal survival requirement clause in the decedent’s governing instrument. Similarly, there is also no need for a marital deduction equalization clause in the decedent’s governing instrument.

§11.3(b) Post-Mortem Flexibility

The Clayton contingent QTIP marital deduction trust offers the same post-mortem flexibility as does the partial QTIP election, discussed above, including use of the PTP credit under IRC section 2013.

§11.3(c) Apportionment Of Estate Taxes

Whenever a Clayton contingent QTIP marital deduction trust is used, the estate taxes attributable to the property that is not elected for the marital deduction must be apportioned. Since the QTIP marital deduction trust constitutes the residue of the grantor’s estate, take care to ensure that estate taxes attributable to the nonelected portion (i.e., the portion that is distributed to the credit shelter trust) are not apportioned against the QTIP marital deduction trust. Many estate tax apportionment clauses routinely apportion taxes to the residue of the grantor’s estate. See, e.g., Pvt. Letter Rul. 199924002. Such a provision could impair the marital deduction (to the extent of the death taxes apportioned against it). It may be appropriate to specifically apportion to the nonelected property any federal estate taxes attributable to that property.

Drafting Example For Will: Estate Taxes To Be Paid From And Charged To Estate. Except as provided in the below sub-paragraph entitled, “Payment Of Death Taxes From Property,” I direct that all federal estate taxes and state death taxes (including interest and penalty thereon), which shall become payable with respect to any property, or interest therein, whether such property or interest passes under this will, my revocable living trust agreement, or otherwise, and which is properly includable in my estate for any such taxation purposes by any domestic or foreign taxing authority, shall be charged to...
and paid out of that portion of the residue of my estate which is not included in a gift qualifying for the marital or charitable deduction. Generation-skipping transfer taxes, including interest and penalty, shall be borne by and be paid out of the property generating the tax (notwithstanding the provisions of IRC section 2603(a)(3)). Except as provided in the below sub-paragraph entitled, “Payment Of Death Taxes From Property,” my executor shall not seek recovery or reimbursement from, or apportionment between or among, the recipients of any such property or interest. Federal estate taxes and state death taxes shall not be paid from any bequest that is so elected/deducted for the federal estate tax marital or charitable deduction.

(1) Payment Of Death Taxes From Property. Federal estate taxes (computed on an incremental/marginal basis) and state death taxes and interest and penalty thereon, that are attributable to (i) any disclaimer by a beneficiary (to the extent the disclaimed property does not otherwise qualify for the marital or charitable deduction and is so elected/deducted); (ii) my executor not electing the marital deduction for any property as to which such an election could be made under the qualified terminable interest property provisions of the tax law (but only to the extent that the nonelected portion of said property is considered to be held in separate trust vis-à-vis the elected portion of said property); or (iii) any qualified domestic trust under IRC section 2056A, shall be apportioned against and be paid out of such property, i.e., shall be apportioned against and be paid from the disclaimed, or nonelected but otherwise eligible qualified terminable interest property, or from the qualified domestic trust (respectively), with no right of reimbursement or contribution.

§11.4 ALL OUTRIGHT TO SURVIVING SPOUSE WITH RIGHT TO DISCLAIM TO CREDIT SHELTER TRUST

When the combined estates of the husband and wife are less than the current estate tax applicable exclusion amount, an alternative to the Clayton contingent QTIP election and the partial QTIP election is for the grantor to leave the residue of his or her trust estate outright to the surviving spouse. The surviving spouse can then make a qualified disclaimer of whatever interests or amounts that the spouse determines to be appropriate. IRC section 2518. See, e.g., Pvt. Letter Ruls. 200442027 (cascading disclaimers by surviving spouse used to transfer part of the marital bequest to various other trusts), 9435014 (qualified disclaimer by surviving spouse in order to utilize decedent's applicable exclusion amount) and 8749041 (qualified disclaimer by deceased (surviving) spouse’s executor in order to equalize both deceased spouses’ estates for federal estate tax purposes). A complete sample form of a marital deduction disclaimer trust is contained in the Sample MD Trust (by selecting alternative 2 to paragraphs 3.5, 3.6 and 3.7) contained in Appendix 1.


3 In this regard, it should be noted that each separate interest in property is subject to disclaimer or acceptance, and each separate interest, including any specific amount, part, fraction or asset, or formula amount based on present or future facts independent of the disclaimant’s volition, can be the subject of either a disclaimer or acceptance by the disclaimant. Treas. Reg. §25.2518-3(a)(1).
§11.4(a) Federal Disclaimer Law

Federal law concerning the estate and gift tax consequences of qualified disclaimers is contained in IRC section 2518, which sets forth the rules that must be followed for a disclaimer to be “qualified” and gift-tax free by the disclaimant. IRC section 2046. Section 2518 applies to taxable transfers made after December 31, 1976, that create an interest in the person attempting to disclaim the interest. Treas. Reg. §25.2518-1(a). See, IRC section 2056 (making IRC section 2518 applicable to the estate tax) and IRC section 2654(c) (making IRC section 2518 applicable to the GST tax).

§11.4(b) Requirements For A Qualified Disclaimer

The requirements for a qualified disclaimer under IRC section 2518 are:

1. The disclaimer must be an irrevocable and unqualified refusal by the disclaimant to accept an interest in property. Treas. Reg. §25.2518-1(a)(1).

2. The disclaimer must be in writing. The writing must identify the interest in property disclaimed and be signed either by the disclaimant or by the disclaimant’s legal representative (such an agent authorized under a durable power of attorney, a court appointed conservator/guardian, a personal representative of a decedent, etc.). Treas. Reg. §§25.2518-2(a)(2) and 25.2518-2(b)(1); Pvt. Letter Ruls. 9015017 and 8326110. See also, Pvt. Letter Rul. 8749041, where the executor of the wife’s estate disclaimed part of the wife’s inheritance from her husband’s estate and the disclaimed property (from the deceased husband’s estate) devolved to the executor individually, as the named residuary beneficiary of the husband’s estate.

Practice Point: Each interest in property that is separately created by the transferor is treated as a separate interest and may need to be disclaimed. Treas. Reg. § 25.2518-3(a)(1).

3. The written disclaimer must be received by the transferor of the interest, the transferor’s legal representative, the holder of the legal title to the property to which the interest relates, or the person in possession of the property. Treas. Reg. §25.2518-2(a)(3).

Practice Point: If the mailing requirements of Treas. Reg. §201.7502-1(c)(1), (c)(2) and (d) are met, a timely mailing will be an effective form of delivery to the transferor.

4. The written disclaimer must be received no later than nine months after the later of: (i) the day on which the transfer creating the interest in the disclaimant is made; or (ii) the day on which the disclaimant attains age 21. Treas. Reg. §25.2518-2(c)(3). See, Treas. Reg. §§25.2518-2(d)(3) and (4) concerning disclaimants under the age of 21. For testamentary transfers the nine-month starting point is the date of death. For inter-vivos transfers, the nine-month starting point is when there is a completed gift for gift tax purposes, regardless of whether a gift tax is imposed or whether the property is subsequently included in the transferor’s gross estate. Rev. Rul. 90-45, 1990-1 C.B.175; Treas. Reg. §25.2518-2(c)(3)(i).

Caution: If multiple or successive disclaimers must be made to achieve a desired result, all of them must be made within the same nine-month period. Treas. Reg. §§25.2518-2(c)(3)(i) and 25.2518-2(c)(5), Example 4.

* Common law does not grant a legal representative the authority to disclaim. Therefore, a legal representative’s authority to disclaim must be authorized by applicable state law or be explicitly granted in the governing instrument. Pvt. Letter Rul. 8737034. See, section 11.4(h) below for sample drafting language for a durable power of attorney. See also, section 3.5(G) of Alternative 1 and section 3.6 of Alternative 2 of Sample MD Trust.