15
Marital Deduction Funding Formulas And Their Tax Consequences

§15.1 TWO BASIC TYPES OF MARITAL DEDUCTION FUNDING FORMULAS

There are two types of marital deduction funding formulas that are commonly used by estate planning attorneys. They are: (1) the pecuniary\(^1\) funding formula (of which there are five variations); and (2) the fractional\(^3\) funding formula (of which there are two variations). The pecuniary funding formula may be expressed as an “upfront” pecuniary marital deduction amount, which means that the formula determines the dollar amount to be distributed to the marital deduction trust (with the credit shelter trust receiving the residue of the grantor’s estate)\(^5\), or the pecuniary funding formula may be expressed


\(^2\) A pecuniary bequest is a gift of a specific dollar amount (rather than a share, fraction or percentage of assets). The following are examples of pecuniary bequests: (1) “I hereby devise the sum of $10,000 to my spouse”; (2) “I hereby devise to the trustee of the marital deduction trust, the smallest amount necessary to avoid or minimize the payment of federal estate taxes, considering all relevant factors pertinent to this estate planning objective, including, without limitation, the use of the applicable exclusion amount available at the time of my death”; or (3) “I hereby devise to the GST Tax Exempt Trust the full amount of my unused GST tax exemption available at the time of my death.” It should also be noted that a fraction of an ascertained amount is a pecuniary amount and not a fraction. Thus, wills or trusts that provide for a percentage of the “adjusted gross estate” (as were common under the pre-1982 50 percent marital deduction devises) are by operation, a pecuniary amount. Rev. Rul. 56-270, 1956-1 C.B. 325. However, disclaimers of pecuniary amounts of residual bequests are treated for funding purposes as fractional bequests. See, Treas. Reg. §25.2518-3(d), Example 19.

\(^3\) A fractional share gift is a gift of a specified fraction or percentage of the decedent’s assets (rather than a gift of dollar amount). For example, “I hereby devise one-tenth of the residue of my estate to my son,” or “I hereby devise 90 percent of the residue of my estate to my daughter,” or “Trustee shall divide the residue of my estate into equal shares so as to provide one share for my son and nine shares for my daughter.” Any amount ($A) can be converted into a fraction, where the numerator is $A, and the denominator is $B, which is also the value of the fund (the multiplicand) against which the fraction is to operate. Thus, \((A/B) \times B = A\).

\(^4\) For purposes of this chapter, the nonmarital share is referred to as the credit shelter trust; and the “Family Trust” refers to the credit shelter trust for the benefit of the grantor’s surviving spouse and children, and the “Children’s Trust” refers to the credit shelter trust for the benefit of the grantor’s children and descendants.

\(^5\) For purposes of this chapter, and unless otherwise expressly stated, the term “grantor’s estate” refers to either the grantor’s probate estate or the grantor’s revocable living trust (as a will-probate substitute).
as a “reverse” pecuniary amount, which means that the formula determines the dollar amount to be distributed to the credit shelter trust (with the marital deduction trust receiving the residue of the grantor’s estate). In the case of a fractional funding formula, there is no “upfront” fractional formula or a “reverse” fractional formula (since the fractions representing each are simply reciprocals of one another). Instead, both the marital deduction trust and the credit shelter trust receive a percentage of the residue of the grantor’s estate based upon a formula (expressed as a fraction or percentage) that attempts to minimize the federal estate tax and maximize the use of the deceased grantor’s then available applicable exclusion amount.

§15.2 SELECTING A MARITAL DEDUCTION FUNDING FORMULA

Regardless which formula a practitioner uses, the credit shelter portion is almost always going to start out at or near the applicable exclusion amount (assuming none of the applicable exclusion amount has been applied to lifetime gifts by the grantor) minus any charges against the grantor’s estate. This is particularly true when the grantor’s estate is composed of assets that are less volatile. Lack of appreciation or depreciation during the administration of the grantor’s estate can make the choice of a marital deduction funding formula far less relevant. In many situations, the practical result will be the same regardless of which formula the practitioner uses, which is why many practitioners tend to pick one formula and faithfully use it in nearly all situations. With this as background, the most important factors to keep in mind in selecting a formula (or the formula a practitioner is going to use) are:

§15.2(a) Post-Death Appreciation Or Depreciation

With a date-of-distribution pecuniary funding formula, all post-death appreciation and depreciation is shifted to the residue.

§15.2(b) Income Taxes

Funding a pecuniary formula bequest with appreciated noncash property results in capital gain, and funding with the right to receive an item that constitutes income in respect of a decedent under IRC section 691(a) (“IRD”) accelerates the income tax payable on the IRD.

§15.2(c) Ease Of Administration

Some formulas (e.g., date-of-distribution pecuniary bequests) are easier to administer than others, when addressing such problems as the effect of partial, interim distributions and allocation of income earned during the course of administration.

§15.2(d) Flexibility On Funding

Some formulas (e.g., date-of-distribution pecuniary bequests and pick and choose fractional share gifts) afford more flexibility on funding, especially because of the fiduciary’s unfettered discretion to select among the assets available to fund the bequest.

§15.3 OVERVIEW OF THE FIVE PECUNIARY FUNDING FORMULAS

A pecuniary funding formula generally refers to a dollar amount (as determined by the formula itself).

Drafting Example: I give to the trustee of the marital deduction trust the smallest amount of my estate that will allow full use by my estate of the maximum amount of the federal estate tax applicable exclusion amount available in the year of my death.

§15.3(a) Five Types Of Pecuniary Funding Formulas

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There are five types of pecuniary funding formulas. Three pecuniary funding formulas describe how much money is to be placed in the marital deduction trust, with the residue of the grantor’s estate passing to the credit shelter trust. Two pecuniary funding formulas describe how much money is to be placed in the credit shelter trust, with the residue of the grantor’s estate passing to the marital deduction trust. The five formulas are: (1) the true-worth marital deduction funding formula (also known as the true-worth upfront pecuniary marital deduction funding formula); (2) the fairly representative marital deduction funding formula (also known as the pecuniary fairly representative marital deduction funding formula or the Rev. Proc. 64-19, 1964-1 C.B. 682, marital deduction funding formula); (3) the minimum-worth marital deduction funding formula (also known as the pecuniary minimum-worth marital deduction funding formula); (4) the true-worth credit shelter funding formula (also known as the true-worth reverse pecuniary funding formula); and (5) the fairly representative credit shelter funding formula (also known as the fairly representative reverse pecuniary funding formula or the Rev. Proc. 64-19 reverse pecuniary funding formula). All five types of pecuniary funding formulas are discussed below in greater detail.

§15.3(b) DNI Issues

Under pecuniary funding formula clauses, funding distributions of cash or noncash property (such as stock and bonds) from the distributing entity (such as the grantor’s estate) in satisfaction of the pecuniary amount typically carry out with them distributable net income (DNI) to the distributee (such as the marital deduction trust). IRC section 662(a)(2). Distributions of the residue of the grantor’s estate also carry out DNI to the distributee (such as the residuary credit shelter trust). Treas. Reg. §1.663(a)-1(b)(2).

§15.3(b)(1) DNI Details

Subject to the separate share rule of IRC section 663(c) (which is described below), a distribution from the grantor’s estate under IRC section 661 (other than a specific bequest of money or property described in IRC section 663(a)(1)) carries out the estate’s distributable net income (DNI), whether the distribution is made in cash or with noncash property (or a combination of each), regardless of whether the cash or noncash property comes from income or corpus for fiduciary accounting purposes. (DNI, which is defined in IRC section 643(a), is generally taxable income earned (or received) by the grantor’s estate, subject to certain adjustments. Unless it is the final tax year of the grantor’s probate estate or trust estate, capital gains and capital losses are generally excluded from computation of DNI. DNI is also the maximum amount that will be taxable to the distributee, and is the maximum amount that the fiduciary can deduct for distributions made to a distributee. If the grantor’s probate estate or trust estate has DNI, a distribution of income or principal may carry out that DNI and have an income tax consequence to the distributee.) Pursuant to IRC section 661, the grantor’s estate (the distributing entity) receives a deduction on its fiduciary income tax return for the tax year that the DNI distribution is made and,

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*When does §663(a)(1) apply?...First, a gift of $X will qualify, even if the gift ends up being abated in part (notwithstanding the suggestion to the contrary in Rev. Rul. 57-214 [1957-1 C.B. 203]). See, Rev. Rul. 66-207 [1966-2 C.B. 243]; Rev. Rul. 82-4[,1982-1 C.B. 99]. Second, the gift must be either a specific dollar amount or specific property. Rev. Rul. 72-295 [1972-1 C.B. 197] illustrates a gift that qualifies as neither—as of the date of death, we know neither the dollar value of the gift nor the number of shares of stock. Third, a gift of a dollar amount will not qualify if the amount depends on any exercise of discretion by the executor. Regs. §1.663(a)-(b)(1). Finally, the amount must be ascertainable as of the date of death. This point is illustrated by Rev. Rul. 60-87 [1960-1 C.B. 286] (involving a marital formula provision), although Rev. Rul. 66-207 [1966-2 C.B. 243] (involving a pecuniary bequest that partially abates) is a mild contradiction to this principle.” Robert Danforth, *The Interplay of Kenan v. Comr. and §663(a)(1)*, 30 Tax Management Estates, Gifts and Trusts Journal 139, 142 March 10, 2005.)
pursuant to IRC section 662, the distributee includes the distributed DNI in its income for that year. See, IRC sections 662(c) and 663(b).

When noncash property is distributed from the grantor’s estate, the amount of DNI that is deemed distributed by the grantor’s estate to the distributee (and thus deductible by the grantor’s estate under IRC section 661 and includable by the distributee under IRC section 662), is the lesser of: (1) the noncash property’s income tax basis in the hands of the distributee; or (2) the noncash property’s fair market value on the date of its distribution. IRC section 643(e)(2). If appreciated noncash property is distributed by the grantor’s estate, only DNI equal to the noncash property’s income tax basis is deemed distributed to the distributee. IRC section 643(e)(2)(A).

Under IRC section 643(e)(3), the grantor’s estate may elect to use the noncash property’s fair market value on the date of its distribution as the amount that is deemed to be distributed for DNI purposes. See, Section 15.5(d), below. If an IRC section 643(e)(3) election is made, then the noncash property that is distributed from the grantor’s estate is treated as if it had been sold to the distributee (which could be the marital deduction trust or the credit shelter trust or both trusts, depending on which trusts receive distributions from the grantor’s estate for the tax year in question), and gain or loss is recognized by the grantor’s estate (subject to the rules concerning the nonrecognition of losses between related taxpayers under IRC section 267, which is discussed in section 15.4(c), below). As a result of an IRC section 643(e)(3) election, the distributee is treated as having an income tax basis in the noncash property equal to its fair market value on the date of its distribution, and more DNI is carried out from the grantor’s estate to the distributee. IRC section 643(e)(1).

The separate share rule of IRC section 663(c) limits the amount of DNI allocable to a beneficiary. The separate share rule is designed to prevent one beneficiary from being taxed on income accumulated (by the grantor’s estate) for the benefit of another beneficiary. The separate share rule limits the amount of DNI that is carried out under IRC sections 661 and 662 to a particular beneficiary (the distributee) concerning distributions that are made by the distributing entity (such as the grantor’s estate) to the distributee-beneficiary for the tax year in question. If the separate share rule does not apply, a distribution in satisfaction of a pecuniary bequest can carry out all of the DNI in the grantor’s estate, to the extent the DNI is not otherwise allocated and distributed to other beneficiaries for the tax year in question. Or, it may carry out no DNI if the pecuniary bequest meets the exceptions described in IRC section 663(a)(1) (concerning specific bequests of money or property). However, special rules apply to estates that include IRD assets.

§15.3(c) IRD Issues

All pecuniary funding formulas cause an acceleration of the recognition of income in respect of a decedent (“IRD”)8 by the grantor’s estate if the right to receive an item of IRD (e.g., installment payments of lottery winnings, promissory or installment notes receivable,9 IRAs, 401(k)s, deferred


9 An in-kind distribution by the grantor’s estate of an installment note that is reporting its gain under IRC section 453 and was created before the grantor’s death will not be deemed to be disposition for the purpose of accelerating the deferred/unrecognized gain. IRC sections 453(e)(6) and 453B(c). However, such an exception does not exist when the installment note is distributed in satisfaction of a pecuniary amount owed to a beneficiary. Furthermore, if an installment note is created after the grantor’s death, the distribution of the post-death installment note will trigger the recognition of the deferred gain. Estate of Henry H. Rodgers, 143 F. 2d 695 (2d Cir. 1944), cert denied, 323 U.S. 780 (1944); Rev. Rul. 55-
compensation, accrued but unpaid interest, declared but unpaid stock dividends, etc.) is distributed by the grantor’s estate (the distributing entity) to the distributee under a pecuniary funding formula.\textsuperscript{10} IRC section 691(a)(2); Treas. Reg. §1.691(a)-4(a); \textit{Estate of Marshal L. Noel v. Commissioner}, 50 T.C. 702 (1968). \textit{See also}, Treas. Reg. §1.691(a)-2(b), Examples 1-5, for examples of IRD. If the right to receive an item of IRD passes under the residue of the grantor’s estate, there is no accelerated recognition of IRD by the grantor’s estate (or by the residuary beneficiary, such as a credit shelter trust under a true-worth marital deduction funding formula). \textit{Edward D. Rollett Residuary Trust v. Commissioner of Internal Revenue}, 752 F.2d 1128 (6th Cir. 1985), aff’g 80 T.C. 619 (1983); Treas. Reg. §1.691(a)-4(b)(2); Pvt. Letter Rul. 200234019. Also, if the right to receive an item of IRD is distributed by the grantor’s estate pursuant to a fractional funding formula, there is no accelerated recognition of the IRD by the grantor’s estate. Treas. Reg. §1.691(a)-4(b).

Another way to avoid the accelerated recognition of the right to receive an item of IRD by the grantor’s estate (and the deemed allocation of the accelerated IRD under the IRC section 663(c) separate share rules)\textsuperscript{11} is to make a specific bequest of the right to receive IRD.\textsuperscript{12} A specific bequest of the right

\textsuperscript{10} Treas. Reg. §1.691(a). \textit{See also}, Treas. Reg. §§1.661(a)-2(f) and 1.1014-4(a)(3) (IRD is not eligible for a step up in basis as concerns property acquired from a decedent); Pvt. Letter Rul. 9507008 (funding of pecuniary bequest with U.S. savings bonds causes grantor’s estate to recognize the accrued (but unreported) interest income on the bonds). The estate planner should also be cognizant of the IRC section 691(c) deduction for payment of estate and GST tax and the case of \textit{Estate of Nelle W. Kincaid v. Commissioner}, 85 T.C. 25 (1985), when IRD is specifically bequeathed to the marital deduction share, and estate tax is paid. Under the \textit{Kincaid} holding, IRD can be allocated to the marital deduction trust and receive an IRC section 691(c) deduction for estate taxes paid on the IRD by the nonmarital share. \textit{See also}, Pvt. Letter Rul. 9219006. \textit{See, Estate of Wendell Cherry v. U.S.}, 133 F. Supp. 2d 949 (W.D. Ky. 2001), concerning the manner in which to calculate the IRC section 691(c) deduction.

\textsuperscript{11} Under the separate share rule of IRC section 663(c), accelerated IRD that is not treated as income under fiduciary accounting rules (i.e., accelerated IRD that is treated as corpus under fiduciary accounting rules) is deemed to be allocated pro rata to bequests that can be potentially funded with the IRD, even if the bequests are not entitled to receive any income under the terms of the governing instrument or applicable local law. Treas. Reg. §1.663(c)-(2)(b)(3). In such instance, the grantor’s estate receives a deduction under IRC section 661 for the DNI distribution pertaining to the accelerated IRD, and the recipients of the deemed allocation of the accelerated IRD include their pro-rata share of the accelerated IRD in their income for the tax year in question. Therefore, in the absence of a specific allocation of the IRD assets in the governing instrument, the separate share rule may result in (phantom) DNI (attributable to the accelerated recognition of the IRD) being carried out to more than just the beneficiary whose pecuniary bequest is satisfied with the IRD. Treas. Reg. §1.663(c)-5, Examples 6 and 10. However, a specific direction in the governing instrument concerning the allocation of IRD assets will override the Regulation’s requirement of pro-rata allocation among the potential recipients. Treas. Reg. §1.663(c)-5, Example 9.

\textsuperscript{12} An alternative to a specific bequest of all IRD items is to put a limitation on the amount of IRD items or, conversely, to put a minimum value on the amount of the specific bequest of IRD items to the beneficiary. An example of a specific bequest of IRD items with a minimum value on the amount to be distributed to the beneficiary, might read: “I hereby specifically devise to [name of devisee] the following items that constitute IRD, to wit, [describe the IRD items], plus an additional amount of items that constitute IRD equal to the excess of $50,000 over the final value for federal estate tax purposes of the aforesaid identified items of IRD.” (Note: the distribution to the beneficiary of a right to IRD in satisfaction of a pecuniary bequest (to wit, the (additional) dollar amount necessary to achieve a total bequest of $50,000 in value) will still result in the acceleration of the recognition of tax on the IRD to the grantor’s estate, but to a lesser amount, viz, the additional amount necessary to equal $50,000.) A cap on the amount of IRD items to be distributed pursuant to a specific bequest might read: “I hereby specifically devise to [name of devisee] the following items that constitute IRD, to wit, [describe the IRD items], provided, however, that if the total value of such identified IRD items for federal estate tax purposes exceeds $50,000, then I give to