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Inter Vivos Marital Dispositions

Inter vivos marital deduction dispositions are an alternative to outright gifts for purposes of enabling a less pecunious spouse to use his or her estate tax exemption and generation-skipping tax exemption. These arrangements permit the donor to control the management and the ultimate disposition of the property. The inquiry of this chapter is the extent to which these arrangements can (and cannot) enhance flexibility.

11.01 ABILITY OF DONOR TO CONTROL DURING LIFE OF DONEE

Not an issue in the case of marital arrangements that a property owner creates at the time of his or her death, the donor who during life creates a trust that is to qualify for the marital deduction because of the power of the spouse to appoint or because of a QTIP election cannot retain any ability to establish or alter beneficial enjoyment, *i.e.*, a "power" as defined in Code Section 2613(d) of the generation-skipping tax before the Tax Reform Act of 1986. This conclusion applies only to a power that the donor retains. Any other power to pay principal to the donee spouse is consistent with qualification.

The conclusion that the donor cannot retain a power is the product of a very difficult analysis and of three conclusions that it produces. The first conclusion is that a power that the donor retains prevents the transfer from qualifying for the marital deduction, at least unless the power is a fiduciary power limited by an ascertainable standard. According to Code Section 2523(b)(2), a power that the donor retains to allow an appointee to enjoy the property after the termination of the interest of the donee spouse prevents the transfer to the donee spouse from qualifying for the marital deduction:

(b) Life Estate or Other Terminable Interest. - Where, on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur, such interest transferred to the spouse will terminate or fail, no deduction shall be allowed with respect to such interest -

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(2) If the donor immediately after the transfer to the donee spouse has a power to appoint an interest in such property which he can exercise (either alone or in conjunction with any person) in such manner that the appointee may possess or enjoy any part of such property after such termination or failure of the interest transferred to the donee spouse. For purposes of this paragraph, the donor shall be considered as having immediately after the transfer to the donee spouse such power to appoint even though such power cannot be exercised until after the lapse of time, upon the occurrence of an event or contingency, or on the failure of an event or contingency to occur.

An exercise or release at any time by the donor, either alone or in conjunction with any person, of a power to appoint an interest in property, even though not otherwise a transfer, shall, for purposes of paragraph (1), be considered as a transfer by him. Except as provided in subsection (e), where at the time of the transfer it is impossible to ascertain the particular person or persons who may receive from the donor an interest in property so transferred by him, such interest shall, for purposes of paragraph (1), be considered as transferred to a person other than the donee spouse.

Code Section 2523(e), which applies to power-of-appointment arrangements, and Code Section 2523(f), which engrafts QTIP rules onto Code Section 2523, override the terminable interest rule (of Code Section 2523(b)) in the case of an *interest* that the donor retains. However, Code Sections 2523(e) and 2523(f) do not override the terminable interest rule in the case of a *power* that the donor retains. The regulations specifically provide for this result in the case of QTIP:

Terminable interests that are described in Section 2523(b)(2) cannot qualify as qualified terminable interest property. *Thus, if the donor retains a power described in Section 2523(b)(2) to appoint an interest in qualified terminable interest property, no deduction is allowable under Section 2523(a) for the property*. Treas. Reg. §25.2523(f)-1(a) (emphasis added). *See also* Treas. Reg. §25.2523(b)-1(d).

The donor's retention of a *power* to affect beneficial enjoyment of qualified terminable interest property after the interest of the donee spouse terminates seems to undermine the marital deduction. Anomalously, the donor's retention of an *interest* that succeeds the interest of the donee spouse seems not to produce the same result. Code §2523(f)(1)(B); Treas. Reg. §25.2523(f)-1(d).

The critical question, then, is whether the retained power of the donor to distribute principal to the donee spouse is a retained power to affect beneficial enjoyment after the interest of the donee spouse terminates. The power permits the donor to cause the principal to pass to the donee and, therefore, not to pass to any remainder person. Correspondingly, the power permits the donor to cause the property not to pass to the donee and, therefore, to pass to a remainder person. Accordingly, the power appears inherently to permit the donor to cause an appointee to possess or enjoy the principal after the termination of the interest of the donee spouse. Therefore, the donor's retention of the power (except as discussed, infra) seems to cause the transfer not to qualify for the marital deduction.

An example in the pre-QTIP regulations applies the principle. Given the foregoing, the example seems to apply also to QTIP:

Example. The donor, having a power of appointment over certain property, appointed a life estate to his spouse. No marital deduction may be taken with respect to such transfer, since, if the retained power to appoint the remainder interest is exercised, the appointee thereunder may possess or enjoy the property after the termination or failure of the interest taken by the donee spouse. Reg. §25.2523(b)-1(d)(3).

However, this configuration seems to appear in Ltr. Rul. 9309023 (December 3, 1992) and 9437032 (June 20, 1994) without preventing the gift from being QTIP.

Use of an ascertainable standard to limit the retained power might remove the power from being described in Code Section 2523(b)(2). Thus, it might cause the power not to prevent the transfer from qualifying for the marital deduction. *Cf. Jennings v. Smith*, 161 F. 2d 74 (2d Cir. 1947); *Estate of Budlong v. Commissioner*, 7 T.C. 756 (1946); and *Estate of Carpenter v. United States*, 80-1 USTC ¶13,339 (W.D. Wis. 1980).

The second conclusion is that the power which the donor retains apparently does not prevent the gift of the income interest of the donee spouse for life from being complete, but, unless the power is a fiduciary power and an ascertainable standard limits the power, does prevent the gift of the remainder from being complete, for gift tax purposes. Treas. Reg. §§25.2511-2(c), 25.2511-2(f) and 25.2511-2(g). The exercise of the retained power cannot deprive the donee spouse of an income interest for his or her life. *See* Treas. Reg. §25.2511-2(c). However, the described power clearly is a power to change the beneficiary of principal, *i.e.,* a power to determine whether principal passes to the donee spouse or, instead, to one or more other persons after the death of the donee spouse. Therefore, unless the power is a fiduciary power limited by an ascertainable standard, the power prevents the gift of the remainder from being complete. *See* Treas. Reg. §25.2511-2(c).

If [, on the other hand,] a donor transfers property to himself as trustee ..., and retains no beneficial interest in the trust property and no power over it except fiduciary powers, the exercise or nonexercise of which is limited by a fixed or ascertainable standard, to change the beneficiaries of the transferred property, the donor has made a completed gift and the entire value of the transferred property is subject to the gift tax.

Treas. Reg. §25.2511-2(g). *Pyle v. United States*, 766 F.2d 1141 (7th Cir. 1985), applied Illinois law and held that a gift was complete because the retained interest of the donor was limited by an ascertainable standard.

If the retained power were to prevent the gift of the remainder from being complete, the gift of the remainder would become complete when, during life or at death, the donor ceased to have the power. This would occur, for example, upon the donor's vacation of the office of trustee, upon the donor's exercise of the power to distribute all of the principal to the donee spouse or upon the death of the donee

spouse. Treas. Reg. §25.2511-2(f). If the power terminates before the death of the donee, the termination should qualify the transfer of the remainder interest for the marital deduction. If the power terminates at the death of the donee before the death of the donor, the termination should include the remainder interest (which, due to the death of the donee, is the entire trust) in the taxable gifts or taxable estate of the donor.

The third conclusion is that if the arrangement is intended to qualify for the marital deduction by means of a general power of appointment given to the donee, the power of appointment will include the property in the tax base of the donee even if the creation of the trust fails to qualify for the marital deduction. The result of the three conclusions is that the arrangement cannot serve the tax purpose of hedging against the prior death of the less wealthy spouse.

Consistently with this analysis, the donor can retain the exclusive ability to manage and preserve the property (as opposed to alter or establish its enjoyment) or can select, remove and replace the person(s) to manage and preserve the property. The donor might implement these principles by naming himself or herself as a trustee and giving all powers solely to another trustee (*e.g.,* an independent trustee) and, perhaps additionally, not retaining any ability to eliminate any power and, except according to the principles of Revenue Ruling 95-58, 1995-2 C.B. 191, not retaining any ability to remove and replace any person who possesses any power. *Cf.* Rev. Rul. 79-353, 1979-2 C.B. 325, modified by Rev. Rul. 81-51, 1981-1 C.B. 458 and repealed by Rev. Rul. 95-58, 1995-2 C.B. 191. If the donor had the exclusive ability to add or replace, or to prevent the addition or replacement of, a power holder, the donor could prevent distribution of principal by refusing to appoint a power holder. Arguably, however, this ability of the donor to prevent distribution of principal would not constitute a retained ability to establish or alter beneficial enjoyment, *i.e.,* a power. The ability of a person to grant a power to another is not the same as the person's possession of the power himself or herself. *See United States v. Winchell*, 289 F.2d 212 (9th Cir. 1961). The donor can avoid this issue by providing that any holder of a power either always shall serve or shall commence to serve at the instance of the donee spouse. Alternatively, the donor might name himself or herself as investment advisor, give all powers solely to the trustee (other than the donor) and give control of investments solely to the investment advisor.

11.02 ABILITY OF DONOR TO CONTROL AFTER DEATH OF DONEE

If during life a person makes a gift that qualifies for the marital deduction, can the donor control the property, or benefit from it, after the death of the donee, without including the property in the gross estate of the donor for estate tax purposes? The technical questions are whether, for purposes of Code Section 2036, the donor retained the control or the enjoyment and whether any threshold lower than that of retention is operative for purposes of Code Section 2038. Code Section 2036 explicitly requires retention. Code Section 2038 literally requires only a transfer. Code Section 2038 includes a parenthetical, "(without regard to when or from what source the decedent acquired such power)," that explicitly negates a requirement of retention. However, at least in the case in which the transferred property is included in the tax base of a transferee, the construction in *Estate of Reed v. United States*, 75-1 USTC ¶13,073 (M.D. Fla. 1975), effectively eliminates the parenthetical and resurrects the requirement of retention. *Adolphson v. United States*, 3 CCH Est. & Gift Tax Rept. ¶60,048 (C.D. Ill. 1990), on the other hand, expressly disapproves *Reed* and interprets the parenthetical literally.

Usually, Code Sections 2036 and 2038 are applied, or tested for application, in a context in which the donor explicitly, or by means of an understanding, directly retained enjoyment or control. Any gift that qualifies for the marital deduction presents a distinctive issue for Code Sections 2036 and 2038. The gift is included in the gross estate of the donee after the donor gives the gift and before the donor has the interest in the gift, or the power over it, that might include the property in the gross estate of the donor.