Chapter 6.
Use of the Marital Deduction in Estate Planning

OVERVIEW

The marital deduction is a deduction from the adjusted gross estate for property passing to the surviving spouse. It is considered by many to be the most important estate tax saving device available to a decedent’s estate. Since 1948, individuals have been eligible for tax-saving opportunities related to property passing to a surviving spouse that were previously available only in community property States. The law has been liberalized several times since then. Finally, the 1981 Economic Recovery Tax Act (ERTA) made deductions for both lifetime and testamentary transfers to spouses "unlimited." Thus, the marital deduction now recognizes the role of both spouses' contributions to building the family's assets. Wills written before 1982 that contain a marital deduction clause based on pre-ERTA law should be reviewed and amended if the clause will produce an unsatisfactory result based on current law. Bequests to spouses who are not U.S. citizens do not qualify for the estate tax marital deduction unless they are in a qualified domestic trust. In order to be considered a qualified domestic trust, the trust instrument must provide that at least one of the trustees be a U.S. citizen or domestic corporation and that any distribution from the trust principal be subject to the U.S. trustee's right to withhold the estate tax due on the distribution.

QUALIFYING FOR THE MARITAL DEDUCTION

The decedent’s estate can claim a deduction--the marital deduction--for qualifying lifetime and testamentary (by will at death) transfers of property to a surviving spouse. The deduction for both lifetime and testamentary transfers is unlimited. However, the property must actually pass from the decedent to his (her) spouse. The marital deduction is not available to the estate of a widow, a widower, or an unmarried person.

Transfer of Property Interests

To be eligible for the marital deduction the decedent must have been a citizen or resident of the United States at his (her) death. The decedent must be survived by a spouse, and the property must be passed from the decedent to the surviving spouse. Not only must the value of the property interest be included in the decedent's gross estate, but it must also be of a type that will be included in the surviving spouse's gross estate to the extent that it is not consumed or given away during the surviving spouse's lifetime.

Generally, no marital deduction is allowed for property interests that are terminal interests. A terminal interest is an interest in property that will terminate or fail on the lapse of time or on the occurrence, or failure to occur, of some event or contingency. Examples include life estates and annuities. Another example is property given to a surviving spouse that would revert to the children if the surviving spouse remarries. The purpose of this rule is to require that, if property is transferred to the surviving spouse, it will be included in the surviving spouse's estate unless disposed of during the surviving spouse's lifetime. Thus, whenever trust between spouses is lacking and conditions are attached to gifts or bequests, the use of the marital deduction is on shaky ground. As explained later, there are, however, certain exceptions to the terminal interest rule.

Examples of eligible property transfers to the surviving spouse include: an outright bequest by will; a power of appointment; life insurance pro-ceeds; joint tenancy survivorship; transfers by annuity, insurance, or other contract; and transfers by State laws of intestate distribution. In summary, any property left with no strings attached is an absolute interest and qualifies for the marital deduction.

Property interests passing to a surviving spouse that are not included in the decedent's gross estate do not qualify for the marital deduction. Expenses, indebtedness, taxes, and losses chargeable against property passing to the surviving spouse will reduce the marital deduction.

EXCEPTIONS TO TERMINAL INTEREST RULE

Basically, each spouse must trust the other

40
implicitly for the marital deduction to work effectively. However, there are five exceptions to the terminal interest rule, which generally stipulate that the property interests in question will qualify for the marital deduction if certain requirements are met. They will, however, also be taxable in the surviving spouse’s estate if not consumed or given away before his (her) death.

**Qualified Terminal Interest Property**

Property under a qualified terminal interest property (QTIP) election is eligible for the Federal estate tax marital deduction. Under this election, the value of the property is included in the surviving spouse’s estate at his (her) death. A more detailed discussion follows.

**The General Power of Appointment**

This is the right to determine the ultimate disposition of certain designated property. The survivor must have a life interest that entitles him (her) to all the income (payable at least annually) and must have the power to appoint the property to himself (herself) or his (her) estate.

**Survivorship Condition**

A bequest to a spouse may be conditioned on his (her) survival for a period up to 6 months after the death of the decedent; or on his (her) survival of a common disaster, providing the spouse does, in fact, survive.

**Right to the Payment**

The surviving spouse must have a right to the payment of life insurance, endowment, or annuity proceeds, coupled with a power of appointment for the survivor or the survivor’s estate. Annuities payable from a trust and commercial annuities qualify.

**An Income Interest**

The survivor must have an income interest in a charitable remainder unitrust or annuity trust (see chapter 8) where he (she) is the only noncharitable beneficiary. These conditions apply automatically; however, the executor can elect for these provisions not to apply.
QUALIFIED TERMINAL INTEREST PROPERTY AND THE MARITAL DEDUCTION

A QTIP is a special form of life estate interest given to a surviving spouse that qualifies for the marital deduction. With a QTIP, the estate owner can control the disposition of the remainder interest after the surviving spouse's death. The remainder interest will, however, be included in the surviving spouse's estate. For example, timber property may be put into a QTIP, with the value qualifying for the marital deduction. The surviving spouse receives the income from the timber property for life, with the remainder interest passing to the children or other designated beneficiaries at his (her) death.

The amount of the marital deduction resulting from the QTIP election is the net value of the property involved, after reduction of indebtedness charged against it. The debt to be reduced from the property value includes any estate taxes charged against the property.

Qualification for the QTIP

The QTIP interest must be specifically elected by the executor of the estate on the estate tax return. Once made, it is irrevocable. To qualify, the following conditions must be met: (1) the surviving spouse must be entitled to all of the income from the property payable at least annually for his (her) life, (2) a QTIP interest in property not placed in trust must provide the survivor with rights to income that are sufficient to satisfy the rules applicable to marital deduction trusts, and (3) there must be no power of appointment in anyone to appoint any part of the property to any person other than the spouse during the spouse's life. The fact that a marital deduction formula (as discussed later in this chapter) is used to determine the amount of property passing to a QTIP does not jeopardize the QTIP election (Letter Ruling 8814002).

TO WHAT EXTENT SHOULD THE MARITAL DEDUCTION BE USED?

Because the unlimited marital deduction is such a powerful planning tool, it should be used carefully in order to meet both the forest landowner's objectives and legal constraints on the transfer of property. The survivor's estate, his (her) general state of health, and his (her) ability to manage the additional resources efficiently are also factors to be considered.

Legal Rights

Legal rights of the surviving spouse to take a share of the real property and, in some States, a share of the personal property in the estate must be taken into account in deciding how much and in what form property should pass if it is to qualify for the marital deduction. This, of course, is governed by State law. These decisions are affected by the presence of children from the current and perhaps former marriages of either spouse.

Nontax factors

Nontax factors that may affect the marital deduction's use include the couple's personal relationship, health and age (life expectancy), and degree of confidence in the spouse's business ability because there is always a tradeoff between control and tax savings. Spousal trust permits equalization of the estate's resources and freedom to use all the planning tools that are available to save taxes. A lack of trust, fear of a spouse's remarriage, and perhaps fear of divorce may force an owner to maintain maximum control, which complicates the planning process.

The surviving spouse's resources and the possibility of inheritances from other sources should also be taken into account in projecting tax outcomes. The needs of young children have to be included here as well. The current value of both spouses' estates and the effects on each other's estate tax return should be considered.

Marital Deduction Deferral

If the goal is simply to save the maximum estate tax at the death of the first to die, the marital deduction should be used to the fullest extent. A will that states, "I leave everything to my spouse," results in the deferral of all estate tax on the death of the first to die. This may create a huge tax problem for the estate of the second to die, especially if that person already has a substantial estate of his (her) own. The marital deduction defers the tax until the surviving spouse's death; therefore, the aggregate estate taxes of both spouses should be considered. If the survivor's health is good and normal life...
expectancy is long, the deferral gives time for the survivor to use the additional resources wisely through additional planning or consumption. A number of tax factors, as follows, should be considered.

Maximize Credit.--Maximization of the unified credit in each spouse's estate is the key to use of the marital deduction. The $192,800 credit permits each spouse to transfer $600,000 in net taxable estate value to persons other than the other spouse without estate tax. Thus, together, they can pass $1,200,000 in net taxable value to the children without estate tax cost.

Example 6.1. Assume a forest landowner husband owns 1,200 homogeneous acres of timberland with a net value of $1,200,000 after payment of estate debts and administrative costs. His wife is without assets. (The analysis works the same with husband and wife roles reversed.) If he wills her the entire estate with a marital deduction bequest, his estate will pay no tax. When the wife dies, with income earned used to pay funeral expenses and administrative costs, her estate will face a Federal estate tax of $235,000 on the value of the timberland. This equals a 20-percent reduction in estate value. It may have to be paid by selling part of the property or utilizing Section 6166 (see chapter 14) and paying the tax from timber sale income over time. In addition, there is considerable risk from concentrating the assets in one or the other spouse's estates because the spouse without assets might die first, and the unified credit would be wasted. This result would be similar to the situation where the survivor inherits all the assets.

Balancing the Marital Deduction.--The goal is to balance the expected values in each estate with adjustments for life expectancy, earning power, and ability to manage the assets.

Example 6.2. Assume the same facts as in example 6.1, but now the husband makes an outright bequest of $600,000 in timberland value (600 acres) to the children, which is protected from estate tax by the unified credit. He wills the balance to his wife with a marital deduction bequest, and his estate also pays no estate tax on that portion (600 acres). When the wife dies, her estate has a $600,000 exemption equivalent so that no estate tax is owed and the children have saved $235,000. The disadvantage here, however, is that the wife did not have control of half of the timberland estate that she had helped the family accumulate and that she may need to maintain the lifestyle to which she had grown accustomed.

Survivor's ability.--The survivor's ability and willingness to reduce the size of his (her) estate is a key factor. The spouses' goals with respect to the welfare of the children must be compatible.

Example 6.3. Assume the same facts as before, but now the $600,000 bequest to the children is put into a nonmarital trust from which the wife has the income for life. She has access to the same level of income as before. If desired, a clause can be included for invasion of trust principal subject to an ascertainable standard of living (see chapter 10 on "The Role of Trusts").

The spouse's ability and willingness to adjust the size of his (her) estate must be considered. In example 6.1, the wife's credit will be lost if she dies first, because she owns no assets. This situation can be remedied easily with a gift of $600,000, which balances the two estates, permits use of both credits, and saves $235,000 in taxes after each transfer. This remedy works if the credit is used by the first spouse to die by putting the assets in a nonmarital trust, or by giving it outright to the children. Spousal trust is essential—as discussed above—for this procedure to work.

To summarize the optimum marital deduction strategy: (1) it must be used in conjunction with the available unified credits, (2) it must be used with regard to the survivor's estate, and (3) consideration must be given to the survivor's ability, health, and willingness to reduce the remaining estate to minimize estate tax liability. Generally, the marital deduction is used to defer the tax at the first spouse's death so that additional planning can be done by the surviving spouse.

HOW TO MAKE
A MARITAL DEDUCTION BEQUEST

Basic Patterns

A bequest that qualifies for the marital deduction may be made as an outright gift, a direct transfer to the surviving spouse, or by trust for his (her) benefit (see chapter 10). In any case, the transfer will usually fall into one of the following patterns.

Property.--An outright bequest of specific property may be made in these terms: "I give my wife the
600 acres of timberland that I own in Laidback County, State (legal description)."

**Example 6.4.** Assuming the same facts as in example 6.1, but specifying that the bequest includes zone IV mature timber and zone III maturing timber (see chapter 2, for a discussion of timber zones), will provide liquidity for the surviving spouse’s immediate needs. Alternatively, if the surviving spouse’s needs for liquidity can be met from his (her) own resources, the bequest can be of zone I premerchantable timber and zone II young timber, both of which are rapidly appreciating assets.

Money.--This is known as a "pecuniary bequest," or a gift of money: "I give my husband $600,000." That statement alone does not necessarily make it so, however. The resources have to be in the estate to generate the cash.

**Example 6.5.** Assume the same acreage as in example 6.4, but now the land and timber stands in zones I through IV are assumed to be distributed as follows: bare land equals $300,000, which is equally distributed among the zones; zone I--premerchantable timber only, $90,000; zone II--young growth of 30 cords per acre, $210,000; zone III--young sawtimber, $600,000; and zone IV--mature sawtimber, $900,000; for a total of $1,800,000 in timber and $2,100,000 total value. This situation lets the total value increase reflect the potential value for the property. The acreage is equally divided into 250 acres per zone (which are handled as management units). The timber stands are as follows: the 8- to 10-year-old pine plantations in zone I are valued at $360 per acre; pine pulpwood in zone II is valued at $840 per acre ($28 per cord); the small sawtimber in zone III is valued at $2,400 per acre and is pre-dominately chip-n-saw saw-logs; and the mature sawtimber in zone IV is valued at $3,600 per acre because it is primarily high quality sawtimber. The bequest can include the acreage in zone IV, which will provide sufficient timber that can be sold relatively soon to generate the necessary cash.

Fractional share.--The owner can give a straight fractional share; that is, "I give one-half of my residual estate, outright, to my wife." The "net estate," technically known as the residual estate, is what remains after payment of debts, administrative expenses, specific bequests, and charges.

**Example 6.6.** Assume the same facts as in example 6.5. The timberland portion of the bequest would thus amount to $1,050,000, if the expenses, other bequests, and charges are paid from other liquid resources. This creates an immediate tax bill of $173,500, which could have been deferred.

**Formula Marital Deduction Bequests**

Other things being equal, the preferable approach would be to use a formula marital deduction bequest that sets aside the largest amount that can pass free of the Federal estate tax by way of the unified credit. This circumvents the problems generated when the bequest amounts have appreciated (depreciated in some cases, but rarely for timber) into an unanticipated tax situation. There are three basic formula clauses that are normally used.

Pecuniary.--The pecuniary marital deduction formula is easy to express and may offer greater opportunity for post mortem planning. The bequest can be made outright or in a marital deduction trust (see chapter 10). It directs that the amount to the marital share for the surviving spouse be the sum that minimizes the Federal estate tax payable. The bequest can be made outright or in trust. The residual share corresponding to the exemption equivalent and Federal credit for State death taxes can be disposed of outright or in a nonmarital trust (see chapter 10).

**Example 6.7.** Assume the same facts as in example 6.4. The pecuniary marital deduction share can include the timber from zones III and IV in order to provide liquidity. The residual share can include timber in zones I and II. This places growth and value appreciation in that portion of the first spouse’s estate that will not be taxed again at the second spouse’s death. Amounts in excess of $600,000 in the marital share can be consumed or gifted to reduce the second spouse’s estate value.

Unified Credit.--The pecuniary unified credit formula (see chapter 10) is similar to the pecuniary marital deduction formula. It directs that an amount equal to the exemption equivalent, plus Federal credit for State death taxes, if appropriate, be given outright or in trust. The residual estate in this case will constitute the marital deduction amount that can also be outright or in trust. The results are similar to example 6.7 with respect to appreciation and liquidity.

**Fractional Residuary Marital Deduction Formula.**--This directs to the survivor the smallest fraction that minimizes the Federal estate tax payable. Although
it is harder to calculate than the pecuniary formula--shares can only be determined after a final accounting by the executor--appreciation of estate assets is shared by the spouse and other beneficiaries, and this may be a desirable outcome in terms of family relationships even if it costs some additional tax.

**The Choice of Marital Deduction Formula**

The choice as to which marital deduction formula to use depends on the gain (or loss) potential of estate assets, the preferences as to whether spouse or children or both should benefit from the appreciation (or depreciation) in the estate's timber assets, estate taxes that may be due at the spouse's death, and family relationships. The choice should be made only after an analysis of the financial and tax considerations, with emphasis on the personal preferences of the individuals involved.

Timber Assets.--The treatment should be dictated by the landowner's goals as expressed in the timber management plan. These include continuity of management, keeping the forest property intact as a management unit, financial targets, and nonmonetary considerations of the family. Integrating the timber management plan into the overall estate plan can be facilitated if the timber plan has an estimate of current value by stand or management unit, a projection of net cash flows over the immediate planning horizon (operational plans are usually for 5 years, but sometimes up to 10 years), and a projection of the timber value at the end of the planning period.

Timber assets are dynamic in that they are appreciating assets that respond to weather and markets. Their current value depends on the distribution of timber stands as affected by volume of merchantable timber and product classes (see chapter 4). Timber assets usually appreciate but present particular challenges due to their unitary nature, the fact that only periodic income is usually available, and illiquidity. The appreciation, moreover, will vary with market fluctuations and the stage of the growth cycle that stands are in at a particular time.

Life Insurance.--Life insurance proceeds may qualify for the marital deduction in numerous ways, but a life insurance specialist should be consulted to insure both marital deduction qualification and the best financial choice for the heirs. It is imperative that the policies be carefully coordinated with the overall estate plan with respect to policy ownership, beneficiaries, and settlement options. Otherwise the financial advantages of insurance may be dissipated, and the needs of the beneficiaries left unmet or only partially served (see chapter 11).

Personal Effects.--Special attention should be given to their treatment, including value, when using the marital deduction formulas. Many family heirlooms are difficult to value and difficult to divide. The decedent and heirs often have particular attachments to certain effects that should not be ignored but should be handled separately.
Disclaimer.--In making a marital deduction bequest, it may be desirable to provide in the will that the surviving spouse can refuse to accept any part of the marital bequest. The opportunity for a disclaimer provides a second look at the outcomes (see chapter 7).

State Death Taxes.--The applicable State death taxes, if any, should be reviewed and included in drafting the marital deduction formulas and in other analyses. State death taxes often do not conform to the Federal estate tax model, and they can upset plans if not incorporated (see chapter 19).