

# Suggestions for Drafting Marital Deduction Trusts Under the New Tax Law<sup>©</sup>

The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (2001 Tax Act), provides for a phased-in reduction in the federal estate, gift tax, and generation skipping transfer tax (GST) rates, the phase-in of an increase in the estate, gift, and generation skipping transfer tax applicable exclusion amounts, and the repeal of the federal estate tax and generation skipping transfer tax for persons dying after December 31, 2009. The gift tax, which is a backstop to the income tax, is not repealed. However, on January 1, 2011, the Act's sunset provision automatically repeals all of these changes (including the repeal of the estate and GST taxes) and reinstates the pre-2001 Tax Act federal transfer tax regime. Absent intervening legislation that makes repeal permanent, the pre-2001 Tax Act federal transfer tax system will be in full operation, once again, beginning January 1, 2011.

As a result of the uncertainty of the permanency of estate tax repeal, the reinstatement of the pre-2001 Tax Act federal transfer

tax regimen 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 marital deduction trusts. As discussed below, the *Clayton* contingent QTIP trust election provides tremendous post mortem flexibility.

## All to Surviving Spouse in a QTIP Marital Deduction Trust with *Clayton* Contingent QTIP Election

An alternative to the traditional reduce to zero marital deduction formula is the use of a *Clayton* contingent QTIP election. 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).<sup>1</sup> The property elected for QTIP treatment remains in the QTIP marital deduction trust, while the non-elected portion of the QTIP trust property is generally distributed to the surviving spouse or the decedent's descendants, either outright or in further trust, such as a credit shelter trust or a descendants' trust.

Because a *Clayton* contingent QTIP election is a form of partial QTIP election, they should not be used together for the same marital deduction trust. They are mutually exclusive. Therefore, when using a *Clayton* QTIP do not make a partial QTIP election.

Whenever a *Clayton* contingent QTIP marital deduction trust is utilized, provision needs to be made concerning the apportionment of estate taxes attributable to the prop-

erty that is not elected for the marital deduction. Since the QTIP marital deduction trust constitutes the residue of the grantor's estate, care must be taken to ensure that estate taxes attributable to the non-elected 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. Such a provision could impair the marital deduction (to the extent of the estate taxes apportioned against it). It may be appropriate to specifically apportion to the property not elected for the QTIP marital deduction any federal estate taxes attributable to that property.

The *Clayton* contingent QTIP election provides tremendous postmortem flexibility. This is because the executor has at least 15 months (nine-month due date for filing the decedent's 706 plus a six-month extension) after the death of the decedent to assess the current situation and determine the appropriate response.<sup>2</sup> No other form of marital deduction provides this amount of flexibility. 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 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.

A *Clayton* contingent QTIP election not only permits the executor of the decedent's estate to determine the optimum amount of the marital deduction for equalization purposes if the surviving spouse dies within 15 months of the decedent, but it also permits

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the executor to give consideration to the possible use of the previously taxed property (PTP) credit under IRC section 2013 as concerns a surviving spouse who has died within the 15 months or has a short life expectancy. A considerable overall estate tax savings can result if a *Clayton* contingent QTIP election is made by the decedent's executor and the estate pays some estate tax. A portion of the estate tax paid will be allowed as a credit against the estate tax otherwise payable on the death of the surviving spouse. A credit is allowable under IRC section 2013 for the portion of the tax attributable to the actuarially determined value of the income interest in the portion of the trust that is not elected for QTIP treatment (or for that matter, any other non-marital trust) in which the surviving spouse has an income interest capable of valuation, under IRC section 7520 and Reg. section 20.7520-3(b)(3), (which prohibits use of the tables when death is clearly imminent) even though none of the trust corpus is includable in the surviving spouse's gross estate. Examples of a surviving spouse's trust interest that might provide a PTP credit are the non-elected QTIP portion and a credit shelter trust that provide mandatory income to the surviving spouse for life or a term of years.

The *Clayton* contingent QTIP election allows for a testamentary limited power of appointment to be exercisable by the surviving spouse. Because the executor has tremendous flexibility in the amount of the QTIP election, it may be necessary, in certain situations, for an independent executor to be exclusively vested with the authority to make the election.

The 2001 Tax Act provides challenges to the estate planning professional. The various scenarios that could come into play over the next few years makes drafting a complex and arduous undertaking; and even then, the law may change in light of the current war against terrorism and the deficit spending that the federal government is currently undertaking. In this time of uncertainty, drafting flexible estate planning documents may prove to be cost effective for the client and advantageous to the estate planning attorney. Unknown events between now and January 1, 2010, may result in further changes to the federal transfer tax system. The potential for under-

funding the marital deduction trust through a traditional reduce to zero marital deduction formula becomes greater as the applicable exclusion amount increases through 2009. The *Clayton* contingent QTIP election provides a wait-and-see approach that has tremendous post mortem flexibility. ♦

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## FOOTNOTES

1. In 1997 the IRS, in response to *Estate of Arthur M. Clayton, Jr. v Commissioner*, 976 F2d 1486 (CA 5, 1992) and its progeny, issued regulations effective with respect to QTIP elections made after February 18, 1997, which allow the surviving spouse's income interest in a trust to qualify for treatment as QTIP although it is contingent on a QTIP election being made by the decedent's executor. That portion of property for which the QTIP election is not made can pass to the surviving spouse and/or other beneficiaries (e.g., a credit shelter trust). Reg. section 20.2056(b)-7(d)(3). See also, Reg. section 20.2056(b)-7(h) Ex. 6, which illustrates the operation of the contingent income interest election.
2. Reg. section 20.2056(b)-7(b)(4) 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 [9 months], including extensions [6 months] or, if a timely return is not filed, the first estate tax return filed by the executor after the due date."