

330

Fundamentals of Estate Planning



Assignment 6: The Gross Estate: Inclusions and Deductions

List the requirements for property to qualify for the marital deduction.

Five technical requirements must be met before property qualifies (this means before property is eligible) for the marital deduction (Memory Aid: PRINT).

1. Property must pass or have passed to the surviving spouse: must have been either a gift or a sale or exchange to have a valid transfer; property in survivor's possession enters survivor's estate at death.
2. Receipt of property by a US citizen surviving spouse: surviving spouse must be a US citizen at the time of decedent's death or must become a US citizen by the time the decedent's estate tax return is filed.
3. Included in decedent's gross estate: to be eligible for the marital deduction, the property must meet all requirements for being included in the gross estate for federal estate purposes.
4. Nondivorced status: the spouses must be married, not divorced.
5. Terminable interest rule: marital deduction applies only if the interest passing to the surviving spouse will be taxed to the surviving spouse's estate if kept until the surviving spouse's death.

Explain the purpose of the unlimited marital deduction and describe the qualifying interest's net value that passes to a surviving spouse.

Preferential tax treatment of community-property states.

1. In the nine community-property states, (remember: TWIN CLAN W), only one-half of community property is included in the estate of the spouse who dies first.
2. Residents of common-law states were envious of this preferential tax treatment and some states tried to convert to what was essentially a community-property system.
3. In response, Congress gave a federal estate tax marital deduction to married residents of common-law states.

Tax equality was achieved by allowing an unlimited deduction for assets passing from one spouse to another, either during lifetime or at death. The unlimited marital deduction applies in both community-property and common-law states.

1. The marital deduction is not a device to avoid taxation but merely defers taxation until the death of the second spouse.

General rule: the estate tax marital deduction is given on the full net value of a qualifying interest passing to a decedent's surviving spouse which is reduced if taxes are payable out of the marital share of the estate.

Net value: gross estate tax value of property interest at date of death (or at alternate valuation date) less any charges against the property interest.

List the disadvantages and advantages of various types of marital bequests and list the factors that affect to what extent the marital deduction should be applied.

Outright bequest: direct transfer of property to surviving spouse through life insurance death proceeds or will.

1. Five advantages:

- Spouse may use or manage assets as desired.
- Trustee's fees and court accountings are eliminated.
- Assets received by spouse are available to spouse's executor to satisfy liquidity needs.
- Nonincome-producing assets may be transferred to and kept by surviving spouse.
- Discourages spouse from electing against the will.

2. Five disadvantages:

- Spendthrift spouse may consume assets.
- Creditors can attach the bequest.
- Assets remaining at surviving spouse's death will be included in surviving spouse's probate estate.
- Management may not have investment knowledge.
- Surviving spouse can exclude children and favor a second spouse in disposing of bequest.

Power-of-appointment trust.

1. Surviving spouse can normally appoint the person who will receive the remainder of the trust at the surviving spouse's death; seven other advantages:

- Discourages electing against will.
- Right to dispose of property during surviving spouse's lifetime is limited.
- Income and principal distributions can be made to suit needs of surviving spouse.
- Protection against spendthrift spouse.
- Creditors cannot reach assets.

- Asset management and financial advice provided.
 - Probate of trust principal is avoided at death of second spouse.
2. Three disadvantages:
- Trustee's fees and accounting costs.
 - Assets not automatically available to surviving spouse's executor at surviving spouse's death (for payment of taxes and costs).
 - Nonincome-producing property cannot be added to or kept in trust.

Estate trust.

1. Six advantages:
- Protection against spendthrift spouse.
 - Income and principal can be given to surviving spouse at trustee's discretion (although spouse does not have a right to demand the income or principal).
 - Nonincome-producing property can be bought and kept by trustee.
 - Protection against surviving spouse's creditors (during surviving spouse's lifetime).
 - Assets available to surviving spouse's executor at death.
 - Lifetime assignments of trust property may not be made by surviving spouse.
2. Three disadvantages from surviving spouse's viewpoint:
- Restriction on disposal of trust property by surviving spouse during lifetime.
 - Accounting costs and trustee's fees.
 - No freedom of surviving spouse to use or manage trust assets.

QTIP trust.

1. Five advantages:
- Protection against creditors.
 - Avoidance of probate of trust principal at death of surviving spouse.
 - No power for surviving spouse to dispose of the property.
 - Grantor is assured that trust assets will go to those grantor selects.
 - Spendthrift spouse cannot consume assets.
2. Three disadvantages:
- False sense of security that estate owner's objectives will be realized.

- Asset use restricted for surviving spouse.
- Nonincome-producing property can be used to fund the trust only if the surviving spouse is granted power to demand that the assets be income producing.

Nine factors to be considered in deciding to what extent the marital deduction should be used (Memory Aid: READ TESTS).

1. Remarriage of surviving spouse: less than maximum use of marital transfer if, for example, husband does not want wife's next spouse to use the property the first husband has accumulated.
2. Estate's liquidity needs: maximum use of marital deduction if decedent's estate is nonliquid.
3. Access to assets by the surviving spouse: the younger the surviving spouse, the greater the financial needs.
4. Donor lacks confidence in spouse's judgment: less than maximum use of marital transfer.
5. Tax bracket of the surviving spouse: added income from marital assets is not advisable if surviving spouse is already in a high tax bracket.
6. Estate tax savings.
 - At first death: maximum use of marital deduction.
 - Both estates: remaining marital deduction assets may cause more estate tax problems at the death of the second spouse.
7. State death tax laws: property in a marital trust may bypass state death taxation at second death, depending on state law.
8. Time value of money: maximum use of marital deduction allows money saved on taxes to be invested or to produce enough funds to offset any added tax at death of second spouse.
9. Size of surviving spouse's estate: assets should be transferred to surviving spouse until the size of the survivor's estate equals the exemption equivalent of the federal credit.

Explain how either an underqualification or an overqualification may affect the amount of federal estate taxes due and describe how the tax can be reduced by using formulas.

Overqualification: full advantage of an estate owner's applicable credit amount is not taken; more property than necessary to eliminate the estate tax goes to the surviving spouse and is subject to taxation at the surviving spouse's death.

1. Possible solution: use a properly funded CEBT where assets equal the applicable exclusion amount.

Underqualification: not as much property passed to surviving spouse tax free as was allowed.

Formula bequest: a formula stated in a will determining the share of the estate that makes most efficient use of the estate owner's applicable credit amount; two types:

1. Pecuniary (dollar) amount bequest.
2. Fractional-share bequest.