THE UNLIMITED MARITAL DEDUCTION

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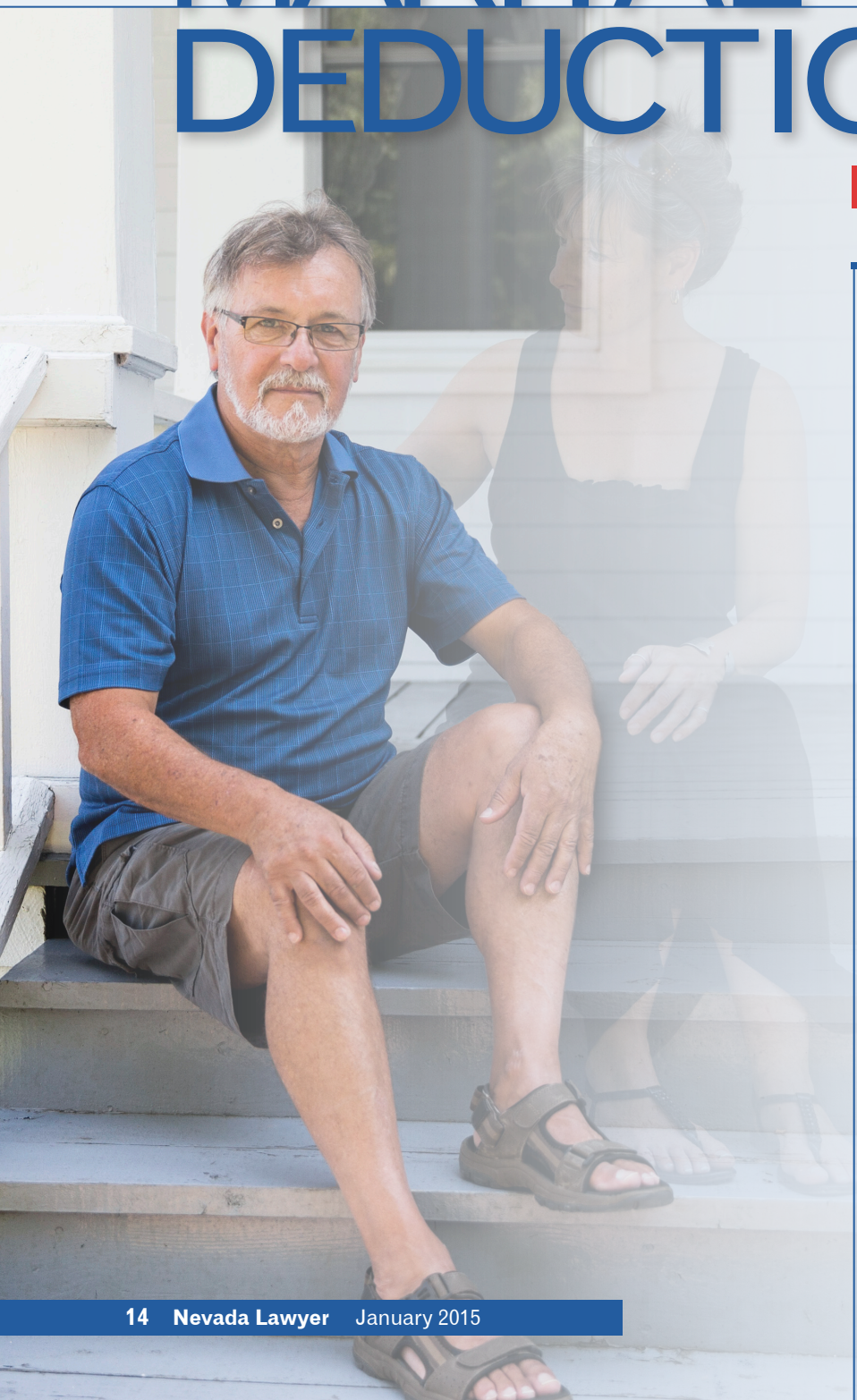

Internal Revenue Code (IRC) § 2001(a) imposes an estate tax on a decedent's taxable estate. The taxable estate is determined by the value of the gross estate, less any allowable deductions. IRC § 2056 allows a deduction from the gross estate for any property that passes from the decedent to his or her surviving spouse. The value of the gift is immaterial, as long as the surviving spouse is a U.S. citizen.

The purpose of the marital deduction is to defer the payment of estate tax until the death of the surviving spouse. It is not an exemption from estate tax. The rules for qualifying a transfer to a surviving spouse for the marital deduction are designed to ensure that any such transferred property is owned by the surviving spouse for purposes of the estate and gift tax. In 2013, the U. S. Supreme Court held that the marital deduction is also available to legally married same-sex couples. (*United States v. Windsor* 570 U.S. 12 (2013)).

Requirements for a Marital Deduction Gift

IRC § 2056(a) imposes four independent requirements in order for a gift to a spouse to qualify for the marital deduction. Each requirement must be met for the gift to be eligible.

1. The surviving spouse must be a U.S. citizen;
2. The interest must pass to the surviving spouse;
3. The interest must be included in the decedent spouse's gross estate; and
4. The interest must not be a terminable interest.

If the surviving spouse is not a U.S. citizen, the amount that can pass free of estate tax to the surviving spouse is limited to the annual gift exclusion for non-U. S.-citizen spouses: $145,000 (indexed for inflation), in 2014. However, pursuant to IRC § 2056(d), an unlimited amount may pass to a Qualified Domestic Trust (QDOT) for the benefit of the surviving non-citizen spouse. The rules for creating, operating and maintaining the QDOT during the life of the surviving spouse are complex and beyond the scope of this article.

The interest must be part of the decedent's gross estate and must actually pass from the decedent to the surviving spouse. This seems pretty straightforward but may not be. For example, if the decedent exercised a power of appointment over property in a trust established by his parents in favor of his surviving spouse, such a transfer would not be a transfer from the decedent and would not qualify for the marital deduction.

No marital deduction is allowed for transfers of property that are terminable interests. Thus, gifts of life estates, terms of years, annuities, patents, copyrights and any other contingent interests do not qualify for the marital deduction, unless they meet other requirements detailed below. The gift must also be includable in the spouse's estate.

Types of Marital Gifts Which Qualify for the Unlimited Martial Deduction

Outright Gift to Surviving Spouse

An outright gift to a surviving spouse is an unconditional transfer directly to the surviving spouse. The surviving spouse has full control over the transferred property and may do with it as he or she wishes, and the assets are includable in the surviving spouse's estate, to the extent they are not consumed.

Gift to Surviving Spouse's Trust

In a typical revocable living trust scenario, two or more trusts are created at the death of the first spouse. One or more trusts hold the deceased spouse's property and the other trust holds the surviving spouse's property. The usual survivor's trust gives the surviving spouse the right to amend or revoke the terms of the trust and to make withdrawals at will. A gift to the survivor's trust has an advantage over an outright gift, since the survivor's trust will likely avoid probate and likely has plans for incompetency of the surviving spouse. However, any restrictions in the survivor's trust, with respect to the gift from deceased spouse, may disqualify the survivor's trust for the marital deduction. Remarriage restrictions, life estates and gifts to third parties are examples of restrictions that could disqualify the trust for the marital deduction.

Gifts in Trust for the Surviving Spouse

Often, married couples want to leave property to their spouses in an irrevocable trust, a trust whose terms may not be modified by the surviving spouse. Each reasons that they would like the other to have access to the income and principal of all of the assets of the marriage until the other's death, but each partner wants to ensure that his or her own share of the marital property is disposed of in a particular way when the surviving spouse dies. Since a gift to an irrevocable trust for the life of the surviving spouse, with the property then passing by the terms of the trust to third party (children, grandchildren, charities, etc.), is, by definition, a terminable interest, such a transfer does not qualify for the marital deduction. It is possible, however, to qualify an irrevocable trust for the marital deduction by careful adherence to the qualified terminable interest rules under IRC § 2056(b)(7).

Gifts to a Qualified Terminable Interest Trust (QTIP)

In 1981, IRC § 2056(b)(7) was enacted to allow for transfers to irrevocable trusts by deceased spouses to their surviving spouse, that are, in fact, terminable interest gifts, as long as the trust meets certain criteria. If the trust meets the requirements, and the deceased spouse's executor makes a timely election, the gift will qualify for the marital deduction. The advent of the QTIP trust allows for the deceased spouse to benefit the surviving spouse by providing income and access to principal to the survivor, but not allowing the survivor to modify the terms of the trust to alter the disposition of the assets of the trust at the death of the survivor. As a result of this control feature, the QTIP trust is widely used in estate planning.

QTIP Trust Requirements

The QTIP trust qualifies for the marital deduction under IRC § 2056(b)(7), as long as the survivor has a "qualifying income interest for life" and no person, including the surviving spouse, has the power to appoint any QTIP property to any person, other than the surviving spouse. (IRC § 2056(b)(7)(B)). A qualifying income interest for life means that the survivor must be entitled to all of the income from the property, payable annually or at more frequent intervals.

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Operation of the QTIP Trust During Survivor's Lifetime

The income interest must provide "…substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust." (Treas. Reg. § 20.2056(b)-5(f)(1)). This requirement is not satisfied if the "…primary purpose of the trust is to safeguard property without providing the spouse with the required beneficial enjoyment." (Treas. Reg. § 20.2056(b)-5(f)(5)). A QTIP trust that allows the trustee to hold non-productive property is problematic in this regard, unless the survivor is granted the power to direct the trustee to make the property productive or to convert the property into productive property. (Treas. Reg. § 20.2056(b)-5(f)(4)). The income interest must be for the entire life of the survivor; it cannot be terminated for any reason, including remarriage. (Treas. Reg. § 20.2056(b)-7(d)(3)). There is no requirement that the survivor have the right to withdraw principal of the trust.

No property of the trust may be distributed to any person, other than the surviving spouse. (IRC 2056(b)(7)(B)(ii)(II)). Income distributed to a third party violates the requirement that all income be distributed to the surviving spouse, and a distribution of principal to a third party deprives the survivor of income that might have been earned by that principal. An underlying purpose of this scheme is to prohibit distributions from the trust which might then escape estate taxation at the death of the survivor. The QTIP trust may grant the surviving spouse a testamentary limited power of appointment to allow for some planning flexibility.

Operation of the QTIP at the Death of Survivor

The principal and any undistributed income of the QTIP are included in the survivor's estate and are subject to estate tax based upon their then-fair market value. The assets of the QTIP, however, are not aggregated with the rest of the survivor's estate. This can be advantageous in the event the QTIP and survivor's trust own fractional interests in the same property, which might be subject to valuation discounts.

The estate tax attributable to the QTIP property is subject to recovery from the remaindermen of the QTIP trust. (IRC § 2207A(a)(1)). However, the surviving spouse may waive the recovery in his or her will.

The use of the marital deduction at the death of the first spouse to die will defer any estate taxes due until the death of the second spouse. Adherence to the QTIP rules will allow the surviving spouse to benefit from the deceased spouse's assets, while still allowing the deceased spouse to control the ultimate disposition of his or her assets. **NL**

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