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How to Fund and Administer Post-Death Subtrusts in a Declining Economy

David E. Libman, Esq.*

INTRODUCTION

Married couples often set up Joint Revocable Living Trusts as a means to avoid probate and reduce estate administration costs.¹ Joint Revocable Living Trusts avoid probate by transferring title to the property during life, but they do not avoid income or estate taxes to the grantor. Income from the Joint Revocable Living Trust (a grantor trust) is taxable to the grantor during life.² In a community property state, community property used to fund a Joint Revocable Living Trust retains its community property character.³ As such, upon the first spouse's death, his gross estate includes his community share of the Joint Revocable Living Trust property, which means that his community share of the property could be subject to estate taxes.⁴ As a means of reducing those estate taxes down to zero at the first

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¹ Est. Plan. Analysis (RIA) ¶ 33,104 (2008) (discussing the estate planning advantages of a revocable lifetime living trust). In California, trusts are revocable unless the trust instrument says it is irrevocable. CAL. PROB. CODE § 15400 (Deering 2004).

² I.R.C. § 676(a) (2008); 26 C.F.R. § 1.676(a)-1 (2004).

³ See, e.g., CAL. FAM. CODE § 761(a) (Deering 2006) (regarding revocable trusts, “community property that is transferred in trust remains community property during the marriage”).

⁴ In particular, under I.R.C. section 2038(a), the value of the decedent's gross estate includes “the value of all property . . . where the enjoyment thereof was subject at the date of his death” to the decedent's power “to alter, amend, revoke, or terminate” that property interest. I.R.C. § 2038(a) (2008). Similarly, Section 2036 includes in decedent's gross estate property in which he retained a possession, enjoyment, or income interest; or for which he retained the right to designate persons who shall possess, enjoy, or receive income from the property. I.R.C. § 2036(a) (2008). Even if decedent relinquishes his Section 2036 or 2038 interests in trust property prior to death, if such relinquishment occurs within three years of the decedent's death, Section 2035 might still draw that property back into the decedent's estate if it would have been included in the decedent's gross estate under Sections 2036, 2037, 2038, or 2042. I.R.C. § 2035(a) (2008). All references to “Sections” in this article shall be to the Internal Revenue Code unless otherwise noted. In the case of pronouns that could be referring to males or females, the masculine form will be used throughout.

death, however, the Joint Revocable Living Trust often establishes an A, B, C Subtrust Plan.

Upon the death of the first spouse, an A, B, C Subtrust Plan distributes property within the Joint Revocable Living Trust to an A Trust (the Survivor's Trust), a B Trust (the Credit Shelter Trust), and a C Trust (the Marital Deduction Trust).⁵ Trust A, the Survivor's Trust, receives the surviving spouse's share of community assets. Trust B, the Credit Shelter Trust (also sometimes called a "Bypass Trust"), typically receives assets wrapped in the protection of the remaining applicable exclusion amount available to the first-to-die decedent spouse—the amount of assets that can be in the decedent's gross estate without being subject to estate tax.⁶

Through the conclusion of 2008, the applicable exclusion amount is \$2 million, which is reduced by up to \$1 million to the extent that decedent gifted property out of his gross estate during life.⁷ Trust C, the Marital Deduction Trust, receives the decedent's property that did not fund the Credit Shelter Trust, and avoids estate taxes via Section 2056's marital deduction.⁸ Thus, the basic structure looks like this:

Joint Revocable Living Trust		
↓	↓	
Surviving spouse's community share	Decedent's community share	
↓	↓	↓
Trust A (Survivor's Trust)	Trust B (Credit Shelter Trust)	Trust C (Marital Deduction Trust)

The Joint Revocable Living Trust often distributes assets to its subtrusts (in particular, Trusts B and C) via various forms of pecuniary (fixed-dollar amount) or fractional share formula clauses, which can have greatly varying funding and tax consequences.⁹ These formula clauses, and the planning that occurs in conjunction with administering them, often *assumes assets will appreciate*.

⁵ See Monica Dell'Osso & Frayda L. Bruton, [3 Est. Plan.] Cal. Transactions Forms § 15:82 (1999); BORIS I. BITTKER, ELIAS CLARK, & GRAYSON M.P. MCCOUCH, FEDERAL ESTATE AND GIFT TAXATION 551 (9th ed. 2005) (discussing how a particular formula clause could reduce estate taxes to zero).

⁶ See I.R.C. § 2010(a), (c) (2008).

⁷ *Id.* The applicable exclusion amount rises to \$3.5 million in 2009 and is eliminated in 2010 due to the repeal of the estate tax. *Id.*; see also Sebastian V. Grassi, Jr., *Choosing the Appropriate Marital Deduction Funding Formula*, 33 EST. PLAN. 27, 27 (2006).

⁸ I.R.C. § 2056 (2008).

⁹ See generally Grassi, Jr., *supra* note 7.

For example, assume you have a pecuniary bequest that requires distribution to the Credit Shelter Trust of assets in kind valued as of their date of distribution. Also assume you expect those assets to appreciate significantly in value after the decedent's death. It makes sense to fund that bequest with assets in kind as soon as possible in order to (1) avoid significant capital gains realization between date of death and date of distribution values, and (2) to capture later asset appreciation free from estate taxation under the shield of the Credit Shelter Trust.¹⁰ Appreciation, however, cannot always be assumed. As of the writing of this article, numerous experts are either predicting a United States recession or acknowledging that a recession is already occurring.¹¹

This article focuses on suggestions regarding the funding and administration of post-death subtrusts in a declining economy. What follows throughout the remainder of this article is a discussion of (1) the basic mechanics of the A, B, C Subtrust Plan; (2) an explanation of various subtrust funding clauses and their effects, including when and how those clauses result in the Joint Revocable Living Trust's realization and recognition of gain or loss; and (3) a set of suggestions for the funding and administration of subtrusts that focuses on what might work best when assets are depreciating. Specifically, the latter set of suggestions includes an assessment of the following possibilities:

1. When a pecuniary bequest of assets in kind distributed at date of distribution values could fund the Credit Shelter Trust with depreciating assets, postpone funding.
2. When a pecuniary bequest of assets in kind could fund the Marital Deduction Trust with depreciating assets, consider funding promptly.
3. In a declining economy, consider using fractional share formula for subtrust funding.
4. A Section 643(e) election may provide a means to recognize loss on certain types of distributions to subtrusts that would not have normally allowed for loss recognition.
5. When depreciating assets could result in underfunding of the Credit Shelter Trust, disclaimers or Partial QTIP Elections may cure what went wrong in funding.
6. Try to avoid a Section 754 election when receiving partnership property that has decreased in value below its inside basis.
7. Pre-death transfers of assets may be a way to avoid a step-down in

¹⁰ See Jerry A. Kasner, Benton C. Strauss & Michael S. Strauss, 2 Post Mortem Tax Plan. (RIA) ¶ 13.04[8]-[10] (3d ed. 2008), available at 1999 WL 1020364.

¹¹ Justin Fox/Davos, *Can the World Stop the Slide?*, TIME, Feb. 4, 2008, at 26; Daniel Gross, *The Unspeakable R Word*, NEWSWEEK, Mar. 10, 2008, at 24; James C. Cooper, *It Sure Looks Like A Recession*, BUSINESS WEEK, Mar. 17, 2008, at 11.

basis of certain assets and, thus, preserve the loss in those assets.

8. In limited circumstances, the Section 2032 alternate valuation date election may be a way to save on estate taxes.

I. THE BASICS: SOME MECHANICS OF THE A, B, C SUBTRUST PLAN

With an A, B, C Subtrust Plan, proper planning of subtrust funding can help reduce (1) estate taxes, (2) generation skipping transfer (“GST”) taxes, and (3) ordinary and capital gains income taxes, not only for the distributing trust/estate, but also, potentially, for its beneficiaries. In making planning considerations, it is helpful to keep in mind the basic differences in tax rates. As of 2008, the current high rate for long-term capital gains is 15% (but not for collectibles, which is 28%).¹² The current high income tax rate for individuals and estates is 35%.¹³ The current top estate tax rate is 45%.¹⁴ GST transfers such as a “taxable distribution, taxable termination, or direct skip” are taxed at the maximum estate tax rate of 45%.¹⁵

Thus, all other things being equal, total tax avoidance is preferred. If that is not possible, it is better to pay capital gains rates than ordinary income rates. And it is better to pay income tax rates than it is to pay GST or estate tax rates. On the first death, estate tax can be avoided on the Survivor’s Trust and via the Credit Shelter and Marital Deduction Trusts. Furthermore, an exemption from GST tax can be attributed to a subtrust. Therefore, a discussion of some of the mechanics of how those subtrusts can be manipulated is in order.

A. General Power Appointment Versus QTIP Marital Deduction Trusts

Section 2056(a) allows a marital deduction from the value of the decedent’s gross estate of an “amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse.”¹⁶ Section 2056(b)(1) disallows a decedent from taking the marital deduction if he passes a “terminable interest” to his surviving spouse.¹⁷ A “terminable interest” is an interest that will terminate or fail “on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur.”¹⁸ Terminable interests can include life estates, terms of years, or defeasible fees passed from the decedent to the surviving spouse.¹⁹

¹² I.R.C. § 1(h) (2008).

¹³ See *id.* § 1(a)–(e); Rev. Proc. 2007-66, 2007-2 C.B. 970, *modified and superseded, but not with respect to the applicable 35% income rate*, by Rev. Proc. 2008-54, 2008-38 I.R.B. 722.

¹⁴ I.R.C. § 2001(c) (2008).

¹⁵ *Id.* §§ 2001(c), 2641(b).

¹⁶ *Id.* § 2056(a).

¹⁷ *Id.* § 2056(b)(1).

¹⁸ *Id.* § 2056(b).

¹⁹ 26 C.F.R. § 20.2056(b)-1(b) (2004).

Certain Marital Deduction Trusts provide an exception from the disqualifying “terminable interest rule,” namely, the Marital Deduction Trusts envisioned by Subsections 2056(b)(5) (the “General Power of Appointment Trust”) and 2056(b)(7) (the “QTIP Trust”). With a Section 2056(b)(5) General Power of Appointment Trust, the decedent gets the marital deduction for a transfer in trust in which the surviving spouse (1) is entitled for life to receive “all the income from the entire interest” or a “specific portion thereof,” (2) has a general power of appointment over that trust property to appoint the same to herself or her estate, and (3) in which no third party has the power to appoint that trust interest to “any person other than the surviving spouse.”²⁰

The General Power of Appointment Trust can cause the first-to-die spouse some pre-death concern that his or her surviving spouse might ultimately gift or will trust property to someone the first-to-die would not like. For this reason, many estate planners and their clients prefer the Section 2056(b)(7) QTIP Trust. A Section 2056(b)(7) QTIP Trust allows an exception to the terminable interest rule if “qualified terminable interest property” (hereafter “QTIP”) passes from the decedent to the surviving spouse.²¹ To benefit from this QTIP exception, the decedent’s executor must make a proper irrevocable election on the decedent’s estate tax return to transfer QTIP property with a “qualifying income interest for life” to the surviving spouse.²² A “qualifying income interest for life” means (1) the surviving spouse must be entitled to all income from the property no less than annually; and (2) that no person, not even the surviving spouse, has power to appoint “any part of the property to any person other than the surviving spouse” while the surviving spouse is alive.²³

Unlike the Section 2056(b)(5) General Power Of Appointment Trust, the Section 2056(b)(7) QTIP Trust does not provide the surviving spouse with a general power of appointment, thus avoiding the concern inherent in a General Power of Appointment Trust that the surviving spouse would give trust property to someone the first-to-die might not have chosen.²⁴ Even though the QTIP Trust essentially allows the first-to-die to dictate where the property therein will go after the surviving spouse’s death, the value of the QTIP property interest that passed to surviving spouse will ultimately be included in the surviving spouse’s gross estate.²⁵

²⁰ I.R.C. § 2056(b) (2008); *see also* 26 C.F.R. § 20.2056(b)-5(j) (2004).

²¹ I.R.C. § 2056(b)(7) (2008).

²² *Id.* § 2056(b)(7)(B)(i)-(v).

²³ *Id.* § 2056(b)(7)(B)(ii); 26 C.F.R. § 20.2056(b)-7(d), (e)(2) (2004).

²⁴ I.R.C. § 2056(b)(7)(B)(ii)(II) (2008); *see also* 26 C.F.R. § 20.2056(b)-5(g) (2004) (regarding the general power of appointment in a Section 2056(b)(5) trust).

²⁵ I.R.C. § 2044(b)(1)(A) (2008).

1. Partial QTIP Elections

Keep in mind that the decedent's executor makes the QTIP election on the decedent's estate tax return: Regulation 20.2056(b)-7(d)(3)(i) permits that election to be partial.²⁶ When a Partial QTIP Election is made, the QTIP trust will not fail simply "because the portion of the property for which the election is not made passes to or for the benefit of persons other than the surviving spouse."²⁷ Hence, the Partial QTIP Election can provide a means of fully funding the Credit Shelter Trust, which will be discussed in greater detail *infra*.

2. Generation Skipping Tax Issues and Why it Might be Better to Use a 2056(b)(7) QTIP Trust to Utilize a Reverse QTIP Election

The QTIP Trust also uniquely offers generation skipping tax ("GST") benefits—in particular, the option of a Reverse QTIP Election, which is not possible with a Section 2056(b)(5) General Power of Appointment Trust. GST transfers (such as taxable distributions, taxable terminations, or direct skips) are taxed at the maximum federal estate tax rate, which is 45% through 2009.²⁸ Each person gets a GST exemption amount equal to the applicable exclusion amount—currently, \$2 million in 2008.²⁹

Many times, the Credit Shelter Trust has beneficiaries and provisions that would lead to GST transfers. As such, it is often desirable to allocate GST exemption status to that Credit Shelter Trust. But allocation of GST exemption status to a trust must be made to the entire trust (not just portions of the trust or specific assets).³⁰

Assume that a decedent has used up \$1,000,000 of his applicable exclusion amount during life, leaving only \$1,000,000 of applicable exclusion amount available to fund the Credit Shelter Trust at death. Assume also that, for whatever reason, the decedent has his full \$2,000,000 of GST exemption available at death. By allocating \$1,000,000 of GST exemption to the Credit Shelter Trust, the decedent would waste the remaining \$1,000,000 of his available GST exemption *but for* the ability to make a Reverse QTIP Election.

A Reverse QTIP Election allows the decedent to be treated as transferor of the QTIP trust for GST purposes, even though the QTIP trust will be

²⁶ 26 C.F.R. § 20.2056(b)-7(d)(3)(i) (2004).

²⁷ *Id.*

²⁸ I.R.C. §§ 2641(b), 2001(c) (2008). Typically, for GST purposes, property is "valued as of the time of the generation-skipping transfer." *Id.* § 2624(a). Nonetheless, direct skip property that is included in the transferor's gross estate automatically receives its estate tax value, which will be the alternate valuation date value, if the estate elects the same. *Id.* § 2624(b); 34B AM. JUR. 2D *Fed. Tax'n.* ¶ 146, 174 (2008). Similarly, all property that transfers in taxable terminations due to the decedent's death may be alternatively valued as of the Section 2032 alternate valuation date. I.R.C. § 2624(c) (2008).

²⁹ I.R.C. §§ 2631(c), 2010(c) (2008).

³⁰ 26 C.F.R. § 26.2632-1(a) (2004).

included in the surviving spouse's estate for estate tax purposes.³¹ The Reverse QTIP Election is irrevocable and must be made on the tax return on which the election is made, such as a Form 706 return upon the decedent's death.³² Because GST exemption can only be allocated to an entire trust, a partial Reverse QTIP Election is not allowed.³³ As such, unless the entire QTIP Trust will qualify for GST exemption without severance (which is unlikely), the solution to this dilemma is to set up two QTIP Trusts from the outset: one that is GST exempt and one that is GST non-exempt.³⁴

If the exempt and non-exempt QTIP Trusts are to be severed on a fractional basis, they *need not* be funded proportionately, but may be funded non-proportionately, "provided funding is based on either the fair market value of the assets on the date of funding or in a manner that fairly reflects the net appreciation or depreciation in the value of the assets measured from the valuation date to the date of funding."³⁵ If the exempt and non-exempt QTIP trusts are to be severed based on a pecuniary amount to be paid on the basis of values other than date of distribution values, then the trustee must "allocate assets to the pecuniary payment in a manner that fairly reflects net appreciation or depreciation in the value of the assets in the fund available to pay the pecuniary amount measured from the valuation date to the date of payment."³⁶

II. AN EXPLANATION OF SUBTRUST FUNDING CLAUSES

The Joint Revocable Living Trust or will typically distributes to the Credit Shelter and Marital Deduction Trusts via formula clauses, which generally fall into two broad categories: pecuniary formula clauses and fractional share formula clauses.³⁷ Pecuniary formulas bequest assets with an ascertainable dollar value into a particular trust, leaving the residue to go to the other trust.³⁸ For example, a pecuniary credit share formula funds the Credit Shelter Trust with a pecuniary amount and leaves the residue to fund the Marital Deduction Trust.³⁹

Conversely, a pecuniary marital formula funds the Marital Deduction Trust with a pecuniary amount and leaves the residue to fund the Credit Shelter Trust.⁴⁰ Fractional formulas fund one trust (e.g., the Marital Deduction Trust) with a fraction in which the numerator is the desired value of

31 I.R.C. §§ 2652(a)(3), 2044 (2008); Kathryn G. Henkel, Est. Plan. & Wealth Preservation: Strategies & Solutions (RIA) ¶ 5.05[6][a] (2003), available at 1999 WL 1017502.

32 26 C.F.R. § 26.2652-2(a)-(b) (2004).

33 *Id.* § 26.2632-1(a).

34 *Id.* § 26.2654-1(b); Henkel, *supra* note 31, ¶ 5.05[6][a].

35 26 C.F.R. § 26.2654-1(b)(1)(ii)(C) (2004).

36 *Id.* § 26.2654-1(a)(ii)(B), (b)(1)(ii)(C).

37 BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 549; William P. Streng & Mickey R. Davis, Retirement Plan. Tax & Fin. Strategies (RIA) ¶ 12.03[4] (2003), available at 2000 WL 59417.

38 BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 549-50.

39 Streng & Davis, *supra* note 37, ¶ 12.03[4][d].

40 *Id.* ¶ 12.03[4][e].

the trust, and the denominator is the value of the residue of all assets from which that Marital Deduction will be carved; what is left passes to the residuary share (e.g., the Credit Shelter Trust).⁴¹

The following is an example of a will provision that distributes to a Trust A Survivor's Trust; a Trust B Credit Shelter Trust *via a pecuniary bequest of property in kind*; and a Trust C QTIP Trust, which receives the residue of the decedent's community share:

If my wife survives me the trust estate shall be divided into three (3) trusts, hereinafter called Trust "A", Trust "B" and Trust "C", respectively. Trust "A" shall contain my wife's share of our community property. Trust "B" shall contain a sum equal to the largest amount that can pass free of federal estate tax under this Article by reason of the unified credit allowable to my estate but no other credit and after taking account of dispositions under previous Articles of this Will and property passing outside of this Will which do not qualify for the marital or charitable deduction and after taking account of charges to principal that are not allowed as deductions in computing my federal estate tax. For the purpose of establishing the sum disposed of by this Article the values finally fixed in the federal estate tax proceeding relating to my estate shall be used. I recognized that no sum may be disposed of by this Article and that the sum so disposed of may be affected by the action of my Executors in exercising certain tax elections.

The balance of my estate shall pass into Trust "C". All state death taxes on Trust "C", and any expenses deducted on the federal income tax rather than estate tax return, shall be charged against Trust "B". The Executor shall satisfy the bequest to Trust "B" in cash or kind, or partly in each; assets allocated in kind shall be deemed to satisfy this amount on the basis of their values at the date or dates of distribution to Trust "B". The selection of assets in making distributions in satisfaction of the bequest shall not be subject to question by any beneficiary, and no adjustment shall be made to compensate for disproportionate allocation of unrealized gain for federal income tax purposes. If my wife does not survive me, the residue of my estate shall pass to Trust "B". Said trusts shall be held, administered and distributed as hereinafter provided⁴²

A. An Explanation Regarding Distributable Net Income and Realization of Capital Gains and Losses

Cash or property distributions from an estate or trust normally carry out distributable net income ("DNI"), which may be (1) deductible from the estate or trust's taxable income and (2) includible in the beneficiaries' gross income.⁴³ When receiving a distribution of non-cash property, the value of DNI that the beneficiary is deemed to receive is the lesser of the

41 BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 549–50; James B. Bertles & Joel H. Yudenfreund, *Choosing a Formula Clause Based on Funding Effects*, 19 EST. PLAN. 165, 170 (May/June 1992).

42 Est. Plan. Analysis (RIA) ¶ 38,411 (2008).

43 I.R.C. §§ 643(a) (defining distributable net income), 651 ("Deduction for trusts distributing current income only"), 661 ("Deduction for estates and trusts accumulating income or distributing corpus"), 662 ("Inclusion of amounts in gross income of beneficiaries of estates and trusts accumulating income or distributing corpus") (2008); Bertles & Yudenfreund, *supra* note 41, at 166.

property's adjusted basis or its fair market value at the date of distribution.⁴⁴ DNI does not include capital gains or losses from the sale or exchange of capital assets.⁴⁵ And pecuniary bequests fulfilled with cash do not entail realization of capital gains or losses.⁴⁶

1. Estates and Trusts May Realize Gain or Loss by Fulfilling a Pecuniary Bequest with an In-Kind Property Distribution

Estates or trusts will recognize gain or loss if the fiduciary (1) fulfills a pecuniary bequest of a beneficiary's right to receive a specific dollar amount with an in-kind property distribution, or (2) elects to have the distribution receive gain or loss treatment under Section 643(e).⁴⁷ Absent a Section 643(e) election, funding a fractional share or fairly representative bequest does not result in realization or recognition of gain or loss for the estate or trust because the property being distributed is not satisfying a specific pecuniary bequest.⁴⁸

To provide some context, pursuant to Section 2031, a decedent's gross estate is generally valued at its fair market value as of the decedent's date of death, unless the decedent's executor elects a Section 2032 alternate valuation date (discussed *infra*).⁴⁹ Pursuant to Sections 1014(a) and 643(e), the basis of property received from a decedent is generally its fair market value as of the date of the decedent's death (unless the decedent's executor has elected the Section 2032 alternate valuation date) adjusted for gain or loss recognized by the estate or trust on the distribution.⁵⁰

Essentially, therefore, Section 1014(a) has the effect of stepping up or down a decedent's basis on the date of death. There are, however, exceptions. For example, Section 1014's date of death valuation rule does not apply with respect to income in respect of a decedent ("IRD").⁵¹ Satisfaction of a pecuniary bequest with the right to receive IRD can accelerate recognition of income by the recipient of that right; in that case, the recipient must recognize the fair market value of that IRD right at the time of the transfer.⁵² IRD exceptions aside, however, the big picture to keep in

44 I.R.C. § 643(e)(2) (2008); Bertles & Yudenfreund, *supra* note 41, at 166.

45 I.R.C. § 643(a)(3) (2008).

46 Boris I. Bittker & Lawrence Lokken, 2 Fed. Tax'n Income Est. & Gifts (RIA) ¶ 40.4.2 (3rd ed. 2000); see also BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 550.

47 Marc M. Stern & Robert S. Tippet, *Income Taxation of Trusts*, in FUNDAMENTALS OF POSTMORTEM TRUST ADMINISTRATION PROGRAM HANDBOOK 209, § 11.50, at 241 (CEB Apr./May 2004).

48 Bertles & Yudenfreund, *supra* note 41, at 167, 170–71.

49 I.R.C. § 2031(a) (2008); 26 C.F.R. § 20.2031-1(b) (2004); 10 Jacob Rabkin & Mark A. Johnson, Current Legal Forms with Tax Analysis (MB) § 7.35 (2007) (ch. 7 by William P. LaPiana). Date of death valuation includes property that the decedent transferred during life, but which still ends up included in the value of his gross estate at death. *Id.*; see also *Ingleheart v. Comm'r*, 77 F.2d 704, 711 (5th Cir. 1935).

50 I.R.C. §§ 1014(a), 643(e)(1) (2008); 26 C.F.R. § 1.1041-1(a) (2004).

51 I.R.C. § 1014(c) (2008).

52 See *id.* § 691(a)(2); 26 C.F.R. § 1.691(a)-1(b) (2004) (defining income in respect of a decedent); Est. Plan. Analysis (RIA) ¶ 80,474 (2008).

mind is that estates or trusts may realize gain or loss on the distribution of in-kind property if the fiduciary is fulfilling a pecuniary bequest to a beneficiary “in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed.”⁵³

When an estate or trust funds a trust via a specific pecuniary bequest of property in kind, the estate realizes capital gains or loss for income tax purposes based on the change in valuation of that property between decedent’s *date of death* and the estate’s *date of distribution*.⁵⁴ Given that the administration of an estate can be a lengthy process, the gain or loss that can occur between death and distribution can be substantial if significant appreciation or depreciation occurs during that time. After the distributing estate or trust recognizes its gain or loss, the beneficiary trust’s basis in the property received is its fair market value on the date of distribution.⁵⁵

2. The Section 645 Election Can Preserve Loss Recognition When Distributing From a Joint Revocable Living Trust to a Subtrust

Funding a subtrust with depreciated property could lead to realizing a loss. Section 267, however, disallows recognition of loss on distributions between related parties, including between the trustee of a trust and “a beneficiary of such trust.”⁵⁶ Given that a subtrust could be the beneficiary of a Joint Revocable Living Trust, Section 267 could technically disallow recognition of loss on a distribution from a Joint Revocable Living Trust to a Credit Share or Marital Deduction Trust.

Nevertheless, Section 267(b)(13) provides an exception that allows for recognition of loss on distributions for sales or exchanges “in satisfaction of a pecuniary bequest” between “*an estate* and a beneficiary of such *estate*.”⁵⁷ Section 267(b)(13)’s exception, however, only uses the word “*estate*” not “*trust*.”⁵⁸ Be that as it may, Section 645 allows both the executor of the estate (if one exists) and the trustee of a “qualified revocable trust” (i.e., a trust deemed owned by the decedent’s estate under section 676) to *elect* to treat that “qualified revocable trust” as part of the *estate*.⁵⁹ Therefore, in the case of a distribution from a Joint Revocable Living Trust, a Section 645 election can be made in order to allow recognition of a loss because that trust can now be deemed an *estate* and come within the Section

⁵³ 26 C.F.R. § 1.661(a)-2(f) (2004); *see also* Kenan v. Comm’r, 114 F.2d 217, 219 (2d Cir. 1940); Bertles & Yudenfreund, *supra* note 41, at 166.

⁵⁴ 26 C.F.R. § 1.1014-4(a)(3) (2003) (noting that (1) if property with a fair market value of \$175,000 on the decedent’s death was used to fund a trust pursuant to a specific pecuniary bequest, and (2) if that property had appreciated to \$200,000 on the date of transfer into the trust, then the estate transferring that property to the trust would realize \$25,000 of gain, and the trust would take that property with a date of distribution basis of \$200,000).

⁵⁵ *Id.*

⁵⁶ I.R.C. § 267(a)(1), (b)(6) (2008); Stern & Tippet, *supra* note 47, at § 11.50, at 241.

⁵⁷ I.R.C. § 267(b)(13) (2008) (emphasis added).

⁵⁸ *Id.*

⁵⁹ I.R.C. § 645(a), (b)(1) (2008). To make a Section 645 election, Form 8855 must be filed by the due date that a Form 1041 is due for the taxable estate.

267(b)(13) exception.⁶⁰

B. Pecuniary Formulas and Revenue Procedure 64-19

Suppose that a pecuniary marital share funding clause for a Marital Deduction Trust gives the fiduciary discretion to select assets for funding in kind to be valued at their *date of death* values with the residue going to the Credit Shelter Trust. Because assets used for funding are deemed to have *date of death* values, such a bequest avoids capital gains or loss on those assets between the date of death and date of distribution.⁶¹ Moreover, because the fiduciary has discretion to select the assets in kind, he might allocate depreciating assets to the Marital Deduction Trust and appreciating assets to the Credit Shelter Trust to later reduce the size of the surviving spouse's estate, and, correspondingly, the estate tax due on such estate.⁶²

Before 1964, fiduciaries often utilized the foregoing type of "heads we win, tails you lose" selection in their funding choices.⁶³ In 1964, however, the IRS issued Revenue Procedure 64-19 to specifically address when and whether it would allow the marital deduction in situations where a fiduciary has discretion to "satisfy bequests in kind with assets at their value as finally determined for Federal estate tax purposes," in effect their value as of the *date of death*.⁶⁴

Revenue Procedure 64-19 disallows the marital deduction for pecuniary funding clauses seeking to satisfy bequests of non-cash assets with *date of death* values in situations where that fiduciary had no clear limitation as to how to allocate assets.⁶⁵ Revenue Procedure 64-19, however, allows the marital deduction if applicable laws or the distributing instrument (e.g., a will or trust) instructs the fiduciary to use either a *true worth* or *fairly representative* formula.⁶⁶ The fiduciary, however, may not be given discretion to choose either the true worth or fairly representative method, or a mixture of them.⁶⁷

⁶⁰ *Id.* §§ 645(a), 267(b)(13); Scott H. Malin, *Strategies for Handling Difficult Fiduciary Income Tax Issues*, 25 EST. PLAN. 410, 414 (Nov. 1998).

⁶¹ Dell'Osso & Bruton, *supra* note 5, at § 15:46, at 43.

⁶² *Id.*

⁶³ Kathryn G. Henkel, *Est. Plan. & Wealth Preservation: Strategies and Solutions* (RIA) ¶ 49.02[2][a] (2003), available at 1999 WL 1017869.

⁶⁴ Rev. Proc. 64-19 § 1, 1964-1 C.B. 682, 683; David B. Gaw, *Subtrust Allocation and Funding on the Death of the First Spouse*, in *FUNDAMENTALS OF POSTMORTEM TRUST ADMINISTRATION PROGRAM HANDBOOK* 389, § 14.30, at 433-34 (CEB Apr./May 2004).

⁶⁵ Rev. Proc. 64-19 § 2.03, 1964-1 C.B. 682, 683.

⁶⁶ *Id.* § 2.01-02.

⁶⁷ *Id.* § 2.02-03; Dell'Osso & Bruton, *supra* note 5, at § 15:46, at 43; *Est. Plan. Analysis* (RIA) ¶ 44,838 (2008) (citing as authority a "Speech by Chief Counsel, 10/19/64"); *cf.* Rev. Rul. 90-3, 1990-1 C.B. 175 (emphasizing a fiduciary's duty to act impartially and fairly towards the beneficiaries).

1. True Worth Pecuniary Formulas

Revenue Procedure 64-19's *true worth formula* option allows the marital deduction when the fiduciary is *required* to distribute assets that have "an aggregate fair market value at the *date, or dates, of distribution* amounting to no less than the amount of the pecuniary bequest or transfer, as finally determined for Federal estate tax purposes."⁶⁸ For example, when funding a pecuniary Marital Deduction Trust under a true worth formula, at the *date of distribution*, that Marital Deduction Trust would receive assets in kind valued at no less than the amount of the pecuniary bequest; the residue would fall to the other Credit Shelter Trust.⁶⁹ A true worth formula clause might include the following language:

My personal representative shall select and distribute to the trustee the cash, securities and other property, including real estate and interests therein, that will constitute the trust, *employing for the purpose values current at the time of distribution.*⁷⁰

True worth pecuniary formulas take the form of (1) true-worth marital deduction formulas, which fund the Marital Deduction Trust with the pecuniary amount, leaving the residue to the Credit Shelter Trust; or (2) true-worth credit shelter trust funding formulas (a.k.a. reverse pecuniary marital deduction funding formula), which fund the Credit Shelter Trust with the pecuniary amount, leaving the residue to the Marital Deduction Trust.⁷¹

With true worth pecuniary formulas, appreciation in asset values after the date of death ends up increasing the size of the residuary bequest.⁷² Depreciation in asset values after the date of death ends up decreasing the size of the residuary estate.⁷³ Revenue Ruling 90-3 addresses whether fluctuations in the amount of residuary distribution to the Marital Share (e.g., following a pecuniary credit shelter funding formula) would disqualify it for the marital deduction.⁷⁴ Ultimately, the IRS determined that "the possibility that post death fluctuations in the fair market value of estate assets may diminish the residuary bequest to the surviving spouse does not cause the residuary bequest to be a nondeductible terminable interest for purposes of section 2056(b) of the Code."⁷⁵

When a subtrust receives distributions via a true worth pecuniary formula, the distributing trust recognizes gains or losses (if a Section 645 election was made) on the difference in the assets' value between the date of

⁶⁸ Rev. Proc. 64-19 § 2.02, 1964-1 C.B. 682, 683 (emphasis added).

⁶⁹ Grassi, Jr., *supra* note 7, at 30; Dell'Osso & Bruton, *supra* note 5, at § 15:46, at 43; Streng & Davis, *supra* note 37, ¶ 12.03[4][e]; Gaw, *supra* note 64, at § 14.31, at 434.

⁷⁰ VARLEY H. TAYLOR, JR., 6A VERNON'S OKLA. FORMS 2D: ESTATE PLANNING § 8.11(b) (2002). (emphasis added).

⁷¹ *Id.* § 8.11(e); Grassi, Jr., *supra* note 7, at 30.

⁷² Gaw, *supra* note 64, at § 14.31, at 434.

⁷³ *Id.* § 14.32, at 435.

⁷⁴ Rev. Rul. 90-3, 1990-1 C.B. 175.

⁷⁵ *Id.*

death and date of distribution; that gain or loss will be attributed to the residuary share.⁷⁶ The beneficiary trust's basis in the property received is its fair market value on the date of distribution.⁷⁷

2. The Fairly Representative Formula

Revenue Procedure 64-19 also allows for a *fairly representative method* funding option, under which the fiduciary must satisfy the pecuniary bequest to the Marital Deduction Trust by distributing assets "fairly representative of [post-death] appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer."⁷⁸ If the fairly representative formula is used, "the marital deduction is equally determinable and may be allowed in the full amount of the pecuniary bequest or transfer in trust passing to the surviving spouse."⁷⁹

Basically, this means that if you are going to fund a pecuniary bequest based on *date of death* values, when making the distribution you need to use assets that are fairly representative of appreciation that has occurred since the decedent's *date of death*. A fairly representative formula clause might be worded as follows:

My executor shall value the property distributed in satisfaction of this bequest at the adjusted basis of such property for federal income tax purposes; provided, however, that my executor must select property of my estate that, in the aggregate, is fairly representative of the total of all appreciation or depreciation in the value of all property available for distribution in satisfaction of this bequest between the date of valuation for federal estate tax purposes and the date or dates of distribution.⁸⁰

Funding the Marital Deduction Trust under a *fairly representative formula* is not automatically treated as a sale or exchange and does not automatically result in a realization of capital gains or losses by the distributing trust.⁸¹ The basis in the property distributed is its carryover date of death value.⁸² With a fairly representative formula, appreciation and depreciation that occurs in the decedent's gross estate between the date of death and date of distribution almost always results in overfunding or underfunding of both the Marital Deduction Trust and the Credit Shelter Trust.⁸³

⁷⁶ I.R.C. § 645 (2008); Gaw, *supra* note 64, §§ 14.31, 14.35, at 434–36.

⁷⁷ 26 C.F.R. § 1.1014-4(a)(3) (2004).

⁷⁸ Rev. Proc. 64-19 § 2.02, 1964-1 C.B. 682, 683; Est. Plan. Analysis (RIA) ¶ 44,838 (2008).

⁷⁹ Rev. Proc. 64-19 § 2.02, 1964-1 C.B. 682, 683.

⁸⁰ Henkel, *supra* note 63, ¶ 49.02[2][a][v].

⁸¹ See Gaw, *supra* note 64, § 14.33, at 435–36.

⁸² See I.R.C. § 1014(a) (2008).

⁸³ Gaw, *supra* note 64, § 14.33, at 435; Bertles & Yudenfreund, *supra* note 41, at 169.

3. The Minimum Worth Formula

Several commentators and practitioners suggest that Revenue Procedure 64-19 also allows for the use of a “minimum worth” hybrid type formula.⁸⁴ A minimum worth formula funds a pecuniary bequest with assets valued at the *lesser* of their *date of death* or *date of distribution* values.⁸⁵ A minimum worth clause may look like this:

My executor shall value the property distributed in satisfaction of this bequest at the lesser of the adjusted basis of such property for federal income tax purposes or the fair market value of such property as of the date or dates of distribution.⁸⁶

The *lowest basis possible* nature of the minimum worth clause means that funding will not result in gain realization but could result in recognition of loss—provided, of course, that the proper Section 645 elections are made.⁸⁷ At least one commentator suggests that the minimum worth formula is almost never used today and is not conducive for GST exemption planning.⁸⁸

C. Formula Clauses Unaffected by Revenue Procedure 64-19

1. Proportionate and Non-Proportionate Fractional Share Formulas

Revenue Procedure 64-19 does not apply, and hence does not forbid, the marital deduction for bequests or transfers of fractional shares “under which each beneficiary shares proportionately in the appreciation or depreciation in the value of the assets to the date, or dates, of distribution.”⁸⁹ Fractional share clauses typically fall into two categories: (1) proportionate funding clauses, which apply the funding fraction based on *date of death* values; and (2) non-proportionate funding clauses, which apply the fraction based on *date of distribution* values of the residuary share available for distribution.⁹⁰

A proportionate fractional share marital formula might look like this:

I give to my spouse [or to a qualifying trust for her benefit] the fraction of my residuary estate determined as follows. The numerator shall be the smallest amount that, if allowable as a marital deduction for federal estate tax purposes, will result in no federal estate tax being due from my estate, taking into account all other deductions allowed for federal estate tax purposes, the unified credit, the amount of gift tax payable with respect to post-1976 taxable gifts, and the state death tax (but only to the extent that the latter credit does not increase the state death tax payable to any state). The denominator of the fraction shall be the federal estate tax value of my residuary estate so determined. For purposes of this

⁸⁴ See, e.g., Bertles & Yudenfreund, *supra* note 41, at 165–66; Henkel, *supra* note 63, ¶ 49.02[2][a][iv]; Grassi, Jr., *supra* note 7, at 30; Gaw, *supra* note 64, § 14.34, at 436.

⁸⁵ Grassi, Jr., *supra* note 7, at 30; Gaw, *supra* note 64, § 14.34, at 436.

⁸⁶ Henkel, *supra* note 63, ¶ 49.02[2][a][iv].

⁸⁷ *Id.* ¶ 49.02[4][b][v]; Bertles & Yudenfreund, *supra* note 41, at 167.

⁸⁸ Grassi, Jr., *supra* note 7, at 30.

⁸⁹ Rev. Proc. 64-19 § 4.01(1), 1964-1 C.B. 682.

⁹⁰ TAYLOR, JR., *supra* note 70, § 8.11(f)–(g); Grassi, Jr., *supra* note 7, at 32–34; Bertles & Yudenfreund, *supra* note 41, at 170–71.

gift, my residuary estate shall include only assets that would qualify for the federal estate tax marital deduction if they were distributed outright to my spouse.⁹¹

With the foregoing formula in mind, assume you have a decedent with a completely unused \$2,000,000 applicable exclusion and \$5,000,000 of his community share to be split between the Marital Deduction and Credit Shelter Trusts. In that situation, the numerator of the fraction will be \$3,000,000 (\$5,000,000 – \$2,000,000), and the denominator will be \$5,000,000. That 3/5 fraction will be multiplied against each asset available for distribution.

The foregoing proportionate fractional funding can often present an administrative hassle for the fiduciary.⁹² This is because for purposes of distribution, the fraction for the proportionate fractional share formula is applied to each asset available for distribution on a pro-rata basis, and each asset is fractionalized.⁹³ Moreover, the process of fractionalizing each asset strips the fiduciary of the ability to select which assets go into which trust.⁹⁴

To overcome the lack of fiduciary discretion inherent in a proportionate fractional share clause, practitioners often like to modify the foregoing proportionate formula clause by adding language that makes it a non-proportionate “pick and choose” clause.⁹⁵ With the “pick and choose” clause, each time there is a distribution, the fraction is applied to the value of the asset pool available for funding.⁹⁶ Unlike the proportionate fractional share formula, which does not require any revaluation of assets after the date of death, the “pick and choose” formula necessitates revaluing all the assets available for distribution each time that a distribution is made.⁹⁷ Thereafter, the fiduciary has *discretion* to satisfy whatever dollar amount the fraction yields by picking and choosing assets in kind for distribution.⁹⁸

I suggest language that looks something like the following could be added to the foregoing proportionate formula clause example in order to make it a “pick and choose” clause:

In making the distributions contemplated above, the trustee shall have discretion to select assets in kind for distribution, which discretion shall not be subject to question by any beneficiary. Each time the trustee makes a distribution, all assets then available for distribution shall be revalued as of their date of distribution, and the fraction shall be applied to those assets based on their revaluation as of the date of that distribution.

⁹¹ Streng & Davis, *supra* note 37, ¶ 12.03[4][f].

⁹² Bertles & Yudenfreund, *supra* note 41, at 171; Grassi, Jr., *supra* note 7, at 32.

⁹³ Streng & Davis, *supra* note 37, ¶ 12.03[4][f]; TAYLOR, JR., *supra* note 70, § 8.11(f); Bertles & Yudenfreund, *supra* note 41, at 170–71.

⁹⁴ TAYLOR, JR., *supra* note 70, at § 8.11(f)(2).

⁹⁵ *Id.* at § 8.11(g); Streng & Davis, *supra* note 37, ¶ 12.03[4][f].

⁹⁶ Grassi, Jr., *supra* note 7, at 32–33; Bertles & Yudenfreund, *supra* note 41, at 171.

⁹⁷ Grassi, Jr., *supra* note 7, at 33.

⁹⁸ *Id.*

Revenue Ruling 69-486 dealt with a trustee who had no authority to make a non-proportionate distribution in kind but did so because of a mutual agreement between the beneficiaries.⁹⁹ The Service held that such a non-proportionate distribution, when not within the discretion of the trustee, would receive exchange status, which could therefore result in the estate realizing capital gains.¹⁰⁰ Various subsequent IRS private letter rulings have suggested that there will be no income tax consequence (i.e., no realization of gain or loss) with a “pick and choose” formula when the fiduciary is given discretion to pick and choose the assets.¹⁰¹

Funding with fractional share bequests, whether proportionate or non-proportionate, yields tax results that are similar to the “fairly representative” method discussed above. Because the fractional share bequests automatically reflect a fractional share of appreciation or depreciation that occurs between the date of death and date of distribution, they do not generate any capital gain or loss for income tax purposes.¹⁰² The recipient’s basis in the property is its carryover date of death value (i.e., the fair market value at the date of the decedent’s death).¹⁰³

Appreciation or depreciation in the decedent’s gross estate typically results in either over-funding or under-funding of the respective Marital Deduction Trust and Credit Shelter Trust shares.¹⁰⁴ As a result, typically, a fractional share bequest does not allow the Credit Shelter Trust to capture any of the benefits of post-death appreciation or depreciation that may occur between date of death and date of distribution.

2. Bequests of Specific Assets

Revenue Procedure 64-19 does not apply to bequests of specific assets, meaning that such bequest could qualify for the marital deduction without violating Revenue Procedure 64-19.¹⁰⁵ Because a specific asset bequest does not constitute a sale, the estate realizes “no gain or loss from the distribution of property specifically bequeathed.”¹⁰⁶ The beneficiary’s basis in the asset received is its fair market value on the date of decedent’s death.¹⁰⁷

⁹⁹ Rev. Rul. 69-486, 1969-2 C.B. 159.

¹⁰⁰ *Id.*

¹⁰¹ Kasner, Strauss, & Strauss, *supra* note 10, ¶ 13.04[4] (citing Private Letter Rulings 7929054, 8029054, and 8119040).

¹⁰² BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 551; *see also* 26 C.F.R. § 1.1014-4(a)(3) (2003); Bertles & Yudenfreund, *supra* note 41, at 171.

¹⁰³ I.R.C. §§ 1014(a), 643(e) (2008); 26 C.F.R. §§ 1.1014-1(a), 1.1014-4(a) (2003).

¹⁰⁴ Grassi, Jr., *supra* note 7, at 31-34.

¹⁰⁵ Rev. Proc. 64-19 § 4.01, 1964-1 C.B. 682.

¹⁰⁶ Kenan v. Comm’r, 40 B.T.A. 824, 827 (B.T.A. 1939), *aff’d*, 114 F.2d 217, 219-21 (2d Cir. 1940).

¹⁰⁷ I.R.C. §§ 1014(a), 643(e)(1) (2008); 26 C.F.R. §§ 1.1014-1(a), 1.1014-4(a) (2003).

3. Pecuniary Bequests to be Satisfied With Cash, In Kind Without Discretion, or When Assets Selected by The Fiduciary for In Kind Distribution Must be Distributed at Date of Distribution Values

Revenue Procedure 64-19 does not apply to a pecuniary bequest or transfer in trust, whether in a stated amount or an amount computed by the use of a formula, if:

- (a) The fiduciary must satisfy the pecuniary bequest or transfer in trust solely in cash, or
- (b) The fiduciary has no discretion in the selection of the assets to be distributed in kind, or
- (c) Assets selected by the fiduciary to be distributed in kind in satisfaction of the bequest or transfer in trust are required to be valued at their respective values on the date, or dates, of their distribution.¹⁰⁸

The consequences to the foregoing types of bequests are as follows: Cash distributions do not constitute a sale and therefore do not entail realization of gain or loss by the estate.¹⁰⁹ Rather, as is discussed *supra*, a cash distribution from a trust normally carries out distributable net income that may be (1) deductible from the trust's taxable income and (2) includible in the beneficiaries' gross income.¹¹⁰ And obviously, the beneficiary's basis in the cash would be the value of the cash.

Specific assets to be distributed in kind without fiduciary discretion presumably would or would not receive sales treatment, depending on whether they were to be distributed based on date of death or date of distribution values. And fiduciary distributions of assets to be selected in kind and valued as of their date of distribution would receive sale treatment and realize gain or loss, the result being that the subtrusts receiving the distributions would take a basis in those assets equal to their fair market value as of the date of distribution.¹¹¹

¹⁰⁸ Rev. Proc. 64-19 § 4.01, 1964-1 C.B. 682.

¹⁰⁹ See Bittker & Lokken, *supra* note 46, ¶ 40.4.2; see also BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 550.

¹¹⁰ I.R.C. § 643(a) (defining distributable net income), § 651 (deduction for trusts distributing current income only), § 661 (deduction for estates accumulating income or distributing corpus), § 662 (including amount in gross income of beneficiaries or estates and trusts accumulating income or distributing corpus) (2008); Bertles & Yudenfreund, *supra* note 41, at 166.

¹¹¹ 26 C.F.R. §§ 1.661(a)-2(f), 1.1014-4(a)(3) (2004); see also Henkel, *supra* note 63, ¶ 49.02[4][b][v]. In that regard, incidentally, the IRS has ruled in a Technical Advice Memorandum that when the fiduciary is given broad discretion to fund a pecuniary Credit Shelter Trust (thus funding the Marital Deduction Trust with the residue), such discretion will not disqualify the marital deduction if the fiduciary is required to act in an impartial manner with respect to all beneficiaries in funding that Credit Shelter Trust. I.R.S. Tech. Adv. Mem. 8649002 (Aug. 14, 1986) available at 1986 WL 371019; see also Est. Plan. Analysis (RIA) ¶ 44,838 (2008).

III. SUGGESTIONS REGARDING SUBTRUST FUNDING AND ADMINISTRATION WHEN ASSETS ARE DEPRECIATING

A. When a Pecuniary Bequest of Assets In Kind Could Fund the Credit Shelter Trust with Depreciating Assets, Postpone Funding

As mentioned above, a pecuniary distribution of assets in kind based on date of distribution values typically results in recognition of capital gains or losses by the estate.¹¹² With that in mind, assume a market where assets are generally appreciating and you have a client with a significant Joint Revocable Living Trust interest (e.g., a \$5,000,000 community property share) that will distribute to both a Credit Shelter Trust and a Marital Deduction Trust. Assume further that the Credit Shelter Trust can shield all unused applicable exclusion amounts up to \$2,000,000, which would leave approximately \$3,000,000 for a Marital Deduction Trust.

In the foregoing example, it might make sense to fund the smaller of the two trusts (i.e., the Credit Shelter Trust) with a pecuniary true worth formula. This approach can completely fill the Credit Shelter to its \$2,000,000 limit; it will also result in fewer potential capital gains than would be the case if the \$3,000,000 Marital Deduction Trust funded with the pecuniary bequest.

If, on the other hand, the Marital Deduction Trust is expected to be smaller, it could potentially make more sense to fund it with a pecuniary true worth formula. In a depreciating market, however, that could prevent you from filling the Credit Shelter to its capacity because it will receive the negative fluctuation of the residue.¹¹³

For the sake of further explanation, assume that a Joint Revocable Living Trust distributes to a Credit Shelter Trust with a pecuniary true worth formula, which would subject the distribution to capital gains and loss treatment. If assets are expected to appreciate significantly in between the *date of death* and the *date of distribution*, it makes sense to fund that pecuniary credit share bequest as soon as possible in order to (1) avoid significant capital gains realization between date of death and date of distribution values, and (2) capture later appreciation on those assets free from estate taxation by virtue of the shield of the Credit Shelter Trust.¹¹⁴ A delay in pecuniary funding of that Credit Shelter Trust (while assets appreciate) results in (1) greater potential for capital gains on funding, and (2) a larger residue falling into the Marital Deduction Trust at the time of distribution.

¹¹² Gaw, *supra* note 64, § 14.32, at 435.

¹¹³ See discussion *infra* Part III.B.1; see also BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 551 (posing the question of when it makes sense to fund the Credit Shelter or Marital Deduction Trusts with a pecuniary true worth formula); Grassi, Jr., *supra* note 7, at 29 (discussing how the residuary Credit Shelter Trust of a pecuniary marital deduction formula will “enjoy any appreciation (or suffer any depreciation) that occurs during the administration of the grantor’s estate”).

¹¹⁴ See Kasner, Strauss, & Strauss, *supra* note 10, ¶ 13.04[8]–[10].

Ultimately, when the second spouse dies, there will be more property subject to estate tax in his or her estate.¹¹⁵

On the other hand, if assets are expected to *depreciate* between the *date of death* and *date of distribution*, the value of the residuary trust will decrease.¹¹⁶ Furthermore, after funding, the assets used to satisfy the specific dollar amount that funded the pecuniary trusts may continue to decline in value. For example, if you funded a Credit Shelter Trust with property in kind worth \$2,000,000 in January 2008, by July 2008, that property might only be worth \$1,700,000. Therefore, especially when funding a pecuniary Credit Shelter Trust, an incentive exists to fund with assets that are less likely to depreciate further after funding—provided that you comply with Revenue Procedure 64-19 and use date of distribution values for valuation instead of date of death values.¹¹⁷

When assets are declining in value, there is an incentive to postpone pecuniary distributions to the Credit Shelter Trust to (1) allow the estate to realize greater capital losses when the Credit Shelter Trust actually funds, and (2) allow for the possibility of placing more assets in the Credit Shelter Trust because of their lower date of distribution values. After funding, if the economy shifts and those assets in the Credit Shelter Trust start appreciating, a greater number of assets will be able to appreciate free from estate taxation.

The following possible pecuniary credit share formula clause might be effective in addressing the foregoing concerns that can come from the effects of asset appreciation or depreciation:

As soon as is reasonably possible after the decedent's date of death, (1) the Trustee shall determine the amount of the decedent's remaining applicable exclusion amount ("Remaining Applicable Exclusion Amount") available to the decedent as of the decedent's date of death, and (2) the Trustee (or a qualified investment advisor of the Trustee's choosing) shall make an assessment (the "Valuation Assessment") as to which assets in the decedent's estate are likely to appreciate or depreciate in value during the duration of estate administration, including an assessment of the extent to which such appreciation or depreciation may occur. Once that Valuation Assessment is made, the Trustee shall have discretion to select assets in kind and distribute the same into the Credit Shelter Trust to the extent of the Remaining Applicable Exclusion Amount.

All assets selected by the Trustee to be distributed in kind to the Credit Shelter Trust shall be valued at their respective values on the date, or dates, of their distribution. If, based on the Valuation Assessment, the Trustee determines that the Credit Shelter Trust can be filled primarily with assets that are either likely to appreciate or not likely to depreciate, then the Trustee shall attempt to distribute such assets into the Credit Shelter Trust as soon as reasonably possible after the decedent's death in order to avoid unnecessary capital gains taxes based on the

¹¹⁵ See *id.*

¹¹⁶ Gaw, *supra* note 64, § 14.32, at 435.

¹¹⁷ Bertles & Yudenfreund, *supra* note 41, at 166–67; Rev. Proc. 64-19 § 2, 1964-1 C.B. 682.

passage of time.

If, on the other hand, based on the Valuation Assessment, the Trustee determines that the Credit Shelter Trust will have to be filled with assets that are not likely to appreciate or that are likely to depreciate, then the Trustee shall wait to distribute such assets to the Credit Shelter Trust until the latest time possible so as to avoid needless waste of the Remaining Applicable Exclusion Amount by virtue of distributing depreciating assets to the Credit Shelter Trust before it was necessary to do so.

In utilizing his or her distributing discretion, including with respect to timing of distributions, the Trustee shall comply with all Federal, State, and local laws. Any questions regarding whether the Trustee acted reasonably with respect to the time of a distribution shall be considered in light of only the information reasonably available to the Trustee at the time of the distribution, and not in light of information that only became available after such distribution.

All residuary assets that the Trustee does not distribute into the Credit Shelter Trust shall be distributed to the Marital Deduction QTIP Trust, but the Trustee has discretion, if he or she believes it necessary, to distribute certain assets into the Marital Deduction QTIP Trust before he has completed all distributions into the Credit Shelter Trust.

In the event that circumstances could result in underfunding of the Credit Shelter Trust to the full extent of the Remaining Applicable Exclusion Amount, the Trustee shall have discretion to make a Partial QTIP Election in order fully fund the Credit Shelter Trust. Furthermore, to the extent that the surviving spouse properly disclaims (pursuant to Section 2518) any interest in the Marital Deduction QTIP Trust at a time when the Credit Shelter Trust is not fully funded to the extent of the Remaining Applicable Exclusion Amount, then such disclaimed interest shall be distributed to the Credit Shelter Trust to the extent of the Remaining Applicable Exclusion Amount.¹¹⁸

B. When a Pecuniary Bequest of Assets In Kind Could Fund the Marital Deduction Trust with Depreciating Assets, Consider Funding Promptly

What if you have a pecuniary marital share formula under which the residue falls to the Credit Shelter Trust? If assets are depreciating, does it still make sense to postpone funding? Perhaps not. As mentioned *supra*, with the pecuniary marital share formula, the residuary Credit Shelter Trust reaps the benefits of appreciation or suffers the detriment of depreciation that occurs between the date of death and the pecuniary distribution to the Marital Deduction Trust.¹¹⁹ That is, if the fiduciary waited a long time to satisfy the pecuniary bequest to the Marital Deduction Trust with assets that are depreciating, he would need even more assets to satisfy that pecuniary dollar amount, which means that the residuary Credit Shelter Trust would receive even less.

¹¹⁸ See discussion *infra* Part IV.E for further explanation of Partial QTIP Elections and disclaimers.

¹¹⁹ Grassi, Jr., *supra* note 7, at 29.

On the other hand, if near the date of death, the fiduciary promptly funded the Marital Deduction Trust with assets based on date of distribution values that are expected to depreciate further in value, he would have satisfied that bequest with fewer assets than would be necessary later. This prompt funding of the pecuniary marital share at least leaves open the possibility that those residuary assets that funded the Credit Shelter Trust could appreciate over time. As such, when assets are depreciating, it may make more sense to fund the pecuniary marital share promptly.

C. In a Declining Market, Use of a Fractional Share Formula Could be Desirable

Assume that a trust distributes to its subtrusts via a fractional share formula, which will not result in any realization of gain or loss upon the distribution absent a Section 643(e) election. If assets are generally depreciating, then the strategy of funding the Credit Shelter Trust right away via a pecuniary bequest in order to avoid capital gains no longer applies. After all, unfortunately there are few or no capital gains to avoid. Rather, after that fractional distribution, the fractionalized assets distributed will simply retain their carryover date of death value.¹²⁰ Therefore, a fractional share “pick and choose” formula might be more attractive than it would normally be in an appreciating market.

The fractional share “pick and choose” formula offers the fiduciary discretion—after applying the fraction to the assets available for distribution—to choose which assets end up in which subtrust without having to worry about violation of Revenue Procedure 64-19.¹²¹ Moreover, because the “pick and choose” fractional share requires revaluation of all assets available for distribution each time a distribution occurs, each distribution has the effect of *naturally equalizing* any appreciation and depreciation that has occurred up to that point in time.¹²²

Still, a pecuniary true worth formula based on date of distribution values also offers a great deal of “pick and choose” flexibility for the distributing fiduciary.¹²³ Therefore, unless there is a concern that the fiduciary will not be able to gauge which assets should go in which trust—in which case the *naturally equalizing* effect of a “pick and choose” fractional formula might be desirable—a pecuniary true worth formula still seems like it would be a preferable formula choice because of its flexibility.

¹²⁰ 26 C.F.R. § 1.1014-4(a)(3) (2004).

¹²¹ Rev. Proc. 64-19 § 4.01, 1964-1 C.B. 682, 684 (mentioning non-applicability of Revenue Procedure 64-19 to fractional share bequests “under which each beneficiary shares proportionately in the appreciation or depreciation in the value of assets to the date, or dates, of distribution”).

¹²² Jeffery N. Pennell & Richard H. Clark, *Estate Tax Marital Deduction*, [Est. Gifts & Trusts] Tax Mgmt. (BNA) No. 843-2nd, at A-150 (Mar. 7, 2005).

¹²³ *Id.* at A-125.

D. If All Assets Distributed in a Fairly Representative or Fractional Bequest Have Depreciated, Consider Using a Section 643(e) Election to Recognize Loss

As discussed *supra*, certain types of fractional share, fairly representative, and residuary bequests do not ordinarily result in the realization of gain or loss by the estate or trust. Nevertheless, under Section 643(e)(3), the fiduciary of an estate or trust may elect to recognize gains or losses on a distribution of non-cash property in kind to a beneficiary, in which case the property is treated as though it were sold to the beneficiary at its fair market value.¹²⁴ Regulation section 1.661(a)-2(f) suggests that a Section 643(e) election presents a gain/loss realization *option* “in addition” to the required realization of gain and loss for specific pecuniary bequests of in-kind property discussed *supra*.¹²⁵ Therefore, a Section 643(e) election provides an option that can give sales treatment to fractional share, fairly representative, and residuary bequests for purposes of realizing (and then recognizing) gain or loss.¹²⁶

One concern might be that even if a Section 643(e)(3) election allows for recognition of loss, such loss would not be deductible in the case of a distribution from a Joint Revocable Living Trust to a subtrust due to the disallowance of deductions between related taxpayers (such as fiduciaries and beneficiaries of a trust) contained in Section 267.¹²⁷ Nonetheless, a Section 645 election to treat the qualified revocable trust as an estate may allow the loss recognition of a Section 643(e)(3) election without the impediment of Section 267 related party disallowance.¹²⁸ Another concern lies in the language of Section 643(e)(3)(B), which requires that a Section 643(e) election applies “to all distributions made by the estate or trust during a taxable year,” meaning that the election may not be discretionarily used only for particular asset distributions.¹²⁹

In light of the foregoing, a fiduciary may want to consider a Section 643(e)(3) election where the Joint Revocable Living Trust’s use of fairly representative or fractional distributions throughout the year results in a net distribution of depreciated assets for which no loss would normally be recognized. Depending on how the math works out, it might be worth it to the trust (deemed the estate via a Section 645 election) to recognize the net loss via the Section 643(e) election. In any given tax year, the distributing trust

¹²⁴ I.R.C. § 643(e)(3) (2008); John L. Peschel & Edward D. Spurgeon, Fed. Tax’n Trusts, Grantors, and Beneficiaries (RIA), ¶ 3.05[2][a], (3d ed. Aug. 1998), available at 1999 WL 1032362; see also IRS Website, <http://www.irs.gov/instructions/i1041/ch02.html#d0e6290> (follow “Question 7” hyperlink under “Other Information”) (last visited Aug. 22, 2008).

¹²⁵ 26 C.F.R. § 1.661(a)-2(f) (2004).

¹²⁶ Henkel, *supra* note 63, ¶ 49.02[4][a]; Bertles & Yudenfreund, *supra* note 41, at 170–72.

¹²⁷ I.R.C. §§ 267(a)(1), (b)(6) (2008).

¹²⁸ *Id.* §§ 267(a)(1) & (b)(6), 643(e)(3), 645; see also *id.* § 267(b)(13) (creating an exception to the loss disallowance between related parties “in the case of a sale or exchange in satisfaction of a pecuniary bequest [between] an executor of an estate and a beneficiary of such estate”).

¹²⁹ I.R.C. § 643(e)(3)(B) (2008); Henkel, *supra* note 63, ¶ 49.02[4][a].

may deduct the capital losses only to the extent of up to \$3,000 in excess of the amount of its capital gains.¹³⁰ Any loss beyond that \$3,000 over gain threshold can be carried over to future years until fully utilized.¹³¹ Although \$3,000 may not seem like much in any given year, the ability to net accumulated losses against anticipated gains in subsequent years could ultimately result in valuable tax savings for the estate or distributing trust.¹³²

E. Consider Using a Disclaimer and/or a Partial QTIP Election in Order to Fully Fund a Credit Shelter Trust that was Underfunded because of Depreciating Assets

Section 2518 allows a person to submit an irrevocable and unqualified written disclaimer of an interest passing to him within nine months of receipt, so long as (1) the disclaimant has not accepted any benefits of the interest disclaimed, and (2) the interest disclaimed will pass to the disclaimant's spouse or someone else without any direction from the disclaimant.¹³³ If the disclaimant makes a qualifying disclaimer, then gift, estate, and GST transfer taxes apply as though the disclaimed interest had never been transferred to the disclaimant.¹³⁴ In some situations where the expected size of the estate may not even exceed the applicable exclusion amount, it might be advisable to simply abandon use of a formula clause altogether, leave the entire estate to the surviving spouse, and include instructions in the will or Joint Revocable Living Trust that any amount the surviving spouse disclaims should be used to fund a Credit Shelter Trust.¹³⁵

Assume, however, that the distributing instrument creates and funds a Marital Deduction Trust and a Credit Shelter Trust. If such funding results in an underfunding of the Credit Shelter Trust share, a disclaimer of the Marital Deduction Trust share by the surviving spouse may be a means to fill that Credit Shelter share to its full capacity.¹³⁶ The surviving spouse would, however, need to make such a disclaimer before he or she took any of the benefits of the QTIP trust (e.g., before receiving income from the same). Otherwise, the disclaimer would be ineffective.¹³⁷ If a disclaimer is to achieve the desired results of shifting funds to the Credit Shelter Trust, it is advisable for the will or Joint Revocable Living Trust to include language instructing that property disclaimed from the Marital Deduction Trust should go to the Credit Shelter Trust.¹³⁸

¹³⁰ I.R.C. § 1211(b) (2008); Stern & Tippet, *supra* note 47, § 11.49, at 240.

¹³¹ I.R.C. § 1212(b)(1)(B) (2008); Stern & Tippet, *supra* note 47, § 11.49, at 240.

¹³² I.R.C. § 1211(b) (2008).

¹³³ 26 C.F.R. § 25.2518-2(a) (2004); I.R.C. § 2518 (a), (b) (2008).

¹³⁴ 26 C.F.R. § 25.2518-1(a)(3)(b) (2004).

¹³⁵ Grassi, Jr., *supra* note 7, at 35; *see also* 26 C.F.R. § 20.2056(b)-7(d)(3)(i) (2008); Henkel, *supra* note 31, ¶ 5.05[6][a].

¹³⁶ Streng & Davis, *supra* note 37, ¶ 12.03[7].

¹³⁷ Jerry A. Kasner, Benton C. Strauss & Michael S. Strauss, 2 Post Mortem Tax Plan. (RIA) ¶ 15.10 (3d ed. 1998), available at 1999 WL 1020381; I.R.C. § 2518(b)(3) (2008).

¹³⁸ Streng & Davis, *supra* note 37, ¶ 12.03[7].

On the positive side, a disclaimer approach provides tremendous flexibility in the ability to fund the Credit Shelter Trust with whatever amount the surviving spouse is willing to disclaim. On the negative side, you need a surviving spouse that is willing to make such a disclaimer.¹³⁹ As such, a Partial QTIP Election has several potential advantages over a disclaimer if the goal is to make adjustments to the amount of assets that will ultimately end up in the Credit Shelter Trust.¹⁴⁰

With a Partial QTIP Election, the decedent's executor (not the surviving spouse) has the discretion to make a Partial QTIP election.¹⁴¹ And the Partial QTIP Election does not necessarily need to be made within nine months of the decedent's death, given the ability to obtain a six month extension beyond the nine month deadline after the decedent's date of death to file the estate tax return.¹⁴² Thus, the decedent's executor has extra time, beyond what is available for a disclaimer by the surviving spouse, to determine whether a Partial QTIP Election is warranted in order to adequately fund the Credit Shelter Trust.¹⁴³ If underfunding of the Credit Shelter Trust is a concern—for example, because of concerns that a residue will be smaller in light of a declining economy—it might make sense to include language in the will or Joint Revocable Living Trust giving the fiduciary discretion to make a Partial QTIP Election.

On the other hand, a disclaimer could be better than a Partial QTIP Election as a means of placing appreciating assets in the Credit Shelter Trust and depreciating assets in the Marital Deduction Trust. This is because when an executor makes a Partial QTIP Election, the Regulations require that the "partial election must be made with respect to a fractional or percentage share of the property [available for QTIP treatment] so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property."¹⁴⁴ As such, a Partial QTIP Election cannot shift certain appreciating assets to one trust while shifting other depreciating assets to another trust.¹⁴⁵

Assume the distributing instrument allows the fiduciary to distribute assets in kind, (e.g., pursuant to a pecuniary formula). If, before funding of the QTIP trust, the surviving spouse disclaims a portion of the same, then the fiduciary will presumably have discretion to distribute certain appreciating assets to the Credit Shelter Trust—assuming that the will or Joint Revocable Living Trust has appropriate language directing disclaimed interests to the Credit Shelter Trust.¹⁴⁶

139 See Grassi, Jr., *supra* note 7, at 34.

140 Kasner, Strauss & Strauss, *supra* note 137, ¶ 15.10.

141 I.R.C. § 2056(b)(7)(B)(v) (2008); 26 C.F.R. § 20.2056(b)-7(d)(3)(i) (2004).

142 I.R.C. §§ 6075(a), 6081 (a) (2008); 26 C.F.R. § 20.6081-1(a)-(c) (2004).

143 Kasner, Strauss & Strauss, *supra* note 137, ¶ 15.10.

144 26 C.F.R. § 20.2056(b)-7(b)(2) (2008).

145 Kasner, Strauss & Strauss, *supra* note 137, ¶ 15.10.

146 *Id.*

F. If Possible, Avoid a Section 754 Election when Receiving Partnership Property that has Decreased in Value Below its Inside Basis

Normally, when a partner obtains a partnership interest in a sale or exchange, he takes a cost basis (i.e., an outside basis) in his partnership interest.¹⁴⁷ If that partner dies after the partnership assets have appreciated or depreciated, then, according to Section 743(a), the inside “basis of partnership property shall *not be adjusted* as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner *unless the election provided by Section 754* (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership or unless the partnership has a *substantial built-in loss* immediately after such transfer.”¹⁴⁸ Thus, if a decedent has an interest in a partnership with assets that have appreciated from their inside basis value, and that decedent dies passing that interest to a beneficiary (e.g., like a subtrust), the beneficiary’s inside basis in those assets would remain the same as the decedent’s unless a valid Section 754 election has been made.¹⁴⁹

For example, assume a four-person partnership, consisting of Partners A, B, C, and D, with equal partnership interests (i.e., 25% per partner). The partnership has as its only asset a long-term capital asset worth \$100,000 with an inside basis of \$40,000 (i.e., \$10,000 per partner). Each partner has a partnership interest worth \$25,000 (25% of 100,000) and an inside basis in the asset of \$10,000 (25% of 40,000). If the capital asset is sold for \$100,000, each partner realizes \$15,000 of gain (i.e., \$100,000 – \$40,000 = \$60,000, and 25% of \$60,000 = \$15,000).

On the other hand, what if the partnership did not sell the \$100,000 capital asset and Partner D died, leaving his partnership interest to a beneficiary (“Benie”)? Benie’s outside basis in D’s partnership interest would be \$25,000. Absent a Section 754 election, Benie’s inside basis in the \$100,000 long-term capital asset would remain \$10,000 (i.e., Partner D’s carryover inside basis). If the partnership sold that \$100,000 capital asset the next day, Benie would have to realize the same \$15,000 of gain that will be respectively realized by Partners A, B, and C.¹⁵⁰

If the partnership had properly filed a Section 754 election, Benie’s adjusted inside basis in the \$100,000 capital asset would have been adjusted upward to \$25,000, rather than remain at \$10,000, in order to reflect the difference in value between Benie’s outside proportionate \$25,000 partnership interest share and Partner D’s pre-death \$10,000 inside basis in

¹⁴⁷ I.R.C. § 742 (2007); STEPHEN A. LIND, STEPHEN SCHWARZ, DANIEL J. LATHROPE, & JOSHUA D. ROSENBERG, *FUNDAMENTALS OF BUSINESS ENTERPRISE TAXATION* 260–61 (Foundation Press 3d ed. 2005).

¹⁴⁸ I.R.C. § 743(a) (2008) (emphasis added).

¹⁴⁹ *Id.*

¹⁵⁰ See generally LIND ET AL., *supra* note 147, at 260–68 (discussing Section 743(a) and the Section 754 election).

the capital asset.¹⁵¹ Benie would not realize any gain on that sale. A Section 754 election could also decrease Benie's inside basis in the partnership property if Benie's outside proportionate partner share basis was worth less than Partner D's previous inside basis in partnership property.¹⁵²

In light of the foregoing, when assets are appreciating and a partnership interest passes from a decedent to a beneficiary (including a beneficiary subtrust), a Section 754 election makes sense because it adjusts the beneficiary's inside basis in partnership property upwards and thus minimizes capital gains and/or income to that beneficiary. On the other hand, if assets are depreciating, a Section 754 election becomes less appealing, especially for assets that might have a higher inside basis than their actual fair market value. By not making the Section 754 election when assets depreciate, a subtrust beneficiary to a decedent's partnership interest might be able to reap the benefits of deducting losses on the transfer of partnership property, which has retained the decedent partner's inflated inside basis.¹⁵³

The benefits of avoiding the Section 754 election with depreciating assets can only be realized to the extent the property does not have what Section 743(d) refers to as a "substantial built-in loss."¹⁵⁴ That is, if a partnership's adjusted basis in the property exceeds that property's fair market value immediately after the transfer by greater than \$250,000, then the partnership has a substantial built-in loss with respect to that property.¹⁵⁵ Section 754's basis adjustment is mandatory (not an election) for "substantial built-in loss" property, and it has the effect of decreasing that inflated adjusted basis in the partnership property to the value of the transferee's proportionate partnership interest.¹⁵⁶

To be clear, Section 743's mandatory "substantial built-in loss" basis adjustment rule does not apply to certain electing investment partnerships or securitization partnerships.¹⁵⁷ Specifically, a loss limitation rule applies to electing investment partnerships, under which the "transferee partner's distributive share of losses (without regard to gains) from the sale or exchange of partnership property" is only allowed to the extent that "such losses exceed the loss (if any) recognized by the transferor . . . on the transfer of the partnership interest."¹⁵⁸ For securitization partnerships, no mandatory substantial built in loss rule or loss limitation rule applies.¹⁵⁹

¹⁵¹ See I.R.C. §§ 754, 743(b), 734(b) (2008); see also Don W. Llewellyn, *Estate Planning For the Departing Executive: Conserving the Estate—A Comprehensive Overview—The Impact Of Recent Tax Reform*, 4 J.L. & COM. 277, 302 (1984).

¹⁵² See I.R.C. §§ 754, 743(b), 734(b) (2008); see also Llewellyn, *supra* note 151, at 302.

¹⁵³ See LIND ET AL., *supra* note 147, at 262.

¹⁵⁴ I.R.C. § 743(b), (d) (2008).

¹⁵⁵ *Id.* § 743(d)(1) (2008).

¹⁵⁶ I.R.C. § 743(b)(2) (2008); see also LIND ET AL., *supra* note 147, at 262.

¹⁵⁷ I.R.C. § 743(e)–(f) (2008).

¹⁵⁸ *Id.* § 743(e)(2); 33 AM. JUR. 2D *Federal Taxation* ¶ 2126 (2008).

¹⁵⁹ I.R.C. § 743(f) (2008); 33 AM. JUR. 2D *Federal Taxation* ¶ 2127 (2008).

G. A Transfer of Certain Depreciated Assets Pre-Death May Preserve Loss by Avoiding a Step Down in Basis at Death

Because an estate receives depreciated property from the decedent at its date-of-death fair market value, whatever loss the decedent might have had in that property could go permanently unrecognized in the case of property that receives a step-down in basis.¹⁶⁰ One pre-death strategy to avoid this scenario is to have a spouse (e.g., husband) facing imminent death transfer depreciated property to his spouse (e.g., wife) before death by gift.¹⁶¹ In that case, pursuant to Section 1041(b), the donee spouse takes the property with the same depreciated basis that it had in the hands of the donor “immediately before the transfer,” thus preserving the loss inherent in that depreciated property.¹⁶²

In fact, with such a transfer between spouses, the donee spouse takes the donor’s basis regardless of “whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of the transfer.”¹⁶³ Keep in mind, however, that in a community property state like California, there could be a question of whether the gift received by the donee spouse is separate property or still 50/50 community property.¹⁶⁴ Therefore, the couple should probably do a transmutation agreement to the effect that any remaining community interest of the donor in the gift to the donee spouse shall be considered the donee spouse’s separate property.¹⁶⁵

A donor may also potentially preserve loss in depreciated property by gifting it to a non-spousal donee.¹⁶⁶ Section 1015 makes the basis of such gifts to non-spousal donees the same as in the hands of the “donor or the last preceding owner by whom it was not acquired by gift.”¹⁶⁷ Unlike with gifts between spouses, with gifts between non-spouses, Section 1015(a) instructs that if the basis exceeds the property’s fair market value, “then for the purpose of determining loss the basis shall be [the property’s] fair market value.”¹⁶⁸ Therefore, a gift to a non-spousal donee is only effective in avoiding a step-down in basis (and thus a permanent non-recognition of loss) if the donee holds the property received until its value goes back up and exceeds the donor’s fair market value basis at the time of the gift.¹⁶⁹

¹⁶⁰ Robert A. Coplan, *Opportunities and Risks for Planners During a Recession*, 18 EST. PLAN. 203, 208 (July/Aug. 1991); I.R.C. § 1014(a) (2008).

¹⁶¹ Coplan, *supra* note 160, at 208.

¹⁶² I.R.C. § 1041(b) (2008); 26 C.F.R. § 1.1041-1T, A-11 (2008).

¹⁶³ 26 C.F.R. § 1.1041-1T, A-11 (2008).

¹⁶⁴ In California, property a spouse acquires by gift during marriage is that spouse’s separate property. CAL. CONST. art. I, § 21; CAL. FAM. CODE § 770(a)(2) (West 2004).

¹⁶⁵ See WILLIAM W. BASSETT, CALIFORNIA COMMUNITY PROPERTY LAW § 4:16 (2008); CAL. FAM. CODE § 852 (West 2004) (describing the requirements of transmutation agreements).

¹⁶⁶ Coplan, *supra* note 160, at 208.

¹⁶⁷ I.R.C. § 1015(a) (2008).

¹⁶⁸ *Id.*

¹⁶⁹ Coplan, *supra* note 160, at 208.

Keep in mind that with either of the foregoing gifting scenarios, pursuant to Section 2035, the property could be drawn back into the donor's estate if (1) the donor dies within three years of the gift; *and* (2) the property, if it had not been given away, would have been included in the decedent's estate under Section 2036 (regarding transfers with a retained life estate), Section 2037 (regarding certain reversionary interests retained by the transferor), Section 2038 (regarding certain revocable transfers), and Section 2042 (regarding proceeds of life insurance).¹⁷⁰ Otherwise, because Section 2035 applies only to the aforementioned four statutes, it does not apply to outright gifts that do not implicate the foregoing four statutes made within three years of the decedent's death.¹⁷¹

As an alternative to transferring via gift, selling an asset that is declining in value before death will cut losses on that asset, and at the same time allow the decedent to realize that loss (and recognize loss to the extent that it exceeds capital gains by \$3,000) for income tax purposes.¹⁷² Such a sale (provided it is not fraudulently made merely for the purpose of avoiding taxes) will not risk drawing that property back into the decedent's estate under Section 2035.

H. If Estate Tax Will be Due on the First-To-Die Spouse's Estate, Consider Electing Section 2032's Alternate Valuation Date to Reduce Estate Tax

Any article that focuses on what to do when assets depreciate probably warrants at least a brief discussion of Section 2032's alternate valuation date election. When it is an option, Section 2032's alternate valuation date applies three different rules for valuation of the decedent's estate:

- (1) Property the estate "distributed, sold, exchanged, or otherwise disposed of, within 6 months after the decedent's death" thereafter is valued at its *date of distribution* value.¹⁷³
- (2) Property not otherwise "distributed, sold, exchanged, or otherwise disposed of" within that 6-month period shall be valued as of the alternate valuation date.¹⁷⁴
- (3) Estate interests that change in value between the decedent's death and the alternate valuation date due to the "mere lapse of time" receive their date of death (as opposed to alternate valuation date) values, "with adjustment for any difference" in those values "as of the later date *not due to mere lapse of time*."¹⁷⁵

¹⁷⁰ I.R.C. §§ 2035, 2036, 2037, 2038, 2042 (2008).

¹⁷¹ *Id.* § 2035(a)(2).

¹⁷² *See generally id.* §§ 1211, 1212, 1221, 1222.

¹⁷³ *Id.* § 2032(a)(1).

¹⁷⁴ *Id.* § 2032(a)(2) (setting the alternate valuation date at six months after the decedent's death).

¹⁷⁵ *Id.* § 2032(a)(3) (emphasis added); 26 C.F.R. § 20.2032-1(a)(3) (2004). Such "mere lapse of time" property includes assets like life estates, remainders, and patents that naturally decrease in value solely because of the passage of time. 26 C.F.R. § 20.2032-1(f) (2004). In essence, the Code retains those properties' date of death valuations and only allows alternate valuation for decreases in their value unrelated to the mere passage of six months. *Id.*

Section 2032(c) only allows the alternate valuation date election if such election will decrease *both* (1) the value of the decedent's gross estate and (2) the "sum of the tax imposed . . . with respect to property includible in the decedent's gross estate."¹⁷⁶ The goal of most A, B, C Subtrust Plans is to reduce any estate tax to zero on the first spouse's death.¹⁷⁷ Hence, the alternate valuation date is not generally be an option on the first death.¹⁷⁸

If, however, Section 2032 is an option, it provides some excellent planning opportunities in a declining market beyond the obvious effects of reducing the value of the gross estate and the amount of the estate tax.¹⁷⁹ In particular, since property "distributed, sold, exchanged, or otherwise disposed of" within six months of the decedent's death is valued at its *date of distribution* value, a fiduciary should consider selling property before the six month alternate valuation date in those cases where it is desirable to ensure that certain property ends up in certain beneficiaries' hands.¹⁸⁰

Such a sale before the six-month deadline will cut the estate's losses on property expected to continue declining in value. The sale will not, however, reduce estate tax on that depreciating property, which would presumably be worth less if it continued to decline in value up to the six month alternate valuation date. For property that is expected to continue declining in value even after it passes to a Marital Deduction Trust, such a sale before the six-month alternative valuation date in the first spouse's estate avoids the even greater step-down in basis that is likely to occur on the death of the surviving spouse.¹⁸¹

Finally, a sale of certain items of property after the date of death but before the elected alternate valuation date may also make sense in those situations where it is expected that property will decline in value during the six month period but then begin to appreciate again before the actual *six months after death* alternate valuation date. For example, if a fiduciary strongly felt that property would be at its lowest value as of three months after the date of death, then distributing that property at its lowest value date will have the ultimate effect of reducing the amount of estate tax due after the alternate valuation date election.

¹⁷⁶ I.R.C. § 2032(c) (2008). Regulation 20.2032-1(b)(1) further explains that the "election may be made only if it will decrease both the value of the gross estate and the sum (reduced by allowable credits) of the estate tax and the generation-skipping transfer tax payable by reason of the decedent's death with respect to the property includible in the decedent's gross estate." 26 C.F.R. § 20.2032-1(b)(1) (2008).

¹⁷⁷ BITTKER, CLARK, & MCCOUCH, *supra* note 5, at 551.

¹⁷⁸ Sandra Price, *Estate Tax Returns*, in FUNDAMENTALS OF POSTMORTEM TRUST ADMINISTRATION PROGRAM HANDBOOK 253, § 12.21, at 307 (CEB Apr./May 2004).

¹⁷⁹ See I.R.C. § 2032(c) (2008). When the alternate valuation date is an option, the decedent's estate tax return reflecting that election must include itemized (1) descriptions of all property in the decedent's gross estate at the time of death, (2) disclosures of all "distributions, sales, exchanges, and other dispositions" that occurred within six months of the decedent's death, and (3) valuations of all such items of property. 26 C.F.R. § 20.6018-3(e)(6) (2008).

¹⁸⁰ I.R.C. § 2032(a)(1) (2008).

¹⁸¹ See *id.* § 1014 (a).

I. If Enacted, the Portable Applicable Exclusion Could Avoid the Effects of Depreciation

In June 2006, the House of Representatives approved House Resolution 5638, known as the Permanent Estate Tax Relief Act of 2006, by a relatively substantial 269-156 vote.¹⁸² HR 5638 sought to (1) substantially increase the applicable exclusion amount to \$5,000,000, and (2) render the applicable exclusion amount portable by adding to the surviving spouse's applicable exclusion amount the "aggregate deceased spousal unused exclusion amount."¹⁸³ HR 5638 would require the first-to-die spouse's executor to make an irrevocable election that would allow the "unused exclusion amount" to be later used by the surviving spouse.¹⁸⁴

Within weeks of its House passage, the Senate received HR 5638 and read it into Senate proceedings twice and then placed it on the Senate's legislative calendar.¹⁸⁵ Nonetheless, the Senate never took any further action regarding HR 5638 after the resolution was placed on its legislative calendar.¹⁸⁶ Essentially, at this stage, HR 5638 appears to be legislatively dead.

A portable exclusion amount would allow a surviving spouse to avoid the problem associated with having a first-to-die spouse fund a Credit Shelter Trust with assets destined to further decline in value before the surviving spouse's death. Think about it: If the first-to-die spouse had \$2,000,000 worth of depreciating assets that funded a Credit Shelter Trust and were worth only \$1,000,000 by the time the surviving spouse died, then the Credit Shelter trust proved to be an inferior choice to a portable exclusion amount. In that example, if the first-to-die had not funded a Credit Shelter Trust at all, but instead had elected (via his executor) to give the surviving spouse the portable exclusion, then at the surviving spouse's death, the full \$2,000,000 of the first-to-die's unused applicable exclusion amount would still be available to shield assets from estate tax. Instead, because the assets depreciated to \$1,000,000 in the Credit Shelter Trust of the first-to-die, essentially \$1,000,000 of value that could have been protected from estate tax evaporated between the first and second death.

On the other hand, the problem with the portable exclusion is that it does not increase in value between the first and second death, thus preventing the estate-tax-free appreciation that can occur in a Credit Shelter Trust. In the foregoing example, if the \$2,000,000 of assets in the Credit Shelter Trust would have increased to \$3,000,000 by the death of the surviving

¹⁸² Permanent Estate Tax Relief Act of 2006, H.R. 5638, 109th Cong. §§ 2(b), 3(a) (2006), *available at* <http://www.govtrack.us/congress/billtext.xpd?bill=h109-5638> (last visited Aug. 24, 2008) [hereinafter H.R. 5638]. For a summary of all actions related to H.R. 5638, including votes, see the Thomas Library of Congress website, <http://thomas.loc.gov/cgi-bin/bdquery/z?d109:HR05638:@@X> (last visited Aug. 24, 2008) [hereinafter *Summary Regarding HR 5638*].

¹⁸³ H.R. 5638, *supra* note 182, at § 3(a).

¹⁸⁴ *Id.*

¹⁸⁵ *Summary Regarding HR 5638*, *supra* note 182.

¹⁸⁶ *Id.*

spouse, \$1,000,000 in extra value would have escaped estate tax. If the decedent's executor had foregone the Credit Shelter Trust in favor of the portable exclusion amount, only \$2,000,000 in value would be available to the surviving spouse as a portable exclusion amount at her death. The extra \$1,000,000 in appreciation would not have escaped estate taxation.

CONCLUSION

No one particular solution or strategy is a universal panacea for dealing with subtrust funding and administration in a declining market. There are, however, many approaches and strategies that can help make the best of the difficult scenarios presented by a declining economy. In terms of the big picture, the following major points discussed above bear repeating:

1. When a pecuniary bequest of assets in kind distributed at date of distribution values could fund the Credit Shelter Trust with depreciating assets, postpone funding.
2. When a pecuniary bequest of assets in kind could fund the Marital Deduction Trust with depreciating assets, consider funding promptly.
3. Although a fractional share formula may not have seemed that desirable when the economy was good, now that it is declining, the fractional share formula may be less unattractive and possibly even desirable.
4. A Section 643(e) election provides a means to recognize loss on certain types of distributions to subtrusts (e.g., pursuant to fractional share or fairly representative formulas), which would not have normally allowed for loss recognition.
5. In some circumstances, such as when depreciating assets could result in underfunding of the Credit Shelter Trust, disclaimers or Partial QTIP Elections may be desirable to fix what went wrong in funding.
6. If possible, avoid a Section 754 election when receiving partnership property that has decreased in value below its inside basis.
7. Pre-death transfers of assets may be a way to avoid a step-down in basis of certain assets and, thus, preserve the loss in those assets.
8. In limited circumstances, the Section 2032 alternate valuation date election may be a way to save on estate taxes.

Good luck, and, hopefully, the economy will soon be on the road to recovery, so that you will rarely need to consider any of the foregoing strategies.