Florida Law Review

Volume 39 | Issue 5 Article 5

December 1987

Unifying the Unified Court

Robert B. Smith

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Robert B. Smith, *Unifying the Unified Court*, 39 Fla. L. Rev. 1153 (1987).
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UNIFYING THE UNIFIED CREDIT

*Robert B. Smith**

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The author wishes to express his appreciation to University of Florida Professor Michael J. Oberst for his contributions to this article.

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I. INTRODUCTION

The basic tools of testamentary estate tax planning for a married individual are the unified credit against federal estate and gift tax and the unlimited estate tax marital deduction.[1] The unlimited marital deduction shelters from federal estate tax all property the first dece-

1. *See* Mair, *Proper Utilization of the Unlimited Marital Deduction — Theory and Practice*, 41st NYU ANNUAL INST. ON FED. TAX'N 48-1, 48-29 (1983); Doussard, *Estate Planning After the Economic Recovery Tax Act of 1981*, 60 TAXES 22, 25 (1982); Llewellyn, *Estate Planning for the Married Couple*, 28 VILL. L. REV. 491, 498 (1983).

dent of a married couple leaves to the surviving spouse.[2] The unified credit shelters up to $600,000 worth of property from federal estate tax.[3]

An individual may use either tool to pass property free of federal estate tax. However, the credit provides one significant benefit not allowed by the marital deduction. Any amount left to the surviving spouse that qualifies for the marital deduction is included in the surviving spouse's gross estate for federal estate tax purposes to the extent not consumed or given away by the survivor.[4] Thus, the marital deduction only defers estate tax until the surviving spouse's death; it does not eliminate it.[5] On the other hand, property sheltered by the unified credit from estate tax at the death of the first spouse can escape inclusion in *both* spouses' estates under a proper estate plan.[6] The credit can therefore prevent some limited amount of property from incurring *any* federal estate tax at the spouses' generational level.

Under existing law, many married persons who can benefit from using the unified credit must establish a trust to hold property that can be sheltered from tax by the credit, even if the spouse would prefer to leave all property to the survivor outright.[7] Such trusts are, however, frequently complex and expensive.

This article proposes amending the law to pass a decedent's unused credit to a surviving spouse, thus eliminating for many taxpayers the necessity of using a trust to obtain the benefit of the credit. Various policy and practical considerations are also discussed.

II. BACKGROUND

A. *Federal Transfer Taxes and the Unified Credit*

Under current federal tax provisions, an individual who makes lifetime gifts in excess of an annually renewable $10,000 per donee

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2. I.R.C. § 2056(a). Unless otherwise stated all Code references are to the Internal Revenue Code of 1986, as set forth in the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), as amended by the Revenue Act of 1987, Pub. L. No. 100-203, ___ Stat. ___ (1987) (the 1987 Act).

3. I.R.C. §§ 2010(a), 2001(c)(1). The credit is $192,800 under § 2010(a). Under the estate tax rate table in § 2001(c)(1) the tax on $600,000 would be $192,800. Thus, the credit eliminates tax on $600,000.

4. I.R.C. §§ 2056, 2031, 2041, 2044. *See* Phillips, *Planning for the Use of the Unified Credit*, 41st NYU ANNUAL INST. ON FED. TAX'N 47-1, 47-13 (1983).

5. *E.g.*, Garlock, *Estate Tax Unlimited Marital Deduction Has Limited Advantage in Larger Estates*, 56 J. TAX'N 236 (1982); Mair, *supra* note 1, at 215; Phillips, *supra* note 4, at 47-13.

6. *E.g.*, Phillips, *supra* note 4, at 47-13.

7. *Id.*

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exclusion is generally subject to federal gift tax.[8] However, the donor's transfers to a spouse or charitable organization are usually deductible in determining the amount of gifts subject to federal gift tax in any given year.[9] The remaining amount (federal taxable gifts) is the base amount used to determine the gift tax due on the donor's gifts made during the year.[10] To determine the rate applicable to the current year's federal taxable gifts, taxable gifts made in prior years are added to the figure for the current year. The gift tax that would be paid on prior gifts if made in the current year is treated as a credit against any gift tax due on the total.[11]

Transfers at death are generally subject to federal estate tax.[12] An individual's "gross estate" for federal estate tax purposes is composed of all property the decedent owns, plus property not owned under common law ownership concepts, but property that Congress deems the decedent to control sufficiently to be treated as if owned for tax purposes.[13] Property the decedent passes to a spouse or charity is generally deducted to determine the amount subject to federal estate tax, as are certain expenses of administering the estate.[14] The remainder after all deductions (federal taxable estate) is the base amount upon which federal estate tax is calculated.[15] The decedent's taxable gifts made after 1976 are added to the base to determine the applicable estate tax rate.[16] The amount of tax that would be paid on such gifts if they were made on the date of death is treated as a credit against the tax calculated on the total.[17]

B. *Unification in 1976*

Prior to 1977, the tax rates applied to federal taxable gifts were lower than those applied to the federal taxable estate, and prior taxable gifts were not aggregated with the decedent's taxable estate to determine the applicable estate tax rate.[18] Since gift tax rates were lower

8. I.R.C. §§ 2501(a)(1), 2502, 2503(a)-(b).
9. *Id.* §§ 2522-2523.
10. *Id.* §§ 2503(a), 2502(a)(1).
11. *Id.* § 2502(a).
12. *Id.* § 2001(a).
13. *Id.* §§ 2031, 2033, 2035-2038, 2041, 2042, 2044.
14. *Id.* §§ 2056, 2055, 2054.
15. *Id.* § 2001(b)(1)(A).
16. *Id.* § 2001(b)(1)(B).
17. *Id.* § 2001(b)(2).
18. Regarding the rate difference, see I.R.C. §§ 2001, 2502(a) (1976) (gift tax rates were separate and were only 75% of the estate tax rates applicable to transfers of the same size). With respect to the aggregation of taxable gifts with the taxable estate, *compare* I.R.C. § 2001

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than estate tax rates, those wealthy enough to make substantial lifetime gifts had an advantage: they could transfer property by gift and pay transfer tax at the lower gift tax rates.[19] Further, even if the rates for gifts and estates were made identical, the wealthy would still have the advantage of using two sets of transfer tax brackets by making lifetime gifts and testamentary transfers.[20] Congress concluded in 1976 that these advantages of the wealthy were unfair to other taxpayers.[21] To eliminate these advantages, the Tax Reform Act of 1976 (the 1976 Act) "unified" the federal gift and estate tax rates by making the rate schedules identical, and directed that lifetime taxable gifts (made after 1976) be aggregated with testamentary transfers solely to determine the tax rate applicable to the decedent's gross estate.[22]

Before 1977, an exemption from gift tax for aggregate lifetime transfers of $30,000 was provided, and $60,000 of property was exempted from estate tax.[23] In 1976, Congress determined that these exemptions were too small.[24] However, it also concluded that enlarging the exemptions would favor the wealthy,[25] because an exemption is subtracted from the amount to be taxed and reduces the amount of value taxed at the highest rates applicable to that estate. Thus, an exemption provides a greater benefit to those incurring tax at higher rates than to those incurring tax at lower rates.[26] To avoid these problems with increased exemption levels, Congress adopted the unified credit against federal gift and estate tax.[27]

(1976) *with* I.R.C. § 2001(b) (1977 & 1986); H.R. REP. No. 94-1380, 94th Cong., 2d Sess. (1976) 10-13 [hereinafter H.R. REP. No. 94-1380], 1976-3 C.B. 744-47. Although H.R. REP. No. 94-1380 was the report of the House Ways and Means Committee on H.R. 14844, a bill regarding the revision of estate and gift tax laws that was not directly a portion of the 1976 Tax Reform Act, the portions of H.R. 14844 dealing with unification of rates and aggregation of gift and testamentary transfers were generally adopted in the 1976 Tax Reform Act. S. REP. No. 94-1236, 94th Cong., 2d Sess. 252 & app. A at 608 (1976), 1976-3 C.B. 808, 929, 958 [hereinafter Conference Report].

19. H.R. REP. No. 94-1380, *supra* note 18, at 11.

20. *Id.*

21. *Id.*

22. *Id.* at 12-13. The 1976 Act is officially known as the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525 (1976).

23. I.R.C. §§ 2521, 2052 (1976).

24. H.R. REP. No. 94-1380, *supra* note 18, at 15-17; Conference Report, *supra* note 18, Appendix A at 607-08.

25. H.R. REP. No. 94-1380, *supra* note 18, at 15.

26. *Id.*

27. *Id.*; *see also* S. REP. No. 94-938, pt. 2, 94th Cong., 2d Sess. 13 [hereinafter S. REP. No. 94-938], 1976-3 C.B. 655.

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C. *History of the Unified Credit*

Until consumed, the credit reduces dollar-for-dollar the amount of gift tax due on any taxable lifetime gifts of an individual. Any credit not consumed by lifetime transfers applies to reduce or eliminate estate tax due on the individual's taxable estate.[28] The credit is neither renewable[29] nor transferable.[30] If an individual makes no lifetime gifts and at death has no taxable estate, perhaps because all the property qualifies for the marital deduction or the charitable deduction, that individual's spouse cannot use the decedent's credit.

The 1976 Act initially set the credit at $30,000, which sheltered approximately $120,600 of property from tax, and provided for annual increases through 1981 to $47,000, sheltering $175,625 from tax.[31] The Economic Recovery Tax Act of 1981 (the 1981 Act) increased the credit through annual increments to $192,800 in 1987, sheltering $600,000 from tax.[32] Neither the Tax Reform Act of 1986 nor the Revenue Act of 1987 changed the credit.[33]

The following example illustrates the basic application of the unified credit. Assume a widower has two adult children, makes gifts worth $60,000 to each child in 1987, and dies in 1988, leaving $500,000 in trust for the children and having made no other gifts during his lifetime.

Of each $60,000 gift, $10,000 would qualify for the $10,000 annual exclusion.[34] The remaining $50,000 would be subject to federal gift tax. The tentative tax due under the applicable tax tables on a $100,000 taxable gift is $23,800.[35] However, in 1987, the taxpayer has available a unified credit of $192,800,[36] which would be applied against the $23,800 tax due, eliminating it entirely.

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28. I.R.C. §§ 2505(a), (d), 2010(a), 2001(a).

29. *Id.* §§ 2505(a), (d), 2010(a).

30. *Id.*

31. Conference Report, *supra* note 18, at 607-08.

32. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 401, 95 Stat. 299 (1981).

33. Section 10401 of the 1987 Act amended I.R.C. § 2001(c) to impose an additional 5% gift or estate tax on taxable transfers exceeding $10,000,000 and less than $21,040,000 ($18,340,000 for transfers after 1992). This change recaptures the benefit of the unified credit and the lower estate and gift tax brackets when taxable transfers fall within the designated range. Under this structure, the credit is still available to all persons, and is still extremely beneficial to those whose taxable transfers will be below $10,000,000, and can be of some limited benefit to those making taxable transfers in excess of that amount. Accordingly, the basic discussion of the unified credit in this article remains valid, but is of substantially less significance to those making taxable transfers in excess of $10,000,000 than was the case before the 1987 Act.

34. I.R.C. § 2503(b).

35. *Id.* §§ 2502(a) & 2001(c)(1).

36. *Id.* § 2010(b).

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Upon his death in 1988, the taxpayer would have a total gross estate of $500,000 and, assuming for simplicity's sake that his estate had no deductions, a taxable estate of $500,000, the amount placed in trust for the two adult children. To determine the tax due on the $500,000, the statutory system requires that the $100,000 of taxable gifts made in 1987 be added to the $500,000, and that the tax determined on the resultant sum be reduced by (i) the amount of federal gift tax that would be *payable* on the $100,000 if it were transferred as a gift at the time of death, and (ii) a credit of $192,800.[37] Thus, in this example the tax would be calculated on a $600,000 base ($100,000 lifetime taxable gifts plus $500,000 taxable estate). The tax due on the $600,000 base would be $192,800.[38] The taxpayer would have no tax payable on the gift of $100,000, because the $23,800 tax would be reduced to zero by the credit applied to gift tax. A tax of $192,800 would be due and reduced to zero by the credit of $192,800.[39]

III. How the Unified Credit Shapes Current Estate Planning

A. *The Credit as a Planning Tool*

1. The Unlimited Marital Deduction

In current estate planning, the marital deduction and the unified credit generally can be used most effectively in unison once an estate

37. The addition of the $100,000 taxable gift to the $500,000 taxable estate is mandated, *id.* § 2001(b)(1)(B). The determination of tax due on the sum of the $100,000 taxable gift and $500,000 taxable estate is directed by § 2001(b)(1). The reduction of the estate tax determined on the $600,000 by the gift tax that would be payable under the gift tax provisions on the $100,000, as if it were transferred as a gift on the date of death, is required by § 2001(b)(2). The amount of gift tax payable is the amount due after application of the unified credit under § 2505(a). Thus, only the out-of-pocket gift tax that would be paid on the $100,000 gift reduces the estate tax due on the aggregate $600,000 amount. The remaining estate tax due on the $600,000 is then reduced by the credit of $192,800 as required by § 2010(a). This does not give the taxpayer a double benefit from the unified credit. The application of the credit against the gift tax due on the $100,000 gift makes the amount of gift tax subtracted from the estate tax due on the $600,000 aggregate amount smaller than it would otherwise be. (For instance, in the text example, the gift tax due on the $100,000 gift would be $23,800 before application of the credit. However, because the credit applies to it first, no amount of gift tax is credited against the estate tax due.) If the entire credit of $192,800 were not again available to reduce estate tax, the taxpayer would have gotten the use of only a part of $192,800 at death, rather than the full credit. The statutes thus add the taxable gifts made back to the estate only to determine what transfer tax rate ought to apply to the property passing at death. The statutes restore the credit against estate tax to its full $192,800 level so that the lifetime gift is not taxed again.

38. *Id.* § 2001(c)(1).

39. *Id.* § 2010(a).

reaches a certain size.[40] To understand the role of the credit in this type of planning, the workings of the unlimited marital deduction must be briefly described.

The marital deduction shelters from federal estate tax any amount left by an individual to a surviving spouse in a manner that satisfies statutory requirements.[41] If all property is left to the survivor, no estate tax will be due on the estate of the first to die. Any amount that qualifies for the marital deduction in the estate of the first to die, however, is includible in the survivor's gross estate, unless consumed or given away during the survivor's life.[42]

To illustrate, suppose a husband and wife each own property worth $600,000. At death the husband leaves his $600,000 to his wife outright. The entire $600,000 will qualify for the marital deduction, and will be deducted from the decedent's gross estate. If no other property is includible in his gross estate, then his taxable estate for federal estate tax purposes will be zero, and no tax will be due. However, the gross estate of the wife will then be $1,200,000, as it will include her own $600,000 and her deceased husband's $600,000. Thus, the husband's use of the marital deduction to shelter his $600,000 of property from federal estate tax merely defers the tax on that property until his wife dies.

2. Use of the Unified Credit

If, rather than using only the unlimited marital deduction, the first spouse to die shelters a portion of the estate from tax by using the unified credit, and leaves that portion in a manner that prevents its inclusion in the surviving spouse's gross estate, that portion can escape tax in both spouses' estates.[43] If the husband in the preceding example leaves all his property to his wife, then her estate will be worth $1,200,000. If the wife has a full unified credit available to her, tax due on her death will be $235,000: tax of $427,800 less her credit of $192,800. Alternatively, if the husband uses his credit to shelter his $600,000 from estate tax and passes it in a manner that excludes it from the wife's estate, then at the wife's death the husband's $600,000 is not in the wife's estate. The wife's credit entirely shelters her own $600,000 from tax. Thus, the total $1,200,000 passes free of estate

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40. Llewellyn, *supra* note 1, at 498-99; Phillips, *supra* note 4, at 47-13 & 47-14.
41. I.R.C. § 2056.
42. *See supra* note 4.
43. Phillips, *supra* note 4, at 47-13.

tax. Good tax planning therefore demands that if the combined property of both spouses has a total value in excess of $600,000, some use of the credit of the first to die should be made.

The same tax savings can be obtained where $1,200,000 of property is owned by one spouse, where either that spouse dies first or that spouse splits the estate by making a $600,000 lifetime gift to the other spouse.[44] Significant tax savings can still be achieved if the first to die has less than $600,000, but owns some substantial amount of property, and the survivor has a separate estate that, when added to the property of the first to die, totals more than $600,000.[45]

B. *Methods of Using the Unified Credit*

The methods of using the unified credit can vary greatly, depending on the inclinations and financial circumstances of the taxpayer. However, many taxpayers cannot avoid use of a trust in making effective use of the credit.

1. Lifetime Gifts

An individual can make a lifetime gift of property that uses some or all of the donor's credit and excludes the transferred property from the estate of the donor's spouse. For example, a husband could give up to $600,000 of property to his children outright during his life. The gift would incur no out of pocket gift tax but would consume the husband's entire credit, assuming he had already used his annual exclusions with respect to his children in that year and had made no prior taxable gifts. The gift property would not be includible in his spouse's gross estate. Thus, no matter what the spouses' order of death might

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44. If the first to die has $1,200,000, that spouse can shelter $600,000 from estate tax using the unified credit, and shelter the other $600,000 from tax by leaving it to the surviving spouse in a manner qualifying for the marital deduction. On death, the survivor's credit will shelter that $600,000 from tax. However, because which spouse will die first is never certain, use of the credit of the one that dies first can be assured only if each spouse has the $600,000 necessary to use the credit. If one spouse has all the property, the spouse *can* give the other $600,000 during life. Then if the donee dies first, the donee can utilize the credit to shelter the $600,000 gift from estate tax. The lifetime gift will incur no transfer tax because of the unlimited marital gift tax deduction under I.R.C. § 2523.

45. Suppose the husband dies first with $400,000 of property and the surviving wife owns $600,000 of her own. If the husband leaves all $400,000 to his wife outright, the tax on the aggregate $1,000,000 on the wife's death will be $345,800, minus the wife's credit of $192,800, resulting in a tax of $153,000. If the husband uses his credit, the combined tax on the two estates will be zero. His credit will eliminate the $121,800 tax otherwise due on his $400,000, and the wife's credit will eliminate the tax on her $600,000, producing a comparative savings of $153,000.

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be, that $600,000 of property will escape estate tax in both estates. This use of the credit allows any post-gift appreciation of the gift property to escape federal transfer tax and shifts the income on the property out of the estates of both spouses. However, for couples who own in the aggregate enough property to be concerned about using the credit of the first to die, which is any amount over $600,000, but who cannot afford to make such a gift, this use is unrealistic. Even for those who can afford such a gift, it may be unattractive for a variety of reasons, such as, immaturity of the children.

2. Bequests Excluding the Surviving Spouse

Each spouse's will could be written to provide that if that spouse predeceases the other, $600,000 of the decedent's property would pass outright to persons other than the surviving spouse, such as the couple's children. The property would not be includible in the survivor's estate and would thus completely escape federal transfer tax. However, this method is not feasible for many couples because the support needs of the survivor dictate that some or all of the benefit of the $600,000 sheltered from tax by the unified credit be available to the survivor.

3. Testamentary Credit Shelter Trust

Each spouse with sufficient property to make use of the credit can adopt a will which creates a "credit shelter trust" if that spouse dies first. Such a trust may benefit the surviving spouse through income or principal distributions and may benefit the couple's children, or others, such as grandchildren or ancestors. The trust terms include the property that passes to the trust in the estate of the spouse whose will creates it, and the credit protects that property from tax in that spouse's estate. The property is not includible in the survivor's gross estate, and the remainder passes to the couple's children or other beneficiaries as designated in the trust.

This approach allows the surviving spouse to benefit from the property sheltered from tax by the credit of the first to die. The credit shelter trust is the most effective method under current law of using the unified credit of the first to die for couples who cannot afford to use the credit in another manner.

4. Partial QTIP Election

It is possible to establish for the surviving spouse's benefit a trust that qualifies for the marital deduction only to the extent the executor

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elects so to qualify it on the decedent's estate tax return.[46] Such a trust provides another opportunity to achieve the same basic result as the credit shelter trust.

The first to die accomplishes this by leaving the entire estate to a trust of this type, which is generally referred to as a "QTIP" trust.[47] The executor elects to qualify for the marital deduction only that portion of the QTIP trust *in excess* of the amount that can be sheltered from tax by the decedent's unified credit. Thus, the unelected portion of the QTIP trust uses the decedent's credit.

Some marital deduction provisions limit the terms that the elected *and* unelected portion of the QTIP trust can have. For instance, all income of both portions of the trust must be paid annually to the surviving spouse, and no corpus distributions can be made from either portion to one other than the surviving spouse during the spouse's lifetime.[48] Thus, compared to a credit shelter trust, the partial QTIP election requires giving up significant flexibility regarding distributions to others, and fixes the timing of and necessity of income distributions to the surviving spouse from the property sheltered by the credit.

IV. Complexity Arising From the Use of Such Trust Arrangements

Complexities arise when either a credit shelter trust or partial QTIP election is employed to maximize the use of a first dying spouse's unified credit.

A. *Ignorance*

The testator, surviving spouse, and other affected family members are often completely unfamiliar with the concept of a trust and the

46. I.R.C. § 2056(b)(7).

47. The acronym "QTIP" comes from the term "qualifying terminable interest property" used in § 2056(b)(7). That term is defined to mean property passing from the decedent, in which the decedent's surviving spouse has a "qualifying income interest" for life, and which the decedent's executor has elected to treat as deductible on the estate tax return. A qualifying income interest exists when the surviving spouse is entitled to all the income from the property, payable at least annually, and no person has any power to appoint any of the property to any person other than the surviving spouse during the survivor's life. Nothing in § 2056(b)(7) requires that the survivor be given *any* control over the ultimate disposition of the principal held by the QTIP trust, although the principal is included in the survivor's estate pursuant to § 2044.

48. The Treasury Department's position is that any portion of the trust property not subjected to the executor's election must continue to meet the QTIP requirements. Prop. Treas. Reg. § 20.2056(b)-7(c), Ex. 7 has flush language stating "an income interest (or life estate) that is contingent upon the executor's election . . . is not a qualifying income interest for life."

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legal relationships and duties that arise from its creation. The family advisor may explain complexities that arise from: (i) the separation of the beneficial interest in property from the legal ownership; (ii) the possible division of the beneficial interest into several aspects, giving different persons different interests in various aspects of the beneficial interest in the property; and (iii) the tax issues that a trust can generate. Such extensive advice may, however, be beyond the advisor's expertise or the client's budget. A client's age, health, and education may also limit the utility of the advice.

B. *Trustee Selection Issues*

For a host of reasons, the testator may desire to give the surviving spouse substantial control over management of the credit shelter trust property, or none at all. The degree of control granted to the surviving spouse may create several tax and non-tax problems.

1. Surviving Spouse Named as Sole Trustee

For a credit shelter trust or an unelected QTIP portion to achieve its purpose, the property in it must *not* be included in the survivor's gross estate. When the survivor is named as sole trustee, inclusion in the survivor's gross estate can be prevented only if the survivor's rights as trustee are not a "general power of appointment" for tax purposes.

A general power of appointment is a power to use the trust principal for the power holder's own benefit. Property subject to such a power is included in the power holder's gross estate, as if the power holder owned it.[49] Generally, if a person serves as sole trustee and has the power to encroach on trust corpus for personal or creditor benefit, a general power of appointment exists unless: (i) the power to distribute trust corpus for self benefit is subject to a standard that relates to the trustee's health, maintenance, and support (an "ascertainable standard"); or (ii) the encroachment authority is limited to withdrawing the larger of $5,000 or five percent of the trust principal annually (a "5 and 5" withdrawal right).[50] If the sole trustee has no power to encroach on corpus for personal or creditor benefit, a general power of appointment will not exist.[51]

Each protective limitation produces its own problems when applied to a surviving spouse. Using ascertainable standards often leads to

49. I.R.C. § 2041.
50. *Id.* § 2041(b)(1)(A), (b)(2).
51. *Id.* § 2041(b)(1).

controversy with the Internal Revenue Service (the Service) over whether the standard is ascertainable by reference to the survivor's health, maintenance, and support, as it must be to affect the tax consequences.[52] A "5 and 5" withdrawal right may overly restrict the survivor's access to the trust corpus. Completely eliminating the survivor's access to trust corpus may be inconsistent with the surviving spouse's support needs.

2. Surviving Spouse Named as Equal Co-Trustee

The surviving spouse's right to encroach on trust corpus is not a general power of appointment if another person who has an interest in the trust property "adverse" to the survivor's interest serves as co-trustee with the survivor.[53] The co-trustees have adverse interests if each has a beneficial interest in the trust corpus, a distribution to one necessarily reduces the benefit available to the other, and the survivor of the two will have all of the rights over the trust property that the trust terms provide the trustee.[54]

However, co-trustees are not adverse when each co-trustee will be replaced upon ceasing to serve.[55] Further, the adverse co-trustee

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52. *See* Treas. Reg. § 20.2041-1(c)(2). *See, e.g.*, Strite v. McGinnes, 330 F.2d 234 (3d Cir.), *cert. denied*, 379 U.S. 836 (1964). The trustee had a power to encroach on trust corpus for her own benefit for "reasonable needs," "proper expenses," and "benefit or comfort," under Pennsylvania law, which restricted the exercise of powers of appointment to exercise in good faith. *Id.* at 235 n.1. The power was held to be a general power not limited by an ascertainable standard relating to health, maintenance, and support. *Id.* at 240. *See also* Estate of Sowell v. Commissioner, 708 F.2d 1564 (10th Cir. 1983), *reversing* 74 T.C. 1001. The trustee had a power to encroach on trust corpus for her own benefit "in case of emergency or illness." *Id.* at 1565. The governing language was held to be an ascertainable standard related to health, maintenance, and support, and therefore not a general power of appointment. *Id.* at 1568. The Tax Court had instead read the term "emergency" expansively to include emergencies not related to health, maintenance, support. *Id.* The Court in Brantingham v. United States, 631 F.2d 542 (7th Cir. 1980) held that a widow's power to encroach for "maintenance, comfort and happiness" was limited by an ascertainable standard within the meaning of § 2041(b)(1)(A) under applicable Massachusetts law. *Id.* at 547. In Peoples Trust Co. v. United States, 412 F.2d 1156 (3d Cir. 1969), a widow was granted the power to demand "such amounts out of the principal as . . . [she] from time to time may require; she to be the sole judge as to the amounts and frequency of such principal payments. *Id.* at 1158. Taxpayers argued that under applicable New Jersey state law "require" should be read to mean "needs," and that "needs" under New Jersey law was limited to needs for health, maintenance, and support. *Id.* at 1160. This argument was rejected and the power was found to be a general power of appointment. *Id.*

53. I.R.C. § 2041(b)(1)(C)(ii).

54. Treas. Reg. § 20.2041-3(c)(2) &(3); Rev. Rul. 79-63, 1979-1 C.B. 302; Rev. Rul. 76-503, 1976-2 C.B. 275.

55. It is often desirable for purposes of certainty and continuity, or where competing interests provide checks and balances on one another, to provide that when any co-trustee ceases to serve, another person shall be appointed. Rev. Rul. 76-503, 1976-2 C.B. 275, relying

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might predecease the surviving spouse, thus eliminating the adversity, causing the trust property to be includible in the survivor's estate and undermining the usefulness of the trust.[56] Tensions may also arise between adverse co-trustees over the appropriate exercise of the power to distribute corpus. As a person with an interest "adverse" to the surviving spouse will usually be a family member, such tensions can be particularly unpleasant.

3. Surviving Spouse Denied a Voice in Principal Distributions

A surviving spouse can be prevented from having a general power of appointment, and yet allowed to have a voice in investment policy and other trust decisions. This occurs if the survivor is named as one of two or more co-trustees and is prohibited from having any voice in principal distribution decisions, leaving all such decisions to the other co-trustee(s).[57]

However, if the only co-trustee is also a trust beneficiary who can benefit currently from the trust property, the other co-trustee may have a general power of appointment over the trust property. In that case, if the co-trustee predeceases the surviving spouse, the trust property may be unnecessarily included in the co-trustee's estate for estate tax purposes. A similar problem may arise with more than two co-trustees. If this issue is avoided by restricting the access of the other co-trustees to corpus, controversy may still arise over the appropriate exercise of the corpus distribution authority in favor of the surviving spouse.

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on Treas. Reg. 20.2041-3(c)(2)-(3), states that when the original co-trustees have adverse economic interests, but will not succeed to the voice of any other original co-trustee who ceases serving because the one ceasing will be replaced, then the original co-trustees are not adverse and do have general powers of appointment under § 2041.

56. For instance, suppose a decedent's will establishes a credit shelter trust that authorizes distributions of trust principal to the surviving spouse or the couple's only child during the surviving spouse's lifetime, and names the spouse and child as co-trustees. If the child predeceases the spouse, and the spouse succeeds to all trustee powers, the spouse clearly has the authority, absent state law restrictions, to make a self appointment and would thus have a general power of appointment, causing the credit shelter trust to be unnecessarily taxable in the estate.

57. Treas. Reg. 20.2041-1(b)(1) provides in part:

> The mere power of management, investment, custody of assests, or the power to allocate receipts and disbursments as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

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4. Surviving Spouse Not Named as a Trustee

The surviving spouse may not be named as a co-trustee or have any encroachment authority, thus eliminating any general power of appointment issue as to the surviving spouse.[58] However, several problems in determining the quantity and timing of distributions may still arise, depending on the trust terms, who the beneficiaries are other than the surviving spouse, and who is named trustee.

C. *Expenses*

The expenses of administering the trust may add substantially to the cost of managing the trust property. Additional fees may be incurred to pay the fiduciary and secure legal and accounting advice that would not be necessary if the property were owned outright. Trustees with responsibilities to remaindermen as well as to current beneficiaries often need legal and accounting advice regarding the appropriate resolution of competing interests of different beneficiaries, which would not be necessary if the surviving spouse owned the property outright. In addition, income tax consequences of dealing with property held in trust may be more complex than dealing with the same property held outright, and thus may require more sophisticated and expensive tax planning and advice.

D. *Tensions Between Beneficiaries*

A testator who finds it necessary to have a trust for its estate tax benefits may establish one with distribution terms as flexible as possible, to provide maximum benefit for all family members. The trust may authorize income and corpus distributions to beneficiaries other than the surviving spouse for income shifting purposes, estate planning reasons, or for flexibility to provide younger generations some of the family resources when needed. When this approach is used, disputes and tensions involving the timing, amount, and recipients of distributions may arise between the surviving spouse and the other beneficiaries. Tensions may also arise over trust investment policies, especially when the surviving spouse is the primary income beneficiary and wants to maximize income, while remainder beneficiaries want growth.

If the surviving spouse is not the decedent's first spouse, and the decedent has children by another person who are beneficiaries of the

58. I.R.C. § 2041(b)(1) requires that the power be exercisable *by the taxpayer* "in favor of himself, his estate, his creditors or the creditors of his estate."

trust, even only as remaindermen, the potential for disputes, tensions, and even legal clashes, with attendant legal expenses for the trust, may increase substantially.

E. *Special Asset Problems*

1. The Residence

The residence is often the most rapidly appreciating asset in many estates that are just large enough to use the unified credit in the estate of the first spouse to die. Since the property in the credit shelter trust escapes federal estate tax entirely, it is often desirable to place that asset in the trust to avoid taxation of post-death appreciation.[59] Even when the potential for appreciation does not make it desirable to allocate the residence to the trust, the size of the estate may prevent complete funding of the trust without using the residence or an interest in it.

The trust's ownership of the residence may cause substantial income tax liability that would be avoided if the surviving spouse owned the residence outright. Under section 1034 the recognition of gain realized on the sale of property used as the principal residence is deferred if the amount realized is reinvested in a new principal residence within certain time limits.[60] Section 121 allows individual taxpayers age fifty-five or over to exclude from income up to $125,000 of gain realized on sale of property used as a principal residence.[61] However, a credit shelter trust is not considered to be the taxpayer that uses a residence, even when the trust owns the residence and the trust beneficiary uses it.[62] Thus, if the residence is placed in the credit shelter trust, the benefit of both of these provisions may be lost.

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59. Barcal & Sliskovich, *Considerations in Allocating Residential Real Property in a Three-Trust Estate Plan*, 59 J. TAX'N 90, 91 (1983).

60. I.R.C. § 1034(a).

61. *Id.* § 121(a)(2).

62. *Id.* § 1034(a) requires that the property sold be used by the "taxpayer" as the principal residence. Rev. Rul. 54-583, 1954-2 C.B. 158, construing the predecessor to I.R.C. § 1034 under the Internal Revenue Code of 1939, held that a trust that owned a residence used by its beneficiary could not defer recognition of gain upon sale and subsequent reinvestment of the funds in a new residence because the trust was not the "taxpayer" who used either property as its principal residence. I.R.C. § 121(a)(2) provides that the exclusion from gain granted by that section only applies if the property sold "has been owned and used by the taxpayer as his principal residence . . . ." It would appear that the reasoning of Rev. Rul. 54-583 would apply to § 121 as well.

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2. Stock of an S Corporation

An S corporation, so called because its taxation is governed by subchapter S of the Internal Revenue Code, is generally not taxed at the corporate level. Most items of income and deduction "flow through" to the shareholders and are included on their individual returns. This treatment, which has become much more desirable as individual income rates on unearned income have fallen, is available only if various requirements, including limitations on trust shareholders, are met.[63] To fund the credit shelter trust adequately, it may be necessary to distribute to the trust stock of an S corporation owned by the decedent, which may cause the corporation to lose its status as an S corporation unless the trust meets the rigid requirements of a "qualified subchapter S trust" (QSST).

To be a QSST, the trust must, among other requirements, have only one income beneficiary at a time, distribute all of the trust income to that beneficiary annually, distribute corpus only to that beneficiary, and distribute all of the trust assets to that beneficiary if the trust terminates during the life of that person.[64] Because of these rigid requirements, it may be desirable, or necessary to accomplish the testator's desires, to create a separate trust to hold only the S corporation stock, which adds expense and complexity.

F. *The Trust May Be an Additional Income Taxpayer*

1. The Hybrid Tax Nature of a Trust

Under current law, a trust is a hybrid for income tax purposes. It can be both a taxable entity that pays tax directly on its own income and a conduit that passes income to its distributees.[65] In a very general sense, trusts pay the tax on income they retain and the trust beneficiaries pay the tax due on income distributed to them. This concept can be very confusing to testators and trust beneficiaries who are often more accustomed to dealing with taxation of individuals and separately taxable entities.

2. Limited Benefit From the Complexity

In addition to the confusion caused by a trust's hybrid status, the benefit of the status has been reduced in the last few years. A trust formerly could satisfy a requirement that it distribute income by distributing appreciated property without recognizing any gain. The dis-

63. I.R.C. §§ 1361-1379.
64. *Id.* § 1361(d)(3).
65. *Id.* §§ 641(a), 651(a), 652(a), 661(a), 662(a).

tributee, who took the value of the property into income as if it were a cash distribution, obtained a stepped-up basis in the distributed property.[66] If the beneficiary sold the property before additional appreciation occurred, the appreciation would escape income taxation entirely. The Deficit Reduction Act of 1984 (the 1984 Act) changed the law, and now the trust must either recognize the gain on the distribution, or the distributee must take the trust's basis in the property.[67] Prior to 1987, a trust that could distribute income among several beneficiaries could save aggregate income taxes by spreading its income among itself and the beneficiaries so as to minimize the applicable tax rates.[68] However, the compression of trust and individual rates achieved by the 1986 Act, and the addition of the so-called "kiddie tax," has greatly reduced any income tax benefit provided by trusts.[69] Taxpayers are therefore receiving substantially less tax benefit for the expense and complexity incurred from establishing a credit shelter trust.

G. *Conclusion Regarding Trusts*

Using a trust to maximize unified credit usage may prove unattractive to a client for several reasons. Yet current law may lead the client to accept the problems to save up to $235,000 in estate tax that would otherwise come due at the death of the surviving spouse, substantially reducing the amount of property ultimately available to benefit younger family generations.

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66. Treas. Reg. § 1.661(a)-2(f); H.R. REP. NO. 98-861, 98th Cong., 2d Sess. 869-870 (1984), 1984-3 C.B. 123.

67. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 81, 98 Stat. 597 (1984), 1984-3 C.B. 105-06.

68. For example, assume a trust in 1985 had two dependent minor beneficiaries who had no income other than what the trust distributes to them. The trust had income of $86,400, but distributed $28,800 to each beneficiary and retained $28,800. Under the I.R.C. § 1 rates then applicable, the maximum aggregate tax paid by the three taxpayers would be $19,162, compared with $31,135 if the entire $86,400 were taxed to one of the individuals (a difference of nearly $12,000), or $22,066 if the income were taxed equally to the two individuals (a difference of nearly $3,000).

69. Under § 1(i), unearned income in excess of $1,000 received by a child under age 14 is taxed at the marginal rates of the child's parents. Using the example set forth *supra* note 67, after 1988, when the I.R.C. § 1 rates, § 63 standard deductions and § 151 personal exemptions prescribed by the 1986 Act have fully phased in, the maximum aggregate tax if the $86,400 were distributed equally would be $17,843, as compared with $23,044 if the income were all taxed to one individual over age 14 (a difference of about $5,000), or $17,871 if the income were taxed equally to two individuals (a difference of less than $30). Compare these differences with those *supra* note 68.

V. TRANSFERABILITY OF THE CREDIT AS AN ALTERNATIVE TO USE OF A TRUST

A simple means to relieve the estate planning pressure to utilize a credit shelter trust or partial QTIP election is to amend current law to provide that any credit shelter amount not used by the first dying spouse will be available to the surviving spouse.[70] One spouse could simply leave everything to the other, when consistent with the spouse's desires and other planning considerations. The first dying spouse's

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70. Most of the estate and gift tax provisions were unchanged by the Tax Reform Act of 1986 [hereinafter the 1986 Act]. The Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1431-1433. In fact, no proposals for reform of those provisions were included in the President's proposals to Congress for tax reform that led to the 1986 Act. *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985) [hereinafter the President's Tax Proposals]. However, by letter dated November 19, 1985, from then Assistant Secretary of Treasury Ronald A. Pearlman to Hugh Calkins, Chairman of the Section of Taxation of the American Bar Association, the Treasury affirmed its continuing interest in federal transfer tax reform, and requested the assistance of practitioners in developing recommendations for reform in the area. In response to that letter, the ABA established the Task Force on Transfer Tax Restructuring, which has released its Report on Transfer Tax Restructuring (May 5, 1987) [hereinafter the Task Force Report]. On October 20, 1987, the House Ways and Means Committee approved a tax package that included a number of proposed estate and gift tax changes and the 1987 Act contained some of these changes. Thus, despite the massive scope and broad significance of the 1986 Act, it appears that federal transfer tax reform is still a subject ripe for consideration in the eyes of both the Treasury and practitioners.

The Task Force Report proposes amendments to estate and gift tax provisions in a broad range of areas. *Id.* at 5-9. One of the proposals is that the credit be replaced with an exemption of $600,000 for each individual, and that the exemption be transferable. The difference between that approach and making the credit transferable is estate tax on approximately $103,000. If exemptions of $600,000 are allowed and used, the aggregate exemptions of two spouses would shelter $1,200,000 from tax. If the existing unified credit were made transferable, aggregate credits of two spouses, a credit of $385,600, would shelter $1,097,073 from tax rather than $1,200,000. The difference is a result of estate tax rate progressivity. The Task Force Report includes the table reproduced below, showing that progressivity approximately the same as is achieved under the current credit and rate structure can be achieved by adopting a flat 50% rate on all transfers above $1,200,000 and using $600,000 per person exemptions rather than a credit against tax. Unfortunately a detailed analysis of the benefits of a flat rate and an exemption versus a credit is beyond the scope of this paper. However, the Task Force's presentation certainly demonstrates that progressivity can be achieved despite use of an exemption, and the exemption would be simpler to deal with than a credit for planning and calculation purposes, since aggregation of two exemptions would not result in the loss of shelter for $103,000 as occurs with a credit.

Despite the difference between a credit and an exemption, the basic issue of transferability of the ability to protect property from tax arises for the same reasons, and is subject to the same policy considerations, whether an exemption or credit is used. There would, however, clearly be different planning considerations under the two approaches.

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credit would then be available at the death of the survivor to shelter property passing to younger generations.[71] The spouses would be treated as a unit for testamentary uses of the unified credit.[72] This

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TABLE

The table below compares, for estates of stated sizes, the progressivity of (a) a low-exemption progressive-rate estate tax (we have used the pre-1977 estate tax, with a $60,000 exemption and 25 rate brackets ranging from 3% to 77%) and (b) a high-exemption flat-rate tax (we have assumed a $600,000 exemption and a flat 50% rate). The two right-hand columns show that the effective rate of the latter tax is approximately as progressive as that of the former.

Taxable estate before exemption	Tax under clause (a) above	Tax under clause (b) above	Effective tax rate under (a)	Effective tax rate under (b)
$ 500,000	$ 126,500	$ -0-	25.30%	-0-
1,000,000	303,500	200,000	30.35%	20.0%
2,000,000	726,200	700,000	36.31%	35.0%
3,000,000	1,231,400	1,200,000	41.05%	40.0%
4,000,000	1,802,800	1,700,000	45.07%	42.5%

Id. at 4.

71. Many situations will remain in which use of a credit shelter trust at the death of the first spouse to die is preferable to leaving everything to the survivor, even if the credit is transferable. For instance, if the surviving spouse is a second spouse, the decedent may have children by a first marriage who the decedent wishes to benefit from the credit shelter amount, either during or after the life of the survivor. The decedent may also wish to benefit the surviving spouse from that amount, and a trust may be the only solution in that situation.

Or a married couple may each own $600,000 of rapidly appreciating property. If the first to die establishes a credit shelter trust and the potential appreciation occurs, at the survivor's death the appreciation escapes estate tax too. However, if the first to die leaves everything to the survivor and the credit of the first to die transfers to the survivor, the appreciation on the property of the first to die (and the $103,000 described *supra* note 70) will incur estate tax at the survivor's death.

Yet, there are other situations in which credit transferability will be very useful. Suppose a stable married couple with adult children has aggregate assets of $750,000. Each spouse trusts the other to leave to the children any property remaining at the death of the survivor. The assets are a home and cash type investments, all unlikely to appreciate substantially. Under current law, this couple might choose to use a credit shelter trust under the will of the first to die, but would probably prefer not to do so. Transferability of the credit could be ideal for them.

72. The unlimited marital deduction treats spouses as a unit for estate tax purposes. *See* text section VI.B. Allowing the transfer of the unused credit of the first to die to the survivor extends this same unit treatment to the credit. Arguably, however, if a married couple is treated as an estate tax unit, the credit available to them should be something less than the equivalent of twice the credit of a single person. Gutman, *Reforming Federal Wealth Transfer Taxes After ERTA*, 69 VA. L. REV. 1183, 1219-35 (1983). To some extent it would be less than equivalent because of rate progressivity, although if the Task Force Report exemption approach were adopted, this would not be the case. *See supra* note 70. It can also be argued that if spouses are to be treated as a unit for estate tax purposes, a different estate tax rate structure may

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process would obviate the need to create a trust solely to use the credit of the first spouse to die. However, if the first to die wished to control the ultimate disposition of the $600,000 sheltered by the unified credit at the surviving spouse's death, the first dying spouse could still elect to use a credit shelter trust.

VI. Policy Considerations Surrounding Transferability of the Credit

A. *Similar Situations Should Be Similarly Taxed*

As a matter of basic fairness, the federal estate tax should similarly tax two transfers of property with essentially identical economic and distributive consequences. Yet current law governing the unified credit does not apply in this manner, as demonstrated in the following comparison.

Of course, some economic and control differences exist between the surviving wife's owning her husband's $600,000 outright and its being held in trust for her benefit. However, since the credit shelter trust terms give all the income to the wife, require that she receive the corpus for her health, maintenance, and support, and authorize discretionary corpus distributions only to her, the differences are simply not so great as to justify imposing a $235,000 tax.

This situation is particularly unfair if it results solely because couple *A* did not receive advice as to the use of a credit shelter trust while couple *B* did. Such significantly different tax consequences are harsh and inequitable when both couples are disposing of property in essentially the same manner.

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appropriately be imposed on them. *See* Gutman, *supra*, at 1223-26. A full discussion of these issues is beyond the scope of this paper, which assumes the continued availability of a full credit to each spouse. However, it should be noted that any structure that would seek to provide a lower credit amount to persons when they are married than when they are single would involve significant complexity. For instance, suppose a single person has made gifts using all available credit and then marries and has a smaller credit. Should there be some additional transfer tax imposed then? Suppose a married couple makes gifts equal to their combined credits, but one of them supplies all the gift property. If the couple divorces, should the former spouse who actually made the gifts have available the greater credit available to a single person reduced by (i) the one-half share of the credit available while married, or (ii) the total amount of credit the former spouse used during marriage? Other issues abound. *Id.* at 1226-39.

Marrying and divorcing couples bounce back and forth between different income rates for married couples and single persons, but income tax is determined *annually*, while transfer tax is determined on a cumulative, lifetime basis. It is reasonably within the province of Congress to conclude that this structural difference in the two systems, and the complexity inherent in providing a lower credit to persons when they are married than when they are single, are sufficient reasons not to pursue the unit concept to its extreme logical conclusion.

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TABLE 1

	Couple A	Couple B
H's property	$600,000	$600,000
W's property	$600,000	$600,000
Spouse dying first	H	H
Disposition of H's property	All to W	All to the credit shelter trust for W; trust terms provide all income to W and corpus must be distributed to W for her health, maintenance and support, and trustee has discretion to distribute additional corpus; remainder to the children.
Tax payable at H's death	0 due to marital deduction	0 due to H's unified credit
W's taxable estate at her death	$1,200,000	$600,000
Tax at W's death	$235,000	-0-
Total tax on both estates	$235,000	-0-
Ultimate disposition	To the children	To the children
Amount passing to children	$965,000	$1,200,000

B. *Consistency of Treatment*

The proposal that the unused credit of the first dying spouse pass to the surviving spouse requires treating the spouses as a unit for federal estate tax purposes. Congress has already partially embraced this treatment through the 1981 Act, and sound and persuasive reasons support it.

Prior to 1982, one-half of the gifts between spouses was subject to gift tax.[73] The tax, of course, diminished the amount available to

73. I.R.C. § 2523(a)(2) (1976); Tax Reform Act of 1976 § 2002(b), 90 Stat. 1954-1855 (1976), 1976-3 C.B. 330-31.

support the couple. After 1981, lifetime transfers of any amount between spouses usually incur no federal gift tax.[74] Before 1982, only one-half of a decedent's estate could normally qualify for the estate tax marital deduction.[75] The remaining one-half was subject to estate tax at the death of the first spouse, and the amount remaining to support the surviving spouse was diminished by the tax paid. After 1981, any amount passing in prescribed ways to or for the benefit of the decedent's surviving spouse incurs no federal estate tax.[76]

The rationale for these 1981 changes is that spouses should be viewed as a unit, and the property of the unit should not be subjected to transfer tax until transferred outside the unit by gift, or until both members of the unit have died.[77] The first basic assumption of this rationale is that the spouses' joint efforts outside and inside the home contributed to the accumulation of wealth during their lives, and to the retention of wealth so acquired or brought to the marriage. The second basic assumption of this rationale is that given this joint effort, each spouse reasonably expects all property jointly earned and retained to remain available for support for life, rather than that a significant portion will be consumed by estate tax at the death of the first. These assumptions are broad, but reasonable. Based on them, reason and equity demand that the full amount of the couple's property remain untaxed until it passes outside the unit.

Since the unit approach is sound and makes it appropriate for either spouse to transfer property to the other without gift or estate tax consequences, why should a couple be penalized by the loss of the credit of the first to die when the spouse elects to leave all property to the survivor? On its face, the existing estate tax structure "promises" through the marital deduction provisions to exact no tax until the death of the surviving spouse, when the spouses' property passes to their children or others. It further "promises" through the unified credit provisions to allow a couple to pass up to $1,200,000 free of estate tax to their children or others. But if the couple seeks to take advantage of those promises by the simplest, most direct and inexpensive means — the first to die leaves all property to the other — they can unexpectedly incur a $235,000 "penalty" at the death of the survivor. This is inconsistent with the unit concept and could easily confuse taxpayers to their disadvantage.[78]

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74. Economic Recovery Tax Act of 1981, § 403(b), 95 Stat. 301 (1981), 1981-2 C.B. 324.

75. Tax Reform Act of 1976, § 2002(a), 90 Stat. 1954 (1976), 1976-3 C.B. 330.

76. Economic Recovery Tax Act of 1981, § 403(a), 95 Stat. 301 (1981), 1981-2 C.B. 324.

77. H.R. REP. No. 97-201, 97th Cong., 1st Sess. 159 (1981), 1981-2 C.B. 377 [hereinafter H.R. REP. No. 97-201].

78. The "promise" to allow a couple to pass up to $1,200,000 to their children or other beneficiaries free of estate tax also supports the proposal in the Task Force Report to replace

C. *Simplicity*

Another desirable feature of any tax system is simplicity. To the extent possible, the system should be simple enough for the population being taxed to take advantage of the major tax reduction features provided.

For many couples owning aggregate property valued over $600,000, the only practical means of using the credit of the first to die is by creating a credit shelter trust. Such a trust, however, may introduce unnecessary complications or increased expenses. In pursuit of simplicity of use, the credit should be designed to pass to the survivor the unused credit of the first to die.[79]

D. *Fairness as Between Wealthier and Less Wealthy Taxpayers*

Simple notions of fairness demand a tax policy that does not advantage wealthier taxpayers solely by virtue of their wealth. This policy gave rise to the 1976 Act's unification of transfer tax rates and inclusion of taxable gifts in the estate for determining the estate tax rate.

The current unified credit structure is also unfair in allowing wealthier taxpayers to use more easily both spouses' credits without using a trust. They may do so through inter vivos gifts or outright bequests to persons other than the surviving spouse. The wealthy who choose to use a trust are also better able to afford it.

For example, one spouse may own several million dollars' worth of property while the other owns much less property. Under current law, if both spouses consent, gifts by one spouse to a third party are treated for federal gift tax purposes as though each spouse made

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the credit with an exemption of $600,000. *See supra* note 70. If one spouse has the use of both credits in a testamentary situation, the combined credits will shelter only $1,097,073 from tax, rather than $1,200,000, because of rate progressivity. Thus, even transferability of the credit fails to fulfill the promise to the taxpayer to exempt $1,200,000 to the extent of tax on approximately $103,000. While a progressive rate structure is desirable, it is also desirable that taxpayers be aware of what exemption amount is available without complicated computations.

The Task Force Report proposes to impose a flat 50% estate tax rate on transfers in excess of its proposed $600,000 exemption, or on transfers in excess of $1,200,000 when the first dying spouse's exemption passes to the survivor, arguing that the effective estate tax rate under this type of structure remains progressive. *Id.* at 3-4. For example, the effective rate on a $1,000,000 taxable transfer by a single person under the Task Force Report's proposals is 20%: ($1,000,000 − $600,000) × 50% = $200,000/$1,000,000 = 20%. The effective rate under this plan on a $2,000,000 taxable transfer would be 35%: ($2,000,000 − $600,000) × 50% = $700,000/$2,000,000 = 35%.

79. Simplicity also supports the proposal in the Task Force Report of an exemption rather than a credit. *Supra* note 70.

one-half of the gift.[80] Under this provision, spouses can effectively act as a gift tax unit as to third parties, with one of them able to use the annual exclusion, unified credit, and gift tax rate structure of the other.[81] This gift splitting technique allows the wealthier spouse to make a gift up to $1,200,000 during life and thus use the credit of the less wealthy spouse. Taxpayers who cannot afford such a gift are effectively denied this method of using each other's credit, and cannot preserve the credit of the first to die without incurring the complexities and expenses of a trust.

In addition, a wealthy taxpayer married to a spouse who has no property can easily use the spouse's credit without making a gift outside the "unit," even if the spouse without property dies first. The wealthy taxpayer can afford to give the other spouse $600,000, and could even use a QTIP type marital deduction trust to control who benefits from that $600,000 after the other spouse's death. Other taxpayers may not be able to part with control of $600,000 while living, because it constitutes too large a portion of available property.

The design of current law penalizes the less wealthy taxpayer, creating a barrier to efficient use of both spouses' credits, and inherently favoring the taxpayer who can avoid a trust or more easily afford its inefficiencies.

E. *Policy Considerations Opposing Transferability of the Credit*

1. Complexity Upon Remarriage

Assume a husband (*H-1*) and wife (*W-1*) each have a full unused credit that has been made transferable between spouses at death. If *H-1* is survived by *W-1* and leaves all his property to her, *W-1* would have the benefit of her own credit and the credit of *H-1*. If *W-1* married *H-2* and then predeceased *H-2*, should the credit of *H-1* that had passed to *W-1* be available to *H-2*? If *W-1* survived *H-2*, should she be able to accumulate any unused credit of *H-2* together with her own credit and *H-1*'s credit? Given today's high numbers of remarriages by widows and widowers, these issues are quite real.

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80. I.R.C. § 2513(a).

81. The language of § 2513(a)(1) specifies that if the provision applies, the gift made by one spouse to any person other than the other spouse is treated as made one-half by each spouse for "all purposes of this chapter." The reference is to chapter 12 of Subtitle B of the Internal Revenue Code, dealing with gift taxes. Thus, the non-donor spouse's annual exclusion under § 2503(b) and unified credit under § 2505 is utilized equally with the donor's in determining the gift tax liability on the gift, as if the gift had been made one-half by each.

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If the first question, whether *H-2* can obtain *H-1*'s credit, is answered negatively, a portion of the unfairness relating to the non-transferability of the credit is injected back into the system. If *W-1* cannot pass both her own and *H-1*'s credit to *H-2*, *W-1* will be pressured to create a trust under her will if she predeceases *H-2*, in order to use the otherwise lost credit of *H-1*. This is the very kind of pressure that the transferability of the credit is intended to eliminate. Further, allowing *W-1* to pass both her credit and that of *H-1* does not necessarily mean that more credit is being used than would otherwise be the case. If the credit remained non-transferable, *H-1* could create a trust to use his credit rather than let it go to waste. If the credit is made transferable but limited so that *W-1* cannot pass *H-1*'s credit to *H-2*, then any well-advised *W-1* will probably create a trust upon her death. It would make little sense to adopt a credit transferability rule and then limit its application so that the problem addressed arises again in multiple marriage situations.

As to the second question, if *H-2* desires to pass his own credit to his wife, why should he be unable to do so merely because *W-1* has previously been married? Although that will enable *W-1* to have three credits, *H-1*'s, *H-2*'s, and her own, the same result would be available today through judicious use of trusts. While the transferability of the credit would make it easier to do this, it does not add to the amount of property that can be passed tax free. Further in many second marriages, at least one spouse may have children by a prior marriage, and opt to use a credit shelter trust to preserve funds for the children, rather than leaving all their property to the surviving spouse. Accordingly, the complexities involved in remarriage situations do not pose problems that should prevent amending the law to make the credit transferable.

2. Extension of the Unit Concept

The concept of spouses as a unit has never been used to extend the availability of a credit or exemption against estate tax for an uncertain period of time. However, the unlimited marital deduction has used the unit concept to defer the taxability of property for the period that the surviving spouse survives.[82] Although the new approach is somewhat complex, the proposed change does not pose major policy problems or open the door to inherent abuses. The fact that the approach extends the unit concept should not prevent its adoption.

82. *See supra* note 1 and accompanying text.

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VII. Administrative and Revenue Issues

If a proposed change to the tax laws that is otherwise desirable imposes a heavy administrative burden on the government or taxpayers, or has an excessive effect on revenues, policy considerations may have to yield.

A. *Administrative Issues*

1. First Dying Spouse's Estate Requires a Return

Among other information, federal gift tax returns disclose to the Service how much credit has been used during life.[83] Federal estate tax returns disclose the value claimed as to property passing at death, and the amount of credit used at death.[84] If the credit were transferable, the estate tax return filed for the first dying spouse could include a line stating how much credit is being transferred to the surviving spouse. The Service could contest valuation issues if it concluded that the first dying spouse had used more credit than was shown on the return. After reviewing the first dying spouse's return, the Service could store the surviving spouse's social security number and the amount of additional credit available to the survivor, so that later claims could be verified. This procedure would add little to the government's existing record-keeping burden.

2. First Dying Spouse's Estate Does Not Exceed $600,000

a. All Property Is Left to the Surviving Spouse

Current law requires an estate tax return to be filed if the gross estate exceeds $600,000.[85] No return is due when the gross estate is $600,000 or less.[86] If the person responsible for filing the first dying spouse's estate tax return concludes that no return is required, there is no assurance that the Service will make a timely review of the values claimed as to the estate's assets and the decedent's claimed level of credit usage. Thus, if the credit were transferable, the system could easily be abused when the first dying spouse owned less than $600,000 of property and no return was filed upon death. Abuse, for example, could arise when the first dying spouse had a substantial amount of property, such as $500,000, and left it to the children. The bequest would consume most of the decedent's unified credit. How-

83. IRS Form 709, lines 7-12.
84. IRS Form 706, lines 1-12.
85. I.R.C. § 6018(a)(1).
86. *Id.*

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ever, if no return was filed to inform the Service how much credit the decedent used, a dishonest or uninformed executor of a surviving spouse could again claim the credit of the first dying spouse upon the survivor's death.

If the first dying spouse's estate were left entirely to the survivor, a simple return could provide the Service all the information needed. It would simply disclose that all the decedent's property passed to the surviving spouse, and attach a certified copy of the decedent's will or the administration records, and the amount of credit transferred to the survivor. Values would not need to be checked in this situation because the marital deduction would shelter the decedent's estate from tax regardless of the values. Thus, in this situation, very little additional burden would be placed on the government or the taxpayer.

b. First Dying Spouse Consumes Some Credit at Death

If the first dying spouse had a gross estate with a value less than the $600,000 filing level and left a substantial amount of property in a manner that consumed credit, such as outright to the couple's children, the potential for abuse would arise. One approach to this problem is to require a surviving spouse or representative claiming additional credit to attach a certified copy of the first dying spouse's will, the executor's inventory and a list of the first dying spouse's non-probate assets, if any. If there were no will, a copy of the administration records listing how probate property passed would be provided. Such records would inform the Service how the credit was used at the death of the first dying spouse. The Service would be authorized to contest the additional credit claimed by the surviving spouse. Although this approach avoids requiring a return at the death of the first spouse, and places the government and taxpayers at the same disadvantage of proving the value of property that consumed the first dying spouse's credit many years after the event, neither is likely to accept such a system.

Alternatively, the law could require a full return at the death of the first dying spouse if the following conditions are met: the credit used at such death exceeds a floor amount; some credit is transferred to the surviving spouse; *and* the assets consuming credit at the first death cannot be precisely valued, such as interests in closely-held businesses, real property, jewelry, artwork, and antiques. If the floor amount of credit that must be used at the first dying spouse's death is set to cover normal keepsakes and small bequests often made to children and grandchildren, most estates that would pass credit to the surviving spouse, but are below the current filing threshold, would probably not require a return.

Another approach would require an informational return from all estates purporting to transfer any credit, with the Service authorized to demand, within a limited period, a full return in appropriate situations. Presumably when all or most of the decedent's property passes to the surviving spouse, the Service would not find it worthwhile to demand a full return.

Still another possibility would be to require a full return as a condition to the passage of any credit, with the Service free to develop reasonable administrative exceptions. Couples with aggregate estates well below the $600,000 level would probably not be adversely affected by a decision to forego filing at the death of the first spouse, since the survivor's estate would usually not incur tax even without the benefit of additional credit.

3. Recommended Approach

A hybrid method would seem to put the least burden on the government and taxpayers, while minimizing the abuse potential. The basic design would be as follows.

(i) The general rule would be the same as current law — no return would be required if the estate had a value of $600,000 or less.

(ii) An exception to the general rule would require a full return as a condition to the passage of any unified credit to a surviving spouse.

(iii) An exception to (ii) would require only a brief information return, with appropriate attachments, when the decedent left everything to the surviving spouse.

(iv) A second exception to (ii) would require only an information return, with appropriate attachments, when the value of property other than cash, cash equivalents, or publicly traded securities, passing to persons other than the surviving spouse, was less than $25,000. The Service could then require full information on property passing to persons other than the surviving spouse.

(v) A final exception to (ii) would apply when no return was filed at the death of the first dying spouse. If the surviving spouse or executor could prove that all of the first dying spouse's estate passed to the survivor, then the survivor could use the first dying spouse's credit notwithstanding the absence of a return for the first dying spouse.

B. *Revenue Issues*

1. Context

Federal estate and gift taxes combined produce an estimated $5.5 billion of revenue annually, or about 1.2 percent of the federal revenue

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produced by individual and corporate income taxes.[87] Even if the credit transferability proposal were to decrease estate and gift tax revenue production, it would not necessarily be significant in relation to the national revenues.

2. Estimated Cost of the Proposal

In 1981, when the phased-in increases to the unified credit were adopted, the availability of the increased credit was predicted to produce an annual loss of approximately $3.8 billion of revenue in 1987.[88] If the credit were made transferable, the additional revenue loss could be measured by multiplying the number of those who would utilize transferable credit but are not taking advantage of the credit of the first dying spouse under current law, times the estate tax lost by the use those persons would make of the credit. Data needed to make this calculation is not readily available, but the decrease in revenue is likely to be minimal, even in the context of the revenue produced by the estate and gift tax provisions, much less that produced by the tax system as a whole.

VIII. Conclusions

Current law is severely flawed because it differently taxes estates that pass property with the same economic and distributive consequences. This result is especially undesirable when different tax results hinge entirely on whether the decedent received advice on establishing a credit shelter trust. The decision to treat married couples as a unit for estate and gift tax purposes, together with the 1981 Act increases to the credit, promise to pass all property from one spouse to the survivor free of estate tax, and to allow $1,200,000 to pass to younger generations free of estate tax. This promise is undercut without warning under current law when the first dying spouse fails to use the unified credit. It is inefficient and unnecessarily complex to require a first dying spouse to establish a trust to use the credit.

Current law inherently favors the use of both spouses' credits by the very wealthy, who can afford to make lifetime gifts through bequests to persons other than the surviving spouse and through use of trusts. The expense and complexity of these devices is also a much smaller burden to such persons. Finally, other than avoiding estate

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87. The President's Tax Proposals, *supra* note 70, at 461.

88. H.R. Rep. No. 97-201, *supra* note 77, at 155; S. Rep. No. 97-144, 97th Cong., 1st Sess. 125 (1981), 1981-2 C.B. 460.

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tax under the current system, no discernible benefit necessarily accrues from requiring the establishment of a credit shelter trust.

The amendment of current law to allow the transfer of the first dying spouse's unused unified credit would avoid the unequal tax treatment of similarly situated taxpayers. It would fulfill the promise of the 1981 Act in treating spouses as a unit and allowing spouses to avoid the inefficiency necessarily incurred in establishing a trust. An amendment also would provide a measure of parity between those who are more wealthy and those who are not. The desirable results outweigh the probable minimal revenue cost and additional administrative burden that would be incurred by the government and some taxpayers. Unused unified credit of a first dying spouse should thus be made transferable to the surviving spouse.

Published by UF Law Scholarship Repository, 1987