

Marital Deduction Funding Formulas: Fun for the Entire Family

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Goals:

- Minimize (or preferably eliminate) estate taxes
- Carry out decedent's wishes as to distribution of his or her estate

Tools:

- Pourover will
- Revocable trusts
- Funding formula
- Trust funds within revocable trust
 - Marital Funds (Federal and Mass.), or
 - Marital Funds and Credit Shelter Fund

Our Family:

- Mama.
 - Marital Deduction Trust (QTIP)
 - Income
 - Perhaps Principal
 - SPOA (?)
 - Sole beneficiary
 - Credit Shelter Trust
 - Discretionary Income and/or principal
 - May be shared with kids
 - SPOA (?)

Kids and Grandkids

- Credit Shelter Fund
 - Income and/or principal as directed in trust instrument
 - Shared with Mama
 - SPOA(?) to Mama

Who Gets what?

- Federal Marital Trust:
 - Excess over \$2,000,000
- Massachusetts Marital Trust:
 - Excess over \$1,000,000
- Credit Shelter Trust:
 - \$1,000,000

We have Mama, Kids, Grandkids
covered.

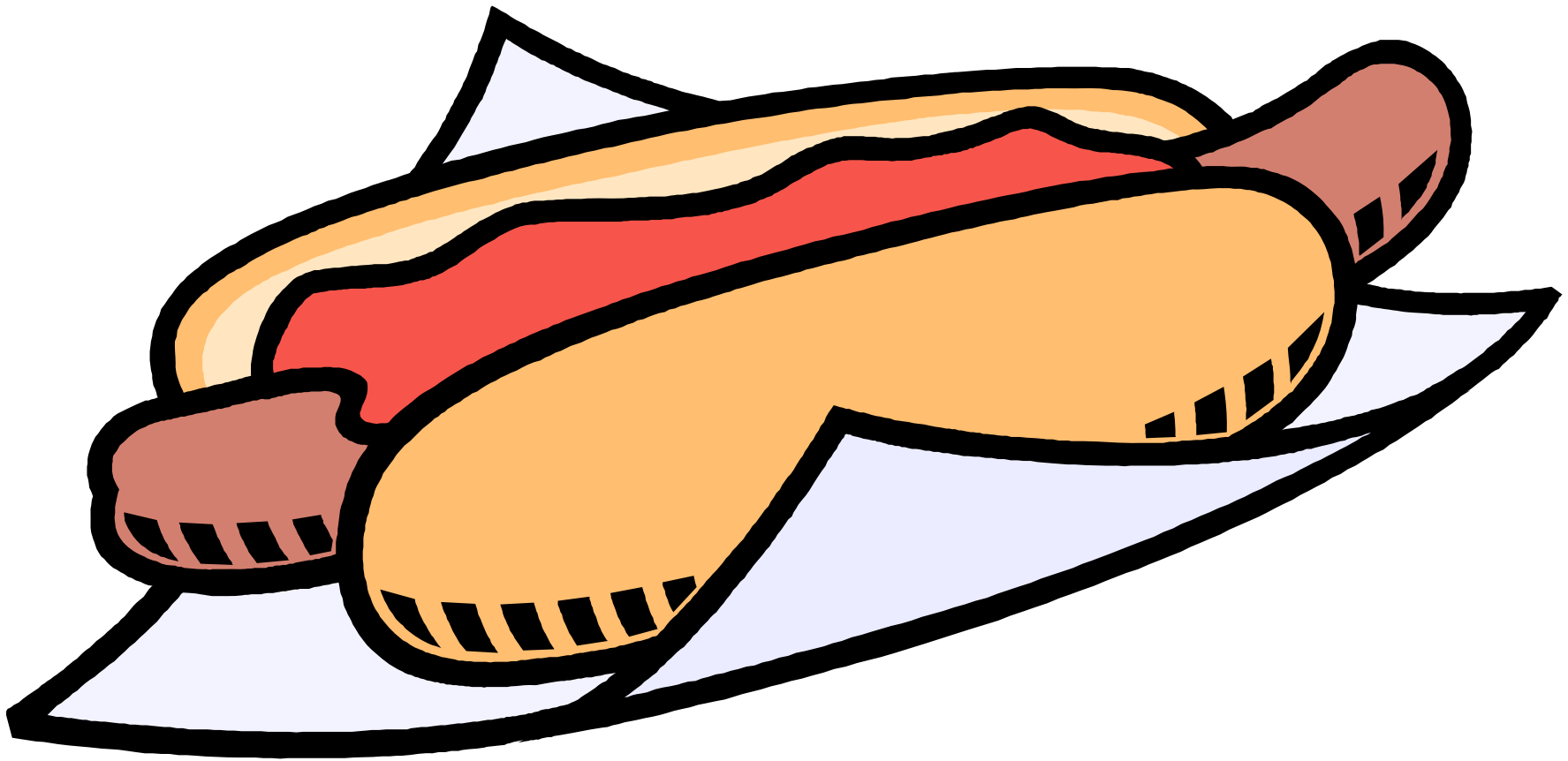
Who is missing from this party?

Papa

Where is his part?

What does he get?

His Part used to be the whole
enchilada,



Now he gets



Peace, rest, and

Thanks, Papa,
from a grateful family.

Did we forget someone?

Yes.

Our Uncle.

Sam.

With good marital deduction planning and thoughtful use of marital deduction formulas, he will continue to be our omitted (or mostly omitted) Uncle Sam.

Marital Deduction Planning

- Massachusetts Marital Deduction Trust.
 - Equal to the excess above the Massachusetts estate tax exemption.
 - Under current law, the amount > \$1,000,000
- Federal Marital Deduction Trust
 - Equal to the excess above the Federal Applicable Exemption Amount (AEA)
 - Under current law, the amount > \$2,000,000

QTIP Elections by Papa's Executor Required

- Massachusetts Election:
 - Everything > \$2,000,000.
- Federal Election:
 - Everything > \$1,000,000
- Both elections made on estate tax return

\$3,000,000 Estate

<u>A</u>	<u>B</u>	<u>C</u>
Federal & Mass. Marital Deduction Trust	Mass. Marital Deduction Trust	Credit Shelter Trust, or Non-elected Marital Deduction Trust
\$1,000,000	\$1,000,000	\$1,000,000

Results At Mama's Death

- A. Federal/Mass. Marital = \$1,000,000**
 - Included in Mama's Federal and Mass. Estate
- B. Mass. Marital alone = \$1,000,000**
 - Excluded from Mama's Federal Estate
 - Included in her Mass. Estate
- C. Credit Shelter Trust = \$1,000,000**
 - Excluded from both Federal and Mass. Estates

Funding Game

- Good Old Days
 - Federal Estate Tax Valuation
 - Depreciating property in elected Marital Fund
 - Appreciating property in Credit Shelter or non-elected marital
 - Reduced taxable estate at Mama's death
- Rev. Proc. 64-19
 - Date of distribution valuation
 - Distribution between funds must be fairly representative of appreciation/depreciation, **or**
 - Capital Gain on initial funding

Funding Formulas

- Pecuniary
 - An amount to either Marital or Credit Shelter Fund
- Fractional
 - Percentage of each asset

Types of Pecuniary Formulas

- Upfront Marital
 - True Worth
 - Fairly Representative (Rev. Proc. 64-19)
 - Minimum Worth
- Upfront Credit Shelter
 - True Worth
 - Fairly representative

Types of Fractional Formulas

- Pro Rata
 - % of each asset
- Pick and Choose
 - BUT, must be “fairly representative” of appreciation and depreciation among assets available for distribution

Three Types of Plans

- Single QTIP
 - All to Marital Fund – Fractional Formula
- Pecuniary Formula
 - An amount to Marital Fund, balance to Credit Shelter
- Fractional Formula
 - A percentage distribution to Marital Fund and Credit Shelter

Single QTIP

A. Mass. And Federal Marital
Deduction Election

\$1,000,000

B. Mass. Marital Deduction
Election Only

\$1,000,000

C. No Marital Deduction
Election

\$1,000,000

Requirements of Single QTIP

- Fractional Formula
- Either
 - “Pick and Choose”, or
 - Pro Rata (rarely used)
- With “Pick and Choose”,
 - Date of distribution values used
 - Assets must be fairly representative of appreciation and depreciation since valuation date

Advantages of Single QTIP

- No tax on funding
- Flexibility of separate QTIP elections for Federal and Massachusetts estates
- No effect on Mama's beneficial interest
- Adjustability between taxable estates if Mama dies within 15 months of Papa
- Possible use of Section 2013 credit
- Investment strategies can adjust income

Disadvantages(?) of Single QTIP

- Kids/issue have no access to income or principal
- No ability to accumulate income
- No ability to shift income to lower bracket T/P
- No ability to shift appreciation to tax exempt fund(s) via a Pecuniary formula

“True Worth” Pecuniary Formula

- An amount specified by formula to Marital Fund or Credit Shelter
- “Upfront Marital”
 - The amount necessary to reduce the Federal and Massachusetts estate tax to zero
- “Upfront Credit Shelter”
 - The largest amount which can pass free of Federal and Massachusetts estate tax

Advantages of True Worth Pecuniary Formula

- Greatest flexibility to pick and choose assets to fund Marital Funds and Credit Shelter
- Protects fund allocated pecuniary amount
 - Date of distribution values control
 - Risk of loss allocated to residuary fund
- All appreciation allocated to residuary fund
- Easy to administer

Disadvantages to True Worth Pecuniary Formula

- Capital gain realized if pecuniary bequest funded with appreciated assets
- Pecuniary bequest larger due to decoupling of Federal and Mass. Estate tax, i.e. increased capital gain tax
- Ordinary income realized for IRD used to fund pecuniary bequest
- No corresponding deduction for loss for depreciated assets (IRC Section 267)
- All risk of loss allocated to residuary fund

\$3,000,000 Taxable Estate

- Upfront Marital claimed on 706:
 - Federal/Mass Marital Fund: \$1,000,000
 - Mass. Marital Fund \$1,000,000
 - Credit Shelter Fund \$1,000,000
- No federal or Massachusetts estate tax

Three years pass...

Assets appreciate to \$4,000,000

- Fed./Mass. Marital Fund \$2,000,000
 - Pecuniary Bequest,
(same amount)

- Credit Shelter Fund \$2,000,000
 - Residuary Bequest,
(plus \$1,000,000 in appreciation)

\$4,000,000 Estate

Marital Fund	\$2,000,000
Basis	<u>\$1,500,000</u>
Capital Gain on Funding	\$ 500,000
C/G tax (fed only) @15%	\$ 75,000

YUCK.

But Hark! All is not lost! Savings in Mama's Estate!

Headlines read:



**“\$1,000,000 in appreciation excluded
from Mama's estate!”**

**“Federal estate tax savings of \$450,000!
Plus estate tax on appreciation!”**

**‘All for the bargain price of \$75,000 in
Capital Gains Tax!’**

Mama's Taxable Estate Tax under Pecuniary Upfront Marital, Papa's Estate Appreciated to \$4,000,000

- Federal:
 - Mama's assets: \$2,000,000
 - Fed. QTIP \$1,000,000
 - Estate tax @ 45% \$ 450,000
 - Capital Gain tax on funding QTIP \$ 75,000
 - Massachusetts
 - Her assets \$2,000,000
 - Mass. QTIP \$2,000,000
 - Estate tax (Section 2011) \$ 286,640
- Total Fed/Mass tax \$ 811,640**

Mama's Taxable Estate under Upfront Credit Shelter, Papa's Estate Appreciated to \$4,000,000

- Federal
 - Her assets \$2,000,000
 - Fed. QTIP \$2,000,000
 - Fed. tax at 45% \$ 900,000
 - Capital gain tax (funding C/S) \$ 75,000
- Massachusetts
 - Her assets \$2,000,000
 - Mass. QTIP \$3,000,000
 - Mass. Tax \$ 398,320
- **Total tax** **\$1,373,320**

Savings in an Appreciating Market

Total tax w/ Upfront C/S	\$1,373,320
Total tax w/ Upfront Marital	\$ 811,640
Savings due to Pecuniary	
Upfront Marital	\$ 561,680

Moral: Pecuniary Upfront Marital works well in appreciating market.

Fractional Formula

- Evens out risks and benefits
- Appreciation/depreciation allocated evenly between Marital and Credit Shelter Funds
- No Capital Gains tax on Funding
- Date of distribution values used at funding

Moral: No big win, no big loss.

Example: Fractional Formula, Papa's Estate Appreciated to \$4,000,000

Marital Funds	\$2,666,666
Fed/Mass Marital	\$1,333,333
Mass. Marital alone	\$1,333,333
Credit Shelter	\$1,333,333
Mama's Estate: \$2,000,000 plus Marital Funds	
Fed. tax on \$1,333,333 @ 45%	\$ 600,000
Mass. Tax on \$4,666,666 (Section 2011)	\$ <u>360,987</u>
Total tax at Mama's death	\$ 960,987

Fractional vs. Upfront Pecuniary Marital Where Papa's Estate Appreciates to \$4,000,000

- Fractional
 - Total tax \$ 960,987
- Pecuniary
 - Total tax \$ 811,640
- Savings due to Upfront Pecuniary Marital \$ 149,347

Estate Depreciates to \$2,000,000

- Pecuniary Upfront Marital Formula
 - Fed/Mass Marital Funds \$2,000,000
 - Credit Shelter Fund 0

- Fractional Formula
 - Fed/Mass Marital Funds \$1,333,333
 - Credit Shelter Fund \$ 666,666

Taxes in Mama's Estate Where Estate Depreciates to \$2,000,000

- Pecuniary Upfront Marital Formula
 - Fed. Tax on T/E on \$1,000,000
 - @ 45% \$ 450,000
 - Mass. Tax on T/E of \$2,000,000 under IRC Section 2011 \$ 286,640
- Total tax on Mama's estate \$ 736,640

Note: No deduction for capital loss

Taxes in Mama's Estate where Papa's Estate Depreciated to \$2,000,000

- Fractional Formula
 - Federal tax on \$666,666
at 45% \$300,000
 - Mass. Tax on \$3,333,333
under IRC Section 2011 \$218,960
 - Total tax: \$518,960
 - Savings over Pecuniary Marital \$217,680

**Moral: Fractional works better in a
depreciating economy.**

Final Words of Wisdom

1. Uncle Sam gets something at the end of the day if the family has assets equal to twice the Federal or Mass. exemptions.
2. Effective use of Marital Deduction Funding Formulas can minimize the hit.
3. Choose formula based on assets in estate and best guess on appreciation and depreciation.