

**FUNDAMENTALS OF WILL DRAFTING**  
**II**  
**(The Federally Taxable Estate)**

presented at

**SURROGATE'S COURT RICHMOND COUNTY**

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Sponsored by

**RICHMOND COUNTY BAR ASSOCIATION**  
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## **FEDERALLY TAXABLE ESTATES**

### **Estates Not Subject to Federal Estate Tax**

The Sweetheart Will (IRC§ 2010 - the unified credit is greater than or equal to the tax)  
Each spouse to the other  
Full marital deduction upon death of first spouse  
No federal tax upon death of 2nd spouse unless substantial growth in estate of surviving spouse.

### **Federally Taxable Estates**

Taking advantage of the unified credit in both spouses' estates.  
Creation of By-pass or Credit Shelter trust  
Carve out the exemption equivalent or \$600,000.00 (Exhibit "A")

### **THE BY-PASS OR CREDIT SHELTER TRUST**

**Purpose: KEEP ASSETS OUT OF SURVIVING SPOUSE'S ESTATE**

#### **Commonly**

1. All income to surviving spouse
2. Remainder to children or named beneficiaries
3. Limited powers of invasion for benefit of spouse
  - a) for health and maintenance - (IRC §2041 and §2514)
  - b) so-called five and five power  
Power to withdraw during any year the greater of \$5,000.00 or 5% of trust corpus [IRC §2041 (b)(2) §2514 (e)];  
Treasury Regulation 20.2041 - 3(d); 25.2514 (3)(c)
4. Spouse as Co-trustee

#### **Consider:**

1. Powers of invasion not limited by ascertainable standard are deemed a General power of appointment

Defeats purpose

Makes property taxable in surviving spouse's estate. IRC§ 2041.

Instead: Use an ascertainable standard whenever a trustee may make payment to benefit himself as trust beneficiary and to benefit a person the trustee is legally obligated to support (whether standards is ascertainable is question State law. Morgan, 309 U.S. 78; 40-1 USTC (S. Ct. 1940))

For model language: "Support; support in reasonable comfort; maintenance in health in reasonable comfort"; Reg. 20.2041 (c)(2); Estate Vissering, 96 TC 749 (1991) rev'd 990 F2d 578, 93-1 USTC Sec. 60, 133 (CA-10,1993)

**COMMENT: Some language to avoid; welfare or happiness; her uncontrolled discretion; her determination not subject to review by any court.**

Example: H's will gave wife the right, as co-trustee, to invade a trust for her "proper maintenance, support,

medical care hospitalization, or other expenses incidental to her comfort and well-being” Held: wife had general power of appointment - property taxable in her estate. I.M. Miller Est., 387 F. 2nd 866.

But note IRC § 2041(b)(1)(C)(ii)

“If the power is not exercisable by the decedent except in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to exercise of the power in favor of the decedent - such power shall not be deemed a general power of appointment”

Therefore:

- Do not appoint spouse as sole trustee.
- Appoint a co-trustee with adverse interest to spouse’s power of invasion.
- Be sure co-trustee is not under control of the spouse.
- Consider EPTL §10-10.1 which prohibits a trustee beneficiary from making discretionary distributions to herself.
- To be cautious - use ascertainable standard.
- Provide in will that spouse is barred from participating in the exercise of any discretion to determine the propriety, or amounts of invasions for her benefit.

## 2. The five and five power

Flexibility for spouse - right to invade trust corpus every year and withdraw the greater of \$5,000.00 or 5% of trust corpus. Exception to general power of appointment. IRC §2041 (b)(2). This power is not-cumulative and will lapse if not exercised.

**COMMENT: Question: if the power is not exercised, has the spouse made a gift? Answer is found in the statute ---- failure to exercise the power is not deemed a “release of power” that would subject the estate to gift tax --- but, again --- same concerns that apply to power of invasion for spouses support apply here --- If spouse is sole trustee and dies possessed of the five and five power which she did not exercise the year of her death, the value of the property subject to the power would be taxable in her estate. Reg 20.2041 - 3(d)(3).**

## 3. Goal-Comfortable support for surviving spouse.

- On Staten Island mostly medium size estates.
- More than ½ of family assets may be lodged in credit shelter trusts.
- Consider spouse’s income from other source.
- Consider the cost of a corporate trustee (See Exhibit “B”)
- Perhaps a sprinkling provision is needed for needs of children - have an independent trustee

**COMMENT: Corporate trustee may be expensive.  
Staten Island Savings Bank has special Trust department for modest trust.**

## 4. Funding the By-pass or Credit Shelter Trust

- Specific directions
- Consider the use of the New York State residence deduction of up to \$250,000.00,  
McKinney’s Tax Law §955 (f)

**COMMENT: Have deduction count twice - increase N.Y.S. tax exempt amount. But beware - residence should be in name of decedent; offset by loss of increase in basis between deaths of 1st and 2nd spouse.**

- Use assets not eligible for marital deduction.

## **BALANCE TO SPOUSE THE UNLIMITED MARITAL DEDUCTION -§ 2056**

Means: deferral of payment of tax until death of 2nd spouse

### Requirements:

Surviving spouse must be a U.S. citizen. (Reg. 20.2056(a)-1)

**[Our focus U.S. citizens spouse; non citizen spouses see Sec. 2056 (d) and Exhibit “C”**

Survivorship presumption in decedent’s will when circumstances make it impossible to determine who died first will be recognized.

[Put in one (1) Will only - remaining Will subject to EPTL 2-1.6 which directs that decedent is required to have survived].

**Comment:** Note New York Law, EPTL § 2-1.6(e). Do not have presumption in both Wills. Valid marriage - legal separation not a bar to the deduction. (Rev. Rule. 56-368, 1956-2 C.B. 896)

Interest must be includable in decedent’s estate and must “pass” to the surviving spouse.

**Comment:** Includable in decedent’s Will + property may not qualify for a deduction under any other section, e.g. Claims v. Estate by Surviving Spouse - such as a bona fide debt of Estate to spouse - casualty losses for property passing to surviving spouse and deducted as such.

### “Passing” requirement:

Reg 20.2056 (c)-2

- Joint tenancy
- Appointee or taker in default under power of appointment over which decedent was power holder
- Dower/courtesy
- Beneficiary of Life Insurance proceeds.
- By gift or bequest from decedent.
- Spouse as beneficiary as result of disclaimer by 3rd party. Treas. Reg. 20.2056(c)-2(a)(4). Example: All adult unmarried children disclaim in favor of spouse who is named as alternate beneficiary if they predecease without issue.
- Settlement of a controversy regarding disposition of decedent’s estate. Reg. 20.2056(c)-2(a)(6); 20.2056(c)-2(a) (2) - marital deduction for assets passing to surviving spouse in settlement of a controversy regarding the decedent’s Will, provided that the settlement was a “bona fide recognition of enforceable rights of the surviving spouse” . This is presumed where there is a decision from a local court upon the merits in an adversary proceeding - regulation warns: If assignment or surrender results from agreement not to probate the will, marital deduction not approved.

**COMMENT:** Before further exploring marital deduction, let us examine how to divide the estate with the credit-shelter or by-pass portion and the marital deduction portion. **DIVISION INTO CREDIT SHELTER OR PAY-PASS PORTION AND MARITAL DEDUCTION PORTION**

### I. Preresiduary Pecuniary Marital Gift:

For a simple graph - see Exhibit “D”

We see - the amount is determined by a formula which produces the smallest estate tax, after deducting administration expenses.

In same fashion, the credit shelter or by-pass amount may be carved out as a preresiduary pecuniary gift - (see Exhibit "E")

Commonly:

- only assets which qualify for marital deduction may fund the bequest.
- assets for which another credit's available may not fund the bequest
- make early distributions to avoid capital gains.
- appreciation realized by estate does not inure to this pecuniary bequest but to the residuary or credit shelter amount.
- conversely, if estate significantly depreciated in value during period of administration, non-marital share can be destroyed.

**COMMENT: Use of a formula to arrive at a sum - certain distinguishes such as gift from a true sum certain gift. Such a gift is treated as residuary where DNI is concerned - that is to say - Distributable Net Income adheres to a pecuniary formula marital or credit shelter gift. Treas. Reg §1.661(a)-2(f).**

**In regard to whether or not a pecuniary formula bequests share in appreciation - See Matter of McDonnell, 45 Misc, 2nd 57 (Surr. Court, Nassau Cty. 1965)**

**Decedent had created a marital deduction trust, that is to say, had placed the pecuniary marital portion in trust and had given the Executor the power to distribute in cash or in kind and each item of property so distributed in kind shall be valued at date of distribution or at federal estate tax value, whichever is lower.**

**Held: Widow's share may share in appreciation.**

- Gain on funding - Funding the pecuniary gift with appreciated assets - means an increase in principal which must be recognized.

2. Fractional Share Formula:

- both the marital portion and the by-pass portion participate in gains and losses during administration.
- neither by-pass portion, nor marital portion recognize gain or loss on funding.

3. Residuary Marital Gift:

- converse of preresiduary pecuniary formula
- appreciation realized by estate inures to the marital gift
- depreciation in value may destroy marital gift

4. Hybrid Formula: Matter of Guterman, 125 Misc. 2nd 59; Matter of Goutmanovitch, 105 Misc. 2nd 851; EPTL 2-1.9

SOME PROBLEMS PERTAINING TO DIVISION

1. The by-pass trust or the marital portion may be destroyed depending on the circumstances.
2. The pre-residuary pecuniary by-pass or credit shelter trust may never materialize if the unified credit is exhausted because of inter-vivos gifts made by decedent.

Example: Decedent made \$500,000.00 in taxable gifts to his children during his life time. He applies the unified credit on his gift tax returns. He makes \$100,000.00 in specific bequests for which no deduction is allowable.

### 3. Instructions concerning the portion out of which death taxes are payable.

EPTL 2-1.8 Unless otherwise directed in Will, estate tax is apportioned - taxes are placed upon assets that incur them. (See p 5; 6 of Gary Johnson's Outline entitled: Fundamentals of Will Drafting, January 15, 1997).

Avoid "Word Processoritis": I direct that all estate taxes be paid out of my residuary estate and that such taxes shall not be equitably apportioned.....".

Determine effect of such direction. If residuary is divided among credit-shelter and marital portion - interest otherwise deductible may bear a portion of tax liability.

When portion of residuary estate is given to tax exempt beneficiary - (charity or surviving spouse) and such portion bears responsibility for part or all payment of estate taxes, the following results occur:

- a) marital deduction reduced
- b) complex algebraic formula must be used to determine marital deduction (IRS Publication 904 - Interrelated Computation for Estate and Gift Taxes)

Code §2056 (b)(4)(A):

"There shall be taken into account the effect which a tax imposed by this chapter, or any estate, succession, legacy, or inheritance tax has upon the net value to the surviving spouse by such interest. "

In general: pre-division apportionment - marital share bears tax.

Post-division apportionment - that is to say: tax allocated after division into shares (marital and non-marital)-marital share bears no tax.

J. S. Lewald, Exr. (Est of J. Lewald) v. U.S. (DC N.Y. 65-2 USTC Sec 12,350; 245 F. Supp 336);  
E.P. Prezzano, Exr (Est of W.L. Ransom) v. U.S. (DC N.Y. 58-1 USTC Sec 11,741).

Testator may provide that estate taxes be paid without apportionment - "as an expense of administration" - Matter of Cromwell, 303 N.Y. 681(1951).

### 4. Directions about Payment of Administration expenses

Expenses incurred during estate administration are deductible. (Code Sec 2053; 2054).

To Start: the Executor has option to deduct administration expenses on either estate tax return (Form 706) or the fiduciary income tax return (Form 1041) Sec 642 (g).

To the extent administration expenses are payable out of marital portion - marital deduction is reduced - But: same argument which pertains to payment of estate tax out of marital portions not pertinent here, as there is no interrelated computation. We know what the administration expenses are.



- (2) Right to income for life with a general power of appointment in accordance with Reg. 20.2056(b) - 5

(OK if spouse is entitled to income of specific portion of the interest - fractional or percentage share qualifies as a specific portion.)

Special transitional rules for decedents dying on or before October 24, 1992 and certain decedents dying after October 24, 1992 with Wills and Revocable Trusts executed on or prior to that date consult the Code.

- (3) Life insurance or annuity payments held by insurer with a general power of appointment in spouse, meeting the requirements set forth in Reg §20.2056(b)-6
- payments to spouse at least annually
  - spouse must have power to appoint all or a specific portion to herself or her estate
  - power in spouse must be exercised by her alone and in all events
  - no other person may have power to appoint.
- (4) Qualified terminable interest meeting the requirements of Reg §20.2056(b)-7. I.R.C. §2056(b)(7)(B)(i) provides the definition of “qualified terminable property”

**COMMENT: Do not be creative - Be aware to adhere to the precise requirements. Where decedent created a marital trust with lifetime income to spouse, coupled with power of appointment, but if spouse becomes incompetent he receives no benefits from the trust. Held: marital deduction denied. (Exhibit “F”).**

- (5) Interest in a qualified charitable remainder trust in which the spouse is the only non-charitable beneficiary meeting the requirements of Reg §20.2056(b)-8.

Refers to charitable remainder unitrust or charitable remainder annuity trust (Qualified Charitable Remainder Trust - I.R.C. §664).

Interest of spouse qualifies as marital deduction under §2056 (b)-8. Interest of charity qualifies a charitable deduction under §664.

Interest of spouse need not be an interest for life, but may be an interest for a term of years (for purpose of I.R.C. §664 the spouse’s term of years may not exceed 20 years.)

b) Qualifying income interest - definition

- 1) All income paid to spouse payable at least as often as annually (Treas. Reg. §20.2056(b)-7(d).
- 2) No person, including surviving spouse may be granted power to appoint any part of trust assets to anyone other than spouse during spouse's life time. (Treas. Reg. 20.2056(b)-7(d).
- 3) Income payable to surviving spouse but not paid at time of his/her death must be paid to her estate. (so-called "stub" trust income) [But see Shelfer v. Commissioner, 86 F3rd 1045 (11th Cir., 1996)].
- 4) Executor of decedent's estate must make a so-called "Q-tip" election on decedent's federal estate tax return. Treas. Reg 20.2056(b)-7(b)(3) and (4). (This is now done by listing the property on the appropriate schedule)

**THE Q-TIP TRUST**

Caveat Decedent dying before September 30th, 1994, could minimize his spouse's inheritance by placing the elective share in a Q-tip trust. After September 30th, 1994, the Q-tip trust may not be used to satisfy the elective share and the spouse may demand lump-sum payment of the elective share. EPTL 5-1.1 - A(a)(4)

**COMMENT: Beware of dual representation**

**Conflict of Interest have another attorney review waivers of the elective share executed by spouse - anti or postnuptial agreements.**

Advantage of Q-tip trust

1. Spouse gets all income during life time.
2. Decedent controls the distribution of the remainder.
3. Particularly suitable for second marriages when children of the first marriage need to be provided for and for the spouse who is inexperienced in managing money.
4. I.R.C. §2207 A provides that the surviving spouse's estate may recover the estate tax attributable to inclusion of the property in her estate from the remaindermen unless the surviving spouse directs otherwise by will. (See also, EPTL 2-1.12)
5. Assets taxable in surviving spouse's estate. To keep such assets in the predeceased's spouse estate for purposes of claiming the \$1,000,000.00 Generation Skipping Transfer tax exemption, (I.R.C. §2631) a reverse Q-tip election may be made. I.R.C. §2652.

Example: Husband's estate consists of \$1,000,000.00 left in trust for wife, remainder to grandchildren. Husband's executor makes a partial Q-TIP election for \$400,000.00. For the remaining \$600,000.00 he makes use of the unified credit. Husband also utilizes the \$600,000.00 as part of his Generation Skipping Transfer Tax exemption. (He left unused the remaining \$400,000.00 of his exemption). Wife's estate includes the portion for which Husband has taken the Q-TIP election. (That is to say \$400,000.00). As a result wife's estate ends up with \$1.4 which will exceed her \$1,000,000.00 GST exemption. A reverse Q-TIP election will permit Husband's estate to use its remaining \$400,000.00 of GST exemption on the Q-TIP - Result: NO GST for either estate.

### Q-TIP Tips:

1. Do not make the spouse gift contingent on an event. Eg. - Spouse's interest in Trust terminate if he becomes incompetent. **(Exhibit "F")**
2. Do not employ "contingent Q-Tip elections". For example, decedent's executor authorized to create a Q-TIP Trust and to transfer property for which no Q-TIP election is made into a marital trust. Reasoning: Executor has impermissible power to appoint property away from spouse. But see recently issued new temporary regulations permitting deductions for contingent Q-Tips (Exhibit "G").
3. Be sure not to draft provision whereby estate taxes are payable out of the Q-TIP portion.
4. Be sure to employ the Final Regulations (T.D. 8522. 2/28/94). Inter alia: pecuniary amount may qualify as a "specific portion"; marital trust may be divided with two separate trusts in order to reflect a partial Q-Tip election.

**COMMENT: Be sure not to engage in "word-processoritis". That is to say, your memorized trust powers should not conflict with the Regs.**

5. If you have made a mistake, cure it.  
Example: Trustee has discretion to invade principal for benefit of children. Answer: Have children disclaim their interest in the trust during spouse's lifetime. Matter of Chessie Lee McGarity, N.Y.L.J., 7/19/95 page 31 column 3, Suffolk County Surrogate's Court; Matter of Daniel Linden, N.Y.L.J., 4/28/95 page 34 column 4, Surrogate's Court, Westchester County.

### RENUNCIATION (DISCLAIMERS)

Note: IRC §2518 has no filing requirement. New York's EPTL §2-2.11 requires filing or the renunciation Code §2518 (c)(3) gives the disclaimant an opportunity to cure technical defects in otherwise valid disclaimers.

**COMMENT: When the testator's estate is modest, but growth is expected or where the testator is opposed to being locked into a credit-shelter trust for the surviving spouse, consider an "all to the spouse" will with a credit-shelter trust waiting to receive any assets renounced by the surviving spouse.**

#### Disclaimers or Renunciations - definition

A formal, written, declaration that the donor does not wish to accept the gift - either inter-vivos or testamentary - and as a result of such refusal the interest passes without any direction by the person making the disclaimer to another person or persons.

Fiduciaries have the right to disclaim on behalf of the beneficiary. The guardians of a minor or incompetent may disclaim on behalf of his ward (EPTL §2.1.11(e); Mental Hygiene Law §81.

Effect of Renunciation - The renouncing person is deemed to have predeceased the testator. Gift will pass to the beneficiary who is next in line.

**COMMENT: At one time the guardian of an incompetent could disclaim to create or maintain Medicaid eligibility. Under New York's implementation of OBRA of '93 such a renunciation is deemed an uncompensated transfer of assets. Social Service's Law §366(5)(d)(1)(i); 18 NYC RR 360-4.4(c)(2)(i)(a)(2)**

Creditors' interest may be defeated by a renunciation [EPTL §2-1.11 (6)(2)].

Renunciation must take place within 9 months of effective date of disposition - for transfers by Will - this is date of death of testator. For trust - date of transfer into trust.

Joint Tenancies - because a joint tenant may unilaterally sever joint ownership until the death of the other joint tenant, the interest in the survivor is not considered an effective disposition until the death of the first joint tenant for purposes of renunciation. To the extent the renouncing party has contributed to the amounts, he may not renounce. EPTL §2-1.11.

Effect of Renunciation - accelerates the possession and enjoyment of subsequent interests, because the renouncing party is deemed to have predeceased.

Renunciation is irrevocable

Renunciation may take place for a part or share of asset.

Formalities must be observed. Affidavit of no-consideration must be attached. Renunciation must be timely filed with the court.

Disclaimant may not accept any interest or benefits from the disclaimed amounts. - Exception: surviving spouse may make a valid disclaimer of an interest that passes to a trust in which she retains an income interest. Reg 25.2518-2(e)(5).

**COMMENT: Examples to regulations make clear that such a trust which conveys not only income interest to wife, but powers of invasion limited by ascertainable standard and the so called 5+5 power we discussed earlier will qualify as a proper vehicle into which assets disclaimed by surviving spouse may flow.**

Advantages:

1. Allows planning at the time of death of first spouse.
2. Allows tax planning for the modest estate where growth is expected.